

I N S I D E T H E M I N D S

Common Issues in Tax Law

*Leading Lawyers on Handling Tax Audits,
Executing Tax Appeals, and Monitoring Client Tax
Compliance*



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Mega Trends and Current Issues in the Tax World

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As the French financier Colbert, financial adviser to Louis XIV, once said, “Taxation is the art of plucking the goose while getting the fewest squawks.”

Governments are always hungry for revenue. Our federal and state governments are no exception.

As our economy has morphed over the last fifty years from a manufacturing-based economy into a “post-industrial” service-based economy, our tax laws have had great difficulty in adjusting to that change. Tax laws that worked well for a manufacturing economy have become progressively less and less effective with respect to our new service-based economy. Our systems of taxation have grown more and more arthritic and inadministrable. Congress continues to layer additional complexities on the one hand in vain attempts to plug “loopholes” while at the same time adding ill-conceived and poorly designed statutes designed to implement this or that policy objective. Finally, Congress calls upon an understaffed, undertrained, and underfunded Internal Revenue Service to enforce these laws of extraordinary complexity. Not surprisingly, our current tax system leaves a great deal to be desired.

The Irreversible Trend toward Greater Complexity

In response to the conflicting goals of “plugging loopholes” while providing “tax incentives” to encourage economically desired behavior, Congress continues to enact a mishmash of ill-conceived and complex legislation.

For example, the manufacturing tax credit contained in IRC § 199, which was enacted in 2007, is, when you study it, nothing but a very complicated rate reduction for the manufacturing industry. Arguably, whatever money Congress saved taxpayers with this new methodology will be more than offset by billions of dollars of cost in tax compliance expense. Indeed, you could almost hear the chuckles from the Big Four accounting firms with the enactment of Section 199 as they quickly and correctly realized that this new section is a virtual “full employment” act for tax accountants.

The ill-considered “Fair Tax” concept is an unfortunate reaction to these kinds of unnecessary complexities. The concept of a simple flat rate national sales tax has great superficial appeal. But, as numerous studies have shown, to replace the lost revenue that would result from a repeal of the federal income tax would result in an actual federal tax rate of at least 31 percent under the so-called “Fair Tax.” Combine this with state and local sales taxes and you could easily be looking at a combined 38 to 39 percent rate applicable to all transactions. Any such new tax would radically change consumption patterns and literally destroy large sectors of the economy. And it would result in ruinous inflation.

Proponents of the Fair Tax system need to remember the law of unintended consequences. For instance, when Congress passed the 1986 Internal Revenue Code and enacted the Passive Activity Loss rules contained in IRC § 469, it did not intend a number of the consequences that ensued. As a policy matter, the Passive Activity Loss rules were a necessary response to the proliferation of tax shelters that were, in effect, creating negative tax rates. Transactions wholly lacking in economic justification proceeded simply because the transactions produced guaranteed tax losses and, on an after-tax basis, a guaranteed net return. The presence of these tax shelters created a huge demand for depreciable assets, particularly real estate, which resulted in driving up prices for depreciable assets which could be financed with debt.

When Congress passed the Passive Activity Loss rules, it removed this stimulus and deflated the real estate market by at least 20 percent. Indeed, some would say between 30 to 40 percent. This collapse in real estate prices in turn destroyed the Savings and Loan industry and wiped out many of the major real estate companies in the United States. Those of us who remember those years and Congress’s response in the creation of the Resolution Trust Corporation know too well the incredible unintended consequences that changes in tax laws can have.

Truth be told, we very well know how to simplify the Tax Code if we really want to. The solution: unify capital gains and ordinary income rates, broaden the tax base, and eliminate deductions. This was the recipe for the 1986 Internal Revenue Code. As enacted, this solution lasted exactly two years.

Now, whether one should tax capital gains and ordinary income at the same rate can be debated as a policy matter. But there is no question that the minute two sources of income are taxed differently, the result is to create incentives to do things in different ways and to create complexities in the tax laws. The fact of the matter is that this system of different rates of tax for different types of income has been around for a long time. And that seems to be where we will be for the foreseeable future.

The Growing Failure of Compliance

One of the most fundamental and corrosive threats to our tax system is Congress's inability to enforce the laws it is passing.

