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by Tom Cullinan

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IRS Settlement Initiatives Can Improve Compliance

by Tom Cullinan

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In this article, Cullinan examines how reduced resources have affected the IRS's ability to address abusive transactions and how voluntary compliance initiatives can improve outcomes for the IRS and taxpayers.

IRS Commissioner Daniel Werfel said several months ago that he is "very much interested in exploring things like safe harbors" to encourage compliance. According to the commissioner, the IRS's efforts to "ensure wealthy individuals, large corporations, and complex partnerships pay the taxes they owe" will require "a diverse portfolio of different solutions." At one end of the spectrum would be enforcement and "along that continuum, there may be opportunities for us to explore agreements, safe harbors, voluntary compliance initiatives."[1]

More recently, the commissioner said, regarding a planned settlement initiative for taxpayers claiming the employee retention credit, "I've been around government a long time and seen a lot of different voluntary compliance programs where you're trying to set the incentive where people will come in. . . . You have to do it in a way that they see it's to their benefit."[2]

Below I examine how the IRS's declining resources have affected its ability to maintain meaningful audit coverage for what the agency perceives as "abusive" or "tax avoidance" transactions and how voluntary compliance initiatives can provide some redress.[3] That is followed by an overview of the IRS's historical use of voluntary compliance initiatives to fully or partially resolve those types of transactions. Werfel's interest in those initiatives, if fairly structured, can provide substantial relief and savings for taxpayers and the IRS.

IRS Resources

According to a recent Government Accountability Office report, as of September 2022 the IRS was conducting hundreds of investigations involving more than 40 types of abusive tax schemes.[4] Yet the IRS has not had the resources for meaningful enforcement efforts against all transactions it believes are abusive. (For the record, I offer here no opinion on whether any specific transaction is abusive; the topic here involves options available to the IRS once it has determined — rightly or wrongly — that a transaction is abusive.) As the IRS explained in the Inflation Reduction Act Strategic Operating Plan:

> The IRS tracks many known, high-risk issues in noncompliance, such as digital asset transactions, listed transactions and

[1] Lauren Loricchio, "ABA Section of Taxation Meeting: IRS Commissioner Open to Voluntary Compliance Initiatives," *Tax Notes Federal*, May 15, 2023, p. 1226.

[2] Doug Sword, "IRS Refining Approach to ERC Repayment Program, Werfel Says," *Tax Notes Federal*, Oct. 30, 2023, p. 901.

[3] I have used the terms "promoter," "abusive," and "tax avoidance transaction" in this article to align with IRS and statutory terminology. This article does not address the merits of any specific transaction and does not take a view on any alleged promotional activity.

[4] GAO, "Abusive Tax Schemes: Additional Steps Could Further IRS Efforts to Detect and Deter Promoters," GAO-23-105843, at 11 (Dec. 2022).

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> certain international issues. These issues arise in multiple taxpayer segments, and data analysis shows a higher potential for noncompliance. *Recent resource limitations have prevented the IRS from sufficiently examining these issues*, while new issues that could significantly raise noncompliance and fraud schemes emerge each year, especially as new tax laws are enacted.[5] [Emphasis added.]

That does not tell the full story.

Longtime practitioners may recall the tax shelters of the late 1990s and early 2000s, when the IRS listed about 30 transactions. Many practitioners represented either investing taxpayers or alleged promoters in the resulting tax controversies, and to the best of my knowledge, the IRS audited 100 percent of the known inventory of participants (when the statute of limitations was open) and promoters. Fast-forward 20 years to 2018 and most of the recent enforcement efforts in this area were focused on just two transactions that the IRS had determined to be abusive: syndicated conservation easements and specific microcaptive insurance transactions.[6]

But the IRS was not auditing the full inventory of syndicated conservation easement transactions until 2019, when then-Commissioner Charles Rettig issued a directive to audit 100 percent of top-tier partnerships for tax years 2017 and 2018 with conservation easement issues.[7] And in 2020 the IRS sent letters to taxpayers who had participated in some microcaptive transactions, asking if they had stopped. The IRS explained that it would "take your actions in response to this letter into account when considering future compliance activity related to your microcaptive insurance arrangement."[8] Many practitioners construed those letters as saying, "If you just tell us that you stopped doing it, we won't audit you." In the span of 20 years the IRS went from auditing 100 percent (or close to it) of the participants in 30 transactions to struggling to audit the participants in just two.

