2019 DELAWARE TAX INSTITUTE

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2019 INCOME TAX DEVELOPMENTS

NOTABLE CASES IN FEDERAL INCOME TAX

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NOTABLE CASES IN FEDERAL INCOME TAX

I. POLICY

Deferral to Agencies' Rule-Making Interpretation

Kisor v. Wilkie, 139 S. Ct. 2400, 204 L. Ed. 2d 841 (6/26/19)

The Supreme Court, ruled, effectively 5-4, that the principle of *Auer v. Robbins*, 519 U.S. 452 (1997), which requires that judges defer to administrative agencies' reasonable interpretations of their own ambiguous regulations, should be limited but not overturned.

Justice Kagan's majority opinion held that courts should only defer to an agency's interpretation of its own regulation if it is genuinely ambiguous. Otherwise, "the reg then must mean what it means – and the court must give it effect, as the court would any law," and courts should try to resolve any ambiguities. Courts should defer to an agency only where its interpretations are genuinely reasonable. "And even then, not every reasonable agency reading of a genuinely ambiguous rule should receive *Auer* deference. Rather, a court must also make an independent inquiry into whether the character and context of the agency interpretation entitles it to controlling weight."

The Petitioner unsuccessfully sought disability benefits in 1982, alleging he had developed post-traumatic stress disorder from his military service. In 2006, he moved to reopen his claim. The VA this time agreed he was eligible for benefits, but it granted those benefits only from the date of his motion to reopen, not from his first application. The Board of Veterans' Appeals affirmed, based on its interpretation of an agency rule governing such claims.

The Federal Circuit affirmed, applying *Auer*, concluding that the regulation at issue was ambiguous, so it therefore deferred to the Board's interpretation of the rule. The Supreme Court unanimously agreed that the case should be reconsidered by a lower court. The Court concluded that the appeals court had not worked hard enough to determine the meaning of the reg itself.

The Petitioner asked the Court to overrule *Auer*, discarding the deference to agencies. Four justices agreed, leaving a bare majority to retain the precedent of *Auer*. Justice Kagan: "Kisor asks us to overrule not a single case, but a 'long line of precedents'— each one reaffirming the rest and going back 75 years or more."

Justice Roberts, who joined in the majority, joined with dissenting Justice Kavanaugh to say the issues "surrounding judicial deference to agency interpretations of their own regs are distinct from those raised in connection with judicial deference to agency interpretations of statutes enacted by Congress," and they "do not regard the Court's decision today to touch upon the latter question."

In *Chevron U.S.A. Inc. v. Natural Resources Defense Counsel, Inc.*, 467 U.S. 837 (1984), the Supreme Court held that (1) If the intent of Congress is clear, IRS and the courts must give effect to the unambiguously expressed intent of Congress; (2) If the statute is silent or ambiguous as to a specific issue, the question for a court is whether the agency's answer is based on a permissible construction of the statute. An agency's regs are given controlling weight unless they are "arbitrary, capricious, and manifestly contrary to the statute."

SALT Limitation

State of New York v. Mnuchin, 124 AFTR ¶2019-5302, D.C.N.Y. (9/30/19)

Four states' challenge to the state and local tax cap in the 2017 Tax Act was dismissed.

The states first claimed that the SALT cap meaningfully impaired their ability to pursue their own preferred tax policies and therefore violated the federalism principles of the U.S. Constitution. The court found that the federal government's power to lay and collect taxes is exhaustive and embraces every conceivable power of taxation. Therefore, Congress holds plenary power under the Constitution to tax income and to grant exemptions from that tax. That plenary power knows no restriction except where one is expressed in or arises from the Constitution.

The states' second argument was that Congress was attempting to coerce specific states' tax policies. The court pointed to a line of cases which held that just as Congress may impose conditions on federal spending to encourage preferred state-level policies, it may also influence the states by enacting a tax on an activity that it cannot authorize, forbid or otherwise control.

Exempt Organization Regulations

Mayo Clinic, 124 AFTR 2d ¶2019-5122, D. Minn. (8/6/19)

A district court held that Reg. § 1.170A-9(c)(1), defining "educational organization" for purposes of charitable contributions, to be invalid, because Treasury added requirements in the regulation that are not found in the Code.

The Mayo Clinic, parent of the Mayo Clinic College of Medicine and Science, brought a refund action to obtain $11 million in refunds due to taxes it had paid on unrelated business income, which would not have been treated as such if it were an educational organization. The IRS conceded that Mayo maintains a regular faculty and curriculum with regularly enrolled students in attendance where its educational activities are regularly carried on, but said it is not an "educational organization" since it did not pass the "primary function" and "merely incidental" tests of Reg. § 1.170A-9(c)(1). The IRS argued that because Mayo's primary purpose was health care, it couldn't qualify as an educational organization (which would not be subject on the unrelated business income received from a partnership). The IRS stated that education must be an organization's primary function and its non-educational activities must be merely incidental to its educational activities.

The court found that it impermissibly added the "primary-function requirement" and the "merely-incidental test" to the requirements already in the statute.

Disclosure of Substantial Donors

Bullock, No. CV-18-103 D. Mont. (7/30/19)

A district court held that Rev. Proc. 2018-38, which eliminated IRS's previous requirement that many exempt organizations – including social welfare organizations, some of which operate Super PACs and other dark-money political groups – report donor information, is invalid because the Service did not adhere to the Administrative Procedure Act's notice and comment requirements.

Montana and New Jersey claimed that they have used the names and addresses of significant contributors, obtained from Schedule B on various Form 990s, to identify suspicious patterns of activity, and enforce their own charitable registration laws.

The IRS conceded that it did not follow the APA's required notice and comment procedures, but claimed the states lacked standing to challenge its regulations. The court disagreed, based on the two-part test to determine standing: (1)"whether the agency's action injured the organization's interest;" and (2) whether the organization expended resources to counteract that harm.

The IRS then argued that the court could not review the Rev. Proc., because it has broad discretion to "relieve any organization or class of organizations ... from filing, in whole or in part the annual return required ... where [it] determines that such returns are not necessary for the efficient administration of the internal revenue laws."

The court disagreed. It said that the Rev. Proc. explicitly upends a 50-year practice and effectively amends the existing rule. The Rev. Proc. directs tax-exempt organizations to forego existing policy and informs these organizations that they "are no longer required to report the names and addresses of their contributors" as previously required.

2017 Tax Act

Kerven, 123 AFTR 2d ¶2019-428, D. N.Y. (2/12/19)

A district court held that an individual taxpayer did not have standing to challenge the unfairness of the Tax Cuts and Jobs Act. To demonstrate standing, a plaintiff must have alleged such a personal stake in the outcome of the controversy as to warrant his invocation of federal-court jurisdiction. The suit alleged that the TCJA violated the Fourteenth Amendment because it creates "gross inequality" in taxation in that (1) the repatriation section of the TCJA made a grossly unequal treatment and lack of any reasonable attempt to adjust the burden with a fair and reasonable degree of equality; and (2) the law saddles future taxpayers with a $1.5 trillion loan to underwrite a reduction in taxes for current taxpayers.

II. DEDUCTIONS, EXCLUSIONS AND INCLUSIONS

Travel Expenses

Brown, T.C. Memo 2019-30 (4/8/19)

A financial consultant was denied a deduction for travel expenses, because he failed to prove that his family home (and not the site of a long-term assignment) was his tax home.

The deduction allowed for traveling expenses in § 162(a)(2) applies for travel from home. When a taxpayer accepts employment either permanently or for an indefinite time away from his usual abode, his tax home shifts to the location of the new principal place of business.

An Atlanta resident entered a three-year contract with a New Jersey client that required him to work on-site four days a week. He traveled weekly to see his family, at his expense. Held: his tax home shifted to New Jersey, so the travel expenses were disallowed. His weekly travel from New Jersey for weekends with his wife and children was not "in the pursuit of a trade or business."

Liljeberg v. Comm., 122 AFTR 2d ¶ 2018-5395, D.C. Cir. (11/2/2018)

The D.C. Circuit, affirming the Tax Court, held that foreign students who traveled to the U.S. as part of a work-travel exchange program could not deduct their travel costs

A nonresident alien, participated in the U.S. Department of State Summer Work Travel Program, whose purpose is "to provide foreign college and university students with opportunities to interact with U.S. citizens, experience U.S. culture while sharing their own cultures with Americans they meet, travel in the United States, and work in jobs that require minimal training and are seasonal or temporary in order to earn funds to help defray a portion of their expenses."

