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Tax Controversy Services

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Tax Court Invalidates Transfer Pricing Regulations, Finding That They Did Not Satisfy the Reasoned Decisionmaking Standard under State Farm

In *Altera Corp. and Subs. v. Comm'r*,[1] the taxpayer challenged the validity of Treasury Regulations promulgated pursuant to Internal Revenue Code ("IRC") § 482 under the Administrative Procedure Act ("APA"). Altera Corp. and its foreign subsidiary, Altera International entered into a master technology license agreement that allowed Altera International the right to use and exploit certain of Altera's intangible property. Altera Corp. and Altera International also entered into a research and development cost-sharing agreement ("CSA"), under which Altera Corp. and Altera International agreed to pool their respective resources and share the risks and costs of the research and development of the intangible property. In addition to cash compensation, during 2004-2007, Altera Corp. granted stock-based compensation ("SBC") to certain employees who performed research and development under the CSA. Altera Corp. included the cash compensation paid to these employees in the shared cost pool, but did not include the SBC. The Internal Revenue Service ("IRS") determined that Altera Corp. should have included the SBC as a shared cost, and issued notices of deficiency for 2004-200 to Altera Corp. on the grounds that if the SBC had been included in the shared cost pool, Altera Corp. would have received additional income from Altera International to cover those costs. In response to the notices of deficiency, Altera Corp. filed a petition in the Tax Court.

[1] 145 T.C. No. 3 (July 27, 2015).

Section 482 generally authorizes the IRS to allocate income and expenses among related entities to prevent tax evasion and ensure that taxpayers clearly reflect income relating to transactions between the related entities. Treas. Reg. § 1.482-1 explains that the standard to be applied when determining the true taxable income of a controlled taxpayer is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. Treas. Reg. § 1.482-7(d)(2) requires related parties who have entered into cost sharing agreements to share stock based compensation costs. Altera Corp. argued that Treas. Reg. § 1.482-7(d)(2) was arbitrary and capricious and therefore invalid.

The APA provides that in promulgating regulations, an agency must publish a notice of proposed rulemaking, provide interested persons an opportunity to participate in the rule making, and, after consideration of the relevant matter presented, incorporate in the rules a concise general statement of their basis and purpose. These requirements apply only to legislative regulations, not interpretive ones. The IRS argued that Treas. Reg. § 1.482-7(d)(2) was an interpretive regulation, but the Tax Court disagreed, and found that the regulation was legislative, and therefore subject to the APA.

Next, the Tax Court determined that Treas. Reg. § 1.482-7(d)(2) should be reviewed using the reasoned decisionmaking standard from the *State Farm* case.[2] In order to engage in reasoned decisionmaking, an agency must examine the relevant date and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made.[3] Applying this standard to the facts, the Tax Court found that Treas. Reg. § 1.482-7(d)(2): (1) lacked a basis in fact; (2) Treasury failed to rationally connect the choice it made with the facts it found; (3) Treasury failed to respond to significant comments; and (4) the regulation was contrary to all the evidence before Treasury. Additionally, the Tax Court found that, in promulgating Treas. Reg. § 1.482-7(d)(2), the IRS failed to explain how the regulations were consistent with the fundamental arm's length standard set forth in Treas. Reg. § 1.482-1, given that all evidence indicated that it was not. As a result, the Tax Court held that Treas. Reg. § 1.482-7(d)(2) was invalid.

Applying *Chevron*, Tax Court Upholds Validity of Section 911 Regulations Specifying the Requirements for Making an Election to Exclude Foreign Earned Income

Recently, in *McDonald v. Comm'r*,[4] the Tax Court analyzed the validity of certain provisions of Treas. Reg. § 1.911-7. Nancy McDonald ("Taxpayer") is a US citizen who worked abroad during 2009 and did not file a federal income tax return for the 2009 year. In January of 2012, the IRS prepared and filed a substitute for return ("SFR") for the Taxpayer's 2009 year. The IRS then issued a statutory notice of deficiency ("NOD") to the Taxpayer in April of 2012. Instead of petitioning the Tax Court, the Taxpayer filed a 2009 Form 1040, *US Individual*

[2] *Motor Vehicle Mfrs. Ass'n of the US v. State Farm Mut. Auto. Ins. Co.*, 463 US 29 (1983).
[3] *Id*. at 43.
[4] T.C. Memo 2015-169.