For instance, the original issue discount rules (OID) of IRC § 1271-1275, which put taxpayers on forced matching accrual accounting, simply cannot be understood by anyone without very savvy financial modeling skills. Were it not for the invention of the handheld computer, these sections would have never been enacted. Indeed, when the legislation was new, representatives of the Treasury Department often explained various aspects of the legislation and regulations by reference to the buttons you punched on the then ubiquitous HP30 handheld pocket calculator.

Now that Congress (or, more accurately, its committee staff) have sophisticated computer systems, our legislators, with the able assistance of bright young policy wonks with little or no practical experience, write tax rules that are extremely complicated and are fiendishly difficult to master. Members of Congress routinely lament in floor debates on tax legislation that they often have not even had time to read the legislation, much less to understand it. This results in a huge delegation of responsibility to congressional committee staffs.

For example, under the rules of new Section 409A, if a deferred compensation arrangement inadvertently fails to qualify for deferral, then amounts deferred under the arrangement are immediately taxable at ordinary rates *and* are subject to an additional 20 percent tax, *plus* interest and penalties. The tests are complex and can apply to things such as severance arrangements, option plans, and the like that most business people would not even think of as deferred compensation. It takes very

sophisticated people to administer and comply with this kind of rule. It takes an even more sophisticated audit agent to catch it and to enforce it.

Unfortunately, there are few IRS agents who fully understand these concepts, or the equally challenging concepts of partnership taxation, international hybridization, subpart F income, etc., etc. etc. The list goes on and on.

The complexity of the current tax code has contributed mightily to the “Tax Compliance Gap.” The IRS likes to brag that Americans voluntarily pay tax. But that is simply not true. More than 80 percent of the taxes that are collected are collected at the source by withholding. The Tax Compliance Gap, which is the spread between the revenue that is actually collected and the revenue that is theoretically collected, continues to grow. The most recent estimates by the Congressional Budget Office estimate the Tax Compliance Gap exceeded \$300 billion in uncollected taxes in 2006 alone, for instance.

A large portion, if not the bulk, of the Tax Compliance Gap stems from those areas where taxes cannot be collected or are not collected at the source. It is not that Americans are dishonest. Rather, if there is no way to collect a tax at the source, it is difficult to make the tax laws work. Again, one of the great surface appeals of the Fair Tax is that it imposes a clear obligation to collect all taxes at the source of the transaction.

Indeed, you have to question what kind of tax system we have when in this country even average taxpayers routinely shell out hundreds of dollars annually to fill out tax returns that are supposedly “simple.” In that regard, the proponents of the Fair Tax have a valid point. And how many members of Congress do you think actually fill out their own tax returns? Or even would know how if they wanted to try to do so?

Unfortunately, the growth in the Tax Compliance Gap is one of those long-running trends. And this can only continue to grow in a tax system where compliance is so difficult. Whether it is the subtleties of the 1031 deferred exchange rule, nexus issues for sales tax purposes, 409A present value calculations, 704(b) partnership allocation complexities or the like, these are

very, very complex rules that require very, very, very sophisticated compliance.

Simply stated, our government is not set up to deal with the tax situations of taxpayers who are independent contractors/self-employed, or taxpayers for whom there is no withholding of taxes on income. This is true at the level of both large service partnerships, as well as small partnerships consisting of two or three people.

In summary, we are facing increasingly complicated tax rules and increasing difficulties in policing the tax system. The only real solution is improved enforcement. This means spending more money on salaries to hire more and better trained employees for the IRS. Until that happens, the government will always be on the losing side of the contest.

Accountants and Lawyers as Tax Compliance Officers

Unfortunately, at least for tax professionals, a major response to this trend of *de facto* unenforceability in the area of tax law manifests itself in the move by Congress and the IRS to attempt to solve the enforcement problem by making tax accountants and tax lawyers compliance officers for the government.

For instance, as of January 1, 2008, by virtue of IRC §6694, an accountant or lawyer is now potentially liable *personally* for penalties if he or she signs or participates in the preparation of a tax return that takes a position that is not more likely than not correct and the adviser knew or had reason to know it was not correct *unless* the taxpayer discloses the position on the taxpayer's return. Ironically, the *taxpayer* can continue to file the taxpayer's individual return *without disclosure* as long as the taxpayer has a reasonable basis to believe that the position is correct. But the *accountant* cannot sign the return unless the accountant concludes that the tax position is more likely than not correct, or alternatively discloses the position. Thus, these amendments to IRC §6694 create a terrific incentive for taxpayers to file their own returns or to take tax returns in-house.

