IRS Insights | A closer look

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Supreme Court upholds section 965 tax in *Moore v. United States*

The Supreme Court has ruled the section 965 transition tax is constitutional. Last year, many taxpayers and practitioners were surprised when the Supreme Court agreed to hear a challenge to the section 965 transition tax on the grounds that it was an unconstitutional, unapportioned direct tax. The tax community wondered whether the Supreme Court would invalidate section 965 and, if so, if its ruling would implicate other areas of tax law (*for example*, partnership taxation) or other international tax regimes (*for example*, the subpart F and global intangible low-taxed income regimes). On June 20, 2024, the Supreme Court upheld section 965.

Section 965 transition tax

As part of the Tax Cuts and Jobs Act of 2017, Congress enacted the section 965 transition tax. In general, section 965 required US shareholders to pay a one-time transition tax on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the US. The section 965 tax liability was generally applicable in the 2017 and/or 2018 tax years. However, taxpayers could elect to pay their section 965 tax liability in eight yearly installments.

Supreme Court upholds section 965

In *Moore v. United States*, No. 22-800, the taxpayers argued that section 965 violated the Constitution because it was an unapportioned direct tax on property (i.e., shares of stock). The taxpayers claimed that the tax was not a tax on income (i.e., an indirect tax which would not require apportionment) because income taxes require "realization" and section 965 did not tax any income realized by the taxpayers. The Government contended that section 965 was a tax on income (an indirect tax).

The Supreme Court acknowledged that realization did occur in this case, albeit at the level of the specified foreign corporation owned by the taxpayers:

> Critically, however, [section 965] does tax realized income—namely, income realized by the [specified foreign corporation owned by the taxpayers]. [Section 965] attributes the income of the corporation to the shareholders, and then taxes the shareholders (including the [taxpayers]) on their share of that undistributed corporate income.

Moore at p. 8.

The Supreme Court held that "Congress may attribute an entity's realized and undistributed income to the entity's shareholders or partners, and then tax the shareholders or partners on their portions of that income" based on the Supreme Court's "longstanding precedents, reflected in and reinforced by Congress's longstanding practice." *Id.*

The Supreme Court analogized section 965 to the various regimes referenced in longstanding precedents (*for example*, partnership taxation, S corporation taxation, and the subpart F regime) and further held that section 965, which operates in the same basic way as such regimes, is constitutional.

Conclusion

The Supreme Court explicitly stated that its holding is narrow and applies only when Congress treats the entity as a pass-through. The Supreme Court said that nothing in the opinion should be construed as authorizing a tax on both an entity and shareholders or partners on the same undistributed income realized by the entity. Likewise, the Supreme Court stated that the opinion did not address whether realization is a constitutional requirement for an income tax.

Tax Court upholds early election into BBA

To elect in early to the centralized partnership audit regime created by the Bipartisan Budget Act of 2015 (BBA), a partnership had to represent that it had sufficient assets to pay any imputed underpayment that may result from an audit. In *SN Worthington Holdings LLC v. Commissioner*, the partnership made that representation, but the IRS determined it did not have sufficient assets.[1] The Tax Court upheld the election because the regulation required the partnership only to represent it had sufficient assets (rather than establish or prove it had sufficient assets).

Background

When Congress enacted the BBA, it was effective for all partnerships for tax years beginning after December 31, 2017.[2] However, Congress allowed partnerships to elect in early for tax years beginning after November 2, 2015.[3] Treasury issued regulations providing the procedures and requirements for taxpayers to elect in early to the BBA. One of the requirements is that the partnership represent it has sufficient assets to pay a potential imputed underpayment (IU) if audited.[4]

Facts

In the case, the IRS selected SN Worthington's 2016 return for audit and notified SN Worthington it could elect to apply the BBA rules instead of the current, soon-to-be-replaced TEFRA regime. SN Worthington completed the form to elect to apply the BBA and made all required representations, including that it had sufficient assets to pay any IU resulting from the audit. The IRS exam team determined SN Worthington did not have sufficient assets and notified SN Worthington that the IRS would conduct the audit under TEFRA. The IRS conducted the audit under TEFRA procedures, and SN Worthington signed documents referencing the TEFRA procedures.

At the end of the audit, SN Worthington told the IRS exam team it should be applying BBA. The exam team issued the final partnership administrative adjustment (FPAA) under TEFRA. SN Worthington petitioned the Tax Court arguing the FPAA was invalid because was not issued under BBA.