He worked as a lifeguard in Wisconsin, traveled to Chicago, Washington and New York City before returning to Finland. He has not returned to the U.S. since. The Tax Court found that the expenditures for travel and living expenses were not "away from home" under § 162(a)(2) because they lacked "a business reason to maintain a distant, separate residence" away from their principal place of employment and so could not claim a personal residence as a tax home.

Investment Deduction

Ray, T.C. Memo 2019-36 (4/15/19)

The developer of a computer program designed for use in investment activity could not deduct legal fees in a suit against an investment manager as a business expense under § 162, but could deduct them as expenses for the production of income under § 212.

Marijuana

Feinberg, 916 F. 3d 1330 10th Cir. (2/26/19)

Business deductions for marijuana business, legal under state law were denied, because the business involved unlawful trafficking in a controlled substance, § 280E forecloses deductions.

Patients Mutual Assistance Collective Corporation, 151 T.C. No. 11 (11/29/18)

A medical marijuana dispensary could not take business deductions for the non-cannabis inventory. Held: the sale of other products was too closely linked to the sale of marijuana to constitute a separate business. The same staff was used. The taxpayer's brand development activity was entirely entwined with the marijuana business and could not be treated as a separate enterprise.

The taxpayer was liable for tax on its gross receipts as reduced by cost of goods sold. To determine cost of goods sold, the taxpayer cannot apply § 263A to include indirect expenses, since it prohibits capitalization of otherwise nondeductible costs, such as drug trafficking expenses.

Worthless Debt

2590 Associates, LLC, T.C. Memo. 2019-3 (2/1/19)

An LLC was permitted to take a bad debt deduction in the year the promissory note became worthless even though the principal of an entity that was having difficulty making payments on a loan, arranged for the lender to transfer the note to another entity managed by the principal in return for an ownership interest in that second entity. The transaction did not extinguish the loan.

The court enumerated the factors that generally determine whether a transaction represents bona fide debt, as opposed to capital: (1) the names given to the debt instruments (2) a fixed maturity date, (3) the source of repayment, (4) a legally enforceable right of repayment, (5) the creditor's right to participate in the debtor's management, (6) the subordination of the obligation to other debts, (7) the intent of the parties, (8) the debtor's capitalization and use of the funds, (9) the identity of interest between creditor and principal, (10) the payment of interest, (11) the entity's ability to obtain loans from outside lending institutions, (12) the extent to which the advance was used to acquire capital assets, and (13) the failure of the debtor to repay on the due date or to seek a postponement.

Net Operating Loss Carrybacks

Bea, No. 18-10511, 11th Cir. (2/5/19)

Taxpayers were not entitled to an NOL carryback against their previous year tax deficiency because they irrevocably waived their ability to carry back their NOL by making an election under § 172(b)(3). The taxpayers unsuccessfully argued that because they paid a professional to prepare their tax returns but didn't understand the implications of the election, and it was the preparer's error to put the taxpayers in an undesirable tax position, they should not be responsible for the election, but the court held the taxpayers could not disavow the unambiguous language of the irrevocable election they made on their signed tax return for the year at issue.

Silipigno v. U.S., 123 AFTR 2d ¶2019-392, 2nd Cir. (1/30/19)

The Second Circuit, affirming a district court, disallowed two net operating loss carrybacks. One was denied because a valid claim for refund was never filed, the other because proof of allowable deductions was not presented. The court rejected the claim that a satisfactory "informal refund claim" for 2004 was made on Form 1045, Tentative Application for Refund, based on Code § 6411, which provides that a tentative application for refund based on an NOL carryback "shall not constitute a claim for credit or refund." The other refund claim was denied on the ground that the claimed NOL carryback would be offset by a significant deficiency resulting from his failure to substantiate costs of goods sold.

Exclusion for Physical Injuries or Sickness

Doyle, T.C. Memo 2019-8 (2/6/19)

The taxpayer could not exclude amounts he received under a settlement agreement with his employer under § 104(a)(2). Although the taxpayer suffered ailments as the consequence of the emotional distress he suffered when he was fired him for being a whistleblower, the settlement payments weren't on account of personal physical injuries or physical sickness. The taxpayer identified nausea, vomiting, headaches, backaches in his Tax Court petition and testimony, but the documentation behind the settlement agreement (which identified $250,000 of the settlement for "alleged emotional distress damages") did not identify part of his payments to be on account of personal physical injuries or physical sickness.

The Tax Court noted the "crumbling barrier between psychiatry and neurology," but also that the Code takes a binary view of the mind and body, which binds the Court, which concluded the taxpayer "may well be right ontologically, but not legally."

Mortgage Interest

Pugh, T.C. Memo 2019-101 (2/28/19)

The owner of a software business was allowed to deduct mortgage interest. He had purchased two properties to expand his business but his venture failed. The Tax Court held that the properties were not "held for investment" as defined under § 163(d)(5). Therefore, the interest paid to finance the acquisition of the properties was not treated as investment interest and the taxpayer's entitlement to deductions for that interest was not subject to any limitation. However, the properties were "allocable" to the taxpayer's business and the interest paid in connection with the indebtedness on the properties was treated as mortgage interest and not as personal interest under § 163(h)(2)(A).

Cancellation of Indebtedness

Connell, T.C. Memo 2018-213 (12/26/18)

An award extended by the Financial Industry Regulatory Authority Dispute Resolution Panel that extinguished a debt owed by an individual to a financial services firm qualified as cancellation of debt income, and therefore, taxable as ordinary income. The individual made several arguments in his filings with the FINRA Panel, some of which were for payments in the acquisition of his book business, which would be in the nature of capital gain, others for a breach of an employment contract. The Court found that the record did not show which specific argument the FINRA Panel found most persuasive when it extinguished the balance of the loan, so the individual did not meet his burden to establish that the amount at issue was solely for the acquisition of his book of business.

Business Deductions

Cavanaugh, 123 AFTR 2d ¶2019-566, 5th Cir. (3/29/19)

The Fifth Circuit affirmed that an S corporation could not deduct legal fees and settlement costs arising from a lawsuit against it and its employees based on the employees' conduct during a holiday weekend in which another employee died after using cocaine, nor could it deduct its reimbursement of a settlement payment made in the case by its CEO. A wrongful death suit stemmed from cocaine ingestion by the companion of an executive of the corporation. No deduction was allowed, as none of its employees' conduct arose from its profit-seeking activities, and the corporation was not required to reimburse the founder for his portion of the settlement costs. They "were engaged in non-profit-seeking activities that did not arise from or further [its] business, and were far from any company property."

Captive Insurance

Syzygy Insurance, T.C. Memo 2019-34 (4/10/19)

Payments through a microcaptive insurance arrangement and its fronting carriers are not deductible as insurance premiums. Because the microcaptive was not operating an insurance business in the true nature of insurance, the election under § 831 to treat the premiums collected as nontaxable was disallowed. The court found that the carriers engaged in a circular flow of funds, the contracts were not arm's-length, but instead aimed at increasing deductions, and the premiums were not actuarially determined. The fronting carriers did not qualify as bona fide insurance companies, so their § the carriers did not issue insurance policies. Consequently, the corporation's reinsurance of those policies did not distribute risk. The transactions also did not qualify as insurance in the commonly accepted sense. The court rejected the argument that amounts paid for an invalid insurance arrangement can nevertheless be deductible under Section 162(a).

III. ALIMONY, JOINT RETURNS AND DOMESTIC RELATIONS

Alimony

Siegel, 117 T.C.M. (CCH) 1048, T.C. Memo. 2019-11 (2/14/19)

A divorced husband, who paid arrears in alimony payments pursuant to a court order, was allowed to deduct the payments for the tax year at issue. The individual paid the arrears in connection with termination of his marriage to avoid a jail term under the court order. Contrary to the IRS's contention, the court order did not qualify as a money judgment. It order qualified as a contempt order that was made to achieve the payment of arrears related to alimony. Lump-sum payments of alimony or child support arrears generally retain their character as alimony or child support under the statutory law.