Another example of the tendency to externalize the compliance of tax laws are things such as the amendments to Circular 230. For instance, one of the

biggest impacts of the recent spate of corporate tax shelters has been the development of the concept of the “listed transaction” and the drive to turn accountants into auditors for the government. This is just another example of this irreversible trend of externalizing tax enforcement. It will get worse, not better, in the future because the government simply does not have the resources or the ability to make the tax system work as is currently set up.

Another example is the current debate about whether the “economic substance doctrine” should be codified. Even IRS representatives have stated it should not be codified as it is essentially common law test and should be left to the courts. However, there is real risk such legislation will ultimately be passed, as much because the Senate sees it as a revenue raiser as for any other reason.

If Congress continues to enact tax legislation that purports to be “technical legislation” to raise money, it will continue to put lawyers and accountants in the unenviable position of forcing them into the direction of “auditing” their own clients’ returns.

IRC § 6694 and the recent amendments to Circular 230 are, in effect, an effort by the government to externalize its costs of tax compliance. Simply put, the United States government wants to turn tax professionals into its auditors. We are well on the way to that resolution.

Of course, one of the problems with this theory is that it assumes a high level of knowledge and sophistication on the part of the tax preparers. While this may be true for the peak of the profession, the fact of the matter is that even the very best accountants and the very best tax lawyers can, and do, make mistakes. Needless to say, the tax lawyers and accountants who are not the very best make many more.

Thus, we see ourselves in the middle of the Scylla and Charybdis, with two conflicting trends pulling tax compliance in opposite directions. On the one hand, we are faced with the great (and ever increasing) complexity of the Tax Code. On the other, we have a weaker IRS that is less and less able to enforce the law effectively. The response is an understandable effort by the government to externalize the problems and costs of enforcement by

forcing private lawyers and accountants into the role of tax compliance officers.

These are unhealthy trends. In order for enforcement to be effective, it must be prompt and certain—and currently it is neither. The reality is it takes the government years to find something is wrong and then years more to resolve the issue. For every issue the government unearths, there are hundreds of issues it does not find. So as long as taxpayers believe they can run the red light with impunity, the temptation to do so will be strong.

Another noticeable trend in response to the relative ineffectiveness of enforcement is the tendency of the government to overreact on a selective and vindictive basis when it detects what it perceives to be “abuse.” It is certainly difficult to understand any other reason for why the government found it necessary to single out one group of partners at KPMG for *criminal* prosecution when there were hundreds, if not thousands, of taxpayers across the country doing the same or worse.

We will not have effective enforcement of the tax laws unless and until it is certain and swift. The only way to make that happen is to simplify the system and spend whatever it takes to have competent people in charge of enforcement. Neither of those solutions is on anyone’s horizon.

Specific Trends and Issues

The De Facto Repeal of the Corporate Income Tax

The de facto repeal of the corporate income tax is a reality.

The numbers over the last forty to fifty years show that the corporate income tax as a percentage of the total revenues of the U.S. budget has steadily decreased. At least one reason for this is the proliferation of “flow-through” entities, particularly limited liability companies (LLCs) and S Corporations. “Flow-throughs” in the tax world are entities which are not separately taxed, but which rather serve as conduits for the allocation of income to their members or owners. It is the owners of these flow-through entities who then pay the tax on their respective shares of income.

For good policy reasons, Congress continues to make it easier and easier for businesses to elect out of the corporate tax. For instance, S corporations have always had limitations on the maximum number of shareholders. Congress has steadily increased that number of permitted shareholders over the years, starting with fifteen in 1954, then to thirty-five, then to seventy-five and currently one hundred. Moreover, in 2005 Congress liberalized the S Corporation provisions so as to permit a form of family attribution for up to seven generations of the same family so that family members can elect to be treated as a single shareholder for purposes of the S Corporation rules. These amendments enabled one of the largest privately held companies in the world with several hundred individual owners and billions in revenue to make an S election.

