RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

Bruce A. McGovern
Professor of Law and Director, Tax Clinic
South Texas College of Law Houston
Houston, Texas 77002
Tele: 713-646-2920
e-mail: bmcgovern@stcl.edu

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Note: This outline was prepared jointly with Cassady V. ("Cass") Brewer, Professor of Law, Georgia State University College of Law, Atlanta, GA.

I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

III. INVESTMENT GAIN AND INCOME

IV. COMPENSATION ISSUES

A. Fringe Benefits

B. Qualified Deferred Compensation Plans

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

1. The taxpayer took a shot at a deduction for deferred compensation but only scored an A-I-R B-A-L-L! A-I-R B-A-L-L! A-I-R B-A-L-L! Hoops, LP v. Commissioner, T.C. Memo. 2022-9 (2/23/22). In a memorandum opinion, the Tax Court (Jude Nega) has held that an accrual method partnership could not deduct unpaid salary and wages relating to deferred compensation owed to two players (Zach Randolph and Michael Conley) for the Memphis Grizzlies of the NBA. The taxpayer-partnership, Hoops, LP ("Hoops") sold the Memphis Grizzlies' NBA franchise and substantially all of its assets to a buyer in 2012. The buyer assumed substantially all of the liabilities and obligations of Hoops as part of the acquisition, including the obligation to pay approximately $10.7 million (discounted to present value) in nonqualified deferred compensation to the two players. Hoops had included the accrued $10.7 million liability in its amount realized in connection with the sale. Hoops did not deduct the $10.7 million on its originally filed partnership tax return on Form 1065 for 2012. Instead, Hoops filed an amended return on Form 1065-X for 2012 in October of 2013 claiming the $10.7 million accrued liability as a deduction. Following an audit, the IRS issued a notice of final partnership administrative adjustment disallowing the deduction, and Hoops petitioned the Tax Court. The parties stipulated that the $10.7 million accrued liability was nonqualified deferred compensation governed by the catch-all "other plans" provision of § 404(a)(5). Section 404(a)(5) and the regulations under that provision allow a deduction for payments under such nonqualified deferred compensation plans "only in the taxable year of the employer in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includible in [the employee's] gross income." Reg. § 1.404(a)-12(b)(1). Hoops argued that the timing rule in § 404(a) is incorporated into the economic performance requirement of § 461(h), and due to the sale, the deduction was accelerated under Reg. § 1.461-4(d)(5)(i) which provides:

> If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer.

Alternatively, Hoops argued that if the $10.7 million liability was not deductible upon the sale, then it should not have been included in Hoops's amount realized as part of the sale. The IRS argued in response that Reg. § 1.404(a)-12(b)(1), not § 461(h) or Reg. § 1.461-4(d)(5)(i), controlled to allow the deduction only when the deferred compensation is paid and includable in the players' gross income regardless of whether economic performance had occurred or whether the liability was considered part of Hoops's amount realized in connection with the sale.

Judge Nega's Opinion. Judge Nega agreed with the IRS and relied on the regulations under § 461 and § 446, which provide that "[a]pplicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred [under § 461(h)] is taken into account." Reg. §§ 1.461-1(a)(2)(i), 1.446-1(c)(1)(ii)(A). Judge Nega therefore reasoned that § 404(a)(5) and Reg. § 1.404(a)-12(b)(1) controlled to disallow the partnership's deduction unless and until the deferred compensation was paid and includable in the gross income of the players. Judge Nega cited the Ninth Circuit's decision in *Albertson's, Inc. v. Commissioner*, 42 F.3d 537, 543 (9th Cir. 1994), *aff'g* 95 T.C. 415 (1990), as support. In *Albertson's*, the Ninth Circuit relied upon legislative history to determine that Congress enacted § 404(a) expressly to match the timing of an employer's deduction and an employee's inclusion of nonqualified deferred compensation. Furthermore, regarding whether the $10.7 million deferred compensation liability should have been included in Hoops's amount realized upon the sale, Judge Nega determined that it should, citing the general rules of §§ 1001(a), 1001(b), and Reg. § 1.1001-2(a)(1), which provide that a taxpayer's amount realized includes liabilities from which the taxpayer is discharged as a result of transferring property.

Comment. Hoops argued that the $10.7 million nonqualified deferred compensation arrangement should not be considered a "liability" includable in amount realized under § 1001(b) and Reg. § 1.1001-2(a)(1). Support for this position can be found in § 108(e)(2), which provides that "[n]o income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction." Similarly, § 357(c)(3)(i) provides that an obligation is not treated as a liability for purposes of § 351 if the payment thereof "would give rise to a deduction." And, Reg. § 1.752-1 provides that an obligation is not treated as a liability for purposes of § 752 unless it (i) creates or increases the basis of any of the obligor's assets (including cash); (ii) gives rise to an immediate deduction to the obligor; or (iii) gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. The court, however, rejected Hoops's argument and held that, under the general rules of § 1001(b) and Reg. § 1.1001-2(a)(1), "Hoops was required to take into account the amount of the deferred compensation liability in computing its gain or loss from the sale."

Appeal: Hoops has appealed to the U.S. Court of Appeals for the Seventh Circuit.