Claim of Right

Mihelick, 123 AFTR 2d ¶2019-791, 11th Cir. (6/18/19)

A payment to an ex-spouse pursuant to their divorce agreement was a deductible loss under § 165(c)(2) and, therefore, qualified for treatment under the claim of right doctrine under § 1341. Her husband was CEO of a privately-held corporation that paid him $1 million per year. While married, they filed joint returns. After the divorce, they learned they had to return $600,000 of the income they had received from the business, which meant they had paid taxes on $600,000 they didn't get to keep. Since they had both benefitted from the income at issue, they agreed to split the liability evenly. So he returned the full $600,000, and she reimbursed him $300,000. He deducted the $300,000, using the claim of right doctrine under § 1341, but when she tried the same thing, the IRS denied her request. The IRS must allow a taxpayer to deduct the previously paid income taxes if the income was later paid back.

IV. EXEMPT ORGANIZATIONS AND THE CHARITABLE DEDUCTION

Interest on Refunds

Wichita Center of Graduate Medical Education 123 AFTR 2d ¶2019-493, 10th Cir. (3/7/19)

Charleston Area Med. Center 124 AFTR 2d ¶2019-5366, Fed. Cir. (10/17/19)

The Tenth Circuit and the Federal Circuit joined the Second, Sixth, and Seventh Circuits in concluding that the interest rate IRS is required to pay with respect to tax overpayments by corporations, which is a lower rate than that which applies to overpayments by other taxpayers, applies to overpayments by nonprofit corporations.

Parsonage Allowance

Gaylor, 919 F.3d 420, 7th Cir. (3/15/19**)**

Reversing a district court holding that the parsonage allowance (which allows a member of the clergy to exclude the rental value of a home from gross income) violates the U.S. Constitution's Establishment Clause, the Seventh Circuit held that the parsonage allowance in § 107(2) to be constitutional.

The Seventh Circuit found that the provision has a secular legislative purpose; its principal effect is neither to endorse nor to inhibit religion; and it does not cause excessive government entanglement.

Charitable Contribution

Oliveri, T.C. Memo 2019-57 (5/28/19)

A preacher was not entitled to deduct as charitable contributions unreimbursed expenses he incurred in connection with his preaching. Although the taxpayer was a certified teacher and trainer for his church, and was dedicated to being a preacher, many of the unreimbursed expenses he deducted were personal ones, and not eligible for a charitable contribution deduction.

V. PARTNERSHIPS

Disposal of Partnership Interests

Watts, 123 AFTR 2d ¶2019-329, 11th Cir. (1/10/19)

The Court of Appeals for the Eleventh Circuit vacated a Tax Court decision that two brothers' losses on the disposal of partnership interests weren't ordinary abandonment losses, as they claimed on their returns, but rather were capital losses

The brothers founded a business in 1968, which grew to 40 locations, with $200 million in annual sales, employing hundreds, and attracting the interest of investors. The brothers made an arrangement with a private equity firm, in which they were able to retain an equity interest, each of less than 10 percent. When the business was sold to another private equity firm, the brothers received none of the proceeds.

The brothers reported the transaction as an abandonment of their partnership interests, generating ordinary losses. The Tax Court agreed with the IRS that the losses from the brothers' disposal of their partnership interests were capital losses based on its reading of the partnership agreement.

The Eleventh Circuit disagreed. The IRS agreed with the taxpayers that the Tax Court misread the partnership agreement, so the case was remanded for redetermination.

Sham LLC

Sugarloaf Fund, LLC, 911 F. 3rd 854, 7th Cir. (12/21/18)

The Seventh Circuit upheld a determination that an LLC was formed solely as a sham. The LLC and Brazilian retailers, who purportedly contributed distressed consumer receivables to the LLC, did not form a *bona fide* partnership for servicing and collecting the receivables owed to the retailers. The transaction's sole objective was to shift losses from a tax-indifferent party to a tax-motivated party. The contributions and redemptions to and from the LLC were collapsed into a single transaction and treated as a sale of the receivables; therefore, the receivables had a cost basis rather than a carryover basis.

TEFRA Audits

Keeter, T.C. Memo 2018-191 (11/15/18)

The Tax Court held that it had jurisdiction with respect to the basis of assets distributed by a partnership to one of its partners as part of the partnership's liquidation. The Court rejected the argument made by the taxpayer that the fact that an earlier court case determined that the partnership was a sham prevented the Tax Court from having that jurisdiction.

The taxpayers engaged in a tax shelter to inflate their outside basis in a partnership to generate a tax loss on a subsequent sale. The taxpayers filed suit, arguing that adjustments made in a notice of deficiency attributable to an underlying TEFRA decision did not require a partner-level determination and therefore, the court did not have jurisdiction to hear the case. Where, however, partners claim loss deductions on the sale of assets received in a liquidating distribution from a sham partnership, a partner-level determination is required. TEFRA procedures apply and the notice of deficiency was valid. Adjustments to the loss deductions on the sales of the stock and foreign currency are items that require partner-level determinations and the TEFRA procedures apply.

Gunther, T.C. Memo 2019-6 (2/5/19)

The tax court had jurisdiction to redetermine the tax deficiencies assessed against an individual following partnership-level proceedings under TEFRA audit and litigation partnership procedures. The adjustments to the partner's tax liabilities required partner-level determinations and therefore the normal deficiency procedures applied. Consequently, the Commissioner had to issue a notice of deficiency and the taxpayer had a prepayment forum to challenge the Commissioner's determinations. Therefore, the court had jurisdiction and granted the partner's motion to restrain the assessment or collection of tax.

However, the court lacked jurisdiction to consider the penalties determined at the partnership level nor to enjoin the assessment or collection of the penalties. The liability for the penalties was determined in the prior partnership-level TEFRA proceeding and because liability for penalties is directly assessable at the partnership level, no partner-level determinations were required.

VI. CORPORATIONS

Shareholder basis

Meruelo, 123 AFTR 2d ¶2019-686, 11th Cir. (5/6/19)

The Eleventh Circuit, affirming the Tax Court, held that the fact that entities partially owned by the taxpayer paid expenses for an S corporation partially owned by the taxpayer did not increase the taxpayer's basis in the S corporation's stock and debt.

A real estate developer entered into transactions with various partnerships, corporations, and limited liability companies in which he held an interest. These affiliates often paid expenses for each other or for the S corporation. The payor recorded these payments to its affiliates as accounts receivable, and the payee company recorded them as accounts payable. On December 31 of each year, the S corporation's records showed net accounts payable to its affiliates. The firm's CPA would net a subsidiary's accounts payable to its affiliates against its accounts receivable from its affiliates. A net account payable would be reported as a "shareholder loan," and allocated on the basis of ownership interests. The CPA drafted documents for an unsecured line of credit, with charges on the books. There was, however, no evidence of any payments of on the line of credit. The Tax Court rejected the application of the "incorporated pocketbook" theory, which requires that the taxpayer show that he had a "habitual practice of having his wholly owned corporation pay money to third parties on his behalf."

Affirming, the Eleventh Circuit found that the taxpayer failed to prove that indebtedness between himself and the S corporation was a bona fide obligation that would create basis to allow taking a net operating loss. The taxpayer claimed a deduction for losses suffered by the S corporation, arguing that the monetary transfers between the various business entities partly owned by the taxpayer and the S corporation that were later reclassified as loans established "bona fide indebtedness" that "runs directly" to Taxpayer. The Tax Court determined that hundreds of inter-company transactions between Taxpayer and other flow-through businesses did not create bona fide indebtedness under Taxpayer's "back-to-back" loan theory or incorporated pocketbook theory. The Eleventh Circuit agreed and found that Taxpayer couldn't prove that the S corporation's debt ran directly to him. The court rejected Taxpayer's argument that the monetary transfers should be treated as back-to-back loans based on the economic substance rather than the form where a taxpayer is ordinarily bound by the form of a transaction and cannot argue that the substance of the transaction triggers different tax consequences. The court found that many of the affiliates acted like ordinary business entities, rather than incorporated-pocketbook companies because they disbursed and received funds for business expenses from the S corporation, rather than for personal expenses.

Transferee Liability

Marshall, 124 AFTR 2d ¶2019-5072, 9th Cir. (7/23/19)

The Ninth Circuit upheld a determination that a corporation's shareholders and their wholly owned LLC were liable, as transferees, for a corporation's unpaid taxes under § 6901.

