DELAWARE TAX INSTITUTE

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2016 INCOME TAX DEVELOPMENTS

NOTABLE CASES IN FEDERAL INCOME TAX

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I. DEDUCTIONS, EXCLUSIONS AND INCLUSIONS

Hobby Losses

Stuller Estate v US, 7th Cir., , 2016-1 U.S.T.C. ¶50,165, 811 F.3d 890

Applying the nine factors, listed below, that are used in the analysis, the Seventh Circuit held Taxpayer could not treat their horse farm as a business. Only one factor, expectation of asset appreciation, weighed in their favor, insufficient to offset the findings that the activity never turned a substantial profit; losses were consistent and lasted beyond any arguable start-up phase; no evidence showed that they operated their horse-breeding activity in a manner similar to profitable horse-breeding activities; and the horse-breeding activity's losses generated substantial tax benefits for the couple, who received substantial income from other activities.

- The manner in which the taxpayer carries on the activity
- The expertise or experience of the taxpayer or the taxpayer's advisors
- The time and effort expended by the taxpayer in carrying on the activity
- The expectation that the assets used in the activity may appreciate in value
- The success of the taxpayer in carrying on other similar or dissimilar activities
- The taxpayer's history of losses from the activity
- The amount of occasional profits earned from the activity
- The financial status of the taxpayer
- The elements of personal pleasure or recreation derived from the activity

Roberts, 7th Cir., 117 AFTR 2d ¶ 2016-629

On the other hand, the Seventh Circuit, reversed the Tax Court to conclude that a taxpayer's horse racing activities were entered into for profit.

The Seventh Circuit said the Tax Court would have been better off if, rather than wading through the nine factors (in what it characterized as a "goofy" regulation), "it said simply that a business that is in an industry known to attract hobbyists (and horse racing is that business par excellence), and that loses large sums of money year after year that the owner of the business deducts from a very large income that he derives from other (and genuine) businesses or from trusts or other conventional sources of income, is presumptively a hobby, though before deciding for sure the court must listen to the owner's protestations of business motive."

Moving Expenses

Parmeter, T.C. Summ. Op. 2015-75

The "one-trip" rule was applied to gauge moving expenses. An engineer who moved 182 miles for a new position deducted moving expenses which included 20 round trips, storage facility fees, trailer rental and a hotel room for two nights. The IRS argued that, under Reg. §1.217-2(b)(4) ("The deduction for traveling expenses from the former residence to the new place of residence is allowable for only one trip made by the taxpayer and members of his household; however, it is not necessary that the taxpayer and all members of his household travel together or at the same time."), Taxpayer was only entitled to deduct the cost of one leg of his trip to his new residence, but the court stated that interpretation of the one-trip rule would ignore the actual cost incurred by those who move their own belongings. The court held that Taxpayer could not deduct the cost of the last leg of his trip, but could deduct the mileage at 23¢ per mile for the other round trips. Because Taxpayer provided no evidence of the actual expenses of transporting his property, under Rev. Proc. 2010-51, Taxpayer could use the optional standard mileage rate of 23¢. Under Reg. §1.217-2(b)(3), Taxpayer could only deduct one month of storage expenses, and could not deduct the cost of his hotel room.

Amortization of Intangibles

CGG Americas, Inc., 147 T.C. No. 2

A corporation that conducted marine surveys to detect the presence of oil and gas, then licensed the data to customers who used the data to drill for oil and gas, could amortize geological and geophysical expenses under § 167(h), even though it did not itself own oil and gas interests.

The IRS disallowed amortization deductions for the Taxpayer's expenses in conducting its surveys and processing the data costs on the grounds that "geological and geophysical expenses" in the statute refers only to expenses incurred by Taxpayers that own oil or gas interests; and the expenses were not incurred "in connection with the exploration for, or development of, oil or gas."

The Tax Court held that "geological and geophysical expenses" was not restricted to expenses incurred by owners of oil or gas interests. A taxpayer could incur costs for the purpose of obtaining and accumulating data that would serve as a basis for the acquisition or retention of property acquired or retained by another taxpayer; that is, one taxpayer could obtain data, while the other taxpayer could use the data to determine what property to buy. The survey expenses were "incurred in connection with the exploration for, or development of, oil or gas." Because the surveying was integral to the process of finding oil and gas deposits, the costs of the surveys were incurred in connection with oil and gas exploration and development.

Charitable Deduction of Trust

Green v. U.S., 116 AFTR 2d ¶ 2015-5394

A district court allowed a trust an income tax charitable deduction equal to the fair market value of the property given, and not limited to the property's cost basis.

The trust agreement allowed distributions to charity of "such amounts from gross income" as the trustee deemed appropriate. The trust donated appreciated real estate that had been purchased with income it had received from a partnership in prior years. Initially, the trust's fiduciary income tax return claimed a charitable deduction equal to realty's basis, and later filed an amended return claiming a charitable deduction equal to the fair market value of the real estate.

The IRS argued that the charitable contribution must be traceable to gross income, citing a line of cases discussed in CCA 201042023. The court said that while § 642(c) limits the income tax charitable deduction for a trust to income, it doesn't require the distribution to be made in the same year in which the income was received. The court held that since the real estate was purchased with items that were gross income in prior years, the gross income retained its character as gross income when that income was used to purchase the real estate that was ultimately distributed to charity.

A number of authorities, including *Frank v. Commissioner*, 145 F.2d 411 (3d Cir. 1944) provide support for the government's position, so this ruling should be applied with caution.

Non-Deductibility of Fines

Nacchio, Fed. Cir., 117 AFTR 2d ¶ 2016-765

The rule in § 162(f) that precludes a business expense deduction for fines also precludes a § 165 loss deduction attributable to such a payment. Illegally obtained income that was forfeited to the U.S. government under relevant federal criminal law was a penalty that precluded a § 165 deduction, even though the Justice Department was permitted to, and in fact did, transfer the forfeited funds to victims under that law.

Convicted of insider trading, a Taxpayer was sentenced to 72 months in prison, a $19 million fine, and forfeiture of $44.6 million of income from insider trading that he had reported as taxable income. The U.S. Government acceded to his attorney's request that the forfeited money go to a fund for distribution to his victims, permitted under the Civil Asset Forfeiture Reform Act of 2000.

The Court held that § 162(f) applies for purposes of determining whether a loss deduction may be claimed. As a result, he could not deduct the $44.6 million under § 165(c)(2). The Court said that § 165 is subject to a "frustration of public policy" doctrine, under which a taxpayer cannot deduct a loss where its allowance "would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereto."

Life Insurance

Mallory, T.C. Memo 2016-110

A constructive distribution was caused by the termination of a life insurance policy that had outstanding loan principal and interest that exceeded the Taxpayer's investment.

An amount received under a life insurance contract that is not received as an annuity is included in gross income to the extent it exceeds the investment in the contract.

The Taxpayer purchased a modified single premium variable life insurance policy in 1987. The insured, as owner, could borrow on the policy. If the policy debt ever exceeded the cash value of the policy, the insurance company would terminate the policy after giving notice and opportunity.

Ultimately, debt exceeded cash value, and the policy was terminated. The distribution exceeded premiums by $150,000.

The taxpayer argued that the loans were distributions of the policy's cash value, but the terms of the policy and communications from the insurance company indicated otherwise.

Self-Employment Income

Ryther, T.C. Memo 2016-56

The Tax Court held that scrap metal abandoned by a steel-fabrication business and later sold by the owner of that bankrupt business didn't generate self-employment income, but instead produced miscellaneous income.

Factors favoring the taxpayer: (1) he sold scrap only once or twice a month; (2) he sold the scrap over seven years, with little marketing (a short holding period would indicate he was holding primarily for sale to customers); (3) he didn't use the proceeds to replace the scrap with more scrap.

Other factors – substantiality of the sales; length of time the property was held; whether the property was segregated from his personal property; purpose of acquisition; extent of sales and advertising; time and effort spent on sales – were neutral or the record was not well developed.

II. ALIMONY, JOINT RETURNS AND DOMESTIC RELATIONS

Alimony

Anderson, T.C. Memo 2016-47

Payments to maintain spouse's financial status quo before divorce pursuant to a court order qualified as alimony. When they began divorce proceedings, he owned productive real estate; she was not working. The court's pretrial order instructed the parties to "maintain status quo as to payment of house note or rent, utilities, food, necessities, fixed credit obligations, etc." He continued to pay the mortgages, also transferring $1,000 to her monthly, nine months by electronic transfer, three months by check. The Tax Court held that Taxpayer made the payments to maintain the financial status quo while they were divorcing, and the payments constituted alimony under §71. The pretrial order was a divorce or separation instrument and met the requirements of §71. "In other words, the purpose of the payments was to maintain the status the parties had enjoyed during the marriage."

Execution on Lien

U.S. v. Davis, (CA 6 3/9/2016) 117 AFTR 2d ¶ 2016-499

The Sixth Circuit affirmed that IRS could enforce its tax lien and sell the primary residence owned by the taxpayer and her tax-delinquent husband. In *U.S. v. Rodgers*, 52 AFTR 2d 83-5042, the Supreme Court held that a district court could enforce a tax lien by decreeing a forced sale of an entire property in which a delinquent taxpayer had an interest, even though a non-delinquent person also has an interest in the same property. The non-delinquent is entitled to appropriate portion of the proceeds. Under certain circumstances, among them the likelihood of prejudice to the co-owner, in dislocation costs and in under compensation, the district court may use its discretion to disallow a request for the forced sale. Here, the wife argued that she would be undercompensated, because she had a greater interest because she had a longer life expectancy, both because she was a woman and because her diabetic husband had heart disease.

