TOO GOOD TO BE TRUE AND TOO BAD TO BE TRUE

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In this report, the author questions whether it is fair to impose penalties on taxpayers on the grounds that their tax results were “too good to be true” when the literal language of our code often produces results that many would think were either too good or too bad to be true.

The IRS, in its eagerness to assert penalties against taxpayers in what it perceives to be abusive transactions, is placing emphasis on a “too good to be true” standard. In its recently released audit technique guide, the IRS concludes that a taxpayer may not rely on even an independent tax adviser if the taxpayer knew or had reason to know that the transaction was “too good to be true.”1 Similarly, Treas. reg. section 1.6662-3(b)(ii) provides that for purposes of the negligence penalty, negligence is strongly indicated when 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.” However, the regulation does not preclude a taxpayer’s reliance on its independent adviser. To the contrary, the regulation indicates that the negligence penalty is not applicable if there is a reasonable basis for the position or reasonable cause under Treas. reg. section 1.6664-4. That regulation makes it clear that reliance on the advice of a knowledgeable professional tax adviser can show reasonable cause and good faith.2 Yet the IRS now appears to be using a broader “too good to be true” doctrine as an overriding test in asserting penalties. But when it comes to the code, what really is “too good to be true”?

Sumner Redstone, Chair of the board of Viacom Inc., announced that Viacom had sold a subsidiary without paying any tax on the gain.3 “Too good to be true,” said several tax practitioners who read that report in the media. But it was true. In fact, Viacom had obtained a ruling from the IRS that no tax need be paid. Congress reacted and closed that “too good to be true” loophole.4 Similarly, Seagrams “sold” the DuPont stock it had obtained in its fight with DuPont over Conoco, in a transaction resulting in minimum tax. Seagrams obtained a warrant to acquire DuPont stock that was significantly out of the money and almost certainly would never be exercised. When DuPont then redeemed its stock held by Seagrams, Seagrams argued that because of attribution rules, its interest in DuPont had not been reduced and the redemption resulted in a dividend taxed at a 7 percent rate, because of the dividends received deduction, rather than a capital gain taxable at 35 percent. Despite Lee Sheppard’s contention that this was just too good to be true, it appears that it was true.5

Earlier Esmark had sold a subsidiary in a transaction that was engineered through several steps to take advantage of the then-existing rules that permitted the exchange of appreciated property for a corporation’s stock without gain to the corporation. Esmark wanted to sell its Vicors subsidiary and use the proceeds to redeem some of its stock. Under an agreement, Mobil acquired more than 50 percent of Esmark’s shares in a public tender offer, and Esmark then distributed the shares of Vicors in redemption of the shares acquired by Mobil. The Tax Court recognized that all those steps were part of one overall plan, but nonetheless held that the transaction was not subject to the step transaction doctrine. The doctrine simply did not permit the commissioner to invent steps to treat the transaction as a sale of the Vicors shares to Mobil followed by a public tender by Esmark. Thus, the Tax Court found in favor of Esmark, and the Seventh Circuit affirmed.6 Esmark won, but, following the 1997 tax act, that “too good to be true” loophole also is now gone.7

Other courts have examined situations in which the literal language of the code seems to create a result that is “too bad to be true.” In Commissioner v. Banks,8 the

4See section 355(d) of the Internal Revenue Code of 1986, as amended (the code). Section references are to the code or the regulations thereunder, except as otherwise noted.
5See Lee Sheppard, “Can Seagram Bail Out of DuPont Without Capital Gain Tax?” Tax Notes, Apr. 17, 1995, p. 325. The Seagrams “too good to be true” result was changed by section 1059(e)(1), as added by the Taxpayer Relief Act of 1997.
7See section 355(e), added by the Taxpayer Relief Act of 1997.
Supreme Court held that even though a successful plaintiff received only a portion of the amount awarded to him, because a substantial portion went to his attorney, the entire amount was taxable to the plaintiff. The Court recognized that its holding “can lead to the perverse result that the plaintiff loses money by winning the suit.” While that was “too bad to be true,” it nonetheless seemed to the Court to be required by the tax law, including section 61(a) of the code, which includes in gross income “all income from whatever source derived.” That “too bad to be true” result was erased by Congress in the American Jobs Creation Act of 2004 (P.L. 108-357), section 703, adding code section 62(a)(19).