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

1. Wait, what? A taxpayer gets a "do-over"? This corporate taxpayer was allowed to disavow the form of its two-step acquisition transaction by subsequently treating the separate steps as a single § 351 transaction with boot, thereby *post hoc* generating a partial basis step-up in intangible assets it received in exchange for its stock and resulting in larger amortization deductions. Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14 (3/31/21). This lengthy and complex 100-plus page Tax Court memorandum decision could well have been a reviewed opinion, and as the reader will discover below, perhaps should have been. Essentially, the corporate taxpayer, Complex Media, Inc., engaged in two separate acquisitive transactions. The first was a § 351 exchange in which the taxpayer acquired certain intangible assets from a partnership in exchange for the taxpayer's common stock. In the second transaction, the taxpayer paid cash (approximately $2.7 million) and a granted a "deferred payment" obligation ($300,000) to the partnership to redeem some of the common stock issued in the § 351 exchange. (The cash and deferred payment obligation then were used by the partnership to redeem one reluctant partner's partnership interest.) Complex Media and the partnership from it acquired the intangible assets agreed in the relevant documentation of the transaction to treat the partnership's contribution of assets in exchange for Complex Media's stock as a transaction eligible for nonrecognition pursuant to § 351(a) and to treat Complex Media's redemption of a portion of the shares issued to the partnership as a separate redemption of stock. On its corporate tax return for the year in which the § 351 exchange took place, Complex Media treated the transaction consistently with the manner in which it had agreed to do so (i.e., as a transaction eligible for nonrecognition pursuant to § 351(a) and as a separate redemption of some of the stock it had issued in the § 351 exchange) by reporting that it had taken a carryover basis in the acquired intangible assets pursuant to § 362(a). On its corporate tax returns for the subsequent three years, however, Complex Media effectively treated the two separate steps as a single § 351 exchange, reporting the cash and deferred payment obligation as § 351(b)(1) boot paid for a portion of the intangible assets of the partnership acquired in the exchange. Doing so allowed the taxpayer to step-up its basis in the acquired intangible assets under § 362(a), leading to larger amortization deductions with respect to the intangibles under § 197. The taxpayer would not have been entitled to step-up the basis in the intangible assets if the cash and deferred payment obligation were not boot in the § 351 exchange but instead were funds used to redeem some of the taxpayer's stock issued in the § 351 exchange. Over the IRS's objection, the taxpayer argued, and the Tax Court (Judge Halpern) agreed, that the two steps could be treated as one, even if the taxpayer's chosen form was a § 351 exchange of property solely for stock followed by a separate redemption of some of the stock issued in the § 351 exchange. Thus, with Judge Halpern's blessing, the taxpayer in *Complex Media* was able to *post hoc* recast the taxpayer's chosen form of a corporate acquisition to obtain a better tax result than as originally structured and agreed. We will spare the reader pages and pages of analysis regarding the relatively low bar the courts have set for the IRS to recast a taxpayer's chosen form of a transaction for tax purposes versus the much higher bar set for taxpayers to disavow their chosen form to achieve more favorable tax treatment. Suffice it to say that taxpayers are rarely allowed "do overs" to report transactions for tax purposes in a manner that is inconsistent with their chosen form. Judge Halpern also agreed with Complex Media that the $300,000 deferred payment obligation granted to the partnership could be valued at its face amount rather than at a discount. Valuing the deferred payment obligation at face increased the § 351(b)(1) boot, thereby increasing subsequent amortization deductions taken by the taxpayer. Thus, *Complex Media* is a relatively important and surprising case, albeit a Tax Court memorandum decision.

a. Although it took a while, the IRS has decided to "disavow" Judge Halpern's decision in *Complex Media*. A.O.D. 2023-11 I.R.B. ____ (3/13/23). The IRS has announced that it will not follow *Complex Media* regarding a taxpayer's ability to disavow the chosen form of a transaction for tax purposes, especially if the taxpayer "does not fully, properly, and consistently report the transaction." Furthermore, the IRS will not follow *Complex Media* in determining the fair market value of debt (i.e., the deferred payment obligation) for purposes of § 351(b)(1).

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

VII. PARTNERSHIPS

A. Formation and Taxable Years

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

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

1. Judge Gustafson revisits *Grecian Magnesite*, but this time rules against this non-U.S. taxpayer selling her partnership interest due to § 751. Rawat v. Commissioner, T.C. Memo 2023-14 (2/7/23). We previously have written about the entity-theory versus aggregate-theory dust-up between the IRS and non-U.S. persons selling interests in partnerships conducting business in the U.S. For example, in *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (7/13/17), the Tax Court (Judge Gustafson) ruled against the IRS (and against the IRS's position in Rev. Rul. 91-32, 1991-1 C.B. 107) to hold that a non-U.S. person's gain from the sale of an interest in a partnership conducting a U.S. trade or business is not U.S.-source income (because the partnership interest is personal property) and therefore is not subject to U.S. taxation unless such gain (i) is captured by § 897(g) (gain attributable to U.S. real property) or (ii) is captured by § 865(e)(2) (gain attributable to a U.S. office or fixed place of business). The IRS in *Grecian Magnesite* had argued that a non-U.S. person's gain from the sale of an interest in a partnership conducting business in the U.S. should be analyzed under the aggregate-theory of partnership taxation, meaning that the gain would be considered U.S. source income because it is attributable to the underlying U.S. assets held by the partnership. *See* Rev. Rul. 91-32, 1991-1 C.B. 107. Nevertheless, Judge Gustafson declined to adopt the IRS's reasoning (labeling the IRS's analysis in Rev. Rul. 91-32 as "cursory") and ruled for the taxpayer. Importantly, *Grecian Magnesite* did not address whether the result might be different if the partnership conducting business in the U.S. held inventory items subject to § 751.

Rawat Decision by Judge Gustafson. In Rawat v. Commissioner, T.C. Memo 2023-14 (2/7/23), Judge Gustafson got the chance to address the issue left open in *Grecian Magnesite*: whether gain from a non-U.S. person's sale of an interest in a partnership holding inventory items and conducting business in the U.S. is considered U.S. source income by virtue of § 751 and the U.S. income-sourcing rules of §§ 861-865. This time, the Tax Court (again, Judge Gustafson) adopted the IRS's aggregate-theory argument and held against the taxpayer. The taxpayer in *Rawat* was a Canadian citizen and nonresident of the U.S. during 2007 and 2008. In 2008, the taxpayer sold her interest in a partnership doing business in the U.S. in exchange for a promissory note with a face amount of $438 million. The principal of the promissory note was not payable until 2028. The IRS sought to tax $6.5 million of the taxpayer's gain ("inventory gain") in 2008 because that amount was attributable to § 751 inventory items held by the partnership and allocable to the taxpayer's partnership interest. The taxpayer argued that, because the inventory gain was realized and recognized prior to the enactment of § 864(c)(8) (see below), the Tax Court's decision in *Grecian*

Magnesite controlled. The IRS disagreed, arguing that the inventory gain, unlike the gain in *Grecian Magnesite*, was subject to § 751, thereby rendering the gain as U.S. source income under §§ 861-865 and the IRS's aggregate-theory asserted in *Grecian Magnesite*. This time around, Judge Gustafson ruled for the IRS and against the taxpayer. Judge Gustafson reasoned that, although § 751 is not a sourcing rule, the rule in § 741 generally treating the sale of a partnership interest as the disposition of a capital asset is expressly subject to the § 751 carve-out for inventory items. Then, examining the special sourcing rules under §§ 861(a)(6) (sale or exchange of inventory property) and 865(b) (exception for inventory property), Judge Gustafson concluded that the taxpayer's inventory gain from the sale of her partnership interest should be considered U.S.-source income subject to U.S. tax notwithstanding the Tax Court's holding in *Grecian Magnesite* regarding more general § 741 gain.