Reaching similar result:

Tannenbaum, D.C. N.Y., 117 AFTR 2d ¶ 2016-5120
U.S. v. McGrew, 9th Cir., 118 AFTR 2d ¶2016-5319

Innocent Spouse

Arobo, T.C. Memo 2016-66

No relief was available where the husband had always been the primary financial provider, their lifestyle hadn't changed from years when the couple reported significant business income. She failed to show that she didn't have reason to know there was an understatement in later years when returns showed losses, or didn't even report activity from, the husband's business. Evidence showed that the husband was not deceptive and wife didn't ask questions.

III. LOSSES AND FORGIVENESS OF INDEBTEDNESS

Bad Debt Deduction

Shaw, 9th Cir., 116 AFTR 2d ¶2015-5471

Deduction denied for Taxpayer's advances to family-owned business. Taxpayer didn't establish that the advances were loans because she didn't prove that when she advanced the funds, she had a real expectation of repayment and an intent to enforce collection. Taxpayer provided no documentary evidence about the business's creditworthiness when she executed the line of credit, didn't request collateral, and didn't insist on financial covenants that would condition future advances on the company's adherence to income benchmarks. Instead, taxpayer extended an open-ended, unsecured line of credit that did not require repayment of interest or principal for two years, and provided no evidence that an independent lender would have extended credit on comparable terms.

Timing of Loss

Evans, T.C. Memo 2016-7

The Tax Court concluded that the loss from the foreclosure sale of property that the taxpayer intended to develop was a capital loss in the year in which the foreclosure sale took place, and not in the year in which the taxpayer received his share of the proceeds from the sale. (The loss was a capital loss because the Taxpayer was not in the business of selling property. He worked for a real estate developer and purchased properties to develop or rent on the side. His property sales were sporadic, he did not keep proper books and records and the income he earned from his real estate activities was an insubstantial portion of his overall income.)

Casualty Loss

Alphonso, T.C. Memo 2016-130

A tenant-stockholder in a cooperative housing corporation was not entitled to a casualty loss deduction because the retaining wall's collapse was not a casualty under § 165(c)(3). The Taxpayer argued that the retaining wall's collapse was the result of excess rain that over-stressed a recently installed drainage system and caused increased movement in the wall in the weeks before its collapse. The court held, however, that the collapse was not due to a sudden, unexpected or unusual event; even when a collapse occurs suddenly, it is not a casualty when it was caused by progressive deterioration. A loss that is accelerated by a contributing factor, such as rain or wind, is not a casualty if the loss was caused by progressive deterioration.

Madoff Loss

Heller Estate, 147 T.C. ___, No. 11

An estate was allowed a theft-loss deduction for an account with Bernard L. Madoff Investment Securities, LLC, that was held by a limited liability company whose only asset was the Madoff account. The account manager withdrew money from the account and the estate used its share ($11.4 million) to pay its taxes and administration expenses. After the decedent's death and the withdrawal, the Ponzi scheme perpetuated by Mr. Madoff was revealed. As a result of the Ponzi scheme, the LLC's interest in the account and the estate's interest in the LLC became worthless. When the estate filed its federal estate tax return, the gross estate included the value of the LLC, reported at nearly $16.6 million. The estate also claimed a theft-loss deduction for the $5.2 million difference between the value of the LLC reported on the return and the estate's share of the amount withdrawn from the account. The IRS challenged the deduction as not incurred by the estate since the account was held by the LLC.

Because the issue of whether an estate was allowed a loss deduction for property held by an entity was a case of first impression, the court looked to the language of § 2054 and the purpose of the estate tax. Section 2054 provides for a deduction of a loss incurred during the estate settlement "arising from" theft. The phrase "arising from" allows for a deduction if a sufficient nexus exists between the theft and the estate's loss. The nexus between the theft and the value of the estate's interest in the LLC was direct and indisputable. The estate's loss was directly related to the LLC interest, the worthlessness of which *arose from* the theft.

IV. EXEMPT ORGANIZATIONS

Rate of Interest on Refund

Maimonides Med. Ctr. v. U.S., 2d Cir., 809 F.3d 85

A nonprofit teaching hospital was held to be entitled only to the lower corporate interest rate on refund of FICA taxes, because the Code doesn't distinguish between for-profit and nonprofit corporations for purposes of refund interest. The hospital was entitled to refund of FICA taxes due to a change in regulations. It argued that the lower interest rate which §6621(a)(1) provides for overpayments by "corporations," does not apply to nonprofit organizations that are organized as corporations. The Second Circuit held that the hospital was entitled only to the refund interest rate for corporations and not the general higher interest rate, because the tax Code does not distinguish between profit-seeking and nonprofit corporations for the purpose of the refund interest rate.

Reaching similar result:
United States v. Detroit Med. Ctr., No. 15-01279 (6th Cir. Aug. 17, 2016):
Med. Coll. of Wisc. Affil. Hosps., Inc., v. U.S., (D.C. Wis.) 116 AFTR 2d ¶ 2016-5223

Attempts to Influence Legislation

Parks, (2015) 145 T.C. ___, No. 12

Expenditures by a private foundation for radio messages were taxable expenditures subjecting the Foundation and its manager to excise taxes, because they were incurred in an attempt to influence legislation. The Taxpayers argued that the radio messages were not direct lobbying communications because they did not mention any ballot measure by name.

The Court agreed with IRS that a communication can "refer to" a ballot measure without identifying it by name. Pursuant to the regulations interpreting § 4945(e), a communication refers to a ballot measure if it either refers to the measure by name or, without naming it, employs terms widely used in connection with the measure or describes the content or effect of the measure.

The messages contained a number of factors indicating that they weren't "educational." They distorted the facts or provided no facts, expressing conclusions based more on strong feelings than on objective evaluations. They used inflammatory language or disparaging terms.

The Court also determined that the application of § 4945 and its regulations to Foundation and Loren Parks didn't violate the First Amendment to the U.S. Constitution and that the regulations weren't unconstitutionally vague.

Qualification

GameHearts v. Commissioner, T.C. Memo 2015-218

Gaming organization promoting adult sobriety not entitled to §501(c)(3) exempt status because of inherently commercial nature of recreation provided.

A public benefit nonprofit organization, providing alternative forms of entertainment to adult members for the purpose of promoting adult sobriety, achieves its goal by providing free and low cost tabletop gaming activities in a supervised, non-alcoholic, sober environment, along with access to gaming accessories that are provided without cost to the participants. A participant must be at least 18 years old and sober during play.

The Tax Court held that the organization was not entitled to §501(c)(3) exempt status because of the inherently commercial nature of the recreation provided and the applicant's ties to the for-profit recreational gaming industry. The decisive factor was that the form of the recreation offered as therapy was also offered by for-profit entities. The applicant even emphasized, in its application for tax exemption, that it would introduce new participants to that for-profit recreational market and boost the overall market shares of the industry.

V. PARTNERSHIPS

Tax on Distributive Share

Lamas-Richie, T.C. Memo 2016-63

The Tax Court held that a blogger was liable for tax on his distributive share of partnership income that was not actually distributed to him and of which he was not aware until IRS began examining his return for the year at issue.

Taxpayer started a gossip blog that attracted viewers, then investors, one of whom suggested forming a partnership to own the website and supply capital. Taxpayer received a 41 percent limited partnership interest. His 2011 return, filed in March 2012, did not report any income or loss stemming from his 41 percent limited partnership interest.

The partnership filed its Form 1065 in September. Taxpayer did not receive a copy of his Schedule K-1 and was not aware of the contents of the Form 1065 until IRS began its examination of his 2011 return. IRS ultimately determined a tax deficiency of $7,097 and an accuracy-related penalty of $1,419.

The Tax Court held that, regardless of whether Taxpayer in fact received a distribution or was even aware of the existence of such income at the time it was earned, his distributive share of the Partnership's income was taxable to him in 2011. It was undisputed that he had a 41 percent interest in the Partnership during 2011, and there was no indication that the amount that the partnership reported as business income was incorrect.

Partnership Information

In re: Refco Public Commodity Pool LP, 118 AFTR 2d ¶ 2016-5085

Delaware Bankruptcy Judge Shannon held that a partnership that did not file partnership returns for three years was not liable for a failure-to-file penalty because most of its income and other tax return information came from its investment in another partnership that did not provide the Taxpayer with Schedule K-1's for those years, and despite reasonable efforts, the partnership was unable to obtain that tax information from other sources. At trial, the Taxpayer established reasonable cause under § 6724(a), that the failure to file was due to impediments that were beyond its control.

Existence of Partnership

Methvin, 10th Cir., 109 T.C.M 1409, T.C. Memo. 2015-81

Affirming the Tax Court in a case discussed here last year, the Tenth Circuit held that a Taxpayer's arrangement with an oil and gas well operator was a partnership, so he was liable for self-employment tax. The Taxpayer owned working interests in oil and gas ventures. To obtain these interests, he entered into purchase and operating agreements with the operator. He argued that his involvement with the operator did not qualify as a partnership because (1) his working interests were not governed by a separate organization; and, (2) he was merely a passive investor.

These arguments were rejected in light of the broad definition of "partnership." Under the purchase agreement, the Taxpayer had a direct operating interest in the ventures and enjoyed the right to: (1) inspect receipts, vouchers, insurance policies, legal opinions, drilling logs and reports, copies of drill stem tests, core analyses, electrical surveys, geological reports and other records involving wells that had been drilled; (2) audit the books and records; (3) enter the property to inspect the operations; (4) obtain any information reasonably requested regarding development and operation and (5) to inspect the operators records. He not only shared these rights with the operator, but also shared the cost in the form of a monthly payment in proportion to his share of the working interests.

