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Taxation Section of the State Bar of California

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Message from the Chair

Kevan P. McLaughlin, McLaughlin Legal, APC

It is an exceptional honor and privilege to assume the role of Tax Procedure & Litigation Committee Chair for 2017-2018. Our last year was an exceptional one and I am extremely greatful to Carolyn M. Lee for her dedication and commitment to the Committee. I can only hope to carry the torch with a fraction of her level of exemplary leadership.

I am also thankful to the many others for their invovlement and invaluable assistance with the Committee, including: Executive Committee-Liason Courtney Hopley, Greenberg Traurig (San Francisco); Vice-Chair Stephen J. Turanchik, Paul Hastings (Los Angeles); and Section Coordinator Ellen Louie; and Jane Becker (Santa Cruz).

As the Committee moves into a new year, there are many developments that I hope you will share my enthusiasm for. As you are undoubtedly aware, the structure of California's tax procedure system has undergone a dramatic revision with the creation of the California Department of Tax and Fee Administration ("CDTFA") and Office of Tax Appeals ("OTA"). A great deal has been, and continues to be written on these topics. It is my goal for the Committee to be on the forefront of delivering updated information to our members about these agencies and developments. I am also eager to see the opportunities for the Committee and Taxation Section as a whole as we transition away from the Bar.

My ongoing goals for the upcoming year will be, first and foremost, to continue the Committee's tradition of quarterly meetings in Sacramento, San Francisco, and Southern California. I have always found these meetings to be at the heart of the Committee and the best tool for delivering value to our members. It is my hope to have the first quarterly meeting in Sacramento to highlight the new CDTFA and OTA. The following quarterly meetings are targeted for San Francisco and Southern California. Please do not hesitate to contact me if you have any topic ideas or suggestions for the second or third quarterly meetings. Second, it is my goal to continue the newer tradition of publishing this California Journal of Tax Litigation.

These two goals support the final, and perhaps most important, goal of the year: increase Committee participation and create more interest with newer and younger lawyers. How do we do this? Host meetings. Publish this California Journal of Tax Litigation. Produce webinars. Sponsor programs at other events such as the Annual Tax Policy Conference. Create opportunities for speaking and publishing on behalf of the Committee. In essence deploying the same techniques used to build a successful practice, but now to build a successful Committee.

Interested in learning more about the TPL Committee?
Send an email message to Chair Kevan P. McLaughlin, kevan@mclaughlinlegal.com

How can you help? First, talk to younger attorneys and make them feel welcome in the Committee, especially when it comes to attending our quarterly meetings. Second, help support this publication by writing an article or submitting an idea for one. Third, send any other ideas you might have for meeting topics, speakers, webinars, or areas of interest. There are many, if not endless, ways to get involved and increase participation. Below are also lists of key upcoming dates.

I want to thank each member of the Committee for the opportunity to serve as your Chair and eagerly look forward to the year to come.

Best regards,

Kevan P. McLaughlin, McLaughlin Legal, APC
Chair Tax Procedure and Litigation Committee

KEY DATES

Annual Meeting of the California Tax Bar and California Policy Conference
Park Hyatt Aviara Resort, San Diego .... **November 1 – 3, 2017**

2018 Washington D.C. Delegation Paper Proposal Deadline .... **November 13, 2017**

Webinar: BOE Reform – And One Shall Become Three .... **January 12, 2018**

Q1 2018 *California Journal of Tax Litigation* Submission Due Date .... **January 15, 2018**

California Tax Lawyer Submission Due Date .... **February 15, 2018**

Q1 2018 Meeting of the Tax Procedure & Litigation Committee
Sacramento, CA (exact location TBD) .... **March 2018**

2018 Washington D.C. Delegation .... **May 6 - 8, 2018**

Office of Tax Appeals ("OTA") Optimist

Bruce Givner, JD, LL.M, Law Offices of Givner & Kaye

Mr. Givner has been practicing tax law for almost four decades concentrating on income tax planning, estate tax planning, sophisticated retirement plans, asset protection planning, charitable planning, capital gain planning, tax litigation, and the representation of high net worth and high income families, as well as individuals and their closely held corporations.

A great deal has been written and spoken about the problems with the State Board of Equalization reorganization and partial replacement by the new California Department of Tax and Fee Administration ("CDTFA") and Office of Tax Appeals ("OTA"). Please consider a brief, naively optimistic, view of the OTA's future.

Why The Federal System Works

The federal income tax system has, at its bottom, auditors. They are nice people who typically have a college education and 3 – 5 years of experience.

At the top is a court. For this discussion, let's stick with the U.S. Tax Court because it allows taxpayers to litigate their disputes without paying the tax. There are 19 fulltime Tax Court judges for 323,000,000 people, a ratio of one judge for every 19,000,000 people.

In between the auditor and the court is Nirvana,[1] the IRS Appeals Division. Its "mission" is "to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service." [2] In doing so IRS Appeals considers the "hazards of litigation."[3]

As a result, IRS Appeals settles ≈ 90% of all cases. If it did not do so, the U.S. Tax Court would come crumbling to a halt. As it is, the esteemed Chuck Rettig[4] says "Every taxpayer is entitled to his or her decade in court."

Why The Previous State Tax System Did Not Work

The Number Of Courtrooms

The state tax system has, at its bottom, auditors (similar to the federal income tax auditors). At the top of the state tax system has been the Superior Court. However, there are ≈ 1,500 Superior Courts for 39,000,000 people, a ratio of one courtroom for every 26,000 people. That is a shocking comparison: one for every 26,000 people (state) compared to one for every 19,000,000 people (federal). That alone suggests that the state system is under no pressure to make deals to keep taxpayers' cases from clogging up the courts.

The Need To Pay The Tax To Get To Court

However, that has not been the biggest difference. The biggest difference, as all readers know, is that to get to court in the state tax system the taxpayer *must pay the tax*. As a result, no state agency has been under pressure to settle cases and which did so, zealously, using the hazards of litigation. Protest was primarily a "pick a winner" system. The FTB Settlement Bureau, as its name

[1] Indian religions assert it to be a state of perfect quietude, freedom, highest happiness along with it being liberation from the repeating cycle of birth, life and death. https://en.wikipedia.org/wiki/Nirvana
[2] IRS Publication 4227 https://www.irs.gov/pub/irs-pdf/p4227.pdf
[3] IRM 8.6.1.6.2 (3). (10-01-2016): "In resolving disputes, Appeals may consider new theories and/or alternative legal arguments that support the parties' positions when evaluating the hazards of litigation in a case. …."
[4] Hochman, Salkin, Rettig, Toscher & Perez, Beverly Hills, California.

indicates, settles cases. Sometimes a good settlement was possible. However, if you compared 1,000 cases in IRS Appeals and 1,000 cases in the FTB Settlement Bureau, the difference was glaring (and not in the taxpayers' favor). That difference was due to the pressure on IRS Appeals to not clog up the Tax Court and the lack of pressure on the FTB Settlement Bureau to not clog up our Superior Courts, fortified by the knowledge that taxpayers must pay the tax to get there.

The "Fantastic"[5] OTA Possible Future

Criticisms of the OTA have been thoroughly aired elsewhere including, but not limited to, the fact that judges will only be ALJ Is with only 5 years' experience as lawyers and little tax background. However, it is possible to look at the glass as 3/4ths full rather than 1/4th empty.

Written Opinions

The importance of having written opinions in every case cannot be overlooked or, I think, overstated. The APA provides that an administrative decision "may not be expressly relied on as a precedent unless it is designated as a precedent decision by the agency."[6] However, an "agency may designate as a precedent decision a decision…that contains a significant legal or policy determination of general application that is likely to recur."[7] With a flood of cases by taxpayers wanting to argue with the FTB, not wanting to pay the tax, and with the pressure to issue written opinions in 100 days, the OTA must establish precedent on which the ALJs can rely. "An agency shall maintain an index of significant legal and policy determinations made in precedent decisions. The index shall be updated not less frequently than annually…. The index shall be made available to the public by subscription…."[8]

Time Pressure.

