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The Burden of Persuasion in Tax Litigation

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In Federal tax matters, the burden of proof in litigation to overturn a deficiency asserted by the Internal Revenue Service is generally on the taxpayer.[1] The recent decision of the Court of Appeals for the Seventh Circuit in *Kohler Co. v. United States*, No. 05-4472 (Nov. 20, 2006), identifies an important limitation on that principle, in the context of the thorny problem of the computing the "amount realized" on a sale where the property received -- foreign currency proceeds of a "debt-for-equity swap" -- was difficult to value. In *Kohler*, where neither the Service nor the taxpayer provided adequate evidence to enable the trial court to value the property received, the Court of Appeals held that the failure of proof resulted in a victory for the taxpayer. Another recent decision of the same Court of Appeals, however, *JPMorgan Chase & Co. v. Commissioner*, Nos. 05-3730 & 05-3742 (August 9, 2006), contrasts sharply with *Kohler*, as the Court of Appeals there criticized the Tax Court for failing to give adequate deference to the Commissioner's method for valuing the property (interest rate swaps) involved in that case.

'Kohler Co. v. United States'

The deficiency at issue in *Kohler* arose from the decision made in 1986 by the taxpayer, a manufacturer of plumbing fixtures, to build a manufacturing plant in Mexico with an estimated cost of not less than $29,000,000. In order to acquire the Mexican currency needed to pay for the costs of acquiring land and constructing the plant, Kohler decided to make use of a debt-for-equity swap program that had been launched by Mexico to help retire its dollar-denominated debt at a time of governmental default and fiscal instability in that country.

Under the swap program, a person desiring to make an investment in Mexico could obtain the necessary Mexican pesos by first purchasing dollar-denominated debt that had been issued by the Mexican government and then presenting that debt, to the Mexican government, for redemption. The government would pay for the retirement of the debt through pesos in a restricted account. Since Mexico had defaulted on much of its dollar-denominated debt, such debt was available for purchase in the United States at a substantial discount to its face amount.

The number of pesos in the restricted account would be determined by reference to a market conversion rate for the exchange of an amount of dollars, equal to the face amount of the debt, for pesos. That rate was then discounted by an amount which depended on the Mexican government's evaluation of the desirability of the proposed investment -- with a more desirable investment being subject to a smaller discount (or no discount at all) and therefore reflecting a more favorable exchange rate, relative to the dollars actually expended for the acquisition of the debt to be exchanged, from the taxpayer's perspective.

To take advantage of the program, Kohler arranged in 1987 to purchase $22,400,000 in face amount of Mexican government debt from a bank for $11,100,000. That debt was then transferred to the Mexican government, which had approved Kohler's project, in exchange for a Mexican peso restricted account funded with pesos worth $19,500,000 at the then-current free market exchange rate.

The pesos in the restricted account could, in general, be spent only on the approved project. If any of the pesos were not spent on the project, the unspent pesos could not be freely converted to dollars until 1998. Kohler in fact used all of the pesos in the restricted account for the acquisition of land and other costs of building its plant.

Kohler treated its purchase of the dollar-denominated debt and subsequent transfer of that debt to the Mexican government in exchange for the restricted peso account as transfers with respect to which no gain was recognized, just as if the debt had been satisfied for $11,100,000, the substantially discounted amount that Kohler had paid for it.

On audit, the IRS asserted a deficiency on the basis that Kohler realized income at the time of the swap transaction equal to the excess of $19,500,000,

i.e., the value of the pesos in the restricted account at the then-prevailing free market exchange rate, over the $11,100,000 amount paid by Kohler for the Mexican debt. Kohler paid the deficiency and sued for a refund in the District Court. The District Court granted summary judgment to Kohler.

The Court of Appeals, in an opinion written by Judge Posner, noted several possible ways to account for the swap transaction. The exchange of the debt for the peso account could be viewed as a nontaxable exchange, but with the taxpayer acquiring the account with a low basis, equal to its $11,100,000 cost for the debt, and ultimately being required to realize as income any bargain element at a later time, perhaps when the taxpayer spent the pesos (which, after all, had a free market value of $19,500,000) on property or construction services having a value of more than $11,100,000, or perhaps when the taxpayer sold the plant.[2]

Since, however, both of the parties before the court treated the transfer of the debt for the peso account as a taxable sale of the debt, the Court of Appeals turned to address the issue of ascertaining Kohler's "amount realized," in order to determine whether or not Kohler had realized a gain on that sale.

Kohler argued that the value of the consideration it received, in the form of the peso account, was no greater than the amount Kohler paid for the debt that it had swapped for the pesos, but the Court of Appeals found this position to be untenable. It seems that the Court of Appeals found it not credible that the taxpayer would have entered into this complex series of transactions without an expectation that the peso account would be worth more to it than the amount it paid to the bank that had sold the Mexican debt to it; also, the taxpayer had an immediate use for the pesos obtained, in the form of payment for the construction of a new plant, in the context of which the taxpayer presumably expected to realize value close to, if not in excess of, the fair market value of the pesos to be expended.

The Court of Appeals also concluded, however, that the Service's position in this litigation, to the effect that the value of the peso account was equal to the full $19,500,000 free market value of the pesos in the account was untenable as well. The court observed that this position did not take into account the restrictions that prevented Kohler from using these funds for any purpose other than building the new plant in Mexico.