Amendment of Partnership Return

United States v. Stewart, 5th Cir., 2016-2 U.S.T.C. ¶50,451

A partnership's amended return was insufficient, without an Administrative Adjustment Request, to permit re-characterization of income as capital gain, rather than ordinary income.

The Partnership's 2004 return reported ordinary income of $20 million. In 2007, Partnership amended the original return to characterize its 2004 income as capital gain and issued amended K-1's to the partners, two of whom amended their 2004 returns and received refunds from the IRS.

The Fifth Circuit reversed a district court to hold that the refunds were erroneous because the partnership returns had not been properly amended as required by §6227, under which for a partnership to properly amend a TEFRA partnership return, an administrative adjustment request must be filed.

Neither the amended returns nor the short statements filed by each partner with that partner's return were in substantial compliance with this requirement, so the re-characterization of the income to capital gain was not valid.

VI. CORPORATIONS

Dividends vs. Compensation

Brinks Gilson & Lione PC, T.C. Memo 2016-20

A law firm was liable for accuracy-related penalties for mischaracterizing dividends it paid to its shareholder-attorneys as deductible compensation.

The firm had 150 attorneys, 65 of whom were shareholders, and another 270 employees. The board of directors set the compensation of shareholder attorneys based on the firm's profits, with a year-end bonus intended to reduce the firm's income to zero. No dividends had been paid for over a decade even though the firm's book value exceeded $9 million. The firm treated all payments to the shareholder attorneys, including bonuses, as deductible employee compensation.

After a closing agreement that resulted in underpayments of $1 million, the IRS imposed accuracy-related penalties. The court rejected the firm's argument that it had substantial authority and reasonable cause. The weight of authority is that owners of a business with significant capital are entitled to a return. Reasonable cause was not demonstrated because the accounting firm's silence as to the deductibility of the bonuses constituted a communication thereon was rejected.

Consolidated Group

Marvel Entertainment, LLC, 2nd Cir., 2016-2 U.S.T.C. ¶50,403

The Second Circuit held that the Tax Court correctly determined that the net operating loss of a consolidated group subject to reduction under § 108(b)(2)(A) as the entire consolidated net operating loss of the group, under the single-entity approach, not the portion allocable to each member. The group members properly excluded their portions of the cancellation of debt income, but incorrectly reduced the allocable portion of CNOL attributable to each member.

A consolidated group member cannot have a separate NOL for a consolidated return year in the absence of a specific consolidated return regulation that allocates and apportions part of the CNOL to that member. No regulation of that nature existed during the short tax year at issue. The CNOL of a consolidated group is a favorable tax attribute that is shared by members of the consolidated group. To accomplish the intent of § 108 while the group is intact, attribute reduction must be applied to the CNOL as a whole and not some lesser portion deemed attributable to the debtor member. The taxpayer's apportionment of its CNOL to its consolidated group members for purposes of § 108(b) attribute reduction produced a result that was inconsistent with the intent of Congress to defer, rather than permanently eliminate, COD income.

Payment of Shareholder's Personal Expenses

Scott Singer Installations, Inc., T.C. Memo 2016-161

A corporation's payment of personal expenses on behalf of its sole shareholder were held to be repayments of loans, not wages. Under *Calumet Industries*, 95 T.C. 257, factors in determining whether transfers by shareholders to corporations are loans or capital contributions include:

- Names given to the documents that would be evidence of the purported loans;
- The presence or absence of a fixed maturity date;
- The likely source of repayment;
- The right to enforce payments;
- Participation in management as a result of the advances;
- Subordination of the purported loans to the loans of the corporation's creditors;
- The intent of the parties;
- The capitalization of the corporation;
- The ability of the corporation to obtain financing from outside sources;
- Thinness of capital structure in relation to debt;
- Use to which the funds were put;
- The failure of the corporation to repay; and
- The risk involved in making the transfers.

Ultimately, the court's inquiry court is "whether the transfer ... constitutes risk capital entirely subject to the fortunes of the corporate venture or a strict debtor-creditor relationship." Transfers to closely-held corporations by controlling shareholders are generally subject to heightened scrutiny.

Corporation as Agent

Barnhart Ranch, Co., T.C. Memo 2016-170

The Tax Court has held that a corporation that owned a business's assets and deposited the business's receipts in its bank accounts was the taxpayer for the business, notwithstanding the corporation's shareholders' arguments that the corporation was merely an accounting arrangement to divide income and expenses among the shareholders.

Boot in Reorganization

Tseytin v. Commissioner, T.C. Memo 2015-247

Taxpayer treated as owner of stock transferred in merger, not agent for third party, and not permitted to offset recognized gain on one block of stock with realized loss on another.

The Taxpayer owned 75 percent of the shares of a corporation. They had zero basis. He purchased the other 250 shares from the unrelated other shareholder for $14 million, then merged the corporation into an unrelated Dutch corporation, receiving cash of $23.1 million and shares worth $30.8 million. This meant a short-term capital loss of $527,000 on the 250 shares, and a long-term capital gain of $40.4 million on the 750 shares.

On his return, the taxpayer treated the 1,000 shares as one block, treated the $23.1 million cash payment as taxable, but reduced it by the $6 million he paid for the 250 shares. Consequently, he reported taxable long-term gain or $17.1 million and tax due of $3.78 million.

The taxpayer then filed an amended return, treating the two groups of shares as separate blocks. On the 750 shares, he reported a long-term gain of $17.3 million; on the 250 shares, he reported a short-term loss of $8.2 million. He netted these amounts and reported a net long-term capital gain of $9.1 million and tax due of $2.6 million.

The IRS treated the shares as two different blocks. It determined that the taxpayer realized long-term gain of $40.4 million on the 750 shares and should recognize taxable gain of $17.3 million from the receipt of cash. The taxpayer realized a short-term loss of $527,000 on the 250 shares. The recognized gain of $17.3 million could not be netted with the realized loss of $527,000. As a result, the taxpayer was liable for $3.81 million in taxes, a deficiency of $30,000 from the original return, and an accuracy-related penalty of $6,000.

The Taxpayer argued that in transferring the purchased shares to the acquiring corporation, he acted as an agent for the seller and those shares should be treated as redeemed by the target corporation prior to the transfer to the acquiring corporation or treated as sold directly to the acquiring corporation by the seller. Alternatively, Taxpayer argued that he should be permitted to offset the short-term capital loss against the long-term capital gain.

The Tax Court agreed with the IRS. It rejected the Taxpayer’s claim that he was not the true owner of the 250 shares and should not be taxed on the $14 million paid for those shares. Taxpayers cannot disregard a transaction’s form of their own making unless there was some fraud or mistake. Thus, he was taxable on the portion of the cash boot allocable to those shares.

The court determined that the taxpayer cannot internally net gains and losses from different blocks of stock. Furthermore, losses realized on one block cannot be netted against gains realized and recognized from another block of stock. The court also agreed with the IRS that the taxpayer was liable for a penalty on his original return for treating the 1,000 shares as one block of stock.

VII. CAPITAL GAIN AND BASIS

Basis in Demutualized Insurance Carriers

Dorrance, 9th Cir., 116 AFTR 2d ¶ 2015-5505

The Ninth Circuit majority held that Policyholders in mutual insurance companies have no basis in the stock that they receive when the insurance company demutualizes, stating that Taxpayers acquired their membership rights in the insurance company at no cost, as an incident of the insurance policies they had purchased. By the time of the demutualization, most of the surplus that created value in the newly-issued stock was attributable to former policyholders. Thus, the value at demutualization was not derived from something paid for by the Taxpayers. Rather, the value of the stock they received was a result of the requirements of the state regulators and what the new stockholders were willing to pay to receive future benefits of share ownership. And, following the transfer of stock, the Dorrances' insurance premiums remained level—reinforcing the fact that they had not been paying a "premium" for any membership rights in the first place.

Royalties

Spireas v. Commissioner, T.C. Memo 2016-163

Royalties from patent agreements that reserved substantial rights to inventor do not qualify for long-term capital gains exception. Capital gains treatment requires that the transfer of rights to the patentable product be of all substantial rights. The rights do not have to be of an actual patent or invention with pending patent application, but it is sufficient that the rights apply to a patentable product, even if a patent application is not ultimately filed.

Taxpayer granted a pharmaceutical company the right to selected products developed using the technology, based on drugs to be "unanimously selected" by both parties. The Taxpayer later developed formulations based on two drugs out of 20 selected for investigation by the parties. The company was granted the exclusive right to produce and sell within the U.S. any product containing the technology. The two drugs were approved by the FDA and achieved commercial success.

Royalty payments received based on a licensing agreement are ordinary income – but a transfer of "all substantial rights to a patent" is considered the sale of a capital asset held for more than one year. The taxpayer argued that he had transferred all rights to two specific formulations for particular drugs. However, the original license agreement did not transfer the rights to the formulation of any specific drug, since such formulations had not at that time been developed. The company was not entitled to outright ownership of subsequently developed technology, but only the right to utilize the technology as described in the original licensing agreement. The taxpayer retained rights to use liquid-solid technology both outside the pharmaceutical field, to develop nutritional supplements, and inside that field, to develop other drugs in collaboration with other companies. Because the Taxpayer retained significant control over the technology covered under the licensing agreement, he therefore did not transfer all substantial rights to the licensee.

Sale of Tax Credits

Route 231 v. Commissioner, 4th Cir., 2016-1 U.S.T.C. ¶50,143

A partnership's sale of tax credits resulted in ordinary income treatment.

Anticipating $7 million in conservation tax credits a partnership entered an agreement with a consortium of investors, who contributed $3.8 million, receiving a 1 percent partnership interest and $1 in Virginia tax credits for every 53 cents contributed.

The IRS determined that the partnership incurred ordinary income of $3,8 million. The sale of the tax credits for cash was a disguised sale under § 707. The Tax Court agreed. The Fourth Circuit upheld, holding that the Tax Court did not err in finding that the partnership would not have transferred $7.2 million of Virginia tax credits to the consortium but for the $3.8 million transferred in return, and vice versa. The court determined that P failed to rebut the presumption created under Reg. § 1.707-3(c) that the transaction between it and Virginia Conservation made within two years was presumed to be a sale "unless the facts and circumstances clearly establish" otherwise.

Property Received for Services

Brinkley v. Comm., 5th Cir., 116 AFTR 2d ¶ 2015-5520

Affirming the Tax Court, the Fifth Circuit, held that payments received by a company's founder in a merger with Google, although nominally for the exchange of his stock, were partly compensation for services rendered. Specifically, the taxpayer was compensated for his future service in his execution of the employment and assignment agreements, and he was not entitled to long-term capital gains treatment.

The taxpayer was compensated in part with restricted stock grants. Google began merger negotiations to acquire the business as a subsidiary. As part of the deal, Google required that the taxpayer turn over all his intellectual property related to the business and become a Google employee. In response to the taxpayer's concern that his equity interest had fallen below the previously-discussed floor of 3 percent, the business agreed to pay him a lump sum after completion of the transaction. The agreement summarizing this arrangement described the payment as "compensation."

After the merger, the sub issued a paycheck to the taxpayer showing "stock compensation pay" of $1.8 million, and withheld tax from this payment showing that it characterized the amount as ordinary income. On his return, the taxpayer treated the amount as long-term capital gain. The employer treated it as W-2 compensation. The taxpayer categorized the withheld tax as estimated payments made by him. The Fifth Circuit affirmed the Tax Court's holding held that payment in exchange for his equity interest in the sub after Google's acquisition was ordinary income, compensation for services rendered previously or in the future.

VIII. REAL ESTATE

Passive Losses

Williams v. Comm., 5th Cir, 117 AFTR 2d ¶ 2016-393

Affirming the Tax Court, the Fifth Circuit held that although the passive activity loss rules in § 469 don't explicitly say that they apply to S corporations, those rules, and specifically the passive loss self-rental rule which treats otherwise passive income as non-passive income, do in fact apply to rentals by S corporations.

Married taxpayers owned an operating business, a C corporation in which they materially participated, and its landlord, an S corporation in which they did not materially participate. The real estate S corporation had net rental income, which the taxpayers, who were not engaged in a real estate business, reported as passive income on Schedules E, which they offset with passive losses.

The IRS reclassified the S corporation's income as non-passive pursuant to an exception to Reg. § 1.469-2(f)(6) providing that net rental income received by the taxpayer for use of property in a business in which the taxpayer materially participates is treated as non-passive income.

The taxpayers argued that § 469 does not, on its face, mention S corporations, so the regulation that defines a taxpayer's activities to include those conducted through an S corporation, is contrary to Congressional intent. The Fifth Circuit agreed that § 469 did not need to specifically refer to S corporations because S corporations were merely pass-through entities, and its individual shareholders were the ultimate taxpayers. Thus, in a real sense, an S corporation was not a taxpayer; rather, its shareholders were taxpayers. Because S corporations do not pay taxes directly, there was no need for § 469 to include S corporations in its list of potential "taxpayers."

Leland, T.C. Memo 2015-240

A lawyer's reconstructed records were held sufficient to show material participation. The Tax Court has held that an attorney who owned a farm which was farmed by another party, but for which the taxpayer was responsible for maintaining the infrastructure, established his material participation in the farming activity for purposes of the passive activity rules, despite his not maintaining contemporaneous records of the time he spent in that activity.

Taxpayer did not keep contemporary records of time he spent at the farm but he reconstructed his records in preparation for trial by reference to a calendar he kept at his law practice and credit card receipts and invoices for various purchases related to the farm activity. The Court also agreed with Mr. Leland's inclusion of travel time in his reconstructed logs, noting that the facts of the case established that Mr. Leland's travel time was integral to the operation of the farming activity rather than incidental and was not to avoid the disallowance, under § 469 and its regulations, of any loss or credit from the farming activity.

Material Participation

Stanley, D.C., Ark., 116 AFTR 2d ¶ 2015-5419, 2015-2 U.S.T.C. ¶50,560

For purposes of the real estate professional's exception to the passive activity loss rules, a real estate management executive, who also owned interests in the properties managed by his firm, could count his work for the entity as work in managing his own real estate interests.

Taxpayer was president of a property management company. He was also president of a company that provided telecommunications services to properties managed by the management company, and acquired interests in over 100 real estate entities. He reported all interests as non-passive. He argued (1) he was a real estate professional able to treat rental real estate activities as *per se* passive; and (2) his real estate and business activities could be grouped as an appropriate economic unit, the business activities were insubstantial in relation to the rental activities and each owner of the business activities owned the same proportion of the rental activities.

The IRS argued that (1) Taxpayer was not a 5 percent owner of the management company (which is required if services as an employee are to constitute material participation in a real estate business), because he could not transfer his stock and had to redeem it on leaving employment; (2) Taxpayer did not qualify as a real estate professional; (3) the activities were not appropriately grouped; and (4) he did not materially participate in an appropriately grouped activity as required to show non-passive income or loss. The court rejected the government's arguments, saying:

› It was immaterial whether Taxpayer bore risk of loss regarding the stock or made a capital contribution in exchange, and that that the requirement in § 416(i)(1)(B)(i)(I) that the stock be outstanding does not require that the stock be readily transferable or free from risk of forfeiture.

› The Taxpayer was not required to keep track of time spent in his activities in real property businesses and other activities to substantiate that he is a real estate professional. Because the management company was a real property business in which he participated, he qualified under § 469(c)(7), saying that under Regs. § 1.469-5(f)(1), any work done, regardless of the capacity in which the work is done, in connection with an activity in which the individual owns an interest is treated as participation in the activity.

› Except for several activities for which Taxpayer did not meet the evidentiary burden, the court found that the grouping of the rental activity, his participation in the management company, his participation in the telecommunications supplier, and the golf courses were appropriately grouped as an economic unit, considering factors such as common control, the extent of common ownership, location and interdependencies among the activities.

Gragg, 9th Cir., 2016-2 U.S.T.C. ¶50,370

The Ninth Circuit affirmed that a real estate agent must show material participation in her real estate rental activities if she is to deduct losses from those activities. Interests in rental real estate cannot be grouped with any non-rental interests owned by the taxpayer—even those that are also in real estate. Thus for example, a qualifying taxpayer who develops real property, constructs buildings, and owns an interest in rental real estate cannot group the rental real estate interest with the development or construction activities. Married Taxpayers sought to deduct losses from their rental properties, arguing that her status as a real estate professional rendered the real estate losses non-passive *per se*, and therefore deductible under § 469, regardless of material participation.

The IRS determined, the Tax Court held and the Ninth Circuit affirmed that real estate professionals must still show material participation. The Ninth Circuit concluded that real estate professionals were not exempted by Congress from the requirement that a taxpayer show material participation in order to deduct losses from a real estate investment.

Exchanges of Property

Bartell, 147 T.C. —, No. 5

A reverse exchange was approved for tax-deferred treatment under § 1031, because, at the relevant time, ownership of the property to be exchanged was in a third-party exchange facilitator.

Taxpayer engaged in a reverse like-kind exchange where it received the replacement property before disposing of the relinquished property. To facilitate the exchange and avoid a self-exchange, Taxpayer used a third-party intermediary to hold title to the exchanged properties while Taxpayer received most of the traditional attributes of ownership. Taxpayer reported deferred income under the § 1031 exchange.

The Tax Court held that the reverse exchange qualified under § 1031, saying that the appropriate legal standard allowed taxpayers wide latitude in structuring their affairs to qualify under § 1031. The Ninth Circuit previously held that a third-party intermediary may acquire only title to facilitate a § 1031 exchange while taxpayers simultaneously receive the benefits and burdens of ownership, contrary to general income tax ownership principles. Following *Golsen v. Commissioner*, 54 T.C. 742, aff'd, 445 F.2d 985 (10th Cir.1971), the court reasoned that the reverse like-kind exchange qualified because the Ninth Circuit would be the proper appeals venue. The court also noted that the reverse exchange occurred before the effective date of Rev. Proc. 2000-37, which provided a safe harbor for reverse exchanges and was thus inapplicable.

The Malulani Group, Limited, T.C. Memo. 2016-209

A real estate leasing company was not entitled to defer recognition of the gain it realized on an exchange of property with its subsidiary.

The taxpayer argued that it first diligently sought a replacement property from an unrelated party and only turned to its subsidiary when the deadline to complete the deferred exchange was imminent.

Held, the taxpayer's decision to acquire the replacement property from a related person only after it had already engaged a qualified intermediary, did not distinguish the transaction sufficiently from cases in which the taxpayers decided to acquire replacement properties from related persons before hiring qualified intermediaries. Moreover, the taxpayer failed to demonstrate that tax avoidance was not a principal purpose of the exchange. Had the exchange been allowed, the Taxpayer and its subsidiary would have been able to cash out of investment in the property almost tax free because the subsidiary was able to offset the gain recognized with its net operating losses, resulting in a net tax savings to the taxpayer and its subsidiary as an economic unit. The net tax savings achieved through use of the related party's NOL's demonstrated the presence of a tax-avoidance purpose notwithstanding a lack of basis shifting. Therefore, the taxpayer structured the transaction with a tax avoidance purpose.

