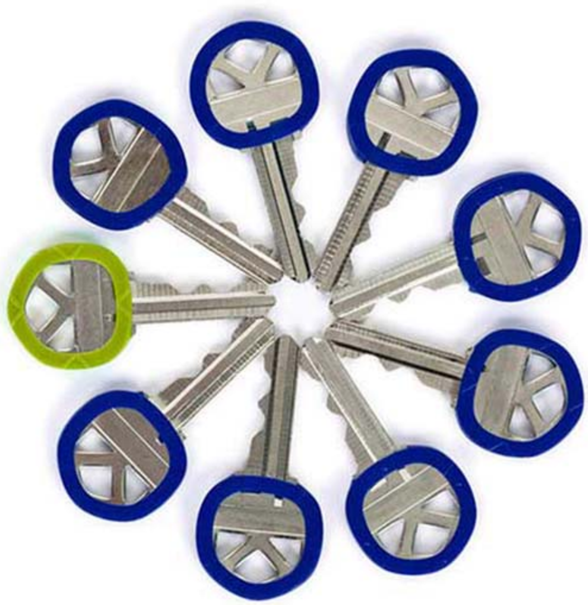

In this issue:

Tax Court Holds that the Two-Year Lookback Period of Section 6511(b)(2) Bars an Individual From Receiving a Refund Even Though IRS Agreed the Individual Overpaid His Taxes

Petitioner and taxpayer Don McAuliffe ("McAuliffe") was serving as a judge in Fairfield County Municipal Court in Ohio when, on April 23, 2003, he was indicted by a Grand Jury on several federal mail fraud and money laundering offenses for burning down his house and seeking the insurance proceeds.[1] Less than a week later, McAuliffe was taken into custody and held without bail. In February 2004, after a three-week trial, McAuliffe was found guilty of all offenses and later sentenced to a total of 156 months in jail. McAuliffe was in federal custody from April 2003 until he was released in August 2014.

[1] *McAuliffe v. Comm'r*, T.C. Summary Opinion 2016-25.

During 2003, McAuliffe received gross income of $80,000, and had $12,156 of federal income tax withheld. McAuliffe testified that his tax affairs from April 2003 on had been handled by his “attorney-in-fact” and his parole officer, who, in addition to being a full-time parole officer, was also a part-time return preparer for H&R Block. McAuliffe testified that while he was in jail, his income taxes were the last thing on his mind, and he had no involvement in his taxes after April 2003.

While a request for an extension of time to file McAuliffe’s 2003 federal income tax return had been filed, the IRS showed no receipt of a return. McAuliffe’s parole officer could not recall if she had filed a 2003 federal income tax return for McAuliffe, and his attorney-in-fact stated that he had not mailed a 2003 return for McAuliffe to the IRS. In 2007, lacking a return filed by McAuliffe, the IRS prepared a substitute for return under IRC § 6020(b), and proposed a deficiency in tax of $18,774 plus penalties for failure to file, failure to pay, and failure to make estimated tax payments.

In response to the notice of deficiency, McAuliffe sent the IRS a copy of his 2003 return that he claimed was timely filed by his attorney-in-fact and which bore a stamped signature.[2] McAuliffe admitted that he had never seen the 2003 return prior to that time. The return reported zero taxable income and zero tax on the basis of a variety of claimed losses, including a purported business loss for $52,056 for “excavation.”

At trial, the IRS conceded that McAuliffe’s tax liability was $10,291, and therefore he had overpaid his tax liability for 2003. However, the IRS argued that the refund of the overpayment was barred by the statute of limitations. The Tax Court looked at IRC § 6512(b)(1), which authorizes the court to determine the amount of an overpayment of tax in respect of a taxable year for which a deficiency has been determined, and IRC § 6512(b)(3), which imposes the limit on the amount of any overpayment that may be refunded. Specifically, IRC § 6512(b)(3) provides that no refund shall be allowed unless the Tax Court determines that the tax was paid within the period which would be applicable under IRC § 6511(b)(2). Titled “Limit on amount of credit or refund,” IRC § 6511(b)(2) provides that the amount of a refund shall not exceed the amount of tax paid during the two years immediately preceding the filing of a claim for refund when that claim was not filed within three years of the original due date of the return. In this case, because McAuliffe submitted his 2003 return to the IRS in 2008, and that date was more than two years after his 2003 tax was paid through withholding on his income during 2003,[3] he was not entitled to any refund even though the IRS agreed that he had overpaid his taxes for 2003.