The final word: 2017 Tax Cuts and Jobs Act Overturns <u>*Grecian Magnesite*</u> *and Supports the Tax Court's Holding in* <u>*Rawat*</u>*.* Regardless of the Tax Court's holdings in *Grecian Magnesite* and *Rawat*, readers may recall that the 2017 Tax Cuts and Jobs Act, § 13501, amended § 864(c) by adding § 864(c)(8) effective for dispositions after November 27, 2017. Section § 864(c)(8) provides that gain or loss (after 11/27/17) on the sale or exchange of all (or any portion of) a partnership interest owned by a nonresident alien individual or a foreign corporation in a partnership engaged in any trade or business within the U.S. is treated as effectively connected with a U.S. trade or business (and therefore taxable by the U.S. unless provided otherwise by treaty) to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The amount of gain or loss treated as effectively connected under this rule is reduced by the amount of such gain or loss that is already taxable under § 897 (relating to U.S. real property interests). Thus, § 864(c)(8) overturns the Tax Court's holding in *Grecian Magnesite* effective for partnership-interest gain recognized after November 27, 2017, and supports the Tax Court's holding in *Rawat* for partnership-interest inventory gain recognized before or after November 27, 2017.

E. <u>Inside Basis Adjustments</u>

F. <u>Partnership Audit Rules</u>

G. <u>Miscellaneous</u>

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. <u>Exempt Organizations</u>

B. <u>Charitable Giving</u>

X. TAX PROCEDURE

A. <u>Interest, Penalties, and Prosecutions</u>

B. <u>Discovery: Summonses and FOIA</u>

C. <u>Litigation Costs</u>

D. <u>Statutory Notice of Deficiency</u>

E. <u>Statute of Limitations</u>

1. If you're on "island time," or think you might be, here's why you might want to "meticulously" and "intentionally" file a U.S. federal income return even if you think you have $0 U.S. gross income and $0 U.S. tax liability. <u>Tice v. Commissioner</u>, 160 T.C. No. 8 (4/10/23). In a case with extremely narrow application, the Tax Court (Judge Pugh), in a unanimous, reviewed opinion, has held that filing a return solely with the U.S. Virgin Islands Bureau of Internal Revenue ("VIBIR") does not trigger the limitations period under § 6501 for the IRS to assess tax. The taxpayer in this case claimed to be a bona fide resident of the U.S. Virgin Islands (USVI) for tax years 2002 and 2003. Accordingly, pursuant to § 932(c) (coordination of

U.S. and USVI income taxes), the taxpayer filed his Form 1040 for those years only with the VIBIR (the USVI's IRS counterpart). The IRS audited the taxpayer and challenged his status as a bona fide resident of the USVI but did not issue a notice of deficiency until 2015. The taxpayer petitioned the Tax Court and moved for summary judgment on the grounds that the IRS's notice of deficiency was time-barred under § 6501(a), which generally provides that the IRS can assess tax within three years after a return is filed. Nevertheless, the Tax Court held that the IRS's notice of deficiency was timely and that the § 6501 limitations period had not begun to run against the IRS because the taxpayer did not show "meticulous compliance" by *intentionally* filing a return with the IRS. In so holding, the Tax Court aligned itself with decisions of the Eighth and Eleventh Circuits. *See Coffey v. Commissioner*, 987 F.3d 808 (8th Cir. 2021), *reversing and remanding Hulett v. Commissioner*, 150 T.C. 60 (2018), and *Commissioner v. Estate of Sanders*, 834 F.3d 1269 (11th Cir. 2016).

Appleton and Hulett distinguished. The Tax Court distinguished its holding in *Tice* from its seemingly contrary holding in *Appleton v. Commissioner*, 140 T.C. 273 (2013). The taxpayer in *Appleton* also filed returns for 2002-2004 with the VIBIR only; however, the IRS had subsequently received copies of the taxpayer's USVI returns from the VIBIR. The IRS had received the *Appleton* taxpayer's USVI returns through the so-called "cover-over" process whereby the VIBIR requests that taxes paid to the U.S. by USVI residents be remitted (i.e., "covered over") to the USVI. The VIBIR invokes the cover-over process by sending critical portions of a taxpayer's return information to the IRS. A cover-over request typically includes a partial or complete copy of a taxpayer's USVI return. The IRS conceded in *Appleton* that "the taxpayer's subjective intent has no role to play" in determining whether a return has been properly filed. The taxpayer and the IRS in *Appleton* also stipulated that the taxpayer was a bona fide resident of the USVI for the years in issue. Thus, the taxpayer contended, and the Tax Court in *Appleton* agreed, that the copies of the taxpayer's USVI returns for years 2002-2004 transmitted to the IRS started the § 6501 limitations period vis-à-vis the IRS. The *Hulett* taxpayer made an argument similar to that made by the taxpayer in *Appleton* about the cover-over process triggering the § 6501 limitations period, and the lead Tax Court opinion in *Hulett* adopted this argument to hold for the taxpayer regarding the § 6501 limitations period. As noted above, however, the Eighth Circuit reversed the Tax Court's decision in *Hulett*, holding that the VIBIR-IRS cover-over process is not sufficient to "meticulously comply with the requirements to file with the IRS." *See Coffey v. Commissioner*, 987 F.3d 808 (8th Cir. 2021). Similarly, the Eleventh Circuit in *Commissioner v. Estate of Sanders*, 834 F.3d 1269 (11th Cir. 2016), also rejected the cover-over argument, holding that "a taxpayer who files a return only with the VIBIR does not trigger the statute of limitations unless he actually is a bona fide resident of the USVI." The taxpayer in *Tice* reserved making a similar argument as the taxpayer in *Appleton* (i.e., that VIBIR return copies sent to the IRS start the statute of limitations against the IRS under § 6501), so expect another Tax Court decision on this issue soon.

