"MANNING UP": TWENTY-FIRST CENTURY TALES OF TAX AVOIDANCE AND EXAMINATION OPTIONS ON THE I.R.S.'S TABLE

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INTRODUCTION

> *"Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."*
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> – Justice Learned Hand, *Helvering v. Gregory* (1934)[1]

> *"If tax compliance were an industry, it would be one of the largest in the United States."*
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> – Nina E. Olson, National Taxpayer Advocate (2013) [2]

The U.S. tax system is a "self-assessment" model: upon determining how tax provisions apply to their transactions, taxpayers pay any tax due, and report the transactions to the I.R.S. in sufficient detail to permit the I.R.S. to confirm that liability was correctly calculated.[3]

Paradoxically, the tax system is so complex that it incessantly creates ambiguity and opportunity for abuse. Determining one's tax obligations is often difficult, even for taxpayers with simple profiles. When enterprising taxpayers with complicated facts are tempted to test the boundaries, the I.R.S. must devote significant resources to establishing and policing those boundaries.

The term "tax shelter" is defined in the Code as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.[4]

In this article we look at two very different taxpayers, and their participation in tax shelters – as well as reasons for which each became in recent weeks the focus of the tax press and/or the public at large.

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1 69 F.2d 809 (2d Cir. 1934), at 810, quoting *U.S. v. Isha*m, 17 Wall 496.

2 "Tax code 'is 10 times the size of the Bible'," StarTribune.

3 See *Beard v. Commr.*, 82 T.C. 766 (1984), affd. 793 F.2d 139 (6th Cir. 1986).

4 Code §6662(d)(2)(c)(ii). The purpose is to clarify situations in which a taxpayer may obtain relief from a 20% penalty for understating taxes because the position was either disclosed or there was substantial authority for the position; participation in a "tax shelter" prevents such relief from being applicable.

BRISTOL-MYERS SQUIBB

Bristol-Myers Squibb (also referred to as "B.M.S.") is a New Jersey-based pharmaceutical company ranked #75 on the Fortune 500 list in 2021.[5] Formed by the 1989 merger of Bristol-Myers and Squibb, two major New York pharmaceutical companies, the company is a global manufacturer of drugs used to fight cancer, HIV/AIDs, and cardiovascular disease, among other disorders.[6]

In 2012, a wholly owned U.S. subsidiary of B.M.S. transferred appreciated intangible property – apparently, patents to leading pharmaceutical drugs – in exchange for shares of a foreign unlimited liability company treated as a partnership for U.S. Federal income tax purposes.[7] The stated purpose of the transaction was to "better align the geographical and operational focus" of the B.M.S. global affiliated group. The net effect of amortization claimed by the partnership, some of which was allocated back to the U.S., was to reduce B.M.S.'s U.S. tax bill by approximately $1.4B.

As part of entering into this transaction, an outside adviser was retained to value the contributed assets using a discounted cash flow analysis; the produced valuation report allocated fair market value almost entirely to each patent's "on-patent" period, *i.e.*, the remaining period of validity; the report assumed precipitous decline in each patent's value upon expiration; the adviser also valued the contribution as a percentage of the total assets of the foreign partnership, including certain high-basis, high-value property contributed by a related foreign partner.

Meanwhile, the property contributed by the related foreign partner was non-depreciable or otherwise had a tax basis roughly corresponding to its fair market value.

B.M.S. received two opinions supporting the claimed tax benefits, including one from PricewaterhouseCoopers ("PwC") and the white shoe law firm of White & Case LLP.

The Field Advice

In a letter providing advice for audit agents around the country (the "F.A.A." or "Field Advice"),[8] the I.R.S. Office of Chief Counsel analyzed the transaction in detail. It noted that Code §704(c), a rule also mentioned in the 2015 notice which allocates taxable appreciation in contributed property to be allocated back to the contributing partner, was applicable.

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5 In 2021, Bristol-Myers Squibb had revenues of $42.5B, revenue growth of 62.6% from the preceding year. See here.

6 For a list of select medicines, see here. Bristol-Myers supplied penicillin to Allied Forces in World War II. Squibb, a pharmaceutical company founded in 1858 in Brooklyn, New York, supplied Union troops in the American Civil War, and started publishing Squibb's Ephemeris of Materia Medica after failing to convince the American Medical Association to incorporate higher purity standards. See here.