The Tax Court dismissed McAuliffe’s complaint that this result was unfair, in view of the fact that the IRS agreed there was an overpayment. The court noted that the Supreme Court had clearly instructed that the limitations on allowance of refunds prescribed by IRC §§ 6511 and 6512 are to be given effect “without regard to an individual’s perceived notion of fairness.”[4]

Seventh Circuit Affirms Reformation of Faulty Assessment Statute of Limitations Extensions

In the March 2015 edition of *IRS Insights*, we reported on the Tax Court’s decision in *Hartland Mgmt. Services. Inc. v. Comm’r*.[5] In *Hartland*, the IRS determined deficiencies and accuracy-related penalties over multiple years against a husband and wife and several of their related corporations. When the assessment statutes of limitations for the taxpayers’ earliest years were nearing expiration, the IRS prepared Forms 872, *Consent to Extend the Time to Assess Tax* for those years. However, when filling out the Forms 872, the IRS did not correctly identify the tax years for which extensions were being requested. The taxpayers’ representative did not alert the IRS to the mistakes, but instead signed and returned the forms to the IRS.
URL: http://newsletters.usdbriefs.com/2015/Tax/IRSI/150309_2.html

[2] At trial, McAuliffe explained that his parole officer possessed his personal signature stamp, which she used for both tax and nontax purposes.
[3] This was deemed to have been paid on April 15, 2004, under IRC § 6513(b)(1).
[4] *Comm’r v. Lundy*, 516 U.S. 235 (1996).
[5] T.C. Memo. 2015-8, *modified by* T.C. Memo. 2015-37.

Subsequently, the taxpayers argued that the assessment statutes of limitations for some of the tax years at issue were closed because the Forms 872 identified the wrong tax year and, thus, were insufficient to extend them. The IRS acknowledged the forms' defects but requested that the Tax Court reform the agreements based on the existence of a mutual mistake. The court reviewed the actions of the representative and the IRS – both before and after signing the agreements – and concluded that a mutual mistake had been made. As a result, the Tax Court allowed reformation of the Forms 872 and concluded that the taxpayers' assessment statutes of limitations for the years at issue were extended.

Three of the taxpayers from the *Hartland* case – the Kunkels and Integra Engineering, Ltd. – appealed the Tax Court's decision to the Seventh Circuit. In *Kunkel v. Comm'r*,[6] the taxpayers argued that the Tax Court had made a mistake because, based on the evidence available to the court, it was impossible to show by "clear and convincing evidence" the IRS's or the taxpayers' representative's true intent.[7]

With respect to the standard of proof, the Seventh Circuit found that only a "preponderance of the evidence" was required for reformation of the agreements.[8] The court also disagreed with the taxpayers' contention that the IRS's or the taxpayers' representative's "true intent" was the proper focus of inquiry. The court noted that under both state and federal law, intent is only relevant if it is *expressed to the other party*. As a result, the court refused to consider thoughts or hidden motivations of the representative or taxpayers.

After reviewing the record, the Seventh Circuit found no clear error or abuse of discretion by the Tax Court, and affirmed the reformation of Forms 872, thereby allowing assessment of the tax and accuracy-related penalties. Despite ruling in the IRS' favor, at the end of its opinion the court showed some sympathy for the taxpayers' situation, stating "[w]e are conscious of the irony in allowing the IRS to collect a 20% penalty for the errors in the Kunkels' 2008 return, when the IRS has made an error of its own." The court, however, sustained the penalties because the taxpayers did not ask the court to set aside the penalties on any grounds other than that the assessments were untimely.

Rev. Proc. 2016-30 Modifies Pre-Filing Agreement Procedures including Significantly Increasing User Fees

On May 4, 2016, the IRS issued Rev. Proc. 2016-30[9] superseding Rev. Proc. 2009-14[10], which updates the procedures for a taxpayer under the jurisdiction of IRS' Large Business & International Division ("LB&I") to request examination and resolution of specific items before filing its tax return. Executed agreements under this program are referred to as pre-filing agreements ("PFAs"). Rev. Proc. 2016-30 is effective for PFA requests received on or after May 4, 2016.

Rev. Proc. 2016-30 makes several modifications to the PFA procedures and expands the scope of eligible issues to include items related to changes in accounting methods requested under automatic change procedures. Additionally, it significantly increases the user fee. Rev. Proc. 2016-30 increases the user fee from $50,000 to $134,300 for requests submitted on or after June 3, 2016 and the fee is further increased to $218,600 for requests submitted on or after January 1, 2017.

