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38 DTR K-1

Tax Shelters

Former Submarine Commander Torpedoes IRS in Penalty Battle



By Erin McManus

Former U.S. Navy nuclear submarine commander Corbin McNeill finally got his chance to go to battle with the IRS over a \$4.59 million penalty, and won (*McNeill v. United States*, D. Wyo., No. 2:14-cv-00172, unpublished order filed 2/24/17).

McNeill had reasonable cause to claim on his tax return a \$20 million paper loss from a distressed asset/debt (DAD) tax shelter and did so in good-faith reliance on Ernst & Young, which prepared his tax return, and the law firm of De Castro, West, Chodorow, Glickfield & Nass Inc., which provided him with an opinion letter blessing the tax aspects of the transaction, a federal judge ruled Feb. 24.

Tom Cullinan, a tax partner at Eversheds Sutherland (US) LLP in Atlanta, told Bloomberg BNA Feb. 27 "the case is a road map of how the government litigates a penalty case. They make the same arguments in every case. The government says because the taxpayer's representations to their tax adviser were false, the taxpayer can't rely on the adviser's opinion."

"It's nice to see a court really look at the facts with an open mind about them. The government has a very good track record with these penalty cases. It wins most of them," Cullinan said. "It wouldn't surprise me if the government appealed or if they didn't," he added. The IRS didn't respond to a request for comment.

"It is clear from the testimony that no advisor reasonably and fairly alerted Mr. McNeill about the importance of a profit motive, business purpose and economic substance underlying the partnerships and DAD transaction," Judge Nancy D. Freudenthal of the U.S. District Court for the District of Wyoming said in a findings of fact, conclusions of law, and order granting the petition for refund.

Mary A. McNulty, a partner at Thompson & Knight LLP in Dallas, said in a Feb. 27 e-mail, "the court's findings of fact are more favorable to the taxpayer than is typical in tax shelter cases involving the reasonable cause and good faith defense. The court clearly viewed Mr. McNeill as a credible witness."

Lawrence M. Hill, a tax partner at Winston & Strawn LLP in New York, told Bloomberg BNA in a Feb. 27 e-mail, "this is one of the more favorable reasonable cause cases in the tax shelter arena that have come down. The Court acknowledged that the decision was a 'close call,' but must have believed that the taxpayer was a very credible witness, because other courts have rejected the defense in analogous circumstances."

Sophistication Isn't Tax Knowledge

The IRS also argued that McNeill's sophistication in business should have alerted him to the questionable aspects of the transaction. After retiring from the Navy, McNeill went to work in the energy industry, eventually becoming chairman of the board and co-chief executive officer of Exelon Corp. He retired from Exelon in 2002.

Freudenthal said, "while unquestionably smart and accomplished in his own right, in the context of the complex DAD shelter before the Court which was specifically designed and implemented by others to exploit the tax code's partnership provisions, Mr. McNeill is not knowledgeable or sophisticated."

The IRS tried to dodge the substantive battle by arguing that McNeill's status as tax matters partner in one of the tax shelter partnerships precluded him from pursuing a partner-level defense to the penalty. Freudenthal initially agreed and dismissed McNeill's refund claim for the penalty.

The U.S. Court of Appeals for the Tenth Circuit disagreed, and in a decision authored by Supreme Court nominee Neil M. Gorsuch, found that the Tax Equity and Fiscal Responsibility Act (TEFRA) didn't prevent the "managing (or tax matters) partner from pursuing a reasonable cause/good faith defense in later partner level proceedings."

McNeill didn't dispute in his partner level challenge the \$7.75 million in taxes and interest he owed after the IRS determined that the tax shelter transactions were shams and disregarded the partnerships through which the transactions were conducted.

Freudenthal began her findings by saying the "case is not about the IRS's conclusion that a highly complex series of partnership transactions were done solely for purposes of tax avoidance as a sham, lacking economic substance and not for any legitimate business and were thus illegal. The Court accepts that we have an abusive tax shelter."

Snapshot

- Retired energy company executive had reasonable cause to claim loss, relied in good faith on tax advisers
- Didn't have specialized knowledge to question professional advice on tax shelter

Hill said, "the decision has little precedential value, but similarly situated taxpayers will cite to it for whatever persuasive value it may provide."

Cullinan said, "the court's analysis was good. It did a very thorough job of addressing all of the government's contentions. It will be a very difficult decision about whether to take it back to the Tenth Circuit. These cases are so fact driven, it's really tough for the loser to get it turned around on appeal unless there's some legal hook."

Leech Tishman Fuscaldo & Lampl LLC, Drinker Biddle & Reath LLP and Hickey & Evans LLP represented McNeill. The Department of Justice Tax Division represented the IRS.

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