7 Field Attorney Advice ("F.A.A.") 20204201F (April 22, 2020) (the "F.A.A." or "Field Advice").

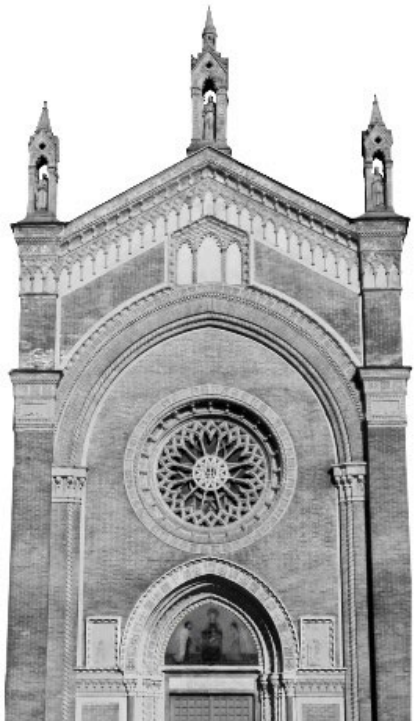
8 See *supra* note.

As outlined in the Advice, Code §704(c), aided by a special partnership anti-abuse rule,[9] permitted the I.R.S. to place the foreign partnership on a so-called curative accounting method. The method would prevent the U.S. affiliate from benefiting from Irish patent amortization while causing all the U.S. patents' gain to be allocated to the tax-indifferent foreign partner. To do so, the I.R.S. invoked an anti-abuse rule specific to Code §704(c) matters.

Unlike the general partnership anti-abuse rule,[10] which requires a "principal purpose" to be tax benefits in order for the I.R.S. to recharacterize a transaction, the Code §704(c) anti-abuse rule, enacted in 1993, requires the I.R.S. simply to show that the taxpayer operated "with a view to" tax benefits, a much lower bar.[11] The I.R.S. determined it was met. It is not precisely clear where the B.M.S. matter ended up afterwards, and it is quite possible that B.M.S. settled with the I.R.S. for less than the full amount of asserted tax due.

After the government improperly leaked a not fully redacted Field Advice through the Tax Notes research portal, however, the New York Times obtained a copy and exposed the transaction and its participants.[12] Almost a year later, in 2022, Senate Finance Committee Chairman Ron Wyden[13] sought additional information on the transaction from B.M.S.'s Chairman.[14] Noting that the offshoring reduced B.M.S.'s effective tax rate from 24.7% to minus 7%, he inquired into its economic substance and whether or not B.M.S. was contesting the I.R.S.'s decision. He also asked whether B.M.S.'s auditors had reviewed the transactions.

One additional aspect noted in Senator Wyden's letter was that hundreds of pages of legal advice failed to refer even once to Code §704(c), a glaring omission. A failure by "sophisticated outside advisors" to address key issues "raise[d] serious questions as to whether such an omission was deliberate. Other observers have been more understanding of B.M.S. and critical of the Senator.[15]



9 Treas. Reg. §1.704-3(a)(10).

10 Treas. Reg. §1.702-2(b). This general rule allows the I.R.S. to recharacterize transactions with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability "in a manner that is inconsistent with the intent of subchapter K."

11 Another author has suggested Code §197 would not permit B.M.S.'s I.P. offshoring from giving rise to amortization in any event; see Karen C. Burke, "Transfers of Zero-Basis Intangibles to a Partnership," Tax Notes, Jan. 18, 2022. However quick and dirty, the I.R.S.'s approach was less technically demanding and got to the point faster.

12 "An Accidental Disclosure Exposes a $1B Tax Fight With Bristol Myers", April 1, 2021, and available here.

13 Senator (D-OR) from 1996.

14 Letter from Ron Wyden, Chairman: Committee on Finance, to Giovani Caforio, Chairman of the Board and C.E.O., Bristol Myers Squibb, Jan. 18, 2022.

15 For example, an article by the Wall Street Journal's editorial board pointed out the murkiness of the law and alleged the Senator's letter was a witch hunt for purely political purposes. "Democrats Find a Pharma Scapegoat: Tax sleuth Ron Wyden discovers a 10-year-old, legal deduction," WSJ.com, Jan. 26, 2022.

MANN CONSTRUCTION V. UNITED STATES

The second transaction examined involves Mann Construction, an owner-managed construction business focusing on warehouses and retail outlet malls in the Midwest since 1975, and operated out of Harrison, a town with population of 2,150.[16] According to the company website, they have designed several Dollar stores and a drive-thru banking facility in Harrison, Michigan.[17] They have 2 reviews and a 4-star rating on Google.[18]

"A listed transaction is a variety of reportable transactions which is the same or substantially similar to one of the types of transactions that the I.R.S. has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."

