RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

We apologize to our readers. If we had more time, this outline would be much shorter.

By

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I. ACCOUNTING

A. Accounting Methods

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

1. Legal expenses incurred related to the preparation of applications to the FDA for approval of generic drugs are capital expenditures while legal expenses incurred to defend patent infringement suits are currently deductible. Mylan, Inc. & Subsidiaries v. Commissioner, 156 T.C. No. 10 (4/27/21). The taxpayer, Mylan, Inc., and its subsidiaries manufacture both brand name and generic pharmaceutical drugs. Mylan incurred substantial legal expenses in two categories. First, Mylan incurred legal expenses in connection with its applications to the FDA seeking approval of generic drugs. To obtain this approval, Mylan submitted abbreviated new drug applications (ANDAs). The ANDA application process for generic drugs includes a requirement that the applicant certify the status of any patents covering the respective brand name drug previously approved by the FDA (referred to as a "paragraph IV certification"). One option available to the applicant is to certify that the relevant patent is invalid or will not be infringed by the sale or use of the generic version of the drug. An applicant making this certification is required to send notice letters to the holders of the patents informing them of the certification. Such a certification is treated by statute as patent infringement and the holder of the patent is entitled to bring suit in federal district court. Mylan incurred substantial legal expenses to prepare the notice letters it sent in connection with its ANDA applications. Second, Mylan incurred substantial legal expenses in defending patent infringement lawsuits brought by the name-brand drug manufacturers against Mylan in response to the notice letters that Mylan sent. Mylan claimed deductions for both categories of legal expenses. The IRS, however, determined that all of Mylan's expenses were capital expenditures under § 263(a). The Tax Court (Judge Urda) held that the legal expenses incurred by Mylan to prepare notice letters were capital expenditures but the legal expenses Mylan incurred to defend patent infringement suits were currently deductible business expenses.

FDA applications for generic drugs and notice letter costs. The court first addressed the issue of whether the costs Mylan incurred to prepare the notice letters it sent in connection with its ANDA applications should be capitalized under § 263. The court's analysis focused in large part on the regulations under § 263 regarding intangibles. These regulations require a taxpayer to capitalize both amounts paid to *create* an intangible and amounts paid to *facilitate* an acquisition or creation of an intangible. Reg. § 1.263(a)-4(b)(1)(ii), (iv). With respect to creation of an intangible, Reg. § 1.263(a)-4(d)(5)(I) provides:

> A taxpayer must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights under a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

With respect to facilitating the acquisition or creation of an intangible, Reg. § 1.263(a)-4(e)(1) provides:

> [A]n amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances.

Mylan and the IRS disputed whether Mylan's legal fees were incurred to "facilitate" the acquisition of a right obtained from a governmental agency and therefore were required to be capitalized. They agreed that the relevant "transaction" was *acquisition* of an FDA-approved ANDA with a paragraph IV certification. But they disagreed on when this acquisition occurs. Mylan argued that the acquisition of an FDA-approved ANDA occurs when the FDA completes its scientific investigation and issues an approval letter. The IRS asserted that the acquisition of an FDA approved ANDA with a paragraph IV certification occurs only when the approval letter issued by the FDA becomes effective. The distinction is that the FDA may issue an approval letter but the approval does not grant any rights to the applicant until it becomes effective. Only when the approval becomes effective does the applicant have the right to begin delivery of a generic drug. *See* 21 U.S.C. § 355(a). With respect to Mylan's legal fees incurred in preparing the notice letters relating to the filing of its ANDA's with paragraph IV certifications, the court concluded that these costs were capital expenditures. The notice is a required step in securing FDA approval of an ANDA. According to the court, because the notice requirement was a prerequisite to securing FDA approval, "the legal expenses Mylan incurred to prepare, assemble, and transmit such

notice letters constitute amounts incurred 'investigating or otherwise pursuing' the transaction of creating FDA-approved ANDAs … and must be capitalized."