The alternative minimum tax has also wreaked havoc for executives in the high-tech industry who exercised stock options only to find that they were restricted on the sale of the stock, and when it could finally be sold, the bottom had dropped out of the market. The consequence was that the AMT resulting from the exercise exceeded the value of all of the stock received and, in some instances, all of the net worth of the executives. Thus, in Spelts v. Commissioner, the Tax Court held that the IRS did not abuse its discretion in refusing the taxpayers’ offer in compromise on an AMT liability incurred when exercising incentive stock options. The Tax Court considered whether the IRS’s denial of the taxpayers’ offer was an abuse of its discretion. The taxpayers argued that their AMT liability was “unfair and inequitable,” because it resulted in a tax rate of approximately 220 percent, and that Congress designed the offer in compromise statute to provide relief in those situations. The Tax Court reluctantly disagreed, noting that it is not within the power of the IRS or the courts to override tax laws even though they appear inequitable. The court concluded that the taxpayers’ liability was properly calculated and that only Congress could correct the unfair consequences of the AMT.

Similarly, many taxpayers have fallen on the shoals of transactions that are too good to be true or too bad to be true. The issue there was whether the taxpayers could deduct their passive management fee expenses from their directly related nonpassive management fee income. The IRS insisted that the plain language of code section 469(a) prohibited those deductions. The taxpayers argued that the literal language of the code should not apply to them, because it was clear, based on legislative history, that Congress intended their situation to be exempt from section 469(a)’s limitations. The court stated that the “threshold problem with the [taxpayers’] position is that nothing in the plain language... suggests that an exception” exists. Furthermore, the court noted, “this is an inequity in the United States Tax Code that only Congress or the Secretary (as the holder of delegated authority from Congress) has the authority to ameliorate.” Thus, many courts take the position that the code is too complex and must be followed whether the result is too good to be true or too bad to be true.

The entire code is now riddled with complexity. In many everyday circumstances a taxpayer not carefully advised can wind up paying a substantial tax even though his neighbor engages in the same transaction without tax. For example, neighbors John and Robert each want to sell raw land and each has located a prospective purchaser. Each wants to reinvest the sales proceeds in what he thinks will be faster-appreciating raw land. John sells his property and, after two weeks, finds the exact property he is looking for, purchases that property, and then visits his tax adviser. He is advised that the new investment needs to appreciate enough to at least cover the tax he must pay on the sale of his prior investment. Robert, on the other hand, consults a tax adviser before selling his property. The adviser suggests that he use a qualified intermediary — a party who will purchase the property from him — sell the property to the purchaser that Robert has negotiated with, and then, when Robert locates the desired replacement property, the qualified intermediary will purchase that property with the proceeds received from the sale of Robert’s property and transfer title to Robert. Robert has incurred fees to his tax adviser and the qualified intermediary, but that cost is substantially below the tax that he would have paid. Is Robert’s result “too good to be true?” Perhaps, but he has just been led through the code’s labyrinth by a good adviser.

Given the complexity of the code, several courts, like the Hillman court, have said that it is not within their province to drift from the statutory language. Whether a transaction is too good to be true or too bad to be true is a question that Congress — not the courts — must address. A few of these cases are described below.

- Gitlitz v. Commissioner, 531 U.S. 206, Doc 2001-1085, 2001 TNT 7-13 (2000). Among the federal courts, there was a conflict over whether cancellation of indebtedness (COD) income that was exempt from tax under the insolvency exclusion of section 108 could be used to increase an S shareholder’s basis in stock. In Gitlitz, the Supreme Court held that an insolvent S corporation’s excluded COD income should be passed through to potentially solvent shareholders.