As the IRS explained in the strategic operating plan, that was because of resource limitations. While the IRS could (and eventually did, in the case of syndicated conservation easements) audit 100 percent of the taxpayers that it believes to have participated in a purportedly abusive transaction, shifting those enforcement resources will cause the IRS to have less coverage in other important areas.

Indeed, the decline in IRS resources may have limited the number of transactions that the IRS could list in the first place, at least conceptually. In deciding whether a transaction should be listed, the IRS might consider:

- the egregiousness of the abuse;
- how easily the transaction can be replicated;
- how widespread the promotion of the transaction is;
- whether the IRS can obtain information about participants through other means (that is, data analysis on returns);
- whether there is any limit on the type of taxpayer that can participate (that is, if anyone can do it or only those with specific uncommon tax attributes); or
- the likelihood that listing the transaction may dissuade future participants.

Those all seem rather obvious, but here is another: If one were to assume that good tax administration requires the IRS to audit 100 percent of the known participants in a listed transaction, should the IRS list a transaction if it does not have the resources to audit all the participants? A "listed transaction is a transaction that is the same or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."[9]

Taxpayers must disclose their participation in a listed transaction. What then is the effect on tax

[5] IRS, Publication 3744, at 78.

[6] The IRS identified specific microcaptive transactions as transactions of interest in Notice 2016-66, 2016-47 IRB 745. The IRS has more recently proposed to list some microcaptive transactions. *See* REG-109309-22.

[7] *See* Treasury Inspector General for Tax Administration, "Opportunities Exist for the IRS to Develop a More Coordinated Approach to Examination Workplan Development and Resource Allocation," 2023-30-008, at n.18 (Feb. 8, 2023).

[8] Philip Karter, J. Scot Kirkpatrick, and Patrick McCann Jr., "IRS Letter 6336: To Respond or Not to Respond, That Is the Question," *Tax Notes Federal*, June 1, 2020, p. 1543.

[9] Reg. section 1.6011-4(b)(2).

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administration if the IRS does not audit taxpayers that have told the IRS they have done something that the IRS has concluded is a tax avoidance transaction? (Some readers may be cross with me for suggesting that the IRS should audit *anyone*. I am not. I am merely stating the self-evident fact that the IRS is going to use its enforcement resources to audit *someone*, so one could reasonably argue that the IRS should devote those resources to what it sees as the most abusive transactions. My point is, that decision must be balanced against the opportunity cost of redeploying those resources from other work.)

The IRA funding will certainly allow the IRS to hire and train more employees to audit emerging issues and promoted transactions, and the IRS has indicated in the IRA Strategic Operating Plan that it intends to do just that. Werfel has said that the IRS will use a portion of the new enforcement funds to "increase our compliance efforts on those posing the greatest risk to our nation's tax system, whether it's the wealthy looking to dodge their fair share or promoters aggressively peddling abusive tax schemes."[10] Recent structural changes within IRS, including the creation of the Office of Promoter Investigations, the Office of Fraud Enforcement, and the Joint Strategic Emerging Issues Team are, in part, intended to allow the IRS to more quickly identify and determine treatment streams for abusive transactions.

We have seen the IRS begin listing transactions again. The agency was very active from 1998 to 2004, listing about 30 transactions. Then things slowed down, with only six transactions listed between 2005 and 2017 (four transactions between 2005 and 2008, then one in 2015 and one in 2017) and then none until this year. In 2023, it has proposed listing four transactions (so far) — syndicated conservation easements, specific microcaptives, some Malta pension plans, and monetized installment sales — and a charitable remainder annuity trust transaction appears to be on deck.[11] Does the IRS have the resources to audit 100 percent of the participants? Probably, but only if it opts to reallocate enforcement resources from other important programs.