Litigation expenses. The court reached a different conclusion regarding Mylan's litigation expenses, holding that they were currently deductible. The IRS argued that a patent infringement suit is a step in obtaining FDA approval of an ANDA. The court disagreed, however, and reasoned that the outcome of a patent litigation action has no effect on the FDA's review of a generic drug application. The FDA continues its review process during the course of a patent infringement action and may issue a tentative or final approval of an application before the infringement action is finally decided. A successful patent dispute does not guarantee that a generic drug manufacturer will obtain FDA approval of an ANDA. While it is true that a successful challenge by a patent holder will result in a prohibition of the marketing of a generic drug found to infringe, the court reasoned that the coordination of the FDA approval process with the outcome of related patent litigation does not insert the patent litigation into the FDA's ANDA approval process. A patent on a name brand drug does not prevent FDA approval of a generic version of the drug and patent litigation on the part of the patent holder is not a step in the FDA's approval process for a generic drug. In reaching its conclusion that the litigation expenses incurred by Mylan were currently deductible as ordinary and necessary expenses, the court also applied the "origin of the claim" test, which inquires as to "'whether the origin of the claim litigated is in the process of acquisition", enhancement, or other disposition of a capital asset." *Woodward v. Commissioner*, 397 U.S. 572, 577 (1970); see also *Santa Fe Pac. Gold Co. v. Commissioner*, 132 T.C. 240, 264-265 (2009). Here, the court reasoned, Mylan's legal expenses arose from legal actions initiated by patent holders in an effort to protect their patents. The court followed the decision of the U.S. Court of Appeals for the Third Circuit in *Urquhart v. Commissioner*, 215 F.2d 17 (3d Cir. 1954), which held that patent litigation arises out of the exploitation of the invention embodied in the patent and, therefore, costs incurred to defend a patent infringement suit are not capital expenditures because they are not costs incurred to defend or protect title but rather are expenses incurred to protect business profits. Because Mylan's legal expenses arose out of the patent infringement claims initiated by the patent holders, the court held, they were currently deductible.

C. Reasonable Compensation

D. Miscellaneous Deductions

E. Depreciation & Amortization

F. Credits

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. Split-dollar life insurance benefits provided to an S corporation employee-shareholder are guaranteed payments taxable as ordinary income and not a distribution with respect to stock, says the Tax Court. De Los Santos v. Commissioner, 156 T.C. No. 9 (4/12/21). In this unanimous, reviewed opinion by Judge Lauber, the Tax Court addressed the appropriate tax treatment of benefits received by a shareholder-employee of an S corporation under a split-dollar life insurance arrangement provided by the corporation. The taxpayer was the sole shareholder of an S corporation of which both he and his wife were employees. Pursuant to a welfare benefit plan adopted by the S corporation, the corporation paid the premiums on a life insurance policy on the taxpayers' lives. In an earlier, related decision, the Tax Court had ruled that the plan constituted a compensatory split-dollar life insurance arrangement under Reg. § 1.61-22(b). See *De Los Santos v. Commissioner (De Los Santos I)*, T.C. Memo 2018-155. The issue addressed in this decision is how benefits from such split-dollar arrangements are taxed. The taxpayers argued that the economic benefits the husband received under the split-dollar life insurance arrangement constituted a distribution to the husband as a shareholder under § 301 as opposed to compensation received as an employee.

Taxation of split-dollar life insurance. There are two basic types of split-dollar life insurance arrangements: "compensatory" arrangements and "shareholder" arrangements. A compensatory arrangement is entered into in connection with the performance of services, for example, by an employee for an employer. In contrast, a shareholder arrangement is entered into between a corporation and a shareholder. Under both arrangements, the "owner" (here the welfare benefit plan established by the S corporation) of the life insurance contract pays the premiums and the "non-owner" (here the taxpayer, Mr. De Los Santos) retains an interest in the policy, such as an interest in the policy's cash value or the ability to name the policy's beneficiary. Any economic benefits of a split-dollar arrangement are treated as being provided to the non-owner of the insurance contract. The non-owner must take into account the full value of all economic benefits less any consideration paid by the non-owner. See Reg. § 1.61-22(b)(2)(ii) and (iii).

Background and Sixth Circuit's decision in Machacek. In arriving at its conclusion that this was a compensatory arrangement and not a corporate distribution, the Tax Court declined to follow the decision of the U.S. Court of Appeals for the Sixth Circuit in *Machacek v. Commissioner*, 906 F.3d 429 (6th Cir. 2018), *rev'g* T.C. Memo. 2016-55 (3/28/16), upon which the taxpayers in this case rested their argument that their split-dollar arrangement was governed by the rules of § 301, which apply to corporate distributions. In *Machacek*, the taxpayer and his wife were the sole shareholders of a subchapter S corporation of which the taxpayer also was an employee. Pursuant to a benefit plan adopted by the S corporation, the corporation paid the $100,000 annual premium on a life insurance policy on the taxpayer's life under an arrangement that the parties agreed was a compensatory split-dollar arrangement. The Tax Court (Judge Laro) held that the taxpayers had to include in income the economic benefit of the arrangement. In an opinion by Judge White, the Sixth Circuit reversed and remanded and held that the economic benefits of the arrangement must instead be treated as distributions of property by the S corporation. The court relied on Reg. § 1.301-1(q)(1)(i), which provides:

> the provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement, as defined in § 1.61-22(b)(1) or (2), of economic benefits described in § 1.61-22(d) . . . is treated as a distribution of property.