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14Id. at 232.
15Id. at 234.
16In a speech at a meeting of Tax Executives Inc., Charles Rossotti, former IRS commissioner and member of the president’s tax reform panel, likened the complexity of the current code to “a snowball running downhill, gathering more and more snow, that eventually becomes an avalanche.” BNA Daily Tax Report, Oct. 26, 2005.
shareholders to increase their basis in the shares before any attribute reduction was required. That resulted in a double benefit to the taxpayer: The income was excluded but still increased his stock basis to allow him to deduct previously unused losses. The Supreme Court rejected the too-good-to-be-true-type argument of the IRS, holding that under “a plain reading of the statute, we reject this argument and conclude that excluded discharged debt is indeed an item of income, which passes through to the shareholders and increases their bases in the stock of the S corporation.”

However, in 2002 Congress modified section 108 to plug what was deemed to be a loophole providing results that were “too good to be true.” (See the Job Creation and Worker Assistance Act of 2002, P.L. 107-147, and technical explanation of the Jobs Act amending code section 108(d)(7)(A), so that cancellation of indebtedness income that is excluded from the gross income of an S corporation shareholder no longer results in an adjustment to the stock basis of that shareholder.)


The taxpayer, a holding company, held more than 80 percent of the stock of five C corporations, which maintained their inventory under the dollar-value last-in, first-out method. After a series of transactions designed to convert the subsidiaries into partnerships, the taxpayer acquired limited partnership interests in five partnerships that held the inventory formerly held by the subsidiaries. The taxpayer then elected S corporation status. The IRS asserted that because of the taxpayer’s conversion to an S corporation, the taxpayer must include the partnerships’ LIFO reserves in its gross income, treating the partnerships as an aggregate of their partners so that their inventories would be deemed to be owned by the taxpayer.

In applying the plain meaning of the applicable code section, the court held that the taxpayer did not own any inventory at the time of its S corporation election. The court stated, “It is worsome to think that a taxpayer may not know in advance whether this would be the day that the fictional aggregate theory or the fictional entity theory of partnerships will be applied on an ad hoc basis. Relying upon the plain meaning of the statute, in a legitimate business transaction, a taxpayer desires the right to be able to predict in advance what the tax consequences of such transaction will be with reasonable certainty. Here the statute just does not do what the litigation position of the Commissioner would have it do. Any potential windfall to holding companies must be cured by Congress, not the judiciary.”


The taxpayer, a retailer of garments, acquired two retail-

ers that offered credit card plans (in-house credit cards), which subjected the taxpayer to regulation in all 50 states. In 1989, to alleviate that situation, the taxpayer formed World Financial Network National Bank (WFNNB) to provide credit card plans for the taxpayer’s retailers. By having a national bank, the taxpayer could “export” the interest rate from the state in which the bank is located to all other states. WFNNB funded its lending activity partially through the sale of jumbo certificates of deposits (CDs) to unrelated parties.

A foreign subsidiary of the taxpayer purchased some of those jumbo CDs and the IRS immediately said that resulted in an investment in the United States by the foreign subsidiary, which in turn resulted in a constructive dividend distribution to the taxpayer under subpart F of the code. The taxpayer stated that subpart F did not apply to bank CDs. The Tax Court believed that this was too easy a way around the subpart F requirements.

Applying a plain meaning analysis, the Sixth Circuit reversed the Tax Court’s decision against the taxpayer and held that a controlled foreign corporation’s purchase of a CD from its affiliated credit card bank qualified for the subpart F exception for “deposits with persons carrying on the banking business.” In reaching its conclusion, the court stated that “in its zeal ‘to effectuate the intent of Congress,’ the Tax Court failed to interpret the plain language of section 956(b)(2)(A).” While the lack of such a prohibition is “obviously not the policy that the Tax Court would promote were it an uber-legislature,” the court warned, “it is not the Tax Court’s role to inject its own policy determinations into the plain language of statutes.”

- Brown Group, Inc. v. Commissioner, 77 F.3d 217, Doc 96-2911, 96 TNT 19-6 (8th Cir. 1995).