[6] No. 15-2232, 2016 U.S. App. LEXIS 8570 (7th Cir. May 10, 2016).
[7] "Clear and convincing evidence" is a standard more stringent than the "preponderance of evidence" standard but not as stringent as the "beyond a reasonable doubt" standard. Under the "clear and convincing evidence" standard, a party must show that something is highly probable or reasonably certain.
[8] *Under this standard*, the court could rule for whichever side had the stronger evidence, an easier standard for the IRS to meet.
[9] 2016-21 I.R.B. 981.
[10] 2009-3 I.R.B. 324.

Background on Pre-Filing Agreements

The PFA program was initially introduced in Rev. Proc. 2001-22[11] and has been modified through subsequent revenue procedures.[12] Per the IRS website, the PFA process is designed to provide a framework within which the taxpayer and the IRS can work together to resolve the identified and examined issues and encourage taxpayers to request consideration of an issue prior to filing the tax return. The desired effect of the program is to reduce the cost and burden of a post-filing examination, provide certainty regarding transaction, and better utilize both taxpayer and IRS resources.

A PFA is only available for completed transactions or events, which have yet to be reported by a taxpayer on a tax return.[13] The years covered under a PFA may include the current taxable year, any prior tax year for which the original return is not yet due and not yet filed; and a limited number of future taxable years in conjunction with current or prior periods.[14] Generally, a PFA is only available for situations that require a determination of facts or application of well-established legal principles to known facts, and issues that involve a methodology to determine the appropriate amount of an item of income, allowance, deduction or credit.[15] Certain types of issues such as transfer pricing issues, annual accounting periods and penalty issues, are expressly excluded and a list of these items is set forth in Section 3.08. The IRS may refuse to address an issue in a PFA based on tax administration.[16]

In 2015, the IRS received 17 PFA requests, accepted 12 requests and closed 13 requests, with the screening process averaging 48 days and evaluation process averaging 296 days.[17] The below chart illustrates the issues that were received, accepted and closed with an agreement for 2015:[18]

Issue	**Received**	**Accepted**	**Closed**
Worthless Stock/Bad Debt Deduction	3	3	2
IRC 41, Research Credit	4	1	1
Cost Segregation Study & Depreciation/Depletion	1		1
Gain/Loss on Sale/Exchange of Property/Stock			2
Deductibility of Settlement /Fine Payments	2	4	2
Treatment of Interest of member of Consolidated Group	1		
Deductibility of Charge offs of Partially Worthless Debt	1		
Tax Consequences of a Merger/Acquisition/Liquidation	2	1	1
Withholding and Reporting Requirements	2	2	3
Bankruptcy Issues	1	1	1

Accounting Method Changes under Rev. Proc. 2016-30

Rev. Proc. 2016-30 expands the scope of potential issues for PFAs to include items resulting from a change in method of accounting, both automatic and non-automatic changes. It is important to note that a PFA may not be used to obtain consent to change a method of accounting. However, the IRS may enter into a PFA to determine items, such as a section 481 adjustment, stemming from accounting method changes including those pursuant to the automatic change procedures.

---

[11] 2001-9 I.R.B. 745.
[12] Rev. Proc. 2005-12, 2005-2 I.R.B. 311; Rev. Proc. 2007-17, 2007-4 I.R.B. 368; Rev. Proc. 2009-14, 2009-3 I.R.B. 324.
[13] Rev. Proc. 2016-30; *see also* Rev. Proc. 2009-41.
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] https://www.irs.gov/businesses/prefiling-agreement-program-statistics-calendar-year-2015
[18] *Id.*

User Fee Increase

Rev. Proc. 2016-30 significantly increases the user fee for the PFA program. The revenue procedure almost triples the user fee for requests submitted on or June 3, 2016 and more than quadruples the user fee for requests submitted on or after January 1, 2017.

Recent comments by an IRS official have indicated that user fee increases may not be limited to the PFA program. IRS deputy associate chief counsel (procedure and administration) Kathryn Zuba noted on May 6, 2016 at the American Bar Association Section of Taxation Meeting that taxpayers should expect increases in other user fees for special services to reflect the full cost of those services.[19] She further noted that the IRS' decision to raise the PFA fees to full cost in stages would be typical of other user fee adjustments.[20]

Tax Court Holds that Administrative Procedure Act Doesn't Apply to Deficiency Cases

In *Ax v. Commissioner*,[21] the taxpayers formed a captive insurance company (the "Captive") that provided coverage for their limited liability company (the "LLC"). In 2009 and 2010, the LLC paid insurance premiums to the Captive and deducted those expenses, and those deductions then flowed through to the taxpayers' return.

