Making Litigation Complex

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A primary cause of the length and complexity of recent tax litigation is the government's assertion of the economic substance doctrine. Although the government's intent seems to be to frighten people away, once the doctrine is unleashed, the government can't control what it will do, including possibly upsetting previously settled law.

On May 17 a district court in Massachusetts released a 357-page opinion upholding all adjustments to the plaintiffs' partnerships' returns in two consolidated tax shelter cases.[1] The shelter involved contributing offsetting foreign currency options to partnerships to get an overstated tax basis in property that generated a tax loss. To justify the contributions, the plaintiffs allegedly relied on the opinion in *Helmer v. Commissioner*,[2] which was a government victory. The transactions were basically the same as those in the recent Tax Court cases *Country Pine* and *New Phoenix*, but the opinion did not cite those cases.[3] In *Fidelity*, the taxpayers' hopes of success depended primarily on: (1) the offsetting options being treated as separate instruments, (2) the partnership to which the options were transferred being treated as a partnership, (3) the sold option not being treated as a liability assumed by the partnership, and (4) a tax loss in the tens of millions looking like a reasonable outcome of a relatively small investment. The taxpayers lost on every basis listed above except the third, which was the one issue that was purportedly decided in the taxpayers' favor in *Helmer.*

The new opinion is significant for several reasons.

First, it did *not* refer to the codification of the economic substance doctrine from a month and a half earlier, but relied principally on that doctrine to rule for the government. As we move further into the future, presumably court opinions relying on the economic substance doctrine to disregard transactions that happened before March 31, 2010, will begin to at least discuss the codification . . . or not, in which case we have a really long time to wait to see how codification plays out in court (but not in planning).

Second, the case illustrates how government reliance on the economic substance doctrine makes for especially lengthy and factually complicated litigation, principally caused by the government.

Third, the case may be one of the last of the era of blockbuster knock-down, drag-out economic substance doctrine cases litigated over classic tax shelters, for the reasons that (1) the pipeline of those cases is drying up; (2) few taxpayers can afford to pay so much to gamble with a diminishing hope of success; and (3) future economic substance doctrine tax controversies will likely involve more government efforts to apply the doctrine to classically appropriate tax planning.

Finally, the opinion called into question *Granite Trust*,[4] which involved a classic method of appropriate tax planning, and once again shows that ''the judge ain't always right but he is always the judge.'' Put another way, Chief Counsel has recently protested that ''nothing has changed'' after the enactment of section 7701(o), but it can't restrain the courts (or the Department of Justice for that matter) unless it very carefully orchestrates its economic substance doctrine audit and litigation stance, which so far it does not seem willing to do.

A. The Path of the Litigation

For readers without the time to peruse the case's docket sheet's 526 entries over almost five years, the following list provides highlights:

September 1, 2005: Complaint filed by the tax matters partner of the partnership challenged adjustments for 2001 year. (Later, two cases were combined for trial.) Previously the plaintiff partner had deposited his tax liability as adjusted of $62.1 million as required as a precondition to suit in the federal district court, which presumably was his venue of choice, and sought recovery thereof. The complaint is less than forthcoming about how the plaintiff recognized income that he wanted to shelter in 2001. It explains that he exercised stock options early in the year and had ''economically unrealized taxable income'' because the value of the stock dropped shortly thereafter. Plaintiff invested in a partnership that invested in offsetting options and recognized very large amounts of income and loss in 2001, roughly offsetting. He bought out most of the interest of the other partner, but the complaint does not explain how or how much

[1] *Fidelity International Currency Advisor A Fund LLC v. United States*, 2010-1 U.S. Tax Cas. (CCH) P50,418 (D. Mass. May 17, 2010), *Doc 2010-10960, 2010 TNT 96-16*.

[2] T.C. Memo. 1975-160.

[3] *Country Pine Finance, LLC v. Commissioner*, T.C. Memo. 2009-251, *Doc 2009-24438, 2009 TNT 213-9*; *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161 (2009), *Doc 2009-8186, 2009 TNT 67-6*.

[4] *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956).

loss plaintiff recognized for tax purposes to offset his similarly unquantified stock option income; yet that offset is what the case is about. For a full discussion of the currency options transaction in the context of *Country Pine*, see an earlier article in this column.[5]

The complaint contained 13 counts: (1) one for penalties, (2) six related to partnership rules, and (3) three related to options or foreign currency rules.