The requirement to issue written opinions within 100 days after rendering a final decision[9] will create tremendous pressure on the three judge panels to issue brief opinions. In the beginning they will rely on the little precedent available from SBE published opinions; on the vast trove of federal precedent; and on their own analysis. However, as time goes by they will have their own, expanding body of precedent on which to rely. Of course many will be strictly factual in nature. However, when legal issues predominate, their own prior cases will show how the matter is to be resolved.

Pressure On FTB

The FTB will come under pressure, as time goes by,[10] to settle cases due to (i) the growing body of OTA precedent (which taxpayers will be able to cite in audits, Protests and Settlement) and (ii) the deluge of cases filed with the OTA. The FTB Settlement Bureau may never become the Nirvana of IRS Appeals. However, over time it will have to more carefully weigh the "hazards of litigation" or the State of California will require dozens of 3 judge panels to handle the onslaught.

Conclusion

To those who made a significant portion of their living under the old system, of course any change may be unwelcome. However, for the rest of us who had only infrequent, frustrating contact with the state system, especially those who have been more familiar with the federal system, this change has nothing but upside potential.

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[5] "A Major, Super-Classy List of Donald Trump's Favorite Words and Phrases, for Everyone Who is Not A Loser," *New York Magazine* (December 22, 2015) http://nymag.com/daily/intelligencer/2015/08/donalds-dictionary.html

[6] Government Code §11425.60(a).

[7] Government Code §11425.60(b), first sentence.

[8] Government Code §11425.60(c).

[9] Government Code §15675.

[10] A song written by Herman Hupfeld in 1931 which became most famous in 1942 when part of it was sung by the character Sam (Dooley Wilson) in my second favorite move (after *Apocalypse Now) Casablanca.*

YTL Corner (All Readers Welcome): *A Change of Ownership for Property Tax Purposes AND Documentary Transfer Tax Purposes*

Ashley B. Kerins, Sullivan Hill Lewin Rez & Engel

Ashley Kerins is a member of Sullivan Hill's Business and Corporate Transactions and Tax practice groups. She focuses her practice primarily in the areas of real estate, corporate, partnership and business transactions and in tax planning, tax controversy resolution. As a member of the Business and Corporate Transactions group, her practice extends to real estate transactions, financings and business organizations.

The California Supreme Court recently held in 926 North Ardmore Avenue, LLC v. County of Los Angeles that the transfer of an interest in a legal entity, which results in a property tax reassessment because of a "change in ownership" of the legal entity, also triggers the documentary transfer tax ("DTT").

The issue arose following several transfers of an apartment building. In 1972, a mom and dad established a family trust and transferred an apartment building they owned into it. In 2007, dad died. The apartment building and other trust assets were transferred from the family trust to an administrative trust maintained for mom's benefit. The sons were named successor trustees and, as such, conducted a series of transactions. First, they conveyed the apartment building from the administrative trust to an LLC, of which the administrative trust was the sole member. Second, they transferred the administrative trust's membership interest in the LLC to a partnership, in which the administrative trust held a 99 percent partnership interest. Third, the administrative trust's 99 percent partnership interests were divided into four subtrusts, all maintained for the benefit of mom. Fourth, the various subtrusts transferred their interest in the partnership to two trusts maintained for the sons (the "Sons' Trusts"). The sons were each the sole beneficiary of one of the Sons' Trusts. The transfer from the subtrusts to the Sons' Trust did not involve the execution of a deed. Rather, the parties executed limited partner transfer and substitution agreements, but the agreements were not recorded and did not mention the apartment building. The sons signed promissory notes in favor of mom's subtrusts. The amount paid was determined by an appraisal.

The fourth transaction was materially different than the previous transactions. In the first three transactions, the mom had a beneficial interest in the apartment building. In the fourth transaction, the sons acquired a beneficial interest that they did not previously have.

The Los Angeles County Assessor (the "Assessor") determined there was a change of ownership after the fourth transaction. As such, the Assessor reappraised the property and issued a supplemental property tax assessment, which was paid. The property tax reassessment was not in dispute.

Thereafter, the Los Angeles County registrar-recorder (the "Recorder") demanded payment of the DTT. The DTT assessment is in dispute. The Recorder argued that the DTT was due because the apartment building had undergone a change in ownership (mom used to be the beneficial owner and, later, sons were the beneficial owners); it is immaterial if the transfer of realty was accomplished directly by a deed or indirectly as a transfer of a legal entity. Essentially, the Recorder looked to

whether there was a change of ownership for property tax purposes as a basis to impose the DTT. The LLC argued that the DTT is only a levy on written instruments that transfer ownership of real property, not unrecorded written instruments that transfer legal entity interests and do not refer to or show the location of the realty.

The Court agreed with the Recorder and upheld the imposition of the DTT. In reaching its decision, the Court reviewed two things: (1) Revenue and Taxation ("R&T") code section 11925, and (2) federal cases that interpreted the former documentary stamp act, which the Documentary Transfer Tax Act (the "DTTA") was based upon.

R&T code section 11925 provides an exemption to the imposition of the DTT. Section 11925 provides that if a partnership (or an entity treated as a partnership for federal income tax purposes) holds realty and there is a transfer of an interest in the partnership or entity, the DTT will not be imposed provided: (1) the partnership or entity is a continuing partnership under Internal Revenue Code ("IRC") section 708, and (2) the partnership or entity continues to hold the realty. The Court rationalized that the exemption illustrates the DTT could be triggered by transfers of interests in a legal entity. If not, the exemption would be unnecessary.

The Court also analyzed cases that interpreted the DTTA's "predecessor," the documentary stamp act. The Court found that the crucial inquiry in that line of cases was whether there was a change in beneficial ownership. If so, the documentary stamp act applied.

Combining its analysis of R&T code section 11925 and the documentary stamp act, the Court upheld the imposition of the DTT. The Court concluded "the critical factor in determining whether the [DTT] may be imposed is whether there was a sale that resulted in a transfer of beneficial ownership of real property. The change in ownership rules, though enacted after the [DTTA], fit squarely into this framework…Put another way, the change in ownership rules are designed to identify precisely the types of indirect property transfers that the [DTTA] is designed to tax." So, if there is a change of ownership for property tax purposes under R&T section 64, the recorder's office can impose the DTT if there is a written instrument for consideration. The written instrument does not have to reference the property or be a formal recorded deed.

Practitioners should consider the DTT whenever there is a change of ownership for property tax purposes, even if a deed is not recorded.

Practice Pointers: *Managing Risk. Are You Proactive or Reactive?*

Henry Angelino, Angelino & Associates

Henry Angelino is the owner of Angelino & Associates, a strategic business and operations consulting firm focused on providing services to the legal community.

Attorneys are highly educated individuals capable of handling complex legal matters and drafting/interpreting intricate legal documents and business contracts. They manage their client's risk throughout the litigation process from the initial assessment of a case to the pre-trial discovery and settlement portion and ultimately to trial and appeals, as required. In each step of the process, they are evaluating and managing their client's risk while attempting to achieve the most favorable result. So why do many attorneys elect to react to a non-paying client or a malpractice suit instead of proactively managing their risk? The easy answer is that lawyers are extremely busy

working on current matters and trying to retain new clients, so they are less focused on the process required to proactively manage the client-attorney relationship. So what steps can a lawyer take to be proactive versus reactive in managing risk?

Proactive risk management starts with a set of written policies and procedures in place to manage the entire client-attorney relationship from initial contact with a potential client through the closing of the matter file and the collection of the final invoice. These policies and procedures, coupled with standard forms and letters, will enable a firm to have a repeatable and streamlined process with specific requirements to minimize risk and increase the likelihood of a positive relationship and financial outcome. Let's examine each phase of the attorney-client relationship and determine how to be less reactive and more proactive.