The IRS disallowed the deductions and explained in the notice of deficiency (the "NOD") that the taxpayers had not established that the deductions were valid insurance expenses nor that they were actually paid. The taxpayers filed a petition in Tax Court, and the IRS filed an answer that did not make any affirmative allegations as to the disallowed deductions. The IRS then filed a motion for leave to amend the answer to affirmatively allege facts in support of the assertions that the use of the Captive lacked economic substance and that the expenses were neither ordinary nor necessary.[22]

The taxpayers opposed the motion, citing *Mayo Foundation for Medical and Educational Research v. United States*,[23] and arguing that the Administrative Procedure Act (the "APA") and *SEC v. Chenery Corp.*[24] barred the IRS from raising new grounds to support the NOD beyond the grounds that were originally stated.[25]

First, the Tax Court found that the taxpayers' reliance on *Mayo* was misplaced, as that case involved a dispute about the deference to be accorded to agency regulations. Although the taxpayers argued that the Supreme Court had rejected the concept of "tax exceptionalism" and declined to carve out an approach to administrative review that applied only to tax law, the Tax Court held that *Mayo* did not abolish the distinction between agency actions, for which there is no other adequate remedy in a court, and deficiency cases, which have a special review procedure in Tax Court.

Similarly, the Tax Court held that while *Chenery* may restrict a reviewing court from relying on reasons not considered by an agency in its determinations, it only does so in cases where Congress has exclusively entrusted the matter to that agency, not in deficiency cases where Congress has authorized the Tax Court to redetermine tax liabilities. Additionally, the Tax Court found that several sections in the Internal Revenue Code reflect Congress' intention that

[19] Kathryn Zuba, IRS deputy associate chief counsel (procedure and administration) at American Bar Association Section of Taxation Meeting on May 6, 2016 in Washington, DC, as reported by Tax Analysts.
[20] *Id.*
[21] 146 T.C. No. 10.
[22] The IRS noted that it was pleading the "ordinary and necessary" issue out of an abundance of caution, stating that this ground was implicit in the NOD. Accordingly, while the IRS acknowledged that it had the burden of proof with respect to the economic substance issue, it argued that it did not bear the burden of proving that the expenses were not ordinary and necessary.
[23] 564 U.S. 44 (2011).
[24] 318 U.S. 80 (1943).
[25] The taxpayers also argued that the raising of the new issues unfairly prejudiced them and that one of the new issues was inadequately pleaded.

the Tax Court decide deficiency cases by making its own determination, not by simply reviewing the NOD for an abuse of discretion.[26]

Finally, the Tax Court held that the APA did not affect the deficiency case regime that was already in place before the APA was enacted. The taxpayers admitted that deficiency cases are subject to a *de novo* review by the Tax Court, but nonetheless argued that the Tax Court could address only the IRS's action, findings, and conclusions set forth in the NOD. Noting that the Supreme Court had previously stated that the APA was not intended to abolish previously established procedures for agency review[27] (such as those for deficiency cases), and that the taxpayers' proposal that a deficiency case be confined to the issues stated in a NOD would be a radical change from longstanding practice, the Tax Court held that the APA does not apply to deficiency cases.

As a result, the Tax Court held that, subject to the Tax Court's rules, the IRS, in a deficiency case, may affirmatively plead grounds not stated in the NOD.

A Taxpayer Invoking the Substance-Over-Form Doctrine to Reform its Own Contract is Prevented by the *Danielson* Rule

In a recent Tax Court case, *Makric Enterprises Inc. v. Commissioner*,[28] a taxpayer attempted to invoke the substance-over-form doctrine to disavow the form of a sale in which it had participated. The Tax Court ruled that it was prevented from doing so by the *Danielson* rule.

In the transaction at issue, three shareholders ("owners") owned Makric Enterprises Inc. ("Makric"), which was a holding company that owned 100% of Alpha Circuits Inc. ("Alpha"). As part of a sale of Alpha, the owners originally planned to liquidate Makric and then sell their shares of Alpha directly to the buyer. Partway through the selling process, the owners determined that this plan would not have the desired tax effects (i.e. long-term capital gains), and expressed an interest in changing the structure to a sale of Makric instead.