Thus, the corporate level tax as to privately held businesses is rapidly being eliminated. As a policy matter, this may be a very good thing. Corporate taxes do not make a lot of theoretical sense in the first place. What makes sense is that taxes are paid at least once by the owners who receive the economic benefits in the enterprise. Businesses pass on taxes as costs.

But the fact of the matter is the government still needs the money from the corporate tax and we still have a corporate income tax. Indeed, Congress periodically makes vain efforts to protect that corporate tax base from “erosion.” For example, the publicly traded partnership rules of IRC §7704 were enacted in the 1980s in response to the proliferation of what were then known as publicly traded partnerships.

Another issue associated with the de facto repeal of the income tax is the necessity to preserve the S-election while permitting investments by non-qualified shareholders such as non-U.S. persons, partnerships, pension plans, or other entities. Our firm has developed a solution to this problem involving what we call a drop-down LLC, which “freezes” the gain inside the S Corporation and shifts future asset appreciation to the “common” equity holders who acquire that equity as ownership in an LLC. Again, however, this is a complex transaction and requires great expertise on the part of the tax professionals, both as to formation and ongoing operations as it involves compliance with both the S Corporation rules *and* the partnership rules of Subchapter K.

Against this backdrop, young accountants or attorneys starting out in the tax area should seriously consider focusing on learning the principles of partnership taxation. Partnership taxation is an extremely complicated area and one which many accountants and the government do not understand. Subchapter K and flow-through taxation in general is very tricky. And it is a growth industry.

Bankruptcy Tax Issues

The French have a wonderful saying, “Le plus ça change le plus c’est la même chose” (“the more things change, the more they stay the same”). That is certainly the case in the intersection of bankruptcy and tax.

In 1988, tax practitioners were spending hours analyzing the concept of cancellation of debt income (COD income) and the intersection of COD with the “insolvency exception” exclusion currently codified in IRC § 108. With the sub-prime mortgage meltdown and resulting credit crunch, this issue has yet again reemerged. Therefore, COD will be a huge tax issue in the coming years.

The dilemma that COD poses is the tension between tax policy and bankruptcy policy. The theory of bankruptcy is to give debtors a fresh start. Tax policy, however, says that when a debt is forgiven or canceled, the cancellation of indebtedness is treated as an accretion to wealth resulting in income under IRC § 61. This gives rise to taxable income and an associated tax liability. So, for instance, if I borrow \$100 million and I experience financial difficulty, if my lender gives me a \$20 million concession in an effort to effectuate a work-out, that results in taxable income from the cancellation indebtedness unless I am insolvent.

But in many situations it would be in the best interest of the economy if debts could be compromised without creating a tax liability. The tax liability then becomes a disincentive to the cancellation of indebtedness. In other words, if it is good policy for private parties to compromise debts from a financial and economic policy, why shouldn’t the government likewise compromise its claim for taxes arising from the adjustment?

As we see vulture funds buying up the current sub-prime mortgage pools and other collateralized debt obligations at huge discounts, cancellation of debt is going to be a huge issue for both the legal and accounting professions for the next several years. This is because, as discussed above, accountants and tax lawyers are now the police officers who have to enforce these rules.

Congress's recent hustle to solve this problem for the consumer public in H.R. 3648, the "Mortgage Forgiveness Debt Relief Act of 2007," does not address the fact that COD income will be a huge and even more significant issue in the work-outs of billions of dollars of collateralized debt obligations.

The Most Common Areas of Malpractice

Our law firm and our client base are both highly entrepreneurial. We have a large real estate and real estate capital markets practice as well as a large technology client base. These two sectors are not the typical "old economy" manufacturing economy for which the Tax Code was originally built. Perhaps because of the composition of our client base, we see certain mistakes that are made over and over again.

For example, on the corporate side, probably the most frequent area of malpractice we see is with respect to S Corporations. The S Corporation rules simply are not well understood by taxpayers or, to a surprising degree, by their tax professionals. We are frequently confronted with S Corporations that have impermissible shareholders (S Corporations generally are limited to U.S. resident individual taxpayers and certain trusts and estates), two classes of stock (S Corporations are limited to one class of stock) or which have inadvertently made non-pro rata distributions. Any of these can violate and terminate S status.

Compliance with 704(b) and 704(c) Allocations.

On the LLC and partnership side of the equation, the biggest problems we see on a recurrent basis are compliance with the 704(b) and 704(c) rules.