Tax Court decision

The Tax Court agreed that SN Worthington had elected to apply the BBA regime and, thus, the FPAA issued under TEFRA was invalid. The court reasoned that the regulations required the partnership to only *represent* that it had sufficient assets, not to *establish* that it had sufficient assets. The court stated that "when determining whether an election is valid, the Commissioner may not require the taxpayer to satisfy more stringent requirements than the provisions authorizing the election." The court also rejected the IRS's argument that the election frustrated the purpose of section 1101 of the BBA, because the IRS could still collect the IU from the partners if the partnership could not pay. The court also noted that when regulations are unclear, courts construe them against the draft.

Conclusion

Because of the unique factual situation giving rise to this case, it may have limited impact. However, it is a reminder that that taxpayers should understand the requirements and consequences of any election they make, especially when dealing with complex and evolving tax regimes.

IRS summons issued on behalf of Argentina is valid

In a recent decision, a District Court dismissed a petition to quash an IRS summons issued at the request of the Argentinian tax authorities.[5] In dismissing the petition, the Court concluded: (1) the Court lacked subject matter jurisdiction for one of the petitioners, (2) the petition was untimely, and (3) the summons was valid.[6]

Background

In July 2023, the IRS received an exchange of information request ("EOI request") from Argentina pursuant to the U.S.-Argentina tax information exchange agreement (TIEA), which allows the tax authorities of each country to exchange information to assist each other with the administration and enforcement of domestic tax laws.

The Argentinian authorities sought information regarding a taxpayer under investigation by the Argentinian tax authorities. The taxpayer was believed to be the beneficial owner of an LLC and had purportedly failed to report the LLC's financial accounts to Argentina, in violation of local tax laws. Pursuant to the EOI request, the IRS issued a summons to taxpayer's bank, directing the bank to present copies of specific documents related to taxpayer's bank accounts and accounts owned by the LLC.

The LLC and a relative of taxpayer subsequently filed a petition to quash the summons, claiming the IRS may not have complied with the standards established by the court in *United States v. Powell* [7] for the enforcement of a summons.

District Court decision

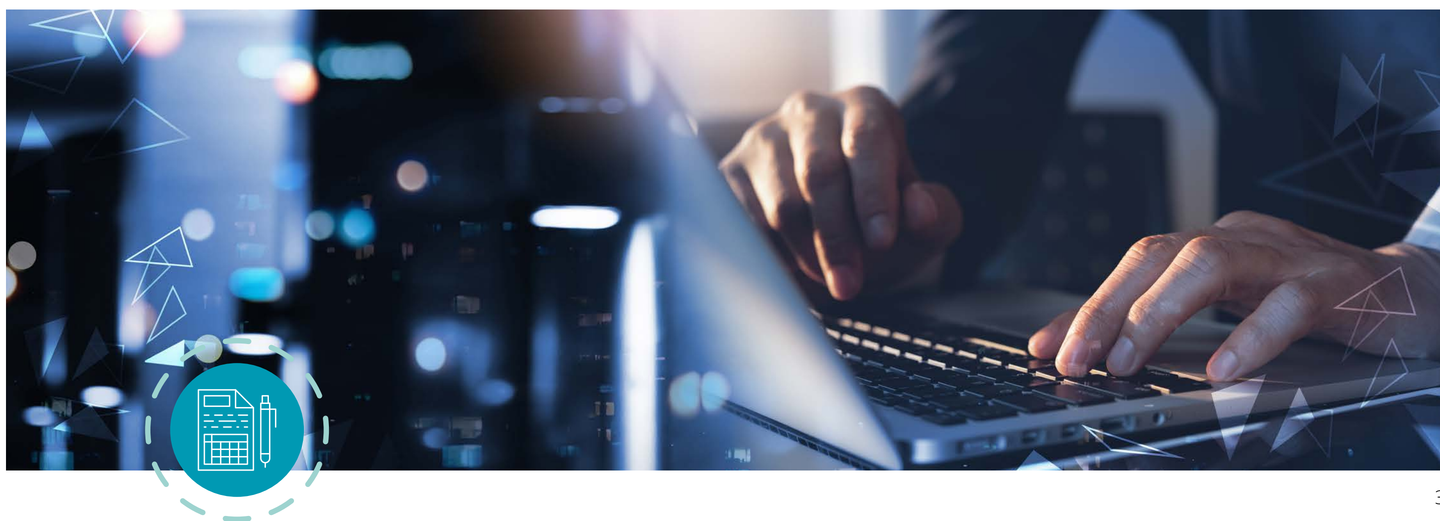
In ruling on the petitioners' motion to quash, the Court first concluded that it lacked subject matter jurisdiction over taxpayer's relative because she was not identified in the IRS summons and therefore lacked standing to file a petition to quash the summons.[8]