During fiscal 2022, the IRS processed more than 262.8 million tax returns and other forms. Within that number were about 161.6 million individual returns; 31.18 million employment-related tax returns; 5.6 million S corporation returns; 4.6 million partnership returns; 4.06 million estate, gift, and trust-related returns; and 2.26 million corporate returns.[12] There are, of course, also nonfilers, making the number of returns that should have been filed even larger.[13]

The vast majority of IRS revenue agents work in either the Large Business and International Division or the Small Business/Self-Employed Division. As of March 31, 2023, the IRS had 2,908 revenue agents working in LB&I and 4,227 working in in SB/SE.[14] That is 7,135 revenue agents. (Some of those are managers or have management responsibilities, so the number in the field is a few hundred less.) Redeploying even a few dozen to focus on listed or other purportedly abusive transactions comes with a significant opportunity cost, given the IRS's inventory of work.

On September 18, 2023, the IRS announced that it is looking to hire 3,700 new revenue agents. Even assuming that it is able to fill that quota in a tight labor market, those agents will take time to train. In fact, in the near term IRS audit rates will almost certainly decrease because to train the new hires the IRS will need to redeploy revenue agents who would otherwise be working cases.

The IRS could stretch its enforcement resources regarding transactions that it considers abusive by implementing various voluntary compliance initiatives.

Voluntary Compliance Initiatives

It was once routine for the IRS to offer to settle disputes regarding transactions that it found abusive. The standard offer for individuals was a

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[10] *See* IR-2023-166 (Sept. 8, 2023).

[11] Jonathan Curry, "Treasury and IRS Appear to Set Sights on 'Hoffman' CRATs," *Tax Notes Federal*, Oct. 30, 2023, p. 915.

[12] IRS 2022 Data Book, Table 2 (Apr. 14, 2023).

[13] The IRS estimates that for the 2014-2016 tax years, about 8 percent of the tax gap is attributable to nonfilers. *See* GAO, "Tax Gap" (last visited Dec. 5, 2023).

[14] TIGTA, "The IRS Needs to Leverage the Most Effective Training for Revenue Agents Examining High-Income Taxpayers," Report No. 2023-30-054, at 10 (Aug. 31, 2023).

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deduction for out-of-pocket costs and a reduced penalty in exchange for the taxpayer conceding the disputed tax benefit. The IRS made that type of offer as part of its effort to clean up what one former IRS chief counsel called the "tax shelter phenomenon of the 1970's and 1980's."[15] The IRS made the same offer for most technical transactions that evolved in the late 1990s and early 2000s.[16]

The IRS occasionally offered better terms. For example, it offered to settle the foreign leveraged investment program and offshore portfolio investment strategy, sections 302 and 318 basis-shifting transaction on terms that allowed taxpayers to keep 21.6 percent of the original tax benefit (including deemed transaction costs), with penalties to be determined based on whether the taxpayer disclosed participation under Announcement 2002-97.[17] To my knowledge, the most taxpayer-favorable offer for transactions that mostly involved individuals was for the notional principal contract transaction listed in Notice 2002-35 (often called contingent deferred swaps). That offer allowed those taxpayers to keep a portion of the intended deferral and conversion (from ordinary to capital).[18]

Corporations tended to fare better. The IRS offered to settle corporate-owned life insurance, section 351 contingent liability transactions, and lease-in, lease-out transactions on terms that allowed taxpayers to keep roughly 20 percent of the tax benefit, depending on the transaction.[19] I wonder if that is because the IRS perceived corporations to be more willing to litigate. Or perhaps it was because, around that time, two different appellate courts rejected the IRS's position in the then-listed corporate dividend-stripping transaction.[20] (An IRS listing notice or regulation reflects the IRS litigating position. It does not bind taxpayers or the courts regarding the actual tax treatment.)