January 13, 2006: The government's lengthening of the case started immediately; it took three months to file an answer, even though the answer basically denied all averments and put the entire complaint into issue. That is likely attributable in part to the jury rigged system we have for litigating tax disputes. Whereas identical cases were being litigated contemporaneously in the Tax Court by Chief Counsel attorneys, this case was litigated by a DOJ attorney, with the cooperation of the local U.S. Attorney for Massachusetts. No doubt DOJ coordinated to some extent with Chief Counsel (but Chief Counsel cannot tell DOJ what to do). So a three-party team on the government's side could reasonably need 90 days to answer a complaint that everyone knew would be denied.

March 3, 2006: Joint Statement on Scheduling filed. The government contemplated substantially more discovery and more time for discovery than did the plaintiff, but neither party projected that the trial of the case would occur as late as 2008 (the trial ended virtually on Christmas Eve, 2008).

March 31, 2006: Government served a subpoena duces tecum on KPMG seeking pattern evidence not directly related to this case. Plaintiff filed a motion to quash.

May 11, 2006: The court denied the motion to quash and granted a protective order.

December 19, 2006: Joint Proposed Schedule: The government wanted to present a tutorial to the judge. The parties projected they would be ready for trial by March 2008.

March 5, 2007: In addition to a large volume of other discovery motions and disputes, the plaintiff filed a motion to compel the government to turn over documents related to its legal position, including those related to the tax shelter listing Notice 2000-44, the *Helmer* case, and the 200 persons listed in subpoenas issued by the government. That request falls into the ''tit for tat'' category. If the government is going to pursue discovery into peripheral areas like the tax adviser's other clients and thought processes, then the taxpayer feels license to pursue equally peripheral areas like the government's thought processes.

May 4, 2007: Motion denied after a large number of filings in connection with the motion.

May 23, 2007: Letters rogatory issued to Isle of Man and Ireland to supply experts on their local law. Many additional filings related to this issue.

Various dates: Large number of motions, hearings, and decisions on motions for protective orders and sealing records by various persons.

Various dates: Motions related to exclusion of several expert reports.

January 28, 2008: Status conference: Plaintiff requests case be set for trial; court refuses.

April 1, 2008: Status conference: Court allows 25 total depositions.

August 15, 2008: Plaintiff's Motion for Partial Summary Judgment on validity of Reg. section 1.752-6. This is the first and only motion for summary judgment filed in the case.

September 4, 2008: Joint Pretrial Memorandum. The plaintiff forecasts evidence about the business nature of its partnership and its care in getting good legal advice. The government explained in a way that the complaint did not, that the options investments had created a paper loss of $158 million in one case. The defendant and plaintiff both set out contested fact issues related to business purpose and substance, but the defendant's fact issues were more extensive and presumably tracked the counts of the complaint, which presumably tracked the original grounds for the deficiency assessments. The parties' short statements of the issues of law were substantially similar, with both agreeing that the first issue was whether the short options were liabilities under section 752 (this was one of the few issues that the court's opinion stated was specifically not decided), and the plaintiff asking whether the offsetting options were one instrument for tax purposes. Plaintiff estimated 20 court days for trial; the government estimated 40. The parties stipulated 80 paragraphs of basically introductory facts. Plaintiff listed 38 witnesses and defendant listed 70 possible witnesses.

September 22, 2008: Bench trial began.

December 23, 2008: Bench trial concludes on day 47.

January 12, 2009: Parties filed post trial Memoranda of Law.

February 28, 2009: Government filed proposed findings of fact. It contains 1,379 findings of fact (later expanded to 1,394) and 134 conclusions of law. The taxpayers' proposal was for 1,058 paragraphs of facts.

April 17, 2009: Parties filed CDs of proposed findings of fact and conclusions of law.

May 29, 2009: Parties file penalty briefs.

September 14, 2009 and thereafter: Government files notices of decisions favorable to its position: *Schering-Plough, American Boat, Country Pine*; taxpayer filed decision in *TIFD* (a taxpayer tax shelter victory).

May 17, 2010: Opinion entered containing 1,329 findings of fact and 113 conclusions of law.