Client intake begins with a referral or an inquiry from a potential client and requires the attorney to ensure the potential client understands that a client-attorney relationship does not exist until certain requirements are met. Additionally, sharing confidential information before a client-attorney relationship exists does not preclude the attorney from representing a party adverse to the potential client. Making sure this disclaimer is made and understood before proceeding; prevents an unintentional conflict of interest. Moving forward with the intake process should include a screening process with the collection of client contact and matter information, a conflict check, and a background check for new clients. Additionally, the attorney should look for "red flags" that indicate a less than optimum client before deciding to engage the client. A good question to ask is whether the client has had previous representation in the matter and why they are no longer being represented by that attorney. Lastly, if you decide not to engage a client, remember to send a non-engagement letter to document the fact.

The client-attorney relationship is the next area for concern as poorly managed client expectations and communications can cause a relationship to deteriorate. Ensuring that the engagement letter includes a clearly defined scope of work and an appropriate deposit/retainer is obtained is a good first step in managing risk. Informing the client in writing and ensuring they clearly understand how the matter will be handled, the steps and timeline involved, and the potential costs involved are also important in managing expectations. A budget may be especially beneficial in a contentious litigation matter, so the client is not surprised by extraordinary fees and costs. Frequent communication between the attorney and the client on the status of the matter and the next steps to be taken can keep the relationship running smoothly.

Collections is another area to examine as a clearly defined collection program and timeline can significantly reduce the risk of "unintentional" pro bono cases. Start by reaching out to a new client and welcoming them to the firm after the initial invoice has been sent to assist in "training" the client to submit payment in a timely manner and establish a positive business relationship. Effectively managing deposits/retainers to ensure they are sufficient to cover trial costs and are available to cover the final invoice also reduces the risk and amount of nonpayment. Knowing when to send out pre-formatted demand letters and when to disengage from a client that refuses to pay allows your staff to better support your collection efforts. Filing a suit for fees should be a last resort after all other efforts have failed, and the impact on future malpractice insurance premiums and the likelihood of recovering outstanding payments have been considered. Counter-suits are frequently the response to filing a suit for fees, so incorporating the statute of limitations in the collection timeline and proactively managing the collection process is essential to minimizing your risk.

An additional proactive risk management practice is the use of closing and disengagement letters to formally end representation in a matter. The California statute of limitations for legal malpractice is tolled if an attorney continues to represent a plaintiff in a matter for which the alleged wrongful act or omission occurred. Thus, the use of these letters establishes the date from which the statute of limitations for a specific legal engagement runs. Closing letters should be an administrative action taken to signify the completion of the scope of work for which the attorney was hired. It does not mean the attorney is not representing the client in other ongoing matters. Disengagement letters are used when the attorney no longer wishes to represent a client due to an incompatibility such as nonpayment or a decision by the client to not continue with representation by the firm.

Hopefully you will never be threatened with a malpractice suit or have one filed against you, but if you are, you need to be proactive in contacting your insurance broker and carrier. Depending on your policy, failing to inform your carrier of a potential claim may invalidate your coverage if an actual claim is filed after your next annual renewal. Lastly, don't make the mistake of thinking that a client

won't file a suit just because you have a great relationship with them. In the end, filing a claim is a business decision and not a personal one. Be proactive and not reactive, report the incident when it occurs.

Proactive risk management is a business decision to develop and implement policies and procedures that enable a firm to have a repeatable process governing the client relationship and handling of legal matters from beginning to end. It requires an investment of time and effort up front but will provide a significant return on investment by allowing you and your team to consistently minimize risk while providing legal services to optimal clients.

Recent Cases of Interest

Robert S. Horwitz, Hochman Salkin Rettig Toscher & Perez PC

Robert S. Horwitz is a principal of Hochman, Salkin, Rettig, Toscher & Perez PC in Beverly Hills, where he represents clients in civil and criminal tax matters. He was chair of the Taxation Section for the 2015-2016 year.

The plaintiff in ***Bedrosian v. United States***, 120 AFTR 2d ¶ 2017-5253 (E.D. PA Sept. 20, 2017), was president of a pharmaceutical company. In the early 1970s, he frequently traveled to Europe on business. He set up an account at a Swiss bank in order to have ready access to cash during his travels. After several years, Bedrosian began to use the account as a savings account. The Swiss bank was subsequently acquired by UBS. Bedrosian did not actively manage the account, but he was aware of what occurred in the account through documents he received from UBS and through annual meetings with a UBS representative. In 2005, UBS proposed lending 750,000 Swiss francs to Bedrosian and converting the account into an investment account. He accepted and a second account was created at UBS. In 2008, UBS notified Bedrosian that he had to repay the loan and close his accounts. He transferred the funds to Hyposwiss Bank.

Until 2007, Bedrosian's accountant was Handelman. In the mid 1990's, Bedrosian told Handelman about the UBS account. Handelman told Bedrosian that he was breaking the law each year by not reporting the account on his tax return, that he could not "unbreak" the law and that he should do nothing because his estate would deal with it after he died. Bedrosian therefore did not report the account.

Handelman died in 2007. Bedrosian got a new accountant, who filed Bedrosian's 2007 return in 2008. The 2007 return checked the box "yes" to the question whether he had an offshore account and identified Switzerland as the country where the account was located. In 2008 Bedrosian also filed for the first time an FBAR. The FBAR form listed only the smaller of the two accounts, which held approximately $250,000. The larger UBS account, with $2 million, was not listed. According to Bedrosian, he did not know how his new accountant learned of the Swiss accounts, since he only gave him the same materials he gave Handelman, which were tax-related documents he received for the year.

About this time, Bedrosian testified that he became aware of the seriousness of not reporting foreign accounts. On the advice of an attorney, Bedrosian filed amended tax returns for 2004 forward reporting his foreign income. The IRS began an audit of Bedrosian in 2011. Bedrosian cooperated with the IRS. He was assessed a $975,789 penalty for willfully failing to report the larger of his two accounts on his 2007 FBAR filing. Bedrosian testified that he always considered the

UBS accounts as one account and that he did not pay much attention to the FBAR form when he signed it. In late 2008, almost sic months after filing the FBAR, Bedrosian sent two letters to UBS, one requesting it to close the larger account and the other requesting it to close the smaller account.

The Court determined that Bedrosian did not willfully fail to report the larger account on his 2007 FBAR. The case is interesting for more reasons than this. First, procedurally, it was a lawsuit instituted by Bedrosian for the return of $9,757 that he paid toward a $1 million FBAR penalty. Because the amount he sought to recover was not more than $10,000, he was able to sue in district court under the Little Tucker Act (28 USC §1346). The Government counterclaimed for the balance owed, $1,007,345. It thus should be obvious that you can pay only a fraction of an FBAR penalty and sue to recover on the ground that the penalty is an illegal exaction.

the District Courts have jurisdiction over lawsuits against the Government where the amount sought does not exceed $10,000. If Bedrosian had paid more than $10,000, he would have sued in the Court of Federal Claims, which has exclusive jurisdiction in non-tax cases in which the amount of money sought from the Government is more than $10,000. The Government counterclaimed for the unpaid balance.

The case presented two legal issues: what is the Government's burden of proof in FBAR penalty cases and what does "willful" mean that for purposes of a civil FBAR case. The Court in Bedrosian adopted the view advanced by the Government: it needs to prove that the taxpayer was willful by a preponderance of the evidence, and not by the heavier burden of proving willful by clear and convincing evidence. It also held that "willful" means that a knowing or reckless failure to file an accurate FBAR form. It rejected Bedrosian's claim that willful required proof of a voluntary and intentional violation of a known legal duty. According to the Court this was the standard used in criminal cases but not civil cases. These legal holdings were consistent with the published decisions in the FBAR cases the Government has won.