The IRS obviously thought these types of settlement programs were beneficial, given that it offered resolutions for more than 20 different transactions in the early 2000s alone. The initiatives certainly helped the IRS avoid a lot of litigation. Of course, some taxpayers decided to litigate, but most settled and complied with the IRS view.

That said, the IRS could have offered better terms; some of the settlement offers did not fairly reflect the hazards of litigation involving those transactions. Sometimes taxpayers who litigated obtained much better results. For example, the IRS offered to resolve so-called son-of-BOSS transactions on terms that would require taxpayers to forgo the disputed tax benefit, get a deduction for transactional costs, and pay a penalty. That offer failed to acknowledge that some taxpayers had strong arguments that the IRS's adjustments were procedurally invalid or barred by the statute of limitations. The IRS ultimately lost the statute of limitations argument in the Supreme Court.[21] Many cases with that statute of limitations issue likely could have been settled — had the IRS appropriately considered the hazards of litigation.

However, as noted, most taxpayers decided to accept the IRS's terms, as shown by the relative scarcity of subsequent tax litigation. One thing that may have helped drive the participation rate was communication between the IRS and the tax bar. In fact, I first met former commissioner Rettig in 2002, when our two firms were part of a group that was representing taxpayers who had participated in foreign leveraged investment program transactions. The group collectively represented most taxpayers who had participated in that transaction, and we engaged with the IRS

[15] B. John Williams, "Resolving Tax Shelters: By Settlement or Litigation," remarks to Chicago Bar Association, Federal Taxation Committee (Feb. 25, 2003).

[16] In Announcement 2005-80, 2005-2 C.B. 967, the IRS announced a settlement initiative for 21 different transactions, including 16 of the 31 transactions that were listed at that time. The IRS explained in the accompanying release that the remaining 15 listed transactions were either dormant or the subject of separate settlement offers. The settlement required taxpayers to concede 100 percent of "the transaction's tax benefits," but allowed them to deduct transaction costs and provided for a reduced penalty of 5 to 20 percent, depending on the transaction.

[17] IRS, Announcement 2002-97, 2002-2 C.B. 757.

[18] 2002-1 C.B. 992. This was a "private" offer that the IRS sent to individual taxpayers. *See* Lee A. Sheppard, "IRS Settling Contingent Deferred Swap Shelters," *Tax Notes*, Mar. 6, 2006, p. 1029.

[19] *See* Rev. Proc. 2002-67, 2002-2 C.B. 733 (contingent liabilities); Announcement 2002-96, 2002-2 C.B. 756 (COLI); Lynnley Browning, "I.R.S. Offers to Settle Tax-Seller Dispute," *The New York Times*, Aug. 6, 2008 (describing private letters for LILO/SILO).

[20] *IES Industries Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); and *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001).

[21] *United States v. Home Concrete & Supply LLC*, 566 U.S. 478 (2012).

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with the hope of obtaining a global settlement offer.

I do not think the IRS would say it was negotiating with us, but we had some open conversations that gave each side insight into the other's positions — and maybe more familiarity with the facts and law. I suspect the part that mattered most to the IRS was that the group represented the vast majority of participating taxpayers, which provided a relatively easy platform for implementing a settlement. The tax bar followed the same path with several other transactions of the day. Groups formed and met with IRS leaders to exchange information and positions; the IRS eventually offered a global settlement (some better than others).

For reasons I cannot explain, those types of meetings do not seem to happen anymore. While individual taxpayers and promoters still approach the IRS, they represent only a fraction of the participant population. To the best of my knowledge, there have been no recent macro-level meetings between IRS and the tax bar regarding ways to globally resolve transactions that the IRS has determined are abusive.

