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Promoter Penalties and the Full-Payment Rule: FLIP, OPIS, and BLIPS Revisited

By Donald P. Board • Wood LLP

They say that hard cases make bad law. Judges are only human, after all, so they can be tempted to set questionable precedents to avoid inflicting "hard" (*i.e.*, harsh) results on sympathetic litigants. On the flip side, cases that arouse judges' moral indignation can make some pretty bad law, too.

That elusive quality known as "judicial temperament" is supposed to keep both of these tendencies in check. With prosecutors, however, the situation is more complicated. The nature of the job requires them to switch back and forth among *multiple* professional personae, each of which may have its own ideal temperament.

At the most fundamental level, we count on prosecutors to wield society's terrible—though not terribly swift—sword against every species of domestic malefactor. To do so, prosecutors must engage wrongdoers and their counsel in the adversarial process. This demands, or at least rewards, a partisan, martial spirit.

Yet we demand more than ferocity from our champions. Even the toughest D.A. is supposed to exercise quiet, mature, and disinterested judgment before deciding to lower the boom. Prosecutors must be able to curb their—and our—avenging enthusiasm.

KPMG Chronicles

Modulating prosecutorial passion is not always easy. Consider the Department of Justice's controversial pursuit of KPMG and its confederates for their roles in the tax-shelter scandals of the early 2000s.

In 2005, the DOJ filed the largest criminal tax *ever* against KPMG and 17 individuals for conspiring to defraud the United States of at least $2.5 billion in tax revenues. KPMG promptly entered into a deferred prosecution agreement, in which it acknowledged the criminal wrongdoing and promised to clean up its act. The DPA also required KPMG to pay $456 million in fines, criminal restitution, and civil tax penalties.

That was a hefty hit, to be sure—about $300,000 per partner. Prosecuting KPMG, on the other hand, would have propelled the firm over the same cliff that had claimed Arthur Andersen a few years before. This time, calmer heads prevailed at the DOJ. (One suspects, however, that the decision to spare KPMG frustrated the working prosecutors who had documented the firm's crimes.)

The DOJ had no such reservations about prosecuting the *individuals* who had been at the center of the shelter scandal. The most prominent defendant was KPMG's deputy chairman, Jeffrey Stein, a lawyer, who had been a leader of the firm's lucrative tax practice. Probably the most egregious was another lawyer, John Larson, a KPMG tax alumnus who has founded an advisory firm that may have earned $200 million pedaling the FLIP, OPIS and BLIPS shelters.

A criminal prosecution is not a dinner party, but there are limits. The DOJ discovered this the hard way, after word got out that the government had not-so-gently persuaded KPMG to stop paying the defendants' legal fees. Judge Kaplan, who was no softy when it came to shelters, felt he had no choice but to dismiss the indictments against 13 of the defendants, including Mr. Stein, on the ground of prosecutorial misconduct. [*See J. Stein*, 495 FSupp 390 (SDNY 2007); *aff'd*, CA-2, 541 F3d 130.]

The DOJ's excessive zeal left only four defendants to go to trial. In December 2008, a jury convicted three of them of tax evasion. This included Mr. Larson, who was sentenced to 10 years in prison and fined $6 million. Judge Kaplan said he wanted to send a message "that will say to other quick-buck artists, 'not so fast.'"

$61-Million Day in Court?

But the IRS was not done with Mr. Larson. In 2011, it slapped him with a $160-million penalty for failing to register several KPMG shelters as required by Code Sec. 6111(a). The IRS Appeals Office upheld the penalty on the merits. But it trimmed the *amount* of the assessment to a mere $61 million to reflect payments by Mr. Larson's fellow promoters.

Mr. Larson contended that the penalty was still about $54 million too high. This would have been a good time to file a petition with the Tax Court and let a judge decide. Unfortunately for Mr. Larson, his penalty did not involve a *deficiency*, so the Tax Court lacked subject-matter jurisdiction under Code Sec. 6213(a). [*See, e.g., S.G. Smith*, 133 TC 424, Dec. 58,028 (2009).]

In 2015, Mr. Larson sent the IRS a check for $1.4 million, along with a Form 843 seeking a refund and abatement of the penalty. The IRS denied Mr. Larson's claim, so he filed suit in the Southern District of New York. The DOJ then moved to dismiss on the ground that the District Court didn't have subject-matter jurisdiction, either.