The Tax Court found, and the Ninth Circuit agreed, that corporation took multiple steps that could be collapsed because the shareholders had constructive knowledge that the corporation's taxes would not be paid. Therefore under § 6901 and the Oregon fraudulent transfer statute, the multiple steps in the transaction could be collapsed and deemed a transfer that rendered the taxpayers liable as transferees.

VII. CAPITAL GAIN AND BASIS

Like-Kind Exchanges

Malulani, 123 AFTR 2d ¶2019-776, 9th Cir. (6/12/19)

The Ninth Circuit has affirmed a Tax Court holding that related-party transactions weren't eligible for like-kind treatment under § 1031.

A series of like-kind exchange transactions, which involved a qualified intermediary and property acquired from a related party, violated the § 1031 related-party rules even though the taxpayer did not have a prearranged plan to purchase property from the related party. The taxpayer initially sought a replacement property from an unrelated party through a qualified intermediary, but turned to its subsidiary when the deadline to complete the deferred exchange was imminent. The lack of a prearranged plan or intent to purchase a replacement property from its subsidiary when it sold the first property was irrelevant.

Capitalization

Wasco Real Properties I, LLC, 2018-2 USTC ¶50,511, 9th Cir. (12/5/18)

The Ninth Circuit upheld a finding that a partnership must capitalize property taxes and interest corresponding to the portion of its property on which almond trees were grown. The property taxes at issue were incurred by three partnerships in the course of using the land to grow the almond trees. Paying the property taxes benefitted almond production, since the land could continue to be used for growing the trees. Therefore, the property taxes had to be capitalized and were allocable to property (the almond trees) that produced future income. The interest allocable to the land on which the partnerships grew the almond trees also was required to be capitalized, because the land was necessary and indispensable to growing them. Thus, the cost of the land was an indirect cost to the extent the land was used to grow the trees. The interest paid on financing that portion of the land was indebtedness directly attributable to almond production expenditures.

Transfer of Patent

Meggs, T.C. Memo 2019-5 (2/4/19)

Payments that were made to a corporation in consideration for a transfer of a patent qualified as long-term capital gains. The record showed that the corporation valued the patent and was specifically tasked with acquiring the patent from the developer. It also appeared that the corporation would want something in return for the additional payments; therefore, an addendum provided for additional payments in exchange for the transfer of the developer's rights in the patent to the corporation.

Capital Contributions

Brokertec Holdings, T.C. Memo 2019-32 (4/9/19)

Cash grants by a state redevelopment agency to entice a taxpayer to its move offices from the World Trade Center to New Jersey after 9/11 were held to be nontaxable contributions to capital, and not income. The Tax Court focused on the intent of the State of New Jersey, and found that it was to induce Company to establish their offices in a targeted area to bring new jobs and help revitalize the area. Therefore, the court found that the grant provided a nontaxable contribution to capital. The IRS has promptly appealed: "The mere fact that a payment is made to induce the taxpayer to relocate does not mean that it qualifies as a contribution to capital."

Return of Capital

Ginsburg, 123 AFTR 2d ¶ 2019-652, Fed. Cir. (4/25/19)

The Federal Circuit, affirming a Claims Court decision, held that a state tax refund attributable to a state's brownfields credit was taxable income and not, as claimed by the taxpayers in one of their arguments, a return of the capital that it had expended to do the brownfields cleanup.

The taxpayers argued the credit was a reimbursement of a portion of capital costs relating to their investments for the cleanup and redevelopment of the property. The Court said that the refunded amount was an "undeniable accession to wealth" and the taxpayers had complete dominion and control over the payment of the credit. There were no restrictions on their use of the refund.

Capital Loss

Breland, T.C. Memo 2019-59 (5/29/19)

Two individuals were partially allowed to deduct long-term capital loss which they sustained following the foreclosure of the mortgage on their three properties. The taxpayers had bought the properties and had filed a Form 8824, Like-Kind Exchanges, treating this transaction as eligible for deferred recognition of gain. However, the taxpayers defaulted on a mortgage loan secured by the properties which was later purchased by a bank. Further, the taxpayers filed a Form 1040X, Amended U.S. Individual Income Tax Return, that reduced the sale price of the properties to the bid price paid by the bank and reported an increased capital loss.

The Tax Court concluded that the fair market value of the properties at the time of the foreclosure sale was the bid price of the bank because of the absence of an objective appraisal or other reliable evidence for the same. In addition, the amount realized by the taxpayers from the foreclosure of the sale was not in satisfaction of the entire loan. The taxpayers failed to substantiate the adjusted basis in the properties. Therefore, the Tax Court allocated the carried over basis among the properties proportionately.

VIII. BANKRUPTCY

Jurisdiction over Tax Penalty

Bush, 124 AFTR 2d ¶2019-5280, 7th Cir. (9/23/19)

The Seventh Circuit, reversing a district court, held that a bankruptcy court had jurisdiction to determine which tax penalty applied to a taxpayer. It also held that whether a tax issue was related to the rest of a bankruptcy claim must be assessed at the outset of the bankruptcy filing, not after other creditors have made bankruptcy claims.

Tolling of Statute of Limitations

Dixon, 124 AFTR 2d ¶2019-5085, N.D. Ind. (7/24/19)

The taxpayer's claim for a refund for 2012 was barred by statute of limitations. The taxpayer filed timely administrative claims for refund in 2015 and 2016, which were denied. The taxpayer also filed for bankruptcy in 2010, which was completed in 2016. The taxpayer filed for a refund in district court in 2018, which was dismissed as barred by the statute of limitations. The court held that the statute is tolled under § 6503 with respect to collection of taxes, but not for a suit brought against the United States.

Discharge

Nedelka, 10-11803 (BLS), D. Del. Bankr. (12/20/18**)**

The tax liabilities of debtors of a trust were not discharged because the returns for the debts were not filed on time, or at least two years before the commencement of the bankruptcy case. The record showed that the return for the tax year at issue was filed in the same year in which the taxpayers filed their petition for Chapter 13 bankruptcy. As a result, any collection activity for tax liabilities incurred by the taxpayers did not violate the discharge injunction. Further, any collection activity taken by the IRS for post-petition interest on the taxpayers' tax liabilities for two other tax years at did not violate the discharge injunction for the same reasons although those debts were paid in full by the debtors pursuant to their confirmed plan. Because those debts were not discharged, any outstanding post-petition interest on those debts remained the personal liability of the debtors.

Insolvency Exclusion

Bui, T.C. Memo 2019-54 (5/21/19)

The taxpayer was allowed exclude the amounts of discharge of indebtedness income only to the extent that it was qualified principal residence indebtedness or due to her insolvency. The exclusion was denied for loans that were not used for capital improvements to her home. A third loan, used to pay for a driveway expansion and repair work, was allowable as qualified principal residence indebtedness. The Taxpayer was insolvent by about $42,000 immediately before the discharge of indebtedness and therefore, the court held that such amount may be excluded as well.

Invalid Nonrecourse Debt

Milkovich, 123 AFTR 2d ¶ 2019-710, D. Wash. (5/17/19)

A district court held that a mortgage discharged in bankruptcy became a nonrecourse debt because the amount of debt on the date of the discharge was so much less than the value of the mortgaged property on that date the debt became invalid and, therefore, the interest that the taxpayer paid with respect to the mortgage was not deductible.

Interest deductions are generally allowed, even when the debt does not subject the taxpayer to personal liability, but there is an exception to this general rule when the nonrecourse liability exceeds a reasonable estimate of the fair market value of the indebted property. In such a case, an interest deduction is not allowed. Most courts have ruled that where the debtor has the choice of abandoning the property that secures the debt rather than make payment, there is valid indebtedness only where the debtor has an economic incentive to satisfy the obligation.

IX. EMPLOYMENT AND PAYROLL

Lost Wages Subject to RRTA

BNSF Railway Co. v. Loos, 139 S. Ct. 893, 203 L. Ed. 2d 160 (3/4/19)

Reversing the Eighth Circuit, the Supreme Court held, 7-2, that, where a jury awarded a railroad employee damages for the employee's injuries caused by the railroad's negligence, the portion of the award that was for lost wages was subject to the Railroad Retirement Tax.

The employee was awarded $85,000 in pain and suffering, $11,212.78 in medical expenses, and $30,000 in lost wages. Applying cases in Social Security, the Court held that the similarity between the definitions of "compensation" and "wages," is relevant for deciding cases involving the RRTA term "compensation," and reversed the Eighth Circuit conclusion that "compensation" for RRTA purposes means only pay for active service.

