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

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

1. Legal expenses incurred to defend patent infringement suits are currently deductible. Actavis Laboratories, FL, Inc. v. United States, 161 Fed. Cl. 334 (8/19/22). The plaintiff in this case, Actavis Laboratories Florida, Inc. (Actavis), was the substitute agent for Watson Pharmaceuticals, Inc. (Watson). Watson manufactured both brand name and generic pharmaceutical drugs. To obtain approval of generic drugs, Watson submitted to the Food and Drug Administration 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 (commonly known as the Hatch-Waxman Act, 21 U.S.C. § 355) as patent infringement and the holder of the patent is entitled to bring suit in federal district court. Watson incurred substantial legal expenses in defending patent infringement lawsuits brought by the name-brand drug manufacturers against Watson in response to the notice letters that Watson sent. Watson deducted these legal expenses on its 2008 and 2009 tax returns. Following audits of these returns, the IRS issued a notice of deficiency disallowing Watson's deductions on the basis that the costs incurred in defending the patent infringement litigation were capital expenditures under § 263(a). Watson paid the amounts sought by the IRS and, after filing amended returns requesting refunds, brought this action in the U.S. Court of Federal Claims seeking refunds of $1.9 million for 2008 and $3.9 million for 2009.

The U.S. Court of Federal Claims (Judge Holte) held that the legal expenses incurred by Watson in defending the patent infringement litigation were currently deductible. The IRS argued that the costs were capital expenditures under Reg. § 1.263(a)-4(b)(1), which requires taxpayers to capitalize amounts paid to *acquire or create* an intangible and amounts paid to *facilitate* an acquisition or creation of an intangible. According to the government, the costs facilitated the acquisition of an intangible, specifically, an FDA-approved ANDA. The court, however, disagreed. The court relied on the "origin of the claim" test established by the U.S. Supreme Court in *United States v. Gilmore*, 372 U.S. 39 (1963). As interpreted by a later decision, *Woodward v. Commissioner*, 397 U.S. 572 (1970), the deductibility of litigation expenses under the origin of the claim test depends not on the taxpayer's primary purpose in incurring the costs, but "involves the simpler inquiry whether the origin of the claim litigated is in the process of acquisition [of a capital asset] itself." Here, the court reasoned, Watson's legal expenses arose from legal actions initiated by patent holders in an effort to protect their patents. The court followed a long line of decisions, including that of the U.S. Court of Appeals for the Third Circuit in *Urquhart v. Commissioner*, 215 F.2d 17 (3d Cir. 1954), which have held that 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 Watson's legal expenses arose out of the patent infringement claims initiated by the patent holders, the court held, they were currently deductible. The court further concluded that Reg. § 1.263(a)-4(b)(1) did not require the costs to be capitalized because Watson's defense of the patent infringement litigation was not a step in the FDA's approval process for a generic drug:

> The FDA's review of an ANDA does not include patent related questions. When a generic drug company files an ANDA with a Paragraph IV certification, it certifies the patents associated with the relevant [drug] are either invalid or will not be infringed by the proposed generic drug. The FDA performs no assessment of that certification as a part of its ANDA review process—"[a]ccording to the agency, it lacks 'both [the] expertise and [the] authority' to review patent claims[.]"

a. The Federal Circuit has agreed that legal expenses incurred by a taxpayer seeking FDA approval of a generic drug to defend patent infringement suits are currently deductible. Actavis Laboratories, FL, Inc. v. United States, ___ F.4th ___ (Fed. Cir. 3/21/25), *aff'g*, 161 Fed. Cl. 334 (8/19/22). In an opinion by Judge Stark, the U.S. Court of Appeals for the Federal Circuit has affirmed the Claims Court's decision and has held that legal expenses incurred by a taxpayer seeking FDA approval of a generic drug to defend patent infringement suits are currently deductible.

As described earlier, the FDA approval process for an ANDA seeking approval of a generic drug requires the applicant to 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 type of certification is required to notify the holders of patents on the relevant brand name drug that it has made this certification. Such a certification is treated by statute (commonly known as the Hatch-Waxman Act, 21 U.S.C. § 355) as patent infringement and the holder of the patent is entitled to bring suit in federal district court.

The taxpayer incurred substantial legal fees ($3.89 million in 2008 and $8.48 million in 2009) in defending patent infringement litigation brought by holders of patents on brand name drugs in response to the notice letters that the taxpayer sent. The U.S. Court of Federal Claims held that these costs were not capital expenditures and that the taxpayer therefore could deduct them currently as ordinary and necessary business expenses. The government appealed. On appeal, the Federal Circuit affirmed the Claims Court's decision.