The Sixth Circuit reasoned that the quoted cross reference to Reg. § 1.61-22(b) indicates that Reg. § 1.301-1(q)(1)(i) applies whether the split-dollar arrangement is a shareholder arrangement or a compensatory arrangement and is dispositive. Thus, according to the Sixth Circuit, when a shareholder-employee receives benefits under a compensatory arrangement, the "benefits are treated as a distribution of property and are thus deemed to have been paid to the shareholder in his capacity as a shareholder." Subsequently, the Sixth Circuit denied the government's petition for rehearing, in which the government asserted that the decision in *Machacek* could lead to the unanticipated consequence of causing the termination of an employer's status as an S corporation because treating the economic benefits of a split-dollar arrangement as a distribution to only one shareholder (i.e., without a

corresponding distribution to all other shareholders) may result in the S corporation having an impermissible second class of stock.

Tax Court's analysis in this case. In this case, the S corporation adopted an employee welfare benefit plan (the "Legacy Plan") to provide its employees with, among other things, life insurance benefits. To be eligible under the Legacy Plan, the taxpayers were required to provide services to the S corporation as their employer. Under the Legacy Plan, the taxpayers were entitled to death benefits from a second-to-die life insurance policy. During the years in issue, the S corporation made substantial premium payments to the Legacy Plan to fund the death benefits. The taxpayers did not report any income from their participation in the Legacy Plan. The taxpayers conceded that the S corporation provided them with death benefits in exchange for their performance of services and that receipt of these benefits was through the Legacy Plan as employee benefits. However, like the taxpayers in *Machacek*, the taxpayers took the position that, when a shareholder receives economic benefits from a split-dollar insurance arrangement, such benefits should be treated as a distribution of property under § 301 and that this is true notwithstanding that the insurance benefits are received in exchange for services rendered to an employer by an employee. The Tax Court disagreed with the taxpayers' contention that, while the husband's annual salary was ordinary income and did not qualify as a corporate distribution, any welfare benefits under the Legacy Plan should be treated as corporate distributions. Because the split-dollar arrangement was based on the performance of services, the Tax Court concluded, it could not be an arrangement between the corporation and the taxpayer husband as a shareholder. Accordingly, the corporate distribution rules under § 301 were inapplicable. Instead, the court concluded, any economic benefits must be treated as compensation for services and therefore ordinary income to the taxpayers. After reviewing the Sixth Circuit's analysis in *Machacek*, the Tax Court indicated that, "[w]ith all due respect, we are unable to embrace the reasoning or result of the Sixth Circuit's opinion in Machacek." Specifically, the Tax Court concluded that the regulation on which the Sixth Circuit had relied, Reg. § 1.301-1(q)(1)(i), does not apply because the same regulation provides that it "is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such." Reg. § 1.301-1(c). The Tax Court reasoned that it was not bound to follow the Sixth Circuit's decision in *Machacek* in the current case because the current case is appealable to a different federal court of appeals (the Fifth Circuit). See *Golsen v. Commissioner*, 54 T.C. 742, 756-757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). Having freed itself from the Sixth Circuit's reasoning in *Machacek*, the Tax Court held that, if a corporation provides a benefit to a shareholder in the shareholder's capacity as an employee, the payment does not constitute a distribution subject to the rules of § 301. Instead, the Tax Court concluded, the economic benefits received by the taxpayers here were taxable as compensation for services under a compensatory split-dollar arrangement.

Treatment of the economic benefits as a guaranteed payment under § 707. Having arrived at the conclusion that the economic benefits received by the taxpayers were compensation for services taxable as ordinary income, the Tax Court turned to the question of how fringe benefits are taxed under subchapter S. The court applied § 1372, which provides that, for purposes of applying the provisions of subtitle A of the Code that relate to employee fringe benefits, (1) an S corporation is treated as a partnership, and (2) any 2-percent shareholder of the S corporation is treated as a partner of such partnership The Tax Court then applied its prior decision in *Our Country Home Enterprises v. Commissioner*, 145 T.C. 1 (2015), in which the court held that, where a corporation provides economic benefits to its shareholder-employee under a compensatory split-dollar arrangement, it is generally treated as a payment of compensation. However, there is an exception to the general rule if the employer is an S corporation that provides benefits to a 2-percent shareholder in return for services rendered. Under such circumstances, the 2-percent shareholder is treated as a partner in applying the employee fringe benefit rules. Because the 2-percent shareholder is treated as a partner, the economic benefits under the split-dollar arrangement are treated as guaranteed payments under § 707(c) and included in gross income under § 61. Applying these rules, the Tax Court concluded that, because the taxpayer husband in this case owned 100 percent of the stock of the S corporation, the S corporation was treated as a partnership and taxpayer husband was treated as a partner under § 1372(a). Thus, the economic benefits received by taxpayer husband under the life insurance policy held by the Legacy Plan were "guaranteed payments" subject to § 707(c) and taxed as ordinary income.