Between 2013 and 2017, Mann established an employee-benefit trust paying premiums on cash-value life insurance for the benefit Brook Wood and Lee Coughlin, its founders and sole shareholders. In the I.R.S.'s view, such a trust generates excess deductions to the company and is also designed to transfer a significant part of the insurance policy value to the insured's beneficiary tax-free. The arrangement was flagged by the I.R.S. as a "listed transaction" in Notice 2007-83.[19]

A listed transaction is a variety of reportable transactions which is the same or substantially similar to one of the types of transactions that the I.R.S. has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction.[20] Each taxpayer engaging in a listed transaction must report the transaction during each year of participation using Form 8886, *Reportable Transaction Disclosure Statement*, which is attached to the return for the year in question.[21] The instructions to the form clearly indicate that the mere reporting on the form does not mean that the tax benefits will be automatically disallowed. In *Mann*, all the taxpayers failed to file the form. In consequence, upon auditing the company's 2013 tax return, the I.R.S. imposed penalties both on the company and its shareholders.

Paying the penalties to the I.R.S., the taxpayers first sought administrative refunds, and failing that, recovery in Federal court by challenging the penalties on four grounds:

1. The 2007 notice failed to comply with notice-and-comment procedures under the Administrative Procedure Act.
2. The notice constituted unauthorized agency action.
3. The notice was arbitrary and capricious.
4. Even if the notice were valid, the arrangement was not within its scope.

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16 It is near the junction of U.S. 127 and M-61, though according to Wikipedia U.S. 127 actually bypasses the city. Harrison is bordered by Budd Lake on the east; the biggest local events are the Clare County Fair and the Frostbite Open Golf Tournament on Budd Lake. See here.

17 See here.

18 One of the reviewers assures us that "They do good work."

19 See also Notice 2009-59, defining "listed transactions" for purposes of Code §6707A, cross-referencing Notice 2007-83 at §2(33).

20 Treas. Reg. §1.6011-4(b)(2).

21 In addition, in the first year in which the taxpayer participates in a reportable transaction, a copy of the form must also be mailed to the Office of Tax Shelter Analysis ("O.T.S.A.").

The I.R.S. agreed that it had not followed the notice-and-comment procedures required by the Administrative Procedure Act ("A.P.A.").

Background: Growing Inroads by the A.P.A.?

In fact, until 2019 the I.R.S. and Treasury generally have proceeded for decades with a view that tax regulations were outside the A.P.A.'s ambit (a kind of tax exceptionalism). Typically, this involved issuance of temporary regulations without notice and comment, followed by final regulations many years later. A chip in this edifice was created by the 2011 Supreme Court case of *Mayo Foundation for Medical Education and Research et al. v. United States*,[22] which upheld certain wage withholding rules under the Federal Insurance Contributions Act.

In a first, *Mayo* cited non-tax administrative law cases normally discussed only when analyzing A.P.A. issues, not tax issues. A second case swiftly followed in *United States v. Home Concrete & Supply, LLC*,[23] this time rejecting a Treasury regulation running counter to courts' interpretations of a long-standing tax rule, the six-year extended statute of limitations applicable to certain understatements under Code §6501(e).

Under the A.P.A., it may be permissible for an administrative agency to introduce rules without notice-and-comment, provided it can show good cause. In *Mann*, the I.R.S. simply asserted that it was not required to do so. Unlike the 2011 and 2012 opinions, the court this time fully unfurled an A.P.A.-type analysis, to conclude that the I.R.S.'s obligation to identify reportable transactions under Code §6707A, enacted by Congress in 2004,[24] could not be met through mere issuance of interpretive guidance like the notice. The I.R.S. retorted that its failure to follow notice-and-comment was because in A.P.A. terms, Notice 2007-83 was an "interpretive rule" rather than a "legislative rule;" or, even if the notice were acknowledged to be a legislative rule, the I.R.S. was exempted from complying with A.P.A.-type rules by Congress. This was an odd argument to make, particularly given the fact that in 2019 the Treasury Department specifically issued a policy statement committing to notice-and-comment rulemaking.[25]

The Sixth Circuit evaluated Notice 2007-83 and found it wanting. The argument of tax exceptionalism was dismissed out of hand.

