



What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute



Robert Probasco

Material in this webinar is for reference purposes only. This webinar is sold with the understanding that neither any of the authors nor the publisher are engaged in rendering legal, accounting, investment, medical or any other professional service directly through this webinar. Neither the publisher nor the authors assume any liability for any errors or omissions, or for how this webinar or its contents are used or interpreted, or for any consequences resulting directly or indirectly from the use of this webinar. For legal, financial, medical, strategic or any other type of advice, please personally consult the appropriate professional.

About the Webinar Speaker

- About Robert Probasco, Partner, Thompson & Knight LLP
- Focuses his practice on tax controversy with special emphasis on cases for large corporate taxpayers, interest on refunds and deficiencies, penalties, oil and gas issues, partnerships, and tax shelters.
- Also a Certified Public Accountant in Texas.
- Has authored numerous articles and made numerous presentations concerning federal tax controversies and maintains a blog focusing on related issues.
- Heavily involved in the Tax Section of the State Bar of Texas and currently serves as the Vice Chair of the Tax Controversy Committee. In that capacity, he recently testified at Treasury/IRS public hearings on proposed requirements to disclose uncertain tax positions and proposed amendments to Circular 230.
- Recognized in *Texas Monthly* as a Texas Rising Star® for the years 2004–2006 and 2008–2010.
- Email: Robert.Probasco@tklaw.com

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Overview

- The tax gap and increased pressure to find revenue, combined with better tools to identify errors (e.g., disclosure of uncertain tax positions), will likely result in more audits and more proposed adjustments. It may be more likely that the taxpayer can't reach a satisfactory resolution without going to trial.
- Limited jurisdiction means that for some tax issues there is no choice of forum.
- There are key differences between the available courts, greater than in typical civil litigation.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

What to Know

- What you can challenge and where
- How the law differs depending on your choice of forum
- Requirements for filing in different courts
- How pretrial procedures vary between courts
- Options for trial

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Different Trial-Level Courts for Federal Civil Tax Disputes

- U.S. Tax Court
- U.S. District Courts
- U.S. Court of Federal Claims
- U.S. Bankruptcy Courts

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

U.S. Tax Court

- Based in Washington D.C., but hears cases in a number of different cities. Forum for the vast majority (90%+) of non-bankruptcy tax disputes. As of September 20, 2009, approx. 30,900 cases pending, involving approx. \$23.8 billion. Top 4% of pending cases account for 93% of the total amount in dispute, averaging \$19.6 million per case.
- Pre-assessment redeterminations of proposed adjustments. Taxpayer must file within 90 days of issuance of notice of deficiency or 150 days of issuance of notice of final partnership administrative adjustment (FPAA). The court can determine that there is an overpayment to be refunded to the taxpayer.
- Judicial review of an administrative adjustment request (AAR), the partnership equivalent of a refund claim. Petitioner must file no earlier than six months, and no later than two years, after the date of the AAR, unless the parties agree to an extension of time. The court can determine a favorable adjustment for the partnership instead.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

U.S. Tax Court (continued)

- Exclusive jurisdiction over collection due process determinations (liens or levies), interest abatements, informant awards, and certain limited categories of declaratory actions.
- Simplified “small case” procedure available, but not required, for disputes involving \$50,000 or less (including penalties but not interest) per year. If the small case procedure is chosen, neither party can appeal the decision.
- The government is represented by attorneys from the IRS Office of Chief Counsel. In most cases (75%+), the taxpayer represents herself rather than using an attorney or CPA.
- Decisions are appealable to the U.S. Courts of Appeals for the circuit in which is located the taxpayer’s legal residence or principal place of business; if neither applies, the Court of Appeals for the D.C. Circuit. The parties can stipulate in writing to hear the appeal in a different circuit.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

U.S. District Courts

- Located in each of the 94 judicial districts within the United States. Venue is in the district in which taxpayer has legal residence; for a corporation, the principal place of business, or if none, where the return was filed or the District of Columbia. As of September 30, 2009, approx. 700 cases pending, involving approx. \$7.3 billion.
- Refund suits. Refund claim generally must be filed within three years of the date the return was filed or two years of payment, but can be extended by agreement. The amount of refund is limited to the portion of tax paid during a “lookback” period before the date of filing the claim. The refund suit must be filed at least six months after the refund claim was filed, and no more than two years after the refund claim was disallowed.
- Petition for readjustment of an FPAA issued to a partnership. This is a pre-assessment challenge, but partner filing the petition must first deposit with the IRS the increased tax that would be due from the partner as a result of the FPAA. Statute of limitations is the same as in Tax Court.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

U.S. District Courts (continued)

- Judicial review of an administrative adjustment request (AAR), the partnership equivalent of a refund claim. Statute of limitations is the same as in Tax Court.
- “Little” Tucker Act, civil action “founded either upon the Constitution, or any Act of Congress, or any regulation of an executive department, or upon any express or implied contract with the United States.” Limited to \$10,000 in District Court. Statute of limitations is six years. This applies to certain tax issues that don’t fall within the realm of an ordinary refund suit; it is not a way to avoid the shorter statute of limitations and other requirements for refund suits.
- Exclusive jurisdiction for various procedural or collection actions that do not directly contest the amount of tax due, including petition to quash a third-party summons quiet title action, wrongful levy action, review of jeopardy levy or assessment, claim for refund of trust fund recovery penalty, public disclosure of written determinations (District of Columbia only), or certain actions for civil damages.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

U.S. District Courts (continued)

- The government is represented by attorneys either from the Department of Justice Tax Division or from the local U.S. Attorney's office, depending on the circumstances and location.
- Jury trial is available on request by either party.
- Decisions are appealable to the U.S. Court of Appeals for the circuit in which the District Court is located.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

U.S. Court of Federal Claims

- Based in Washington D.C., but can arrange to sit for trial elsewhere if needed. As of September 30, 2009, approx. 500 cases pending, involving approx. \$2.8 billion.
- Refund suits. Subject to the same administrative claim and pre-payment requirements and the same statute of limitations as in District Court.
- Partnership actions: readjustment of an FPAA or review of an AAR. Subject to the same requirements and statute of limitations as in District Court.
- Tucker Act claims. Subject to the same requirements and statute of limitations as claims under the “little” Tucker Act in District Court, but in the Court of Federal Claims, the claims are not limited to \$10,000.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

U.S. Court of Federal Claims (continued)

- The government is represented by attorneys from the Department of Justice Tax Division.
- Decisions are appealable to the U.S. Court of Appeals for the Federal Circuit.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

U.S. Bankruptcy Courts

- “Units” of, or “adjuncts” to, the U.S. District Courts, which exclusively handle bankruptcy cases.
- Traditionally a forum for disputes about the payment or dischargeability of previously determined tax liabilities, but in recent years have also routinely determined substantive tax disputes, some quite substantial.
- Decisions by the Bankruptcy Court are appealable to the District Court of which it is part or to a Bankruptcy Appeals Panel.
- Bankruptcy Courts hear many more tax disputes than any of the other courts. However, the taxpayer can choose this forum only if it files for bankruptcy. That limits the availability of the forum and also creates significant potential drawbacks. The choice of Bankruptcy Court is usually driven by different considerations than those relevant to choosing between the other three types of court.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Strategic Choice-of-Forum Considerations

- Jurisdiction
- Precedent
- Prepayment versus refund litigation
- Discovery
- Settlement
- Expertise – specialist versus generalist judge
- Trial – location and availability of jury

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Strategic Choice-of-Forum Considerations – Jurisdiction

- As noted above, certain types of actions can only be pursued in Tax Court while others can only be pursued in District Court or the Court of Federal Claims.
- In addition, if the taxpayer waives deficiency procedures, allowing immediate assessment, or does not file a Tax Court petition during the 90 day window after issuance of the notice of deficiency, a refund suit in District Court or the Court of Federal Claims will be the only option. (If a partner does not file a petition for readjustment within the 150 day window after issuance of an FPAA, there is **no** opportunity to challenge the tax liability on the merits.)
- Jurisdiction **always** should be the first consideration.
- The remaining discussion focuses on the most common tax disputes for which there is a choice of forum – taxpayer challenges to the underlying tax liability (including penalties and deficiency interest).

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Strategic Choice-of-Forum Considerations – Precedent

- Outside of jurisdiction, the primary area of investigation before choosing a forum.
- The Court of Federal Claims will follow Federal Circuit precedent, but litigants need to review it carefully. The Federal Circuit also handles appeals from District Courts for patent litigation, for which it follows the precedents of the circuit in which that District Court is located.
- Generally, decisions by the Tax Court and District Court will be appealable to the same Court of Appeals circuit, so precedent would not be a factor in deciding between them.
- But the Tax Court is a court of national jurisdiction and tries to decide cases uniformly. It treats “division” opinions (those decided by the court as a whole) as controlling precedent if the relevant court of appeals has not decided the issue. If so, the Tax Court precedent should be a major factor in choosing the forum.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Strategic Choice-of-Forum Considerations – Prepay or refund

- The availability of funds to prepay, and potential impact on financial reporting, may discourage taxpayers from refund litigation. But those are not the only considerations.
- Disadvantage of refund litigation: the taxpayer may lose some procedural defenses. The taxpayer has to show that it overpaid the correct tax due. If the statute of limitations for assessment has expired, the IRS can reduce any refund by offsetting unrelated items for the same year (even though it couldn't assess them) but can't affirmatively recover additional tax. But the taxpayer may not be able to recover the refund if its only argument, for example, is that the assessment was invalid because the statute of limitations had already expired. The validity of the assessment is no longer at issue, only the correct amount of tax.
- Disadvantage of prepayment challenge: In Tax Court, the statute of limitations for assessment is tolled. The government can raise new issues and the taxpayer may wind up owing more than was asserted in the notice of deficiency.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Strategic Choice-of-Forum Considerations – Discovery

- The Tax Court uses an informal, collaborative discovery process that focuses on a mandatory stipulation of facts for trial.
- Depositions are rare; impossible for party witnesses, and nearly impossible for expert witnesses, without consent.
- District Court and the Court of Federal Claims tend to follow more a more formal discovery process as set forth in the Federal Rules of Civil Procedure or the Rules of the Court of Federal Claims.
- Depositions are much more common and discovery tends to be more extensive.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Strategic Choice-of-Forum Considerations – Settlement

- In Tax Court, unless the taxpayer has already been to Appeals before the notice of deficiency or FPAA was issued, the case is normally referred to Appeals. If the case is not settled in Appeals, the IRS Office of Chief Counsel may settle the case.
- For refund litigation, the Department of Justice controls the decision of whether to settle, although it consults with the IRS Office of Chief Counsel. Settling against the wishes of OCC requires a higher level sign off.
- District Court and the Court of Federal Claims may take a more active role than the Tax Court in resolution, through a settlement conference. However, the government often waits until after discovery to consider settlement.
- A refund of more than \$2 million, whether resulting from refund litigation or a determination of an overpayment in Tax Court, must also be reviewed by the Joint Committee of Taxation.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Strategic Choice-of-Forum Considerations – Expertise

- In decreasing order of expertise and experience with tax law: Tax Court, Court of Federal Claims, and District Court.
- Despite occasional exceptions, going to District Court is unlikely to help with the substance of a weak case, particularly if judges are inclined to defer to agencies' interpretations of the law. But going to District Court may help with a reasonable cause defense to penalties.
- Going to Tax Court may be a good choice if you have a stronger case involving a favorable result from complex structuring. Compared to judges on other courts, a Tax Court judge probably will have seen more sophisticated tax planning and may be more likely to recognize that your transaction really isn't outside the mainstream.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Strategic Choice-of-Forum Considerations

– Trial (location/jury)

- In District Court, trial will be in the district where the taxpayer resides or has its principal place of business. The Court of Federal Claims normally hears cases in Washington D.C. but may be willing to make arrangements to hear the case elsewhere.
- The Tax Court offers the most flexibility concerning location of trial. It regularly schedules trial sessions in a variety of different cities. Although the decision would be appealable to the same circuit as decisions by the District Court, based on where the taxpayer resides or has its principal place of business, the taxpayer can request trial anywhere.
- Only the District Court offers the option of a jury trial. In the past, juries may have reflected a public bias against the IRS. However, in today's economic and political climate, juries are even less likely to be sympathetic to most corporations or wealthy individuals. Either party can demand a jury, so filing a refund suit in District Court with a particularly unsympathetic taxpayer can be dangerous.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Case Study #1

- The corporation engaged in a multi-million dollar loss transaction involving the contribution of appreciated assets to, and a simultaneous distribution from, a newly formed partnership. The transaction was structured to avoid treatment as a disguised sale of the appreciated assets. The corporation obtained an opinion from a highly regarded CPA firm that the transaction “should” be respected by the IRS. The CPA firm, which had a long-standing relationship with the corporation, also helped draft the transactional documents.
- Exam disagreed with the CPA firm’s conclusion and issued a notice of deficiency to recognize a gain on the contributed assets, but did not make any other adjustments to the tax year and did not propose penalties. The asserted deficiency is \$150 million.
- Where would you litigate?

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Case Study #1 (continued)

- The huge amount involved would tempt most taxpayer to contest the deficiency in Tax Court in order to avoid having to pre-pay the asserted deficiency.
- This appears to be sophisticated tax planning of a type in which many taxpayers engage. Without knowing more details about the transaction or differences in relevant precedent, this may be something that a Tax Court judge would be more ready than a judge from District Court or the Court of Federal Claims to accept as ordinary tax planning.
- But going to Tax Court represents a huge gamble here because of the exposure to new issues. If the taxpayer pays the deficiency and files a refund suit, at worst the taxpayer has paid \$150 million (plus interest) and gets no refund. In Tax Court, even if there is nothing else problematic about the tax return, the government could assert an accuracy-related penalty. The opinion is no guarantee against the penalty. The corporation could wind up paying an additional \$30 million penalty.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Case Study #2

- The partnership engaged in a complicated multiple-party transaction that resulted in a multi-million dollar artificial loss. The partnership was newly formed for purposes of engaging in the transaction, which was marketed to the ultimate taxpayer by a well-regarded law firm. The partnership received an opinion from the law firm that the transaction should be respected by the IRS and that it was not a “listed transaction.”
- Exam disagreed, and disallowed not only the large tax losses generated but also all other deductions on the return. The FPAA conclusion was based on several theories, including that the partnership itself should be disregarded as a sham. The FPAA also asserted the application of the 20% accuracy-based penalty as well as the failure to disclose penalty.
- Where would you litigate?

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Case Study #2 (continued)

- It appears that there are no other issues that the government could raise in refund litigation, as in Case Study #1.
- If this does indeed appear to be substantially similar to a listed transaction, there is little prospect of success with regard to the tax liability itself, regardless of forum. The primary purpose for litigating this dispute may be to reduce penalties. One important objective would be to minimize the cost of reaching that settlement.
- Challenging the FPAA in District Court or the Court of Federal Claims will likely increase litigation costs substantially. In District Court or the Court of Federal Claims, the government is likely to wait until after discovery to enter into settlement negotiations and discovery in a case like this, particularly when intent and motive/business purpose will be key questions, would likely be very extensive and expensive. Tax Court probably offers the best prospects of keeping litigation costs down, and is unlikely to result in a worse settlement than in other courts.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Case Study #3

- The partnership engaged in a complicated multiple-party transaction that resulted in a multi-million dollar artificial loss. The partnership was newly formed for purposes of engaging in the transaction, which was marketed to the ultimate taxpayer by a well-regarded law firm. The partnership received an opinion from the law firm that the transaction should be respected by the IRS and that it was not a “listed transaction.”
- Exam disagreed, and disallowed not only the large tax losses generated but also all other deductions on the return. The FPAA conclusion was based on several theories, including that the partnership itself should be disregarded as a sham. The FPAA also asserted the application of accuracy-based penalties, including alternatively the 40% gross valuation misstatement penalty, as well as the failure to disclose penalty.
- Where would you litigate?

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Case Study #3 (continued)

- This is, of course, similar to Case Study #3 and a similar conclusion applies: Tax Court is probably the best solution. This scenario adds another consideration, however – the 40% gross valuation misstatement penalty. Most Courts of Appeal allow the application of the 40% penalty in situations like this. The Fifth and Ninth Circuits, however, have held that the 40% penalty does not apply when a deduction or loss is disallowed as improper (e.g., due to a lack of economic substance) rather than excessive.
- If the partnership already has its principal place of business in the Fifth or Ninth Circuit, the taxpayer can simply file a petition for readjustment of the FPA in Tax Court.
- If the partnership's principal place of business is elsewhere, however, it **might** be relatively easy to shift the principal place of business to the Fifth or Ninth Circuit before filing the Tax Court petition.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Common Misconceptions

- Number 1 – You don't have to contest immediately; you can always pay and wait to decide to sue for a refund.
- Number 2 – You have little to lose by going to court; you can always concede and drop the case if needed.
- Number 3 – The Tax Court doesn't handle any refund litigation.
- Number 4 – You can't go to District Court or the Court of Federal Claims before assessment.
- Number 5 – Because it's not an Article III court, the Tax Court doesn't apply equitable remedies.
- Number 6 – Litigation is litigation; the cost will be about the same no matter where you go.
- Number 7 – All Federal Circuit precedent applies to all cases in the Court of Federal Claims.
- Number 8 – If you're audited and pay an assessment, a later refund claim can only dispute the items assessed.
- Number 9 – If you have a weak case, go to District Court; you'll probably draw a judge unfamiliar with tax law.
- Number 10 – When you're suing the IRS, taxpayers are sympathetic plaintiffs.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco

Conclusions

- Before making the choice of forum, the taxpayer should have a clear idea of the objectives of litigation – delay, victory on the tax liability, reduction of penalties, etc.
- The evaluation of potential litigation forums requires a careful review and evaluation of not only jurisdiction and relevant precedent but also potential exposure from other issues on the tax return.
- Given the number of relevant factors, and actions that may be necessary to get to your preferred forum, the evaluation should begin well before receiving the notice of deficiency or FPAA.

What Tax Lawyers Need to Know Before Choosing a Forum for Their Next Federal Civil Tax Litigation Dispute

Robert Probasco