B. Qualified Deferred Compensation Plans

C. Nonqualified Deferred Compensation, Section 83, and Stock Options

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

C. Hobby Losses and § 280A Home Office and Vacation Homes

D. Deductions and Credits for Personal Expenses

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

1. Tax Court holds rent paid by corporation to its shareholders is partially a constructive dividend. Plentywood Drug, Inc. v. Commissioner, T.C. Memo. 2021-45 (4/26/21). Plentywood Drug, Inc. (Plentywood, Inc.) is a Montana C corporation that operates a pharmacy in a building located in Plentywood, Montana, that the corporation occupies as a tenant. Plentywood, Inc. has four shareholders (two married coules). In their individual capacities, the four shareholders equally co-own the building that is leased by Plentywood, Inc. In 2011, Plentywood, Inc. paid a total of $83,548 in rent to the four shareholders. In 2012 and the following year, the rent was increased to $192,000. By having the corporation deduct the rent from its income each year, Plentywood, Inc. and its shareholders were able, to an extent, to avoid the normal double taxation of a C corporation's income. On audit, the IRS disallowed substantial portions of the rental deductions and took the position that the rent paid far exceeded what the fair market rent would have been in each of the years. In the words of Judge Holmes, the IRS "lassoed" the shareholder owners of the building, characterized a portion of the rents as nondeductible constructive dividends to the four shareholders, and then "branded" the shareholders and the corporation with accuracy-related penalties. The Tax Court noted that the IRS does not often question the reasonableness of rents, but sometimes does so when the "landlord and tenant might not have an incentive to drive a hard bargain":

> "When there is a close relationship between lessor and lessee and in addition there is no arm's length dealing between them, an inquiry into what constitutes reasonable rental is necessary to determine whether the sum paid is in excess of what the lessee would have been required to pay had he dealt at arm's length with a stranger. * * *"

Place v. Commissioner, 17 T.C. 199, 203 (1951), *aff'd*, 199 F.2d 373 (6th Cir. 1952). The issue was whether the rent paid by Plentywood, Inc. to the four shareholders was a fair market rent. To the extent that the rent paid by Plentywood, Inc. exceeded a fair market rent, the excess of the actual rent paid over a fair market rent would be a constructive dividend to the shareholders. As is typical in valuation cases, each side introduced expert testimony. The determination of a fair market rent was made more difficult by the small size of the town of Plentywood, which had a population of only 1,700. The taxpayer and the IRS each criticized the methodology and conclusion of the opposing side's expert. For example, the IRS argued that Plentywood, Inc's expert did not adhere to the Uniform Standards of Professional Appraisal Practice (USPAP). The USAP, the court noted, are not federal rules of evidence. Although Montana requires licensed appraisers to follow USPAP, the court relied on its prior decisions in which it had declined to adopt USPAP as the sole standard for reliability of an expert appraiser. See *Whitehouse Hotel Ltd. P'ship v. Commissioner*, 131 T.C. 112, 128 (2008), *rev'd on other grounds*, 615 F.3d 321 (5th Cir. 2010). According to the court, although the failure of Plentywood, Inc's expert to follow USPAP may adversely affect the weight the court gives to expert testimony, it does not, by itself, make the testimony so unreliable as to be inadmissible. The court had its own criticisms of the methodology used by each side's expert. For example, Judge Holmes was critical of the use by Plentywood Inc.'s expert of comparables from the neighboring town of Williston, Montana, which is

eight times larger than the town of Plentywood and had experienced an economic boom in the oil industry that affected rents. Judge Holmes was also critical of the use by the IRS's expert of two government-subsidized multifamily residential housing units and a very small donut shop as comparable properties in assessing the rent paid for space used for a retail drug store operation. Instead, Judge Holmes focused on the Post Office building in Williston as the most comparable building for purposes of determining a fair market rent. To "round up" the analysis of the Tax Court here, Plentywood, Inc. and its shareholders asserted that the annual rent of $192,000 per year was reasonable while the Tax Court concluded that the fair market rent for the space was $171,187.50. Finally, the court declined to uphold the accuracy-related penalties the IRS sought to impose under § 6662(a) on the shareholders because the IRS had failed to meet its burden of production to show that it had obtained supervisory approval of the initial determination of the penalties as required by § 6751(b). *See, e.g.*, *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017). The corporation, the court reasoned, could not rely on § 6751(b) to avoid accuracy-related penalties because the corporation bore the burden of production for its own case and had failed to show that the IRS had not obtained the required supervisory approval. Nevertheless, the court concluded, the corporation was not subject to accuracy-related penalties because neither ground relied on by the IRS (substantial understatement of income of negligence or disregard of rules) was satisfied. Given that the rent in question was overstated by only approximately $20,000, the court concluded, there was no substantial understatement of income as that term is defined in § 6662(d)(1)(B). And given the difficulty in determining a fair market rent and the small overstatement of rent that occurred, the corporation had a reasonable cause, good faith defense to the claim that it had been negligent or disregarded rules. As valuation opinions go, one could reasonably conclude that these Montana taxpayers "wrangled" an excellent outcome.