Section 7609 authorizes the IRS to issue a summons to a third party for information about a taxpayer.[9] Before issuing the summons, the IRS must generally notify anyone named in the summons.[10] A party who is named in the summons and entitled to notice is also entitled to challenge the summons by initiating procedures to quash the summons within 20 days of service of the notice.[11] The Court held that because the IRS summons only named taxpayer and the LLC, taxpayer's relative was not entitled to notice and therefore also not entitled to challenge the summons.[12] As a result, taxpayer's relative lacked standing to challenge the summons and the Court lacked subject matter jurisdiction over her action.[13] The Court also concluded that the petition to quash was untimely because it was filed 28 days after the IRS provided taxpayer and the LLC with notice, therefore any challenge to the summons was barred by the statutory 20-day limitations period.[14]

The Court also rejected petitioners' argument that the IRS summons may not have complied with the standards set forth in *Powell*, concluding the summons was valid because it was issued by the IRS in good faith. In its analysis, the Court applied the four-factor test articulated in *Powell* which sets forth the general standards for a valid summons – (1) an investigation is being conducted for a legitimate purpose, (2) the inquiry is relevant to that purpose, (3) the IRS does not already have the information it seeks, and (4) the IRS followed the administrative steps necessary for issuing the summons.[15] The Court determined the IRS's summons satisfied the four *Powell* factors because the summons was issued pursuant to a legitimate investigation by the Argentinian tax authorities into taxpayer's tax liabilities. The purpose of the IRS's inquiry was relevant to the investigation, the IRS did not already have the information it sought, and the Argentinian tax authorities had exhausted all other measures for obtaining the requested information. The Court also determined the IRS had taken all of the administrative steps required by the Internal Revenue Code for the issuance of the summons. Accordingly, the Court concluded the IRS summons was valid and had been issued in good faith.

Conclusion

The Court ultimately dismissed the petition to quash the IRS summons, highlighting that Congress gave the IRS "broad statutory authority" to issue summons and such authority extends to summons issued on behalf of treaty partners.[16]



Letters from IRS didn't extend the limitations period within which taxpayer was required to file refund suit

In June 2023, Michelle Moy, the taxpayer, filed a complaint in federal district court seeking a refund of 2008 federal income tax overpayments related to the alleged omission by the IRS of certain foreign tax credits.

The IRS assessed approximately $32,500 in tax for the 2008 tax year following the taxpayer's failure to timely file an income tax return. The taxpayer alleged that she had paid more than $20,000 in foreign taxes to the United Kingdom for the 2008 tax year and that the IRS failed to incorporate a foreign tax credit in its calculation of the tax due. In April 2018, the taxpayer filed a refund claim, which the IRS denied–as time barred–on August 1, 2018. Thereafter, the taxpayer filed a protest with the IRS Independent Office of Appeals.

Appeals issued three separate letters (in December 2019, February 2020, and March 2020) advising the taxpayer that it was reviewing the matter and would respond shortly. In January 2021, Appeals affirmed the IRS's denial of the refund claim and dismissed the taxpayer's appeal. The basis for dismissing the appeal was that the taxpayer failed to file a lawsuit in federal district court or the US Court of Federal Claims within two years of the August 1, 2018 denial.

In response to the refund suit, initiated in June of 2023, the government moved to dismiss under Federal Rule of Civil Procedure 12(b)(1) arguing that the taxpayer's complaint wasn't filed within the two-year period for refund suits as required by section 6532(a)(1). Additionally, the government argued that equitable tolling did not apply to the taxpayer's claim.

Under section 6532, "[n]o suit or proceeding under section 7422(a) for the recovery of any internal revenue tax, penalty, or other sum, shall be begun … [a]fter the expiration of 2 years from the date of mailing … of a notice of disallowance." The two-year period of limitations can be extended upon a written agreement between the taxpayer and the Secretary. *See* section 6532(a)(2). The Code, however, is explicitly clear that "[a]ny consideration, reconsideration, or action by the Secretary with respect to such claim following the mailing of a notice by certified mail or registered mail of disallowance shall not operate to extend the period within which suit may be begun." *See* section 6532(a)(4).