Income Tax Return, in May of 2012, reporting $101,244 of income, and excluding $23,032 attributable to the foreign earned income exclusion ("FEIE"). In July of 2012, the IRS processed the Taxpayer's Form 1040, and closed the initial NOD.

The IRS subsequently selected the Taxpayer's 2009 return for audit. As a result of the audit, the IRS issued the Taxpayer a second NOD, on June 20, 2013. In the second NOD, the IRS disallowed the Taxpayer's claimed FEIE because: (1) the Taxpayer did not make a valid election and file Form 2555, *Foreign Earned Income*, with a timely return; (2) the Taxpayer did not elect to exclude the foreign income on a previous return; and (3) the Taxpayer did not otherwise comply with the procedural rules to make a valid election to exclude the foreign earned income under Treas. Reg. § 1.911-7(a)(2). The Taxpayer filed a petition with the Tax Court based on this second NOD. The IRS filed a motion for partial summary judgment, and the Taxpayer opposed the IRS's motion and filed a cross-motion for partial summary judgment arguing that Treas. Reg. § 1.911-7 is invalid because it is an invalid interpretation of the statute because it imposes an additional timing requirement that is absent from the statute, and the twelve-month deadline in Treas. Reg. § 1.911-7(a)(2)(i)(C) is arbitrary and neither necessary nor appropriate to carry out the purposes of IRC § 911.

The Tax Court examined whether Treas. Reg. § 1.911-7 was entitled to deference, in accordance with *Chevron, USA., Inc. v. Natural Res. Def. Council, Inc.*[5] and its progeny. Specifically, the Tax Court used the *Chevron* two-step analysis to determine: (1) whether Congress has directly spoken to the precise question at issue; and (2) whether the IRS's interpretation is a "reasonable interpretation" of the enacted statutory text, or is arbitrary and capricious in substance, or manifestly contrary to the statute. As to step 1, the court concluded that Congress has not specifically addressed the issue because the statute did not explicitly preclude the Secretary from imposing a deadline. As to step 2, the court concluded that the Secretary's interpretation and implementation of IRC § 911 are valid because Treas. Reg. § 1.911-7 reasonably implements both: Congress's specific grant of authority in IRC § 911(d)(9) to prescribe regulations that are necessary and appropriate to carry out the purposes of the statute; and Congress's general grant of authority under IRC § 7805(d) to prescribe rules for the time and manner of making elections.

After determining that Treas. Reg. § 1.911-7 was valid, the Tax Court found that the Taxpayer was not eligible to make an election under Treas. Reg. § 1.911-7(a)(2)(i)(D) because she did not meet the requirements of Treas. Reg. § 1.911-7(a)(2)(i)(D)(1) and Treas. Reg. § 1.911-7(a)(2)(i)(D)(2), where she owed tax and did not file Form 1040 and Form 2555 before the IRS discovered that the Taxpayer failed to elect the exclusion. Additionally, the Taxpayer failed to comply with Treas. Reg. § 1.911-7(a)(2)(i)(D)(3), which required her to provide a statement indicating that it was filed pursuant to Treas. Reg. § 1.911-7(a)(2)(i)(D). As a result the Tax Court granted the IRS's motion for partial summary judgment.

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[5] 467 US 837 (1984).