Reading between the lines and clarifying. It appears that, if in addition to the taxpayer's USVI return filed with the VIBIR, the taxpayer had *meticulously* and *intentionally* filed a Form 1040 with the IRS for 2002 and 2003—even if the return so filed listed $0 gross income, $0 deductions, and $0 tax—the statute of limitations of § 6501 would have run against the IRS. Further, for USVI returns filed for 2006 and later tax years, Reg. § 1.932-1(c)(2)(ii) expressly provides that the § 6501 limitations period begins running against the IRS based solely upon filing a return with the VIBIR in which the taxpayer takes the position that he or she is a bona fide resident of the USVI.

a. Wow! That was fast. Estate of Tanner v. Commissioner, T.C. Memo 2023-54 (5/1/23). In a case appealable to the Eleventh Circuit and with facts virtually identical to *Tice*, the Tax Court (Judge Buch), in a memorandum decision, refused to grant summary judgment to a taxpayer who argued that the cover-over process between the VIBIR and IRS triggers the § 6501 limitations period on assessment of tax for the IRS. Instead, Judge Buch ruled that a genuine issue of material fact remained to be determined: whether the taxpayer "intended the VIBIR's transmission of the cover-over requests to be the filing of his returns." In both *Tice* and *Estate of Tanner*, the IRS neither (i) conceded that the taxpayer's subjective intent has no role to play in determining whether a return has been properly filed, nor (ii) stipulated that the taxpayer was a bona fide resident of the USVI. Thus, Judge Buch's opinion noted that both *Appleton* and *Hulett* are distinguishable. Judge Buch further noted that the *Estate of Tanner* case is appealable to the Eleventh Circuit and governed by the *Estate of Sanders* decision mentioned above. Therefore, the Tax Court's decision in *Estate of Tanner* also supports the conclusion that, if a taxpayer wishes to ensure the running of the § 6501 statute of limitations against the IRS, the taxpayer would be well advised to file a return in the U.S. even if that return shows $0 gross income, $0 deductions, and $0 tax. Again, with respect to USVI returns filed for 2006 and later tax years, Reg. § 1.932-1(c)(2)(ii) expressly provides that the § 6501 limitations period begins running against the IRS based solely upon filing a return with the VIBIR in which the taxpayer takes the position that he or she is a bona fide resident of the USVI.

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

1. The Tenth Circuit stirs the previously muddied water on whether a late-filed return is a "return" that will permit tax debt to be discharged in bankruptcy proceedings. In re Mallo, 774 F.3d 1313 (10th Cir. 12/29/14), *cert denied*, 135 S. Ct. 2889 (6/29/15). In an opinion by Judge McHugh, the Tenth Circuit held, with respect to taxpayers in two consolidated appeals, that a late return filed after the IRS had assessed tax for the year in question was not a "return" within the meaning of 11 U.S.C. § 523(a) and, consequently, the taxpayers' federal tax liabilities were not dischargeable in bankruptcy. The facts in each appeal were substantially the same. The taxpayers failed to file returns for the years 2000 and 2001. The IRS issued notices of deficiency, which the taxpayers did not challenge, and assessed tax for those years. The taxpayers subsequently filed returns, based on which the IRS partially abated the tax liabilities. The taxpayers then received general discharge orders in chapter 7 bankruptcy proceedings and filed adversary proceedings against the IRS seeking a determination that their income tax liabilities for 2000 and 2001 had been discharged. Section 523(a)(1) of the Bankruptcy Code excludes from discharge any debt for a tax or customs duty:

> (B) with respect to which a return, or equivalent report or notice, if required—
>
> (i) was not filed or given; or
>
> (ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of filing of the petition;

An unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provides that, for purposes of § 523(a):

> the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared under section 6020(a) of the Internal Revenue Code … but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code ….

The court examined a line of conflicting cases in which the courts had applied a four-factor test, commonly known as the *Beard* test (*Beard v. Commissioner*, 793 F.2d 139 (6th Cir. 1986)), to determine whether a late-filed return constitutes a "return" for purposes of 11 U.S.C. § 523(a) and concluded that it did not need to resolve that issue. Instead, the court concluded that, unless it is prepared by the IRS with the assistance of the taxpayer under § 6020(a), a late return is not a "return" because it does not satisfy "the requirements of applicable nonbankruptcy law (including applicable filing requirements)" within the meaning of the language added to the statute in 2005.

- In reaching its conclusion, the Tenth Circuit agreed with the analysis of the Fifth Circuit in *In re McCoy*, 666 F.3d 924 (5th Cir. 2012), in which the Fifth Circuit concluded that a late-filed Mississippi state tax return was not a "return" within the meaning of 11 U.S.C. § 523(a).

- The Tenth Circuit's interpretation of 11 U.S.C. § 523(a) is contrary to the IRS's interpretation, which the IRS made clear to the court during the appeal. The IRS's interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10), is that "section 523(a) does not provide that every tax for which a return was filed late is nondischargeable." However, according to the Chief Counsel Notice, a debt for tax assessed before the late return is filed (as in the situations before the Tenth Circuit in *In re Mallo*) "is not dischargeable because a debt assessed prior to the filing of a Form 1040 is a debt for which is return was not 'filed' within the meaning of section 523(a)(1)(B)(i)."

a. The First Circuit aligns itself with the Fifth and Tenth Circuits and applies the same analysis to a late-filed Massachusetts state income tax return. In re Fahey, 779 F.3d 1 (1st Cir. 2/18/15). In an opinion by Judge Kayatta, the First Circuit aligned itself with the Fifth and Tenth Circuits and concluded that a late-filed Massachusetts state income tax return was not a "return" within the meaning of 11 U.S.C. § 523(a). In a lengthy dissenting opinion, Judge Thompson argued that the majority's conclusion was inconsistent with both the language of and policy underlying the statute: "The majority, ignoring blatant textual ambiguities and judicial precedent, instead opts to create a per se restriction that is contrary to the goal of our bankruptcy system to provide, as the former President put it in 2005, 'fairness and compassion' to 'those who need it most.'"

