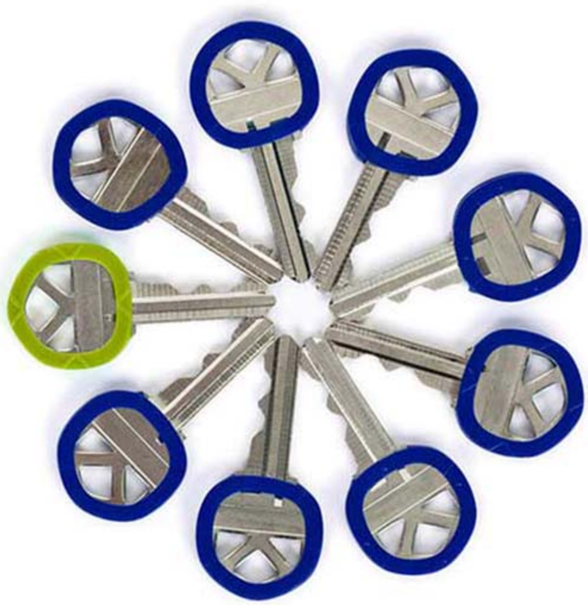

In this issue:

The Federal Circuit Court of Appeals Holds Tax Shelter Penalties for Failure to Register Are Not Divisible

In *Diversified Group Inc. v. United States*, the Federal Circuit Court of Appeals affirmed the Federal Claims Court's decision that penalties assessed under Section 6707 for failure to comply with tax shelter registration requirements are not divisible. Diversified Group, Inc. ("Taxpayer") and its president (collectively "Appellants") had filed suit to seek refunds for tax shelter penalties assessed under Section 6707; Appellants, however, only paid the portion of the penalty related to two clients. The Court of Federal Claims dismissed the Appellants suit for lack of subject matter jurisdiction, due to the failure to pay the penalty in its entirety. The Appellants appealed on the grounds that the Section 6707 penalty should be divisible.

In this case, Appellants sold two types of tax avoidance strategies, Option Partnership Strategy ("OPS") and Financial Derivatives Investment Strategy ("FDIS"), to 192 clients between 1999 and 2001. In 2002, the Internal Revenue Service ("IRS") conducted a penalty audit of the Taxpayer for its potential failure to register OPS and FDIS as tax shelters.[1] Pursuant to Section 6111,[2] any tax shelter organizer is required to register "not later than the day on which the first offering for sale of interests in such tax shelter occurs." If an organizer fails to comply, then it will be subject to a penalty under Section 6707.

In December 2013, the IRS issued Notices of Proposed Adjustment ("NOPAs") to the Appellants asserting that OPS and FDIS were tax shelters under Section 6111. The IRS assessed penalties of $24,868,451 for the failure to register OPS and $17,241,032 for failure to register FDIS. Mechanically, the IRS calculated the respective penalties based upon one percent of each client's investment, which were then aggregated to calculate the amount of the total penalty.[3]

In February 2014, the Taxpayer paid $15,500 to satisfy the penalty calculated based on one particular client (i.e., one percent of one client's total investment for utilizing OPS, plus interest). Similarly, its president paid $18,370 for one client's total investment for utilizing FDIS, plus interest. The Appellants then sought refunds from the IRS for the penalties (and interest) that they had paid. The IRS denied the refund claims and the Appellants filed suit seeking refunds.

The Claims Court dismissed the suit, finding that the Appellants had failed to satisfy the full-payment rule established in *Flora v. United States*, 362 U.S. 145 (1960), for the court to have jurisdiction for the refund claim and dispute of total penalties. In *Flora*, the Supreme Court determined that full payment of an assessed tax or penalty was required to sue for refund. However, it recognized that in certain cases, such as excise tax refund claims, the tax or penalties could be divisible. As noted by the Federal Circuit, the Court's decision in *Flora* has been interpreted to hold that a taxpayer with a divisible penalty may pay the full amount with respect to one transaction and sue for a refund of that particular amount, which will also determine the liability for the entirety of the penalty or tax.

In its decision, the Federal Circuit first noted that an appellant bears the burden of establishing the court has jurisdiction by a preponderance of evidence.[4] The Appellants argued that the Section 6707 payment was divisible, thus payment of the amount allocable to one specific client was sufficient for full payment under *Flora*. As support, the Appellants pointed towards the requirement to file a separate Form 8264 (i.e., tax shelter registration form) for each client, and the IRS' method of calculation of the amount of the penalty. As summarized by the court, "in effect, Appellants argue that this case involves 192 tax shelters which [IRC] § 6111 required them to register." Conversely, the IRS asserted that OPS and FDIS were two tax shelters with 192 instances. The IRS argued that the assessed penalties under Section 6707 were for failure to register the two specific tax shelters, i.e. OPS and FDIS, in their entirety. Thus, according to the IRS, the penalties could not be divided.

The Federal Circuit interpreted the language of Section 6707 to contemplate a "single act of failing to register the tax shelter" and stated that "this omission creates a single source of liability, regardless of how many individuals or transactions are involved in the tax shelter." In support, the court looked towards the language of Section 6111 and regulations and noted that a tax shelter refers to the aggregate investment, and not to individual transactions. Further, it dismissed the argument that the requirement to file multiple Forms 8264 created 192 tax shelters.

The Federal Circuit also examined at what point a tax shelter arises to trigger the penalty under Section 6707 (i.e., whether upon offering or upon each sale). The court stated that the definition of tax shelter under Section 6707 was potentially ambiguous and that it was necessary to examine the phrase in context with other provisions. For example, Section 6111(a)(1) requires that a tax shelter be registered "not later than the day on which the first offering for sale of interests in such tax shelter occurs" and if "tax shelter" was intended to refer to each specific sale, then the language of "first offering" would be untenable. Lastly, the court noted that Congress could not have intended to allow organizers to freely market these types of strategies without having to disclose until the first sale.