The parties disagreed regarding the appropriate method of analysis for determining the deductibility of the taxpayer's legal fees. The taxpayer asserted that the "origin of the claim" test established by the U.S. Supreme Court in *United States v. Gilmore*, 372 U.S. 39 (1963) applied. As interpreted by a later decision, *Woodward v. Commissioner*, 397 U.S. 572 (1970), the deductibility of litigation expenses under the origin of the claim test depends not on the taxpayer's primary purpose in incurring the costs, but rather on "whether the origin of the claim litigated is in the process of acquisition" of a capital asset. The government argued that whether the taxpayer could deduct its legal fees was governed by Reg. § 1.263(a)-4(b)(1), which requires taxpayers to capitalize amounts paid to *acquire or create* an intangible and amounts paid to *facilitate* an acquisition or creation of an intangible. The court ultimately concluded that it did not need to decide which of these two methods of analysis applied because, regardless of which method applied, the legal fees paid by the taxpayer were deductible as ordinary and necessary business expenses.

Regarding the origin of the claim test, the government asserted that origin of the claim giving rise to the legal fees was the taxpayer's filing of an ANDA with the FDA seeking approval of the generic version of the drug. The taxpayer argued that the origin of the claim was the commencement of litigation against the taxpayer by the holders of patents on the brand-name version of the drug. The court agreed with the taxpayer. The court acknowledged that the taxpayer, like all those who file an ANDA with the FDA, is pursuing a capital asset, i.e., is pursuing an FDA-approved ANDA. Nevertheless, the court reasoned that the patent-infringement litigation brought by the patent holders against the taxpayer would not determine whether the FDA approved the taxpayer's ANDA. Such litigation "typically proceeds in parallel with the FDA's regulatory review, but the two lanes are distinct." For example, the court pointed out, the FDA could approve an ANDA whether or not the patent holder prevailed in the patent infringement litigation against the applicant who filed the ANDA. Therefore, the court concluded, the origin of the claim was the commencement of the patent infringement litigation against the taxpayer. According to the court, it was undisputed that legal fees incurred in defending an ordinary patent infringement suit (i.e., one that did not arise as a result of an applicant's filing of an ANDA) are deductible business expenses. Therefore, if the appropriate method of analysis was the origin of the claim test, the taxpayer was entitled to deduct its legal fees.

Regarding the government's position that the deductibility of the taxpayer's legal fees was governed by Reg. § 1.263(a)-4(b)(1), the key question was whether the costs incurred by the taxpayer to defend patent infringement litigation *facilitated* the acquisition or creation of an intangible within the meaning of Reg. §§ 1.263(a)-4(b)(1)(v) and 1.263(a)-4(e)(1)(i). The "intangible" in question is an FDA-approved ANDA, i.e., the right to market the generic drug. According to the court, however, whether the FDA approves (or disapproves) an application for approval to market a generic drug does not depend on the outcome of the patent infringement litigation:

> The intangible asset sought by the ANDA filer is final, effective approval of the ANDA itself – and acquisition of that asset is not facilitated by Hatch-Waxman litigation. As we explained in connection with the origin of the claim standard, and as is equally true even if C.F.R. § 1.263 governs, that intangible asset is pursued through, and can be granted only by, the FDA. … Thus, the Hatch-Waxman litigation does not facilitate the acquisition of the FDA-approved ANDA, and hence it does not facilitate acquisition of an asset providing a significant future benefit.

- The court's analysis and conclusions in this case are consistent with those of the U.S. Court of Appeals for the Third Circuit in *Mylan, Inc. v. Commissioner*, 76 F.4th 230 (3d Cir. 7/27/23), *aff'g* 156 T.C. 137 (4/27/21).

C. Reasonable Compensation

D. Miscellaneous Deductions

1. Here's a shocker. An attorney could not deduct the costs of racing a Dodge Viper automobile as an advertising expense for his law practice. Avery v. Commissioner, 134 A.F.T.R.2d 2024-6331 (10th Cir. 12/9/24), *aff'g*, T.C. Memo. 2023-18 (2/21/23). The taxpayer in this case, an attorney, had his own personal injury law practice in Colorado. He married a woman from Indiana, moved there, and became licensed to practice law in Indiana. He failed to generate much business in Indiana and continued to maintain his practice in Colorado. In Indiana, he became involved in car-related activities as a way to meet potential clients. At first, he acquired a 30-year old Ferrari and one other collector car and began participating in car shows. Later, he became interested in car racing. He purchased and rebuilt a 2000 Dodge Viper and attended a racing school in Indianapolis. He later acquired a 2009 Dodge Viper and competed at road racing events in seven states. He won some local championships and, at one point, placed in the top 10 nationally. Although the taxpayer believed that his racing would enable him to meet clients, he was able to identify only two instances in which his racing connected with his law practice. On one occasion, he consulted with a Pizza Hut franchisee whom he met through racing, and on another, he met a surgeon who later served as an expert witness in a personal injury case he tried in Denver. The taxpayer's name appeared on small areas above the driver's window and the passenger window of his racing vehicle and a decal for his law practice, the Avery Law Firm, appeared on the back tail of the car. He maintained a web page for his "Viper Racing Team" that included videos and photos of his racing and that was linked to the Facebook page for his law practice. The years in issue were 2008 through 2013. The taxpayer initially failed to file returns for some of these years and the IRS prepared substitutes-for-returns (SFRs). Ultimately,he prepared and filed original or amended returns for all of the years. He claimed a large amount of advertising expenses for his law practice, including approximately $136,000 of costs that he was able to substantitate related to his car and his racing activity. The taxpayer never responded to notices of deficiency for the years in question and the IRS issued both a notice of intent to levy and a notice of federal tax lien. The taxpayer requested a collection due process (CDP) hearing and, in the CDP hearing, sought to challenge the underlying tax liability. After the IRS issued a notice of determination upholding the collection action, the taxpayer filed a petition in the U.S. Tax Court. In the Tax Court, the IRS conceded that the taxpayer could challenge the underlying tax liability because he had never received the notices of deficiency. *See* I.R.C. § 6330(c)(2)(B). The Tax Court (Judge Lauber) held that the taxpayer could not deduct his car-related expenses as ordinary and necessay business expenses under § 162. The Tax Court observed that a cost is "ordinary" for this purpose if it is customary or common for the type of business involved, and is "necessary" if it is appropriate and helpful in carrying our the business activity. *See, e.g.*, *Welch v. Helvering*, 290 U.S. 111, 113-14 (1933). In determining whether a cost is ordinary and necessary, the court stated, "the courts have focused on the taxpayer's primary motive for incurring the expense and on whether there is a reasonably proximate relationship between the expense and the taxpayer's occupation." If a cost "is primarily motivated by personal reasons, no deduction is allowed." In this case, the Tax Court concluded, the taxpayer's car-related costs were not ordinary and necessary business expenses:

> It is neither "necessary" nor "common" for attorneys to incur such costs. Petitioner greatly enjoyed car racing, which he found more exciting than his previous hobby of acquiring collector cars and participating in car shows. But we find that both activities were hobbies. No deduction is allowed for personal expenses of this kind.

On appeal, in an opinion by Judge Rossman, the U.S. Court of Appeals for the Tenth Circuit affirmed. The Tenth Circuit rejected the taxpayer's argument that the Tax Court had improperly considered his personal enjoyment of car racing in determining whether his costs were ordinary and necessary business expenses. The taxpayer asserted that this could lead "to a situation where expenses incurred in maintaining what is otherwise indisputably a work vehicle will be deemed by the Commissioner to be personal expenses simply because the owner enjoys driving the vehicle." The Tenth Circuit held that, even if the Tax Court had considered personal enjoyment as one factor in determining whether the costs were ordinary and necessary, the Tax Court had properly considered his primary motive in incurring the costs and his enjoyment of the activity was relevant to his primary motive.

E. Depreciation & Amortization

1. Section 280F 2025 depreciation tables for business autos, light trucks, and vans. Rev. Proc. 2025-16, 2025-11 I.R.B. 1100 (2/12/25). Section 280F(a) limits the depreciation deduction for passenger automobiles. For this purpose, the term "passenger automobiles" includes trucks and vans with a gross vehicle weight of 6,000 pounds or less. The IRS has published depreciation tables with the 2025 depreciation limits for business use of passenger automobiles acquired after September 27, 2017, and placed in service during 2025:

2025 Passenger Automobiles with § 168(k) first year recovery:	
1st Tax Year	$20,200
2nd Tax Year	$19,600
3rd Tax Year	$11,800
Each Succeeding Year	$ 7,060
2024 Passenger Automobiles (no § 168(k) first year recovery):	
1st Tax Year	$12,200
2nd Tax Year	$19,600
3rd Tax Year	$11,800
Each Succeeding Year	$ 7,060

For leased vehicles used for business purposes, § 280F(c)(2) requires a reduction in the amount allowable as a deduction to the lessee of the vehicle. Under Reg. § 1.280F-7(a), this reduction in the lessee's deduction is expressed as an income inclusion amount. The revenue procedure provides a table with the income inclusion amounts for lessees of vehicles with a lease term beginning in 2025. For 2025, this income inclusion applies when the fair market value of the vehicle exceeds $62,000.