In holding that Bedrosian did not act willfully the Court accepted his testimony: "even if he did know that he had a second account yet failed to disclose it on the FBAR, there is no indication that he did so with the requisite *voluntary or intentional state of mind*; rather, all evidence points to an unintentional oversight or a negligent act." (Emphasis added.) Note, the Court does not mention reckless or discuss whether Bedrosian's failure to review the form for accuracy, or to note that only one account was listed rather than two, was reckless. Instead, it focused on whether Bedrosain's failure was "voluntary or intentional."

The Court compared Bedrosian's conduct to that of the taxpayers in *U.S. v Williams*, 489 F. App'x 655 (4th Cir. 2012), *U.S. v McBride,* 908 F.Supp. 2nd 1186 (D. Utah 2012), and *U.S. v Bussel*, (C.D. Cal. 2015), and found his conduct less egregious. Since the Government failed to meet its burden of proof, Bedrosian was entitled to a return of the money "illegally exacted from him."

Now you can sue the IRS for fraudulent conveyance, but you first have to file for bankruptcy in a bankruptcy court located within the Ninth Circuit. In ***DBSI, Inc./Zazzali v United States***, __ F. 3rd ___ (9th Cir. 2017), the debtor was an S corporation headquartered in Idaho. DBSI and related entities acquired, developed, managed and sold commercial real properties throughout the United States. They did so illegally through a Ponzi scheme. Several of the corporate insiders were prosecuted and convicted of fraud.

Since DBSI was an S corporation, its income passed through to its shareholders. DBSI paid income tax on their behalf. Between 2005 and 2008, it paid approximately $17 million income tax owed by several of its insiders to the IRS and additional amounts to state tax agencies. The IRS had paid over $3 million in refunds to the shareholders.

In 2008, DBSI filed for bankruptcy. In October 2010, a liquidating plan was confirmed. Thereafter, the trustee filed fraudulent transfer adversary proceedings under the Idaho Uniform Fraudulent Transfer Act ("UFTA") against corporate insiders, the IRS and 25 state tax agencies. The state tax agencies all settled. The issue before the Court was whether Congress had expressly waived sovereign immunity for fraudulent conveyance actions against the United States in

bankruptcy cases, since a third-party creditor was barred by sovereign immunity from maintaining a fraudulent conveyance action against the United States outside of bankruptcy.

The bankruptcy court denied the IRS's motion to dismiss. The IRS appealed to district court. While the case was pending, the Seventh Circuit issued its opinion in *In Re Equipment Acquisition Resources*, 742 F. 3rd 743 (2015), holding that the waiver of sovereign immunity in Bankruptcy Code §106(a)(1) did not waive sovereign immunity for state law fraudulent transfer claims under Bankruptcy Code §544(b)(1).

In district court, the IRS conceded that the tax payments were fraudulent transfers under the UFTA, that the trustee could set aside fraudulent transfers made within four years of bankruptcy and that it had failed to establish that it received the funds in good faith for value. The district court affirmed the bankruptcy court and held that the trustee could recover amounts paid to the IRS less the amounts refunded to the shareholders. It entered judgment against the IRS for $13.7 million. The IRS appealed and the trustee cross-appealed. The Ninth Circuit affirmed.

Bankruptcy Code § 106(a)(1) provides that "sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section with respect to the following," including actions under § 544. Section 544(b) states that "the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title."

According to the Ninth Circuit, § 544 put the trustee in the same position as an unsecured creditor. Outside of bankruptcy sovereign immunity would bar a suit under the UFTA by an unsecured creditor against the IRS. The IRS argued that since there was no unsecured creditor who could pursue a UFTA claim against it, the trustee was precluded from pursuing such a claim in bankruptcy.

The IRS admitted that §106(a)(1) "unambiguously abrogates the federal government's sovereign immunity with respect to Section 544." It argued, however, that it only waived sovereign immunity as to those claims with respect to which sovereign immunity was waived outside of bankruptcy.

The Ninth Circuit began its analysis by noting that to interpret §§ 106(a)(1) and 544(b)(1), it was required to look at the statutory language and statutory scheme as a whole. Under §106(a)(1)'s terms, § 544(b)(1) "only means one thing: a trustee needs only identify one unsecured creditor who, but for sovereign immunity, could bring an avoidance action against the IRS." In its view, §544(b)(1) cannot be read without §106(a)(1).

The Court noted that § 106(a)(1) was enacted after § 544(b)(1) and Congress was aware that the latter section codified a trustee's power to invoke state law. According to the Court, the IRS's interpretation would nullify §106(a)(1)'s effect on §544(b)(1) since it would require a trustee to show that there was a separate waiver under "applicable law." The Court rejected the IRS claim that its interpretation would not render § 106(a)(1) meaningless because it would apply to claims under §544(a) since Congress did not limit the waiver to just § 544(a).

The Court also rejected the argument that since §106(a)(1) applies to state and local governments, if they waived sovereign immunity for fraudulent transfer actions §106(a)(1)'s waiver as to §544(b)(1) would not be rendered a nullity. If a state government waived sovereign immunity, there would be no need for §106(a)(1)'s waiver. The Court held that §106(a)(1) waives sovereign immunity as to §544(b)(1) including the underlying state cause of action. To construe the statutory language otherwise "would ignore the plain text of Section 106(a)(1), something that we are not at liberty to do."

The Seventh Circuit's decision, in *In re Equipment Acquisition Resources* used a two-step analysis: first, had there been a waiver of sovereign immunity, and second, does state substantive law provide an avenue for relief. The Seventh Circuit held that §106(a)(1) waived sovereign immunity as to §544(b)(1) claims, but that state substantive law did not provide an avenue for relief since under applicable state law a creditor would be barred from suing the IRS because of sovereign immunity. The Ninth Circuit gave two reasons for rejecting the Seventh Circuit's analysis. First, since Congress waived

sovereign immunity as to § 544(b)(1) claims, it also did so as to any underlying state law cause of action. Second, both the Bankruptcy Code and the UFTA define "debtors" and "creditors" to include governmental entities and both provide substantive causes of action against governmental entities. The Seventh Circuit's analysis would have required two waivers of sovereign immunity, which the Ninth Circuit said is "contrary to the plain text of Section 106(a)(1)."

The Ninth Circuit also rejected the Seventh Circuit's and the IRS's argument that its holding potentially runs afoul of both the appropriations clause and the supremacy clause of the Constitution. That a creditor could not sue the IRS for fraudulent transfer outside of bankruptcy is irrelevant since the case only dealt with the trustee's right to sue in bankruptcy. Although Congress must approve a release of federal funds, the Ninth Circuit held that it had done so through Bankruptcy Code §106(a)(1) and §550(a)(1), which allows the trustee to recover from the recipient of a voidable transfer. Thus there was no violation of the appropriations clause.

The Ninth Circuit also found the supremacy clause argument wanting, since § 544(b)(1) only authorizes the trustee to pursue the government in federal court. While the Ninth Circuit viewed the statute as unambiguous, it noted that its interpretation was supported by both equitable principles and the Bankruptcy Code's "object and policy." Allowing voidable transfer actions to be maintained against the IRS put it on an "equal footing with other creditors" and aligned with the Bankruptcy Code's goal of an equitable distribution among all creditors. The district court was affirmed.

This is another in the continuing saga of Return Preparer Tales of Woe, ***United States v. Davis***, ___ F. 3rd ___ (D.C. Cir. 2017), starring a school teacher/return preparer, Sherri Davis, and her son, Andre. Ms. Davis and Andre were convicted of conspiracy to defraud the United States, 18 U.S.C. §§ 2, 371, and aiding and abetting the filing of returns that reported false charitable contribution and business deductions. Andre's story ended happily (sort of), but his mother's did not.