Brown Group wholly owned a domestic subsidiary, International, which wholly owned a Cayman Islands corporation, Brown Cayman, which in turn owned 88 percent of a Cayman Islands partnership, Brinco, which acted as a purchasing agent for Brown Cayman. That chain of ownership would clearly have resulted in subpart F income to Brown Group if Brinco, the purchasing agent, had been a corporation rather than a partnership. Because it was a partnership, Brown Group contended that it was not a “related person” under the rules of section 954(d)(3), and therefore its income did not have subpart F consequences.

The IRS did not dispute that Brinco was not a related person to Brown Cayman or International, but instead maintained that Brown Cayman must be treated as if its distributive share of partnership income had been earned directly from the source.
from which the foreign partnership earned its income under the general principles of the aggregate theory of partnership taxation.

The court disagreed, stating, “Although our holding may result in a tax windfall to the Brown Group due to the particularized definition of ‘related person’ under the pre-1987 version of section 954(d)(3) of the Internal Revenue Code, such a tax loophole is not ours to close but must rather be closed or cured by Congress.”

- Textron, Inc. v. US, 561 F.2d 1023 (1st Cir. 1977). The corporate taxpayer owned a company with worthless debt and stock but with no future income prospects. Therefore, the taxpayer merged the worthless corporation with a profitable corporation to take advantage of the losses from the worthless debt and stock. The IRS argued that the court should adopt a special definition for “worthlessness” to disallow the deduction of the loss. The court refused to adopt the IRS’s view and ruled for the taxpayer, stating, “This matter should be cured by statute or regulation, not by a far reaching retroactive court decision.”

- The Falconwood Corp. v. United States, 422 F.3d 1339, Doc 2005-18305, 2005 TNT 171-52 (Fed. Cir. 2005). An individual owned an affiliated group that filed a consolidated return. The group’s parent merged into a subsidiary and the group was converted into a group of subchapter S corporations. The issue was whether the three hours between the merger and the conversion were long enough to allow the group to use its net operating loss carryovers. The consolidated return regulations said that the group remained in existence if there was a succession to the former parent’s assets and an existing member became the new parent. There was no mention as to how long the group had to remain in existence. The court held for the taxpayer, applying the literal words of the regulation. Quoting a 1917 Supreme Court opinion, Gould v. Gould, 245 U.S. 151, 153 (1917), the court stated:

In the interpretation of statutes levying taxes it is the established rule not to . . . enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen.

And what a code we have. It is not the simple code Judge Learned Hand and the Supreme Court dealt with in the seminal case establishing the business purpose doctrine, Gregory v. Helvering. At that time, the code merely excluded from taxation distributions in reorganizations with no definition of a “reorganization” to lead a jurisprud into determining just what constituted a tax-free transaction. The court had no difficulty in finding that Mrs. Gregory’s receipt of property temporarily encapsulated in a subsidiary of her corporation, followed by the immediate sale of that subsidiary, was, in fact, a dividend distribution rather than a tax-free reorganization. A tax-free reorganization was a transaction accomplished for the reconstitution of a business. In Mrs. Gregory’s transaction, there were no business purposes. Today, however, the reorganization definitions are clearly laid out — or maybe not so clearly, but in some detail. Nonetheless, a business purpose has become engrafted as an additional requirement for tax-free reorganization treatment.

There are, of course, several other judicially developed doctrines in the tax field. Practitioners are accustomed to testing transactions by running them through the gauntlet of the sham in fact doctrine, the sham in substance doctrine, the step transaction doctrine, and the business purpose (or economic substance) and substance-over-form doctrines. Those well-worn judicial limitations on tax transactions do not seem to be as dependent only on the IRS’s conclusion that it does not like the transactions as is the “too good to be true” pronouncement. Thus the recognized judicial limitations are a bit easier for tax advisers structuring transactions to cope with than is a “too good to be true” barrier.

The sham in fact limitation should not trap any taxpayer or tax adviser. Steps the taxpayer asserted took place never took place. The sham in substance doctrine, however, is much closely related to the step transaction and substance-over-form doctrines. Those concern unnecessary steps that have been interposed in a transaction. Again, fairly easily discernable.