Exelon Corporation, successor to Unicom Corporation, 147 T.C. ___, No. 9

Taxpayer did not qualify for § 1031 for like-kind exchange treatment because it exchanged its power plants for an interest in financial instruments.

Taxpayer sold two fossil fuel power plants for a gain of $1.6 billion. Using a qualified intermediary, the Taxpayer acquired another plant appraised at $725 million and partial interests in two plants with a combined appraised value of $890 million. In each transaction, Taxpayer leased the properties back to the original owners, who in turn made advance rental payments to Taxpayer. The lease agreements also contained fixed-price purchase options at prices "in excess of the anticipated fair market value" of the plants at the time the purchase options could be executed. Taxpayer reported the transactions as like-kind exchanges. "Leveraging the new lease in such a manner would leave Unicom in substantially the same cash position."

Taxpayer would lease the exchange assets for 20-25 years to tax-exempt public utilities under a triple net lease with an end-of-term fixed purchase option. Unicom would pass on a portion of its tax deferral benefit to the lessees through a reduction in rent. The lessee would defease its rental obligations, and thereby monetize the lower rental cost into an up-front cash benefit.

The IRS argued that the transactions did not transfer benefits and burdens of ownership to Taxpayer because they were not true leases; that the purported exchanges were "prepackaged, promoted tax products which subjected it to no residual value risk, only a theoretical, *de minimis* credit risk"; that the agreements were instead properly characterized as loans since the transactions didn't transfer the benefits and burdens of ownership to the power company.

The Tax Court agreed. The agreements were not true leases but rather properly characterized as loans since the transactions did not transfer the benefits and burdens of ownership to Taxpayer. Negligence penalties were assessed, as Taxpayer should have known that the conclusions in its attorneys' tax opinions were inconsistent with the terms of the deal.

Forfeited Deposit

Cri-Leslie, LLC, 147 T.C. __, No. 8

A partnership was not allowed to treat its right to retain forfeited deposits from a canceled sale of real property as capital gain.

The property, a hotel, was acquired for use in the partnership's hotel and restaurant business as property used in a trade or business under § 1231. The partnership contracted to sell the property, but the purchaser defaulted and forfeited a deposit.

In a case of first impression, the court concluded that the real property was not a capital asset, as defined in §1221(a)(2), was §1231(b) property, and that §1234A, linking the characterization of gain or loss with respect to a capital asset with the characterization of the gain or loss from termination of certain contractual rights, applied only to capital assets. The court noted that despite any intellectual inconsistency, forfeited deposits from the termination of a contract to sell a hotel held as a passive investment would be taxed at capital gains rates, whereas those forfeited deposits would be ordinary income when the hotel is used in a trade or business.

Amount Received

Bobo, T.C. Summary Opinion 2016-74

A cash payment made to a delinquent mortgagor from a mortgage company in connection with a deed in lieu of foreclosure, in an agreement to leave the property promptly and with other covenants, was additional proceeds from the deemed sale of the property and not ordinary income.

IX. EMPLOYMENT AND PAYROLL

Worker Classification

Hampton Software Development LLC, T.C. Memo 2016-38

For purposes of the rule in § 6330(c)(2)(B) that permits a taxpayer to challenge the existence or amount of his tax liability at a collection due process hearing if he did not receive a statutory notice of deficiency, the Tax Court held that where the issue in a case is whether the taxpayer misclassified a worker as an independent contractor, a Notice of Determination of Worker Classification is treated as a statutory notice of deficiency.

The Taxpayer classified its maintenance man as an independent contractor. IRS issued a 30-day letter and after a deadlock at Appeals, issued a Notice of Determination of Worker Classification determining that he was an employee; the Taxpayer was not entitled to Section 530 relief and additional taxes owed. The Tax Court ruled that, for purposes of the rule in § 6330(c)(2)(B), the of Determination of Worker Classification is treated as a statutory notice of deficiency.

Employee Business Expenses

Michael Jones, 146 T.C. No. 3

An Arizona judge could not deduct unreimbursed expenses that he incurred in his position "above the line" rather than as miscellaneous itemized deductions subject to the 2 percent floor. Because he was paid a salary, the fact that his court system is funded in part by fees did not make him eligible an exception in § 62(a)(2)(C), whereby employee business expenses with respect to services performed by a state official who is compensated in whole or in part on a fee basis are deductible in computing adjusted gross income, and therefore business expenses are deductible without regard to the 2 percent floor on miscellaneous itemized deductions.

Trust Fund Penalty

McClendon, DC Tex., 2016-2 U.S.T.C. ¶50,480

The founder of a company that owed employment taxes, and who used company funds to pay employees ahead of the IRS, was liable for the trust fund recovery penalty. He made a personal loan to the company, which used the funds to pay the company's payroll obligations. He argued that, because the terms of his loan to the company were that it was for the "restricted purpose" of paying employees, the funds were therefore "encumbered," and so could not be used to pay employment taxes. The court held that a person cannot voluntarily impose a contractual limitation on company funds to make them encumbered in the sense that they do not have to be paid first toward tax obligations. Funds are "encumbered" only when some restriction, such as a security interest, precludes the funds from being used for the trust fund taxes.

X. ACCOUNTING

AICPA v. IRS, D.C. Dist., 118 AFTR 2d ¶ 2016-5089

A district court, on remand from the D.C. Circuit, rejected the AICPA's challenge to IRS's Annual Filing Season Program (AFSP). The court said AICPA's challenge, brought on the grounds that the program would cause it competitive injury, failed the "zone-of-interests" test.

In 2014, IRS announced a voluntary education program, AFSP, for unenrolled return preparers, and announced that it would publish a directory of preparers that would include persons who completed the program including persons with recognized credentials. The Treasury Secretary may regulate practice before the Department of the Treasury; and before admitting a representative to practice, require that the representative demonstrate good character, good reputation, necessary qualifications to enable the representative to provide to persons valuable service; and competency to advise and assist persons in presenting their cases. 31 USC 330(a).

AICPA sued under 5 USC 702, claiming that IRS lacks statutory authority to implement the AFSP. The District Court held that the AICPA did not have standing for its suit. The Circuit Court reversed, holding that the AICPA has "competitor standing" – that it showed that the AFSP would result in an actual or imminent increase in competition.

On remand, IRS argued that AICPA falls outside of the zone of interests regulated by 31 USC 330(a). The District Court ruled that the AICPA failed the "zone of interests" test and, therefore, did not grant AICPA an order enjoining the implementation of the AFSP. The association's only grievance was the alleged brand dilution competitive injury, not sufficient to satisfy the zone-of-interests test as a representative of persons "regulated by" the statute.

The Court further held that AICPA sought to eliminate the program, notwithstanding its potential benefit to consumers, because its government-backed credential rendered unenrolled preparers better able to compete against other credentialed preparers and uncredentialed employees of association members. The association's interest in avoiding competition was directly opposed to the consumer-protective interests articulated by § 330(a). AICPA could offer no explanation, apart from its consumer-confusion argument, why its interest in dismantling the AFS Program furthered Congress's goal of consumer protection. Rather, the association's interest in scuttling the AFS program, which included an incentive that could cause competitive harm to CPA's, was more likely to frustrate than further the statutory objectives of § 330(a).

Amounts at Risk

Mandich v. United States, Fed. Cl., 2015-2 U.S.T.C. ¶50,552

Passive activity loss that is not allowed to be deducted under § 465 at-risk rules must be carried over and deducted in later year with respect to operation of same activity. Suspended losses from one activity may not be used to offset income from different activity

Practitioner-Client Privilege

Schaeffler, 2nd Cir., 116 AFTR 2d ¶ 2015-5407

The Second Circuit, vacating and remanding a district court, held that where a corporate group shared memos prepared by its CPA on a potential restructuring and refinancing plan, with its major lender, the group didn't waive practitioner-client privilege, and the memos qualified for work product protection.

A party that shares otherwise privileged communications with an outsider is deemed to waive the privilege. While the privilege is generally waived by voluntary disclosure of the communication to another party, the privilege is not waived by disclosure of communications to a party that is engaged in a "common legal enterprise" with the holder of the privilege. Such disclosures remain privileged "where a joint defense effort or strategy has been decided upon and undertaken by the parties and their respective counsel...in the course of an ongoing common enterprise [and] multiple clients share a common interest about a legal matter."

Attorney-client privilege extends to communications between a taxpayer and any "federally authorized tax practitioner," a term that includes certified public accountants with respect to tax advice, to the extent the communication would be privileged if it were between a taxpayer and an attorney. (§ 7525(a)(1)). The parties may share a "common legal interest" even if they are not parties in ongoing litigation. It is unnecessary that there be actual litigation in progress. The Court said that the dispositive issue was, therefore, whether the Taxpayer's common interest with the other party was of a sufficient legal character to prevent a waiver by the sharing of the tax memo.

Completed Contract Method

Shea Homes, Inc. v. Commissioner, No. 14-72161 (9th Cir. Aug. 24, 2016)

The Ninth Circuit affirmed the Tax Court decision that Taxpayer properly applied the completed contract method of accounting to report home sales in their planned developments. The subject matter of the contracts consisted of both the home and the development, including amenities, common areas and infrastructure, meaning that the contract for the sale of an individual home was not complete for purposes of § 460 until the developer was released from its obligations. The court agreed with the Tax Court's holding that Taxpayer was selling not just a house and a lot, but also the homeowner's interest in and right to use the various upscale amenities included in T's developments. As a caution to taxpayers who may believe that large developments may qualify for long or almost unlimited deferral periods, the court reiterated the Tax Court's statement "that a determination of the subject matter of the contract is based on all the facts and circumstances."