Most clients and their accountants simply do not understand how these rules work. Moreover, because the accurate implementation of 704(b) and 704(c) requires detailed factual knowledge of the history of the business activities of the enterprise, mistakes often happen. Last year, for instance, I received two different calls from two different clients, each of whom was represented by a Big Four firm, shortly before the April 15 filing deadline. In each case, the Big Four accounting firm had just discovered that it had made a mistake in the prior year's return with respect to the 704(b) allocations. In each case, the accounting firm wanted to go back and correct the allocation retroactively with amended returns for the partnership and all of its partners. This would have caused huge disruptions, forcing all of the owners of those companies in the prior years to file amended returns.

The point is that it is simply too easy to make mistakes in this area. If the Big Four accounting firms make mistakes in this area, how much more likely is it for a smaller accounting firm with less expertise to do so? And heaven help regular old taxpayers.

“Employee Partner” Issues

Another area where we see recurrent mistakes being made, because taxpayers and their advisers simply do not understand the rules, is the area of equity-based compensation. This is true both on the corporate side with respect to grants of options and equity interests and on the LLC and partnership side, with respect to restricted profits interests and equity grants.

For instance, clients generally have no idea that a member of an LLC or a partnership cannot be an employee and cannot receive a W-2. It is well settled and has long been well settled that an owner/member of an LLC or other partnership entity must receive a K-1. Any “salary” the owner receives must be reported as a guaranteed payment. The member is not subject to withholding and must file estimated tax returns with respect to the guaranteed payment salary.

And yet, this error comes up all the time. Quite understandably, it is difficult for businesspeople to understand why the simple nature of the

entity would result in something so much a matter of basic administration changing.

S Corporation and QSSS Elections

Another common foot fault in the S Corporation area that we frequently see is the missed or defective S Corporation elections. We also see many missed qualified Subchapter-S subsidiary elections (so called QSSS elections). Although the government has become more flexible with respect to permitting taxpayers to cure slipups under these rules, this is still a frequent area where elections are missed and, quite frankly, an area of recurrent malpractice.

83(b) Elections

However, my personal favorite in terms of the most consistent area of malpractice in the tax area is the missed 83(b) election. The problem arises with frightening regularity. This is the most common mistake we see. And it is one area where, if missed, there really is no cure.

An 83(b) election must be made, if at all, within thirty days of receipt of rights in property received for services that are subject to a substantial risk of forfeiture if the recipient wishes to “close” the transaction, pay tax immediately (generally at little or no cost), and start the holding period for capital gain purposes. Otherwise, the taxable event is deferred until the restriction lapses and the property “vests.” Think restricted stock grants as the prototype situation where this arises.

To “close” the transaction immediately, the recipient must make an 83(b) election within thirty days of receipt of rights in the property. There are no extensions. The 83(b) election is not made with the tax return (although a copy of the election must be *filed* with the tax return). Indeed, a copy of the election has to be filed in three separate places—with the tax return, with the company’s tax return, and within the thirty-day period.

I often laugh and say that if I could put a large sign in our lobby it would be “FILE YOUR 83(b) ELECTION WITHIN THIRTY DAYS OF RECEIPT OF THE PROPERTY!” I have seen situations where the failure

to make the 83(b) election has literally cost the taxpayer millions in additional tax. I have seen it missed by the finest law firms and accounting firms in the country. And I see these errors with alarming regularity.

Taxable Mergers of LLCs and Corporations

Many people simply do not understand LLCs. LLCs are a wonderful tool. But the lay public often thinks that an LLC is another form of a corporation. Alarming, sometimes many lawyers and accountants do as well. Although an LLC shares with a corporation the attribute of limited liability, an LLC is *not* a corporation for tax purposes (unless it elects to be treated as one). Therefore, a merger of an LLC with a corporation is generally a taxable event.

This then leads to the question of how far in advance of a merger is it necessary for an LLC to convert into a corporation (which generally can be done on a non-taxable basis) for the ensuing merger to be tax deferred? This question arises with alarming regularity. The response of course is, “How high is up?”

Withholding on Distributions to Partners

The Tax Compliance Gap is most acute where there is a significant withholding issue. In the state tax area, a common trouble spot for businesses pertains to withholding on distributions to non-resident partners or owners of S Corporations.