Tax Court Upholds a TEFRA Partnership's Statute Extension despite the Lack of an Authorized Signature, Based on the Signatory's Apparent Authority

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") governs examinations of, and assessments against, certain partnerships. One feature of the TEFRA regime is the Tax Matters Partner ("TMP"), which acts as the IRS's point of contact during an examination and is entrusted with certain powers that allow it to act on behalf of the partnership. One of those powers provides that the TMP can sign an extension of the assessment statute of limitations that binds all partners.[6]

The selection of the TMP is governed by IRC § 6231(a)(7). Once a TMP is in place, removal is only possible for a few specific reasons: death of the TMP, adjudication that the TMP cannot manage its person or estate, liquidation or dissolution of the TMP, resignation of the TMP, subsequent designation of a new TMP for that year, or revocation of the designation of the TMP.[7] Absent from these reasons is the departure of the TMP from the partnership or the subsequent designation of a new TMP for a later year.

In *Summit Vineyard Holdings LLC v. Commissioner*,[8] the Tax Court examined the validity of an extension of the assessment statute that was signed by the current TMP, rather than the TMP for the year under examination. On its Form 1065 for the tax year 2007, Summit Vineyard Holdings LLC ("Summit"), designated Summit SV Holdings LLC ("Summit SV") as the TMP. In 2009, Meridian Equity LLC ("Meridian") replaced Summit SV as Summit's TMP for that and subsequent years. The same person, Eric Gjelde, was the managing member of both Summit SV and Meridian.[9] During the examination, the IRS requested an extension of the assessment statute of limitations. Gjelde signed the Form 872-P, *Consent to Extend the Time to Assess Tax Attributable to Partnership Items*, as managing member of Meridian, the current TMP for Summit, rather than as managing member of Summit SV, the TMP for the tax year 2007. The IRS issued a notice of final partnership administrative adjustment ("FPAA") after the expiration of the normal assessment statute of limitations, but before the expiration of the extended assessment statute under the Form 872-P.

Summit alleged that the FPAA was untimely because the Form 872-P was invalid and therefore the assessment statute was never extended. Summit argued that the Form 872-P was invalid because Gjelde signed it in his capacity as managing member for Meridian, which was the current TMP, rather than in his capacity as managing member for Summit, which was the TMP for the taxable year 2007, The IRS contended that it reasonably believed that Gjelde had the authority to act on behalf of Summit due to Gjelde's status as managing member of both Summit SV and Meridian, and the fact that he signed Summit's Form 1065 for the taxable year 2007. Concluding that the law of a state where a contract is made is controlling in

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[6] IRC § 6229(b)(1)(B). In addition to the TMP, any other person authorized by the partnership in writing to enter into such an agreement can sign an extension of the assessment statute.
[7] Treas. Reg. § 301.6231(a)(7)-1.
[8] T.C. Memo. 2015-140.
[9] Because Summit SV and Meridian were both LLCs, a person who could bind them under state law had to sign on their behalf as TMP.

deciding questions of apparent authority, the court looked at Washington state law, which says that "apparent authority exists where words or conduct by the principal are reasonably interpreted by a third party as conferring authority upon the agent." The court noted that Summit's conduct had contributed to the IRS's belief that Gjelde had authority as managing member of Meridian. Specifically, Summit's CPA, who was authorized to act on behalf of the partnership by a Power of Attorney, had led the IRS to believe that Gjelde had authority in his capacity at Meridian to sign the Form 872-P. Additionally, the court noted that Gjelde was the correct natural person to sign the extension. As a result, the court found that the IRS's reliance on the statute extension was reasonable and the FPAA was issued timely.

The Tax Court Denies a Taxpayer's Motion to Dismiss Premised upon IRS's Failure to Follow TEFRA Procedures

In *Green Gas Del. Statutory Trust v. Comm'r*,[10] the Tax Court rejected the motion to dismiss for lack of jurisdiction filed by the Green Gas Delaware Statutory Trust ("Green Gas"). Green Gas asserted that the IRS failed to properly follow administrative procedures, and that the IRS did not properly determine the tax treatment of the partnership items on the notice of final partnership administrative adjustment ("FPAA").

