Significant Cases

This section describes cases that generally do not involve any of the ten most litigated issues, but nonetheless highlight important issues relevant to tax administration.[1] These decisions are summarized below.

In *United States v. Windsor*, the Supreme Court held unconstitutional the Defense of Marriage Act's denial of a spousal deduction to a same-sex couple in computing the federal estate tax.[2]

Edith Windsor and her same-sex spouse, Thea Spyer, long-time New York residents, were married in Canada in 2007. Spyer died in 2009, leaving her entire estate to Windsor. Because of the Defense of Marriage Act (DOMA),[3] which prevented them from being treated as married under federal law, Windsor did not qualify for the marital deduction under IRC § 2056(a). Windsor paid the estate tax (in her capacity as executor) and filed a claim for refund. The IRS denied the claim, concluding that under DOMA, Windsor was not a "surviving spouse." Windsor then filed suit, seeking a refund and a declaration that DOMA violates the Equal Protection Clause of the Fifth Amendment of the U.S. Constitution.

After concluding that the couple's marriage would be recognized under New York state law and that Windsor was entitled to a refund, the United States District Court for the Southern District of New York declared that section three of DOMA violated the Equal Protection Clause of the U.S. Constitution.[4] Both the U.S. Court of Appeals for the Second Circuit[5] and the Supreme Court[6] agreed that section three of DOMA is unconstitutional.

In support of its holding, the Supreme Court reasoned that by history and tradition, the regulation of marital relations is virtually within the exclusive providence of the states, necessarily diminishing federal authority in this area. It discussed how section three of DOMA has the impermissible principal purpose and effect of identifying and making unequal a subset of state-sanctioned marriages. Moreover, it observed that DOMA forces same-sex couples to live as married for the purpose of state law but unmarried for the purpose of federal law, thus diminishing the stability and predictability of basic personal relations that New York and other states found it proper to acknowledge and protect.

1 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2012, and ending on May 31, 2013. For purposes of this section of the report, we generally use the same time period.

2 *United States v. Windsor*, 133 S. Ct. 2675 (2013), *aff'g* 699 F.3d 169 (2d Cir. 2012), *aff'g* 833 F. Supp. 2d 394 (S.D.N.Y. 2012) [hereinafter *Windsor*]. The same issues arose in *Gill v. Office of Pers. Mgmt.*, 699 F. Supp. 2d 374 (D. Mass. 2010), *aff'd sub. nom. Massachusetts v. U.S. Dep't. of Health & Human Servs.*, 682 F.3d 1 (1st Cir. 2012) [hereinafter *Gill*]. For prior coverage of *Gill and Windsor*, see National Taxpayer Advocate 2010 Annual Report to Congress 418, 426-27 (discussing *Gill*) and National Taxpayer Advocate 2012 Annual Report to Congress 564, 567-70 (discussing *Gill* and *Windsor*).

3 For purposes of federal law, section three of DOMA defines "marriage" as "a legal union between one man and one woman as husband and wife," and "spouse" as "a person of the opposite sex who is a husband or a wife." Defense of Marriage Act, Pub. L. No. 104-199, § 3(a), 110 Stat. 2419 (1996) (codified at 1 U.S.C. § 7).

4 *Windsor*, 833 F. Supp. 2d at 406.

5 *Windsor*, 699 F.3d at 188.

6 *Windsor*, 133 S. Ct. at 2696.

This case is particularly significant for tax purposes because every federal statute (including the tax code) that refers to "marriage" or a "spouse" will no longer be tied to the unconstitutional definition provided by DOMA. As Justice Scalia observes in his dissent, this leaves many unanswered questions:[7]

> Imagine a pair of women who marry in Albany and then move to Alabama, which does not 'recognize as valid any marriage of parties of the same sex'… When the couple files their next federal tax return, may it be a joint one? Which State's law controls, for federal-law purposes: their State of celebration (which recognizes the marriage) or their State of domicile (which does not)? (Does the answer depend on whether they were just visiting in Albany?) Are these questions to be answered as a matter of federal common law, or perhaps by borrowing a State's choice-of-law rules? If so, *which* State's? And what about States where the status of an out-of-state same-sex marriage is an unsettled question under local law?[8]

The case will also have an immediate effect on the IRS because many same sex-couples are also likely to amend their returns to change their filing status.[9]

In *PPL Corp. v. Commissioner*, the Supreme Court held that a taxpayer was entitled to a foreign tax credit for the payment of a United Kingdom windfall tax because, in substance, it was a tax on income, notwithstanding its form as a tax on value.[10]

After the United Kingdom (U.K.) privatized 32 then-public utilities between 1984 and 1996, managers quickly cut costs, reaping higher-than-expected profits. In 1997, the U.K. enacted a one-time "windfall tax" to recoup excess profits.

PPL, part owner of a privatized U.K. company subject to the windfall tax, claimed a credit for its share of the windfall tax on its 1997 federal income tax return. PPL relied on IRC § 901(b)(1), which states that any "income, war profits, and excess profits taxes" paid overseas are creditable against U.S. income taxes. A foreign tax is creditable if its "predominant character" is that of an "income tax in the U.S. sense."[11] A foreign tax's predominant character is that of a U.S. income tax if it "is likely to reach net gain in the normal circumstances in which it applies."[12]

In form, the windfall tax was based on the difference between each company's "profit-making value" and "flotation value." It was computed using a complicated valuation formula that incorporated profits, but the tax was not directly imposed on income or profits. However, PPL reasoned that the tax formula could be algebraically recomputed as a tax on income or profits, and that it would reach net gain under normal circumstances. Thus, it argued the windfall tax was creditable.

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7 For further discussion of implementation issues, see Most Serious Problem: *Domestic Partners and Same-Sex Couples Need Federal Tax Guidance, supra*.

8 *Windsor*, 133 S. Ct. at 2675.

9 For a discussion of unanswered federal tax questions posed by state laws governing domestic partnerships, see National Taxpayer Advocate 2010 Annual Report to Congress 211 (Most Serious Problem: *State Domestic Partnership Laws Present Unanswered Federal Tax Questions*); National Taxpayer Advocate 2012 Annual Report to Congress 449 (Status Update: *Federal Tax Questions Continue to Trouble Domestic Partners and Same-Sex Spouses*). The government recently issued Notice 2013-61, and Revenue Ruling 2013-17, which address some of these questions.

10 *PPL Corp. v. Comm'r*, 133 S. Ct. 1897 (2013), *rev'g* 665 F.3d 60 (3d Cir. 2011), *rev'g* 135 T.C. 304 (2010) [hereinafter *PPL*].

11 Treas. Reg. § 1.901-2(a)(1)(ii) (as amended in 2013).

12 Treas. Reg. § 1.901-2(a)(3)(i) (as amended in 2013).

The IRS rejected PPL's claim. It reasoned that any algebraic rearrangement of the windfall tax was improper. The Tax Court disagreed with the IRS,[13] but the U.S. Court of Appeals for the Third Circuit reversed.[14] In a related case, the U.S. Court of Appeals for the Fifth Circuit held the U.K. windfall tax was creditable.[15] In holding in favor of PPL, the Supreme Court agreed with the Fifth Circuit's view that the tax was creditable.

The Supreme Court reasoned that foreign tax creditability depends not on the way a foreign government characterizes its tax, but on its economic substance. For most of the affected companies, the tax formula's substantive effect was to impose a tax on all profits above a threshold. Thus, the Supreme Court held the U.K. windfall tax was creditable against PPL's U.S. income tax.

This case is significant because the IRS argued that form should govern the result rather than substance. In other contexts, the IRS usually argues that economic substance controls tax treatment and vigorously opposes arguments that form should govern.[16]

In *Historic Boardwalk Hall, LLC v. Commissioner*, the U.S. Court of Appeals for the Third Circuit held that an investor was not a bona fide partner in a partnership and could not claim flow-through tax credits because the investor lacked a meaningful stake in the partnership's success or failure.[17]

The New Jersey Sports and Exposition Authority (NJSEA) and Pitney Bowes, Inc. (PB) formed Historic Boardwalk Hall, LLC (HBH), to renovate the East Hall, a popular convention center in Atlantic City, New Jersey. HBH allocated certain rehabilitation expenditures to PB, allowing PB to claim historic rehabilitation tax credits (HRTC) under IRC § 47.[18] Purchase and sale options limited the risk to PB and essentially guaranteed a three-percent return on its investment in addition to the tax credits.

The IRS disallowed PB's rehabilitation tax credits, arguing that the HBH partnership was a sham, lacked economic substance, and was not really a partnership, but rather a vehicle to allow NJSEA to impermissibly sell tax credits to PB.

The Tax Court disagreed, sustaining the allocation of the credits to PB.[19] In its view, the parties intended to form a partnership for a legitimate business purpose (*i.e.*, to rehabilitate the East Hall), and PB's motivation was not limited to the credits.[20] It also expected a three percent return. Moreover, PB's investment

13 *PPL*, 135 T.C. 304 (2010).

14 *PPL*, 665 F.3d 60 (3d Cir. 2011), *rev'g* 135 T.C. 304 (2010).

15 *Entergy Corp. v. Comm'r*, 683 F.3d 233 (5th Cir. 2012), *aff'g* T.C. Memo. 2010-197. Entergy Corporation was an owner of one of the 32 companies that were privatized. This circuit split created the possibility that similarly situated competitors in the same industry could have received different federal income tax credits based solely on which circuit's precedent applied.

16 Substance over form arguments may take on even greater significance now that a taxpayer may be subject to a strict liability penalty of up to 40 percent of any underpayment (or refund claim) resulting from a transaction that lacks economic substance or fails to meet the requirements of "any similar rule of law." Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067 (codified at IRC § 7701(o), 6662(b)(6), 6662(i), and 6676(c) and applicable to transactions entered into after March 30, 2010, the date of enactment). *See also* IRC § 6664(d)(2) (no reasonable cause exception for transactions lacking economic substance).

17 *Historic Boardwalk, LCC v. Comm'r*, 694 F.3d 425 (3d Cir. 2012), *rev'g and remanding* 136 T.C. 1 (2011), *cert. denied*, 133 S. Ct. 2734 (2013) [hereinafter *Boardwalk*].

18 IRC § 47 allows a taxpayer to claim a tax credit equal to 20 percent of the qualified rehabilitation expenditures with respect to a certified historic structure.

19 *Boardwalk*, 136 T.C. 1 (2011).

20 *Boardwalk*, 136 T.C. 24 (2011).

had a potential for loss. Accordingly, it concluded that PB was a partner, HBH was a partnership, and the arrangement had economic substance.[21]

The U.S. Court of Appeals for the Third Circuit disagreed, reversing the Tax Court. The Third Circuit assumed that HBH had economic substance, but concluded that PB was not a bona fide partner.[22] It reasoned that PB's investment was more like debt than equity because PB had no meaningful downside risk or potential for gain in excess of its three percent return. NJSEA had even agreed to reimburse PB for any disallowed HRTCs. Moreover, NJSEA was financially secure and able to complete the project without PB, minimizing the risk the project would not be completed or that it would not be able to honor its obligations to PB.[23]

This decision is significant because it increases the cost and complexity of using partnerships to sell tax credits.[24] While hindering the sale of tax credits likely promotes respect for the tax system, it may also reduce the attractiveness of the credits. According to a consulting firm cited by the U.S. Court of Appeals for the Third Circuit, tax-exempt owners of historic properties (like NJSEA) could have expected an investor to pay $.80 to $.90 per dollar of HRTC.[25] This percentage has likely declined as a result of the court's decision, especially now that an additional penalty may apply to transactions deemed to lack economic substance.[26]

In *Shockley v. Commissioner*, the U.S. Court of Appeals for the Eleventh Circuit held that a protective petition filed with the U.S. Tax Court by persons without actual or apparent authority to represent the taxpayer nonetheless suspended the taxpayer's period of limitations on assessment.[27]

After an audit of the Shockley Communications Corporation's (SCC) 2001 return, the IRS timely mailed a statutory notice of deficiency (SNOD) to SCC to the address shown on the return. SCC did not file a petition with the U.S. Tax Court to dispute the deficiency.

The IRS simultaneously mailed a duplicate SNOD to the Shockleys (SCC's former officers and shareholders), even though the Shockleys no longer had authority to act for SCC. During 2001, another company purchased all the shares of SCC and the Shockleys resigned from their positions. The Shockleys filed a protective petition, alleging that the SNOD they received, which identified both them and SCC as the taxpayer, was invalid because they were not the taxpayer. In addition, the Shockleys alleged that the

21 *Boardwalk*, 136 T.C. 29-30 (2011).

22 *Boardwalk*, 694 F.3d at 449-63. The court cited *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006) (concluding nontaxable foreign banks, which were allocated most of the partnership's taxable income but that did not share in its business risks, were not partners for tax purposes), and *Virginia Historic Tax Credit Fund 2001 LP v. Comm'r*, 639 F.3d 129 (4th Cir. 2011) (holding that those who invested in a partnership in exchange for an allocation of state tax credits without assuming meaningful business risks did not contribute funds to the partnership as partners, but rather paid to purchase tax credits).

23 Although "mindful of Congress's goal of encouraging rehabilitation of historic buildings," the court objected to the "prohibited sale of tax credits" presented by this case. *Boardwalk*, 694 F.3d at 462-63.

24 In light of the new penalty applicable to transactions that lack economic substance (cited above), the decision may also be significant because neither court adopted the IRS's argument that the transaction had no economic substance.

25 *Boardwalk*, 694 F.3d at 434.

26 If policymakers want to provide an incentive to rehabilitate historic properties, this may be an opportune time to reevaluate whether the HRTC is the most effective method for doing so. For a more in-depth discussion, see National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (Research Study: *Evaluate the Administration of Tax Expenditures*) and National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75-104 (Research Study: *Running Social Programs Through the Tax System*).

27 *Shockley v. Comm'r*, 686 F.3d 1228 (11th Cir. 2012), *rev'g and remanding* T.C. Memo. 2011-96.

SNOD was invalid because it was sent to their personal residence and not the address of SCC. The Tax Court dismissed the case on the basis of the Shockleys' unopposed position that they lacked capacity to pursue it on SCC's behalf.

Next, the IRS assessed SCC's liability, issued notices of transferee liability to the Shockleys, and sought to secure payment from them. The Shockleys petitioned the Tax Court, arguing that the notices of transferee liability were not timely.[28]

The IRS generally has to issue a notice of transferee liability within one year after the end of the period of limitations on assessment (POL).[29] The POL generally ends three years after a return is filed.[30] However, the POL is suspended for the 90-day (or 150-day) period during which the taxpayer is permitted to file a petition in the Tax Court, plus 60 days.[31] This suspension is further extended if "a proceeding in respect of the deficiency is placed on the docket of the Tax Court."[32] Thus, the notice of transferee liability would not have been timely unless the Shockleys' earlier protective petition extended the POL with respect to SCC.

The Tax Court held that the Shockleys' petition did not extend the POL for SCC. It first concluded that the notice the IRS sent to the Shockleys was a nullity as to SCC because the IRS did not send it to SCC's last known address. Next, it concluded that the Shockleys' petition did not give rise to "a proceeding in respect of the deficiency." It reasoned that the petition was not filed on behalf of SCC, was not in respect of a valid deficiency notice, and did not prohibit assessment against SCC. Thus, it held the notice of transferee liability was not timely.[33]

The U.S. Court of Appeals for the Eleventh Circuit reversed the Tax Court. It did not disturb the Tax Court's holding that the SNOD the Shockleys received was invalid as to SCC. However, it concluded that the Shockleys' petition was "a proceeding in respect of the [SCC] deficiency" that extended the POL. It relied primarily on the plain language of the statute and the Supreme Court's admonition to construe statutes of limitation strictly in favor of the government.[34]

This case is significant because it may suggest that anyone who files a petition with respect to an IRS notice runs the risk of extending the POL for the taxpayer, even if the IRS knows the petitioner has no actual or apparent authority to represent the taxpayer and even if the notice at issue is not a valid SNOD.[35]

28 The Shockleys' position was consistent with the IRS's published position. *See* Rev. Rul. 88-88, 1988-2 C.B. 354 (stating if an invalid SNOD is issued, "the filing of a Tax Court petition with respect to [that notice] does not stop the running of the period of limitations under section 6503(a)."). The IRS is generally bound by its published positions. *See Rauenhorst v. Comm'r*, 119 T.C. 157 (2002) (refusing to allow the IRS to take a position contrary to its own guidance); IRM 35.7.2.1.8(8) (Aug. 11, 2004) ("Respondent may not argue against his published position"). It is unclear if the parties were aware of the IRS's published position, as we did not locate any citations to Rev. Rul. 88-88 in any of the pleadings filed in the Tax Court.

29 IRC § 6901(c).

30 IRC § 6501(a).

31 IRC § 6213(a), 6503(a)(1). This 90-day (or 150-day) period commences on the date the IRS mails the SNOD to the taxpayer. IRC § 6213(a).

32 IRC § 6503(a)(1).

33 *Shockley v. Comm'r*, T.C. Memo. 2011-96.

34 *Shockley*, 686 F.3d at 1235-1238 (quotations omitted), *rev'g* T.C. Memo. 2011-96.

35 As of this writing, however, the case is still pending before the Tax Court on remand. For further commentary on this case, see Andy Roberson and Kevin Spencer, *11th Circuit Allows Invalid Notice to Suspend Assessment Period*, 2012 TNT 153-3 (July 24, 2012).

In *In re: Grand Jury Subpoena*, the U.S. Court of Appeals for the Fifth Circuit held that the Fifth Amendment privilege against self-incrimination does not apply to the disclosure of foreign bank accounts on Form TD F 90–22.1, Report of Foreign Bank and Financial Accounts (FBAR).[36]

The target of a grand-jury investigation (the "witness") refused to comply with a government subpoena seeking records of foreign bank accounts that he was required to keep and report on Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts*, pursuant to the Bank Secrecy Act (BSA). The witness cited his Fifth Amendment privilege against self-incrimination. The government moved to compel production of the records, arguing that the "Required Records Doctrine," which is in effect an exception to the privilege against self-incrimination, was applicable. The U.S. District Court for the Southern District of Texas denied the motion, and the government appealed.

The U.S. Court of Appeals for the Fifth Circuit reversed, concluding that the Required Records Doctrine applied. Under the doctrine, the government may require that certain records be kept and later produced without implicating the privilege against self-incrimination. The doctrine "does not empower the government to command every citizen to keep a diary of their crimes under the guise of regulation."[37] Rather, it permits the government to inspect records it requires an individual to keep as a condition of voluntarily participating in a regulated activity.[38] The doctrine may apply when (1) the purposes of the inquiry are "essentially regulatory" rather than criminal, (2) the information is of a kind which the regulated party has "customarily kept," and (3) the records are assumed to have "public aspects" that render them analogous to public documents.

The witness argued that because a primary purpose of the BSA is to fight crime, it fails the requirement to be "essentially regulatory." However, the court concluded that the BSA satisfies the requirement because another purpose of the BSA is to support regulatory investigations, as evidenced by the fact that BSA information is distributed to several civil and regulatory agencies.

The witness did not contest that bank account information is "customarily kept." However, he argued that because those subject to the BSA are not regulated and have not engaged in activities with the public or in the public sphere, their banking records lack "public aspects."[39] The court rejected this reasoning. It observed that under the witness's logic, Congress could only require those with foreign accounts to keep and produce records of the accounts if it first placed additional substantive regulatory restrictions on them to inject them with public aspects. Moreover, the court observed that records generally considered private (*e.g.*, medical records) can possess public aspects. It reiterated that the Treasury Department shares foreign bank account information with a number of different agencies, imbuing it with "public aspects." Thus, it concluded the privilege against self-incrimination was not a defense to the subpoena because the Required Records Doctrine was applicable.[40]

36 *In re: Grand Jury Subpoena*, 696 F.3d 428 (5th Cir. 2012). Form TD F 90-22.1 was subsequently replaced by Form 114.

37 *Id*. at 433.

38 For example, the Supreme Court held that the government may require a wholesaler of fruit to keep and produce certain records to enable enforcement of the Emergency Price Control Act, which was passed following World War II to prevent inflation and price gouging. *Shapiro v. United States*, 335 U.S. 1 (1948).

39 *In re: Grand Jury Subpoena*, 696 F.3d at 435.

40 The court also mentioned that affirming the district court would have created a circuit split. *In re: Grand Jury Subpoena*, 696 F.3d at 431 (citing *In re: Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011*, 691 F.3d 903 (7th Cir. 2012) and *In re: Grand Jury Investigation M.H. v. United States*, 648 F.3d 1067 (9th Cir. 2011)).

This case is significant because it suggest the Fifth Amendment privilege against self-incrimination does not apply to a wide range of private information that the IRS may require taxpayers to keep in connection with their tax returns.[41]

In *United States v. Quality Stores, Inc.*, the United States Court of Appeals for the Sixth Circuit held that supplemental unemployment benefit (SUB) payments to involuntarily terminated employees are not "wages" subject to Federal Insurance Contributions Act (FICA) taxes.[42]

Quality Stores made payments to employees who were involuntarily terminated in connection with its bankruptcy and discontinuance of operations, as required by its supplemental unemployment benefit (SUB) plans. It treated the payments as wages on Forms W-2, and withheld and paid employment taxes on them. Quality Stores and some of its employees sought a refund of the FICA tax, arguing that the payments were not wages, but rather SUB payments that were not taxable under FICA. The IRS denied the claim because in its view only certain SUB payments — not those at issue — qualify for a narrow exception to FICA described in a series of Revenue Rulings.[43] The bankruptcy court agreed with Quality Stores, as did the district court, and the United States Court of Appeals for the Sixth Circuit, concluding that the SUB payments were not wages for purposes of either FICA or federal income tax (FIT).

Under the court's analysis, Congress adopted a definition of "wages" for FIT purposes that is nearly identical to the definition of "wages" included in FICA. In its 1981 decision in *Rowan*, the Supreme Court confirmed that the term "wages" has the same meaning in both statutes.[44] IRC § 3402(o) states that for FIT purposes a SUB payment is "treated as if it were a payment of wages," and by implication, not actually wages.[45] Legislative history indicates that SUB payments "do not constitute wages."[46] According to the court, Congress allowed SUB payments to be treated as wages under IRC § 3402(o) to facilitate FIT withholding for taxpayers. Thus, the court held that SUB payments are not wages for either FIT or FICA purposes.

The IRS agreed that under IRC § 3402(o), SUB payments are not wages for purposes of FIT. However, it argued that they are wages for purposes of FICA. It reasoned that Congress legislatively superseded *Rowan* when it enacted the "decoupling amendment" in 1983. It cited legislative history and cases indicating that Congress intended the definition of wages to be more broadly construed under FICA.

According to the court, however, the text of the decoupling amendment simply authorized Treasury to promulgate regulations (not administrative guidance) to provide for different exclusions from wages under FICA than under the FIT withholding laws. But, the government has not issued any.

41 However, some have argued that a person can still assert privilege with respect to certain line items on the FBAR form. *See* Edward M. Robbins, *The Fifth Amendment FBAR Lives!*, 2013 TNT 123-9 (June 26, 2013).

42 *United States v. Quality Stores, Inc.,* 693 F.3d 605 (6th Cir. 2012), *aff'g* 424 B.R. 237 (W.D. Mich. 2010), *aff'g* 383 B.R. 67 (Bankr. W.D. Mich. 2008), *cert. granted*, 82 U.S.L.W. 3177 (2013) [hereinafter *Quality Stores*].

43 *Quality Stores*, 693 F.3d at 619. *See, e.g.*, Rev. Rul. 56-249, 1956-1 C.B. 488 and Rev. Rul. 90-72, 1990-2 C.B. 211 (providing an exception for a stream of payments coordinated with the receipt of unemployment compensation, but not for a lump-sum payment).

44 *Quality Stores*, 693 F.3d at 613 (citing *Rowan Cos. v. United States*, 452 U.S. 247 (1981)).

45 If the SUB payments were actually wages, then some employees might lose the very state unemployment benefits that the SUB payments were intended to supplement. *Id*. at 617.

46 *Quality Stores*, 693 F.3d at 612 (quotations omitted).

The court also distinguished a holding by the Federal Circuit in *CSX* that reached a different conclusion as inconsistent with the Federal Circuit's own precedent.[47] This case is significant because it creates a split of authority, which the Supreme Court has agreed to review, regarding whether SUB payments are subject to FICA, even if they do not meet the exception described in the IRS's administrative guidance. It has also prompted those who made or received SUB payments to file claims to recover FICA taxes.[48]

In *Allcorn v. Commissioner*, the U.S. Tax Court held the IRS has discretionary authority to abate interest on an excessive refund even if the refund was caused, in part, by taxpayer error.[49]

Mr. Allcorn mistakenly reported $4,000 in estimated tax payments as withholding on line 62 (federal income tax withheld) rather than on line 63 (estimated tax payments) of his 2008 Form 1040, *U.S. Individual Income Tax Return*. He included a note with his return, which explained: "Additional $4,000 was sent with Form 1040-ES." He correctly reported his total payments on Line 71.

The IRS double-counted Mr. Allcorn's $4,000 payment and sent him a refund of $4,000 more than he requested. When the IRS discovered its error, it demanded $4,514 — the $4,000 plus a $300 late payment penalty and $214 in interest. The IRS abated the penalty, but declined to abate the interest.

Pursuant to IRC § 6602, when the IRS issues an erroneous refund, it must charge interest on the amount. Section 6404(e)(2), however, requires the IRS to abate interest on any "erroneous refund under section 6602," provided the refund did not exceed $50,000 and the taxpayer (or a related party) had not caused the refund. Mr. Allcorn believed he had not caused the $4,000 erroneous refund, and thus petitioned the Tax Court with respect to the IRS's determination not to abate the interest.

The IRS first argued that IRC § 6404(e)(2) did not apply because the payment was not an "erroneous refund under section 6602." IRC § 6602 only applies to refunds "recoverable by suit pursuant to section 7405."[50] Thus, the IRS asserted that because it could recover the refund using summary assessment procedures under IRC § 6201(a)(3) (*i.e.*, the IRS authority to make "math error" adjustments), the requirement to abate interest under IRC § 6404(e)(2) did not apply.[51] The court rejected this argument, reasoning that the IRS could have chosen to recover the erroneous refund by filing a civil suit under IRC § 7405.[52]

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47 *Id*. at 615-16 (citing *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008) [hereinafter *CSX*], as a decision contrary to the court's holding in *Anderson v. U.S.*, 929 F.2d 648 (Fed. Cir. 1991)). In *CSX*, the Federal Circuit concluded that "the text of section 3402(o) does not require that FICA be interpreted to exclude from 'wages' all payments that would satisfy the definition of SUB in section 3402(o)(2)(A)." *CSX*, 518 F.3d at 1342.

48 In the government's petition for a writ of certiorari, it indicated that the same issue is pending in 11 cases and more than 2,400 administrative refund claims, with a total amount at stake of more than $1 billion. *Quality Stores, petition for cert. filed*, 2013 WL 2390247 (May 31, 2013) (No. 12-1408). On October 1, 2013, the United States Supreme Court granted this petition, see 82 U.S.L.W. 3177 (2013).

49 *Allcorn v. Comm'r*, 139 T.C. 53 (2012).

50 Sections 7405(a) and (b) authorize the government to file a civil action to recover certain erroneous refunds. An erroneous refund suit is not, however, the sole means for the IRS to collect an erroneous refund. *See, e.g.*, CCDM 34.6.2.7(2)(a) (June 12, 2012) ("Assessable erroneous refunds may also be recovered by administrative action within the applicable period of limitation upon assessment and collection.").

51 *Allcorn*, 139 T.C. at 59.

52 *Id*. at 59-60.

Next, the IRS argued that IRC § 6404(e)(2) was inapplicable because Mr. Allcorn's error contributed to the erroneous refund. The court agreed that because of Mr. Allcorn's error, the IRS was not required to abate the interest.

However, the court went on to conclude that the IRS had discretionary authority to abate interest under IRC § 6404(e)(2), despite Mr. Allcorn's error. The court cited (1) cases applying IRC § 6404(e)(2) in situations where the taxpayer was somewhat at fault, (2) the legislative history of IRC § 6404(e)(2), which suggests Congress intended to increase the IRS's authority to abate interest, and (3) an Internal Revenue Manual provision that suggests the IRS has discretionary authority under IRC § 6404(e)(2) to abate interest on erroneous refunds in excess of the $50,000 amount provided by law.[53]

This case is significant because it clarifies the IRS's discretionary authority to abate interest on erroneous refunds under IRC § 6404(e)(2), even if taxpayer error contributes to the refund, the refund exceeds $50,000, and the IRS can recover it using summary assessment procedures (*i.e.*, math error authority).

In *Loving v. Internal Revenue Service*, the District Court for the District of Columbia held the IRS lacked authority to issue regulations governing the conduct of registered tax return preparers, and enjoined the IRS from enforcing them.[54]

In June 2011, the Treasury Department issued regulations governing "registered tax return preparers," a previously unregulated group of 600,000 to 700,000 paid preparers.[55] In order to protect the consumers and the public fisc, the regulations require each preparer to obtain a valid preparer tax identification number (PTIN), pass a background check and an exam, pay an annual fee, and take fifteen hours of continuing education courses each year. Sabina Loving and two other preparers who had not previously been regulated by the IRS filed suit, claiming the regulations were not authorized by law and would cause them to increase prices or go out of business.

The IRS first argued that it did not need statutory authority to regulate preparers because each agency has inherent authority to regulate those who practice before it. However, the court concluded that this general authority does not apply because a specific statutory provision (*i.e.*, 31 U.S.C. § 330) defines the agency's authority.

Under the framework set forth in *Chevron*, agency regulations are entitled to deference unless they (1) contradict an unambiguous statute, or (2) adopt an unreasonable construction of it.[56] In this case, 31 U.S.C. § 330 authorizes Treasury to "regulate the practice of representatives," and to "require that the representative demonstrate…competency to advise and assist persons in presenting their cases," before

53 *Id*. at 63-66 (citing *Converse v. United States*, 839 F. Supp. 1274 (N.D. Ohio 1993); *Lindstedt v. United States*, 78 A.F.T.R.2d (RIA) 6211 (Fed. Cl. 1996); H.R. Rept. No. 99-426, at 844 (1985); and IRM 20.2.7.5(2) (Mar. 9, 2010)).

54 *Loving v. Comm'r*, 920 F. Supp. 2d 108 (D.D.C. 2013).

55 *See* T.D. 9527 (June 3, 2011), 76 Fed. Reg. ¶ 32,286, 32,299. These persons are sometimes referred to as "unenrolled" preparers. *See* Treas. Reg. § 601.502(b)(5)(iii); Rev. Proc. 81-38, 1981-2 C.B. 592. Attorneys, certified public accountants, enrolled agents and enrolled actuaries were already subject to IRS regulation under Circular 230. The National Taxpayer Advocate has long championed the regulation of return preparers as necessary to protect consumers. *See* National Taxpayer Advocate 2008 Annual Report to Congress 423 (Legislative Recommendation: *The Time Has Come to Regulate Federal Tax Return Preparers*); National Taxpayer Advocate 2004 Annual Report to Congress 67 (Most Serious Problem: *Oversight of Unenrolled Return Preparers*); National Taxpayer Advocate 2003 Annual Report to Congress 270 (Legislative Recommendation: *Federal Tax Return Preparers Oversight and Compliance*); National Taxpayer Advocate 2002 Annual Report to Congress 216 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*); Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 2013 TNT 92-31 (May 13, 2013).

56 *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

admitting a "representative to practice."[57] In addition, 31 U.S.C. § 330(b) authorizes Treasury to suspend or disbar "a representative" from "practice" before the Treasury Department in certain circumstances, and also to impose a monetary penalty.

The IRS argued that the terms "practice" and "representative" are ambiguous and that it reasonably interpreted them as covering tax return preparers. Thus, the court should uphold the regulations under the second prong of *Chevron*.

The court disagreed, finding that the D.C. Circuit had previously "rejected the argument that a statute is ambiguous when it fails to define a broad term."[58] It concluded that the statute unambiguously fails to authorize the government to regulate tax return preparers — failing under the first prong of *Chevron*. According to the court, 31 U.S.C. § 330(a)(2)(D) equates "practice" with advising and assisting with the presentation of a "case," not the filing of a tax return.[59] Thus, the statutory definition of practice "makes sense only in connection with those who assist taxpayers in the examination and appeals stages of the process."[60]

Next, the court reasoned that because Congress has enacted at least ten penalties targeting specific misconduct by tax return preparers with specific sanctions, 31 U.S.C § 330(b) should not be interpreted to provide the IRS with overlapping discretion to penalize preparers for the same conduct.[61] It went on to observe that IRC § 6103(k) specifically authorizes the IRS to disclose information about violations triggering these specific penalties to state and local agencies that license, register or regulate preparers, but does not authorize the IRS to disclose violations of 31 U.S.C. § 330. One explanation for this omission, according to the court, is that 31 U.S.C. § 330 does not apply to preparers.[62]

Finally, the court observed that if the IRS's arguments were accepted, then the IRS could disbar a preparer pursuant to its authority under 31 U.S.C. § 330 for the same conduct that would enable it to seek an injunction against the preparer under IRC § 7407. Thus, an injunction would rarely be necessary. According to the court, this weighed against interpreting 31 U.S.C. § 330 as granting the IRS authority to regulate return preparers. Accordingly, the court granted Loving's motion for summary judgment, holding that the IRS lacked statutory authority to issue and enforce the regulations governing "registered tax return preparers," and enjoined the IRS from enforcing them.

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57 31 U.S.C. § 330(a)(1), (a)(2)(D).

58 *Loving*, 917 F. Supp. 2d 67, 74 (D.D.C. 2013) (citing *Goldstein v. SEC*, 451 F.3d 873, 878 (D.C. Cir. 2006)).

59 The court stated that because the law was enacted before the federal income tax, Congress could not have contemplated that it would authorize the regulation of income tax return preparers. For an alternative analysis and different conclusion, see Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 2013 TNT 92-31 (May 13, 2013). *See also* Lawrence B. Gibbs, *Loving v. IRS: Treasury's Authority to Regulate Tax Return Preparers*, 2013 TNT 203-50 (Oct. 21, 2013).

60 *Loving*, 917 F. Supp. 2d at 74. Unenrolled tax return preparers are generally authorized to represent a taxpayer before the IRS during the examination of a return that they prepared, but not before IRS appeals or collection functions. *See* 26 C.F.R. § 601.502(b)(5)(iii).

61 The court did not comment on the fact that the IRS did not have authority to impose a monetary penalty until 2004. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title VIII, § 822(a)(1), (b), 118 Stat. 1418, 1586-587.

62 Another explanation is that IRC § 6103 does not prevent the disclosure of sanctions under Title 31. Indeed, the IRS Office of Professional Responsibility (OPR) posts on its website sanctions imposed under Title 31, including censure, suspension or disbarment from practice before the IRS, as well as all final agency decisions following an appeal. *See, e.g.*, OPR, Announcement of Disciplinary Sanctions, http://www.irs.gov/Tax-Professionals/Enrolled-Agents/Announcements-of-Disciplinary-Sanctions. Thus, state and local agencies could simply check the OPR website on a regular basis.

The government filed a motion to suspend the injunction pending appeal. The court denied the motion but then modified the terms of the injunction.[63] On February 25, 2013, the government filed a motion for a stay pending appeal. On March 27, 2013, the U.S. District Court for the District of Columbia denied the motion for stay.[64] The government has appealed the district court's decision to the U.S. Court of Appeals for the District of Columbia Circuit. This case is significant because it will affect hundreds of thousands of tax return preparers and the taxpayers they serve.

In *Dorrance v. United States*, the United States District Court in Arizona held that a taxpayer must allocate basis between the life insurance policy and stock received when a mutual insurance carrier demutualizes.[65]

In 1995, a trust purchased policies from various mutual life insurance companies. As a policyholder it had certain ownership rights (mutual rights) normally held by stockholders, such as the right to vote and the right to receive the mutual company's "surplus" should it liquidate. Between 1998 and 2001, each of the insurance companies demutualized, distributing shares of stock (or cash in lieu of stock) to compensate for the loss of the mutual rights. The trust received stock valued at about $1.8 million, and in 2003, sold it for about $2.2 million. It reported the entire $2.2 million as gain, paid the resulting tax, and then filed for a refund, claiming that its basis should be allocated to the stock to offset the gain. The IRS did not pay the claim, and the trust filed suit.

The IRS argued that the trust did not meet its burden to prove it had paid for the mutual rights or that the stock had any basis at all. Accordingly, it should not be entitled to recover any basis in connection with the stock sale. The court rejected this argument because it concluded the trust had paid something for the mutual rights (and thus the stock) when it paid premiums for policies that included both the policy rights and mutual rights. It reasoned that if it is clear that a taxpayer is entitled to some deduction, but cannot establish the full amount claimed, it is improper to deny the deduction in its entirety.[66]

The trust argued it should recover its basis pursuant to the "open transaction" doctrine because it was impractical or impossible to allocate the basis in the mutual life insurance policy between the property it received in the demutualization transaction (*i.e.*, the stock and non-mutual policy).[67] If applicable, the doctrine would allow the trust to use its full basis in the policy to offset any gain on the stock sale before allocating any remaining basis to the non-mutual policy.

The court rejected this argument. While acknowledging that the Court of Federal Claims had concluded in the *Fisher* case that the open transaction doctrine applied to a demutualization transaction, it observed that neither of the parties in *Fisher* analyzed how much the taxpayer paid for the mutual rights — with the IRS arguing they paid nothing and the taxpayer arguing the amount could not be determined.[68]

63 *See Loving*, 920 F. Supp. 2d 108 (D.D.C. 2013) (modifying the injunction to make clear that the IRS is not required to suspend the PTIN program and not required to shut down all of its testing and continuing-education centers).

64 *See Government Files Brief in D.C. Circuit Court in Return Preparer Oversight Case*, 2013 TNT 62-20 (Apr. 3, 2013).

65 *Dorrance v. United States*, 877 F. Supp. 2d 827 (D. Ariz. 2012).

66 *Id*. at 831 (citing *Cohan v. Comm'r*, 39 F.2d 540, 543 (2d Cir.1930)).

67 *See, e.g., Burnet v. Logan*, 283 U.S. 404 (1931); *Pierce v. United States*, 49 F. Supp. 324 (Ct. Cl. 1943).

68 *Fisher v. United States*, 82 Fed. Cl. 780 (2008), *aff'd without opinion*, 333 F. App'x 572 (Fed. Cir. 2009) [hereinafter *Fisher*]. For prior coverage of *Fisher*, see National Taxpayer Advocate 2008 Annual Report to Congress 468-469 (speculating: "We wonder if the [Fisher] court would have reached a different conclusion if the IRS's expert had valued the ownership components of the policy at an amount greater than zero.").

The court was also concerned that open transaction treatment would produce a windfall. In effect, all of the basis would be allocated to the stock — the asset that would be sold — while the asset that does not require basis — the policy — would have its basis reduced.[69]

Moreover, unlike the taxpayer in *Fisher* who had received cash at the time of the demutualization, the taxpayer in this case received stock that had appreciated before being sold. Thus, even gains on the stock following the demutualization could be offset by basis increases — increases resulting from post-demutualization payments on the policy – if it applied the open transaction doctrine.

Finally, the court reasoned that because the value of both the mutual rights and the policy itself could be determined at the time of the demutualization, there was no concern that the taxpayer might pay tax on a transaction that might later show a loss. Thus, it concluded that the parties must equitably apportion basis between the stock and the policy pursuant to Treasury Regulation § 1.61-6(a).

The district court later amended its opinion, holding the trust's basis was about $1 million, which represented the value of shares received to compensate for relinquishing voting rights and for past (but not future) contributions to surplus, as determined by the companies.[70]

This case is significant because it highlights how the tax treatment of stock or cash received in a demutualization transaction remains unsettled.[71] It suggests that taxpayers who receive stock (or cash) from mutual insurance companies in demutualization transactions must report taxable gains by allocating basis between the policy and the mutual rights (*i.e.*, stock or cash), rather than deferring gains under the open transaction doctrine.

In *United States v. McBride*, the United States District Court in Utah held that a taxpayer's failure to file Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts*, was willful because the government showed by a preponderance of the evidence that the taxpayer either knew or, deliberately or with reckless disregard, avoided learning of his filing requirement.[72]

Mr. McBride, a partner in a U.S. business, hired a financial management firm to move business profits offshore to avoid U.S. income tax. The firm's promotional materials informed Mr. McBride about the FBAR reporting requirements. When presented with the tax avoidance plan, Mr. McBride's first reaction was that "this is tax evasion." Yet, he did not obtain a second opinion or disclose his interest in the offshore accounts to his accountant or tax return preparer. He checked the box on Schedule B of his federal income tax returns "no" to indicate that he had no interests in foreign accounts exceeding the reporting threshold. The IRS imposed a civil penalty against Mr. McBride for willfully failing to file an FBAR, and ultimately sued in district court to collect the penalty.

69 *Dorrance*, 877 F. Supp. 2d at 834 (quoting commentators).

70 *Dorrance*, 111 A.F.T.R.2d (RIA) 1280 (D. Ariz. 2013).

71 *See, e.g.*, Mark Persellin and Kent Royalty, *The Demutualized Stock Basis Conundrum: Update And Planning Implications*, Corporate Taxation, 39 WGL-CTAX 17 (Nov./Dec. 2012). Although the IRS has not issued an Action on Decision, it disagrees with *Fisher* and had been holding claims for refund pending a decision in *Dorrance*. *See Cadrecha v. United States*, 104 Fed. Cl. 296 (2012); Letter from IRS Associate Chief Counsel (Income Tax & Accounting) to Senator Harkin (May 23, 2011), *reprinted as*, IRS Will Not Refund Tax Paid on Sale of Life Insurance Company Stock, 2011 TNT 180-28 (Sept. 16, 2011); IMRS 11-0001391 (2011), http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Issues-Closed-in-Calendar-Year-2011-Sorted-by-Subject. It is now denying them. *See Reuben v. United States*, 111 A.F.T.R.2d (RIA) 620 (D. Cal. 2013).

72 *United States v. McBride*, 908 F. Supp. 2d 1186 (D. Utah 2012).

The court first decided that the U.S. has the burden to prove Mr. McBride's violation was willful by only a "preponderance of evidence," rather than by the higher "clear and convincing evidence" standard that applies to fraud.[73] The court also stated that the IRS could establish willfulness on the basis of reckless conduct, such as making a conscious effort to avoid learning about the FBAR reporting requirements — requirements explained on the face of a tax return (*i.e.*, willful blindness).

In this case, however, the IRS met is burden by showing that Mr. McBride had actual knowledge of the FBAR filing requirements because his financial management firm had informed him about them. Mr. McBride testified that the purpose of the scheme was to avoid disclosure and reporting the existence of the foreign interests, because "if you disclose the accounts on the form, then you pay tax on them,"[74] which went against the purpose of the scheme. The court also found that he deliberately withheld information about the accounts from his preparer and accountant. It reasoned that Mr. McBride either knew he was violating the FBAR reporting requirements or intentionally avoided learning whether he was violating the FBAR reporting requirements. Thus, the court held that Mr. McBride's violation was willful.

This case is significant because it confirms that the government has the burden to prove its case by a preponderance of the evidence when it seeks to impose the penalty applicable to willful FBAR violations. It may also suggest that the government can meet its burden if it can show that the taxpayer intentionally avoided learning about whether his or her actions violated the FBAR reporting requirements. Because the government established Mr. McBride *actually* knew about the FBAR reporting requirements and deliberately concealed the offshore accounts from his accountant and preparer, however, this conclusion might be characterized as dicta. Notably, this case does not stand for the proposition that if the government establishes a taxpayer signed a return, which failed to report the existence of an interest in a foreign account on Schedule B, then it has automatically met its burden to prove willfulness.[75]

73 IRC § 7454(a); Tax Court Rule 142(b) ("In any case involving the issue of fraud with intent to evade tax, the burden of proof in respect of that issue is on the respondent, and that burden of proof is to be carried by clear and convincing evidence. See Code sec. 7454(a).").

74 *McBride*, 908 F. Supp. 2d at 1199.

75 Analysis in other cases may support that conclusion, however. *See, e.g., United States v. Sturman*, 951 F.2d 1466, 1477 (6th Cir. 1991) ("It is reasonable to assume that a person who has foreign bank accounts would read the information specified by the government in tax forms. Evidence of acts to conceal income and financial information, combined with the defendant's failure to pursue knowledge of further reporting requirements as suggested on Schedule B, provide a sufficient basis to establish willfulness on the part of the defendant."). *But see* IRM 4.26.16.4.5.3(6) (July 1, 2008) ("The mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, by itself, to establish that the FBAR violation was attributable to willful blindness.").