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

IV. COMPENSATION ISSUES

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

1. We can envision the late-night condom ads now: "Hurry while supplies last! IRS-approved, pre-tax prophylactics on sale today!" Notice 2024-71, 2024-44 I.R.B. 1026 (10/17/24). Perhaps embarrassed by the prospect of truly analyzing the matter (or perhaps pushed by the prophylactic industry), the IRS has pronounced with scant discussion that amounts paid for condoms will be treated as amounts paid for medical care under section 213(d). *What's the backstory, you ask?* Well, as many of our readers know, amounts paid for "medical care" as defined in § 213(d) are deductible as itemized expenses to the extent such expenditures exceed 7.5 percent of a taxpayer's adjusted gross income and are not compensated by insurance or otherwise. *See* IRC § 263(a). These days, of course, given the ubiquitous nature of health insurance and the increase in the standard deduction, relatively few taxpayers claim itemized deductions for medical care expenses. Nevertheless, to be eligible for payment from or reimbursement by a health flexible spending arrangement (health FSA), Archer medical savings account (Archer MSA), health reimbursement arrangement (HRA), or health savings account (HSA), a taxpayer's medical expenses must qualify as amounts paid for "medical care" within the meaning of § 213(d). Section 213(d) provides in relevant part that "medical care" expenses are "amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body." Regulation § 1.213-1(e)(1)(ii) further provides that deductions for medical care expenses under § 213 are limited to expenses "incurred primarily for the prevention or alleviation of a physical or mental defect or illness" and do not include deductions for expenses that are merely beneficial to an individual's general health. The Tax Court held over 70 years ago that whether an expense is incurred for the prevention of disease, or other form of medical care under § 213(d) depends upon the facts and circumstances. *See Stringham v. Commissioner*, 12 T.C. 580, 584 (1949). After citing and summarizing § 213(d), Reg. § 1.213-1(e)(1)(ii), and *Stringham*, Notice 2024-71 reasons that "depending on the specific facts and circumstances, amounts paid for condoms may or may not be considered medical expenses under section 213(d)." Then, under the heading of "SAFE HARBOR"—talk about a double-entendre—with no other discussion, Notice 2024-71 concludes: "The Treasury Department and the IRS will treat amounts paid for condoms as amounts paid for medical care under section 213(d)." The IRS obviously doesn't want to discuss the issue any further so neither will we.

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

VII. PARTNERSHIPS

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

1. If only I had cashed the check sooner! A taxpayer was not entitled to keep over $277,000 erroneously refunded to him because the government's action to recover it was timely: the two-year limitations period for the government to sue to recover an erroneous refund under § 7405 starts to run when the refund check clears the Federal Reserve. United States v. Page, 116 F.4th 822 (9th Cir. 9/12/24). Due to a clerical error, the IRS issued to the taxpayer a refund check in the amount of $491,104 when his refund should have been only $3,463, which meant that the government had overpaid the taxpayer by $487,641. After the government demanded the return of the erroneous refund the taxpayer returned $210,000 but kept the remaining $277,641. The government brought legal action against the taxpayer in a U.S. District Court under § 7405 to recover the balance. Section 7405(a) authorizes the government to recover an erroneous refund through a civil action. According to § 7405(d), the limitations period for the government to bring such an action is specified in § 6532(b). Section 6532(b) provides that a suit to recover an erroneous refund is allowed if it is "begun within 2 years after the making of such refund." The District Court dismissed the government's complaint based on its view that the two-year limitations period began to run when the taxpayer received the refund check. Although the exact date on which the taxpayer received the check was not known, the government's complaint asserted that the refund check had been mailed on May 5, 2017, and that the taxpayer had cashed the check on April 5, 2018. The government brought legal action to recover the refund on March 31, 2020. The District Court apparently reasoned that the taxpayer must have received the check before March 31, 2018 (the date two years before the government brought legal action) because "it defies common sense to believe it took 330 days [from the date of mailing] for Page to receive the check in the mail." In an opinion by Judge Desai, the U.S. Court of Appeals for the Ninth Circuit reversed and remanded. The court held that a refund is "made" within the meaning of § 6532(b) "when the refund check clears the Federal Reserve and payment to the taxpayer is authorized by the Treasury." The taxpayer cashed the check on April 5, 2018, which meant that the check cleared on or after April 5, 2018. Therefore, the government's action to recover the erroneous refund, brought on March 31, 2020, was timely. In reaching this conclusion, the court relied on the U.S. Supreme Court's decisions in *United States v. Wurts*, 303 U.S. 414 (1938), in which the Court held that a refund is "made" within the meaning of the statute when it is paid (rather than when it is allowed), and *O'Gilvie v. United States*, 519 U.S. 79 (1996), in which the Court held that the limitations period of § 6532(b) begins to run when the taxpayer receives the refund check rather than when the check is mailed. The Court in *O'Gilvie* stated that "t]he date the check clears . . . sets an outer bound," but neither *Wurts* nor *O'Gilvie* expressly considered whether the date the check clears (rather than the date on which the check is received) should control the running of the two-year limitations period. According to the Ninth Circuit, both *Wurts* and *O'Gilvie* "made clear that *payment* triggers the statute of limitations under § 6532(b)." Further, the court stated, "[t]he date the check clears is the more appropriate benchmark for defining when a refund is paid." The court noted that "payment cannot be made until the funds change hands," and that funds do not change hands until the check is presented to the Federal Reserve and the Secretary of the Treasury authorizes payment. For example, the court observed, if the taxpayer had returned or shredded the refund check, the government would have no basis for bringing legal action against him. The court also was persuaded by the ability to determine with certainty when the check clears. In contrast, the precise date on which a taxpayer receives a refund check if often (as in this case) unknown. In addition, the court observed, treating the date the check clears as the date on which the refund is made avoids an unnecessary split among the U.S. Courts of Appeals. The two U.S. Courts of Appeals that have considered this question both concluded that the date on which the check clears is the date on which the refund is made. *United States v. Greene-Thapedi*, 398 F.3d 635 (7th Cir. 2005); *United States v. Commonwealth Energy System*, 235 F.3d 11 (1st Cir. 2000). Finally, the court observed that its prior decision in *United States v. Carter*, 906 F.2d 1375 (9th Cir. 1990), did not dictate a different result. Although in *Carter* the court had held that the date on which the refund check was received triggered the running of the two-year limitations period of § 6532(b), it had not addressed the current question of whether the date on which the check clears controls because, in *Carter*, the parties had asked the court to decide only whether the date of mailing or the date of receipt controlled. Because the government brought its action against the taxpayer in *Carter* within two years of the date of receipt, the court had not considered the question whether the date on which the check clears should control.