B. The Opinion

Perhaps the form of opinion is standard in the district court of Massachusetts, but it has some peculiarities, mainly in obscuring conclusions of law as purported findings of fact. F.R. Civ. P. 52 requires the court to make findings of fact and conclusions of law to support a judgment. A court order (or an opinion with a judgment) issued under this rule actually involves four elements: (1) findings of fact; (2) legal reasoning, which can include resolving disputes about the applicable law and its

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[5]Jasper L. Cummings, Jr., ''The New Normal: Economic Substance Doctrine First,'' *Tax Notes*, Jan. 25, 2010, p. 521, *Doc 2010-597, 2010 TNT 15-16*.

meaning; (3) conclusions of law; and (4) judgment.[6] For example, the four elements of the well known *Palsgraf* decision might look like this:

> *1. Finding of facts.* The guard on the railroad car attempted to pull the passenger into the car and the guard on the platform attempted to push him into the car from behind. The guards' efforts to aid the passenger caused the package the passenger was holding to fall on the rails. Unbeknownst to the guards, the package contained fireworks, and the package exploded when it hit the rails. The shock reportedly knocked down scales at the other end of the platform (although later accounts suggest that a panicking bystander may have upset the scale), which injured Mrs. Helen Palsgraf (Plaintiff).
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> *2. Legal reasoning.* Where plaintiff proves she suffered harm that was not caused by the willful act of another, to recover she must prove ''that the act as to him had possibilities of danger so many and apparent as to entitle him to be protected against the doing of it though the harm was unintended.''[7]
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> *3. Conclusion of law.* Plaintiff failed to prove that the act as to her had possibilities of danger so many and apparent as to entitle her to be protected against the doing of it though the harm was unintended.
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> *4. Judgment.* For the defendant. [Mercifully, bench trial opinions in famous tax cases are much more similar to this example than to the opinion of the Massachusetts district court.[8]]

Although there is some confusion about so-called mixed questions of law and fact, the confusion being fueled by the stark difference in the reviewability of the trial court's fact findings and legal conclusions, the fundamental definition of conclusion of law must include a court's determination of how the facts match up with the law's requirements, otherwise there is no conclusion of law.[9]

Instead of proceeding in that fashion, the opinion finds facts (far too many facts), identifies the applicable legal standards as the conclusions of law rather than as its legal reasoning, and then identifies its conclusions of law as ''summary factual conclusions.'' Presumably the aim of that methodology is to somehow cloak the conclusions of law with the clearly erroneous standard for reversal that is applied to fact finding, rather than subject them to the *de novo* review of conclusions of law.

The opinion appears to have adopted most of the government's proposed findings of fact (supplied on a CD), although they are by no means identical. However, the opinion does not closely follow the so-called conclusions of law proposed by the government. The government's law conclusions read more like a brief that explained the position on the law, including simply reciting much undisputed law, such as penalty statutes, and then applied the law to the facts and found the taxpayers to have failed the various tests. The government's law included:

- A discussion of how Congress can promote an activity through tax policy, which means that the economic substance doctrine may not be relevant to a particular tax benefit, although it is relevant to the benefit claimed by the taxpayers in this case because the benefit was not intended by Congress. The government emphasized the centrality of Congress' intent.
- A discussion of three First Circuit opinions that appeared to flunk the economic substance doctrine but that are still good law because congress intended the results the taxpayers claimed; one of those cases was *Granite Trust*. In that case, the company allowed a parent corporation to sell 21 percent of the stock of a subsidiary so that it could liquidate the subsidiary outside section 332 for purposes of obtaining a particular tax benefit.
- There was no partnership because the second partner was a straw man.
- Application the step transaction doctrine to treat the partnership and not the partners as having bought the offsetting options (so as to eliminate the *Helmer* issue) and to ignore the allocation of tax attributes between the two partners.
- Application of the partnership antiabuse rule to disregard the partnership.
- Treatment of the offsetting foreign currency options as a single position, which would negate the basis play.
- Denial of the losses under the allowance provision, section 165(c), because the transactions were not entered into for profit.