b. A Bankruptcy Appellate Panel in the Ninth Circuit disagrees with the First, Fifth, and Tenth Circuits. The Ninth Circuit now might have an opportunity to weigh in. In re Martin, 542 B.R. 479 (B.A.P. 9th Cir. 12/17/15). In an opinion by Judge Kurtz, a Bankruptcy Appellate Panel in the Ninth Circuit disagreed with what it called the "literal construction" by the First, Fifth and Ninth Circuits of the definition of the term "return" in Bankruptcy Code § 523(a). The court emphasized that the meaning of the language in the unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides that "the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)," must be determined by taking into account the context of the surrounding words and also the context of the larger statutory scheme. Taking this context into account, the court reasoned, leads to the conclusion that the statutory language does not dictate that a late-filed return automatically renders the taxpayer's income tax liability non-dischargeable. "Why Congress would want to treat a taxpayer who files a tax return a month or a week or even a day late—possibly for reasons beyond his or her control—so much more harshly than a taxpayer who never files a tax return on his or her own behalf [and instead relies on the IRS to prepare it pursuant to § 6020(a)] is a mystery that literal construction adherents never adequately explain." The court also rejected the IRS's interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10) that, although not every tax for which a return is filed late is nondischargeable, a debt for tax assessed before the late return is filed (as in the situation before the court) is not dischargeable because the tax debt is established by the assessment and therefore arises before the return was filed. Instead, the court concluded that binding Ninth Circuit authority predating the 2005 amendments to Bankruptcy Code § 523(a) requires applying the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether a late-filed return constitutes a "return" for purposes of 11 U.S.C. § 523(a). The court concluded that the Bankruptcy Court, which had held that the taxpayers' late-filed returns were "returns" within the meaning of the statute, had relied on a version of the *Beard* test that did not reflect the correct legal standard. Accordingly, the court remanded to the Bankruptcy Court for further consideration.

c. The Eleventh Circuit declines to decide whether a late-filed return always renders a tax debt nondischargeable in bankruptcy. In re Justice, 817 F.3d 738 (11th Cir. 3/30/16). In an opinion by Judge Anderson, the Eleventh Circuit declined to adopt what it called the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits because it concluded that doing so was unnecessary to reach the conclusion that the taxpayer's federal income tax liability was nondischargeable in bankruptcy. The taxpayer filed his federal income tax returns for four tax years after the IRS had assessed tax for those years and between three and six years late. The court concluded that it need not adopt the approach of the First, Fifth and Tenth Circuits because, even if a late-filed return can sometimes qualify as a return for purposes of Bankruptcy Code § 523(a), a return must satisfy the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) in order to constitute a return for this purpose, and the taxpayer's returns failed to satisfy this test. One of the four factors of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The Eleventh Circuit joined the majority of the other circuits in concluding that delinquency in filing a tax return is relevant to whether the taxpayer made such an honest and reasonable attempt. "Failure to file a timely return, at least without a legitimate excuse or explanation, evinces the lack of a reasonable effort to comply with the law." The taxpayer in this case, the court stated, filed his returns many years late, did so only after the IRS had issued notices of deficiency and assessed his tax liability, and offered no justification for his late filing. Accordingly, the court held, he had not filed a "return" for purposes of Bankruptcy Code § 523(a) and his tax debt was therefore nondischargeable.

d. The Ninth Circuit holds that a taxpayer's tax debt cannot be discharged in bankruptcy without weighing in on the issue whether a late-filed return always renders a tax debt nondischargeable. In re Smith, 828 F.3d 1094 (9th Cir. 7/13/16). In an opinion by Judge Christen, the Ninth Circuit held that the tax liability of the taxpayer, who filed his federal income tax return seven years after it was due and three years after the IRS had assessed the tax, was not dischargeable in bankruptcy. The government did not assert the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits. Accordingly, the Ninth Circuit looked to its prior decision in *In re Hatton*, 220 F.3d 1057 (9th Cir. 2000), issued prior to the 2005 amendments to the Bankruptcy Code on which the First, Fifth and Tenth Circuits relied. In *In re Hatton*, the Ninth Circuit had adopted the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether the taxpayer had filed a "return" for purposes of Bankruptcy Code § 523(a). The fourth factor of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The Ninth Circuit concluded that the taxpayer had not made such an attempt:

> Here, Smith failed to make a tax filing until seven years after his return was due and three years after the IRS went to the trouble of calculating a deficiency and issuing an assessment. Under these circumstances, Smith's "belated acceptance of responsibility" was not a reasonable attempt to comply with the tax code.

The court noted that other circuits similarly had held that post-assessment filings of returns were not honest and reasonable attempts to satisfy the requirements of the tax law, but refrained from deciding whether any post-assessment filing could be treated as such an honest and reasonable attempt.

e. The Third Circuit also declines to consider whether a late-filed return always renders a tax debt nondischargeable and instead applies the *Beard* test. Giacchi v. United States, 856 F.3d 244 (3d Cir. 5/5/17). In an opinion by Judge Roth, the Third Circuit held that the tax liability of the taxpayer, who filed his federal income tax returns for 2000, 2001, and 2002 after the IRS had assessed tax for those years, was not dischargeable in bankruptcy. The court declined to consider whether the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits is correct. Instead, the court applied the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether the taxpayer had filed a "return" for purposes of Bankruptcy Code § 523(a). The fourth factor of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The court stated:

> Forms filed after their due dates and after an IRS assessment rarely, if ever, qualify as an honest or reasonable attempt to satisfy the tax law. This is because the purpose of a tax return is for the taxpayer to provide information to the government

> regarding the amount of tax due. … Once the IRS assesses the taxpayer's liability, a subsequent filing can no longer serve the tax return's purpose, and thus could not be an honest and reasonable attempt to comply with the tax law.

f. The Eleventh Circuit has rejected the one-day late approach to determining whether a late-filed return renders a tax debt nondischargeable in bankruptcy. In re Shek, 947 F.3d 770 (11th Cir. 1/23/20). In a very thorough opinion by Judge Anderson, the Eleventh Circuit has held that a tax debt reflected on a late-filed Massachusetts tax return was discharged in bankruptcy. In reaching this conclusion, the court rejected the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits. The taxpayer filed his 2008 Massachusetts income tax return seven months late. The return reflected a tax liability of $11,489. Six years later, he filed for chapter 7 bankruptcy in Florida and received an order of discharge in January 2016. When the Massachusetts Department of Revenue subsequently sought to collect the tax debt, the taxpayer filed a motion to reopen his bankruptcy case to determine whether his tax debt had been discharged. The Bankruptcy Court held that his tax debt had been discharged. In affirming this conclusion, the Eleventh Circuit focused on the definition of the term "return" in § 523(a) of the Bankruptcy Code, added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides that, for purposes of § 523(a):

> the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared under section 6020(a) of the Internal Revenue Code … but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code ….

The court emphasized that canons of statutory construction dictate the need to give effect to every word of a statute when possible and that the term "applicable filing requirements" must mean something different than all filing requirements. Further, the court reasoned, adopting the "one-day-late" approach and holding that the tax liability reflected on every late-filed return is not dischargeable would render a near nullity the language of § 523(a)(1)(B)(ii) of the Bankruptcy Code, which contemplates that the tax liability on a late-filed return can be discharged as long as the late return is not filed within the two-year period preceding the filing of the bankruptcy petition. The court also rejected the Department of Revenue's argument that the taxpayer's return did not constitute a return under Massachusetts law (which the court viewed as included among "the requirements of applicable nonbankruptcy law"). After rejecting the one-day late approach, the court held that the taxpayer's return was a "return" whether the relevant test is the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) or instead the definition of a return under Massachusetts law. Accordingly, the court held, the taxpayer's tax liability had been discharged.

g. The First Circuit has applied the *Beard* test to conclude that a taxpayer's late-fled return was not a "return" and therefore the taxpayer's tax debt was not discharged in bankruptcy. Kriss v. United States, 53 F.4th 726 (1st Cir. 11/22/22). The taxpayer filed his federal income tax returns for 1997 and 2000 in 2007. In 2012, the taxpayer filed a petition in bankryptcy. After receiving a general discharge of his debts in bankruptcy, the issue arose whether the taxpayer's federal tax liability for 1997 and 2000 had been discharged. In an opinion by Judge Kayatta, the First Circuit held that the tax liability of the taxpayer, whose returns for 1997 and 2000 were filed after the IRS had assessed tax for those years, was not dischargeable in bankruptcy. The court declined to decide whether its prior decision in *In re Fahey*, 779 F.3d 1 (1st Cir. 2/18/15), was controlling. In *In re Fahey*, the court adopted the "one-day late" approach and held that a late-filed Massachusetts state income tax return was not a "return" for purposes of Bankruptcy Code § 523(a). Instead, the court applied the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether the taxpayer had filed a "return" for purposes of Bankruptcy Code § 523(a). The fourth factor of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The court stated:

> Under the subjective version of the Beard test, Kriss's alleged facts, even viewed most favorably to him, fall well short of plausibly qualifying as descriptions of a reasonable effort to file timely returns. Kriss's only excuse for his very belated filings is that his wife falsely assured him that she had filed the returns for him. But the United States tells us that Kriss and his wife were filing separate returns -- an assertion that Kriss does not challenge. Kriss also makes no allegation explaining why he did not respond to notices sent by the IRS inquiring about the status of his unfiled returns. He does not even allege that he ever signed any returns for 1997 or 2000 until 2007. Therefore, applying the Beard test that Kriss urged the bankruptcy court to adopt, he never filed "returns" for the tax years relevant here.

2. In Notice 2007-83, the IRS concluded that certain trust arrangements involving cash value life insurance policies are listed transactions. According to the Sixth Circuit, the IRS failed to comply with the Administrative Procedure Act in issuing Notice 2007-83 and the notice therefore is invalid. Mann Construction, Inc. v. United States, 27 F.4th 1138 (6th Cir. 3/3/22). In an opinion by Chief Judge Sutton, the U.S. Court of Appeals for the Sixth Circuit has held that the IRS failed to comply with the Administrative Procedure Act (APA) in issuing Notice 2007-83, 2007-2 C.B. 960, and that the notice therefore is invalid.

Notice 2007-83. In Notice 2007-83, the IRS examined certain trust arrangements being promoted to business owners. In these arrangements, a taxable or tax-exempt trust is established to provide certain benefits, such as death benefits, to owners of the business and to employees. The business makes contributions to the trust, which the trustees use to purchase cash value life insurance policies on the lives of the owners and term insurance on the lives of non-owner employees. The arrangements are structured so that, upon termination of the plan, the owners of the business receive all or a substantial portion of the assets of the trust. According to the notice, those promoting the arrangements take the position that the business can deduct contributions to the trust and that the owners have no income as a result of the contributions or the benefits provided by the trust. The notice identifies these transactions as listed transactions that must be disclosed to the IRS. Accordingly, those who fail to disclose these transactions are subject to significant penalties pursuant to § 6707A.

Facts of this case. In this case, from 2013 to 2017, a corporation, Mann Construction, Inc., established an employee-benefit trust that paid the premiums on a cash-value life insurance policy benefitting the corporation's two shareholders. The corporation deducted these payments and the shareholders reported as income part of the insurance policy's value. Neither the individuals nor the company reported this arrangement to the IRS as a listed transaction. In 2019, the IRS concluded that this transaction fell within Notice 2007-83 and imposed a $10,000 penalty on the corporation and on both of its shareholders ($8,642 and $7,794) for failing to disclose their participation in the transaction. The corporation and the shareholders paid the penalties for the 2013 tax year, sought administrative refunds on the ground that the IRS lacked authority to penalize them, and ultimately brought legal action seeking a refund in a U.S. District Court. The District Court upheld the validity of Notice 2007-83 and held in favor of the government.

Sixth Circuit's analysis. The U.S. Court of Appeals for the Sixth Circuit reversed the District Court's holding and concluded that the IRS had failed to comply with the APA in issuing Notice 2007-83. The APA generally prescribes a three-step process for notice-and-comment rulemaking. First, the agency must issue a general notice of proposed rulemaking. Second, assuming notice is required, the agency must consider and respond to significant comments received during the period for public comment. Third, in issuing final rules, the agency must include a concise general statement of the rule's basis and purpose. *See, e.g.*, *Perez v. Mortgage Bankers Ass'n*, 575 U.S. 92, 96 (2015). The IRS did not comply with the first requirement in issuing Notice 2007-83 because it did not issue a notice of proposed rulemaking. The government made two principal arguments as to why it was not required to comply with the APA's notice-and-comment requirements. *First*, the government argued that Notice 2007-83 is an interpretive rule that is not subject to the APA's notice-and-comment procedures rather than a legislative rule that is subject to such procedures. The Sixth Circuit rejected this argument and concluded that Notice 2007-83 is a legislative rule. According to the court, the notice imposes new duties on taxpayers by requiring them to report certain transactions and imposes penalties for failure to do so. The notice also carries out an express delegation of authority from Congress, the court reasoned, because § 6011(a) provides that the Secretary of the Treasury is to determine by regulations when and how taxpayers must file returns and statements and § 6707A(c) delegates to the Secretary of the Treasury the authority to identify which transactions have the potential for tax avoidance or evasion and which transactions are substantially similar to such transactions. Because Notice 2007-83 imposes new duties and penalties on taxpayers and carries out an express delegation of congressional authority, the court concluded, the notice is a legislative rule that is subject to the APA's notice-and-comment procedures. *Second*, the government argued that, even if Notice 2007-83 is a legislative rule, Congress had exempted it from the APA's notice-and-comment procedures. The Sixth Circuit rejected this argument as well. According to the court, nothing in the language of the relevant statutory provisions or their legislative history indicated a congressional intent to exempt the IRS from the APA's notice-and-comment procedures when the IRS identifies transactions that have the potential for tax avoidance or evasion and substantially similar transactions. Because the IRS was required to comply with the APA's notice-and-comment procedures in issuing Notice 2007-83 and failed to do so, the court concluded, the notice is invalid. Accordingly, the taxpayers are entitled to a refund of the penalties they paid for failing to disclose the transaction.