The issue also exists, of course, at the federal level under IRC §1446 with respect to distributions to non-U.S. partners. But the issue is less well understood and compliance is even more erratic at the state level with respect to out-of-state partners.

Many states such as Georgia have enacted statutes that impose withholding obligations on distributions to nonresidents. Unfortunately, these statutes and enabling regulations are often poorly drafted. They have nothing to do with cash flow and everything to do with taxable income. And as I find it necessary to remind people all the time, cash and taxable income have little to do with one another. Any similarity in amount is often coincidental.

With the proliferation of flow-through entities conducting multistate business, this is a growing area of difficulty. Compliance issues are growing, and this will become a bigger and bigger issue for businesses in future years.

Avoiding Dealer Status

In the real estate industry, again, the more things change, the more they stay the same. In real estate, by far the biggest single tax issue is how to qualify property as held for investment and thereby avoid “dealer” status. This is critical if the gains from the sale are to be taxed at favorable capital gains rates.

If property is held for sale in the ordinary course of business, it cannot qualify for capital gains. This can have disastrous ramifications in terms of an increased tax rate. For regular taxpayers, it results in the much higher ordinary income tax rates applying. For tax exempt entities such as pension funds and 501(c)(3) entities, such income becomes Unrelated Business Taxable Income that is subject to tax at ordinary income tax rates—something that no tax exempt entity likes to pay. For taxpayers such as REITs, which are subject to 100 percent penalty tax on such income, this is an even more critical issue. And yet the test is a facts and circumstances test. All too often, it turns into a “I know it when I see it,” analysis that is bereft of predictability or logic.

Executive Compensation

The area of executive compensation is problematic these days because of bad legislative policy. When Congress reads about executives getting outlandish severance upon termination, (e.g., Nardelli and Home Depot), or absurd levels of equity-based compensation, (e.g., the Blackstone Partners), we consistently get bad legislative responses. I would submit, however, that it is simply not Congress’s job to regulate how much people get paid. And even if it were, Congress should not try to solve this issue by tinkering with the Tax Code.

While some executives may receive what seem to be outrageous compensation packages, if the investing public elects boards of directors that allow those executives to continue to receive those packages, then it

should be up to them, not to Congress, to regulate what executives can be paid.

Unfortunately, because Congress cannot regulate salaries directly, in the executive compensation area it often tries to do so indirectly through tax legislation. As a result, we have a series of bad tax legislation in the form of IRC §409A (deferred compensation), IRC Section 162(m) (limitations on certain “excessive” employee remuneration), and IRC Section 280G (golden parachutes). The list continues to grow.

Audits and Tax Litigation

One of the biggest challenges that a tax professional faces is dealing with a client who is the target of an audit or otherwise involved in a tax controversy. In that setting, it is necessary to extract a huge amount of information in order to be effective. Yet it seems that the client never tells the lawyer everything that is needed.

Considering how complicated our current Tax Code is, where an LLC can sometimes be a partnership, sometimes a corporation, and sometimes a disregarded entity, you have to ask questions that you might not normally think to ask. This takes lots of time. And tax lawyers and tax accountants charge by the hour and are expensive.

As to the client who is facing potential tax evasion charges in a civil matter, it is important that the client disclose fully what has been done and correct it immediately. Under the current law and practice, as long as the tax evasion is corrected voluntarily, the government will not proceed with criminal action. The key, however, is to get the matter corrected before being contacted and getting it done quickly and correctly. Once a Special Agent from the Criminal Investigation Division shows up, it is a whole new ball game and it is time to call in the criminal lawyers. It is one thing to worry about a client losing money; it is quite another to worry about having to visit the client in a federal penitentiary.

If clients are not going to be completely honest with respect to the disclosures involving a tax matter, I simply cannot help them. It never pays to lie to your doctor or your lawyer. Indeed, I simply will not represent

people whom I cannot trust or who will not give me information that I need. My value to my client lies in my ability to help them evaluate their risk. If I do not have the information, I cannot respond intelligently.

Dealing with the Agent

As I discussed at the outset, on a systemic basis, the IRS is understaffed and underfunded. So getting audited and caught is progressively becoming more and more a game of Russian roulette. But even in Russian roulette, at least one chamber is loaded. So it is in the area of audits and tax controversy. The goal is to minimize the risk of becoming an object of scrutiny. Because once the government does focus, the entire institutional bureaucracy of the IRS is across the table.