The court's legal conclusions differed significantly from those proposed by the government. The so-called legal conclusions consisted principally of 92 numbered paragraphs that stated all of the law on which the court relied, but did not relate the facts to the law. Instead the legal conclusions were followed by a brief summary of factual conclusions that said the transaction did not have economic substance or business purpose, the partnership was not a partnership for tax purposes, the transaction should be treated as one integrated transaction, the partnership should be ignored and its business treated as owned individually by the partners, the paired options should be treated as one position, and the transaction was not entered into for profit. Those conclusions were not accompanied by a summary of the particular facts that lead to them; presumably the court thought that was covered in the 1,000 plus findings. They also did not specifically tie back into the 92 paragraphs of recitation of law. For example, the conclusion that the transaction lacked economic substance and business purpose did not

[6]*See*, *e.g.*, *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602 (1974) (referring to skeletal conclusions of law that are similar to those above).

[7]*Palsgraf v. Long Island Railroad Co.*, 162 N.E. 99 (N.Y. 1928).

[8]*See Frank Lyon Co. v. United States*, 36 A.F.T.R.2d 75-5154 (W.D. Ark. 1975); *Knetsch v. United States*, 2 A.F.T.R.2d 6115 (S.D. Cal. 1958).

[9]*See Pullman v. Swint*, 456 U.S. 273, n.19 (1982); 9-52 *Moore's Federal Practice* — Civil section 52-33[2][a] (''reviewing the underlying facts under the clearly erroneous standard, while reviewing the legal conclusions that flow from the facts de novo. While this often is a difficult task, it seems to be the approach that best conforms to the intent of Rule 52(a)(6).'').

then say that the economic substance doctrine applied and the taxpayer failed to carry its burden of proof and so the tax benefits would be denied. Similarly, the statement that the transaction was not entered into for profit did not tie back into section 165(c) to which it presumably was related.

Not unexpectedly the opinion devoted considerably more attention to the First Circuit's opinion in *Dewees*, which it found controlling, than did the government's law discussion.[10]

The opinion did not contain the government's fairly detailed discussion of how the economic substance doctrine does not apply to undo intended tax benefits, which the government specifically explained as including the *Granite Trust* result in the First Circuit. Rather the opinion stated that it applies a version of the conjunctive test for the economic substance doctrine used in *Dewees*, which "effectively overruled . . . at least as to the broad contours of the economic substance doctrine," its earlier decision in *Granite Trust.* The opinion did have a passing reference to Congress' intent, but nowhere near a clear recognition that the economic substance doctrine is not always "relevant," as Congress indicated in recently enacted section 7701(o). The same day the opinion was issued, *Tax Notes* reported that government officials stated they were not targeting *Granite Trust* transactions and that they still considered it good law.[11]

The opinion gave no indication of understanding that the economic substance doctrine might not be relevant to all transactions and tax issues. It stated that *Granite Trust* and other older cases that do not reflect the "modern view" cannot survive the holding and reasoning of *Dewees*. Therefore the opinion indicated that in no case would simply finding that the transaction actually occurred in fact — as the taxpayer alleged — suffice.

The court upheld the penalties.

The opinion stated it did not decide "whether, if the transactions otherwise had economic substance, were not subject to the step transaction doctrine, and involved valid partnerships, the short options contributed to the partnerships constituted liabilities within the meaning of 26 U.S.C. section 752." That was the one issue both parties said should be litigated and decided.

C. Reversal Protection

The opinion appears to hew to trial judges' tried and true methods of fending off reversal, including:

- relying on the well-financed and staffed U.S. government's tendered draft opinion;
- emphasizing the law in the First Circuit that it followed;
- stating the broadest possible "summary factual conclusions" to leave less room for reversal on the law;
- basing the conclusion on multiple grounds (economic substance doctrine, no partnership, no allocations, one not two options) to leave less room for reversal; and
- Avoiding the hard technical legal questions like whether the option position was a liability for section 752 purposes.

D. What Were They Thinking?

1. The government. The docket entries discussed above strongly suggest that the government is the most responsible party for the length and complexity of the litigation and the opinion. Most of the government's time and effort seems to have related to discovering, proving, and arguing about facts concerning the business purpose and the profit potential of the partnerships. In other words, the government went to great lengths to disprove the two facts that the economic substance doctrine requires the taxpayer to prove.