Sherri had set up "2FT Fast Tax Services," which she registered with the IRS. Her niece, who lived with her at the time, began working for 2FT in 2006. The niece worked during the day, with Sherri joining her in the late afternoon, after her workday at school ended. Although other people worked at 2FT, only Sherri and her niece prepared returns. The fees paid by clients were deposited into Sherri's account. She paid her employees in cash.

CI undercover agents conducted an operation, where they caught on video the niece preparing false returns for the undercover agents. In 2011, the IRS executed a search warrant at 2FT and at Sherri's home. After the search warrants were executed and the computers and business records were seized, the niece agreed to cooperate. She entered into a plea agreement admitting that she conspired to defraud the U.S. of $14 million and to theft in violation of D.C. criminal laws.

Although criminal charges were not brought at this time against Sherri, she was barred from the IRS e-file program. Andre was a recent college graduate who had never worked at 2FT. After she was barred from the e-file program, Sherri started a new tax preparation business, "Davis Financial Services." On the e-file application submitted to the IRS, Andre was listed as the business's principal.

Sherri and Andre were both indicted under §§ 2 and 371 (conspiracy to defraud United States) and §7206(2) (aiding and assisting in filing false returns) and Sherri was also indicted under §7206(2) (filing false returns). At trial the government called eleven former clients of 2FT and Davis Financial and the niece, who was the star witness. She testified that Sherri taught her the fine art of obtaining refunds of all income tax withholdings by claiming false charitable and business deductions, including preparing false substantiating documents. The niece also testified that Sherri would often finish returns while the niece was still logged on to the computer so that it appeared that the niece had prepared the return.

After the search warrants, Sherri and her niece had a falling out and the niece stopped working for 2FT. The niece testified that Andre would come home during spring and summer breaks, but never worked at 2FT. He did plan to work at his mother's business after he graduated. The Government also introduced the EFIN for Davis Financial Services that listed Andre as the principal and records of Tax Wise, a tax software company. Several of the records listed Andre and Davis Financial Services.

Neither Sherri nor Andre testified, but Sherri called seven character witnesses to testify about her honesty and trustworthiness and an IRS Special Agent, who testified that the niece was the only person present at the business when the IRS conducted its undercover operation at 2FT. At the end of trial, the court dismissed one count of aiding and abetting against Andre. The jury convicted Sherri of conspiracy and all of the aiding and abetting counts. It convicted Andre of conspiracy and one count of aiding and abetting. Sherri was sentenced to 48 months incarceration followed by 36 months supervised release and ordered to pay $642,000 restitution. Andre was sentenced to 60 months probation and ordered to pay $37,000 restitution. Both Sherri and Andre appealed.

Andre argued that there was insufficient evidence to convict him of either count and that the prosecutor committed misconduct by mischaracterizing evidence during closing argument. The appeals court first addressed the prosecutorial misconduct claim.

A prosecutor may not refer in either opening statement or closing argument to evidence not admitted during trial. A conviction will be reversed for improper prosecutorial argument only if the defendant can show a) the closeness of the case, b) the centrality of the issue affected by the error, and c) steps taken by the trial court to mitigate the error. Since Andre did not object to the alleged misstatements at trial, the issue was reviewed for plain error.

Reviewing the evidence, the appeals court stated that "the government's case against Andre as to both [counts] … was thin." The evidence was that Andre worked with his mother at Davis Financial Services after graduating college and that false returns were filed with Davis Financial Services' EFIN. The client whose false return was the basis of the aiding and abetting count Andre was convicted of testified that both Sherri and Andre worked on the return and that Sherri finalized it. There was no evidence that Andre entered false deductions on the return. There was no evidence that he specifically intended to file false returns or knowingly joined a conspiracy to defraud.

In closing argument, the prosecutor made numerous "misstatements" about the evidence concerning Andre, including that Andre personally designated bank accounts where tax preparation fees were to be deposited and that Sherri and Andre made "staggering amounts of money" that they did not report on their tax returns. There was no evidence that Andre underreported his income.

The prosecutor also "blatantly misrepresented" [this is shorthand for "lied"] that the niece told Andre about the criminal nature of the business and that he replied that "I know what I'm doing." What she had testified to was that she warned him about working with his mother without specifying why he shouldn't work with her and that the family blamed the niece for the problems and believed that after she left the business the IRS investigation would end. The prosecutor also argued that "defendants" prepared false receipts for the returns they prepared when the only evidence of false receipts related to 2FT, where Andre never worked.

There was "next to no evidence" that Andre had the required *mens rea*. The trial court did not give any remedial instructions to the jury to mitigate the prejudice against Andre. "Given that the evidence against Andre was not such that his conviction was by any means a certainty, the prosecutor's egregious misstatements of it during closing argument amount to plain error and, accordingly, require the reversal of Andre's conviction."

Andre's second issue was whether the evidence against him was sufficient to warrant retrial. The appeals court held there was insufficient evidence to prove guilt on either count so there would be no retrial. The court rejected the government's argument that when viewed collectively the evidence against Andre was incriminating. That Andre agreed to work with his mother was not enough to show the requisite *mens rea* for conspiracy. There was no evidence he knew Sherri was committing tax fraud, "much less that he was involved in falsifying tax returns." Tax Wise documents and an EFIN application with Andre's name didn't show knowing participation in a conspiracy. There was also no evidence of who actually filed the false return that was the basis of the count Andre was convicted of since Sherri often used her employees' computer log-ins to complete returns.

As to the aiding and abetting count, there was no evidence Andre put false information on the returns and the client testified that Sherri finalized the return. The client also testified that when interviewed by the IRS he didn't mention Andre and that he would not recognize Andre if he ran into him. There was no evidence that Andre entered false information on any return or that he knew or intended anyone else to do so. Thus, Andre's conviction was reversed.

Sherri challenged the prosecutor's statement in closing argument that "she is not going to stop until somebody stops her. Your job is to tell her to stop." Her attorney objected and the court sustained the objection and instructed to jury to disregard that comment. Because her attorney made a timely objection, the issue was reviewed for abuse of discretion.

In Sherri's case, the evidence against her was overwhelming. The prosecutor neither bolstered nor discredited any testimony and did not misstate the evidence against her. The trial court gave a curative instruction. Thus, she failed to establish that the alleged misconduct constituted harmful error.

The appeals court also rejected Sherri's argument that the district court erroneously excluded proffered testimony of a psychiatrist since it did not link Sherri's purported mental condition (Attention Deficit Disorder) to her *mens rea*. The prosecution failed to disclose until sentencing that the niece admitted to special agents that she had filed false tax returns. The appeals court rejected Sherri's claim that this was a *Brady* violation since it was cumulative of the niece's trial testimony that she had prepared and filed false returns for a number of years.

Sherri also challenged the tax loss and restitution calculations offered by the government at sentencing. The government contended that the federal tax loss was $642,000 and the DC tax loss was $800,000. The guideline range for tax loss of over $550,000 was 20. The government produced a chart, which the trial court acknowledged needed evidence to explain some of the descriptors. The IRS agent who testified about the chart did not prepare it and his testimony was based on assumptions as to what the descriptors meant. While the government only needs to prove tax loss by a preponderance of the evidence, Sherri had identified sufficient inconsistencies to cast doubt on the reliability of the evidence the government presented. Due to the unreliability of the tax loss evidence, the error could be sufficient to have affected the trial court's evaluation of the seriousness of Sherri's conduct in choosing the sentence. The court therefore reversed the sentence and remanded for resentencing and recalculation of restitution.

Sherri also contended that her trial counsel provided ineffective assistance by failing to introduce evidence of the under cover tape of her niece preparing false returns, his failure to introduce a Facebook page of a client referring to a business which suggested that deductions were not false and his failure to move for a mistrial. The court of appeals remanded for consideration of her ineffective assistance claim.