XI. RETIREMENT PLANS

Anti-Alienation Rule

Family Chiropractic Sports Injury & Rehab Clinic, Inc., T.C. Memo 2016-10

The IRS properly determined that an S corporation's ESOP was not a qualified plan because it failed to follow the terms of its plan document. Under the plan document a terminated participant was entitled to all vested benefits in his or her account and it was to be paid as soon as administratively feasible after termination of employment if the participant so elected or upon death or normal retirement age. In addition, the plan document allowed the participant to choose the form of payment she would receive and contained a prohibition on alienation of or assigning benefits.

Therefore, the ESOP failed when one of the participants transferred 100 percent of her vested interest and relinquished her rights under the ESOP pursuant to her divorce. The divorce decree was insufficient to allow the transfer of plan assets and the transfer of shares from one employee's account to another's alienated her account after it was fully vested. Because the ESOP failed to abide by the plan document's distribution and anti-alienation rules, an operational failure occurred and the ESOP was no longer a definite written program. Moreover, because the failure to follow the plan document's terms was a continuing one, the ESOP was also not qualified for subsequent plan years.

Church Plans

Stapleton v. Advocate Health Care Network, 7th Cir., 817 F. 3rd 517

A pension plan established by a church-affiliated organization was held not a church plan exempt from ERISA's funding requirements because the statutory definition requires a church plan to be established by a church.

The Seventh Circuit stated that the statute requires that a church plan be established by a church, regardless of whether such a plan could be "maintained" by a non-church entity, as the hospital argued. The statute requires that a plan be established and maintained by a church, the court noted. "If a plan could qualify solely on the basis of being maintained by a church-affiliate organization, the established by a church requirement would become meaningless."

This accords with the Third Circuit's 2015 decision. Kaplan v. St. Peter's Healthcare Sys., 810 F.3d 175 (3d Cir. 2015). Petitions for certiorari have been filed before the Supreme Court in both cases.

Roth IRA's

Polowniak, T.C. Memo 2016-31

The Tax Court has held that an individual's attempt to circumvent the Roth IRA contribution limits, by funneling payments through a C corporation in which his Roth IRA held a 98 percent interest, resulted in a § 4973 excise tax on excess contributions. The fee-for-services agreement used, and the payments funneled through the corporation to the Roth IRA, were held to have no purpose other than to bypass the Roth IRA contribution limits. The Court also assessed the taxpayer with failure-to-file and pay penalties under § 6651, as well as accuracy-related penalties under § 6662A for understatements attributable to listed transactions.

Rollover as Business Startup

Powell v. U.S., Fed. Cl., 117 AFTR 2d ¶ 2016-515

The Court of Federal Claims rejected a couple's claim that they had rolled over an IRA distribution into a "Business Owner Retirement Savings Account," a variation of a Rollover as Business Startup account (ROBS). While the court ruled against the rollover because of flaws in the account being rolled over, it added that the IRS views a ROBS as a questionable, but not necessarily abusive, mechanism for individuals to roll retirement funds into a new business. IRS has stated that a ROBS may work as a legitimate tax planning entity but recommends assessment on a case-by-case basis through IRS determination letters. Under a ROBS, (1) a Taxpayer creates a new corporation for the purpose of sponsoring a purportedly qualified retirement plan; (2) the new corporation creates a qualified employee retirement plan and allows participants to invest the entirety of their retirement plan account balance in the corporation's stock; (3) the Taxpayer becomes an employee of the corporation, enrolls in the plan, and conducts a rollover or direct trustee-to-trustee transfer of his IRA or § 401 plan into the new corporate retirement plan, directs his account balance in the qualified retirement plan to purchase stock of the newly formed corporation, then uses the transferred funds to begin a business enterprise.

Taxable Distributions

Vandenbosch, T.C. Memo 2016-29

An anesthesiologist received a taxable distribution from his SEP-IRA because he had unfettered control of the funds distributed. He directed the custodian to deposit the distribution into his personal account, then transferred the money among several personal accounts until he lent the money to a friend to invest for him.

The doctor argued he did not receive a distribution from the SEP-IRA because the transactions should be viewed as a whole, collapsed and treated as an investment by the SEP-IRA – but the promissory note was payable to the taxpayer. His use of the funds and his personal entitlement to repayment indicated that he was not a mere conduit but had a claim of right to the funds.

XII. PROCEDURE

<u>Consent to Extend Statute of Limitations</u>

Hamilton, D. C. Colo., 117 AFTR 2d ¶ 2016-341

The IRS's agreement to limit any adjustments it made to taxpayer's tax to those related to charitable deductions, as a condition to extending the statute of limitations for assessment, didn't impose similar limitations on the court in determining whether the taxpayer was entitled to a refund.

Taxpayer and IRS executed Form 872, Consent To Extend the Time To Assess Tax, in which the parties agreed that any deficiency assessment was to be limited to adjustments to charitable contributions. When the IRS disallowed the Taxpayer's claimed charitable deductions in their entirety, he paid the tax and sought a refund, asking the district court that, in determining the amount of his refund, IRS could not re-determine the correct amount of tax for any items other than the charitable contribution deductions that were the subject of the Notice of Deficiency.

In *Lewis v. Reynolds,* 284 U.S. 281 (1932), the Supreme Court concluded that the ultimate question in a refund case is whether the taxpayer has overpaid his tax, and that this involves a redetermination of the entire tax liability. While no new assessment can be made after the statute of limitations has run, the taxpayer isn't entitled to a refund unless he has overpaid his tax. Thus, even when IRS may not collect a deficiency, it may retain payments already received when they do not exceed the amount which might have been properly assessed and demanded. A taxpayer who seeks a refund has already paid the assessment. He thus must then establish that he has overpaid tax. Proof of that ultimate issue requires the taxpayer to demonstrate both that the amount assessed is incorrect and that the correct amount owed is less than the amount paid. Under *Lewis*, the determination of the correct amount of tax owed must be made by reference to the entire amount owed, regardless of whether the statute of limitations for assessment has expired. The ultimate question presented for decision, upon a claim for refund, is whether the taxpayer has overpaid his tax. While no new assessment can be made, after the bar of the statute has fallen, the taxpayer, nevertheless, is not entitled to a refund unless he has overpaid his tax.

<u>New Issues in Tax Court</u>

Ax, 146 T.C. No. 10

The Tax Court allowed IRS to amend its answer to allege facts in support of two new issues, saying that looking beyond the notice of deficiency did not violate administrative law principles or conventional standards of judicial review. IRS had moved to amend its answer to assert (a) lack of economic substance in a micro-captive insurance arrangement; and (b) premium payments through the micro-captive arrangement were neither ordinary nor necessary. IRS alleged facts in support of these assertions. IRS conceded that it would bear the burden of proof as "new matter" under Tax Court Rule 142(a)(1). The Tax Court concluded that in a deficiency case, IRS may plead grounds not in the notice of deficiency.

Tax Shelter Promoter Penalty

Pfaff v. U.S., D. Colo., 2016-1 U.S.T.C. ¶50,218, 117 AFTR 2d ¶ 2016-507

A district court has concluded that the § 6707 tax shelter promoter penalty isn't a divisible tax. Accordingly, where the taxpayer did not pay the full amount of the penalty assessed by IRS, the district court did not have jurisdiction to hear the taxpayer's suit seeking refund of the partial penalty amount he paid for some of the transactions associated with the tax shelter.

Under *Flora*, 362 U.S. 145 (1960), a taxpayer can sue in district court for a refund of federal income tax only after paying the assessed amount in full, although the Supreme Court noted that there might be an exception to the general rule for divisible tax payments, indicating that, for example, "excise tax assessments may be divisible into a tax on each transaction or event, so that the full-payment rule would probably require no more than payment of a small amount."

While the amount of the § 6707 penalty that was assessed against a person who was required to register a tax shelter was based on the aggregate of the entire amount of investment in the tax shelter, the § 6707 penalty was predicated on a single event — failing to register the underlying tax shelter. Thus, the tax shelter promoter penalty wasn't analogous to the excise tax noted in Flora where there was a tax on each transaction or event.

Offer in Compromise

Rebuck v. Commissioner, T.C. Memo 2016-3

A Taxpayer convicted of marketing fraudulent trust packages was not entitled to alternative payment plan for his taxes unless it included provision for payment of criminal restitution. The Tax Court held that the IRS did not abuse its discretion when it denied his offer in compromise that did not include a provision for the payment of criminal restitution for the trust scheme. The Internal Revenue Manual requires that an offer in compromise provide for full payment of any restitution owed by the taxpayer. "Indeed, it appears reasonable for the Commissioner to decline an OIC from a taxpayer who has committed a crime related to Federal tax but who fails to satisfy a restitution order by a District Court in the criminal case," the court stated.

Hearing Before Levy

Boulware v. Commissioner, D.C. Cir., 2016-1 U.S.T.C. ¶50,217

The IRS did not abuse its discretion in denying a face-to-face hearing or rejecting taxpayer's proposed payment plan. Under Reg. § 301.6330-1(d)(2), A-D-6, collection due process hearings are informal and do not require a face-to-face meeting. The Taxpayer's failure to comply with his tax obligations ($10.8 million assessment after conviction for evasion) made him generally ineligible for a collection alternative, and therefore, the Settlement officer's denial of a face-to-face hearing was reasonable.

One-Examination Rule

Titan International, Inc., 7th Cir., 117 AFTR 2d ¶ 2016-389

The Seventh Circuit has affirmed that the rule in § 7605(b) that limits IRS to one inspection of a taxpayer's books of account for each tax year, does not apply when IRS seeks already-inspected records for an audit of a different tax year.