On the one hand the government cannot be faulted for that tactical approach because it won, i.e., the end justifies the means. But at what cost? As it turned out, the Tax Court had already decided two similar cases in its favor between the trial of this case and its decision more than 16 months later. Although those opinions are lengthy, they pale in comparison to this gargantuan opinion. Does the DOJ intend to hereby set the standard for trying economic substance cases? Will all economic substance doctrine trials require this much effort? Will the issue of the section 752 liability treatment prior to current regulations never be resolved? Is this all part of the in terrorem effect of the codification of economic substance that the Joint Committee candidly said was a purpose of the legislation? Is litigation by attrition the best way for the tax system to go?

Did the DOJ consider that it might put *Granite Trust* into play by the way it litigated this case? Did it consider that the court might read *Dewees* not to lean so heavily on Congress' intent as the government's proposed law conclusions?

2. The taxpayer. In for a dime, in for a dollar, must have been the taxpayer's thinking. And he or his lawyers must have thought that home cooking in the Massachusetts District Court would taste better than the Tax Court servings. On the other hand, maybe paying early and eliminating the huge federal interest charges made sense and revealed a feeling of weakness. He also may have thought the cost of litigation would be less than the penalties (hopefully), and he had a better chance to escape the penalties than the tax. His attorneys certainly revealed no weakness.

In this particular case the identity of the taxpayer may contain the most telling explanation of why this case was so fiercely litigated, evidently sparing no expense. The principal partner litigant was Richard Egan, cofounder of EMC Corp.[12] He committed suicide between the trial of the case and the judgment, apparently because he was

[10]*Dewees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989).

[11]Amy S. Elliott, "IRS Not Targeting Granite Trust Transactions, Official Says," *Tax Notes*, May 17, 2010, p. 751, *Doc 2010-10701, 2010 TNT 94-8*.

[12]Facts taken from Egan's obituary appearing in *The New York Times*, Sept. 1, 2009.

suffering from lung cancer and many other illnesses. He was worth more than $1 billion, as a result of pushing the EMC business to great success. He had served for a year and a half as President Bush's Ambassador to Ireland. Sometimes that kind of client won't take no for an answer.

3. The trial judge. The trial judge was appointed by President Bush and had been on the bench a little more than a year when the complaint was filed. He had practiced in Boston, near where EMC Corp. was located. As indicated above, he seems to have been thinking about reversal protection. But despite his best efforts the case seems to have gotten away from him in terms of length and complexity. He held several scheduling and status conferences, which presumably were aimed at keeping the parties on track, but they (evidently primarily the government) succeeded in expanding the scope of discovery normally allowed (25 rather than 10 depositions, for example) and pushed the litigation into all sorts of peripheral issues about treaties and foreign law and protective orders and pattern evidence and expert opinions on the law. This is what you get when you have scorched earth litigation.

A federal trial judge does not officially have the power to shape the issues for trial on his own. There should have been cross motions for summary judgment in this case, which could have resulted in resolution of some of the legal issues and narrowed the factual issues for trial. But if the parties decline to move for summary judgment then the court does not have the authority granted in Rule 56 to resolve some facts or law issues short of total resolution of the case.

It seems that the normal protective interests of all three parties conspired to force the case to be resolved in a long trial with the largest possible amount of actual or potential evidence: The litigants thought the outcome would come down to painting the taxpayer as reasonable or not, which presumably could be proved by a lot of evidence about who said what to whom and who knew what when and what might have happened and how reasonable other people thought all this was; and the court followed a trial judge's normal approach of letting everything into evidence so as to avoid reversal on the grounds of improperly limiting the proofs; and no one pushed for a resolution of the core legal issues for fear of bifurcating the litigation into a piecemeal resolution that could get reversed, causing the matter to be tried again.

Maybe this is just the way it is in big time litigation and we should not worry (least of all lawyers who hope to get paid to do this stuff). But the trial judge could have more tightly controlled the case and the issues litigated by more tightly controlling the discovery and the trial date and the trial time. Those things he had authority over. But he was probably thinking: which would I rather be doing, holding hearings in criminal drug enforcement cases or listening to smart lawyers wax eloquent about a doctrine that we, the judges ourselves made: the economic substance doctrine? I pick the latter.

Hence the economic substance doctrine is a perfect storm for maximizing tax litigation complexity. Makes figuring out whether a written option is a liability look simple.