Employment Tax

DAF Charter, 152 T.C. No. 14 (5/9/19)

The Tax Court has determined that a Florida limited liability company wholly owned by a foreign corporation was liable for Federal employment taxes and that, as an "American employer," was disqualified from the "crewmen's exemption" under FICA for service performed on or in connection with a non-American vessel or non-American employer under § 3121(b)(4) (which provides that service performed by an individual in connection with a non-American vessel or aircraft isn't employment for FICA purposes if the individual is employed in connection with the vessel or aircraft when it is outside the U.S. and either the individual isn't a U.S. citizen or the employer isn't an American employer).

Under Reg § 301.7701-2(c)(2)(iv)(B), a disregarded entity is treated as a corporation for purposes of federal employment taxes. Therefore, the disregarded entity, rather than the owner, is considered to be the employer of the entity's employees for federal employment tax purposes.

Because the LLC was formed under Florida law, it was liable for FICA taxes on wages paid to the crewmen as an American employer, and ineligible for the § 3121(b)(4) crewmen's exemption.

Trust Fund Recovery Penalty

Romano-Murphy, 152 T.C. No. 16 (5/22/19**)**

The assessment of the trust fund recovery penalty against an LLC member was invalid because the IRS erred in assessing the penalty before making a final administrative determination.

The IRS must provide the member with a pre-assessment determination before assessing the penalty under § 6330(c)(1). The pre-assessment determination requirement is statutory, as is the notification of an assessment of a trust-fund-recovery penalty. Because the final administrative determination was not made before the penalty was assessed, the assessment was invalid.

Self-Employment Tax

Slaughter, T.C. Memo 2019-65 (6/4/19)

The Tax Court held that a successful author's brand was part of her trade or business. As a result, all of her income from her publishing contracts was derived from her trade or business of being a writer and was subject to self-employment tax. Karin Slaughter, a successful author who received substantial royalty income from several publishing contracts, spent time and money on building her personal brand as an author above and beyond merely writing books. Her promotional activities and writing created a very successful brand and body of work.

The taxpayer treated a portion of her income as investment income, payment for an intangible asset beyond that of her trade or business as an author. The IRS contended that all of the payments the author received from her publishing contracts during 2010 and 2011 were derived from her trade or business as an author. The court concluded that the taxpayer's brand was part of her trade or business, a term the court construed broadly to include her brand since she was engaged in developing her brand with continuity and regularity for the primary purpose of income and profit.

X. RETIREMENT PLANS

Deemed Distribution

McEnroe, T.C. Summary Opinion 2019-21 (8/20/19)

K.C. Lim, T.C. Summary Opinion 2018-59 (12/27/18)

In two similar cases, Tax Court held that a taxpayer received a distribution from his employer's retirement plan when he defaulted on a plan loan, even though he later resumed the loan payments. The court based its holding on the fact that the grace period had expired and that he failed to cure the default when he resumed making repayments.

IRA Rollover

Burack, T.C. Memo 2019-83 (7/18/19)

The Tax Court held that where an IRA distribution was rolled over after the 60-day rollover period, and the late rollover was due to the IRA custodian's bookkeeping error, the IRA owner was not liable for taxes on the distribution.

XI. ACCOUNTING

<u>Accrual vs. Cash Method</u>

King Solarman, Inc., T.C. Memo. 2019-103 (8/20/19)

A C Corporation was required to include the proceeds derived from selling solar towers in its gross income. The taxpayer contended that it inadvertently elected the accrual method of accounting. However, the taxpayer's returns were prepared by a CPA and its general ledger was consistent with use of the accrual method. Further, the taxpayer was required to use an inventory because the production, purchase, and sale of merchandise were the sole income-producing factors for the business. The taxpayer also failed all three tests for a "qualifying small business taxpayer" because its business activity was a wholesale trade, it engaged solely in the manufacture and sale of solar towers with no incidental services and it did not fabricate tangible personal property in accordance with customer specifications. The taxpayer satisfied the "all events test" because all responsibility for repair of the towers was shifted to another entity; no further performance was expected from the taxpayer and the amount of the taxpayer's accrued income was determinable in the sales contract and fixed by the promissory note. The taxpayer was also not allowed to use the installment method of accounting because the solar towers were merchandise and were required to be included in inventory at the close of the tax year at issue.

<u>Stock-Based Compensation</u>

Altera, 926 F.3d 1061, 9TH Cir. (6/7/19), reh. den. (11/12/19)

Reversing the Tax Court, the Ninth Circuit upheld the validity of a regulation under § 482 that requires controlled entities entering into qualified cost-sharing agreements to share stock-based compensation costs.

Under § 482, in a transfer or license of intangible property between controlled entities, the IRS may allocate income, deductions, credits or allowances to prevent the evasion of taxes or to clearly reflect income. To achieve a clear reflection of each entity's income, the IRS considers what each entity's income would be had the controlled entities been dealing at arm's length. Under regulations issued in 2003, controlled participants must share intangible development costs in proportion to their share of reasonably anticipated benefits. Reg. § 1.482-7A(d)(2)(ii) requires controlled parties entering into such agreements to share compensation costs of restricted stock, non-statutory stock options, statutory stock options, stock appreciation rights, and phantom stock.

The Ninth Circuit upheld the regulations. They did not exceed the authority delegated under § 482. Treasury reasonably interpreted § 482 as an authorization to require internal allocation methods, provided that the costs and income allocated are proportionate to the economic activity of the related parties and concluded that the regulations reasonably achieved the results required by the statute. Accordingly, the regulations were entitled to deference under *Chevron*.

XII. PROCEDURE

Third-Party Summons

J. B., 123 AFTR 2d ¶2019-458, 9th Cir. (2/26/19)

The Ninth Circuit affirmed a district court order quashing the IRS's third-party summons to the taxpayer's employer, because the IRS failed to provide the "reasonable notice in advance" to taxpayers required in of § 7602(c)(1).

The taxpayers were selected at random for a compliance research examination, as part of the IRS's National Research Program. The IRS letter indicated that they had been selected for the NRP audit, instructed them to contact a revenue agent at the IRS to discuss items on their 2011 tax return, and included a two-page notice, "Your Rights as a Taxpayer," which states, "we sometimes talk with other persons if we need information that you have been unable to provide, or to verify information we have received. If we do contact other persons, such as a neighbor, bank, employer, or employees, we will generally need to tell them limited information, such as your name ... Our need to contact other persons may continue as long as there is activity in your case. If we do contact other persons, you have a right to request a list of those contacted." The IRS issued a summons to his employer for various documents. The taxpayers did not learn that the IRS had issued the summons until after the fact, when their daughter, whom they had listed as a personal representative, received a notice of service of summons in the mail.

Because the only notice to the taxpayers did not directly alert the taxpayers that the IRS may issue a summons to an employer, the Ninth Circuit found that the reasonable notice requirement was not met. The Court rejected the IRS's contention that its mailing provided adequate notice. The Court further found that a reasonable notice must provide the taxpayer with a meaningful opportunity to volunteer records on his own, so that third-party contacts may be avoided.

Tax Liens

First Sentinel Bank, 2019-1 U.S.T.C. ¶50,142, D. Va. (1/25/19)

A bank's mortgage lien survived a nonjudicial foreclosure sale of a real property, so that tax liens against the property were inferior to the bank's lien. The IRS argued that the bank's lien merged with its title when it purchased the property at the foreclosure sale, so that the bank's lien was extinguished and the tax liens elevated in priority. Following Virginia law that where a note holder did not express an intention about merger, one will only be presumed if it accords with the note holder's interests. Here, merger would be against the bank's interests, because it would extinguish its own lien and elevate the tax liens, preventing the bank from selling the property unless it paid the IRS to discharge the tax liens. This result would be unjust, particularly given that it was the trustee rather than the bank who failed to give proper notice to the IRS and therefore prevented the discharge of the tax liens, which far exceed the appraised value of the property.

Filing

Seaview Trading T.C. Memo 2019-122 (9/16/19)

The Tax Court held that a taxpayer's faxing its partnership tax return to an IRS revenue agent was not a proper filing. A partnership purported to file its 2001 partnership return in July 2002, but in 2005, an agent said that the IRS had never received it. The partnership's accountant faxed to the agent a purported copy of the 2001 return with a certified mail receipt purporting to show that the return was initially sent to the IRS in July 2002. The IRS argued that it had never received a return and that faxing a copy to a revenue agent was not properly filing a return.