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

VII. PARTNERSHIPS

A. Formation and Taxable Years

B. Allocations of Distributive Share, Partnership Debt, and Outside Basis

C. Distributions and Transactions Between the Partnership and Partners

1. Tax Court holds that amounts transferred to the partnership by one partner are loans rather than capital contributions and their cancellation resulted in COD income to the partnership. Hohl v. Commissioner, T.C. Memo. 2021-5 (1/13/21). There were several issues in this case that arose out of several purported capital contributions by one partner, Mr. Rodriguez, which were treated by the other three partners, Mr. Hohl, Mr. Blake, and Mr. Bowles, as loans. Upon formation of Echo partnership (Echo), Messrs. Hohl, Blake, and Bowles owned 30 percent each while Mr. Rodriguez owned 10 percent. Over the life of the partnership, Mr. Hohl, the partnership's bookkeeper, recorded loans to Echo in substantial amounts received by Echo from Mr. Rodriguez in sequential years. Echo's partnership tax return on Form 1065 consistently reflected a note payable to Mr. Rodriguez in an amount equal to Mr. Rodriguez' transfers to Echo. None of the partners' Schedule K-1s for the year indicated a beginning capital contribution. Rather, Messrs. Hohl, Blake, and Bowles' capital accounts were all based upon their respective contributions of services. On its Form 1065, Echo reported a net loss each year primarily related to deductions taken for guaranteed payments to partners. Each partner's capital account balance began at zero and then reduced each year by Echo's loss for the year. This resulted in negative capital account balances for the partners. Echo's balance sheet showed an increase each year in liabilities related to amounts transferred by Mr. Rodriquez to Echo. After several years of operations, Echo filed a final return upon which the liability to Mr. Rodriquez was

reflected on the balance sheet but no partner reported any allocation of a share of that liability. The partnership did not report any discharge of indebtedness, nor did Echo allocate any income to any of the partners. After an audit, the IRS adjusted Mr. Hohl's and Mr. Blake's income upward by the amount of each partner's negative capital account balance. The increases represented each partner's share of cancellation of indebtedness. The issue addressed by the Tax Court (Judge Buch) was whether Mr Rodriguez' transfers to Echo were loans or capital contributions. Mr. Hohl and Mr. Blake argued that the transfers were capital contributions while the IRS contended that the transfers to Echo were loans. Focusing on the substance of the transaction and applying the test developed in *Greenberg v. Comm'r*, T.C. Memo 1992-292, Judge Buch focused on three factors: (1) the presence of a written agreement, (2) the intent of the parties; and (3) the likelihood of obtaining a similar loan from disinterested investors. In finding that transfers by Mr. Rodriguez were loans, the Tax Court initially noted that there was no written document. In determining intent, Echo reported the amounts transferred by Mr. Rodriguez as loans on its Form 1065 and allocated a share of liabilities to each partner on their respective Forms K-1. Both Echo and Mr. Rodriguez failed to include the transfers in Mr. Rodriguez' capital account balance and Mr. Rodriguez' ownership percentage never changed as a result of any of the transfers. The Tax Court was persuaded that each of these facts was consistent with the transfers being treated as loans from Mr. Rodriguez to Echo and not capital contributions. Having concluded that the transfers were loans, the court concluded that, when Echo ceased operations and it became certain that Echo would not repay the debt to Mr. Rodriguez, Echo realized income from the discharge of indebtedness. The Tax Court declined to accept Mr. Hohl and Mr. Blake's argument that all of the discharge of indebtedness income should be allocated to Mr. Rodriquez, finding instead that the partnership agreement lacked economic effect because the operating agreement allocated partners distributive shares based upon partner's capital accounts. Relying on all the facts and circumstances, the Tax Court followed the partners' course of conduct wherein Echo allocated losses 10 percent to Mr. Rodriguez and 30 percent to the other three partners. As such, Messrs. Hohl and Blake were allocated 30 percent of the cancellation of indebtedness (C.O.D.) income. The court adopted the IRS's argument that Messrs. Hohl and Blake should each include their respective 30 percent allocation of C.O.D. in income.