In an audit of Taxpayer's 2009 tax return in 2010, IRS summoned Taxpayer's general ledger, flight logs, and other business travel documents. The audit reduced Taxpayer's net operating loss. In 2014, IRS audited Taxpayer's 2010 return and again summoned the 2009 documents, in an inquiry related to an operating loss carry-forward claimed on the 2010 return. Taxpayer refused to comply, asserting that § 7605(b) blocks inspection of already-inspected records unless IRS makes a finding of necessity and notifies the taxpayer in writing of that finding. No such notice was sent.

The Court of Appeals held that § 7605(b)'s rule does not apply when IRS seeks already-inspected records for an audit of a different tax year, saying that "the more natural reading" of the statute limits IRS to one inspection of a taxpayer's books for audits of a given year's tax return.

Estoppel

Blagaich, T.C. Memo 2016-2

A state court's holding that transfers between ex-lovers were "gifts" did not prevent the IRS from taking a different position in arguing that the transfers represented income to her.

Taxpayer was in a romantic relationship with an older man, who provided her with cash and other property. They entered a written agreement to confirm their commitment, under which he made an immediate payment of $400,000. After the relationship deteriorated, he sent her a notice of termination and sought nullification of the agreement, return of a car, diamond ring and cash. He filed a Form 1099-MISC, reporting that he had paid Taxpayer $743,819 in 2010.

The state court held that Taxpayer had fraudulently induced the agreement and entered a judgment against Taxpayer of $400,000, but held that the car, ring and other cash were "clearly gifts" that she could keep. The man's executor revised the 1099-MISC, reducing the compensation to Taxpayer for 2010 to $400,000. The IRS adjusted her income by the full $743,819. Taxpayer argued the state court's holding estopped the IRS from denying that, in 2010, she received a gift.

The Tax Court held that the $400,000 was income because Taxpayer acquired it, "lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition," and that collateral estoppel did not bar the IRS from re-litigating the state court's finding that the other $343,819 was a gift. The IRS was not a party to the state court action, nor, was it a privy to a party or otherwise sufficiently connected to a party.

Mark Swartz, Tax Court Order, Docket No. 3583-10

A taxpayer's criminal conviction for stealing $12.5 million from his employer precludes him from arguing that he did not receive taxable income in that amount.

Whistleblower Awards

Whistleblower 22716-13W, (2016) 146 T.C. No. 6

Penalties for failing to file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (Foreign Bank Account Report or FBAR) under 31 U.S.C. sec. 5321(a) were held not to be "additional amounts" for purposes of the $2,000,000 nondiscretionary award threshold under § 7623(b)(5)(B). Accordingly, FBAR payments must be excluded in determining whether the $2,000,000 amount in dispute requirement has been satisfied.

Reasonable Cause

McNeill, 10th Cir., 2016-2 U.S.T.C. ¶50,401

The Tenth Circuit, reversing a district court, held that a managing partner could assert the reasonable cause defense to penalties in a partner-level proceeding, even after a partnership-level determination that reasonable cause did not exist.

The Taxpayer was managing partner and tax-matters partner of a partnership that he used to further an abusive tax shelter scheme to inflate his losses. The IRS followed TEFRA audit procedures and held that the partnership's claim that no asset sale took place was incredible, that the taxpayer's true basis in the foreign debt was only the modest amount he had contributed, and that this tax-avoidance scheme merited several million dollars in penalties and interest. The taxpayer, as tax-matters partner, filed suit seeking to contest the partnership-level determinations of the IRS. The district court dismissed the suit without prejudice. The taxpayer then filed suit as an individual partner, seeking exculpation from the penalties because he had "reasonable cause" for the position he took and filed his return in "good faith."

The district court held that it was precluded from determining the merits of the taxpayer's partner-level defense by the language of TEFRA, as found at § 6230(c)(4). This section provides, in relevant part, that the determination under the final partnership administrative adjustment (FPAA) by the IRS concerning the applicability of the penalty is conclusive. However, the next sentence states that, notwithstanding this provision, the partner is allowed to raise any partner-level defenses that may apply. The appellate court held that the reasonable cause defense found in § 6664(c)(1) was just such a partner-level defense, and the taxpayer should have been allowed to assert it. A dissenting opinion would have upheld the district court's conclusion that the reasonable cause defense was precluded.

Actions of Representative

Best v. Commissioner, T.C. Memo 2016-32

Attorney who represented two taxpayers in losing case at Tax Court resulting in $5,000 penalty was fined $20,000 for allowing the case to unnecessarily prolong tax collection.

After the Tax Court sustained deficiencies against Taxpayers, the IRS assessed Taxpayers, they didn't pay, the IRS issued a Final Notice of Intent to Levy, and Taxpayers requested a collection due process hearing. The Attorney requested Form 23C, Assessment Certificate Summary Record of Assessments, and Form 4340, Certificate of Assessments, Payments, and Other Specified Matters. The Appeals officer declined to provide these documents. Appeals sustained the levy. Taxpayers argued to Tax Court that the IRS could not proceed with collection because the Appeals officer abused her discretion in relying on the transcripts. The IRS asked the court to impose a §6673 penalty on Taxpayers because Taxpayers "instituted these proceedings primarily for the purpose of delaying collection and that their position is frivolous or groundless."

The Tax Court held that the Appeals officer did not abuse her discretion, because § 6330 does not mandate that the "officer rely on a particular document to satisfy the verification requirement," and held that Attorney would be sanctioned under both the tax code and Tax Court Rules of Practice and Procedure for offering frivolous arguments in his representation after being warned against it. IRS attorneys warned Attorney that if Taxpayer proceeded, the IRS would request the penalty.

Mitigation of Statute of Limitation

Costello, T.C. Memo 2016-33

The IRS could avoid the period of limitations barring assessment against the taxpayers and make adjustments to their income tax returns by using the mitigation provisions of §§ 1311-1314, thereby preventing an improper windfall to Taxpayer.

Mitigation allows for correction of an error made in a closed tax year by extending the limitations period up to one year from the final determination. Thus, claims that are barred by the statute of limitations may still be brought if (1) there has been a "determination" for an open tax year (2) which caused an error described in § 1312; (3) on the date of the determination, any adjustment to correct the error is barred by operation of law (other than a § 7122 compromise or the mitigation provisions); and (4) subject to exceptions, the determination must adopt a position maintained by a party that is inconsistent with the error that has occurred.

Here, a trust maintained a position (it was not liable for tax on the distributions), adopted by the IRS, which was inconsistent with that of the beneficiaries (we are not liable for tax on the distributions either) and the beneficiaries were related to the trust both in the year of error and in the year the trust first maintained its inconsistent position.

Transferee Liability

John M. Alterman Trust, T.C. Memo 2015-231

No transferee liability was found where the Taxpayers took steps to ensure that IRS was paid what it was due, even if those steps were ultimately unsuccessful; Taxpayers did not receive a transfer from the company they sold; and transferee liability couldn't be established. To prevail under a "transferee of a transferee" theory, IRS must prove that there was a fraudulent transfer at each step along the way.

Duty of Consistency

Squeri, T.C. Memo. 2016-116, 111 T.C.M. 1561

Taxpayer was bound by the duty of consistency to recognize in the year reported gross receipts received in a prior year. The Taxpayer deposited checks in year 2 that were received in year 1. The Taxpayer determined its gross receipts for year 2 based on deposits into its bank accounts during the calendar year. These reported gross receipts did not include checks that were received in the tax year at issue but deposited in the following year, but did include checks received in the previous year and deposited in the year at issue. The Taxpayer contended that the gross receipts actually received in the prior year should be excluded from its income for the tax year at issue because they were actually received in a prior year and, since that was a closed year, the IRS did not have the authority to make adjustments for that year.

The duty of consistency applies when: (1) the IRS relied on; (2) a representation or report by a taxpayer; and (3) the taxpayer attempts, after the statute of limitations has run, to change the previous representation or to recharacterize the situation in a way to harm the IRS. When the duty of consistency applies, the IRS may act as if the previous representation, on which it relied, continues to be true even if it is not and the taxpayer is estopped from asserting the contrary.

Here, the taxpayer made a clear representation when it filed Form 1120-S claiming it received gross income in the tax year at issue. The IRS relied on that representation when it accepted the taxpayer's return. Then, after the limitations period expired, the taxpayer attempted to recharacterize the income from the tax year at issue as belonging to the prior, closed year, which would allow the taxpayer to avoid tax on the recharacterized income. Therefore, the duty of consistency applied.

Closing Agreements

Al Davis v US, 9th Cir., 2016-1 U.S.T.C. ¶50,157

The IRS's breach of a closing agreement by making assessments without giving the taxpayer a second opportunity to review its calculations did not invalidate the assessments, so the taxpayer was not entitled to a refund.

Al Davis was a member of a partnership that owned the Oakland Raiders. It entered into a closing agreement with the IRS in which the partners were granted a designated amount of time to review and comment on the IRS's proposed tax liability calculations before any assessments were made. However, the IRS breached this part of the agreement and assessed the taxes without allowing the partners to review its calculations.

The taxpayers were only entitled to a contractual remedy for the IRS's breach of the closing agreement. While the IRS's breach denied the taxpayers the opportunity to review and comment on the assessments before they were made, the breach did not prevent the taxpayers from challenging the assessed amounts in a refund claim or from seeking consequential damages. Moreover, the IRS's breach did not relieve the taxpayers of their obligation to pay taxes; nothing in the closing agreement provided that the assessments would be invalid if the government breached the agreement. The taxpayers also failed to offer any support for their argument that because the closing agreement was "final" any breach meant the taxpayers were not required to pay the taxes assessed under the agreement. In addition, the assessments were timely. The petitioner in the Tax Court proceeding was the partnership; thus, the closing agreement was between the IRS and the partnership, not the individual partners. Therefore, the assessments were properly made within one year after the Tax Court's decision was final.