Refund Claims

Wagner, 122 AFTR 2d ¶ 2018-5442, D. Wash. (11/16/18)

A district court held that § 6532(a), which provides a two-year limitation period on filing refund suits after the IRS disallows a refund claim, is not jurisdictional, because the provision does not provide a clear statement that Congress intended this provision to be jurisdictional. Therefore, a taxpayer's failure to comply with that section does not deprive a court of all authority to hear a case. Because Congress separated the filing deadline in § 6532(a) from the waiver of sovereign immunity in 28 U.S.C. § 1346(a)(1), and placed § 6532 under Procedure and Administration, Congress indicated that the time bar is only procedural and has no impact on the amount of recovery. The court also said two letters from the IRS made unclear to when the IRS credited the taxpayer's accounts or denied refund claims. The IRS first allowed a refund claim but in a later letter two years later rejected the claim. The court found the taxpayer's timely filed suit from the second letter.

Harper, 123 AFTR 2d ¶ 2019-657, D. Cal. (4/25/19)

A taxpayer who provided scant documentation in support of a refund claim, but provided additional information after the IRS denied the claim, did not meet the requirement that a refund claim detail the grounds for the refund claim, sufficient to apprise the IRS of the basis of the claim.

The taxpayers claimed a research credit on an amended return, saying only that they were reporting a "credit for increasing research activity." The IRS denied the credit. The Harpers then brought a refund suit. The IRS asserted that the refund claim submitted by the Harpers failed to adequately set forth the grounds for the credit, a failure that deprived the court of subject matter jurisdiction over the taxpayers' suit for refund. The court held that the taxpayers did not meet the requirements of Reg. §301.6402-2(b)(1), which provides: "No refund or credit will be allowed … except upon one or more of the grounds set forth in a claim filed before the expiration of such period. The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof… A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund or credit." Meaningful administrative review is only possible if taxpayers comply with this requirement.

Borenstein, No. 17-3900, 2nd Cir. (4/4/19)

The Second Circuit held that the Tax Court had jurisdiction to look back three years to order a refund for a taxpayer who failed to file a return prior to the IRS's mailing of a notice of deficiency. The case of first impression was based on § 6512(b)(3), which provides a three-year look-back when a notice of deficiency is mailed during the third year after the return due date plus any extensions.

The taxpayer made timely payments and obtained a six-month filing extension, but failed to file timely. The IRS sent her a notice of deficiency 26 months after the filing due date, and the individual then filed her return reporting a tax overpayment for the year.

The Tax Court has jurisdiction to order refunds of overpayments made: during the two years immediately before the mailing of a notice of deficiency; and during the three years immediately before a notice of deficiency "plus the period of any extension of time for filing the return" if a return was filed and a notice of deficiency was mailed within three years after the filing. Flush language extends jurisdiction to overpayments made during the three years before the notice of deficiency, if the taxpayer failed to file a return before the notice of deficiency and "the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax." The Second Circuit concluded that the language was intended to expand the Tax Court's jurisdiction to order refunds for taxpayers who failed to file a return prior to a notice of deficiency.

Notices of Levy

Gold Forever Music, No. 18-1789, 6th Cir. (4/15/19)

Because royalties sent by music licensing companies to the IRS in a later year were not fixed and determinable in the earlier year when the IRS served notices of levy on them, a wrongful levy action by a music publisher that was owed the royalties was not barred by the statute of limitations.

To collect from a taxpayer who owed millions in tax, the IRS served a notice of levy on the licensing companies he owned, directing them to remit to the IRS property and rights to property that they had or were obligated to pay to the publishing company. Four years later, the licensing companies sent funds to the IRS. The district court dismissed the publishing company's wrongful levy suit as untimely. The court held that the notices of levy did not reach royalties generated after the notices were served, based on the publishing company's agreements with the licensing companies when the notices were served. The only property or obligation to which the levy could potentially attach when the notices were issued was the agreements with the licensing companies to remit future royalties to the publishing company. However, there was insufficient information to determine whether the publishing company's right to receive future royalties was attached by the levies. The royalties appeared to be indefinite, and the lower court should have construed the agreements as "an obligation to attempt to sell some as yet undetermined amount of property for an as yet undetermined price to as yet undetermined buyers," which is not fixed and determinable.

Fraud

Czerw v. Lafayette Storage & Moving, 122 AFTR 2d ¶ 2018-5416, D. N.Y. (11/9/18)

A district court ruled that both the entity required to file the return and its officer or other agent can be liable for damages for fraudulent filing of information returns under § 7434.

Taxpayer Bill of Rights

Moya, 152 T.C. No. 11 (4/17/19)

The Tax Court held that a taxpayer's allegation that the IRS violated the Taxpayer Bill of Rights, by not being responsive to her request to have her audit moved when she moved from one state to another, was not relevant in her Tax Court case in which she protested the proposed deficiency. Under Tax Court rules, trial is a proceeding *de novo*. Thus, the determination of the court must be based on the merits of the case presented to the court, rather than on the administrative record. Any claims that the Service violated TBOR were not relevant to Tax Court deficiency proceeding.

Notices of Disallowance

Hale, 123 AFTR 2d ¶ 2019-696, Ct. Fed. Cl. (5/14/19)

The Court of Federal Claims held that various letters from the IRS to a taxpayer were not notices of disallowance, and thus did not start the two-year period for initiating a refund action.

The taxpayer received correspondence from the IRS (1) explaining a mathematical error she had made in calculating her earned income credit on her return; (2) restating the IRS's position that the earned income credit was calculated incorrectly and had been reduced and (3) requesting more information with respect to her other returns.

The court held that none of the correspondence constituted a notice of disallowance that started the § 6532(a)(1) two-year period for filing a refund suit. Although a notice of disallowance need not take any particular form, it must adequately notify the taxpayer of the Commissioner's adverse action in order to trigger the two-year statute of limitations in § 6532. Notices informing taxpayers that the IRS needs more information to process a claim, along with math error notices or similar correspondence, typically fail to adequately notify taxpayers of a final adverse action or of their right to file suit within two years.

Notice of Deficiency

Gregory, 152 T.C. No. 7 (3/14/19)

The Tax Court held that the IRS had mailed a notice of deficiency to the correct address when it mailed the notice to the address shown on a married couple's Form 1040, even though the couple had filed Form 2848 and Form 4868 with a new address. It therefore held that the couple's Tax Court petition, which was filed too long after the notice of deficiency, was untimely.

A notice of deficiency provides sufficient notice if mailed to the taxpayer's last known address, which is the address shown on the most recently filed and properly filed return unless updated by clear and concise notification of a different address. Even though the couple had filed Forms 2848 and 4868 with their new address, the court noted that is a return for purposes of updating a taxpayer's last known address. Returns are documents that are used to compute a taxpayer's tax liability, and neither of these forms is that type of document. Relevant IRS guidance listing returns do not include these forms.

Fraud

Finnegan, 123 AFTR 2d ¶ 2019-770, 11th Cir. (6/11/19)

The Eleventh Circuit affirmed that the fraud exception to the three-year statute of limitations on assessments applied where a married couple's returns were fraudulently prepared by their preparer. The court also rejected the couple's argument that the Tax Court abused its discretion by accepting the preparer's out-of-court statement admitting his culpability.

The Tax Court previously held, *Allen,* 128 T.C. No. 4 (2007), that the assessments limitations period is extended indefinitely under § 6501(c)(1) if the return is fraudulent, even though it was the preparer rather than the taxpayer who had the intent to evade tax. (The U.S. Court of Federal Claims, affirmed by the Federal Circuit, has ruled that the § 6501(c)(1) open limitation period is restricted to instances in which the taxpayers themselves have the intent to commit fraud.)

Here, the IRS discovered a return preparer and his associates had prepared hundreds of fraudulent returns for 11 years, showing large refunds and partnership losses that flowed through to the individual returns, with deductions for contributions to retirement plans. These taxpayers' returns fit the fraudulent-return mold. Five years after the criminal proceedings, the IRS issued a notice of deficiency to the taxpayers for the eight years that they submitted fraudulent returns.