Green Gas is a statutory trust that elected to be taxed as a partnership for federal income tax purposes. It is subject to the unified audit and litigation procedures of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") for partnership-level proceedings. Green Gas timely filed its 2005 Form 1065, *US Return of Partnership Income*, and subsequently filed an amended Form 1065 claiming Non-Conventional Source Fuel Credits ("FNS credits") amounting to over $5 million.

On August 10, 2009, the IRS issued a notice of beginning of administrative proceeding ("NBAP") for Green Gas' 2005 tax year. On August 20, 2009, the IRS mailed an FPAA to Green Gas disallowing the majority of the FNS credits claimed. The FPAA indicated that the disallowed portion of the FNS credits did not result from sales of qualified fuel generated from the landfills to unrelated third parties and explained that Green Gas had failed to provide substantiation to support the disallowed FNS credits.

Green Gas' Administrative Proceeding Challenges

TEFRA provisions require that the IRS notify the tax matters partner ("TMP") at the beginning of a partnership-level administrative proceeding by issuing an NBAP. Under Internal Revenue Code ("IRC") § 6223(d), an FPAA should not be issued until at least 120 days after the NBAP was issued. In this case, both parties agreed that the IRS did abide by the time frame; however, the Tax Court held that the issuance of a FPAA after an untimely NBAP did not invalidate the FPAA on its face.

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[10] T.C. Memo 2015-168.

Green Gas also asserted that the FPAA was invalid because IRC § 6224 required that the IRS afford a taxpayer an opportunity to meet with the IRS prior to the issuance of the FPAA, and Green Gas had not been given that opportunity. The Tax Court concluded that the TEFRA provisions do not require an administrative meeting with the taxpayer, and the inability of Green Gas to discuss the case with the IRS did not invalidate the FPAA.

Challenges to the IRS's Determination of the Tax Treatment of Partnership Items

Green Gas also asserted that the FPAA did not properly determine the tax treatment of the partnership items. Specifically, Green Gas took the position that the IRS could not have made a determination that the FNS credits should be disallowed because of a lack of substantiation as the IRS never requested substantiation from Green Gas after issuing the NBAP.

First, the Tax Court examined whether the FPAA contained a proper determination. The Tax Court noted that an FPAA is a partnership equivalent to a notice of deficiency, and, to be valid, a notice of deficiency must (1) set forth the amount and (2) provide the applicable year. The Tax Court also stated that the IRS must look at information specific to the taxpayer, and that generally courts do not question the method or procedures that led to the deficiency. Lastly, the Tax Court noted that the Revenue Agent received information from a third-parties, which helped calculate the disallowed credits, thus showing that the IRS utilized information specific to the taxpayer and there was an analysis.

The Tax Court found that the FPAA satisfied the minimum requirements for validity established in prior decisions because the FPAA listed an adjustment derived from taxpayer specific information, stated a reason for disallowing the credits, provided the applicable year, and examined Green Gas' deductions.

Second, the IRS examined whether the FPAA was invalid on its face as the FPAA denied Green Gas' FNS credits due to lack of substantiation, yet Green Gas was not given the opportunity to provide additional information during the proceeding. Green Gas relied upon *Scar v. Comm'r*,[11] which held that a notice of deficiency is invalid, if it reveals, on its face, that the Commissioner failed to make a determination related to that particular taxpayer.

The Tax Court distinguished *Scar v. Comm'r* and its progeny by pointing to the fact that the IRS looked at Green Gas' return, and articulated a specific reason for the denial of the FNS credits. The Tax Court noted that the IRS' adjustments were specific to Green Gas and the IRS denied only a portion of the FNS credits, in addition to noting that the calculation of the net income adjustment indicated that the IRS had examined the Taxpayer's 2005 Form 1065. The Tax Court concluded that the IRS' possession of the 2005 Form 1065 and stated reason for denial of the credits was sufficient to conclude that the FPAA was not invalid. Accordingly, the Tax Court held that the IRS had properly made an adjustment under the TEFRA procedures.

Conclusion

The Tax Court held that the FPAA was valid, and concluded that it had jurisdiction to determine all partnership items for the 2005 tax year.