The business purpose doctrine and the economic substance argument, both of which Congress has refused to codify, engraft tests requiring some purpose other than tax avoidance for a transaction to be sustained. The level of the purpose or economic substance needed to allow the statutory language to perform as expected is unclear. The codification of the economic substance doctrine would require an expectation of a return in excess of the investment and all transaction costs without taking into account any tax benefits from the transaction. Must that level be such that one would not reasonably undertake the risk of the transaction for the expected potential profit? Or must the expected profit exceed the value of the tax benefits? The IRS and Treasury have opposed codification perhaps because they prefer the in terrorem effect of the doctrine that depends to some extent on the vagueness of its parameters.


There is a similar vagueness in the business purpose doctrine. Must a business purpose predominate for a transaction that meets the literal language of the code to be accepted? Remember that in Gregory v. Helvering there was no business purpose. In split-off or spinoff transactions the business purpose must be the motivation for the transaction for it to pass muster under section 355. But that is the arena in which the business purpose doctrine was born. In other circumstances, most courts seem to follow Judge Hand's advice,27 which is that if there is any business purpose, the taxpayer can arrange the transaction in a fashion that best minimizes taxes. Thus, in UPS v. Commissioner,28 the court stated:

A “business purpose” does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a “business purpose,” when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business. . . . This concept of “business purpose” is a necessary corollary to the venerable axiom that tax-planning is permissible. . . . There may be no tax-independent reason for a taxpayer to choose between these different ways of financing the business, but it does not mean that the taxpayer lacks a “business purpose.” To conclude otherwise would prohibit tax-planning.

Treasury and the IRS have attempted to engraft on those recognized judicial limitations other, more amorphous, restrictions. Thus, the IRS has issued a so-called antiabuse regulation in the partnership arena29 that takes the position that anything that the IRS determines does not fall within the intent of subchapter K of the code can be recast by the IRS in any form its pleases. Never mind that there is no clear way to discern the intent of that very complex subchapter. Furthermore, that regulation appears to take the determination away from both Congress and the courts. If practitioners have difficulty coping with the too good to be true doctrine, they are completely adrift in attempting to cope with that regulation.

It is true that with complexity often comes unexpected results. In many instances Congress has taken that into account by giving Treasury broad regulatory authority. However, even that authority must be constrained by the language that Congress has inserted in the code30 or there will be a clear violation of the separation of powers. Without clear guidance from Congress or Treasury, many courts are not willing to move into the legislative arena and rewrite the statutory provision so as to meet the particular problem faced by taxpayers or the IRS.

With the code as complex as it is and with many statutory provisions having results that appear to be unintended, should a layperson second-guess a reputable tax adviser’s advice on the grounds that it just does not seem right, it seems too good to be true? Is it reasonable to expect a “reasonable and prudent person” to actually second-guess a reputable, nationally known tax adviser’s advice as “too good to be true”? The Supreme Court has indicated that lay-taxpayers are entitled to rely on credible tax advisers. See Boyle v. United States.31 In that case, an executor was held liable for a late-filing penalty even though the executor stated that he relied on the attorney who was preparing the estate tax return. The court noted that it required no special training or effort to ascertain that there was a tax deadline for filing the return and thus reliance on an agent regarding that deadline was not reasonable cause. However, the lay-taxpayer could reasonably accept the advice of an accountant or attorney as to whether there was in fact a tax liability, or even a requirement to file a return:

When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a “second opinion,” or to try to monitor counsel on the provisions of the code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. (469 U.S. at 251.)

Despite the Supreme Court’s clear language in Boyle, the IRS has pressed forward with its contention that if it believes a transaction is too good to be true, taxpayers are subject to penalties if they engage in that transaction, whether or not they have contrary opinions from reputable tax advisers. In Long Term Capital v. United States,32 the district court upheld penalties on taxpayers for several reasons, including a failure to second-guess one of the opinions they received. That opinion, according to the court, did not even consider cases in the circuit to which any decision concerning the transaction at issue would be appealed. The court believed that the penalty-exculpatory opinions that were received had been received too late, were not believable, and, as indicated, did not consider all of the relevant authority. Thus, perhaps the taxpayers should have reviewed all the authorities cited by the lawyers and perhaps have done independent research themselves.