The taxpayer agreed that her complaint was filed more than two years after the denial of her refund claim. For her complaint to avoid dismissal, she needed to establish a valid basis for tolling of the two-year period outlined in section 6532(a). The taxpayer's equitable tolling argument was based on the three letters she received from Appeals claiming they were a stall tactic and misled her into delaying the filing of her complaint. The court was not persuaded and held that the letters did not operate to extend the period within which the taxpayer was required to file suit because they were "consideration" or "reconsideration" of the claim and section 6532(a)(4) expressly states that any such action by the IRS isn't sufficient to extend the period of limitations. Because the taxpayer could not establish that the period of limitations had been tolled, the late filing of her complaint required the court to dismiss the refund action against the government.

Ninth Circuit weighs in on start of statute of limitations for government to bring suit to recover erroneous refund

In *United States v. Page*, No. 21-17083 (9th Cir. Jun. 26, 2024), the Ninth Circuit reversed a district court's dismissal of the government's complaint to recover an erroneous refund issued to a taxpayer. The Ninth Circuit held that the statute of limitations for the government to file suit to recover an erroneous refund begins to run when the refund check clears, and not when the check is issued or received; consequently, the Ninth Circuit concluded that the government's suit, which was filed within two years of the date that the refund check cleared, was timely.

Jeffrey S. Page ("Taxpayer") was entitled to a refund of $3,463 in connection with his 2016 Form 1040, *U.S. Individual Income Tax Return*. On May 15, 2017, the IRS issued a refund check to Taxpayer in the amount of $491,104.01, in connection with Taxpayer's 2016 Form 1040. The discrepancy in the amount of the refund resulted from an IRS clerical error. Taxpayer cashed the refund check on April 5, 2018, approximately eleven months after the refund check was issued to him.

When the IRS discovered the error, the IRS sent correspondence to Taxpayer instructing Taxpayer to return the refund that was issued in error. Ultimately, Taxpayer returned a portion of the amount refunded to him, but retained $277,641.01 of the refund.

On March 31, 2020, the government filed suit under Internal Revenue Code ("IRC") section 7405 to recover the outstanding refund amount that was paid to Taxpayer in error. The district court concluded that the suit was barred by the statute of limitation set forth in IRC section 6532(b), which provides: "Recovery of an erroneous refund by suit under section 7405 shall be allowed only **if such suit is begun within 2 years after the <u>making of such refund</u>....**" (emphasis added). According to the district court, the statute of limitations under IRC section 6532(b) begins to run on the date that the taxpayer receives the check, and not the date that the check is cashed. Even though the district court did not know the actual date that the check was received by Taxpayer in this case, the district court determined that the government's complaint was untimely, relying on "common sense."

On Appeal, the Ninth Circuit determined that the statute of limitations under IRC section 6532(b) begins to run when an erroneous refund check clears. Because the Ninth Circuit held that the two-year statute of limitations under IRC section 6532(b) began when Taxpayer's refund check cleared, on April 5, 2018, the Ninth Circuit concluded that the government's complaint, filed on March 31, 2020, was timely. Accordingly, the Ninth Circuit reversed the district court's dismissal of the government's complaint for recovery of the erroneous refund on statute of limitations grounds.

Supreme Court overrules *Chevron* deference

On June 28, 2024, the Supreme Court issued its decision in *Loper Bright Enterprises v. Raimondo,*[17] overruling the *Chevron*[18] deference standard. The Supreme Court held that, under the Administrative Procedure Act (APA), courts are required to exercise their independent judgment and may not defer to an administrative agency's interpretation of the law simply because a statute is ambiguous.[19]

Background

Chevron deference was established by the Supreme Court in 1984 as a two-step test for reviewing an administrative agency's interpretation of a statute it administers.[20] Under the *Chevron* two-step test, courts must first consider whether Congress has "directly spoken to the precise question at issue" and if Congress has unambiguously expressed its statutory intent then that is "the end of the matter" (*Chevron* Step 1).[21] However, if the court determines that both Congress and the statute are silent or ambiguous with respect to the question at issue, the court must grant deference to the administrative agency's interpretation of the statute, so long as its interpretation is not "arbitrary, capricious, or manifestly contrary to the statute".[22]