That is a lost opportunity for both sides. Outside tax lawyers sometimes do not fully appreciate the IRS's positions or its limitations, and those types of meetings can sometimes help some practitioners understand their true hazards of litigation. On the other hand, IRS leaders don't always fully appreciate the strength of taxpayer cases. I would hope that, if the IRS does dust off the global settlement program, the agency and representatives would ensure they understand each other while offers are being developed. I suspect that the settlement programs of the 2000s would have had lower acceptance rates had the tax bar not been involved early on.

Considerations for Compliance Initiatives

I think that Werfel is right to be thinking about compliance initiatives for several reasons. First, there are taxpayers who participated in transactions now in the IRS's crosshairs who want to come back into compliance. The IRS should encourage that. Unfortunately, if the taxpayer is already under audit or in litigation for a transaction that the IRS perceives as abusive, the only options typically are to concede the IRS adjustment, including penalties, or litigate. Most taxpayers facing that choice will litigate (unless the cost of litigation makes that uneconomic), even if they want to get right with the IRS.

Second, the IRS does not have the resources for auditing and litigating with the entire universe of participants in abusive transactions. Settlement programs can allow the IRS to resolve some, most, or all (depending on the terms) of the cases involving a specific transaction without having to audit or litigate the issue with all participating taxpayers. The IRS can then redeploy those resources toward another compliance need. Indeed, in decades past the IRS has announced settlement initiatives before even litigating a single case.[22]

Third, settlement initiatives can be structured to leverage taxpayer resources by requiring them to amend returns or to provide information to the IRS, for example.

Fourth, the IRS would likely collect more tax dollars by using settlement initiatives as a resolution tool. Litigation can be time-consuming, and the longer it takes, the less certain payment becomes. Often the IRS will collect less, even when it prevails completely, than if it had resolved the matter early when the taxpayer was still well funded. Moreover, the IRS can (and frequently has) mandated full payment (or agreed-on collection terms) as part of the settlement terms.

That brings me to terms: There are usually only a few variables to consider: (1) who is eligible, (2) whether the taxpayer will be allowed some portion of the tax benefit at issue, (3) whether the taxpayer will be allowed some other tax savings (usually a deduction for costs), (4) whether the taxpayer will suffer a penalty, and if so at what rate (past global settlements have always featured a reduction of possible penalties), and (5) how the settlement amount will be paid (that is, whether the IRS will allow for payment terms). A related factor that might influence the structure is the expected effect on IRS resources. The same resource constraints discussed earlier would almost certainly cause the IRS to resist

[22] *See e.g.*, Announcement 2002-97, *supra* note 17.

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settlement structures that would require significant resources to implement.

Historically, the most important factor in setting terms has been the hazards of litigation. For example, the IRS offered to settle tens of thousands of cases in the 1980s involving things like horse breeding or cattle raising. The problem was that there weren't any horses or cattle, or at least not enough for all the transactions. So one could reasonably argue that the IRS global settlement offer that would disallow the disputed deductions but allow taxpayers to deduct their costs and pay reduced penalties fairly reflected the hazards of litigation. That still left almost 90,000 cases in Tax Court.[23]

I have heard many practitioners argue that the IRS could easily resolve most cases involving today's transactions if it simply offered enough to make the taxpayers whole. That may be true. One would think that the IRS could have settled many more of the horse breeding and cattle cases if it had allowed taxpayers to keep enough of the tax benefit to at least make those taxpayers economically whole.

So why didn't the IRS do that? I wasn't at the IRS then, but I have worked there more recently, and based on that experience I suspect that the IRS would be concerned that sweetening the settlement simply to increase the acceptance rate would set a dangerous precedent that could lead to future tax shelter activity. I suspect that the IRS would be concerned that future promoters would, in the transactions of tomorrow, point to any such resolution as the worst-case scenario to future potential participants. I am not taking a position here, but practitioners seeking to settle transactions that the IRS has determined are abusive should understand the IRS's concerns and be prepared to address them.