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

G. Miscellaneous

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. Can you avoid penalties by relying on your attorney or CPA to file an extension request? No, says the Claims Court. An executor who relied on an attorney to file an extension request for an estate tax return did not have a reasonable cause defense to late-filing and late payment penalties. Andrews v. United States, 153 Fed. Cl. 665 (5/12/21). The plaintiff, who was the executor of an estate, brought this action seeking a refund of late-filing and late-payment penalties assessed by the IRS against the estate. The estate's return on Form 706 was due on May 8, 2016. The plaintiff retained an estate planning law firm to assist in preparing Form 706 and authorized the firm to file Form 4768 to obtain an automatic six-month extension of time to file. The plaintiff asserts that the attorney who was to file for the extension failed to do so and, after the May 8, 2016, filing deadline, filed Form 706 late and reported tax due of approximately $3 million. The IRS assessed a late-filing penalty of just over $400,000 and a late-payment penalty of just over $75,000. The estate paid the tax due and all penalties and interest, filed an administrative claim for refund of the refund of the penalties and, in this action, challenges the IRS's failure to issue the refund. The government moved to dismiss for failure to state a claim on the ground that the estate could not establish a reasonable

cause defense to the penalties. In an opinion by Judge Davis, the U.S Court of Federal Claims granted the government's motion to dismiss. In reaching its conclusion, the court relied on the U.S. Supreme Court's decision in *United States v. Boyle*, 469 U.S. 241 (1985). In *Boyle*, the Court held that "failure to make a timely filing of a tax return is not excused by [a] taxpayer's reliance on an agent." The Court in *Boyle* distinguished relying on an agent from situations in which a taxpayer relies on the mistaken advice of counsel concerning a question of tax law, which courts have held can constitute reasonable cause. In this case, the Court of Federal Claims held, the executor of the estate had not relied on mistaken advice of counsel, but rather had delegated responsibility for filing an extension request. Under the standard set forth in *Boyle*, the court held, such delegation to an agent does not give rise to a reasonable cause defense to penalties. Accordingly, the court granted the government's motion to dismiss.

2. Can't we cut this guy a break? No, says the Fifth Circuit. Even though the taxpayer was incarcerated and the person he appointed as his attorney-in-fact to file his returns and manage his affairs failed to do so and embezzled hundreds of thousands of dollars, the taxpayer could not establish a reasonable cause defense to penalties. Lindsay v. United States, 4 F.4th 292 (5th Cir. 7/9/21). The taxpayer was incarcerated from 2013 to 2015. He appointed an individual, Keith Bertelson, to act as his attorney-in-fact under a power of attorney that gave Bertelson authority to manage the taxpayer's affairs. Bertelson failed to file the taxpayer's returns and pay taxes due as he had been directed. Bertelson also embezzled the taxpayer's fund. The taxpayer ultimately recovered more than $700,000 in actual damages from Bertelson and $1 million in punitive damages. After being released, the taxpayer filed late returns for 2012 through 2015. The IRS assessed late-filing and late-payment penalties of more than $400,000. After filing an administrative claim for refund of the penalties, the taxpayer brought this action seeking a refund on the basis that his incarceration qualified as a "disability." In an opinion by Judge Stewart, the U.S. Court of Appeals for the Fifth Circuit rejected the taxpayer's argument. The court relied on the U.S. Supreme Court's decision in *United States v. Boyle*, 469 U.S. 241 (1985). In *Boyle*, the Court held that "failure to make a timely filing of a tax return is not excused by [a] taxpayer's reliance on an agent." The Court in *Boyle* distinguished relying on an agent from situations in which a taxpayer relies on the mistaken advice of counsel concerning a question of tax law, which courts have held can constitute reasonable cause. In this case, the Fifth Circuit concluded, the taxpayer had not relied on mistaken advice of counsel, but rather had delegated responsibility for filing his tax returns. Under the standard set forth in *Boyle*, the court held, such delegation to an agent does not give rise to a reasonable cause defense to penalties. The court also concluded that this was not a situation in which the taxpayer was incapable of meeting his filing obligations and therefore did not fall into the category of situations in which courts have recognized a reasonable cause defense for taxpayers who are not physically or mentally capable of complying with a filing deadline. Accordingly, the court granted the government's motion to dismiss.

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

1. Economic hardship relief from a levy is not available to a corporate taxpayer. Seminole Nursing Home, Inc. v. Commissioner, __ F.4th __ (10th Cir. 9/2/21), *aff'g* T.C. Memo. 2017-102 (6/5/17). The taxpayer, a corporation that operated a nursing home in rural Oklahoma, failed to pay its federal withholding and employment taxes in the amount of just over $60,000 for the fourth quarter of 2013. In response to the Service's final notice of intent to levy, the taxpayer requested a collection due process (CDP) hearing, proposed an installment agreement, and submitted a letter to the IRS settlement officer challenging the appropriateness of the levy on the grounds of economic hardship. The taxpayer argued that it was operating at a loss and could not "'provide essential care services to the patients residing at [its] nursing facility'" if the Service were permitted to levy. The taxpayer's assets included more than $313,000 in accounts receivable from Medicare and Medicaid.