Broader implications. The effect of the Sixth Circuit's decision is to preclude the IRS from imposing penalties under § 6707A for failing to disclose a transaction that the IRS identifies in a notice issued without complying with the APA's notice-and-comment requirements. Because the IRS normally does not comply with the APA's requirements in issuing notices, the broader implication of the court's decision is that taxpayers, at least those whose appeals will be heard by the Sixth Circuit, can challenge penalties imposed pursuant to similar notices that identify transactions as listed or reportable transactions. These include Notice 2016-66, 2016-47 I.R.B. 745, which identifies certain captive insurance arrangements, referred to as "micro-captive transactions," as transactions of interest for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 of the Code, and Notice 2017-10, 2017-4 I.R.B. 544, which identifies certain syndicated conservation easement transactions entered into after 2009 as listed transactions.

a. ♪♫"Hey, I'm gonna get you too. Another one bites the dust."♫♪ Notice 2017-10 held invalid for violating the APA. Green Valley Investors, LLC v. Commissioner, 159 T.C. No. 5 (11/9/22). Aligning with the Sixth Circuit's reasoning in *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. 3/3/22), the Tax Court, in a reviewed opinion (11-4-2) by Judge Weiler, has held that another IRS notice identifying a transaction as a listed transaction violated the APA and therefore is invalid.

Notice 2017-10. As mentioned immediately above, the IRS announced in Notice 2017-10, 2017-4 I.R.B. 544, that 2010 and later syndicated conservation easements are another type of § 6707A listed transaction. A typical syndicated conservation easement involves a promoter offering prospective investors the possibility of a charitable contribution deduction in exchange for investing in a partnership. The partnership subsequently grants a conservation easement to a qualified charity, allowing the investing partners to claim a charitable contribution deduction under § 170. See Part IX item B.1. of the outline for a discussion of recent syndicated contribution easement cases.

Intended Effect of Notice 2017-10. The intended effect of Notice 2017-10 was to make syndicated conservation easements subject to special disclosure and list-maintenance obligations under §§ 6111 and 6112, as well as associated penalties for failure to comply. Section 6111 requires each "material advisor" (as defined) with respect to a § 6707A listed transaction to file an IRS Form 8918 (Material Advisor Disclosure Statement). Failure to file Form 8918 may result in penalties under § 6707. In addition, § 6112 requires material advisors to maintain lists of persons who were provided advice concerning a § 6707A listed transaction. Section 6662A, which is central to the *Green Valley Investors* case, imposes an accuracy-related penalty on an understatement of taxable income by a taxpayer participating in a § 6707A listed transaction. Furthermore, a taxpayer-participant in a listed transaction must file IRS Form 8886 (Reportable

Transaction Disclosure Statement) with the taxpayer's return and also may be subject to penalties under § 6707A for failure to disclose required information. Willful failures to file Form 8886 or Form 8918 can result in criminal sanctions under § 7203 (fines and up to one year in prison).

Green Valley Investors. This consolidated case involves IRS examinations of four different syndicated conservation easement partnerships claiming approximately $90 million in combined charitable contribution deductions for tax years 2014 and 2015. In each of the four cases, the IRS filed motions for summary judgment claiming that certain penalties, including the accuracy-related penalty under § 6662A, were properly assessed. The IRS argued that § 6662A applies because the syndicated conservation easements at issue are § 6707A listed transactions as described in Notice 2017-10. The taxpayers objected to the IRS's motions for summary judgment and filed cross-motions for summary judgment that § 6662A should not apply based upon two grounds: (i) because Notice 2017-10 was not issued until after the tax years at issue, the IRS cannot impose the § 6662A penalty retroactively, and (ii) the IRS failed to comply with the notice-and-comment rulemaking procedures of the APA when issuing Notice 2017-10. With respect to the taxpayers' argument that Notice 2017-10 and any corresponding penalties could not be assessed retroactively, the Tax Court declined to rule; however, Judge Weiler's opinion was skeptical of the taxpayers' argument, noting that (i) retroactive penalties have been upheld by the Tax Court in prior cases and (ii) Reg. § 1.6011-4(e)(2) imposes a duty on taxpayers to disclose any transaction that subsequently becomes a listed transaction as long as the period of limitations for assessment remains open. With respect to the taxpayers' second argument that the IRS failed to comply with the notice-and-comment rulemaking procedures of the APA when issuing Notice 2017-10, the Tax Court held for the taxpayers, thereby invalidating the notice. The Tax Court rejected the same arguments that the IRS made in *Mann Construction* and largely followed the reasoning of the Sixth Circuit. The court concluded that Notice 2017-10 is a legislative rule because it "creates new substantive reporting obligations for taxpayers and material advisors, including petitioner and the LLCs, the violation of which prompts exposure to financial penalties and sanctions." Because Notice 2017-10 is a legislative rule, the court concluded, it was subject to the APA's notice-and-comment procedures. The IRS had not complied with those procedures in issuing Notice 2017-10, and the notice therefore was invalid.

Concurring opinion of Judge Pugh. Judge Pugh wrote a lengthy concurring opinion joined by Judges Ashford, Copeland, Kerrigan, and Paris—essentially that the notice-and-comment procedures of the APA should not apply because Congress explicitly authorized Treasury and the IRS to identify listed transactions when Congress enacted the statutory scheme surrounding § 6707A—but ultimately agreed with the majority. Judge Pugh believed that the IRS could and should have invoked the "good cause exception" to the notice-and-comment procedures of the APA to issue temporary regulations (instead of merely a notice). Judge Pugh pointed out that the IRS previously had used the "good cause exception" when it issued Notice 2000-44 (Son-of-Boss transactions) followed by temporary regulations. *See* T.D. 9062, 2003-2 C.B. 46.

Dissenting opinions of Judges Gale and Nega. Judges Gale and Nega dissented from the majority's opinion, piggybacking on Judge Pugh's concurring opinion, but concluded that use of the "good cause exception" was unnecessary and that the APA's notice-and-comment procedures should not apply given the clear statutory scheme surrounding § 6707A.

b. ♪♫"I get knocked down, but I get up again. You're never gonna keep me down."♫♪ IRS issues proposed regulations identifying syndicated conservation easements as listed transactions. REG-106134-22, Syndicated Conservation Easements as Listed Transactions, 87 F.R. 75185 (12/8/2022). Perhaps following Judge Pugh's cue in *Green Valley Investors*, Treasury and the IRS have issued proposed regulations identifying syndicated conservation easements as listed transactions for purposes of § 6707A. The proposed regulations will be effective on the date they are published as final regulations in the Federal Register.

3. Surely, it's not constitutional for the government to revoke or refuse to issue an individual's passport just for having a seriously delinquent tax debt? Isn't there some sort of fundamental right to travel? Don't pack your bags just yet. Franklin v. United States, 49 F.4th 429 (5th Cir. 9/15/22). Section 7345, which addresses the revocation or denial of passports for seriously delinquent tax debts, was enacted in 2015 as section 32101(a) of the Fixing America's Surface Transportation Act, Pub. L. 114-94 (Dec. 4, 2015) (FAST Act). It provides that, if the IRS certifies that an individual has a "seriously delinquent tax debt," the Secretary of the Treasury must notify the Secretary of State "for action with respect to denial, revocation, or limitation of a passport." § 7345(a). In general, a seriously delinquent tax debt is an unpaid tax liability in excess of $50,000 for which a lien or levy has been imposed. § 7345(b)(1). A taxpayer who seeks to challenge such a certification may petition the Tax Court or bring an action in a U.S. District Court to determine if the certification was made erroneously. § 7345(e)(1). If the Tax Court or U.S. District Court concludes the certification was either made in error or that the IRS has since reversed its certification, the court may order the Secretary of the Treasury to notify the State Department that the certification was erroneous. § 7345(e)(2).

The IRS assessed $421,766 in penalties for the plaintiff's failure to file accurate tax returns and failure to report a foreign trust of which he was the beneficial owner. The IRS began collection efforts in 2018. These included issuing a notice of federal tax lien and levying on his Social Security benefits. Pursuant to § 7345, the IRS issued a notice of certification of a "seriously delinquent tax debt" and notified the Secretary of State that his passport should be revoked. The State Department then revoked his passport. The plaintiff attempted to eliminate his liability by submitting two separate offers-in-compromise for doubt as to liability, both of which were rejected by the IRS. He then brought an action in the U.S. District Court for the Northern District of Texas. Among other claims, he asserted various claims related to the IRS's alleged failure to obtain supervisory approval of the penalties as required by § 6751(b). He also challenged the constitutionality of the State Department's revocation of his passport and argued that the revocation violated his rights under the Fifth Amendment. The District Court dismissed the plaintiff's claims under § 6751(b) for lack of subject matter jurisdiction and concluded that, although it had subject matter jurisdiction over his constitutional claim, that claim did not have merit because the passport-revocation scheme of the FAST Act was constitutional under a rational-basis review.

Section 6751(b) claims. Section 6751(b)(1) requires that the "initial determination" of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." The Fifth Circuit concluded that the District Court had correctly dismissed the plaintiff's claims for lack of subject matter jurisdiction. Subject to certain exceptions, the full payment rule established by *Flora v. United States*, 362 U.S. 145 (1960), requires that a taxpayer pay the full amount of tax that the IRS seeks to collect and then seek a refund. A federal district court lacks jurisdiction to hear the claims of a taxpayer who seeks a refund of tax but who has not complied with the full-payment rule (or qualified under an exception to it). Further, the Anti-Injunction Act, 26 U.S.C. §7421(a) (AIA), bars lawsuits filed "for the purpose of restraining the assessment or collection of any tax" by the IRS. The Fifth Circuit concluded that each of the plaintiff's claims under § 6751(b) implicitly challenged the validity of the penalties the IRS had assessed and therefore violated the AIA. The court recognized that, in *CIC Services, LLC v. IRS*, 141 S. Ct. 1582 (2021), the U.S. Supreme Court had held that a challenge to a reporting requirement could proceed even if failure to comply with the reporting requirement resulted in penalties. But the Court in *CIC Services*, the Fifth Circuit observed, had reaffirmed that a challenge to the assessment or collection of a tax or penalty is still barred by the AIA. The plaintiff's claims in this case based on the IRS's alleged failure to obtain supervisory approval of the penalties as required by § 6751(b), the court concluded, implicitly challenged the validity of the penalties and were therefore barred by the AIA.

Constitutional claims. The Fifth Circuit also affirmed the District Court's dismissal of the plaintiff's constitutional challenge for failure to state a claim on which relief can be granted. The plaintiff argued that the State Department's revocation of his passport violated his rights under the

Due Process Clause of the Fifth Amendment. Specifically, the court concluded that international travel is not a fundamental right that must be reviewed under so-called strict scrutiny. If the court's standard of review were strict scrutiny, then any legislative infringement of a fundamental right must be narrowly tailored to serve a compelling government interest. Instead, the court held, because international travel is not a fundamental right, the constitutionality of § 7345 must be determined under either a rational basis standard of review or under so-called intermediate scrutiny. Under a rational basis standard, the court observed, "the restriction at issue survives as long as it is 'rationally related to a legitimate government interest.'" *Reyes v. N. Tex. Tollway Auth.*, 861 F.3d 558 (5th Cir. 2017); *see also FCC v. Beach Comm'cns, Inc.*, 508 U.S. 307, 313 (1993). Under an intermediate-scrutiny standard, "the challenged restriction 'must serve important governmental objectives and must be substantially related to achievement of those objectives.'" *Craig v. Boren*, 429 U.S. 190 (1976). The Fifth Circuit declined to decide whether the passport-revocation scheme must be judged under rational-basis review or instead intermediate scrutiny because, the court held, even under the higher standard of intermediate scrutiny, the statute is constitutional. The federal government's interest in collecting taxes, the court concluded, "is undoubtedly an important one." The passport-revocation scheme, the court held, is substantially related to achieving the government's objective:

> The passport-revocation scheme is also clearly connected to that goal: delinquent taxpayers will be well-incentivized to pay the government what it is owed to secure return of their passports, and those same taxpayers will find it much more difficult to squirrel away assets in other countries if they are effectively not allowed to legally leave the country.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

A. <u>Enacted</u>