So in a tax audit situation, the first rule is to be quiet. The client should not talk more than absolutely necessary. Whatever the auditor may say, the auditor is not here to help. A client is not going to be able to “sweet-talk” an auditor. The client needs to be professional and polite and to remember that although individually the client may be smarter than the auditor on the premises, collectively the IRS is smarter and has vastly more resources. So the key is not to enlarge the inquiry. Above all else, the client needs to avoid drawing attention to issues. Once the Service focuses on the taxpayer, the taxpayer has every prospect of being overmatched.

Understanding the Risk

Clients also need to understand whether the tax issue is a real risk or a small risk. This is not a question of whether it will be audited. Rather, it is a question of whether it is a real risk or a small risk. The question that has to be answered is how likely is the client to prevail if challenged?

“As of” Dating vs. “Backdating”

A recurring issue with clients is what to do in a situation where the client comes in and advises that the parties agreed to such-and-such last year but they neglected to document the transaction.

It is well settled that backdating a document can be tax fraud. On the other hand, documenting what was previously agreed to and simply producing documentation that was dated as of a prior date, fully disclosing the nature of the dating, is permissible. One point needs to be stressed, however. When I have this issue come up with my clients, I always ask them are they all going to be prepared under oath to swear that the agreement they made in fact was the agreement that can be documented. And is everyone going to testify the same way? Otherwise, it does not meet the test of the agreement for the documentation to be effective for the prior period.

To Settle or Litigate

There is an old truism that I am fond of quoting: “A bad settlement is better than a good lawsuit.” That certainly applies in the setting of any tax audit or tax controversy case.

A tax audit is nothing more than an administrative lawsuit. It is important always to balance the risk versus the cost. As a sad reality, it is simply not economically viable to try a case of any substantive complexity these days, unless there is at least \$250,000 at risk. That is because the client is simply going to pay that much in legal fees. That is certainly the case in the tax area.

So, if possible, it is always better to settle the matter early on. If the choice is between paying your lawyer \$50,000 to litigate your case or the government \$25,000 to settle, one is certainly wise to pay the government the \$25,000 and be done with it. If there is a real risk of a \$1 million tax adjustment, and that risk can be settled for \$90,000, that is probably a good business deal because the client is going to pay the lawyer that much or more in any event. That is the brutal reality of risk analysis. It may not be fair, it may not be desirable, but it is the reality.

When clients tell me they want to litigate a matter on principle, I always tell them about a wonderful cartoon that appeared in the *New Yorker* magazine many years ago. In the cartoon there is a lawyer sitting across his desk. The lawyer has just finished listening to the client regarding a prospective matter. The lawyer looks at the client and says, “Mr. Smith, from what you tell me you have an excellent case. How much justice can you afford?”

Justice is indeed expensive in the tax area. That is because tax is hard and complex and you have to have absolutely the best lawyers and the best accountants to address complex issues and facts.

If the taxpayer is a large partnership with a \$2 million to \$3 million tax issue, the taxpayer would be foolish not to incur the expenses necessary to defend the issue and resolve it at the best possible cost. But even those are cases that can and should be settled. If you cannot settle, you have to be prepared to go to the mat.

One thing I make a point to educate clients about is that tax cases settle when the government is ready to settle, not when the taxpayer is ready to settle. Unlike private litigants, the government simply does not have the same incentives. Moreover, the further up one goes in the system, the more likely is the response to become more rigid. So, if a matter can be settled on audit, settle at audit. If it can be settled on appeal at conference, settle at conference. Look for the opportunities to give on small issues so that the agent or conferee can collect some money, declare victory, and settle the larger issues.

Keys to Handling Audits and Tax Controversies

One of the key issues for success in tax controversies is limiting and narrowing the issues. One of my favorite approaches on appeal is to show where the agent was factually wrong. Or I will include records or information that justifies the conferee who is reviewing the file and viewing the agent's report is incomplete or incorrect. Thus, the ability to raise doubts in the conferee's mind about the agent's fairness is often key to getting a favorable result at conference.