The government relied on *W.W. Flora* [SCt, 60-1 USTC ¶9347, 357 US 63, 80 SCt 630, *on reh'g*, SCt, 60-1 USTC ¶9347, 362 US 145, 80 SCt 630 (1960)], in which the Supreme Court held that the United States' waiver of sovereign immunity in internal-revenue cases does not

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apply unless the plaintiff has paid the contested assessment *in full*. The DOJ pointed out that Mr. Larson had not paid anything close to $61 million, so the District Court lacked jurisdiction to hear the case under 28 USC §1346(a)(1).

Mr. Larson said he couldn't pay the full assessment, and that applying the full-payment rule would deny him his day in court (outside of bankruptcy, at least). District Judge Caproni expressed sympathy for Mr. Larson's "circumstances"—as opposed, presumably, to Mr. Larson himself. But she held firm and dismissed the suit. [*See J.M. Larson*, 118 AFTR 2d 2016-7004 (SDNY 2016).]

On April 25, 2018, the Second Circuit affirmed [CA-2, 888 F3d 578]. In an odd twist, Harvard Law School's low-income tax clinic had filed an *amicus* brief supporting Mr. Larson's challenge to the full-payment rule. The Second Circuit was unpersuaded, although it found it "troubling" that a taxpayer could be denied judicial review of a penalty that exceeded his ability to pay. Still, it was up to Congress to address any hardship under *Flora*.

How We Got to Now

To put Mr. Larson and his penalties in perspective, we should review the proliferation of big-ticket tax shelters during the period 1995–2003. This extraordinary episode marked a low point in the history of the professions that have been entrusted with the day-to-day operation of the U.S. tax system. The tax-shelter scandal would repay tax practitioners' study even if Mr. Larson were not in the news.

Classical (*i.e.*, pre-1986) tax shelters were generally designed to permit dentists, lawyers, and other self-employed persons to *defer* paying tax on a portion of their compensation. The shelters that emerged in the effervescent 1990s, in contrast, were directed at business owners who had realized massive capital gains from stock sales or other liquidity events. The new-wave shelters' most striking feature was that they were supposed to *eliminate* the relevant tax, not just defer it.

We will be focusing on KPMG, which led the industry with its promotion of FLIP, OPIS, BLIPS, SC2, and other shelters. But KPMG was certainly not alone. A number of leading accounting firms, abetted by prominent law firms, were up to their necks in shelters. The enormous, easy fees these transactions generated—a percentage of the tax avoided—were just too good to pass up.

PricewaterhouseCoopers, for example, marketed the BOSS shelter until the IRS closed it down in Notice 99-59. PwC also promoted its own version of FLIP, which two ex-KPMG partners had brought to the firm. Ernst & Young made its mark with the COBRA shelter.

All this promoting was done on the down low. Prospective customers were forbidden to disclose these "strategies," even to their own tax advisers. Teams making pitches were instructed to write only on a white board and *never* to leave documents with customers.

The accounting firms created special task forces to develop new schemes, or at last repackage and conceal old ones. KPMG's "Skunk Works" was the best documented, thanks to a Congressional study that published hundreds of in-house emails. [*See* U.S. Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, *U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals* (released on November 18 and 20, 2003).]

While the brainiacs were concocting shelters, their firms were developing what KPMG called an "aggressive sales culture." They recruited experienced sales forces that were paid on commission. BDO Seidman called its group the "Wolf Pack." The firm's internal slogan—"Tax ell!"—speaks for itself.

What the FLIP?!

Most tax shelters were formidably complex. Sometimes this was inevitable, because the strategy required a baroque series of transactions in which two unrelated tax provisions were made to interact in a surprising way. Like Frankenstein's monster, these shelters were stitched together from disparate parts and had to be shocked into lumbering life.

In other cases, the tax strategy was relatively straightforward. But the promoters added layers of complexity (*e.g.*, esoteric "trading strategies") to help disguise what was going on. The bells and whistles also supplied a veneer of profit-oriented activity, even if the customer's motive was 99 percent tax avoidance.

One of KPMG's simpler shelters was FLIP—the "Foreign Leveraged Investment Program." Suppose that Taxpayer was one of the new crop of tech entrepreneurs who had suddenly hit it big. Having sold his company for a $100 million capital gain, Taxpayer now faced $20 million in federal tax.

Tipped off by referrals (for which fees were paid) or its own research, KPMG would reach out to Taxpayer with an amazing but *highly* confidential offer. For seven percent of the tax avoided—just $1,400,000—KPMG and its business partners would make that $20 million liability disappear.

Doing the Cayman Six-Step

The first step in a FLIP transaction was for the promoters to set up a shell corporation in the tax-free Cayman Islands. The new corporation (CaymanCo) would then issue Taxpayer a warrant to purchase 85 percent of its stock. Under Code Sec. 318(a)(4), the holder of an option is deemed to own the optioned shares, so Taxpayer would be treated as owning 85 percent of CaymanCo's equity.

CaymanCo's deemed equity would trigger two more share-attribution rules. Under Code Sec. 318(a)(2)(C), 85 percent of any stock that CaymanCo might hold from time to time would be imputed to Taxpayer. Conversely, any stock held by Taxpayer would be imputed to CaymanCo pursuant to Code Sec. 318(a)(3)(C).

The second step was for Friendly Foreign Bank (FFB) to lend CaymanCo $100 million to purchase (say) 500,000 shares of FFB treasury stock. The loan would be non-recourse and secured by a pledge of the shares. Meanwhile, as step three, Taxpayer would buy a small interest in FFB (*e.g.*, 100 shares).

Step four came two months later, when FFB would redeem the 500,000 shares. CaymanCo would use the redemption proceeds to repay the outstanding loan. Considered on their own, the loan, sale and related repurchase of the 500,000 FFB shares would have accomplished very little.

But there was fifth, critical step. Even as CaymanCo was selling its shares, *Taxpayer* would be purchasing options to acquire an equivalent number of FFB shares for himself. Under the attribution rules described above, (1) Taxpayer would be treated as owning the 500,000 FFB shares covered by his options, and (2) these 500,000 "new" shares would be attributed *to CaymanCo*.

KPMG therefore contended that redemption of the 500,000 shares CaymanCo *actually* owned would result in no net reduction in its ownership of FFB for U.S. tax purposes. The redemption would be treated as a dividend, as opposed to an exchange described in Code Sec. 302(a). Hence, the U.S. tax system would conclude that CaymanCo hadn't recovered any of its $100 million basis in the shares redeemed.

Reg. §1.302-2(c) addresses this kind of orphaned-basis problem by allowing a "proper adjustment" of the basis of any remaining stock. CaymanCo, however, would no longer own any actual FFB shares whose basis could be adjusted. That would leave Taxpayer, to whom the redeemed shares had been attributed under Code Sec. 318(a)(2)(C), as the logical beneficiary of the basis adjustment.

This is when the magic happened. Under KPMG's analysis, CaymanCo's basis in the 500,000 shares of FFB would be added to the Taxpayer's basis in the 100 shares he actually owned. Taxpayer would now have a basis of more than $100 million in a block of shares that he had purchased for $20,000.

The sixth and final step was for Taxpayer to sell his 100 actual shares and report a $100 million capital loss. That would neatly offset the $100 million capital gain that had brought Taxpayer to KPMG's attention in the first place. Taxpayer's $20-million tax liability would have vanished in the soft Caribbean breeze.

Notice 2001-45

KPMG, joined by the venerable Brown & Wood LLP, regularly opined that the capital losses generated in FLIP transactions were "more likely than not" to be upheld. The IRS reached a different conclusion in Notice 2001-45 (July 27, 2001), which identified FLIP, OPIS, and similar "basis-shifting tax shelters" as listed transactions. The IRS announced that it would challenge the claimed losses, and it reminded promoters that they might need to register these shelters under Code Sec. 6111.

Reg. §1.302-2(c) permits a "proper adjustment" to conserve stock basis when a redemption is treated as a dividend, but the IRS contended that an adjustment under these

circumstances was anything but proper. The basis shift depended on treating the complete redemption of CaymanCo as a dividend. But the technical arguments for dividend treatment were built on a series of transitory steps that had no purpose beyond tax avoidance.

Although KPMG had sold hundreds of basis-shifting transactions, there was no tidal wave of litigation following Notice 2001-45. In 2002, the IRS announced a settlement initiative for participants in the FLIP and OPIS shelters. Taxpayers had to give up 80 percent of their shelter losses and transaction costs, with no waiver of penalties.

By late 2005, the IRS had identified 488 transactions involving the FLIP/OPIS tax strategy. In 92 percent of these cases, the taxpayer *accepted* the government's settlement offer. This was not exactly a vote of confidence in a tax position that KPMG and Brown & Wood had concluded was "more likely than not" to be sustained.

The taxpayers who refused to settle have generated a modest caselaw regarding the validity of the basis-shifting shelters. The courts have confirmed that these transactions do not work, and taxpayers have been subjected to penalties. The economic substance doctrine—which Notice 2001-45 did not mention by name—has done the heavy lifting. [*See J.P. Reddam*, CA-9, 2014-1 USTC ¶50,322, 755 F3d 1051; *S.A. Blum*, 2014-1 USTC ¶50,107, 737 F3d 1303 (2013).]

Calculation in the Skunk Works

Some of KPMG's email traffic seems almost calculated to arouse the indignation of Congress, the IRS, the DOJ, and the courts. When sales of the FLIP transaction started to take off, some of KPMG's more scrupulous tax managers began to wonder whether the firm needed to register FLIP as a shelter in accordance with Code Sec. 6111. This led to an internal debate.

The head of KPMG's Department of Professional Practice, the firm's voice of conscience, decided that it was not necessary to register FLIP. He hedged, however, by ordering that further sales of the shelter be halted. This set off to a rush to develop a replacement product that would exploit the same tax provisions in a more convincing manner.

The newly minted gain-elimination "solution" was OPIS, the Offshore Portfolio Investment Strategy. OPIS was supposed to be different enough from FLIP that KPMG could have registered OPIS without implicitly admitting that FLIP should have been registered as well. This turned out to be moot, because KPMG decided not to register OPIS, either.

KPMG gave the matter considerable thought. Two recent hires from the IRS were instructed to get in touch with their former colleagues to ask whether the Service was doing much to follow up on shelter registrations. The answer was no—in part because the IRS did not have the capacity to match shelter registrations with partnership returns.

The practical risks of registration may have been small, but Gregg Ritchie, a senior KPMG tax partner, still opposed disclosure. Mr. Ritchie, who was later indicted, wrote to Mr. Stein that "the rewards of a successful marketing of the OPIS product (and the competitive disadvantages which may result from registration) far exceed the financial exposure to penalties that may arise." He backed this up with a dollars-and-cents analysis:

> [F]inancial exposure to the firm is minimal: Based upon our analysis of the applicable penalty sections, we conclude that the penalties would be no greater than $14,000 per $100,000 in KPMG fees. Furthermore, as the size of the deal increases, our exposure to the penalties decreases as a percentage of our fees. For example, our average [OPIS] deal would result in KPMG fees of $360,000 with a maximum penalty exposure of only $31,000.

Mr. Ritchie's cost–benefit approach to legal compliance carried the day. The head of the Department of Professional Practice had concluded that KPMG needed to register OPIS, but he was overruled. Once again, the scent of easy cash proved irresistible.

Making of a Tax Opinion

The most notorious KPMG emails involved BLIPS ("Bond Linked Investment Premium Structure"), a contingent-liability shelter that went on to set revenue records for the firm. BLIPS was the subject of months of internal discussion before KPMG started promoting it in 1999. The issue was not registration, but

whether KPMG could get to "more likely than not" in its tax opinion.

A key issue was whether BLIPS could reasonably be expected to produce a profit aside from tax benefits. The question was made more difficult by the fact that BLIPS had been developed outside KPMG. The strategy was brought to KPMG by Presidio Advisors, the advisory firm that John Larson had founded with Robert Pfaff after they left KPMG a few years before.

Presidio employed a financial wizard to craft the non-tax economics of the transaction. In a meeting with KPMG, Mr. Wizard suffered from a sudden moment of candor in which he described BLIPS' profit potential as "pie in the sky." Mr. Larson quickly hustled the wizard out of the meeting, presumably to wash his mouth out with soap.

Some of the more skeptical KPMP tax professionals figured that this indiscretion had killed BLIPS. By this point, however, the shelter had acquired too much institutional momentum to stop. Senior managers at KPMG decided that the firm could opine based on representations about profit potential that KPMG would draft and Presidio and the customer would be required to sign.

The only point of the representations was to protect KPMG. Philip Wiesner, a lawyer and the head of KPMG's National Tax Office (later indicted), circulated an email in which he concluded that it was now time to stop debating BLIPS and start marketing the shelter:

> I do believe the time has come to **** [or] get off the pot. The business decisions to me are primarily two: (1) Have we drafted the opinion with the appropriate limiting bells and whistles . . . and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit.

Mr. Stein's response to Mr. Wiesner could not have been clearer: "I vote ****." With that, the matter was settled. KPMG and Presidio went on to earn more than $200 million from the BLIPS shelter.

Things Fall Apart

Messrs. Stein, Ritchie and Wiesner were indicted in 2005, but they were among the 13 defendants whose cases were dismissed on account of prosecutorial misconduct. Messrs. Larson and Pfaff (Presidio) were not so lucky. Neither was R.J. Ruble, a tax partner at Brown & Wood who had collected $23 million by writing hundreds of opinions endorsing KPMG shelters.

Messrs. Larson, Pfaff, and Ruble were convicted of tax evasion, although the jury inexplicably acquitted them on the conspiracy counts. As noted above, Mr. Larson was sentenced to 10 years in prison. Mr. Pfaff was sentenced to eight years, while Mr. Ruble, the last of the "quick-buck artists," got six.

Judge Kaplan enhanced Mr. Larson's sentence in response to his "brazen act" of transferring millions of dollars to various Guernsey trusts, beyond the reach of the U.S. government. The DOJ says Mr. Larsen continues to have interests in overseas trusts. Could this have contributed to his (alleged) inability to pay the IRS's $61-million assessment?

Penalties for Failure to Register

In 2011, the IRS cited Mr. Larson for failing to register FLIP/OPIS (which it treated as a single shelter) and BLIPS as required by Code Sec. 6111(a). The amount of the penalty was calculated under Code Sec. 6707(a)(2). During the years in question (1997–2000), the statutory penalty was the greater of $500 and "1 percent of the aggregate amount invested in such tax shelter."

The IRS's $160-million assessment implies that *$16 billion* was invested in the KPMG shelters. Mr. Larson contended that the penalty should only have been $7 million, which would imply an aggregate investment of only $700 million. That's a big number, but it's still less than five percent of the government's figure.

This difference of opinion reflects a disagreement about what it means to "invest in a tax shelter." Based on the numbers, it appears that Mr. Larson believes that the "amount invested" is what the taxpayer and the promoter would view as the "price" or "cost" of participating in the shelter. In other words, the promoter's fees and the transaction costs that the taxpayer

actually had to pay to get in on the tax-saving action.

Mr. Larson thinks that the participants in the KPMG shelters laid out a total of $700 million to purchase their capital losses—and he would be in a good position to know. The government's figure ($16 billion) plainly goes beyond the taxpayers' out-of-pocket expenses. Notably, however, it is in the same ballpark as the aggregate amount of *losses* that taxpayers claimed under the FLIP, OPIS, and BLIPS shelters.

A shelter penalty determined as a percentage of the phony losses generated would make intuitive sense. However, the IRS's figure was actually calculated pursuant to Chief Counsel Advice 200112003. In the CCA, the IRS determined that the "amount invested" for purposes of Code Sec. 6707(a)(2) meant the amount of funds that flowed (or purportedly flowed) through *the shelter itself*.

According to the CCA, this methodology was mandated by the "plain language of the statute." The IRS acknowledged that the resulting figure "may have very little relation to amounts received by the party to the penalty." But the law is the law.

In 2004, Congress overhauled Code Sec. 6707. The provision now penalizes failures to disclose reportable and listed transactions as defined in Code Sec. 6707A. Failing to disclose a merely *reportable* transaction triggers a modest $50,000 penalty [Code Sec. 6707(b)(1)]. The penalty for failing to disclose a *listed* transaction is the greater of $200,000 and 50 percent of the gross income that the promoter derives from aiding, assisting, or advising with respect to the transaction. If the failure is intentional, this jumps to 75 percent. [Code Sec. 6707(b)(2).]

Linking the penalty to the financial benefit derived by the promoter is sensible from the standpoint of deterrence. Only the IRS knows how much Mr. Larson took home from Presidio, but suppose that his share came to $80 million on a pre-tax basis. A 75-percent penalty for intentional failure to register a pair of listed transactions would pack a $60-million wallop.

Paths Around *Flora*?

Mr. Larson advanced several arguments to avoid the full-payment rule. Even *Flora* recognized an exception for "divisible" assessments. If a single assessment is merely the sum of several independent assessments triggered by separate transactions, the taxpayer may pay the portion of the assessment attributable to *one* transaction and sue for a refund relating to that transaction.

As a practical matter, that may provide judicial review of the entire assessment. The classic example is an assessment of payroll taxes involving multiple employees. The employer may be able to get effective review by paying the tax attributable to a single employee.

In the District Court, Mr. Larson contended that he was entitled to divide the $61-million assessment on a transaction-by-transaction basis. This failed because the "transaction" that triggers a penalty under Code Sec. 6111(a) is simply the failure to *register* a shelter (which happens only once), not the *use* of the shelter on multiple occasions. Mr. Larson dropped this issue on appeal.

Mr. Larson also argued for limiting the full-payment rule to cases in which the taxpayer has had an opportunity to contest the assessment in the Tax Court. He cited the following passage from Chief Justice Warren's opinion in *Flora*:

> A word should also be said about the argument that requiring taxpayers to pay the full assessments before bringing suits will subject some of them to great hardship. This contention seems to ignore entirely the right of the taxpayer to appeal the deficiency to the Tax Court without paying a cent. [362 U.S. at 175.]

According to Mr. Larson, this establishes that the full-payment rule applies only in deficiency cases. The Second Circuit, however, held that *Flora* was decided based on the language and history of 28 USC §1346(a)(1), so Chief Justice Warren's observation concerning the fairness of the result was no more than *dictum*.

Mr. Larson also argued that the IRS's assessment violated the Eighth Amendment as an "excessive fine." In his view, the penalty under Code Sec. 6707 was grossly disproportionate to the gravity of the alleged misconduct. In his brief to the Second Circuit, he said he was guilty of nothing more than "the mere failure to file two forms."

Of course, if those forms had been filed, the IRS could have investigated the KPMG shelters—which is the point of the registration requirement, after all. Investigation might have averted the United States' loss of $2.5 billion in tax revenues. Given the titanic scale of the theft, Mr. Larson's penalty hardly seems excessive.

What Next?

These days, nobody loses a high-profile case in a Circuit Court of Appeals without filing a petition for *certiorari*. Mr. Larson's counsel may go through the motions, but it is hard to see the Supreme Court taking much interest in revisiting *Flora*. At this point, the Court is likely to view hardship under *Flora* as a problem for Congress to deal with.

Despite the Second Circuit's ruling, this is not the end of the line for Mr. Larson. The IRS's assessment related to his failure to register *two* independent shelters (FLIP/OPIS and BLIPS). Although Mr. Larson was not permitted to divide the assessment on a transaction-by-transaction basis, why not divide it *shelter by shelter*?

The IRS says Mr. Larson owes only $1.4 million on the FLIP/OPIS penalty. Hence, he should be able to pay the $1.4 million and sue for a refund. This will give him an opportunity to contest the methodology the IRS used to compute *both* the FLIP/OPIS and the BLIPS penalties.

Alternatively, Mr. Larson can simply file an individual Chapter 11 bankruptcy petition. If there's a problem with the way the penalties were calculated under old Code Sec. 6707(a)(2), he should be able to get them reviewed under 11 USC §505(a). [*See In re Canada*, 117 AFTR 2d 2016-2038 (Bkcy N.D. Tex. 2016); *aff'd*, 119 AFTR 2d 2017-1752 (N.D. Tex. 2017) (overturning shelter-promoter penalty).]

Given these alternatives, the Second Circuit's decision to follow *Flora* to the letter may not be much more than an inconvenience for Mr. Larson. Even if he were a more sympathetic litigant, the result for Mr. Larson would not seem like a particularly hard one.

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