Interest on Assessments

King, 7th Cir., 2016-2 U.S.T.C. ¶50,348

Reversing the Tax Court, the Seventh Circuit held that the IRS properly denied a Taxpayer's request to abate interest that accrued on his payroll tax deficiency while the IRS processed his request for an installment agreement. He argued that he would have paid the liability sooner had he known he was not eligible for an installment agreement.

The Tax Court's decision to abate the interest was incorrect. First, "unfairness" was too vague a standard for abatement. The word is an invitation to arbitrary, protracted and inconclusive litigation – and invites taxpayers to delay paying their taxes.

Hartmann, 3rd Cir., 110 T.C.M 46, T.C. Memo. 2015-129

An IRS Appeals officer did not abuse his discretion in sustaining a proposed levy because the taxpayer failed to comply with the requirements for filing a proposed collection alternative. The Appeals officer asked the individual to provide certain specific documentation in advance of

the Collection Due Process hearing, including an installment agreement or an offer in compromise, a collection information statement and any additional information that would explain his failure to timely file the tax return for the year at issue. The individual provided a proposed installment plan and a completed collection information statement, but not the other documentation, including the delinquent tax return. Requiring that documentation, including the delinquent tax return, was well within the Appeals officer's discretion. Therefore, the Appeals officer properly denied the individual's collection alternative.

Netting of Interest on Refunds

Wells Fargo, Fed. Cir., 2016-2 U.S.T.C. ¶50,333

An acquiring corporation was entitled to net interest in two situations, but not in a third. To be eligible for interest netting, the entity that made the underpayment at the time of underpayment must be the "same taxpayer" as the entity that made the overpayment at the time of the overpayment.

In the first situation, one bank made an underpayment and another bank made an overpayment and the two companies later merged. Thus, the payments were made by two separate corporations since both payments were made before the merger. Therefore, the banks did not meet the "same taxpayer" requirement under § 6621(d). Later changes in corporate structure cannot retroactively change a taxpayer's status as to earlier payments.

In the second situation, the IRS conceded that the corporation could net interest where the surviving corporation made an overpayment before a series of mergers and an underpayment. Before, during and after the mergers, the underpaying and overpaying company had the same Taxpayer Identification Number because it was the surviving corporation in the mergers. Thus, the merged corporations were the same taxpayer even though that the pre-and post-merger corporations were not identical because the bank absorbed four separate corporate entities in the time between its overpayment (pre-mergers) and underpayment (post-mergers).

The third situation was similar to situation two except for the choice of surviving corporation, which had a different TIN. The post-merger entity was the same taxpayer as a pre-merger acquired entity. Under merger law the post-merger surviving corporation was the "same taxpayer" as the pre-merger acquired corporation because, upon closing, the surviving corporation automatically acquired the assets and liabilities of the acquired corporation and the personality of the acquired corporation was subsumed in the survivor. Further, the surviving corporation was automatically liable for the underpayments and was entitled to the overpayments of its predecessors.

When Congress enacted § 6621(d), it did so knowing that it was expanding the IRS's preexisting authority to implement interest netting. The new statute remedied inequities caused by different overpayment and underpayment interest rates and it expanded the IRS's preexisting authority permitting interest netting. Therefore, the legislative history of § 6621(d) indicated that it was meant to be remedial and broadly construed to effectuate its purposes.

XIII. INTERNATIONAL

Expatriation

Topsnik, 146 T.C. No. 1

A German citizen was found to have expatriated when he formally abandoned his status as a lawful permanent resident, so he was liable for tax on the gain attributable to the installment payments he received before he expatriated. Moreover, the taxpayer was also liable for tax on gain from the deemed sale of his right to receive future installments on the day before his expatriation under § 877A, under which all of a covered expatriate's property is treated as being sold on the day before his expatriation for fair market value.

Under § 877A(g)(2), "expatriate" includes any U.S. citizen who relinquishes his citizenship, and any long-term U.S. resident who ceases to be a lawful permanent resident of the U.S. A long-term resident is a non-citizen States who is a lawful permanent U.S. resident in at least eight of 15 tax years ending with the year of expatriation. § 877A(g)(1) defines a "covered expatriate" as an expatriate who, *inter alia*, fails to certify under penalty of perjury that he has met the requirements of this title for the 5 preceding tax years."

Taxpayer failed to file a completed Form 8854 certifying under penalties of perjury that he has complied with all of his U.S. Federal tax obligations for the five tax years preceding the tax year that includes his expatriation date. IRS provided evidence that Topsnik did not file all of his U.S. income tax returns before expatriating and was not in payment compliance for taxes owed for the five years before expatriation in tax year 2010. Because Topsnik failed to certify tax compliance for the five years before expatriation, he was a "covered expatriate" as defined by § 877A(g)(1)(A).

FATCA

Hom, 9th Cir., 2016-2 U.S.T.C. ¶50,358

A poker player's accounts at two online websites were not foreign financial accounts for purposes of the Foreign Account Tax Compliance Act (FATCA). However, his account with an entity that engaged in money transmissions was a foreign financial account because the entity was located in and regulated by the United Kingdom.

Although the individual could carry a balance in his online poker accounts, the funds were used only to play poker and there was no evidence that the accounts served any other financial purpose. Moreover, contrary to the government's contention, the online poker accounts were not "bank" accounts. The dictionary definition of a bank is "an establishment for the custody, loan, exchange or issue of money, for the extension of credit and for facilitating the transmission of funds" and there was no evidence that the online poker accounts were established for any of those purposes.

Credits

Eshel, D.C. Cir., 2016-2 U.S.T.C. ¶50,371

The D.C. Circuit held that taxes paid to the French government – *la contribution sociale generalisée* (CSG) and *la contribution pour le remboursement de la dette sociale* (CRDS), – by Taxpayers who worked in France were creditable under § 317(b)(4) of the Social Security Act.

The United States can enter into a totalization agreement with a foreign country under the Social Security Act, to provide that an individual is subject to social security coverage in the foreign country. The self-employment income of an individual residing in a foreign country is exempt from self-employment tax to the extent that it is subject to taxes or contributions for social security of the foreign country under the agreement. If an individual pays taxes to a foreign country for any period of employment or self-employment which is covered under the foreign country's social security system in accordance with the terms of a totalization agreement, the individual cannot deduct or claim a credit of those taxes for U.S. federal income tax purposes. If particular foreign taxes are covered by or within the scope of a totalization agreement, payment of those taxes to the foreign country is consistent with the taxpayer's obligation under the agreement, and therefore the taxes are paid "in accordance with" the agreement.

The court held that the taxes were paid in accordance with a totalization agreement between France and the United States and so were neither creditable nor deductible. The CSG and CRDS amended and supplemented specified laws making up the French social security system under the plain meaning of the terms. Thus, the taxes were covered by the totalization agreement.

Foreign Earned Income Tax Exclusion

Striker, T.C. Memo 2015-248

A civilian who was assigned by the U.S. Army to NATO did not qualify for the foreign earned income exclusion, despite the fact that all of his duties were part of a NATO mission that he specifically applied to the Army for and that his job performance was evaluated by NATO personnel, because he was hired, paid, and subject to discipline by the U.S. Army was an U.S. employee. Under § 911(a), amounts "paid by the United States or an agency thereof to an employee of the United States or an agency thereof" are not foreign income subject to exclusion.

Reaching similar result, with State Department employees:

Co v. Commissioner, T.C. Memo 2016-19 (Feb. 8, 2016)
Gerencser, T.C. Memo. 2016-151, Dec. 60,671(M)

Production of Foreign Bank Records

Chabot, 3rd Cir., 116 AFTR 2d 2015-5270, cert denied 11/30/2015

The Supreme Court declined to review a decision of the Third Circuit that the "required records" exception to the Fifth Amendment privilege against self-incrimination applies to allow IRS to summon foreign bank account records.

Taxpayers must file a Report of Foreign Bank and Financial Accounts (FBAR) to report a financial interest in, or signature or other authority over, financial accounts in foreign countries exceeding $10,000.

On receiving information from French authorities concerning U.S. persons with undisclosed bank accounts, the IRS issued summonses to Taxpayers. District court rules that summonses were proper under required records exception. Taxpayers claimed that their act of producing the documents was protected under the Fifth Amendment, claiming that responding might subject them to prosecution for their failure to have filed the information in an FBAR.

The district court held, and the Third Circuit affirmed that the "required records exception" applied and the Fifth Amendment did not prohibit production of the documents sought.

In *Shapiro v. U.S.*, 335 U.S. 1 (1948), the Supreme Court held that Congress could require that taxpayers maintain records if they closely served the purpose of a valid, civil regulation (in that case, the Emergency Price Control Act, by which Congress set commodity prices during wartime and required vendors to keep records of their sales). In *Grosso v. U.S.*, 360 U.S. 62 (1968), the. Supreme Court explained that three prongs must be met in order for records to fall within the required records exception: (1) the reporting or record-keeping scheme must have an essentially regulatory purpose; (2) a person must customarily keep the records that the scheme requires him to keep; and (3) the records must have "public aspects."

The Court then analyzed the three prongs of the Grosso test and found that the required records exception applied and that the summonses should be enforced. Specifically, the Court found that although 31 CFR 1014.420 certainly has "criminal aspects" to it, it also serves civil aims of monitoring and facilitating compliance with currency regulation and tax laws; the records mandated by 31 CFR 1014.420 are of the type that reasonable account holders would have and are thus "customarily kept," and foreign bank account records, while having certain privacy protections, are not private documents for all purposes.

Reaching similar result:

U.S. v. Chen, 1st Cir., 117 AFTR 2d ¶2016-469

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