At the CDP hearing, the IRS settlement officer rejected the proposed installment agreement on the grounds that the taxpayer had sufficient assets to pay its outstanding tax liability and that the taxpayer was not current with its federal employment tax deposits for 2014. The IRS settlement officer also declined to consider the economic hardship argument because, under the relevant regulation, Reg. § 301.6343-1(b)(4)(i), relief is available only on account of economic hardship of an individual taxpayer. The regulation provides that the Service must release a levy if one of several conditions is satisfied, including the following:

> The levy is creating an economic hardship due to the financial condition of an individual taxpayer. This condition applies if satisfaction of the levy in whole or in part will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses.

The IRS settlement officer issued a notice of determination upholding the collection action. The taxpayer filed a petition in the Tax Court and moved for summary judgment on the grounds that the regulation's limitation of economic hardship relief to individuals is contrary to the statute (§ 6343(a)(1)(D)) and therefore invalid and that the settlement officer had abused her discretion by failing to consider its request for economic hardship relief. The Tax Court previously had upheld the validity of Reg. § 301.6343-1(b)(4)(i) in *Lindsay Manor Nursing Home, Inc. v. Commissioner*, 148 T.C. 235 (2017), *vacated as moot*, 725 Fed. Appx. 713 (10th Cir. 2018), and in this case the Tax Court (Judge Paris) adhered to its prior decision. Following a remand to the IRS Appeals Office and the IRS's issuance of a supplemental notice of determination upholding the collection action, the Tax Court, in an unpublished order, sustained the IRS's notice of determination. *Seminole Nursing Home, Inc. v. Commissioner*, No. 24577-14L (2/21/20).

On appeal, in an opinion by Judge Hartz, the U.S. Court of Appeals for the Tenth Circuit upheld the validity of the regulation and concluded that the settlement officer had not abused her discretion in sustaining the collection action. The relevant statute, § 6343(a)(1)(D), provides that, "under regulations prescribed by the secretary," a levy shall be released if "the Secretary has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer." The regulation in question interprets the economic hardship exception as being available only to individual taxpayers. The court assessed the validity of the regulation by applying the two-step analysis of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The court concluded in *Chevron* step one that the statute, § 6343(a)(1)(D), is ambiguous, and in step two that Reg. § 301.6343-1(b)(4)(i) is a permissible construction of the statute. In its analysis of *Chevron* step one, the court examined not only the plain language of the statute but also its structure and apparent purpose. The court reasoned:

> In what sense, though, might a corporation suffer economic hardship that could reasonably excuse releasing a tax levy on its assets? Say the corporation is in absolutely dire straits; it cannot survive even if the levy is released, or even if the tax liability is canceled altogether. In that circumstance, what purpose could possibly be served by preventing the IRS from seizing corporate assets under the levy? Perhaps another creditor of the corporation would benefit because it could collect through assets that would otherwise be seized by the IRS. But benefiting other creditors (likely at the expense of the IRS) could hardly be the purpose of the economic-hardship exception. This example points up an essential difference between an individual and a nonindividual entity.

Accordingly, the court affirmed the decision of the Tax Court.

G. Innocent Spouse

H. Miscellaneous

1. Surely it's not constitutional for the government to revoke or refuse to issue an individual's passport just for having a seriously delinquent tax debt? Isn't there some sort of fundamental right to travel? Don't pack your bags just yet. Section 7345, which addresses the revocation or denial of passports for seriously delinquent tax debts, was enacted in 2015 as section 32101(a) of the Fixing America's Surface Transportation Act, Pub. L. 114-94 (Dec. 4, 2015). It provides that, if the IRS certifies that an individual has a "seriously delinquent tax debt," the Secretary

of the Treasury must notify the Secretary of State "for action with respect to denial, revocation, or limitation of a passport." § 7345(a). In general, a seriously delinquent tax debt is an unpaid tax liability in excess of $50,000 for which a lien or levy has been imposed. § 7345(b)(1). A taxpayer who seeks to challenge such a certification may petition the Tax Court (or bring an action in a U.S. District Court) to determine if the certification was made erroneously. § 7345(e)(1). If the Tax Court concludes the certification was either made in error or that the IRS has since reversed its certification, the court may order the Secretary of the Treasury to notify the State Department that the certification was erroneous. § 7345(e)(2). In the following cases, the courts have addressed the constitutionality of this regime.

a. Section 7345 does not prohibit international travel and therefore cannot violate either the Due Process Clause of the Fifth Amendment or the Universal Declaration of Human Rights, says the Tax Court. Rowen v. Commissioner, 156 T.C. No. 8 (3/30/21). The opinion of the Tax Court (Judge Toro) in this case begins as follows:

> For more than two decades, petitioner, Robert Rowen, failed to pay his Federal tax as required by law. The Internal Revenue Service ("IRS") attempted to collect the outstanding amounts through its usual means—sending demands, filing liens, attempting to levy on assets--all without much success. In 2018, when Dr. Rowen's outstanding tax balance was close to $500,000, the Commissioner of Internal Revenue turned to a new tool in his collection toolbox--section 7345.