The eligibility factor also bears special mention. The IRS is wary of rewarding what it regards as the bad actors should they somehow participate in the transaction. The IRS may also be wary of settling with taxpayers who were advised by those who the IRS perceives as bad actors, if those bad actors are candidates for referral to the Criminal Investigation division. I do not agree with that philosophy, because whatever damage a settlement with a taxpayer could cause to a criminal promoter case would only seem magnified once the taxpayer is in civil tax litigation. The IRS does not have the ability to unilaterally stay those cases.

One final factor that deserves discussion is IRS credibility. The IRS does not usually modify settlement terms to make them more taxpayer-friendly unless there is a change in law. The IRS does not want to create the perception that the deal might get better if taxpayers wait it out. So settlement terms usually get worse as time marches on (unless something changes on the legal front, such as the IRS loses a court case).

Taxpayer evaluations of IRS settlement offers are usually more straightforward. In general, they will consider the likelihood of the IRS opening an audit (if it has not already) and assessing tax before the statute of limitations expires. If that seems likely, the taxpayer might then consider whether the offer fairly reflects the merits and hazards of the situation, ability to pay, interest rates, lost investment opportunities, litigation costs, and personal costs (such as stress and time).

Future Compliance Initiatives

Communication is arguably the IRS's most important tool in battling abusive transactions. Most taxpayers try to minimize their audit risk. The IRS's publicizing its views about a specific transaction on its "Dirty Dozen" list or a targeted release will almost certainly dissuade some taxpayers from engaging in that transaction, reducing the number of transactions the IRS might have to address through other means. The question, though, is what to do about taxpayers who have already entered into and reported that transaction.

I believe the IRS should give those taxpayers an early, limited opportunity to resolve the transaction on whatever terms fairly reflect the hazards of litigation. The IRS might even opt to act more generously than the hazards might suggest, given the potential resource savings. In the more egregious cases that might mean allowing the taxpayer to unwind the transaction, without penalty, and allow a deduction for any costs.

[23] Williams, *supra* note 15, at 4.

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In cases with more merit, the IRS offer should allow taxpayers to keep an appropriate portion of the disputed tax benefit. The IRS could exclude some categories of taxpayers, such as those who have docketed cases or those who might be referred to CI. The IRS could also require participating taxpayers to amend their tax returns and make full payment (or enter satisfactory payment terms), which would conserve IRS resources. The point here is to give taxpayers who may have misgivings about tax positions they have taken — once they see those transactions on the IRS website — at least one opportunity to get out using their own resources. That would provide the certain relief that many taxpayers crave and conserve IRS resources.

Some might argue that that type of program could encourage something like an audit lottery, theorizing that a taxpayer might be more willing to engage in an aggressive transaction if he thought he would have time to unwind it without penalty, should the IRS take an interest. But that policy is already established in the qualified amended return (QAR) provisions, which allow taxpayers to amend their tax returns to avoid most penalties — if the amendment is done before the IRS makes specific contacts.[24] Unfortunately, taxpayers often don't know whether those contacts have been made, which undermines the utility of a QAR. And, frankly, most taxpayers have never heard of a QAR. Settlement initiatives, on the other hand, are usually widely communicated, have well-defined eligibility criteria, and can be offered to taxpayers who would not be eligible to file QARs because of disqualifying IRS contacts.

Of course, some taxpayers may opt to litigate. That would be the rational choice when the all-in expected return of litigating is greater than the IRS offer. A taxpayer's expected return from having engaged in a specific transaction — and thus her incentive to settle — will change, however, depending on early litigation results, after which the IRS could make subsequent offers. If taxpayers prevail, the IRS would obviously have to improve the offer. If the IRS prevails, it would have the option of making the offer less favorable (likely depending on the calibration of a first offer), but early wins would likely change taxpayer incentives.

Conclusion

Werfel is right to be thinking about voluntary compliance initiatives. I hope that the IRS and the tax bar find a way work to together on those initiatives. The issues I have identified here are important to the IRS and taxpayers and should help guide conversations on how to implement successful initiatives. ■

[24] *See* reg. section 1.6664-2(c)(2).

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