In the last Recent Cases of Interest column I discussed three recent court of appeals cases holding that a taxpayer could not challenge the merits of a penalty in a collection due process hearing if he previously had the opportunity to do so with IRS appeals. In ***McNeill v Commissioner***, 148 T.C. No. 23 (June 19, 2017), the Tax Court held that a taxpayer could challenge the merits of a penalty relating to a partnership item in a CDP case.

The taxpayers in *McNeill* invested in a distressed asset/debt tax shelter. In 2003, the taxpayer husband purchased an 89.1%interest in Guisan LLC, a limited liability company whose principal asset was Brazilian consumer debt with a high basis and a low fair market value. He had Guisan LLC contribute the debt to LaBaite LLC. The taxpayer was not a managing member or tax matters partner of LaBaite. LaBaite sold the debt for a large loss to an entity related to the tax matters partner.

BDO Seidman prepared Guisan's 2003 partnership return, which reported a flow-through loss from LaBaite. Attached to the partnership return was a Form 8886. Form 8886 is a reportable transaction disclosure statement. (Failure to include a Form 8886 with its return is what led to the penalty that was the taxpayer unsuccessfully sought to challenge in the *Keller Tank Services* case.) EY prepared the taxpayers' 2003 tax return, which reported their flow through share of Guisan's loss. The amount of the loss was more than $10 million. The taxpayers' return also included a Form 8886.

In 2007, the IRS issued a Final Partnership Administrative Adjustment ("FPAA") to LaBaite that disallowed the loss and asserted a § 6662 accuracy-related penalty. Taxpayer husband, as tax matters partner for Guisan, filed a petition in district court challenging the FPAA and deposited an amount equal to the tax and interest on the deficiency he would owe if the FPAA was sustained. Section 6226(e) requires a partner filing a petition with the Court of Federal Claims or a district court to deposit the amount by which the partner's tax liability would be increased if the FPAA were upheld, and §6225(a) permits immediate assessment and collection of tax from the other partners in such a case. In accordance with these provisions, the IRS assessed a deficiency against the taxpayers and applied their deposit against the deficiency. The IRS sent the taxpayers a Form 3552, correction of math errors, for a penalty plus interest of $1.5 million.

In 2008, the IRS mailed the taxpayers a notice and demand for payment, after which it issued CDP notices. The taxpayers timely protested the CDP notices, disputing their liability for the penalties. The taxpayers then moved to dismiss the partnership proceeding with prejudice. The district court dismissed without deciding any partner-level defenses. Despite knowing that the district court dismissal order did not decide partner-level defenses, Appeals determined that the taxpayers could not raise any partner level defense to the penalty and that collection action should proceed. The taxpayers petitioned the Tax Court.

Under TEFRA, a penalty related to a partnership item is determined at the partnership level and is assessed as a computational adjustment. A taxpayer has no right to receive a notice of deficiency with respect to the penalty. To challenge the penalty, the taxpayer must pay the penalty and applicable interest, file a refund claim and, if that is disallowed or not acted upon within 6 months, file a refund suit in district court. Prior to 2006, the Tax Court did not have jurisdiction over CDP cases if it did not have jurisdiction over the underlying liability. In 2006, Congress amended the CDP provisions to expand the Tax Court's jurisdiction to include CDP cases even if it lacked jurisdiction over the underlying liability.

The Tax Court was thus faced with the question of whether in a collection due process case IRS Appeals and, consequently, the Tax Court could consider a challenge to a tax liability if the Tax Court did not have jurisdiction over the underlying liability. The Tax Court held that under the 2006 amendments to the CDP provisions, Appeals and the Tax Court had jurisdiction to consider the underlying liability. The 2006 amendments expanded the Tax Court's jurisdiction to include collection due process proceedings regardless of the type of underlying liability. That the taxpayers' liability for the penalty was not subject to deficiency jurisdiction but instead, outside the CDP context, was solely subject to district court jurisdiction, did not remove the penalty from Tax Court consideration in the CDP context. According to the Tax Court, Congress' intent in enacting the 2006 amendments was not to remove from review certain issues that were not subject to the Tax Court's deficiency jurisdiction, but to expand its jurisdiction to include liabilities over which it otherwise lacked jurisdiction. The penalty assessed against the taxpayers was one example of an item not subject to deficiency jurisdiction that was subject to review under the Court's CDP jurisdiction.

If you have a refund coming, file your return as soon as possible. If you don't, you may not get a credit or refund. The taxpayer found this out the hard way in **Borenstein v Commissioner,** 149 T.C. No. 10 (Aug. 30, 2017). Ms. Borenstein filed a request for an extension to October 15, 2013, to file her 2012 income tax return. She made estimated tax payment s for 2012 of $112,000. These were deemed paid on April 15, 2013. She failed to file a return by the extended due date.

On June 19, 2015, the IRS mailed Ms. Borenstein a statutory notice of deficiency for $1,166,463 plus additions to tax under IRC §§6651(a)(1) and (2) and 6654. On August 29, 2015, the taxpayer filed her original 2012 income tax return. It reported a liability of $79,559 and an overpayment of $32,441. On September 16, 2015, Ms. Borenstein petitioned the Tax Court for redetermination.

The IRS conceded that the return correctly reported Ms. Borenstein's liability and that she was not liable for any addition to tax other than a $247 estimated tax penalty. The IRS claimed that Ms. Borenstein was not entitled to a refund. The parties submitted the issue of whether the Tax Court could grant her a refund on stipulated facts. In a full Tax Court opinion, the Court held that based on the language of IRC § 6512(b)(3), she was not entitled to a refund.

Under IRC §6512(b)(1) and (2) the Tax Court has jurisdiction in a deficiency case to determine an overpayment of tax for a tax period before it and to enforce its determination. The amount of overpayment that can be credited or refunded is governed by §6512(b)(3). That section states:

(3) Limit on amount of credit or refund -- No such credit or refund shall be allowed or made of any portion of the tax unless the Tax Court determines as part of its decision that such portion was paid—

(A) after the mailing of the notice of deficiency,

(B) within the period which would be applicable under section 6511(b)(2), (c), or (d), if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment, or

(C) within the period which would be applicable under section 6511(b)(2), (c), or (d), in respect of any claim for refund filed within the applicable period specified in section 6511 and before the date of the mailing of the notice of deficiency—

***(i)** which had not been disallowed before that date,*

***(ii)** which had been disallowed before that date and in respect of which a timely suit for refund could have been commenced as of that date, or*

***(iii)** in respect of which a suit for refund had been commenced before that date and within the period specified in section 6532.*

In the case of a credit or refund relating to an affected item (within the meaning of section 6231(a)(5)), the preceding sentence shall be applied by substituting the periods under sections 6229 and 6230(d) for the periods under section 6511(b)(2), (c), and (d).

In a case described in subparagraph (B) where the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax and no return was filed before such date, the applicable period under subsections (a) and (b)(2) of section 6511 shall be 3 years.

Subsections (A) and (C) did not apply, since the overpayment was made before the notice of deficiency was filed and a refund claim was not filed before the notice of deficiency was issued. Subsection (B) posits a hypothetical refund claim being filed on the date that the notice of deficiency was issued. Under § 6511(b), if a refund claim is filed within 3 years of the due date of the return, the taxpayer can get a refund of tax paid within that period. If no refund claim is filed within 3 years, the taxpayer can only get a refund of amounts paid within two years of the date the claim is filed.

The flush sentence at the end was added to overrule *Lundy v Commissioner*, 516 U.S. 235 (1996), which held that there was a two-year look back period where the taxpayer had not filed a refund claim as of the date the notice of deficiency was issued, even though the notice was issued within three years of the due date of the return.

The case came down to the interpretation of the flush sentence at the end of subsection (b)(3), specifically what the parenthetical phrase "with extensions" modified.