Supreme Court decision

The case of *Loper Bright* involved a regulation by the National Marine Fisheries Service (NMFS) requiring fishing boats to pay the costs of federal monitors to help prevent overfishing. The regulation was challenged as an impermissible construction of the statute but was ultimately upheld by the appellate court under the *Chevron* deference standard. The Supreme Court subsequently granted review, limited to the question of whether *Chevron* deference should be overruled or clarified.[23]

In its analysis, the Supreme Court discusses the application of the *Chevron* deference standard and identifies *Chevron* as being inconsistent with the APA's requirement that courts "exercise their independent judgment in deciding whether an agency has acted within its statutory authority".[24] The Supreme Court further states that because *Chevron* deference requires courts to "ignore, not follow" their independent judgment, *Chevron* can therefore not be reconciled with the APA.[25] The Supreme Court determined that courts, and not administrative agencies, must decide "all relevant questions of law" arising on review of agency action, even those involving ambiguous laws administered by such agency.[26] Although agency interpretations can still inform judicial judgement, such interpretations are not controlling, and courts may not defer to an administrative agency to interpret the law.[27] Based on the foregoing, the Supreme Court overruled the *Chevron* deference standard and held that courts are required to exercise their independent judgment and may not defer to an administrative agency's interpretation of the law simply because a statute is ambiguous.[28]

Conclusion

With *Chevron* overruled, it is to be determined what standards courts will use to evaluate IRS regulations and it will likely take time for cases to work through the federal court system. Taxpayers should talk to their tax advisors about any potential challenge to IRS regulations.

Ninth Circuit: Taxpayers' refund claim was timely, but no refund allowed under "lookback" rule

A recent case reminds taxpayers that the section 6511(b) lookback rule may limit the amount of refund allowable even if your refund claim is timely under section 6511(a).[29]

Background

The Libitzkys ("Taxpayers") overpaid their 2011 taxes by $692,690. The Taxpayers paid their 2011 income tax with an overpayment credit carried forward from their 2010 tax return and a payment made with their 2011 extension. However, the

Taxpayers' accountant did not timely file their 2011 tax return.

The IRS began sending notices about the missing tax return. In 2015, the Taxpayers' accountant spoke with the IRS and stated that the Taxpayers intended to file a refund claim for the overpaid 2011 taxes. The Taxpayers filed the 2011 return on January 20, 2016. The IRS denied the refund claim as untimely.

The Taxpayers filed a refund claim in the district court; the district court dismissed the case on the grounds that the Taxpayers did not timely file a refund claim because the 2015 informal communications with the IRS did not constitute an informal refund claim. The Ninth Circuit affirmed but for different reasons.

Refund statutes of limitations

Under section 6511(a), Taxpayers must file a refund claim within either (1) three years from the time the return was filed (or the unextended due, whichever is later) or (2) two years from the time tax was paid.[30] Payments made before the due date (i.e., withholding, estimated tax payments, overpayments) are deemed paid on the due date.[31]

However, even if a refund claim is timely, the "lookback" rule in section 6511(b) may limit the amount of the refund the IRS can issue. For claims filed within 3-year period of the return filing, the refund is limited to tax paid within the 3-year period (plus any extension) immediately preceding the filing of the claim.[32] For claims not filed within the 3-year period, the refund is limited to portion of the tax paid within 2-year period immediately preceding the filing of the claim.[33]

Ninth Circuit analysis

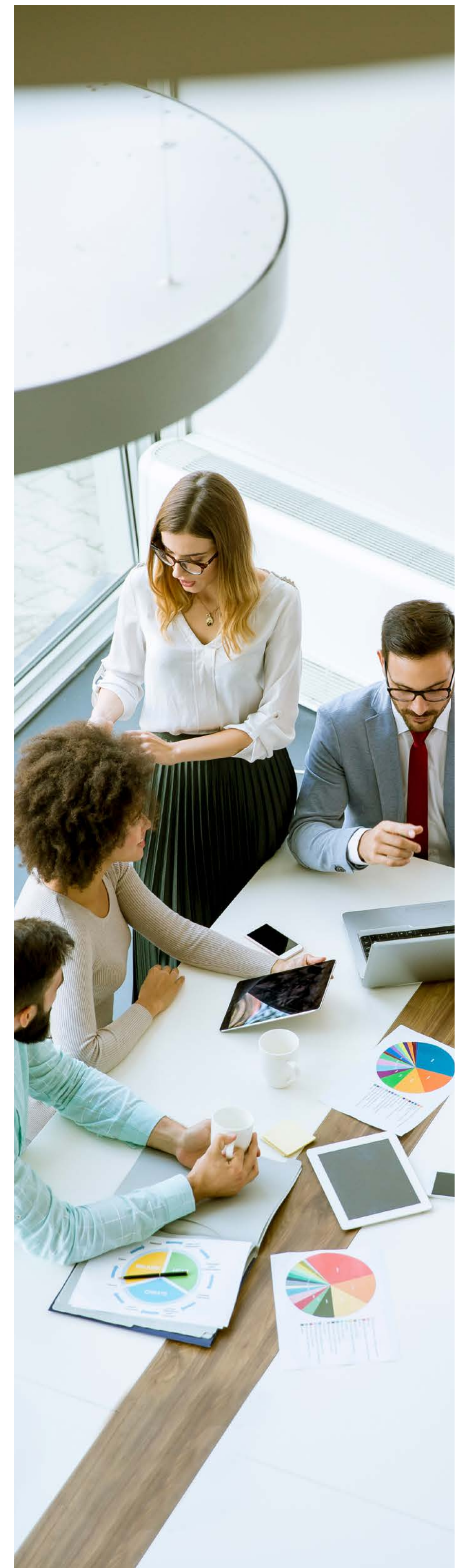
The Ninth Circuit found that the Taxpayers timely filed a refund claim, but they were not entitled to any refund under the "lookback" rule.

The court held that the Taxpayers timely filed a refund claim when they filed their original 2011 Form 1040 on January 20, 2016. However, under the lookback rule, the amount of the refund claim allowed is limited to the payments the Taxpayers made within three years of January 20, 2016 (the date refund claim filed). Here, because all the payments were made more than three years earlier, the Taxpayers were not allowed any amount of refund. The Taxpayers paid their 2011 tax with an extension payment and an overpayment carry forwarded from 2010 income tax return, which was deemed paid on April 17, 2012. Accordingly, to receive a refund of those payments, the Taxpayers would need to file within April 17, 2015.

The court summarily rejected the Taxpayers' informal claim argument. The court said it did not have to decide whether their accountant's 2015 communications with the IRS constituted an informal claim, because even if it was the lookback rule prevented a refund because the informal claim was not made within two years of the payment. The three-year lookback rule did not apply because a formal refund claim had not been filed.

Conclusion

The Ninth Circuit noted the harsh result for the Taxpayers who undisputedly overpaid their income taxes and essentially gave the IRS an interest-free loan of almost $700,000. However, the court stated it was bound by the statutory language enacted by Congress. This case is a reminder of the potentially expensive consequences of failing to meet filing deadlines.



Endnotes

1. 162 T.C. No. 10 (May 22, 2024).
2. See BBA § 1101(g)(1), 129 Stat. at 168.
3. See BBA § 1101(g)(4), 129 Stat. at 168.
4. Treas. Reg. § 301.9900-22(b)(2)(ii)(E)(4).
5. *Reca v. IRS*, 2024 U.S. Dist. LEXIS 92267.
6. Id. at *5-6.
7. *United States v. Powell*, 379 U.S. 48.
8. *Reca v. IRS*, 2024 U.S. Dist. LEXIS 92267, *8.
9. I.R.C. § 7609.
10. I.R.C. § 7609(a)(1).
11. I.R.C. §§ 7609(b)(1), 7609(b)(2)(A).
12. Id.
13. I.R.C. §§ 7609(b)(2)(A), 7609(h)(1).
14. I.R.C. § 7609(b)(2)(A).
15. *United States v. Powell*, 379 U.S. 48.
16. *Reca v. IRS*, 2024 U.S. Dist. LEXIS 92267, *10
17. *Loper Bright Enters. v. Raimondo*, 144 S. Ct. 2244.
18. *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837.
19. *Loper Bright Enters. v. Raimondo*, 144 S. Ct. 2244, 2273.
20. *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837.
21. Id. at 842.
22. Id. at 844.
23. *Loper Bright Enters. v. Raimondo*, 144 S. Ct. 2244, 2257.
24. Id. at 2273.
25. Id. at 2265.
26. Id. at 2270.
27. Id. at 2273.
28. Id.
29. *Libitzky v. United States, No. 23-15614*, 2024 U.S. App. LEXIS 19477, at *15 (9th Cir. Aug. 5, 2024).
30. IRC § 6511(a).
31. IRC § 6513(a).
32. IRC § 6511(b)(2)(A)
33. IRC § 6511(b)(2)(B)

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