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[11] 814 F.2d 1363 (9th Cir. 1987), *rev'g* 81 T.C. 855 (1983).

The Tax Court Concludes that Taxpayer's Petition is Timely Because the Official Closing of the Tax Court Due to a Snowstorm was a Legal Holiday for Purposes of IRC § 7503

Recently, the Tax Court analyzed the application of Internal Revenue Code ("IRC") §§ 7502 and 7503 and timely filing in *Guralnik v. Comm'r*.[12] In this case, Felix Guralnik ("Taxpayer") petitioned the Tax Court to appeal a notice of determination relating to a federal tax lien ("Notice"), which was dated January 16, 2015. Under IRC § 6330(d)(1), a taxpayer must file a petition with the Tax Court within 30 days of the notice date, which was Sunday, February 15.

On Friday, February 13 the Taxpayer mailed his Tax Court petition using Federal Express ("FedEx") First Overnight delivery service. The petition was supposed to be delivered on Tuesday, February 17, 2015, as Monday, February 16 was a legal holiday; however, due to a snowstorm, the District of Columbia ("District"), and federal government offices, including the Tax Court, in the District were officially closed. Accordingly, the petition was not delivered until Wednesday, February 18.

The IRS filed a motion to dismiss asserting that the Taxpayer had not timely filed his petition and therefore the Tax Court lacked jurisdiction to hear the case. Previously, both parties had focused on the timely mailed, timely filing rule under IRC § 7502, generally known as the "mailbox rule." The Tax Court issued an order directing the parties to also address whether, because of the official closing of both District and federal government offices (including the Tax Court) on February 17, 2015, IRC § 7503 served to extend the time within which petitioner was obligated to file his petition with the Tax Court.

Section 7502(a) provides, subject to certain requirements, that a return, claim, statement or other document required to be filed within a prescribed period of time or on or before a prescribed date set forth by the Internal Revenue Code will be deemed timely if delivered to the IRS or office with which the document is required to be filed after the due date, but the postmark shows that the document was mailed either on or before the due date. Under IRC § 7502(f), a taxpayer may utilize a designated delivery service and fall under the purview of the mailbox rule. A "designated delivery service" is defined by IRC § 7502(f)(2) as any delivery service that is designated by the Commissioner after determining that it satisfies the statutory and regulatory standards.

During the Taxpayer's filing period for the petition, the applicable list was contained in IRS Notice 2004-83, which did not contain FedEx First Priority Overnight as a "designated delivery service".[13] The parties stipulated, and the Tax Court agreed that the petition was sent by a class of delivery service that was not contemplated under Notice 2004-83. Accordingly, the Tax Court did not analyze the timeliness of the Taxpayer's filing under IRC § 7502.

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[12] Tax Court Order, Docket No. 4358-15 L. (August 24, 2015).
[13] On May 6, 2015, the IRS issued Notice 2015-38 updating the list of designated private delivery services for purposes of IRC § 7502. Notice 2015-38 includes FedEx First Overnight as a designated private delivery service.

Instead, the Tax Court evaluated the timeliness of the filing under IRC § 7503, which prescribes that if the last day for performing any act falls on a Saturday, Sunday, or legal holiday, the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or legal holiday. For purposes of IRC § 7503, a legal holiday is defined as a legal holiday in the District.

The Tax Court, citing the legislative history of IRC § 7503 to establish that the purpose of this provision was to not count a Saturday, Sunday or holiday if the court was closed for business on that day, found that the closure of the District and federal government offices, due to a snowstorm, qualified as a legal holiday in the District. The Tax Court also pointed out that it would have been impossible for the Taxpayer to file the petition on Tuesday, February 17 as electronic filing is not available, and the court does not have a physical drop box. Accordingly, the court held that the closure on Tuesday, February 17 constituted a legal holiday under IRC § 7503, and thus the Taxpayer's petition was timely filed because the filing due date for the petition was extended until Wednesday, February 18, which was the date that the petition was received and filed by the Tax Court.