The court also noted that, especially under the difficult economic situation then prevailing in Mexico, it was clearly likely that the restrictions on conversion of the pesos and on the expenditure of the pesos outside Mexico would affect the real value of the peso account.

The Court of Appeals therefore framed the question before it as being how a court should choose between two valuations, where each was clearly erroneous. One approach might be to conclude that the party with the burden of proof, apparently the taxpayer in this case, must lose.

The Court of Appeals, however, focused on case law under which, if the IRS asserts a deficiency without any foundation at all for the amount asserted, the taxpayer will not be required to prove "what the assessment should have been," and the asserted deficiency will not be sustained unless the Service provides further support for its case. In this case, the Court of Appeals found the asserted deficiency to be clearly excessive, since it was self-evident to the court that a buyer of restricted pesos would demand some discount by reason of the restrictions on the use of the pesos, while the Service's valuation expert had made no effort at all to quantify the appropriate amount of that discount, but had simply concluded that the pesos were worth their full fair market value.

Because the Service did not present evidence to support the full value that it had asserted for the pesos and had also failed to provide any lower estimate of the value of the restricted account, the Court of Appeals upheld the taxpayer's summary judgment victory in the District Court, observing in closing that "[t]he government played all or nothing, lost all, so gets nothing."

'JPMorgan Chase & Co'

The *JPMorgan Chase* decision, by a panel of the Seventh Circuit Court of Appeals that included two of the same judges as the panel that decided *Kohler*, presents an interesting contrast. *JPMorgan Chase* involved the proper tax accounting for interest rate swaps; the parties agreed that applicable rules required that the securities be "marked to market" annually, but disagreed as to how the swaps should be valued for this purpose.

The Tax Court below had concluded that the taxpayer's valuation methodology did not produce the required "fair market value" for the swaps, and the Court of Appeals did not find any clear error in that conclusion.

The Tax Court had further found that the Service's method for determining the fair market value of the swaps was also deficient and did not, in the Tax Court's view, "clearly reflect" the taxpayer's income. The Tax Court had then crafted its own method of calculation, based on expert testimony, and ordered the parties to make computations based on that method.

The Court of Appeals in *JPMorgan Chase* concluded that the Tax Court had applied the wrong standard in reviewing the Service's chosen method of computation. Under the rules governing methods of accounting, which had been specifically invoked by the Service in *JPMorgan Chase,*[3] deference to the Service's method on the part of the courts was mandatory, unless that method was "arbitrary and unlawful."

The Court of Appeals found that the Tax Court, although it had referred to this deferential standard, had not applied it, and the Court of Appeals therefore remanded the case so that the Tax Court would undertake an analysis of the Service's method of accounting under the "arbitrary or unlawful" standard. Only if the Tax Court found the Commissioner method to be arbitrary or unlawful would the Tax Court then need to decide whether the taxpayer's valuation method should control or whether

the Tax Court had the authority to craft its own method for determining fair market value for the swaps at issue.

Observations

The two cases above, decided by a single Court of Appeals over a period of three months, present contrasting views of government power in the tax area, with *Kohler* emphasizing that a government assessment has to have some support to survive a taxpayer challenge and *JPMorgan Chase* emphasizing the deference owed to the Service once it has taken a position on a tax accounting issue. One point that seems clear from both cases is that a tax litigator must consider not only the substantive provisions of the tax law affecting each point at issue but also the arguments that may be made as to whether one side or the other has met its burden of coming forward with evidence and of proving or disproving the points at issue.

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[1] This rule applies both when a taxpayer challenges an asserted deficiency, prior to payment, in the Tax Court, and when a taxpayer seeks a tax refund by suit in a District Court or in the Court of Federal Claims. Under some circumstances enumerated in Code section 7491, the burden of proof may be shifted to the Service; however, section 7491 does not apply to any corporation that has a net worth in excess of $7,000,000 (see Treasury Regulation section 301.7430-5(f)(2)).

[2] Requiring the taxpayer to claim smaller deductions for depreciation of the plant, as though its cost was only $11,100,000, would be another way to defer the taxpayer's recognition of gain for tax purposes, while still accounting ultimately for the taxpayer's economic gain on the swap transaction.

Another possible approach would be to consider the Mexican government to have made a non-taxable contribution to Kohler's capital with respect to the project, equal to the difference between (i) the market value of the pesos in the restricted account without regard to the restrictions ($19,500,000) and (ii) the $11,100,000 amount paid by Kohler for the debt. This was the approach taken by the Court of Appeals for the Fifth Circuit in *G.M. Trading Corp. v. Commissioner,* 121 F.3d 977 (1997), a case involving almost identical facts. The Court of Appeals for the Seventh Circuit, however, was dubious about this approach, reasoning that, although the Mexican government wanted to encourage foreign investment in Mexico, the primary objective of the swap program was to retire foreign debt, rather than to subsidize a specific investment. The debt reduction was thus a service, presumably provided by Kohler to the Mexican government, and compensation for a specific service could not constitute a contribution to capital.

[3] Although *Kohler* also involved what may be described as a "tax accounting" issue, the Service apparently did not assert the applicability of these particular rules in that case.

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