Moreover, the Sixth Circuit read Code §6707A, which requires taxpayers to file information with respect to reportable transactions, side by side with Code §6011(a), to conclude that listed transactions could not be reportable transactions unless so designated in Treasury Regulations. When the I.R.S. pointed out that Code §6707A(c) specifically should be read alongside Treas. Reg. §1.6011-4(b)(2), which defines a listed transaction, specifically including one designated in a published notice, the Court went even further:

> [T]he agency's reference to its apparent rules of process, without more, does not show that *Congress* exempted Notice 2007-83 from

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22 562 U.S. 44 (2011).

23 566 U.S. 478 (2012).

24 Enacted by the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

25 Department of the Treasury, "Policy Statement on the Tax Regulatory Process," March 5, 2019, which can be downloaded here.

> notice-and-comment rulemaking. The question is whether Congress amended the APA's prerequisites, not whether the IRS did. While the cross-reference is probative of whether Congress was aware of the IRS's transaction-listing procedures, it does not alone suffice to show an express exemption from the APA procedures. Even on its own terms, moreover, the argument falls short. Section 6707A deals with penalties for not reporting certain transactions to the IRS. The statute's key feature is to describe the "type[s]" of "transaction[s]" subject to penalties for non-reporting, namely the ones "determined" by "the Secretary" "because" they have a "potential for tax avoidance or evasion." 26 U.S.C. § 6707A(c)(1). The statute thus addresses a "which transactions" question, not a "what process" question. That does not suffice to create an express modification of the APA's background assumption that rulemaking will go through the notice-and-comment requirements.

Thus, in literally a few brief strokes of the pen, decades of I.R.S. regulatory practice appeared to go up in a puff of smoke.

If the result in *Mann* is upheld, the I.R.S. will face predictable difficulty, particularly in dealing with out-of-the-way areas of the law, done by smaller taxpayers, where audit resources may already be limited. Whether that difficulty will have a long shelf life is unclear. When the taxpayer in *Grecian Magnesite*[26] won a stunning victory over Rev. Rul. 91-32 in the U.S. Tax Court, the ink was hardly dry before Congress revised the law to reverse the outcome of the case by adopting Code §864(c)(8) and §1446(f) on a prospective basis. The court held that gain from the sale or redemption of a foreign taxpayer's interest in a U.S. partnership was not effectively connected income.

"Thus, in literally a few brief strokes of the pen, decades of I.R.S. regulatory practice appeared to go up in a puff of smoke."

CONCLUSION

The two taxpayers we looked at, like their transactions, lie at polar opposite ends of the spectrum. What can one learn from them, or from the difference in result when each was attacked by the I.R.S.? While politically small businesses may not be as attractive targets as large corporate multinationals are for politicians like Senator Wyden, individual tax evasion may reach as high $50 billion a year, suggesting that the cost of auditing and litigating against the latter group is worth the expected return.[27] In short, their stories speak volumes not only about the challenges facing the I.R.S. today and the contours of its future evolution, but also about the state of the nation.

The Sixth Circuit's opinion in *Mann* – particularly if upheld by the Supreme Court – may result in a perception by the I.R.S. of diminishing returns in pursuing smaller

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[26] *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commr.*, 149 T.C. 63 (2017), affd. 926 F/3d 819 (D.C. Cir. 2019).

[27] See a slightly dated report by Joseph Guttentag and Reuven Avi-Yonah, "Closing the International Tax Gap" cited in Congressional Research Service, "Tax Havens: International Tax Avoidance and Evasion", updated Jan. 6, 2022 ("C.R.S. Report"), at n.125. The $50 billion can be fruitfully compared to $50 billion that Kimberly Clausing and Reuven Avi-Yonah estimated in 2008 as the potential revenue gain from moving to a formulary apportionment system for on worldwide income for U.S. corporate taxpayers; see the C.R.S. Report at n.94. While not an "apples-to-apples" comparison, it is instructive.

businesses and individuals participating in the traditional tax shelters. In the short run, it may cause a reallocation of audit resources. In the long run, the more realistic thing is to recognize that the I.R.S. never loses. As Will Rogers said, "the only difference between death and taxes is that death doesn't get worse every time Congress meets."

Thus, assuming for the moment that the 2019 Policy Paper was issued in error, the the I.R.S. may "Mann-up" and request what it needs from Congress, similar to what happened when its position in Rev. Rul. 91-32 was overruled by the Tax Court in *Grecian Magnesite*. In short, the most likely outcome is that the I.R.S. will zealously and successfully petition Congress for a permanent fix, explicitly granting an exception from clunky A.P.A. procedures.