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The Tax Court's Surprising About-Face on the Scope of Sanctions Against the IRS for Attorney Misconduct

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In *Hartman v. Comr.*, T.C. Memo 2008-124, the Tax Court vacated stipulated decisions entered 19 and 15 years earlier as to three petitioners pursuant to settlements of their tax shelter cases and held that they were entitled to the benefits of a secret settlement the IRS made with another petitioner whose case was selected as one of eight test cases. This was a reversal of the position it took in 2005 in *Lewis v. Comr.*, TC Memo 2005-205. This sanction was justified on the ground that the secret settlement was a fraud on the court and that all taxpayers whose cases were part of the test case procedure should be assured that the test cases will be well and fairly tried, regardless of whether or when they settle their cases.

Tax shelter programs promoted by Henry Kersting generated IRS audits and more than 1,800 Tax Court petitions contesting IRS disallowance of deductions claimed by participants in the Kersting programs. The District Counsel attorney serving as the project attorney--with the knowledge of his supervisor--entered into a secret agreement with a petitioner in one of the test cases (Thompson) to reduce his deficiencies, ultimately generating a refund in excess of \$60,000 to be used to pay his attorneys, on the condition that he remain a test case petitioner. This and other fraudulent conduct by the IRS project attorney was disclosed by the IRS after the trial of the test cases and a Tax Court decision upholding the IRS adjustments.

In *DuFresne v. Comr.*, 26 F. 3d 105 (1994), the Ninth Circuit vacated the Tax Court decisions in favor of the IRS entered in the test cases on the ground that the misconduct warranted further investigation. The Tax Court then held an evidentiary hearing and concluded in *Dixon v. Comr.*, T.C. Memo 1999-10, that the misconduct was harmless error. The Ninth Circuit reversed. In *Dixon v. Comr.*, 316 F. 3d 1041 (2003), the Ninth Circuit held that the misconduct was a fraud on the Tax Court and violated the rights of the more than 1,300 Kersting project petitioners who had agreed to be bound by the outcome of the test cases, directing that appellants and all other taxpayers properly before the court be accorded terms equivalent to those provided to Thompson. The Tax Court determined that the Thompson settlement was to be regarded as a 63.37 % reduction of the deficiencies as well as elimination of penalties and additions, together with other adjustments. The IRS and the Kersting project petitioners agreed that this relief would be extended to all docketed cases in the Kersting project remaining open, regardless of whether the petitioners had signed a piggyback agreement. Unresolved were the claims of Kersting project petitioners who had settled and had final decisions entered.

The *Hartman* opinion of May 1, 2008, involves three petitioners who entered into piggyback agreements: Hartman who accepted an offer before the trial, resulting in a stipulated decision entered on January 13, 1989; Lewis who accepted a posttrial settlement offer after the Tax Court had decided the test cases in favor of the IRS and after disclosure of the misconduct, resulting in a stipulated decision entered on June 23, 1993; and Liu who also accepted the posttrial settlement offer, resulting in a stipulated decision entered on March 10, 1993.

After the 9th Circuit's decision in *Dixon*, Lewis filed in the Tax Court in February 2004, a motion to vacate the stipulated decision of 1993. This motion was denied in *Lewis v. Comr.*, T.C. Memo 2005-205, on the ground that Lewis and his counsel had become aware of the misconduct of the IRS attorneys and of pending appeals by the test case petitioners when they agreed to the settlement. Lewis moved for reconsideration and Hartman and Liu moved for leave to file motions to vacate. In *Hartman*, the Tax Court consolidated the cases and in a surprising about-face vacated the stipulated decisions, rejecting *Lewis v. Comr.*, T.C. Memo 2005-205, and concluding that these petitioners are also entitled to the benefit of the Thompson settlement. In *Hartman*, the Court went on to grant relief to "other Kersting project nontest case petitioners who had stipulated decisions entered in their cases on or after June 10, 1985." This class consists of two groups: petitioners like those before the Court in *Hartman* who entered into piggyback agreements and other petitioners who did not enter into piggyback agreements. The IRS is to adjust administratively the accounts of this entire class without requiring them to file motions for leave to vacate. The Court gave the IRS nine months to accomplish this.

With respect to its 2005 Lewis opinion, the Tax Court explained that it had failed to recognize that a sanctionable fraud had been committed on the Court and wrongly required the Lewises to show prejudice and allowed the IRS to dispute the effectiveness of the fraud after the fact, contrary to the holding of the Ninth Circuit in *Dixon*. The proper focus should have been on whether the IRS could through posttrial disclosure and settlement offer purge the fraud and whether these actions otherwise rectified the harm caused by the fraud. The Tax Court concluded that the IRS failed to purge the fraud or rectify the harm. While under normal circumstances the IRS is not required to offer the same settlement terms to taxpayers whose cases are part of a test case proceeding, the Tax Court concluded that fairness required the IRS to provide other Kersting taxpayers the same favorable treatment given to Thompson. The Tax Court cited the unusual circumstances of this test case proceeding and the Treasury Minimum Standards of Conduct. As for the terms of the posttrial settlement agreement, it failed to release the IRS from claims based on the misconduct of IRS attorneys during the trial of the test cases, and in any event, the Tax Court has the inherent power to impose sanctions for fraud which the parties cannot by agreement eliminate. Sanctions were imposed in these previously settled cases "to maintain public trust in the judicial process that employs test case procedures."

As for the sanctions in the form of relief to be granted to other Kersting project nontest petitioners with stipulated decisions entered on or after June 10, 1985, the Court believed those who did not have piggyback agreements had the same standing as those who did. This is because of the Court's show cause procedure; that is, petitioners in a tax shelter project who fail to sign a piggyback agreement will either have their cases set for trial with the test cases or after the final decisions in the test cases, will be ordered to show cause why their case should not be decided in the same way as the test cases.

Hartman concludes with the proviso that the holding is limited to the unique and narrow circumstances of Kersting test case proceedings. Certainly, all hope that the circumstances will prove to be unique, but the notions of fairness and proper conduct found in this opinion have important implications for all attorneys and taxpayers who litigate in this national court, especially in cases where the test case procedure is employed.

Hartman is also notable from the point of view of the Tax Court's jurisdiction. The Tax Court set aside stipulated decisions regarding the three petitioners that were entered in 1989 and 1993, nineteen and fifteen years prior to the opinion of May 1, 2008. What is more, the Court is going to vacate any other stipulated decision regarding a Kersting project petitioner entered on or after June 10, 1985, if the IRS fails to make a timely administrative adjustment giving the petitioner the benefit of the Thompson settlement. *Hartman* makes no reference to §7481 specifying the date when a Tax Court decision becomes final; where no notice of appeal is filed, the decision becomes final upon the expiration of the time for filing the notice. *Hartman* explains that the Court is "protective of the integrity of our judicial process and concerned about deterrence." Fraud on the court trumps finality.

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