F. <u>Liens and Collections</u>

1. A taxpayer has no right to a CDP hearing when the IRS files a notice of federal tax lien pursuant to article 26A of the U.S.-Canada tax treaty, which authorizes the IRS to collect Canadian tax assessments on behalf of Canada. Ryckman v. Commissioner, 163 T.C. No. 3 (8/1/24). The taxpayer in this case resided in Arizona. In 2017, pursuant to article 26A(2) of the U.S.-Canada tax treaty, the Canada Revenue Agency sent to the IRS a mutual collection assistance request seeking assistance in collecting approximately $200,000 in Canadian tax owed by the taxpayer for 1994 and 1995. The U.S. Competent Authority, an office within the IRS, granted the request and an IRS revenue officer mailed a notice of federal tax lien to the Maricopa County Recorder in Phoenix. The revenue officer also mailed to the taxpayer a letter informing her that the notice of federal tax lien had been filed. The letter stated both "that you have the right to a hearing to discuss collection options" and that a hearing under Code § 6320(b), commonly known as a collection due process (CDP) hearing, was "NOT available to you as a Canadian taxpayer in the United States." Nevertheless, the taxpayer requested a CDP hearing by filing Form 12153, Request for a Collection Due Process or Equivalent Hearing. The request indicated that the taxpayer could not pay the balance due and asked the IRS to consider an installment agreement. The revenue officer responded to the taxpayer's request by sending a letter denying the request for a CDP hearing for the following reason:

> Because the foreign tax liability is treated as a finally determined U.S. tax liability, your procedural rights to restrain collection under U.S. law through a CDP hearing under Internal Revenue Code Sections 6320 or 6330 are treated as lapsed or exhausted.

The letter also informed the taxpayer that she could request review under the IRS's Collection Appeal Program. The taxpayer filed a petition in the Tax Court asking the court to determine that the IRS had erred in denying her request for a CDP hearing and that the case should be remanded to IRS Appeals for a CDP hearing.

Tax Court's opinion. In a reviewed opinion (7-1-6) by Judge Copeland, the Tax Court held that the taxpayer had no right to a CDP hearing, that the IRS letter denying her request for a CDP hearing was not a determination regarding her request, and that the court therefore had no jurisdiction to consider her petition. Accordingly, the court granted the government's motion to dismiss for lack of jurisdiction. In general, §§ 6320(a) (liens) and 6330(a) (levies) require the IRS to notify the taxpayer when the IRS has filed a federal tax lien or proposes to levy on the taxpayer's assets to collect tax and to inform the taxpayer of the taxpayer's right to request a CDP hearing. According to § 6330(d)(1), a taxpayer who requests a CDP hearing can, "within 30 days of a determination under this section, petition the Tax Court for review of such determination." The court observed that treaties to which the U.S. is a party and statutes such as the Internal Revenue Code are on equal footing, that courts should endeavor to construe treaties and statutes to give effect to both when they relate to the same subject, and that if a treaty and a statute are inconsistent with each other, then the one that is later in time controls.[1] Article 26A(4)(a) of the U.S.-Canada

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[1] See, e.g., I.R.C. § 894(a) ("the provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to the taxpayer."); I.R.C. § 7852(d)(1) ("For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty

tax treaty provides that, when the U.S. accepts a Canadian revenue claim, the U.S. must treat the claim "as an assessment under United States laws against the taxpayer," which means, the court stated, that the U.S. must treat the accepted claim as a U.S. tax assessment. However, Article 26A(3) provides that an accepted revenue claim

> shall be collected by the requested State as though such revenue claim were the requested State's own revenue claim finally determined in accordance with the laws applicable to the collection of the requested State's own taxes.

A claim is "finally determined" for this purpose, according to Article 26A(2),

> when the applicant State has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the taxpayer to restrain collection in the applicant State have lapsed or been exhausted.

The court interpreted these provisions to mean that that "when the United States accepts a Canadian revenue claim, the claim must be treated as a U.S. tax assessment for which all rights to restrain collection have lapsed or been exhausted." In other words, the U.S. must treat the revenue claim as a U.S. tax assessment for which the taxpayer's administrative and judicial rights to restrain collection, including the right to a CDP hearing, have been exhausted. Therefore, the court concluded, the taxpayer had no right to a CDP hearing and the IRS's letter denying her request for a CDP hearing was not a "determination" within the meaning of Code § 6330(d)(1). Because there was no determination by the IRS, the court reasoned, the court had no jurisdiction to consider the taxpayer's petition.