The IRS's position was that under the plain language of (b)(3), Ms. Borenstein was not entitled to a refund because the notice of deficiency was mailed after the end of the second year following the due date and before the beginning of the third year following the extended due date. Ms. Borenstein argued that the IRS's position resulted in an absurdity, since she would only be entitled to a refund if the notice had been mailed between October 16, 2015 and April 15, 2016, but not

if it was mailed in a "gap" period between April 16, 2015, and October 15, 2015. This did not make any difference to the Tax Court.

Ms. Borenstein's more technical argument was that the parenthetical "with extensions" modified the noun phrase "third year" rather than the immediately preceding phrase "due date." Thus, if the notice of deficiency was issued within three years of the original or extended due date the taxpayer would be entitled to a refund of any overpayment. Under the IRS's interpretation, if the taxpayer timely requested an extension, the look back period for the third year began to run from the extended due date. In Ms. Borenstein's case, since the notice of deficiency was mailed after the second year following the original due date and before the beginning of the third year following the extended due date, she could not get a refund.

The Court reasoned that the taxpayer's interpretation violated the "last antecedent" rule. This rule states that a limiting or modifying clause only modifies the noun or phrase immediately preceding it, which in this case is "due date". According to the Tax Court, this rule is "especially powerful" where the modifying phrase is embedded in a longer grammatical phrase that has a familiar meaning or is a term of art. Under the "last antecedent rule" the Court found it more logical to adopt the IRS's interpretation under which "with extensions" only modifies "due date."

Ms. Borenstein argued that having a third year look-back period that begins to run on the extended due date of the return is at odds with the legislative history. The Court rejected this argument. Since the language of the provision in question is "unambiguous," legislative history is irrelevant. In any event, the Court viewed the legislative history as not supporting her interpretation. While Congress meant to overrule *Lundy*, it didn't intend to have a 42-month look-back period.

The Court also rejected the argument that its interpretation violated the anti-absurdity rule. According to the Court, this rule is not used where the statute is unambiguous and the interpretation is consistent with the plain language of the statute

The Court ended its analysis by noting that due to what appeared to be in artful drafting, subsection (b)(3) may have gaps in coverage. While it is possible that Congress did not think through all the ramifications of its amendment, the courts should not attempt to fill gaps by judicially created remedies. A court is required to give the words of a statute their plain meaning. The Court ended its opinion as follows:

> *The text enacted by Congress makes syntactic sense and has an unambiguous meaning. Construing that text according to its plain meaning does not produce a result "so gross as to shock the general moral or common sense."* Harrelson*, 282 U.S. at 60. "Our unwillingness to soften the import of Congress' chosen words even if we believe the words lead to a harsh outcome is longstanding. It results from 'deference to the supremacy of the Legislature.'"* Lamie*, 540 U.S. at 538 (*quoting United States v. Locke*, 471 U.S. 84, 95 (1985)).*

Portability has been a hot topic among estate and gift tax attorneys. The portability provisions of the Code are codified in IRC §2010(c)(4), which was enacted in 2010. These provisions allow the estate of a deceased spouse to use the unused exclusion amount of the prior deceased spouse in computing estate tax liability. The deceased spouse's unused exclusion amount is commonly referred to as ""DSUE." In ***Estate of Sower v. Commissioner***, 149 T.C. No. 11, the Tax Court addressed whether the Commissioner can examine the estate of the predeceased spouse to determine the amount of the unused exclusion available to the estate of the deceased spouse.

Minnie and Frank Sower were married. Frank died in 2013. His estate filed an estate tax return that did not use all of its exclusion amount. The IRS issued a letter to Frank's estate that it was accepting the return as filed and would not examine the return except under certain specified conditions, none of which were relevant to the case before the Tax Court. Minnie died after Frank. Her estate filed an estate tax return that claimed Frank's DSUE.

Minnie's estate claimed a DSUE from Frank's estate of $1.25 million. Her estate's return reported tax due of $369,000. It later paid an additional $386,000 of tax and interest resulting from a math error. Neither Frank's nor Minnie's estate tax returns reported any taxable gifts.

The IRS reviewed the return for Minnie's estate. As part of that review it also reviewed Frank's estate tax return. The review revealed that Frank's estate tax return erroneously failed to include several taxable gifts that were made prior to 2010. The IRS therefore determined that Minnie's DSUE was $973,000 less than the amount claimed on her estate tax return. It issued a statutory notice of deficiency for $788,000. Minnie's estate petitioned the Tax Court. The parties stipulated to all facts, so the Tax Court was faced with a legal issue of whether due to its closing letter the IRS was barred from examining Frank's estate tax return.

The Court began by analyzing the statutory framework. The Internal Revenue Code imposes an estate tax on the taxable estate of a decedent. Under IRC §2010, an estate is entitled to a "unified credit" against its "tentative tax." The credit is the amount of tentative tax on an "applicable exclusion amount." At the time of Minnie's death, the basic applicable exclusion amount was $5,250,000. As the surviving spouse, Minnie's applicable exclusion amount was the basic exclusion amount plus Frank's DSUE. IRC §2010(c)(2). The DSUE is the lesser of the basic exclusion amount or the amount by which the basic exclusion amount exceeds the sum of the previously deceased spouse's taxable estate and taxable gifts. IRC §2010(c)(4).

IRC §2010(c)(5)(B) authorizes the IRS to examine the estate tax return of the first deceased spouse to determine the DSUE even if the statute of limitations on assessment bars assessment. The Temporary Regulations in effect when Frank and Minnie died emphasized the power of the CIR to examine a pre-deceased spouse's return to determine the proper DSUE amount. IRC §7602 authorizes the IRS to examine every book, record, document and materials that may be relevant to determine the correctness of any return. Based on these provisions, the Tax Court held that, in reviewing Frank's estate tax return, the IRS properly exercised its powers to determine the correct amount of DSUE available to Minnie's estate.

The Court next addressed the various defenses raised by Minnie's estate. Its primary argument was that the closing letter sent to Frank's estate was a closing agreement that barred any subsequent examination of Frank's return. Under that letter, the IRS was not to examine Frank's return except for circumstances that were not applicable. A closing agreement is an agreement between the IRS and the taxpayer that uses prescribed forms and follows certain set procedures. The closing letter issued by the IRS to Frank's estate had none of the hallmarks of an agreement.

The estate next argued that the IRS was estopped to examine Frank's return. To prevail on a claim of estoppel against the IRS, a taxpayer must establish four elements:

a. That the IRS made false statements or misled by its silence;
b. That the false statement or misleading silence must concern facts and not law;
c. The person claiming estoppel must have been ignorant of the facts; and
d. The person claiming estoppel must be adversely affected by the IRS's actions or silence.

The Court found that the estate could not establish any of the elements. Thus, it could not prevail on its estoppel claim.

The estate's next argument was that the IRS conducted an impermissible second examination of Frank's estate tax return. Rather than IRC §7605(b)'s prohibition against second examinations, the estate cited a 1929 case, the rationale of which was rejected by the Supreme Court in *Burnet v Porter*, 283 US 230 (1931), which held that the IRS had the authority to conduct second examinations of a return. The Tax Court noted that in *Estate of Meyer*, 58 T.C. 69 (1972), it held that the IRS can reopen an examination after it issues a closing letter to an estate based on information from unrelated parties. In the case before it, the IRS did not request any additional information from Frank's estate. It acted based on returns already in its possession, i.e., Frank's estate tax return and prior gift tax returns. Thus, there was no second examination of Frank's estate tax return.

The Tax Court further held that even if there was a second examination, it did not violate the second examination rule of §7605(b), since the protection afforded by that section was only available to the taxpayer whose return was previously examined. It was not available to another party.

The Tax Court then rejected a series of additional arguments raised by Minnie's estate. First, it rejected an argument that under Treas. Reg. §25.2050-2(e) the IRS could not examine Frank's return to determine the DSUE amount. It then rejected an argument that the effective date of the portability provisions barred consideration of gifts made prior to the effective date. Since the provisions were effective as to the estates of decedents dying after December 31, 2010, that argument was wanting.

The Court also rejected the estate's argument that Congress did not intend the statute to apply as the IRS applied it. The clearest indication of Congressional intent is the statutory language. The language of the applicable statutes shows that the IRS did not violate Congressional intent.

The estate's final argument was that allowing the IRS to examine Frank's estate tax return violated due process. The Tax Court also rejected this argument since the IRS cannot and did not assess any additional tax against Frank's estate. Since none of the estate's arguments were meritorious, the Court directed that a decision be entered in favor of the IRS.

Excise taxes were once an important source of federal revenues. As recently as the 1950's they accounted for over 20% of taxes collected. Now, excise taxes account for less than 5% of all federal revenues. It was therefore somewhat surprising to read two recent published decisions involving excise taxes: ***Thompson Truck & Trailer, Inc. v. United States***, (C.D. Iowa Aug. 9, 2017), and ***CI Design Group, LLC v. United States***, (D. Idaho Aug. 3. 2017).

The taxpayer in *Thompson Truck & Trailer* is a dealer in heavy trucks. It sold a number of vehicles with diesel particulate filters ("DPF"), which are ceramic devises that, when installed, collect and break down particulate matter from diesel truck exhausts. IRC §4051(a)(1) imposes an excise tax on "the first retail sale" of "trucks, trailers and semi-trailers" bodies, chasses, and "parts and accessories" sold in connection therewith. The taxpayer paid a 12% excise tax on the full sales price of each truck sold. On the theory that DPFs were not subject to the excise tax , it filed a claim for refund. When the refund claim was denied, it filed a refund suit in district court.

The taxpayer's theory was that the IRC does not define "parts and accessories." Treas. Reg. §48-4061(b)-2(a) contains a broad definition of "parts and accessories":

(a) In general. The term "parts or accessories" includes (1) any article the primary use of which is to improve, repair, replace, or serve as a component part of an automobile truck or bus chassis or body, or other automobile chassis or body, or taxable tractor, (2) any article designed to be attached to or used in connection with such chassis, body or tractor to add to its utility or ornamentation, and (3) any article the primary use of which is in connection with such chassis, body, or tractor, whether or not essential to its operation or use.

Treas. Reg. §48-4061(a)-1(a)(3)(ii) states that "amounts charged for machinery or equipment that is installed on a taxable chassis or body are not part of the taxable sale price of the chassis or body if (A) such machinery or equipment does not contribute toward the highway transportation function of the chassis or body… ." In its complaint, the taxpayer alleged that DPFs do not contribute toward the highway transportation function of bodies and chasses it sold. The taxpayer concluded that DPFs were not subject to the excise tax.

The Government moved to dismiss the complaint under F. R. Civ. Pro. R 12(b)(6) for failing to state a claim upon which relief can be granted. In ruling on a motion to dismiss, the Court is required to accept as true all factual allegations in the complaint. The facts alleged must support a facially plausible claim for relief. In its motion, the Government argued that DPFs are clearly encompassed within the statute and, if the statute is ambiguous, they are taxable under the regulations.

In ruling for the Government, the Court applied *Chevron* step one to determine whether the statute is ambiguous. It rejected the taxpayer's claim that the existence of regulations on its face means that a statute is ambiguous. To determine whether there is an ambiguity, the Court has to look to the language of the statute and its context. The issuance of agency guidance is not probative of ambiguity.

The Court found no evidence that the absence of a statutory definition made the phrase "parts and accessories" ambiguous. Where there is no statutory definition, the Court looks to the common meaning, which it determined fit DPFs. Furthermore, there was no exception to the common meaning of "parts and accessories" that would apply to DPFs and the lack of such an exception reveals Congress' intent to make the tax applicable to all parts and accessories sold in connection with a truck. The Court therefore granted the Government's motion to dismiss the complaint.

The taxpayer in *CI Design* won a jury trial in a suit seeking the refund of a penalty for late payment of an excise tax. Prior to trial, the taxpayer made a qualified offer to settle for a refund of $14,285, which the Government rejected. Following trial, the jury returned a verdict in favor of the taxpayer for $29,530. The taxpayer moved for attorney fees of $76,270.39 plus costs of $1,485.63 on the ground that the Government's position was not substantially justified. In the alternative, the taxpayer moved for attorney fees of $50,925.16, because its liability as determined by the jury was less than its liability under the qualified offer.

Under IRC §7430, the prevailing party in a tax case can be awarded litigation costs, including attorney fees, unless the Government's position is substantially justified. IRC §7430(c)(4)(B). Where a party makes a qualified offer that the Government does not accept and it is ultimately determined that its liability is less than the amount under the offer, it is entitled to attorney fees regardless of whether the Government's position is substantially justified. IRC §7430(c)(4)(E). Where the Government's position is not substantially justified, the taxpayer is entitled to all its reasonable attorney fees and costs. Where it makes a qualified offer, it is only entitled to attorney fees after the qualified offer date.

The Court first rejected the taxpayer's claim that the Government's position was not substantially justified. That the taxpayer won at trial does not show that the Government's position was not substantially justified. A position is substantially justified if it had a reasonable basis in law and in fact. The Court examined the evidence presented at trial. It determined that there was substantial evidence that the late payment was not due to reasonable cause. This included a) how the company prioritized its debts, paying its managing members' salaries of $100,000 when it wasn't paying excise tax and having deposits of approximately $8 million during the periods in which tax was not being paid. The Court additionally noted that the Government had won several cases in the Ninth Circuit involving similar issues. The taxpayer's claim turned on the question of whether its president's auto accident and subsequent disability was reasonable cause for the late payment. Since the case could have ended in favor of the Government and there are Ninth Circuit decisions favoring the Government, its position was substantially justified.

The Court next turned to the qualified offer argument. Since the Government turned down an offer and the amount of the refund won at trial was more than the offer, the taxpayer was the prevailing party for purposes of the qualified offer provisions. It was thus entitled to reasonable litigation costs, including attorneys' fees for services rendered after the qualified offer date. The focus of the Court's decision was on whether the attorneys' fees sought were reasonable. It held that they were not.

The taxpayer sought an award of $300 per hour for the partner of the firm representing it and $250 per hour for the associate. The taxpayer argued that $300 per hour is reasonable because 1) it is the prevailing rate in Boise, Idaho, 2) there was a lack of qualified tax attorneys in the Boise area, and 3) the case was complex. The Court capped the award based on a rate of $200 per hour for the partner.

The taxpayer's lead attorney had practiced tax law, including tax controversy, for over 30 years. That an attorney has expertise in tax is not enough to be a special factor authorizing an upward adjustment from $200 per hour. Rather than specialization in taxation, the attorney must have special training or experience in the area "needful for the litigation in question." The Court noted that the taxpayer's attorney submitted an affidavit stating that he "believes" his is one of the

few tax attorneys in Boise. This was not affirmatively stated and the attorney did not identify other attorneys and their rates. The Court also noted that the case was neither difficult nor complex. It was not technical, no expert witnesses were presented and the trial took two days. The attorney's experience in tax was not sufficient to justify a fee over the cap.

As to the associate, he did not submit an affidavit, so the Court reduced his fees by one-third, as it did for the partner. The Court also reduced the fees sought for paralegals by one-third. The Court finally rejected the request for $1,485.63 in fees and awarded only $75.17. There were no receipts for over $800 in claimed costs and most of the remaining costs were for items the Court viewed as office overhead, such as binders, index tabs and similar items.

Finally, the Court noted that the procedure used by the taxpayer to obtain an award of costs was incorrect. It awarded $33,735 in attorney fees and costs and directed the taxpayer to file a bill of costs within 14 days to be taxed by the court clerk in connection with the Court's order.

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