Overpayment of Interest

Pfizer, 124 AFTR 2d 2019-524, 2^{nd} Cir. (9/16/19)

Vacating a district court opinion, the Second Circuit held that a claim against the United States for overpayment interest on a delayed tax refund belongs in the Court of Federal Claims. The taxpayer timely filed its 2008 federal income tax return, showing an overpayment of $770 million, asking the IRS to refund $500 million and to apply the rest to its estimated tax for 2009. The IRS processed the return and prepared refund checks, which the taxpayer never received. The IRS cancelled the checks and deposited the funds into a bank account of the taxpayer six months later. The taxpayer filed a claim in 2013 for overpayment interest. Because the IRS issued the refund checks in 2009, it denied the claim. The district court dismissed the taxpayer's claim. The circuit court held that a claim for overpayment interest is not an action seeking "recovery" of items listed in 28 U.S.C. §1346 that would invoke a district court's jurisdiction.

Litigation Costs

BASR Partnership, No. 2017-1925, Fed. Cir. (2/8/19)

A partnership was entitled to litigation costs because it made a valid qualified offer in a proceeding in which a tax liability was at issue and it incurred reasonable litigation costs. The partnership was a party because it was subject to a TEFRA partnership-level proceeding initiated by the tax matters partner and it met the net-worth requirements. The partnership-level Final Partnership Administrative Adjustment review proceeding conclusively determined the tax treatment of all partnership items, which in turn determined each individual partner's tax liability. Because the partnership successfully raised the statute of limitations defense, the partners incurred no tax liability. The partnership's qualified offer was timely because it was made during the qualified offer period.

The FPAA was the functional equivalent of a deficiency notice and the offer was made more than 30 days before the date the case was first set for trial. Moreover, the partnership's offer of $1 was reasonable; since the finding that the FPAA was untimely resulted in zero tax liability for the partnership's partners and $1 is more than zero, the partnership's offer complied with § 7430. Although the tax matter partner hired the law firm and paid the bills, under the partnership agreement and state law, the managing partner was entitled to reimbursement for reasonable out-of-pocket expenses incurred on behalf of the partnership. The fact that the partnership had no money to reimburse the partner for the litigation costs advanced on its behalf did not change the fact that the partnership was obligated to reimburse the partner. Since the partnership incurred the legal fees, it was unnecessary to examine the net worth of the partners.

The hours spent on the litigation by the partnership's attorneys and paralegals, as adjusted by the court, were reasonable. The attorneys were entitled to an hourly fee above the statutory rate because the issues were complex and concerned numerous provisions of the Code and regulations.

Collection

Atlantic Pacific Management Group, 152 T.C. No. 17 (6/20/19)

The Tax Court held that it lacked jurisdiction to consider penalties because the IRS had not issued a notice of determination to a taxpayer. The taxpayer argued that the court should have ordered the IRS to grant it a Collection Due Process hearing, but the Tax Court held that it lacked jurisdiction to do so because the taxpayer failed to request a hearing within the required time.

Whistleblower Awards

Myers, 124 AFTR 2d ¶2019-5007, D.C. Cir. (7/2/19)

The D.C. Circuit reversed the Tax Court's dismissal of an individual's petition to review the IRS's denial of his whistleblower award claim. Although the Tax Court properly determined that the petition was untimely, the filing period is not jurisdictional and is subject to equitable tolling.

An individual may appeal an IRS whistleblower award determination to the Tax Court within 30 days of such determination. The U.S. Supreme Court has held, *Kwai Fun Wong*, 135 S. Ct. 1625, that most time bars are claim-processing rules that seek to promote the orderly progress of litigation, but they are not jurisdictional, and do not deprive a court of authority to hear a case, unless Congress has clearly so stated.

The whistleblower filed an application in 2009, alleging that his former employer intentionally misclassified him and other employees as independent contractors. In 2013, the IRS denied the claim. He responded to the denial letter and continued corresponding with the IRS about his claim through 2014. In 2015, he petitioned the Tax Court to review the IRS's denial.

The Tax Court agreed with the IRS that the petition was untimely, but the D.C. Circuit reversed its Court's decision to dismiss the untimely petition for review for lack of jurisdiction. Since timely filing is not a prerequisite to Tax Court jurisdiction, the filing period is subject to equitable tolling. Therefore, the Appeals Court remanded the case for the Tax Court to determine whether the taxpayer was entitled to equitable tolling.

Whistleblower, 124 AFTR 2d ¶2019-5090, D. C. Cir. (7/26/19)

The D.C. Circuit reversed the Tax Court's decision to deny a serial whistleblower's request for anonymity. In reviewing whether the Tax Court has abused its discretion in granting a whistleblower's request for anonymity, the appeals court held that the appropriate way to determine whether a whistleblower may proceed anonymously is to balance the whistleblower's legitimate interest in anonymity against countervailing interests in full disclosure.

The Tax Court concluded that Whistleblower hadn't made a sufficient fact-specific case for anonymity under Tax Court Rule 345(a). While the Court was mindful of the legal system's general solicitude for confidential informants, it found that, on balance, Whistleblower's interest in protecting his anonymity was outweighed by the public's interest in identifying serial claimants of whistleblower awards who file petitions in the Tax Court. Because Whistleblower was so prolific in filing claims, the Tax Court labeled Whistleblower "a serial claimant."

The Appeals Court found that the Tax Court improperly considered that Whistleblower was a "serial claimant" using public information to make his whistleblower claims. Neither the whistleblower statute nor any precedent suggests a public policy disfavoring repeat filers or filers who rely upon publicly available information.

The Tax Court claimed that unless it identified serial filers by name, the public would be unable to judge accurately the extent to which the serial filer phenomenon has affected the work of the Tax Court. But the Appeals Court held that it simply does not follow that the public must know the serial claimants' names in order to determine either the extent to which serial filers affect the work of the Tax Court or whether any particular whistleblower is a serial filer.

The Appeals Court pointed out that the Tax Court could serve those interests by alerting the public to the serial filer's history and by explaining the burdens that serial filers impose upon the court; indeed, that is precisely what it did in this case. The use of a unique pseudonym (John Doe, Jane Roe and the like) in all the cases filed by a particular filer would, for example, similarly inform the public in the two respects identified by the Tax Court.

XIII. PRACTICE

PTIN Fees

Montrois, No. 17-5204, D.C. Cir. (3/1/19)

Reversing a district court, the D.C. Circuit upheld the IRS's authority to charge fees for issuing and renewing Preparer Tax Identification Numbers. In 2017, the D.C. district court enjoined the IRS from charging PTIN fees, finding it had no authority to do so under the Independent Offices Appropriations Act in charging tax-return preparers a fee to obtain and renew PTINs.

The Circuit Court held that to justify a fee under that Act, an agency must show that (1) it provides some kind of service in exchange for the fee, (2) the service yields a specific benefit, and (3) the benefit is conferred upon identifiable individuals, and concluded that the PTIN fee satisfies those conditions.

Attorney-Client Privilege

U.S. v. Adams, 122 AFTR 2d ¶2018-5380, D. Minn. (10/27/2018)

After examining the communications between a taxpayer and his accountants *in camera*, the Court found they were protected by the attorney-client privilege under a "Kovel arrangement," that is, where the communications with an accountant if the communications are made in confidence for the purpose of obtaining legal advice from the lawyer.

The IRS asserted that (1) the *Kovel* protection was waived by the taxpayer's subsequent filing of amended tax returns; (2) the crime-fraud exception invalidated any claim of privilege, and (3) the taxpayer communicated with the accountants and his attorney to obtain advice that would further the submission of fraudulent tax returns by misrepresenting transactions. The District Court resolved this question after examining the communications.

Permanent Injunction

U.S. v. Hill, No. 5:17-CV-366-D, D. N.C. (1/7/19)

An individual was permanently enjoined from filing and preparing income tax returns because he and firm repeatedly filed thousands of tax returns that understated tax liability in numerous ways. The individual and his firm committed fraudulent and criminal conduct in preparing tax returns, and took unreasonable tax positions to minimize customers' tax liabilities. He pleaded guilty to willfully filing false tax returns and personally benefitted from the fraudulent scheme. The individual also did not offer any credible assurance of refraining from engaging in activities that may lead to future violations of the law.

XIV. INTERNATIONAL

Collection of Canadian Income Taxes

Retfalvi, 124 AFTR 2d ¶2019-5045, 4th Cir. (7/16/19)

The Fourth Circuit affirmed that the IRS can collect unpaid taxes owed to Canada under the U.S.-Canada Income Tax Convention. The taxpayer argued that because the treaty was ratified by the Senate, any tax collection action based solely on the treaty was not constitutional because it was a bill to raise revenue that did not originate in the House of Representatives.

The Fourth Circuit held that the phrase "bills for raising revenue" in the Origination Clause refers to bills that impose taxes for the general support of the Federal government. The treaty is not a bill and does not impose a new tax or modify an old one. The Treaty merely facilitates the collection of an already existing debt. Further, the Appeals Court held that the Treaty gave the IRS the authority to collect Canadian revenue claims using the procedures under § 6201 and § 6301. Under the Treaty, when the IRS accepts a request from Canada to collect a revenue claim, the IRS must collect the revenue claim as if it were a tax debt owed to the IRS. Therefore, the IRS can use its domestic collection authority to collect a liability owed by a taxpayer to Canada.

FBAR

Shinday, 122 AFTR 2d ¶ 2018-5483, D. Cal. (12/4/18)

A district court held that the monetary limit on the penalty for willfully failing to file a Report of Foreign Bank and Foreign Accounts is an annual one. The maximum penalty for failure to file the FBAR depends on whether the violation was willful. The maximum penalty amount for a non-willful violation is $10,000. The maximum penalty amount for a willful violation is the greater of $100,000 or 50% of the account at the time of the violation. The IRS assessed willful FBAR penalties for four years, totaling $250,000, representing 25 percent of the taxpayer's combined foreign bank accounts at the beginning of the period, and divided them over the four years. The taxpayer unsuccessfully argued that the penalties exceeded the $100,000 penalty cap.

Bedrosian, 912 F.3d 144, 3d Cir. (12/21/18)

A CEO's case was remanded to determine if he willfully failed to file an accurate FBAR. The Third Circuit held that to prove a willful FBAR violation, the government must satisfy the civil willfulness standard, which includes both knowing and reckless conduct. The CEO had two Swiss bank accounts, but only reported one for the tax year at issue. The issue was whether his failure to file an FBAR for the second account was willful. The taxpayer filed amended returns and rectified the issue before he learned the government was investigating him and before he knew the bank turned his information over to the IRS.

Kimble v. U.S., 122 AFTR 2d ¶2018-5544, Ct. Fed. Cl. (12/27/18)

The Court of Federal Claims determined that a taxpayer's failure to file an FBAR was willful and upheld the IRS's imposition of a penalty greater than the $100,000 maximum set out in regs that have not been removed despite a statutory increase in the penalty amount. The Court found that the revisions to the statute effectively nullified the contrary regs.

The taxpayer's stipulations that she did not review her individual income tax returns for accuracy and falsely representing under penalty of perjury, that she had no foreign bank accounts in signing her tax return. Despite Taxpayer having no legal duty to disclose information to her accountant or to ask about IRS reporting requirements, such additional facts do not affect the determination that the conduct was "willful," the court added. The court also found that the IRS didn't abuse its discretion in assessing the maximum penalty of 50% of the account balance because Taxpayer represented that she was the sole owner of the account, she did not have a personal connection to Switzerland, and she was actively involved in the management of the account.

Treaty Relief for Withheld Taxes

Starr International Company, No. 17-5238, D.C. Cir. (12/7/18)

A Swiss entity was allowed to bring a refund suit based on its claim for a reduced rate of tax on U.S. source dividends under the U.S.-Switzerland income tax treaty. The D.C. Circuit reversed a district court that dismissed the suit as raising a nonjudicial political issue.

The treaty provides discretionary relief for persons who are not otherwise entitled to benefits, if the competent authority of the country in which the income arises determines that the person seeking benefits does not operate in the country for the principal purpose of receiving treaty benefits. The treaty requires consultation between the IRS and the Swiss before a refund can be granted.

Because the consultation between the competent authorities had not yet occurred, the district court believed it could not address the taxpayer's claim without answering a political question and it held that the taxpayer lacked standing to pursue its claim. The taxpayer was allowed to bring a claim under the judicial-review provision of the APA. The appeals court reversed, finding the taxpayer's claim was a straightforward case of treaty interpretation and a matter for the court to decide. Further, a decision by the district court would have no impact on the consultation between the competent authorities. If the district court found that the taxpayer was entitled to a refund, it could stay the case pending a refund.

Controlled Foreign Corporations

SIH Partners LLLP, 123 AFTR ¶2019-689, 3rd Cir. (5/7/19)

The Third Circuit affirmed the Tax Court's decision to uphold regulations which provide that an obligation of a U.S. person guaranteed by a controlled foreign corporation is treated as U.S. property held by the CFC, and that guaranteed loan amounts included in income under the regulation were not qualified dividends.

Typically, a CFC's income is not taxable to its domestic shareholders until the income is distributed, or "repatriated" to them. However, under § 956, any investment by a CFC in U.S. property (which includes an obligation of a U.S. person) is considered repatriated income.

The taxpayer was a U.S. shareholder of two CFCs. Both CFCs guaranteed loans made to the U.S. shareholder by a third-party financial institution. After the CFCs distributed their earnings to the U.S. shareholder, the IRS determined that the taxpayer should have reported its income from the CFCs when the CFCs guaranteed the loans. Therefore, the IRS treated each CFC as if it had made the entire loan directly, capping the income at the CFCs' combined applicable earnings. The IRS also determined that the income included under § 956 was not a qualified dividend; so it was taxed as ordinary income at the 35% rate.

Foreign Earned Income Exclusion

Weschenfelder, T.C. Memo 2019-133 (10/3/19)

The Tax Court held that married taxpayers did not make a valid election to exclude foreign earned income under § 911 because they failed to comply with the regulation by placing the required statement on the front page of their 2006 return.

The couple worked on a military base in Germany. They did not file their 2006 return until 2016. It showed a Texas address for the couple, no federal income tax due, and claimed a $71,929 foreign earned income exclusion on Form 2555, Foreign Earned Income Exclusion, which inaccurately reported dates the taxpayers were in the U.S. and omitted information required by the regulations. Critically, the return did not contain the required statement on the first page that their Form 1040 it was "Filed Pursuant to Section 1.911-7(a)(2)(i)(D)."

The Tax Court held that the taxpayers did not make a valid election to exclude foreign earned income under § 911 because they failed to comply with the regulation by placing the required statement on the front page of their 2006 return. The Court rejected the couple's claim that their failure to include the required statement on the front page of their 2006 Form 1040 was immaterial and inadvertent. The Court noted that the couple claimed to have read the instructions to Form 2555 before filing their return but failed to explain how their omission of the required statement could be regarded as inadvertent.

Offshore Disclosure Penalties

Dewees, 123 AFTR 2d ¶2019-602, D.C. Cir. (4/9/19)

The D.C. Circuit affirmed the dismissal of a complaint from a taxpayer, whose U.S. tax liability had been offset against his Canadian tax refund under a treaty provision. He argued that he had been denied due process and equal protection when the federal government offered lower tax penalties to taxpayers participating in a later compliance program.

The taxpayer, a U.S. citizen living and operating a consulting business in Canada, failed to comply with FBAR requirements, so he successfully applied to participate in the Offshore Voluntary Disclosure Programs. The IRS assessed a penalty of $185,000 for not filing the FBARs. The taxpayer refused to pay the assessed penalty and withdrew from the OVDP.

IRS later notified the Taxpayer that it had assessed a different penalty of $120,000 against him for failing to file Form 5471 from 1997 to 2008. He requested an abatement of this penalty for reasonable cause, which was denied.

Pursuant to tax treaty, Canada withheld his Canadian tax refund until the IRS penalties were paid. After paying the penalty, he brought suit, challenging the treaty as unconstitutional under the Eighth Amendment and the Due Process and Equal Protection Clauses of the Fifth Amendment.

The D.C. Circuit affirmed the district court's dismissal of the taxpayer's claim. The taxpayer was seeking a "third bite at the apple." The taxpayer claimed that the federal government unconstitutionally offered lower tax penalties to taxpayers participating in a new Streamlined Filing Compliance Procedures program, but admitted that his prior participation in the Disclosure Program rendered him ineligible for the Streamlined Program. His equal protection argument failed because in matters of purely economic and financial regulations, differences in governmental classifications "cannot run afoul of the Equal Protection clause if there is a rational relationship between the disparity of treatment and some legitimate governmental purpose."