In reaching these conclusions, the court rejected the taxpayer's argument that the statutes providing for the right to a CDP hearing and the provisions of the U.S.-Canada tax treaty were in conflict. The statutes in question, §§ 6320 and 6330, were enacted in 1998, and article 26A of the U.S.-Canada tax treaty became effective in 1995. Thus, if the treaty conflicts with the statutes, the statutes, which were later in time, would control. The court, however, reasoned that the statutes and the treaty were not in conflict. The statutes, the court explained, provide taxpayers with the right to restrain collection by requesting a CDP hearing but also limit administrative and judicial review. In the same way, according to the court, article 26A of the treaty "forecloses those default rights in the context of Canadian revenue claims accepted by the IRS." Thus, the court concluded, "it is entirely possible to construe the CDP statutes and Treaty Article XXVI A so as to give effect to both, and we are therefore bound to do so."

Concurring opinion of Judge Jones. In a concurring opinion, Judge Jones emphasized the importance of adhering to the text of a treaty, "which is an agreement that was negotiated and duly enacted pursuant to the authority vested in the political branches under our constitutional scheme." The court's opinion, she stated, is consistent with the court's "role in interpreting treaties[, which] is to faithfully interpret the text of the agreement. The dissenting opinion, in her view, "misses the forest for the trees in its effort to create friction between the Code and the Court's interpretation of the Treaty."

Dissenting opinion. In a dissenting opinion, Judge Urda (joined by Judges Buch, Pugh, Ashford, Toro, and Weiler) argued that the court's interpretation of the U.S.-Canada tax treaty as foreclosing procedural protections to taxpayers who receive a notice of federal tax lien results in an irreconcilable conflict with the procedural protections later enacted by Congress in sections 6320 and 6330. The court's opinion, in his view, "makes a half-hearted attempt to harmonize the two authorities, but the clash remains." But, he asserted, it does not have to be this way. He argued

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nor the law shall have preferential status by reason of its being a treaty or law."); *Whitney v. Robertson*, 124 U.S. 190, 194 (1888) (courts should attempt to harmonize treaties and statutes, but, when the two conflict, the later in time controls).

that it is possible to read the treaty provisions in a way that does not result in such a conflict. Specifically, Judge Urda argued, the treaty provisions in question distinguish between the *substance* of a revenue claim and the *procedures* by which the claim is to be collected. With respect to the substance of a revenue claim, the treaty uses the law of the applicant country. And with respect to the procedures by which the claim is collected, the treaty uses the law of the requested country. Under this reading of the treaty, when the treaty refers to a revenue claim as being "finally determined" in the sense that "all administrative and judicial rights of the taxpayer to restrain collection in the applicant State have lapsed or been exhausted," the treaty forecloses any inquiry in the requested state into the substantive validity of the claim. But the treaty does not, in his view, take away the procedural protection of a CDP hearing in the requested state (here the U.S.):

> The most apt reading of the relevant provisions together is that the exhaustion text of Paragraph 2 is confined to that Paragraph and that the normal collection procedures of the requested state apply. Under this reading, there is no conflict with the CDP safeguards, including the requirements of a hearing and judicial review.

In summary, the dissent argued that the treaty provisions and the relevant provisions of the Code do not conflict and preserve the taxpayer's right to a CDP hearing.

G. Innocent Spouse

H. Miscellaneous

1. The Sixth Circuit joins other circuits in holding that recklessness is sufficient to establish a willful FBAR violation. United States v. Kelly, 92 F.4th 598 (6th Cir. 2/8/24). The U.S. Court of Appeals for the Sixth Circuit has held that for purposes of imposing an FBAR civil penalty, a "willful violation of the FBAR reporting requirements includes both knowing and reckless violations." With this holding, the Sixth Circuit joins all the other circuits that have addressed this issue. See, e.g., *United States v. Rum*, 995 F.3d 882 (11th Cir. 2021) (per curiam); *Kimble v. United States*, 991 F.3d 1238, 1242 (Fed. Cir. 2021); *United States v. Horowitz*, 978 F.3d 80, 88 (4th Cir. 2020); *Norman v. United States*, 942 F.3d 1111 (Fed. Cir. 2019); *Bedrosian v. United States*, 912 F.3d 144, 153 (3d Cir. 2018). The Sixth Circuit here in *Kelly* adopted the same line of reasoning as the *Norman* and *Horowitz* courts, relying on the U.S. Supreme Court's decision in *Safeco Ins. Co. v. Burr*, 551 U.S. 47, 57 (2007). In *Safeco*, the Supreme Court observed that, when willfulness is a statutory condition of civil (as opposed to criminal) liability, the Court had "generally taken it to cover not only knowing violations of a standard, but reckless ones as well." For purposes of determining whether a reckless (and therefore willful) FBAR violation occurred, the Sixth Circuit also adopted the meaning of recklessness set forth in *Safeco.* Under *Safeco*, reckless conduct in the civil context is determined by application of an objective standard and is defined as an "…action entailing an unjustifiably high risk of harm that is either known or so obvious that it should be known." 551 U.S. at 685 (internal quotations and citations omitted). Based on this authority, the Sixth Circuit stated:

> …in the context of a civil FBAR penalty, the government can establish a willful violation "based on recklessness" by proving that "the defendant (1) clearly ought to have known that (2) there was a grave risk that an accurate FBAR was not being filed and [that] (3) he was in a position to find out for certain very easily."