Despite the owners' interest in selling their shares of Makric (rather than Alpha), all subsequent draft versions of the purchase agreement, plus the final agreement executed seven months later, called for Makric to sell its shares of Alpha to the buyer. Makric's tax return preparer did not read the agreement, but instead relied on a description of the transaction from Makric's CFO, who believed that the agreement called for the owners to sell their shares of Makric. As a result, Makric filed a tax return for the year that did not report the sale of Alpha.

The IRS believed that the sale should follow the form of the purchase agreement, which provided for a sale of Alpha stock by Makric. Accordingly, the IRS issued a notice of deficiency to Makric for tax on the gain that it should have recognized on the sale of Alpha, along with an accuracy-related penalty. Makric argued that, based on the substance-over-form doctrine, the sale should be treated as a sale of Alpha stock by the owners. As an alternate argument, it proposed reformation of the contract based on a mutual mistake between the buyer and the owners.

A taxpayer's ability to disavow the form of their own transaction, set forth in an unambiguous contract, is limited by the *Danielson*[29] rule. Under *Danielson*, taxpayers can disavow the form of their transactions only based on non-tax principles using evidence that would allow for the reformation of the contract (*e.g.*, to prove fraud or duress). The Tax Court looked to the applicable state law (Texas) to interpret the contract. Under Texas law, a threshold issue in contract interpretation is whether the contract is ambiguous. If a contract is unambiguous, extrinsic evidence of the

---

[26] *See, e.g.*, Section 6212(a) (IRS authorized to determine a deficiency and send taxpayer a NOD); Section 6213(a) (Taxpayer entitled to file a petition with the Tax Court in response to NOD); Section 6214(a) (Tax Court has jurisdiction to "redetermine the correct amount of a deficiency even if the amount so redetermined is greater than the amount of the deficiency" in the NOD); Section 6512(b) (Tax Court has jurisdiction to determine the amount of an overpayment made by a taxpayer in connection with a NOD); and Section 7522(a) (Inadequate description by the IRS of the reason for additional tax due in the NOD does not invalidate the NOD).
[27] *Bowen v. Massachusetts*, 487 U.S 879, 903 (1988).
[28] T.C. Memo 2016-44.
[29] See *Comm'r v. Danielson*, 378 F.2d (771 (3d. Cir. 1967).

parties' intent is not considered in its interpretation. If a contract is ambiguous, extrinsic evidence is allowed to resolve the ambiguity.

Thus, in order for it to be able to able to submit evidence of the parties' intent, Makric needed to demonstrate that the contract was ambiguous. Ambiguity can be patent, which means that it is evident on the face of the contract, or latent, which means that it can be proved with extrinsic evidence. For example, if a contract called for delivery to the green house on Pecan Street, evidence of multiple green houses on Pecan Street would prove a latent ambiguity.

The Tax Court held that the contract was not patently ambiguous because the contract clearly identified Makric as the seller, and the Alpha shares were clearly identified as the object of the sale. As a result, in order to attempt to establish that the contract was ambiguous, Makric had to present evidence that the contract contained a latent ambiguity. To support this position, Makric tried to use evidence of the alternate sale structure as proof of the ambiguity, however, the Tax Court held that under Texas law such evidence was not permitted to demonstrate that a contract was ambiguous. The court ruled that the contract was unambiguous and that the *Danielson* rule applied, which precluded Makric from arguing substance over form. Instead Makric had to rely on non-tax principles and present evidence that would be allowed under those principles.

Makric's alternative argument was to attempt to treat the transaction as a sale of Makric by the owners and therefore allow reformation of the contract due to a mutual mistake. The Tax Court noted that Texas law allows for reformation of a contract due to mutual mistake when the parties have a common intention but the contract does not reflect that intention. In such circumstances, external evidence is allowed to show a mutual mistake and no ambiguity is required.

The Tax Court considered Makric's evidence, and found that Makric failed to meet its burden of showing a mutual mistake between the owners and the buyer. Makric had submitted an email along with testimony to show that it had proposed an alternate sale structure and that a representative of the buyer had agreed to such a structure. Although that evidence could show the parties' intent, the court ruled that the evidence was insufficient to prove a mutual mistake. The email had been sent seven months before the final agreement was executed. The final agreement and all its intervening drafts contradict the premise that the parties intended a sale of Makric. The Tax Court ruled that the agreement and its drafts were better indications of the parties' intent than an isolated exchange early in the sales process.

As a result, the Tax Court sustained the IRS's determination and held that the sales agreement unambiguously required the sale of Alpha, not Makric, and therefore Makric was barred from contending that the sale was, in substance, the sale of Makric.