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. Clarke*, the Supreme Court held that to obtain a hearing concerning whether an IRS summons was issued for an improper purpose, a taxpayer must produce circumstantial evidence that plausibly raises an inference of bad faith.[2]

In 2010, the IRS examined returns filed by Dynamo Holdings Limited Partnership (Dynamo) for tax years 2005-2007. In August 2010, the revenue agent signed, but did not mail, a notice of Final Partnership Administrative Adjustment (FPAA).[3] In September and October 2010, immediately following Dynamo's refusal to extend the statute of limitations on assessment, the agent issued summonses to various parties, including Mr. Clarke, the chief financial officer for both Dynamo and Beekman Vista, Inc. (Beekman).[4] In December 2010, the IRS mailed the FPAA to Dynamo.

In February 2011, Dynamo filed suit in the Tax Court to challenge the adjustments reflected in the FPAA. In April 2011, the government sought to enforce the summons in the District Court for the Southern District of Florida so that it could use the information in the case pending before the Tax Court.[5]

By way of background, a district court will enforce a summons under Internal Revenue Code (IRC) § 7604 if the IRS demonstrates it issued the summons for a legitimate purpose, seeks information relevant to that purpose, which the IRS does not possess, and that it followed the administrative steps required by the Code.[6] In a typical case, the IRS satisfies these requirements by producing a sworn affidavit from the investigating agent, which then shifts the burden to the person resisting the summons to raise a "substantial question" as to whether the summons is an abuse of process.[7] If he meets this burden, then an "adversary hearing" is granted at which he may "challenge the summons on any appropriate ground."[8]

1 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2013, and ending on May 31, 2014. For purposes of this section, we generally used the same period, except that we discuss one Supreme Court case decided shortly thereafter and another case that was reversed on appeal after this discussion had been drafted.

2 *United States v. Clarke*, 134 S. Ct. 2361 (2014) [*hereinafter Clarke III*], *vacating and remanding* 517 F. App'x 689 (11th Cir. 2013) [*hereinafter Clarke II*], *vacating and remanding* 2012-2 U.S.T.C. (CCH) ¶ 50,732 (S.D. Fla. 2012) [*hereinafter Clarke I*], *on remand*, 573 F. App'x. 826 (2014) [*hereinafter Clarke IV*].

3 Brief for Respondents at 3, *Clarke III* (No. 13-301). While summons is one of the ten most litigated issues covered elsewhere in this report, we are including a discussion of *Clarke* in this section because it is a decision of the Supreme Court that was decided outside of the reporting period. For a discussion of other notable summons cases, see Most Litigated Issue: *Summons Enforcement*, *infra*.

4 In issuing the summons after signing the FPAA, Mr. Clarke suggests that the agent did not follow the reasoning of Internal Revenue Manual (IRM) 25.5.4.4.8, which states that once a taxpayer's liability has been finally determined, "the examination has been concluded," and "[t]he Service should no longer be in the process of gathering the data to support a determination." Brief for Respondents at 4, *Clarke III* (No. 13-301). However, the IRM only instructs agents not to issue a summons "after a Statutory Notice of Deficiency (SND) *is mailed* to the taxpayer." IRM 25.5.4.4.8(3) (Oct. 4, 2006) (emphasis added).

5 Transcript of Oral Argument at 52, *Clarke III* (No. 13-301).

6 *United States v. Powell*, 379 U.S. 48, 57-58 (1964).

7 *See, e.g.*, *United States v. Lawn Builders of New England, Inc.*, 856 F.2d 388, 392 (1st Cir. 1988). The IRS presented such an affidavit in this case. *Clarke I* at *5. Although Mr. Clarke alleged the agent's declaration was unsworn, the district court characterized this allegation as "baseless." *Id*.

8 *Powell*, 379 U.S. at 58.

However, challenging a summons generally extends the statute of limitations in IRC § 6501 (assessment and collection) and IRC § 6531 (criminal prosecutions).[9]

In this case, Mr. Clarke sought a pre-enforcement hearing and discovery to challenge the summonses, alleging among other things that the IRS issued the summons (1) in retaliation for Dynamo's refusal to extend the period of limitations, (2) to examine another taxpayer (Beekman), and (3) to circumvent the Tax Court's discovery process.[10]

The district court denied Mr. Clarke's request for a hearing and ordered the summons enforced. It observed that events occurring after issuance of the summons (*e.g.*, a Tax Court proceeding) are irrelevant to its validity. It explained that the possibility the summons might enable the IRS to obtain information about Beekman would not render it unenforceable. It also concluded that a hearing was not required based on Mr. Clarke's "mere allegation" of improper purpose to retaliate.[11]

On appeal, the U.S. Court of Appeals for the Eleventh Circuit vacated and remanded the case, holding that the district court abused its discretion in denying a hearing at which Mr. Clarke could question the IRS examining agent about his motives for issuing the summons (though the court declined to authorize discovery). The court reasoned that Mr. Clarke's allegations of retaliation, if true, would make enforcement of the summons improper. It stated that "requiring the taxpayer to provide factual support for an allegation of improper purpose, without giving the taxpayer a meaningful opportunity to obtain such facts, saddles the taxpayer with an unreasonable circular burden, creating an impermissible 'Catch 22.'"[12]

The Supreme Court vacated the judgment of the Court of Appeals and remanded the case, concluding that the taxpayer is entitled to a hearing to examine an IRS agent about his or her purpose for issuing a summons only when the taxpayer can point to specific facts or circumstances that plausibly raise an inference of bad faith. Naked allegations of improper purpose are not enough, but circumstantial evidence can suffice to meet that burden. The Court stated that the U.S. Court of Appeals for the Eleventh Circuit had concluded a naked allegation of bad faith was sufficient. It had not evaluated whether the affidavits presented in the case were sufficient to raise a plausible inference of bad faith. However, the Supreme Court expressly avoided deciding whether using a summons to retaliate for a taxpayer's refusal to extend the statute of limitations or to circumvent the Tax Court's rules of discovery were improper purposes.

This case is significant because it clarifies that a taxpayer is entitled to a hearing to examine an IRS agent about his or her purpose for issuing a summons if the taxpayer presents circumstantial evidence that plausibly raises an inference of bad faith. However, it is still not clear how this standard will be applied.[13] Mr. Clarke could be deemed to have satisfied the standard on remand. If the IRS is concerned that such

9 In general, these limitations periods are tolled if the taxpayer with respect to whose liability the summons is issued, or an agent, nominee, or other person acting under the direction or control of the taxpayer, takes any action to intervene or quash the summons or if the summons remains unresolved for six months. *See generally* IRC § 7609(e); Treas. Reg. § 301.7609-5.

10 For example, a summons can compel a taxpayer to submit to a deposition that he or she might not be required to provide in litigation before the Tax Court. *See* Tax Ct. R. 70(a) ("Discovery is not available under these Rules through depositions except to the limited extent provided in Rule 74.") and Tax Ct. R. 74(c)(1)(B) (treating non-consensual depositions as "an extraordinary method of discovery.").

11 *Clarke I* at *10.

12 *Clarke II* at 691.

13 On remand, the U.S. Court of Appeals for the Eleventh Circuit remanded the case to the district court without providing more specific direction. *See Clarke IV*.

hearings could delay cases, it could take steps to avoid the appearance that summonses have been issued for an improper purpose, and thus reduce requests for hearings.[14]

In *United States v. Woods*, the Supreme Court held the 40 percent gross valuation misstatement penalty applied to partners who claimed outside basis in a partnership deemed a sham.[15]

Mr. Woods formed several partnerships to implement a tax shelter. After the IRS audited the partnerships' tax returns, it disregarded the partnerships as "shams" because they lacked "economic substance." Therefore, the IRS disallowed losses attributable to outside basis in the partnerships that Mr. Woods had claimed.

The 40 percent gross valuation misstatement penalty applies to the portion of any underpayment on a return that is "attributable to… the value of any property (or the adjusted basis of any property) claimed" that exceeds a threshold amount.[16] When an asset's true value or adjusted basis is zero, "[t]he value or adjusted basis claimed ... is considered to" exceed the gross valuation misstatement threshold.[17] Accordingly, the IRS determined that Mr. Woods was subject to the gross valuation misstatement penalty for claiming outside basis in the partnerships.[18]

The U.S. District Court for the Western District of Texas held that the partnerships were properly disregarded as shams but that the valuation misstatement penalty did not apply to the partners.[19] The court explained that when the IRS totally disallows a deduction, it may not penalize the taxpayer for a valuation overstatement included in that deduction. The underpayment is attributable to the improper deduction, rather than a valuation overstatement.[20] Accordingly, the court applied the 20 percent penalty for negligence instead of the 40 percent gross valuation misstatement penalty. The U.S. Court of Appeals for the Fifth Circuit affirmed,[21] but the Supreme Court reversed.

First, the Supreme Court addressed jurisdictional issues. Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),[22] a court in a partnership-level proceeding has jurisdiction to determine

14 For example, the IRS could audit returns more promptly so that summonses are less likely to coincide with a taxpayer's refusal to extend the statute of limitations on assessment. Moreover, Congress has expressed a policy preference for prompt adjustments by enacting IRC § 6404(g), which suspends interest and penalties against individuals if the IRS does not timely provide the taxpayer with a notice specifically stating the amount of any increased liability and the basis for that liability, as further discussed below. *See Corbalis v. Comm'r, infra*. Improving the timeliness of any assessments may also reduce the need for the IRS to enforce summonses when a case is docketed in the Tax Court. In addition, the IRS could rely on the discovery process, rather than enforcement of previously issued administrative summonses, when cases are docketed in the Tax Court. As noted above, it is unclear if these alleged purposes would be improper. In any event, the IRS should avoid any appearance of impropriety.

15 *United States v. Woods*, 134 S. Ct. 557 (2013), *rev'g* 471 F. App'x 320 (5th Cir. 2012), *aff'g* 794 F. Supp. 2d 714 (W.D. Tex. 2011).

16 IRC §§ 6662(b), 6662(e)(1)(A), and 6662(h)(1).

17 Treas. Reg. § 1.6662–5(g).

18 IRC § 6662(h); Treas. Reg. § 1.6662–5(g). For transactions entered into after March 30, 2010, a 40 percent penalty also applies to transactions that lack economic substance, potentially reducing the importance of determining whether an amount was disallowed on the basis of a gross valuation misstatement or a lack of economic substance. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111–152, § 1409, 124 Stat. 1029, 1067-1070 (2010) (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).

19 *Woods*, 794 F. Supp. 2d at 717.

20 *Id*. at 717-19.

21 *Woods*, 471 F. App'x at 320.

22 Pub. L. No. 97-248, Title IV, 96 Stat. 648 (1982) (codified at IRC §§ 6221–6232).

partnership items and "the applicability of any penalty … which relates to an adjustment to a partnership item."[23] The court reasoned that the partner-level gross valuation misstatement penalty "relates to" the determination that the partnerships are shams because the trigger for the partners' valuation overstatement calculation is the conclusion that a sham partnership has zero basis. Thus, it held that the district court had jurisdiction to determine if the penalty could apply to the partners.

The Supreme Court rejected Mr. Woods's argument that a penalty cannot "relate to" a partnership-item adjustment if it requires a partner-level determination, such as a determination of the partner's outside basis. The Court observed that several statutory provisions assume a penalty can relate to a partnership-item adjustment even if the IRS must make partner-level determinations before it may impose the penalty.[24] Thus, it concluded that TEFRA authorizes courts in partnership-level proceedings to determine that a penalty could result from an adjustment to a partnership item, even if actually imposing the penalty may also require other partner-level determinations.[25]

Finally, the Supreme Court held that the gross valuation misstatement penalty provisionally applied to the partners. It rejected the Fifth Circuit's premise that the total disallowance of a deduction is inconsistent with the gross valuation misstatement penalty. It also rejected the taxpayer's argument that the valuation misstatement penalty applies only to factual misrepresentations about an asset's worth or cost, not to misrepresentations that rest on legal errors (like the use of a sham partnership).[26] According to the Supreme Court, the statute references both "value" and "adjusted basis," and "adjusted basis" is a legal term. Thus, both factual and legal errors may trigger the penalty.[27]

This case is significant because it abrogates precedent that made it difficult for the IRS to impose the 40 percent gross valuation misstatement penalty in TEFRA cases involving sham partnerships.[28] Following this decision, if a court in a partnership proceeding makes a "provisional" determination that a penalty applies to the partners, the IRS could then assess the penalty without issuing a deficiency notice. If it did,

23 IRC § 6226(f).

24 *See* IRC § 6664(c)(1) (requiring omissions from income to be "substantial" enough in comparison to a person's overall income to trigger certain penalties); IRC § 6230(a)(2)(A)(i) (requiring the IRS to use deficiency proceedings for computational adjustments that rest on "affected items which require partner level determinations (other than penalties ... that relate to adjustments to partnership items)."); IRC § 6230(c)(4) (stating that while a partnership-level determination "concerning the applicability of any penalty ... which relates to an adjustment to a partnership item" is "conclusive" in a subsequent refund action, that does not prevent the partner from "assert[ing] any partner level defenses that may apply.").

25 For example, the IRS would have to adjust each partner's outside basis before it could impose the gross valuation misstatement penalty based on an outside basis overstatement. Moreover, each partner would remain free to raise, in subsequent, partner-level proceedings, reasons why the penalty should not be imposed on him or her specifically.

26 *Woods*, 134 S. Ct. at 566.

27 Because the Court based its decision on statutory language, it did not analyze legislative history. Moreover, it commented that the Joint Committee on Taxation's General Explanation (*i.e.*, the Blue Book) has the same weight as a law review article—relevant only to the extent persuasive. *Woods*, 134 S. Ct. at 568.

28 For prior coverage of these issues, see, *e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress 574–76, which discussed *Belmont* and *Tigers Eye Trading, LLC v. Comm'r*, 138 T.C. 67 (2012). In *Belmont*, the U.S. Court of Appeals for the Fifth Circuit held that the 40 percent gross valuation misstatement penalty did not apply because the IRS totally disallowed the loss. *Belmont Invs., LLC v. United States*, 679 F.3d 339, 347–48 (5th Cir. 2012). In *Tigers Eye*, the U.S. Tax Court held that it had jurisdiction to determine the partners' outside bases and accuracy-related penalties in a partnership-level proceeding, notwithstanding a seemingly contrary holding by the court to which an appeal would lie (a holding by the Court of Appeals for the D.C. Circuit in *Petaluma FX Partners, LLC v. Comm'r*, 591 F.3d 649 (D.C. Cir. 2010)). *Tigers Eye*, 138 T.C. at 132. As noted in the 2012 report, *Petaluma* was in accord with *Jade Trading, LLC v. United States*, 598 F.3d 1372 (Fed. Cir. 2010). *Belmont*, *Petaluma*, and *Jade* are all abrogated by *Woods*.

then the partners could not contest the penalty in court—or the IRS's determination (if any) concerning partner-level defenses—without first paying it.[29]

In *United States v. Quality Stores, Inc.*, the Supreme Court held that supplemental unemployment benefit (SUB) payments to involuntarily terminated employees were subject to Federal Insurance Contributions Act (FICA) taxes.[30]

In connection with its bankruptcy, Quality Stores made severance payments to employees who were involuntarily terminated, 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" within the meaning of IRC § 3121(a), but rather SUB payments that were not taxable under FICA.

By way of background, for SUB plans to supplement (rather than supplant) state unemployment benefits, it may be necessary to avoid having the SUB payments defined as "wages." Some states only provide unemployment benefits if terminated employees are not earning wages from their employers. If the payments are not wages for purposes of federal income tax (FIT) withholding, however, terminated employees could face significant tax liability at the end of the year because SUB payments are still taxable as income. In the IRS's view, only certain SUB payments that are coordinated with state unemployment benefits—not those at issue—are excluded from wages under FICA, as described in a series of revenue rulings.[31]

In this case, Quality Stores petitioned the bankruptcy court to obtain a refund. 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 severance payments were not wages for purposes of either FICA or FIT.[32]

According to the Court of Appeals for the Sixth Circuit, IRC § 3402(o) states that a severance payment is "treated as if it were a payment of wages," and by implication, not actually wages.[33] It reasoned that Congress allowed SUB payments (*i.e.*, a type of severance) to be treated as wages under IRC § 3402(o) to facilitate FIT withholding for taxpayers. Thus, the court held that SUB payments were not wages.

The Supreme Court disagreed, concluding that the severance payments at issue were wages under a plain reading of the statute.[34] It reasoned that severance payments, like traditional wages, varied based on factors such as length of service, function, and seniority. Moreover, it observed that during a brief period Congress had specifically exempted certain severance payments from the definition of wages.[35] If severance payments were not wages, then repeal of that exemption would have been superfluous.

29 IRC § 6230(a).

30 *United States v. Quality Stores, Inc.*, 134 S. Ct. 1395 (2014), *rev'g* 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).

31 *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).

32 According to the Court of Appeals for the Sixth Circuit, Congress adopted a definition of "wages" for FIT purposes that is nearly identical to the definition of "wages" included in FICA. *Quality Stores*, 693 F.3d at 613 (citing *Rowan Cos. v. United States*, 452 U.S. 247, 255–57 (1981)).

33 As noted above, 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.

34 *Quality Stores*, 134 S. Ct. at 1399-1400.

35 *Id*. at 1401 (citing Social Security Act Amendments of 1939, 53 Stat. 1384, which Congress repealed in 1950).

Next, the Court rejected the argument that if severance payments were wages, then IRC § 3402(o)'s[36] directive to treat them "as if" wages would be superfluous. It reasoned that when Congress enacted IRC § 3402(o), it was aware that only some severance payments were treated as wages pursuant to IRS rulings, but sought to treat all severance payments as wages to prevent workers from facing large tax liabilities at the end of the year. In other words, to the extent IRC § 3402(o) suggests that some severance payments might be excluded from wages (*i.e.*, certain SUB payments coordinated with state unemployment benefits) it does not suggest that all severance payments are excluded.[37]

Finally, the Court reaffirmed "that the meaning of 'wages' should be in general the same for income-tax withholding and for FICA calculations."[38] However, it expressly declined to address the validity of current IRS rulings that exempt from the FICA wage base SUB payments that are coordinated with state unemployment benefits because such payments were not at issue.[39]

This case is significant because it clarifies that severance payments (including SUB payments) that are not coordinated with state unemployment benefits are wages for both FIT and FICA purposes. It is also significant because it leaves unanswered questions about the validity of the IRS's conclusion, set forth in Revenue Rulings 56-249 and 90-72, that SUB payments that are coordinated with state unemployment benefits are not subject to FICA. Moreover, it is unclear if states will seek to use the Supreme Court's holding—that SUB payments are wages—to reduce unemployment benefits to workers eligible for SUB payments.

In *Loving v. Internal Revenue Service*, the United States Court of Appeals for the District of Columbia Circuit held that the Treasury Department lacked authority to regulate the conduct of registered tax return preparers.[40]

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.[41] It issued them pursuant to 31 U.S.C. § 330(a)(1), which grants the Secretary of the Treasury authority to "regulate the practice of representatives of persons before the Department of the Treasury." Sabina Loving and two other preparers challenged the regulations as unauthorized. The District Court for the District of Columbia agreed, and the U.S. Court of Appeals for the District of Columbia Circuit affirmed.[42]

36 In relevant portion, the statute states that "any supplemental unemployment compensation benefit paid to an individual … shall be treated as if it were a payment of wages." IRC § 3402(o).

37 By analogy, "[T]he statement that 'all men shall be treated as if they were six feet tall does not imply that no men are six feet tall." *Quality Stores*, 134 S. Ct. at 1402 (quoting *CSX Corp. v. United States*, 518 F.3d 1328, 1342 (Fed. Cir. 2008)).

38 *Quality Stores*, 134 S. Ct. at 1405.

39 *Id*.

40 *Loving v. Comm'r*, 742 F.3d 1013 (D.C. Cir. 2014), *aff'g* 920 F. Supp. 2d 108 (D.D.C. 2013).

41 *See* T.D. 9527, 76 Fed. Reg. 32,286, 32,299 (June 3, 2011). They are sometimes called "unenrolled" preparers. *See* 26 C.F.R. § 601.502(b)(5)(iii); Rev. Proc. 81–38, 1981-2 C.B. 592, *modified and superseded by* Rev. Proc. 2014–42, 2014–29 I.R.B. 192 for tax returns and claims for refund prepared and signed (or prepared if there is no signature space on the form) after December 31, 2015. Attorneys, certified public accountants, enrolled agents and enrolled actuaries are already subject to IRS regulation under Circular 230. The National Taxpayer Advocate has long championed the regulation of return preparers. *See, e.g.*, 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*).

42 For a discussion of the district court decision, see National Taxpayer Advocate 2013 Annual Report to Congress 334–336 (Significant Cases); National Taxpayer Advocate 2013 Annual Report to Congress 61–74 (Most Serious Problem: *Regulation of Return Preparers*). *See also* Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 139 Tax Notes 767 (2013).

Agency regulations are generally given *Chevron* deference and upheld unless they (1) contradict the unambiguously stated intent of Congress or (2) adopt an unreasonable construction of an ambiguous statute.[43] The IRS argued that the terms "practice" and "representative" were ambiguous and that it reasonably interpreted them as covering tax return preparers. Thus, the court should give the agency *Chevron* deference.

The court disagreed, concluding that the statute unambiguously fails to authorize the government to regulate tax return preparers making the regulations inconsistent with congressional intent – failing the first prong of *Chevron*. It went on to conclude that even if the statute was ambiguous, the regulations were unreasonable in light of the statute's text, history, structure, and context – failing the second prong.

First, the court reasoned that the term "representative" is commonly defined as an agent authorized to act for someone else. However, a preparer is not necessarily authorized to act for the taxpayer unless he or she obtains a power of attorney. Thus, a preparer is not necessarily a "representative."

Second, the court observed that the statute references "practice … before the Department." It reasoned that unlike practicing in the abstract, practice "before" an agency generally refers to an adversarial proceeding. Although commentators had argued that filing a return constitutes presenting a case before the agency, the IRS did not make that argument.[44] Rather, the IRS argued that the statutory language in 31 U.S.C. § 330(a)(2), which authorizes it to consider a person's competency to "assist persons in presenting cases," was irrelevant in determining the meaning of "practice" because Congress meant to use the disjunctive "or" rather than the conjunctive "and" in connecting the list of attributes a person must have before being admitted as a "representative to practice."[45]

The court found the IRS's argument unpersuasive and inconsistent with the original statutory language enacted in 1884 and re-codified in 1982 "without substantive change."[46] It covered "agents, attorneys, or other persons representing claimants before … [the Treasury]" and authorized the Treasury to require them to be competent to "assist such claimants in the presentation of their cases," presumably cases presented in an adversarial proceeding.[47] The court also noted that subsequent Congresses had enacted many specific penalties targeting specific misconduct by tax return preparers with specific sanctions – sanctions that would have been unnecessary if the IRS was already authorized to penalize preparers for the same conduct.[48] Thus, the court concluded that preparers do not necessarily "practice … before the Department," within the meaning of the statute.

As further support, the court cited the *Brown & Williamson* principle "that courts should not lightly presume congressional intent to implicitly delegate decisions of major economic or political significance."[49] Finally, it cited the IRS's past approach to the statute—the IRS never suggested that it possessed this

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

44 *See, e.g.*, Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 139 Tax Notes 767 (2013); Lawrence B. Gibbs, *Loving v. IRS: Treasury's Authority to Regulate Tax Return Preparers*, 141 Tax Notes 331 (2013).

45 *Loving*, 742 F.3d at 1018-19.

46 Act of Sept. 13, 1982, Pub. L. No. 97-258, 96 Stat. 877 (1982).

47 Act of July 7, 1884, ch. 334, sec. 3, 23 Stat. 258 (1884).

48 *Loving*, 742 F.3d at 1020. 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, 1586–87 (2004).

49 *Loving*, 742 F.3d at 1021 (citing *F.D.A. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 160 (2000)).

authority before.[50] Accordingly, the court held that the Treasury Department lacked statutory authority to issue and enforce the regulations governing registered tax return preparers.

This case is significant because it affects hundreds of thousands of return preparers and the taxpayers they serve.[51] As a result of this litigation, the Treasury Department and the IRS have established an Annual Filing Season Program designed to encourage tax return preparers who are not attorneys, certified public accountants, or enrolled agents to improve their knowledge of tax law and to protect taxpayers from preparer errors.[52] On July 15, 2014, the American Institute of Certified Public Accountants (AICPA) filed suit in the U.S. District Court for the District of Columbia, challenging this new voluntary program.[53] The proliferation of litigation regarding the IRS's authority to regulate tax return preparers is an indication that Congress should take action.[54]

In *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, the United States Court of Appeals for the First Circuit held that a private equity firm was engaged in a "trade or business" for purposes of the Employee Retirement Income Security Act of 1974 (ERISA).[55]

Marc Leder and Roger Krouse founded private equity companies, including Sun Fund III and Sun Fund IV (the Sun Funds), to acquire poorly managed companies, install competent management, and sell them within two to five years. Mr. Leder and Mr. Krouse owned affiliated companies, including Sun Capital Advisors, Inc. (collectively, SCAI Companies), and retained control of the Sun Funds' general partners (GPs).

Although the Sun Funds had no employees, SCAI Companies provided employees and consulting services to portfolio companies for a fee. The GPs would reduce the fees they charged the Sun Funds for managing portfolio companies by the amount the portfolio companies paid the SCAI Companies.

The Sun Funds acquired Scott Brass Inc. (SBI). SBI ultimately stopped contributing to its employees' multiemployer pension plan, the Trucking Industry Pension Fund (TPF), and SBI was forced into bankruptcy by its creditors. TPF asserted that the Sun Funds were liable for SBI's unpaid pension contributions under the Employee Retirement Income Security Act of 1974 (ERISA).[56] The Sun Funds filed suit seeking a declaratory judgment that they were not liable, in relevant part, because they were not in a "trade or business," as explained below. The district court agreed, citing tax cases for the proposition that mere investment activity is not a trade or business. However, the United States Court of Appeals for the First Circuit reversed and remanded on this point.

By way of background, entities under common control may be jointly and severally liable as a "single employer" under ERISA if they are engaged in a "trade or business."[57] The Pension Benefits Guarantee

50 The court cited an IRS publication and testimony before Congress by the head of the IRS Criminal Investigation Division and the National Taxpayer Advocate as evidence that the IRS had not previously claimed it had authority to regulate preparers.

51 *Loving v. Comm'r*, 742 F.3d at 1021.

52 Rev. Proc. 2014–42, 2014-29 I.R.B. 192.

53 The U.S. District Court for the District of Columbia dismissed the case after determining the AICPA lacked standing. *AICPA v. IRS*, No. 14-1190 (D.D.C. Oct. 27, 2014).

54 *See* National Taxpayer Advocate Fiscal Year 2015 Objectives Report to Congress 71.

55 *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, 724 F.3d 129 (1st Cir. 2013), *rev'g and remanding* 903 F. Supp. 2d 107 (D. Mass 2012), *cert. denied*, 134 S. Ct. 1492 (Mar. 3, 2014) [*hereinafter Sun Capital*].

56 Pub. L. No. 93-406, 88 Stat. 829 (codified at 29 U.S.C. § 1001 *et seq.*), *as amended by* Multiemployer Pension Plan Amendments Act of 1980, Pub. L. No. 96-364, 94 Stat. 1208 (*codified at* 29 U.S.C. § 1381 *et seq.*).

57 29 U.S.C. § 1301(b)(1).

Corporation (PBGC) is authorized to issue regulations defining trade or business "consistent and coextensive with regulations prescribed for similar purposes by the Secretary of the Treasury under section 414(c) of Title 26," but it has not issued any such regulations.[58]

Instead, the PBGC issued an unpublished ruling. The ruling concluded that while a fund conducting mere investment activity is not a trade or business, a fund that acquires companies to turn them around and sell them is a trade or business because it is for the "primary purpose of income or profit" and conducted with "continuity and regularity."[59] PBGC's "investment plus" test was purportedly derived from *Groetzinger*, a tax case decided by the Supreme Court.[60] Although PBGC argued in an amicus brief that its ruling should be given deference, neither the district court nor the First Circuit gave any special deference to the PBGC.[61] Nonetheless, all three courts analyzed tax cases to determine the statutory meaning of a "trade or business" under ERISA.[62]

The First Circuit ultimately adopted an "investment plus" test in concluding that Sun Fund IV was a trade or business, and thus liable for SBIs unpaid pension contributions. It acknowledged that the absence of trade or business income on the Sun Funds' tax returns cut against treating them as a trade or business. However, it reasoned that Sun Fund IV would receive a direct economic benefit from its active involvement in the management of SBI that a passive investor would not ordinarily derive—an offset to the management fee payable to its general partner.[63]

This case may be significant in two respects. First, it confirms that an agency's unpublished determinations are not necessarily entitled to any special deference in subsequent litigation. Second, it suggests that when a passive investor receives a direct economic benefit as a result of services its agents or affiliates provide to one or more portfolio companies, the investor may be treated as engaged in a trade or business for purposes of ERISA, and potentially, the IRC.[64] If otherwise passive investors in private equity funds are treated as engaged in a trade or business for tax purposes, some could be subject to additional taxes (*e.g.*, foreign investors, tax-exempt investors, and managers holding "profits" interests). This case has prompted significant debate in the tax community.[65]

58 29 U.S.C. § 1301(b)(1).

59 *Sun Capital*, 724 F.3d at 139.

60 *Id*. (citing *Comm'r v. Groetzinger*, 480 U.S. 23 (1987)).

61 Although the PBGC argued in an amicus brief that its letter should be entitled to *Auer* deference under *Auer v. Robbins*, 519 U.S. 452 (1997)—deference to an agency's interpretation of its own regulations—the First Circuit concluded that it was entitled to *Skidmore* deference—deference only to the extent its underlying reasoning has the power to persuade—under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). The court reasoned that *Auer* deference is inappropriate where significant monetary liability would be imposed for conduct that took place at a time when that party lacked fair notice of the interpretation at issue. *Sun Capital*, 724 F.3d at 140. It also noted that the PBGC had not actually defined trade or business in its regulations and that *Auer* deference is inapplicable where regulations simply parrot the statute under the "anti-parroting" principle. *Id*. at 141.

62 However, the First Circuit expressly rejected "the proposition that, apart from the provisions covered by 26 U.S.C. § 414(c), interpretations of other provisions of the Internal Revenue Code are determinative." *Sun Capital*, 724 F.3d at 144.

63 The court remanded the case for further factual development because it could not determine if Sun Fund II received a similar economic benefit from the offset. *Sun Capital*, 724 F.3d at 143 n.20.

64 *See, e.g.*, Tax Analysts, *ABA Meeting: Sun Capital May Provide Opportunity to Reassess 'Trade or Business,' Treasury Says*, 2013 TNT 184-5 (Sept. 23, 2013) (quoting Craig Gerson, Attorney-Adviser, Treasury Office of Tax Legislative Counsel, as saying the decision "may give us [the Treasury Department] an opportunity to reassess what trade or business means" for tax purposes). As for the importance of the decision under ERISA, Sun Funds' appeal asserts that, "by significantly deterring investment funds from providing … financing to distressed companies with multiemployer pension plan obligations, the First Circuit's opinion will deprive such companies of their primary avenue for avoiding bankruptcy." Petition for a Writ of Certiorari at 33–34, *Sun Capital Partners III, LP v. TPF*, 134 S. Ct. 1492 (2014) (No. 13-648).

65 *See, e.g.*, Tax Analysts, *Transcript Available of Tax Analysts' Forum on Implications of Sun Capital*, 2013 TNT 190-29 (Oct. 1, 2013) (roundtable discussion of "the tax implications of the First Circuit's trade or business determination in *Sun Capital*").

In *Morehouse v. Commissioner*, the United States Court of Appeals for the Eighth Circuit held that Conservation Reserve Program (CRP) payments received by an investor were not subject to Self-Employment Contributions Act ("SECA") taxes.[66]

Mr. Morehouse, a Minnesota investor who owned farmland in South Dakota, received annual rents under the Conservation Reserve Program (CRP) from the U.S. Department of Agriculture (USDA) in exchange for implementing a conservation plan.[67] He hired a farmer to carry out most of the plan, but performed minor activities such as purchasing seed and regularly inspecting the property. He reported the CRP payments as rental income from real estate. The IRS issued a notice of deficiency, determining that the CRP payments were subject to Self-Employment Contributions Act (SECA) tax under IRC § 1401.

Generally, SECA tax is imposed on a taxpayer's net earnings from self-employment, which usually include the gross income derived from any trade or business carried on by the taxpayer either personally or through agents or employees, minus qualifying deductions.[68] However, Congress excluded certain "rentals from real estate" from SECA tax.[69]

According to Revenue Ruling 60-32, payments under the Soil Bank Act (a predecessor of the CRP) received by a person who does not materially participate in the production of commodities (*i.e.*, farming), or management of such production, qualify as "rentals from real estate."[70] Subsequently, in *Wuebker*, the United States Court of Appeals for the Sixth Circuit held that a farmer was subject to SECA tax on CRP payments because the farmer's obligations under the CRP contract were so similar to his normal farming activities that they did not rise to the level of "occupancy or use" by the government needed to qualify for the rentals from real estate exception.[71]

Following *Wuebker*, the IRS issued Notice 2006-108, asking for comments on a proposal to obsolete Revenue Ruling 60-32 on the basis that CRP payments could not qualify for the "rentals from real estate" exclusion because they could not be considered rents (even if paid to non-farmers).[72] However, Revenue Ruling 60-32, was never officially obsoleted and therefore still represents the IRS's official position.

Mr. Morehouse argued that the CRP payments were not includible in his self-employment income because they were not derived from (*i.e.*, had no nexus to) his trade or business. Alternatively, he argued that the CRP payments were excluded from SECA tax as rentals from real estate.

66 *Morehouse v. Comm'r*, 769 F.3d 616 (8th Cir. 2014), *rev'g* 140 T.C. 350 (2013).

67 According to a 2013 USDA news release,

> [P]roducers will receive payments on almost 700,000 CRP contracts on 390,000 farms covering 26.8 million acres. In exchange for a yearly rental payment provided by USDA on contracts ranging from 10 to 15 years, farmers and ranchers enrolled in CRP agree to remove environmentally sensitive land from agricultural production and plant grasses or trees that will improve water quality and improve waterfowl and wildlife habitat.

USDA Farm Service Agency, *USDA Issues Conservation Reserve Program Rental Payments, Direct Payments and ACRE Payments*, USDA News Release 0181.13 (Oct. 21, 2013).

68 IRC §§ 1402(a) (defining "net earnings from self-employment"), 1402(b) (defining "self-employment income"), and 1402(c) (defining "trade or business" by reference to IRC § 162); Treas. Reg. § 1.1402(a)-2(b) (providing that the"[t]he trade or business must be carried on by the individual, either personally or through agents or employees.").

69 IRC § 1402(a)(1).

70 Rev. Rul. 60-32, 1960–1 C.B. 23. *See also* Rev. Rul. 65-149, 1965-1 C.B. 434 (1965) ("if this income is received by a farm operator, or a landlord who materially participates, it should be treated as self-employment income. If it is received by a landlord who does not materially participate, it should be treated as rental income and excluded from net earnings from self-employment.").

71 *Wuebker v. Comm'r*, 205 F.3d 897 (6th Cir. 2000).

72 Notice 2006-108, 2006-2 C.B. 1118.

Following the logic of Notice 2006-108, the Tax Court agreed with the IRS. It reasoned that because Mr. Morehouse's receipt of CRP payments depended on his continued maintenance of his land in accordance with the CRP contracts, his participation in the CRP was a trade or business (and not a passive investment) with the requisite nexus to the CRP payments. It also concluded the CRP payments were not rents from real estate.[73]

The United States Court of Appeals for the Eighth Circuit reversed. It distinguished this case from *Wuebker* on the basis that Mr. Morehouse was not a farmer, characterizing the IRS's extension of *Wuebker*'s rationale to non-farmers in Notice 2006-108 as "problematic."[74] It went on to observe that Notice 2006-108 contained "little analysis" and deferred to the IRS's "reasonable" and "longstanding" judgment expressed in Revenue Ruling 60-32, concluding that CRP payments made to non-farmers, such as Mr. Morehouse, constitute rentals from real estate, which are excluded from SECA tax.[75]

This case is significant because it clarifies that CRP payments received by non-farmer investors can qualify for the "rentals from real estate" exclusion from SECA tax. Also notable is that the IRS made, and both the Tax Court and the Eighth Circuit Court of Appeals allowed, arguments inconsistent with the IRS's official published position, as reflected in Revenue Ruling 60-32.[76]

In *BASR Partnership v. United States*, the Court of Federal Claims held that a preparer's fraud could not extend the normal three-year statute of limitations for the IRS to assess a tax.[77]

The BASR partnership entered into a tax shelter that it and its partners reported on returns filed in 2000. In 2010, the IRS issued a Notice of Final Partnership Administrative Adjustment (FPAA) to BASR and assessed additional tax against the partners. The promoter of the tax shelter had the intent to evade tax, but BASR and its partners did not. BASR argued that the FPAA was time-barred because the promoter's "intent to evade" did not extend the assessment statute of limitations for the partners.

Under IRC § 6501, the IRS generally must assess any additional tax within three years after a return is filed,[78] except "in the case of a false or fraudulent return with the intent to evade tax."[79] Some

73 The Tax Court also reasoned that Congress had expressed its intent not to exclude all CRP payments when it enacted legislation in 2008 that specifically excluded CRP payments from the calculation of net earnings from self-employment in certain limited circumstances. Legislation enacted in 2008 specifically excluded CRP payments from the calculation of net earnings from self-employment where the taxpayer is receiving Social Security retirement or disability payments, seemingly based on the assumption that they might otherwise be subject to SECA tax. Food, Conservation, and Energy Act of 2008, Pub. L. No. 110–246, § 15301(a), 122 Stat. 1651, 2263 (codified at IRC § 1402(a)(1)).

74 *Morehouse v. Comm'r*, 769 F.3d at 621.

75 *Id*.

76 The IRS is generally bound by its published positions. *See Rauenhorst v. Comm'r*, 119 T.C. 157, 172-83 (2002) ("Respondent's counsel may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law … we treat the Commissioner's position in …[the revenue ruling at issue], as a concession…. [internal citations omitted]"); CCDM 35.7.2.1.8(8) (Aug. 11, 2004) ("Respondent may not argue against his published position"). However, the public was on notice that the IRS was reconsidering its position because of Notice 2006-108.

77 113 Fed. Cl. 181 (2013), *appeal docketed*, No. 14-5037 (Fed. Cir. Jan. 7, 2014).

78 IRC § 6501(a).

79 IRC § 6501(c)(1). A similar exception applies to "a willful attempt in any manner to defeat or evade tax." IRC § 6501(c)(2).

authority suggests that even a preparer's "intent to evade" may trigger this exception for fraud.[80] Under IRC § 6229(a), however, the IRS generally must assess any additional tax attributable to any partnership item (or affected item) within three years after the partnership return is filed.[81] The period is extended if "any partner has, with the intent to evade tax, signed or participated directly or indirectly in the preparation of a partnership return which includes a false or fraudulent item."[82]

First, BASR argued that IRC § 6229(c), which specifically applies to partnership items, displaces IRC § 6501(c) with respect to them, and any other interpretation would render IRC § 6229(c) superfluous. Under this theory, the FPAA was time-barred because the partners did not have the requisite intent to extend the assessment period. The government countered that IRC § 6229 could extend, but not shorten, the limitations period provided by IRC § 6501. The court agreed with the government on this point.

Next, the government argued that the assessment was authorized under IRC § 6501(c). It reasoned that the promoter's intent to evade tax (or status as an agent of the taxpayer) was sufficient to extend the limitations period. It cited the maxim that statutes of limitations are strictly construed in favor of the government.[83] The government also advanced public policy arguments that the taxpayer's willful ignorance in failing to verify the accuracy of the returns should not be rewarded, and that fraud, whether perpetrated by the taxpayer or a preparer, is particularly difficult for the IRS to detect within the normal limitations period.

The court disagreed with the government. It reasoned that because the language of IRC § 6501(a) is expressly limited to a return filed by "the taxpayer," the fraudulent intent referenced in IRC § 6501(c) is "by implication limited to fraud by the taxpayer."[84] The court cited the legislative history of IRC § 6501(c)(1) and similar statutory language contained in a predecessor statute (*i.e.*, language used to both extend the limitations period and trigger a fraud penalty) as supporting this interpretation. Thus, it held the FPAA was time-barred under IRC § 6501(a).

This case is significant because it suggests that innocent victims of preparer fraud may not lose the benefit of the three-year assessment statute of limitations.

In *Kaplan v. United States*, the Court of Federal Claims held it had jurisdiction to prevent "manifest injustice," even though the plaintiff could not establish he had paid enough to trigger jurisdiction under 28 U.S.C. § 1491(a)(1).[85]

Merchants Restaurant failed to pay its employment taxes for three quarters. Under IRC § 6672, "[a]ny person required to collect, truthfully account for, and pay over" employment taxes (*i.e.*, a "responsible person") who willfully fails to do so is personally liable for a trust fund recovery penalty. The IRS assessed $86,902.76 in trust fund recovery penalties against Mr. Kaplan. He claimed that he was merely an

80 *See, e.g.*, *Allen v. Comm'r*, 128 T.C. 37 (2007) (holding that even where a taxpayer had no intent to evade tax, his preparer's intent to evade tax kept the assessment period open). Some have argued that a preparer's intent does not trigger the fraud exception. *See, e.g.*, Bryan Camp, *Tax Return Preparer Fraud and the Assessment Limitations Period*, 116 Tax Notes 687 (2007); Bryan Camp, *Presumptions and Tax Return Preparer Fraud*, 120 Tax Notes 167 (2008). *See also* Jeremiah Coder, *The IRS's Misguided Fraud Whodunit*, 2012 TNT 190-1 (2012).

81 If filed early, however, the period begins on the last day for filing the partnership return for that year (without regard to extensions). IRC § 6229(a).

82 IRC § 6229(c). The extended period is unlimited for signing or "participating" partners and six years for others. *Id.*

83 *BASR*, 113 Fed. Cl. at 191 (quoting *Badaracco v. Comm'r*, 464 U.S. 386 (1984)).

84 *Id.*

85 *Kaplan v. United States*, 115 Fed. Cl. 491 (2014), *vacating* 113 Fed. Cl. 84 (2013).

investor, not a responsible person. Mr. Kaplan made three $100 payments toward the penalties associated with each of the quarters and filed a claim for refund in order to establish jurisdiction to contest the assessment in court. When the IRS denied his claim, Mr. Kaplan petitioned the Court of Federal Claims, seeking a determination that he was not liable for the penalties.

In general, under the *Flora* rule, neither federal district courts nor the Court of Federal Claims have authority (under 28 U.S.C. § 1346(a)(1) or 28 U.S.C. § 1491(a)(1), respectively) to decide the merits of a tax refund suit, unless the taxpayer-plaintiff has paid the tax in full.[86] Because a trust fund recovery penalty is "divisible" (*i.e.*, relating to separate transactions or events), the *Flora* rule only requires the plaintiff to pay the penalty as to the wages of a single employee for one quarter.[87]

In this case, the government filed a motion to dismiss Mr. Kaplan's complaint because he could not show that his payments satisfied the entire assessment for at least one employee per quarter.[88] Mr. Kaplan argued his payments were sufficient based on estimates from one week's worth of payroll records. The court initially disagreed and dismissed the case.[89]

On reconsideration, the court determined that Mr. Kaplan was caught in a "catch-22" because in order to prove that he was not a responsible person he would first have to produce evidence (*i.e.*, the records required to ascertain the amount needed to satisfy the jurisdictional requirement), which he could only obtain if he were a responsible person. The inequity of his situation was magnified by the government's inability to state what minimum payment would be sufficient. Therefore, to prevent a "manifest injustice," the court accepted his payments as sufficient to establish jurisdiction.

This case is significant to the extent it signals that other courts may relax the *Flora* rule with respect to others caught in a similar catch-22. However, the case may be somewhat unique due to Mr. Kaplan's diligent, but unsuccessful attempts to obtain the payroll information needed to establish that his payments were sufficient and also the IRS's own inability to estimate what payments would have been sufficient.

In *Florida Bankers Assoc. v. United States Department of Treasury*, the District Court for the District of Columbia upheld regulations requiring banks to report interest paid to certain non-resident aliens.[90]

In 2012, the Treasury Department issued final regulations requiring banks to report interest they paid on deposits maintained at U.S. offices to residents of any of the 70 countries that had entered into information exchange agreements with the United States.[91] The preamble to the regulations stated that the IRS needed this information so that it could provide reciprocal information to foreign countries pursuant to information exchange agreements.

The IRS had received comments on the proposed regulations raising concerns that the reporting requirement would negatively affect U.S. banks because customers would close accounts due to confidentiality

86 *See Flora v. United States*, 362 U.S. 145 (1960); *Shore v. United States*, 9 F.3d 1524 (Fed. Cir. 1993).

87 *See, e.g., Psaty v. United States*, 442 F.2d 1154 (3d Cir. 1971); *Steele v. United States*, 280 F.2d 89 (8th Cir. 1960).

88 The IRS could have accepted a "representative amount," but the IRS may have concluded that Mr. Kaplan's payment was not sufficiently representative. *See* IRM 8.25.1.7.4.2 (Oct. 14, 2014) ("[I]f the amount required cannot be accurately determined, the Service may accept a representative amount.").

89 *Kaplan*, 113 Fed. Cl. at 84.

90 *Florida Bankers Assoc. v. United States Department of Treasury*, 113 A.F.T.R.2d (RIA) 498 (D.D.C. 2014), *appeal docketed*, No. 14-5036 (D.C. Cir. Feb. 11, 2014).

91 T.D. 9584, 77 Fed. Reg. 23,391 (Apr. 19, 2012) (codified, in relevant part, at Treas. Reg. § 1.6049-4(b)(5)(i)).

concerns.[92] In the preamble to the final regulations, the IRS discussed existing legal and procedural safeguards, such as provisions in its exchange agreements requiring foreign governments to treat the information as secret. The IRS concluded that because of these safeguards, the regulations "should not significantly impact the investment and savings decisions of the vast majority of nonresidents who are aware of and understand these safeguards and existing law and practice."[93]

The Florida and Texas Bankers Associations challenged the regulations as violating the Administrative Procedure Act (APA) and the Regulatory Flexibility Act (RFA).[94] First, the government argued that the plaintiffs had no standing, and if they did, the Anti-Injunction Act (AIA) or the Declaratory Judgment Act (DJA) barred the court from hearing the case.[95] The court concluded, however, that the association-plaintiffs had standing.[96] Next, the court found that the AIA and the DJA were inapplicable because they only bar suits that would restrain the assessment or collection of any tax. The court acknowledged that a violation of the regulations could trigger a penalty that would be treated as a tax, but it reasoned that this suit was to bar implementation of reporting requirements before any tax (or penalty) had been incurred.[97]

However, the court upheld the regulations. Under the APA, a court will set aside agency actions that are arbitrary and capricious.[98] According to the court, "[t]he agency must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made" in order to satisfy the APA's arbitrary and capricious standard.[99] Under the RFA, the agency must either analyze the proposed rule's impact on small businesses or certify that the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities.[100] The banking associations argued that the regulations would cause more harm to banks (including small banks) than the IRS anticipated, and that the final regulations did not articulate a satisfactory explanation for not taking additional steps to address the risk of capital flight.

92 77 Fed. Reg. 23,391, 23,392 (Apr. 19, 2012).

93 77 Fed. Reg. 23,391, 23,393 (Apr. 19, 2012). One commentator countered that: (a) the preamble does not conclude that the vast majority of nonresident aliens would not withdraw their funds from U.S. banks, but rather that funds would not be withdrawn by "the vast majority of nonresidents *who are aware of and understand these safeguards and existing law and practice*," (b) most people would probably not take the time to learn about the safeguards, and (c) residents of some treaty partners such as China, Egypt, Indonesia, Mexico, Pakistan, Panama, the Russian Federation, and Venezuela, might reasonably fear their governments would not respect the confidentiality provisions of a treaty. *See* Patrick J. Smith, *District Court Misapplies APA in Florida Bankers Association*, 142 Tax Notes 745 (2014).

94 Administrative Procedure Act (APA), 5 U.S.C. ch. 5 and ch. 7; and Regulatory Flexibility Act (RFA), 5 U.S.C. ch. 6.

95 IRC § 7421(a) (AIA); 28 U.S.C. § 2201 (DJA). As the DJA is generally interpreted as baring the same suits as the AIA, the court did not analyze them separately.

96 The government argued the associations lacked standing because they did not submit an affidavit identifying a specific member who was injured by the regulation. *Florida Bankers Assoc.*, 113 A.F.T.R.2d (RIA) 498 at *5. The court reasoned that an affidavit is only required when the association's interest is not self-evident. *Id*. at *6. It found the association's interest self-evident, explaining,

> [P]laintiffs' member banks are directly regulated by the regulations being challenged. They are currently suffering from additional, allegedly unlawful reporting requirements, causing them injury. That injury would undoubtedly be redressed by abrogation of the regulations. Because such a lawsuit 'is germane to the organization[s'] purpose,' which involves policy advocacy on behalf of financial institutions, the Bankers Associations have standing … *Id*.

97 According to the court, "[T]he D.C. Circuit has confirmed that reporting requirements related to Chapter 61A of the Internal Revenue Code—as opposed to the associated penalties found in Chapter 68B—are not subject to the AIA or DJA." *Florida Bankers Assoc.*, 2014 U.S. Dist. LEXIS 3521 at *21 (citing *Foodservice and Lodging Inst., Inc. v. Regan*, 809 F.2d 842 (D.C. Cir. 1987)).

98 5 U.S.C. § 706(2)(A). The association-plaintiffs also argued the regulations failed under 5 U.S.C. § 706(2)(E) for lack of "substantial evidence" to support their conclusions, but the court concluded the "substantial evidence" standard inapplicable and that the challenge would have failed under that standard as well. *Florida Bankers Assoc.*, 2014 U.S. Dist. LEXIS 3521 at *24.

99 *Florida Bankers Assoc.*, 2014 U.S. Dist. LEXIS 3521 at *14 (quoting *Motor Vehicle Mfrs. Ass'n of United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983)).

100 5 U.S.C. §§ 603-605.

The court upheld the regulations under the APA because the IRS reasonably concluded that they would improve U.S. tax compliance, impose a minimal reporting burden on banks, and not cause any rational actor—other than a tax evader—to withdraw his funds from U.S. accounts. The regulations also withstood challenge under the RFA because the IRS reasonably concluded that they would not have a "significant" economic impact on a significant number of small entities. The court discounted the economic impact of capital flight as a speculative indirect economic effect that the government did not need to consider under the RFA.[101]

This case is significant to the extent it suggests that agencies do not need to consider secondary effects, such as capital flight, when promulgating rules under the RFA. In addition, this case confirms the viability of the APA and RFA as vehicles for challenging Treasury regulations and illustrates that the AIA and DIA do not shield regulations that do not directly impose a tax.

In *Corbalis v. Commissioner*, the U.S. Tax Court held that it had jurisdiction to review the IRS's denial of interest suspension under IRC § 6404(g), notwithstanding an IRS Revenue Procedure to the contrary.[102]

After the IRS made an audit adjustment to Mr. Corbalis' returns, he requested interest suspension under IRC § 6404(g). IRC § 6404(g) generally provides that if a taxpayer files a timely return and the IRS does not give the taxpayer timely notice of an additional liability and the basis for the additional liability, then the IRS "shall suspend" interest, provided certain other requirements are satisfied.

In certain circumstances, IRC § 6404(h) authorizes the Tax Court to review the IRS's "failure to abate interest under this section… if such action is brought within 180 days after… [the IRS's] final determination not to abate such interest." On October 11, 2012, the IRS issued Mr. Corbalis Letter 3477, *IRC 6404(g) Interest Suspension*, denying his request for interest suspension.[103] The letter stated that "[t]he judicial review provisions of IRC section 6404(h) do not apply to IRC section 6404(g). Therefore, you do not have appeal rights, nor may you petition the Tax Court for judicial review regarding this letter."[104] On November 9, 2012, Mr. Corbalis filed a protest, asserting the letter constituted a final determination which the Tax Court could review pursuant to its authority to review denials of requests for abatement under IRC § 6404(h).

The IRS filed a motion to dismiss, arguing that the Tax Court had no jurisdiction because IRC § 6404(h) only authorizes it to review a denial of interest "abatement" under IRC § 6404(e), not interest "suspension," under IRC § 6404(g). It cited Revenue Procedure 2005-38, which provides that no judicial review is available under IRC § 6404(h) where the IRS has failed to suspend interest under IRC § 6404(g), with one limited exception.[105] The exception may apply if the IRS's failure to suspend interest was the result of an unreasonable IRS error or delay in performing a ministerial or managerial act, the taxpayer filed a claim for abatement of the interest, and the claim was denied.[106] The exception did not apply in this case.

101 *Florida Bankers Assoc.*, 2014 U.S. Dist. LEXIS 3521 at *35-36 ("RFA calls for agencies to scrutinize only the regulations' direct impact, such as 'reporting, recordkeeping and other compliance requirements'—not indirect impacts caused by the actions of third parties like capital flight.").

102 *Corbalis v. Comm'r*, 142 T.C. No. 2 (2014).

103 Although the IRS also denied Mr. Corbalis' request for interest abatement, the parties agreed that the denial was not a final determination.

104 *Corbalis*, 142 T.C. No. 2, *3.

105 Rev. Proc. 2005-38 § 2.05, 2005-28 I.R.B. 81.

106 *Id*.

In addition, the IRS argued, in the alternative, that Letter 3477 was not a "final determination," which could trigger jurisdiction under IRC § 6404(h).

The Tax Court held it had jurisdiction to review the IRS's denial of interest suspension. It concluded that interest suspension is a category of abatement. It reasoned there is a strong presumption that administrative actions are subject to judicial review,[107] and the requirement in IRC § 6404(g) that the IRS "shall" suspend interest in appropriate circumstances weighed in favor of judicial review. The Tax Court gave Revenue Procedure 2005-38 no deference because it contained "no reasoning" to support its conclusion that with one limited exception, no judicial review of the failure to suspend interest is available to taxpayers. The court also found that Letter 3477 was a final determination for jurisdictional purposes under IRC § 6404(h). It reasoned that if the taxpayer had delayed filing a petition in the Tax Court, the IRS might have argued that the 180-day period for doing so had lapsed.

This case is significant because it confirms the Tax Court has jurisdiction to review denials of interest suspension under IRC § 6404(g). It is also significant because it suggests that revenue procedures and statements in IRS letters are not entitled to deference, particularly when they do not include any reasoning.

107 *Corbalis*, 142 T.C. No. 2, *8 ("…respondent's position ignores a strong presumption that the actions of an administrative agency are subject to judicial review." [Internal citations omitted.]).