92 F.4th at 603-04 (citing *Horowitz*, 978 F.3d at 89).

In this case, the taxpayer was a U.S. citizen who closed his U.S. domestic bank accounts and opened an interest-bearing account at Finter Bank in Switzerland, into which he deposited over $1.8 million. After an investigation, the IRS determined that the taxpayer had willfully failed to timely file FBARs for multiple years and imposed substantial penalties. When the taxpayer failed to pay the penalties, the government initiated an action against him in a U.S. District Court. The district court granted the IRS's motion for summary judgment. In affirming the district court, the Sixth Circuit concluded that the taxpayer had taken steps to intentionally evade his legal duties.

The taxpayer designated his Finter account as "numbered" so that his name would not appear on the bank statements and he requested that the bank retain any account related communications. The Sixth Circuit concluded that these efforts allowed the taxpayer to shield his assets from U.S. authorities and that this evidenced more than mere negligence. Only after Finter notified the taxpayer that it would disclose his account to U.S. authorities did the taxpayer then begin complying with FBAR reporting obligations. The taxpayer did not seek professional advice about his reporting obligations or the tax implications of the assets in the Swiss bank account. Finter temporarily closed the taxpayer's account and warned him that it was required to report to U.S. authorities. Finter also recommended that the taxpayer get professional tax counsel. The taxpayer then requested to participate in the IRS's Offshore Voluntary Disclosure Program (OVPD). The government preliminarily accepted his voluntary disclosure. The taxpayer later transferred the funds in his Swiss bank account to an account with Bank Alpinum in Lichtenstein. He submitted a Form 433-A, Collection Information Statement, to the IRS that failed to disclose the Lichtenstein account. The government later removed the taxpayer from the OVDP because he had failed to provide information about his foreign assets. The court found that the taxpayer was aware of his reporting requirements and that he failed to file future FBAR reports. The taxpayer never consulted tax counsel. Because the taxpayer should have known about the risk of failing to comply and he could have found out by simply asking, the court held that his failure was, at a minimum, reckless. In summary, the court concluded that the taxpayer knew about his foreign account, took steps to keep it secret, did not consult with professionals about his tax obligations, and then, after learning that he had not met reporting requirements in the past, failed to file FBARs for the years at issue. Accordingly, the court held that the taxpayer's failure to satisfy his FBAR requirements for the years in issue was a willful violation of the Bank Secrecy Act.

a. The Ninth Circuit agrees with other circuits: objective recklessness is sufficient for the government to impose a "willful" FBAR penalty. United States v. Hughes, 113 F.4th 1158 (9th Cir. 8/21/24). In an opinion by Judge Koh, the Ninth Circuit has joined several other Circuit Courts of Appeal to hold that objective recklessness is sufficient to impose a "willful" FBAR penalty regardless of the taxpayer's subjective intent. As we have reported many times, the Bank Secrecy Act provides in part that U.S. persons owning an interest in foreign accounts with an aggregate balance of more than $10,000 must file an annual disclosure report. *See* 31 U.S.C. 5314; 31 C.F.R. § 1010.306 (2021). The Financial Crimes Enforcement Network's ("FinCEN") Form 114 — Report of Foreign Bank and Financial Accounts ("FBAR") is used to file the report. The *pro se* taxpayer in this case was a U.S. citizen who owned wine businesses in New Zealand through wholly-owned limited liability companies. As the sole owner, the taxpayer had control over the businesses' bank accounts located in New Zealand. The taxpayer failed to file FBARs with the IRS for the years 2010 through 2013. Failure to properly file FinCEN Form 114 may result in varying penalties under 31 U.S.C. 5321(a)(5), depending upon whether the failure was willful or non-willful. The penalty for willfully failing to file an FBAR disclosure is severe: the greater of $100,000 or 50 percent of each offending account per year. The IRS determined that the taxpayer's failure to file FBARs for the years in issue was "willful" and assessed civil penalties totaling $678,899 against the taxpayer. After a bench trial, the District Court (Judge Spero of the Northern District of California) held that the taxpayer recklessly disregarded the FBAR rules for 2012 and 2013 but not for 2010 or 2011. Although the taxpayer's failure to file FBARs for 2010 and 2011was found by the District Court to be non-willful, the taxpayer had checked a box on the taxpayer's 2012 and 2013 federal income tax returns indicating that she had foreign bank accounts for those years, but she did not file corresponding FBARs. The District Court therefore found that the taxpayer's actions for 2012 and 2013 amounted to "recklessness or willful blindness." Accordingly, the District Court imposed $238,125.19 in "willful" FBAR penalties against the taxpayer for the years 2012 and 2013. The *pro se* taxpayer appealed to the Ninth Circuit, arguing that the District Court applied the wrong legal standard because objective recklessness without regard to a taxpayer's subjective intent should not amount to willfulness under the FBAR penalty regime. The Fifth Circuit, agreeing with five other circuits that have addressed the issue, affirmed the District Court by holding that objective recklessness is sufficient to establish a "willful" FBAR violation. *See United States v. Kelly*, 92 F.4th 598 (6th Cir. 2/8/24); *United States v. Rum*, 995 F.3d 882 (11th Cir. 2021) (per curiam); *Kimble v. United States*, 991 F.3d 1238, 1242 (Fed. Cir. 2021); *United States v. Horowitz*, 978 F.3d 80, 88 (4th Cir. 2020); *Norman v. United States*, 942 F.3d 1111 (Fed. Cir. 2019); *Bedrosian v. United States*, 912 F.3d 144, 153 (3d Cir. 2018).

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

B. Self-employment Taxes

C. Excise Taxes

1. ♫♪ Never ever had a lover who put the pedal to the metal and burn rubber on me. ♪♫ A U.S. corporation that purchased tires from China for resale in the United States was the importer of the tires and therefore liable for the excise tax imposed by § 4071. Texas Truck Parts & Tire, Inc. v. United States, 118 F.4th 687 (5th Cir. 10/8/24), *rev'g* 695 F.Supp.3d 899 (S.D. Texas 9/28/23). Section 4071(a) of the Code imposes an excise tax "on taxable tires sold by the manufacturer, producer, or importer thereof." The taxpayer, a wholesaler and retailer of truck parts and tires based in Houston, Texas, purchased tires from Chinese manufacturers, which shipped and delivered the tires to the taxpayer's doorstep in Houston from 2012 to 2017. The Chinese manufacturers arranged for the tires to be transported from China to the United States, clear U.S. Customs, and be delivered to the taxpayer. The taxpayer neither filed quarterly excise tax returns on Form 720 nor paid any excise tax on the tires. During an audit of these years, the IRS asserted that the taxpayer, rather than the Chinese manufacturers, was the importer of the tires within the meaning of § 4071 and therefore liable for approximately $1.9 million in unpaid excise tax. The taxpayer made a partial payment, filed a claim for refund and, after the IRS failed to act on it, brought suit for a refund in the U.S. District Court for the Southern District of Texas. The District Court granted the taxpayer's motion for summary judgment. On appeal, in an opinion by Judge Douglas, the U.S. Court of Appeals for the Fifth Circuit reversed, rendered judgment for the government, and remanded for a determination of damages. The Fifth Circuit concluded that the taxpayer was the "importer" of the tires under the definition of that term in the relevant regulations, which define an importer of an article as

> any person who brings such an article into the United States from a source outside the United States, or who withdraws such an article from a customs bonded warehouse for sale or use in the United States. If the nominal importer of a taxable article is not its beneficial owner (for example, the nominal importer is a customs broker engaged by the beneficial owner), the beneficial owner is the "importer" of the article for purposes of chapter 32 and is liable for tax on his sale or use of the article in the United States.

Reg. § 48.0-2(a)(4)(i). The District Court concluded that the taxpayer was not the importer of the tires because it did not "bring" the tires into the U.S. The Fifth Circuit agreed with the District's Court's conclusion, but the Fifth Circuit also expressed the view that the District Court had, "without explanation, failed to consider the second half [of the definition]—whether Texas Truck was the beneficial owner and the Chinese manufacturers merely nominal importers." The Fifth Circuit observed that the U.S. Supreme Court had defined importation as "the inducing and efficient cause of bringing the merchandise into the country." *Hooven & Allison Co. v. Evatt*, 324 U.S. 652, 661 (1945), *overruled on other grounds*, *Limbach v. Hooven & Allison Co.*, 466 U.S. 353 (1984). The IRS had applied this same definition, the court observed, in administrative guidance concerning the excise tax on manufacturers. Rev. Rul. 68-197, 1968-1 C.B. 455. In this case, the court concluded, the Chinese manufacturers were the nominal importers and the taxpayer was the beneficial owner of the tires and therefor the importer for purposes of the excise tax:

> There is no doubt that in this instance, the Chinese manufacturers did not act as any more than nominal importers: they did not ship the tires to sell them or initiate new sales to purchasers in the United States. They shipped them to an American entity, which then sold the tires. The Chinese manufacturerswere importers in name only.

In reaching this conclusion, the court was persuaded by the reasoning of the U.S. Court of Appeals for the Federal Circuit, which reached the same conclusion on nearly identical facts. *See Terry Haggerty Tire Co., Inc. v. United States*, 899 F.2d 1199 (Fed. Cir. 1990).

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS