Buyers Can Recover Damages From Abusive Tax Shelters

By Jordan Stanzler

The continued revelations about illegal tax shelters promoted by blue chip accounting firms, banks and law firms has led to a spate of litigation by investors in those tax shelters. As a result of action by the Internal Revenue Service, those investors will most likely owe the government more in back taxes, interest and penalties than the tax savings originally promised by the tax shelter promoters.

One of the key issues, therefore, is the measure of damages that may be recovered from a failed or fraudulent tax shelter. The results may vary widely from one jurisdiction to another and from one cause of action to another.

There has been a steady drumbeat of bad news since the U.S. Senate Permanent Committee on Investigations began looking into the marketing of abusive tax shelters. One target was the national accounting firm of KPMG, which promoted BLIPS (Bond Linked Issues Premium Structures), FLIP (Foreign Leveraged Investment Program), OPIS (Offshore Portfolio) and SC2 (S-Corporation Charitable Contribution Strategy). The Senate concluded that these transactions created "phony paper losses using a series of complex, orchestrated transactions involving shell corporations, structured finance, purported multimillion-dollar loans, and deliberately obscure investments."

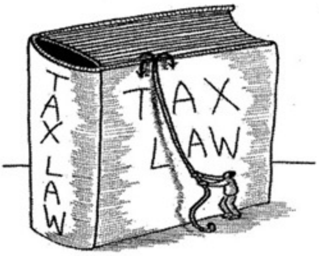
The IRS took action, listing these shelters as "listed transactions" and "potentially abusive tax shelters," requiring taxpayers to pay back taxes, interest and penalties. Other tax shelters, such as COBRA (Currency Options Bring Reward Alternatives), promoted by Ernst & Young, also drew IRS scrutiny.

Soon enough, a handful of investors filed lawsuits and class actions against the accounting firms, securities firms, banks and law firms that had participated in promoting the shelters.

Then came the blockbuster announcement of KPMG, apologizing for its role in unlawful tax shelters, reportedly to avoid a criminal indictment. See "KPMG Apologizes for Tax Shelters," June 15 Wall Street Journal; "KPMG May Dodge One Bullet, Only to Face Another," June 21 The New York Times.

The focus of attention is now shifting from liability to damages. The principal area of contention is which measure of damages will apply — the out-of-pocket damages or the benefit-of-the-bargain damages.

The out-of-pocket measure restores a plaintiff to the financial position he or she enjoyed before the fraudulent transaction, awarding the difference in actual value between what the plaintiff gave and what he or she received. The benefit-of-the-bargain, on the other hand, places a defrauded plaintiff in the position he or she would have enjoyed had the false representation been true, awarding the difference in value between what the plaintiff actually received and what he or she was fraudulently led to believe he or she would receive. *Alliance Mortgage Co. v. Rothwell,* 10 Cal. 4th 1226 (1995).



The tax shelter purchasers should have little difficulty in recovering such out-of-pocket damages as transactional, investment and advisory fees related to the formation of the investment, as well as attorney fees and accounting fees related to dealing with the IRS. See, e.g., *Jones v. Childers,* (1992), affirmed in part, reversed in part, 18 F. 3d 899 (1994). Tax penalties and settlement costs with the IRS are also recoverable. *Stone v. Kirk,* 8 F.3d 1079 (1993).

The recovery of back taxes because of the disallowed tax shelter has proved more controversial. Most courts treat these damages as benefit-of-the-bargain damages that cannot be recovered under federal securities laws:

"The Stones are not entitled to recover as damages the taxes they paid on their 1981 and 1982 income. They did not expect to pay such taxes, to be sure, but expectancy damages — damages designed to give the plaintiff the benefit of the bargain — are simply not recoverable under federal securities law." *Stone.*

The 9th U.S. Circuit Court of Appeals agreed with this reasoning in *DCD Programs Ltd. v. Leighton*, 90 F.3d 1442 (1996), but went on to observe that the taxpayer could recover any higher price paid for the tax shelter than for a comparable investment.

In response to the limited reach of federal securities law, taxpayers have sought relief under common law theories of negligence or fraud. In *Eckert Cold Storage Inc. v. Behl,* 943 F.Supp. 1230 (1996), the plaintiffs sought to recover more than $1million in back taxes and $500,000 in interest after the IRS disallowed deductions in a tax shelter. The court ruled that the plaintiffs were not entitled to benefit-of the-bargain recovery, but nevertheless could recover the tax liability under a theory of alternative investment — that there were other alternative investments that would have produced the desired tax benefits.

"Although plaintiffs are not entitled to expectation damages, it does not follow … that the tax liability is not recoverable under any set of circumstances. Under [California Civil Code Section 3333], plaintiffs may be entitled to damages due to the tax liability, if they can prove that this liability was caused by Grant's negligent or fraudulent advice and would not have otherwise been incurred. To make this showing plaintiffs must prove that they would have sheltered their income in an alternative investment. Plaintiffs may not be able to recoup the entire amount of the tax liability given that the TTC program apparently promised fanciful tax benefits like no other shelter. But to the extent that plaintiffs would have avoided some of the tax liability through investment in shelters that were available to them at the time, they may recover as damages a portion of the tax liability."

See also *Seippel v. Jenkens & Gilchrist,* 03 Civ. 6942, U.S.D.C., S.D.N.Y. (2004): "Because it is possible that the Seippels will be able to prove the extent to which defendants' alleged fraud caused them to forego alternative tax shelters with sufficient certainty, the motion to strike the prayer for back taxes is denied."

Benefit-of-the-bargain damages may also be obtained where there has been intentional misrepresentation by a fiduciary. On this point there is a split of authority. See *Fragale v. Faulkner,* 110 Cal. App. 4th 229, 237 (2003), reasoning that better rule affords the widest theory of recovery against fraudulent fiduciaries:

"Joining those courts that have adopted the broader measure of damages for fiduciary fraud, we conclude that damages are not limited to out-of-pocket losses. The result is consonant with the principle that 'the faithless fiduciary shall make good the full amount of the loss which his breach of faith is a cause' [citing *Salahutdin v. Valley of California Inc.,* 24 Cal. App. 4th 555 (1994)]."

In tax shelter litigation, there is usually no shortage of fiduciaries, such as investment counselors, accountants and lawyers, who may be sued as defendants.

Recovery of interest owed the IRS has also engendered a split of authority, as a majority of courts have held that interest owed to the IRS is not recoverable as an item of damages, where the taxpayer had the use of the money during the time that the tax was avoided. Recovery of interest in this situation has been called a "windfall." See, e.g., *Freschi v. Grand Coal Venture,* 767 F.2d 1041 (1985), vacated on other grounds, 478 U.S. 1015 (1986); *Stone* (plaintiff s not entitled to recover interest because taxpayers had use of money); *Ekert Cold Storage* (interest paid to IRS is represents a payment for plaintiff's use of tax money during period when plaintiffs had use of money).

This rationale, however, has been severely criticized in *Ronson v. Talesnick,* 33 F. Supp. 2d 347, 355 (1999):

"A blanket prohibition against the recovery of IRS interest … is not reconcilable with one of the underlying policies … that a tortfeasor should not benefit from the ingenuity of the harmed plaintiff. Denying recovery of IRS interest from a negligent accountant permits the tortfeasor to benefit from the presumption that a harmed taxpayer has been or should have been ingenious enough to 1) maintain a sum of money that he would have otherwise had to pay over to the IRS and 2) invest that money in a manner in which he earned interest in an amount comparable to the rate charged by the IRS." See also *McCulloch v. Price Waterhouse LLP,* 971 P.2d 414 (1998) (plaintiff not barred from recovering interest owed to IRS).

In sum, the purchasers of abusive tax shelters have a variety of means and legal theories to recover their damages. As more tax shelters come under IRS scrutiny, it is likely that litigation against tax shelter promoters will increase in tandem.

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