The petitioner, Dr. Rowen, was a medical doctor licensed in California who frequently traveled to developing countries to offer medical services free of charge to underserved populations. Pursuant to § 7345, the IRS issued a notice of certification of a "seriously delinquent tax debt" and notified the Secretary of State that his passport should be revoked. As permitted by § 7345(e)(1), Dr. Rowen filed a petition in the Tax Court and asked the court to determine that the IRS's certification of his tax debt as seriously delinquent was erroneous. He argued that § 7345 is unconstitutional because it prohibits international travel in violation of his rights under the Due Process Clause of the Fifth Amendment. He also argued that the statute "violates his human rights under the Universal Declaration of Human Rights ('UDHR')." The Tax Court rejected both arguments. The court noted that an uncodified provision of the 2015 Fixing America's Surface Transportation Act (FAST Act) authorizes the *Secretary of State* to revoke or deny the passport of an individual who has been certified as having a seriously delinquent tax debt. The Tax Court reasoned that, because § 7345 authorizes the IRS Commissioner only to certify that an individual has a seriously delinquent tax and leaves all passport-related decisions to the Secretary of State for action pursuant to the uncodified provision of the FAST Act, § 7345 does not prohibit international travel and therefore cannot violate either the Due Process Clause of the Fifth Amendment or the Universal Declaration of Human Rights.

b. Section 7345 survives a constitutional challenge. Maehr v. United States, 5 F.4th 1100 (10th Cir. 7/20/21). The plaintiff in this case had approximately $250,000 in unpaid federal tax liabilites from 2011. In 2018, pursuant to § 7345, the IRS issued a notice of certification of a "seriously delinquent tax debt" and notified the Secretary of State that his passport should be revoked. The State Department then revoked his passport. The plaintiff brought this action in federal district court challenging the authority of the State Department to revoke passports on the basis of tax liabilities. The U.S. District Court concluded that it did not have subject-matter jurisdiction over the plaintiff claims and granted the government's motion to dismiss for failure to state a claim. On appeal, in an opinion by Judge Lucero, the U.S. Court of Appeals for the Tenth Circuit first concluded that the District Court did have subject matter jurisdiction over the action. The court then addressed the merits of the plaintiff's claims. Specifically, the Tenth Circuit unanimously rejected two of the plaintiff's arguments. The plaintiff argued that "the Privileges and Immunities Clause of Article IV, Section 2 and the Privileges or Immunities Clause of the Fourteenth Amendment encompass the right to international travel and thereby limit the federal government's ability to restrict such travel." The court rejected this argument because the Privileges and Immunities clauses apply only to the states and not to the federal government and do not protect the right to international travel. The court also rejected the plaintiff's argument that the court should review the State Department's revocation of his passport under a standard similar to the standard used by courts to review a writ of *ne exeat republica*. "A writ of *ne exeat republica* is a form of injunctive relief ordering the person to whom it is addressed not to

leave the jurisdiction of the court or the state, for example, to aid the sovereign to compel a citizen to pay his taxes." *United States v. Barrett*, 113 A.F.T.R.2d 2014-749 (D. Colo. 1/29/14). The court concluded that, for several reasons, a writ of *ne exeat republica*, an equitable, common-law remedy, is readily distinguishable from the legislatively-authorized passport revocation provided for in the 2015 FAST Act. In a separate opinion written by Judge Matheson that was the majority opinion of the court on the issue, the court also rejected the plaintiff's argument that the State Department's revocation of his passport violated his rights under the Due Process Clause of the Fifth Amendment. Specifically, the court concluded that international travel is not a fundamental right that must be reviewed under so-called strict scrutiny. If the court's standard of review were strict scrutiny, then any legislative infringement of a fundamental right must be narrowly tailored to serve a compelling government interest. Instead, the court held, because international travel is not a fundamental right, the constitutionality of § 7345 must be determined under a rational basis standard of review. Under this standard, the court noted, "we will uphold a law "if there is any reasonably conceivable state of facts that could provide a rational basis for the [infringement]." See *FCC v. Beach Comm'cns, Inc.*, 508 U.S. 307, 313 (1993)." Section 7345, the court concluded, meets this standard. The federal government has a legitimate interest in raising revenue throuh taxes and "Congress's decision to further this legitimate interest by providing for revocation of passports for those who have a "seriously delinquent tax debt," 26 U.S.C. § 7345(a), is rational."

- In a lengthy concurring opinion, Judge Lucero advocated the view that the proper standard of review for the plaintiff's Fifth Amendment claims is intermediate scrutiny, which falls between the rational basis and strict scrutiny standards. Because neither party argued for that standard of review, Judge Lucero concurred in the court's judgment.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION