

## ARE THE PRINCIPLES OF REV. PROC. 64-22 BEING FOLLOWED TODAY?

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In Rev. Proc. 64-22<sup>1</sup> (the Rev. Proc.), then Commissioner Mortimer Caplin set forth some of the principles involved in administering the Internal Revenue Service (Service). In five short paragraphs he succinctly laid out some valid administrative guidelines. Whether the Treasury, the Congress, or even the Internal Revenue Service have paid proper attention to them since that time is open to debate.

Of course, just as beauty is in the eyes of the beholder, many broad statements of principle are open to interpretation, perhaps in a manner that justifies the positions being taken in recent years. Thus, the former Chief Counsel for the Service Restructuring Commission stated that the Rev. Proc. summed up the Commission's attitude as to how the Service should operate. He indicated that the Commission wanted the Service to follow the principles and shift from an emphasis on enforcement to one on taxpayer service. Perhaps one can read the Rev. Proc. as having an overarching emphasis on service. On the other hand, it addresses administration of the Internal Revenue Code (Code) and states that the Service should raise meritorious issues and should be relentless in its attack on unreal tax devices and fraud.

However, the legislation growing out of the Restructuring Commission's work created a train wreck. The 1998 Internal Revenue Restructuring and Reform Act forbade the Service from keeping enforcement statistics.<sup>2</sup> It then turned around and listed ten deadly

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<sup>1</sup> Rev. Proc. 64-22, 1964-1 C.B. 689.

<sup>2</sup> See STAFF OF THE J. COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1998, at 47-48 (Comm. Print 1998). (hereinafter 1998 GENERAL EXPLANATION) ("The Congress intends that in no event will performance measures be used which rank employees or groups of employees based solely on enforcement results, establish dollar goals for assessments or collections, or otherwise

sins which, if committed by a Service agent, would result in his or her automatic firing.<sup>3</sup> Agents for the Service quickly recognized that if they did nothing there would be no statistical reckoning, while if they did anything they might be fired. The result was that compliance came to a grinding halt. It took a meeting of Internal Revenue Service managers in Chicago and a joint release to all Service personnel by both the Commissioner and the National Treasury Employees Union to once again grease the wheels of tax administration. The joint release may have been unprecedented, but the danger to the tax system had the Service ceased to function as the tax collector was enormous.

One of the side effects of the compliance stoppage was that no substantive tax cases went to Appeals. As a result, senior Appeals Officers were working only collection due process and innocent spouse cases, causing many of them to look to see when they could retire. When the then National Chief of Appeals, Dave Robison, was asked why he was allowing his senior Appeals Officers to work those type of cases, he replied that these were the only type of cases that were in the Appeals inventory. Thus, in enacting the 1998 Reform and Restructuring Act, the Congress ignored the fact that the long-time principles set forth in the Rev. Proc. called for a balancing of service and enforcement, but made the need for enforcement clear.

The principles set out in Rev. Proc. 64-22 still make a lot of sense and also can be used as a gauge of some of the present-day actions of the Service. The Rev. Proc. makes it clear that the Service is to administer the Code and leave tax policy issues to the Congress. For the most part the Service has followed that guidance. Often it does this despite strong criticism, even from the members of Congress who enacted the provision they do not like having enforced against their constituents. From time to time, however, the Service has strayed in an effort to increase its tools in combating revenue leakage. The partnership anti-abuse rule<sup>4</sup> may be an example. While no one can doubt that the partnership form can be, and has been, used to thwart provisions of the Code, it would have been much better for the Service to be specific in setting out the factual instances in which it felt that was the case rather than a broad-side blast to be used at almost every turn. Initially, the Service did not allow this anti-abuse provision

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undermine fair treatment of taxpayers.”).

<sup>3</sup> See 1998 GENERAL EXPLANATION, at 49 (listing violations for which Service employees may be terminated).

<sup>4</sup> Treas. Reg. § 1.702-2 (1994).

to be utilized without prior clearance. However, this quickly changed and many practitioners saw the partnership anti-abuse rule raised in almost every audit.<sup>5</sup>

The partnership anti-abuse rule grew out of the Service's anathema to tax shelters. Commissioner Caplin's admonition for the Service to be relentless in the attack on unreal tax devices has certainly been followed in the tax-shelter arena.<sup>6</sup> A particularly interesting example of this was the Service and Treasury's release of Treas. Temp. Reg. section 1.752-6, which took the position that the contingent obligation to cover an option or a short sale was a liability for section 752 purposes and, consequently, had to be taken into account in determining the outside bases in the partnership.<sup>7</sup> The difficulty faced by the Service was the fact that it had won a case in which it persuaded the Tax Court to hold that an obligation to cover an option was not a liability because it was totally contingent.<sup>8</sup> In the internal discussions concerning this regulation, the Service noted that the regulation was contrary to this case and seemed to recognize that the regulation was carving new ground. The strangest aspect of this regulation, however, is that it was solely retroactive. Asserting an effective date almost four years prior to the promulgation of the regulation, the Service also proposed a different regulation for future treatment of the obligation to cover an option or a short sale.<sup>9</sup>

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<sup>5</sup> *IRS Revises LMSB Directive on Foreign Tax Credit Generators* 2009 TNT 34-14 (Feb. 24, 2009).

<sup>6</sup> *See Nine Tax Professionals Indicted; KPMG Admits Shelters Were Fraudulent* 2005 TNT 167-1 (Aug. 30, 2005); *Four Ernst & Young Partners Indicted For Tax Fraud* 2007 TNT 105-12 (May 31, 2007).

<sup>7</sup> This regulation was an attempt to provide additional authority for the Service's attack on so called "Son of Boss" tax shelters. Those shelters depended upon the transfer of long and short matching options to a partnership with the short option being ignored for partnership basis determination while the cash received for the long option was treated as increasing that basis. The retroactive application of the regulation was rejected by the District Court in *Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006).

<sup>8</sup> *Helmer v. Commissioner*, 34 T.C.M. (CCH) 727 (1975).

<sup>9</sup> Prop. Treas. Reg. § 1.752-7 (2003). Indeed the courts have had fun with this provision. Some recent court decisions have refused to apply the regulation retroactively in view of Code section 7805(b)'s limitation on retroactive regulations. *See Murfam Farms, LLC v. United States*, 2009 TNT 146-84 (Ct. Cl. July 30, 2009); *Klamath, supra* note 7; *Sala v. U. S.*, 552 F. Supp. 2d 1167 (D. Colo. 2008); *Stobie Creek Investments v. U. S.* 82 Fed. Cl. 636 (2008). Others have not been bothered by this. *See Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008) and *Maguire Partners-Master Invs., LLC v. U. S.*, 2009 WL 279100 (C.D. Cal. Feb 4, 2009).

The first court to consider this regulation held that it was inapplicable to the taxpayers who had entered into their transaction far before the regulation.<sup>10</sup> A contrary determination was reached by the Seventh Circuit.<sup>11</sup> In the past, as suggested by Commissioner Caplin, when the Service did not like the way a statute was being interpreted it went to Congress to make the correction. Currently that seems to take too long for the Service.

Another principle espoused by Rev. Proc. 64-22 is that the Service should determine the reasonable meaning of Code provisions and apply them with neither a government nor a taxpayer point of view. However, a recent notice from the Service seems to stray from this principle. In proposed regulation section 301.6231(c)-9, the Service took the position that despite the fact that the partnership provisions of the Tax Equity and Fiscal Responsibility Act (TEFRA) appear to require partnership proceedings in all situations governed by that Act, the Service has the power to opt out of the Act if it feels that should be done.<sup>12</sup> It even gave itself permission to do this when a partnership proceeding under TEFRA had already been lodged in court so long as there had not been a final court determination. There is no question that TEFRA is creaking and requires serious remediation.<sup>13</sup> However, courts agree with Commissioner Caplin: that fix should come from Congress.<sup>14</sup>

Rev. Proc. 64-22 also calls for only meritorious issues to be raised, but never for trading, and it cautions against adopting positions inconsistent with an established Service position. Tax practitioners find, however, that auditing agents are asserting penalties in almost

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<sup>10</sup> *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885 (E.D. Tex. 2007).

<sup>11</sup> *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008). *But see* *Stobie Creek Inv., LLC v. United States*, 82 Fed. Cl. 636 (2008).

<sup>12</sup> 2009-9 I.R.B. 638.

<sup>13</sup> *See* *Tigers Eye Trading, LLC v. Commissioner*, 97 T.C.M. (CCH) 1622 (2009) (stating that TEFRA “has created problems of judicial administration in the case at hand and similar pending cases that will not be resolved by recently proposed regulations.”).

<sup>14</sup> “The general rule is that unless there is some ambiguity in the language of a statute, a court’s analysis must end with the statute’s plain language. When the terms of a statute are clear, its language is conclusive and courts are not free to replace that clear language with an unenacted legislative intent. When the import of the words Congress has used is clear . . . we need not resort to legislative history, and we certainly should not do so to undermine the plain meaning of the statutory language.” *Coggin Automotive Corp. v. Commissioner*, 292 F.3d 1326 (11th Cir. 2002) (citations omitted).

every situation, presumably with the idea that the penalty will be traded for a sustention of some of the positions being taken in the revenue agents' reports. Then National Chief of Appeals David Robison stated that Appeals would not trade penalties for substantive determinations.<sup>15</sup> Nonetheless, today's almost automatic penalty assertion seems to be done for that purpose. Furthermore, the Service itself, in its global settlement proposals, has offered reduced penalties as an inducement to accept its substantive positions.<sup>16</sup>

The advice of Rev. Proc. 64-22 against adopting a position inconsistent with established Service positions was not heeded by Service counsel in *Phillips v. Commissioner*. The result was an excoriation by the Tax Court<sup>17</sup> and a notice from counsel that this should not be done again.<sup>18</sup>

Finally, Commissioner Caplin cautioned that the Service administration should be done with as little delay as possible. For the most part the Service seems to pay heed to this. However, when taxpayers file requests under the Freedom of Information Act (FOIA), they find that the Service delays its responses for as long as possible and then takes a very strained view of what has to be disclosed. This, of course, conflicts with the present administration's statement that government agencies should encourage transparency and undercuts the Congressional mandate set out in the FOIA.<sup>19</sup>

Not everything is off kilter, however. In the early to mid-1980s, many tax practitioners urged the Service to at least issue notices that it was examining particularly abusive transactions so that practitioners would be armed in advising their clients not to engage in those transactions. The Service began responding to those requests and out of that grew the listing process in which the Service describes what it considers to be particularly abusive transactions.<sup>20</sup> Unfortunately,

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<sup>15</sup> I.R.S. Notice CC-2004-036; *see also IRS Advises Chief Counsel Attorneys on Role of Tax Penalties* 2004 TNT 186-9 (Sept. 22, 2004).

<sup>16</sup> *See* I.R.S. Announcement 2004-46 (May 24, 2004); I.R.S. News Release IR-2004-64 (May 5, 2004); I.R.S. Announcement 2002-97 (October 28, 2002).

<sup>17</sup> 88 T.C. 529 (1988) ("Respondent's counsel may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law.").

<sup>18</sup> I.R.S. Notice CC-2004-019.

<sup>19</sup> *See* President's Memorandum for the Heads of Executive Departments and Agencies, 74 Fed. Reg. 4683 (January 21, 2009); *see also* Attorney General's Memorandum for Heads of Executive Departments and Agencies, 74 Fed. Reg. 49892 (March 19, 2009).

<sup>20</sup> Treas. Reg. § 1.6011-4(b)(2) (2007).

Congress then overreacted with severe penalties<sup>21</sup> and a statute of limitations suspension<sup>22</sup> when transactions that were listed were not disclosed. However, listed transactions were not only those described in notices, but also anything substantially similar to the descriptions. Furthermore, taxpayers were told to take a very broad approach in construing what is substantially similar.<sup>23</sup>

The Service properly responded to these harsh results by slowing down the listing process and then turned to a new type of list, transactions of interest.<sup>24</sup> That list did not have the severe repercussions imposed by Congress on listed transactions. Thus, despite the above categorization of instances in which the Service has departed from the principles set out in Rev. Proc. 64-22, there have been real efforts to manage the tax system in a reasonable and effective manner. That, after all, is the overarching meaning of these principles.

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<sup>21</sup> See I.R.C. § 6707 (providing a \$200,000 penalty for a corporation's failure to report a listed transaction); Letter from Senators Baucus and Grassley and Representatives Lewis and Boustany, Jr., the Chairman and Ranking Member of the Senate Committee on Finance, and the Chairman and Ranking Member of the House Committee on Ways and Means, Subcommittee on Oversight, to Commissioner Shulman (June 12, 2009) (requesting that the Commissioner "suspend efforts to collect IRC section 6707A liabilities" in certain cases affecting small businesses while Congress seeks to modify that law) *available at* <http://waysandmeans.house.gov/news.asp?formmode=release&id=905> (follow "Click here" hyperlink).

<sup>22</sup> I.R.C. § 6501(c)(10).

<sup>23</sup> Treas. Reg. § 1.6011-4(c)(4) (2007).

<sup>24</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(E) (2007).