Similarly, in Santa Monica Pictures v. Commissioner,33 the Tax Court imposed penalties despite several opinions from reputable law firms that appeared to bless the transaction. Finding that the transaction had no economic substance, the court dismissed legal memoranda or opinions from Kaye Scholer; Shearman & Sterling; Chamberlain, Hrdlicka, White, Williams & Martin; Grant Thornton; and Ernst & Young. The court examined all of them and found flaws in each one. It therefore imposed

27Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).
28254 F.3d 1014, 1019 (11th Cir. 2001).
29See Treas. reg. section 1.701-2.
penalties on the taxpayers, requiring them to be as versed in opinion-discernment as was the court.

Several other courts have upheld penalties and have used the language “too good to be true” in their opinions. However, the courts do not seem to have adopted a doctrine of “too good to be true” as the basis of their decisions; rather, they analyze the facts, circumstances, and law in researching their conclusions. In the Santa Monica Pictures, LLC case, the Tax Court upheld penalties despite comforting tax advice from several reputable tax advisers. Stating, “Under the circumstances, we believe that a reasonable and prudent person would recognize that these tax losses were ‘too good to be true,’” the court nonetheless went on to examine each of the memoranda or opinions received by the taxpayers and discounted each for a variety of reasons. Despite finding that the transaction was too good to be true, the court devoted 47 pages of its slip opinion to defending its imposition of penalties.

In its war against tax shelters, the IRS has consistently insisted on penalties for taxpayers who had comfort opinions from what one would consider very reliable professionals. In insisting that the opinions can be disregarded, the IRS has asserted several reasons. First, the IRS contends that the opinion writers are in cahoots with the shelter promoter and therefore any opinion must be disregarded. That was clearly not provided for in the code, although the Jobs Act has added restrictions on relying on some of those opinions. When a taxpayer attempted to rely on the opinion of an insurance agent, many in the tax community agreed with the IRS. In more recent cases, however, taxpayers have received opinions from well-regarded tax professionals. Are those taxpayers to believe that the professionals shirked their professional responsibility and gave opinions they knew were incorrect? The IRS also looks to the education level of the taxpayer. But even sophisticated lawyers may not be acquainted with the intricacies of the code. Shades of Boyle. Finally, the IRS contends that the taxpayer should be subject to penalties because she must recognize that the transaction was “too good to be true,” even though the taxpayer has a well-reasoned opinion to the contrary and the quoted statutory language seems to support that opinion.

One can see that there is a clear conflict between the too good to be true argument of the IRS and the plain meaning of the statute holdings of the Supreme Court and other courts. Before we add too good to be true to the judicially inscribed limitations, such as sham transaction, business purpose, substance-over-form, and step transaction, we need to carefully think through how the code is presented to taxpayers through the media and case law. With well-publicized example after example of situations in which the code reaches results that are not only unexpected, but also too good or too bad to be true, it seems inappropriate to impose penalties on taxpayers who not only follow advice from tax professionals but also can see that the advice is based on the literal language of the code.

34Graff v. Commissioner, 673 F.2d 784 (5th Cir. 1982); Neonatology, LLP v. Commissioner, 299 F.3d 221, Doc 2002-17616, 2002 TNT 147-9 (3d Cir. 2002); Pasternak v. Commissioner, 990 F.2d 893, Doc 93-4831, 93 TNT 88-10 (6th Cir. 1993); Conway v. United States, 326 F.3d 1268, Doc 2003-10359, 2003 TNT 80-10 (Fed. Cir. 2003).
35TCM at p. 278 of slip opinion.
37P.L. 108-357, section 812(c)(1).
38Neonatology, LLP v. Commissioner, supra note 34.