Although it is not as important with the IRS, once a tax controversy matter heads into the court system, it is essential to understand and stress the policy behind the statute. Because tax controversies can either proceed to Tax Court or to District Court, the path one chooses has a large import on the method of presentation. Certainly, if one is headed to District Court, it is much more important to argue based on policy in order to persuade the judge the particular facts should lead to different results.

The Relative Role of Lawyers and Accountants in Tax Controversies

Effective defense in tax controversy matters involves a healthy cooperation between the taxpayer, the taxpayer's accountant, and the taxpayer's lawyer.

When counseling a client with respect to an audit, I never reveal my involvement to the IRS agent sooner than necessary. In my experience, lawyers should never make an appearance in an audit situation until it is clear that it needs to be done. In new cases, generally the most effective way to handle an audit is to let the accountant for the taxpayer deal with the audit agent directly. This is especially true at the lower levels. The lawyer can and should assist with developing arguments, consulting with the taxpayer and the accountant in developing theories and organizing authorities, writing memoranda or assisting in any way possible. However, generally speaking, remaining invisible is most effective for the lawyer at this point. This is because the minute a lawyer shows up, the agent will be suspicious that there is more here than meets the eye.

In most cases, therefore, I consult with the accountant handling the matter at the audit level. I only appear when and if it seems that the agent has finally firmed up a position and is not going to be persuaded at the more informal level. Even at this level, I strive to maintain discussions at the lowest level of adversarialness. For instance, I will often reveal my involvement with a memo outlining the taxpayer's position, authorities, additional facts or otherwise simply attacking the issue anew. Rarely is a pure frontal attack the most effective strategy. It is much more effective to persuade and see if you can get the agent to refocus on the case by attacking it from another angle.

Another point is that each tax professional is a fresh face. Often, for instance, the entry of the lawyer can calm things down if matters are becoming adversarial. Also, it could help cause the agent to "rethink" the issue. And finally, it communicates the seriousness and the determination of the client to fight the issue up the chain.

You Can Never Intimidate the Government

As noted earlier, one settles tax cases when the government is ready to settle. It is important to remember when dealing with the government that getting mad simply does not help. The government will settle the case when it is ready, not when you are ready. You cannot make the government settle. The government is not a private litigant and does not have economic incentives to settle. The government has all the time and money in the world (at least all of your time and all of your money). If you insist on settling prematurely, the government will simply take your money.

Internal Compliance

The tax laws are fiendishly complex. Therefore, this puts an incredible pressure on companies to have very strong internal controls and very confident and sophisticated tax compliance personnel. The sad reality is that it takes a lot of money and time to comply with the tax laws.

Yet this need for care and attention conflicts with another trend in business today—the speed with which business is conducted. Clients need to make very big decisions very quickly. I am often called upon to give very sophisticated tax advice that I have not had time to consider and research with the degree I would much prefer. Unfortunately, clients expect and need an immediate response in most cases and often by return e-mail. This growth of electronic commerce and cross-border transactions has made matters more complicated and faster paced. Even small businesses now are multinational operations and the complexities of multinational tax compliance multiply the difficulties of compliance.

Final Thoughts

It is often said but deserves repeating: Never let the tax tail wag the business dog. All things considered, it is better to pay taxes than lose money. Clients sometime lose sight of this reality. One should never take risky actions and make bad business decisions just to save taxes. Always consider the risk/reward equation—i.e., what are the tax savings versus the business risks from restructuring a transaction? For example, in the area of multistate tax compliance, if a taxpayer is getting \$20,000 revenue a year out

of a state, the taxpayer is not going to be overly concerned whether the position on nexus that the taxpayer is taking is particularly aggressive. The downside exposure is simply not that great. However, if the taxpayer is getting \$20 million of revenue, then the taxpayer probably could not run the risk of even a fairly modest risk on a nexus analysis. The exposure is simply too great.

Remember that in this day and age tax professionals are under terrific pressure from the IRS. Taxpayers may be more risk tolerant than their tax advisers.

Similarly, tax attorneys need to remember that they need to be on the same page as the accountants. It does not make sense to recommend a strategy and implement it and then have the strategy blow up when the taxpayer's accountant cannot go along with the strategy or will not sign the return because of the exposure on the tax return. Again, tax compliance has to be a team effort.

As Justice Oliver Wendell Holmes once wrote, "Taxes are the price that we pay for civilization." These days, civilization is pricey. And even figuring out the price is hard.

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