The Federal Circuit held that OPS and FDIS each qualified as a single "tax shelter" and rejected the Appellant's argument that the penalties were divisible. Accordingly, the court held that the Appellants failed to satisfy the full payment rule, and, thus, affirmed the lower court's dismissal of the case for lack of subject matter jurisdiction.

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[1] The decision does not discuss whether OPS and FDIS were tax shelters.
[2] As in effect during the periods at issue.
[3] Ultimately these amounts were reduced due to payments by others.
[4] *Citing to Trusted Integration, Inc. v. U.S.*, 659 F.3d 1159 (Fed. Cir. 2011).

District Court Holds that Taxpayer's Administrative Refund Claim was Deficient for Failing to Include Required Documents

In *Worldwide Equipment of TN, Inc. v. United States*,[5] a truck dealer sought refunds related to excise taxes imposed on one of its truck models. Worldwide alleged that this particular truck was specifically designed for off-road use and should therefore be exempt from a tax intended for highway transportation vehicles. Worldwide filed a series of administrative refund claims with the IRS claiming a total of over $4 million in excise taxes it paid on 227 trucks.

Excise taxes are often collected and paid by a retailer, like Worldwide, on behalf of its customers. Therefore, although Worldwide is the entity paying the taxes to the IRS, the actual cost of the taxes is borne by the customers. As a result, there are special procedures related to refund claims for excise taxes in order to ensure that a retailer does not charge its customers for the excise taxes and then get a refund for those same taxes from the IRS. Section 6416 of the Internal Revenue Code provides the various options available to a retailer seeking refunds of excise taxes to establish it can receive the claimed refund of excise taxes. One such option is for the retailer to show that its customers have provided written consent for the retailer to receive the refund. Specifically, section 6416(a)(1)(D) provides:

> (a) Condition to allowance
> (1) General rule
> No credit or refund of any…excise taxes shall be allowed or made unless the person who paid the tax establishes, under regulations prescribed by the Secretary, that he –
> (D) has filed with the Secretary the written consent of the person referred to in subparagraph (B) to the allowance of the credit or the making of the refund.

In its motion for summary judgment, the United States moved to dismiss Worldwide's refund suit on the grounds that Worldwide had not satisfied the statutory prerequisites for bringing suit. Section 7422(a) of the Internal Revenue Code provides:

> No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected…until a claim for refund or credit has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.

The United States argued that Worldwide never provided the IRS with written consents from the ultimate purchasers of the trucks agreeing to the refund of the excise taxes, as required by section 6416(a)(1)(D). The United States' position was that section 6416(a)(1)(D) required the written consents to be provided to the IRS with the administrative refund claim. The court, however, initially held that the plain language of the statute seemed to make the consents a prerequisite only to the receipt of a refund payment, not to the filing of an administrative refund claim or a refund suit. As a result, the court denied the United States' motion for summary judgment on this issue.

After the United States raised the jurisdiction question again at the pretrial conference, the court allowed the parties to brief the issue, and Worldwide conceded that it had not previously provided the consents to the IRS, but argued that it should be allowed to do so at trial. Two cases cited by the United States, however, indicated otherwise. The Supreme Court, in *United States v. Jefferson Electric Manufacturing. Co.*,[6] and the Sixth Circuit in *United States v. Standard Oil Co.*,[7] both dealt with predecessors of section 6416(a). The courts in those cases determined that these predecessor sections both imposed a limitation on a taxpayer's right to a refund by prescribing an "additional substantive element" that the taxpayer had to prove in order to recover on its claim; that being it had not shifted the burden of the excise tax to another.[8] As a result, without such proof, a taxpayer was not entitled to any refund of the excise taxes. Additionally, both cases held that the predecessor statutes contained an element of timing. The Supreme Court held that one predecessor section required a taxpayer to establish *both* before the IRS and in any subsequent refund suit

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[5] No. 7:14-cv-108 (E.D. Ky. Dec. 12, 2016).
[6] 291 U.S. 386 (1934).
[7] 158 F.2d 126 (6th Cir. 1946).
[8] *Jefferson Elec.* 291 U.S. at 397.

that it had not charged its customers the excise tax.[9] The Sixth Circuit held that the other predecessor section required the taxpayer to assert and prove *both* in the proceeding before the Commissioner and subsequently in the district court, that it had not shifted the burden of the tax to its customers.[10]

The United States also argued that the failure to provide the consents with the administrative refund claim was contrary not to just section 6416(a)(1)(D), but also Treas. Reg. § 301.6402-2(a)(2), which requires a taxpayer to file "supporting evidence" with its administrative refund claim. Worldwide argued that the IRS waived the requirement to provide the written consents by denying the refund claims on the merits. The court acknowledged that the IRS can waive requirements set forth in its own regulations, such as Treas. Reg. § 301.6402-2(a)(2), but held that because the requirement to provide the written consents was also contained in section 6416(a)(1)(D), and because the IRS does not have the power to waive statutory mandates, the requirement was not waived.

Worldwide also argued that it did not have to provide the written consents to the IRS because the agent informed Worldwide that the refund claims were going to be denied. However, the court found that the evidence showed that the IRS had in fact repeatedly requested the consents while the administrative refund claim was pending, and Worldwide was therefore on notice that the consents were needed long before the refund claims were denied. As a result, the court determined that the case law provided by the United States supported the argument that the consents had to be provided with the administrative refund claim, and that the failure to do so therefore rendered the court without jurisdiction to hear the refund suit.

IRS Notice Identifies Certain "Micro-Captive" Transactions as Transactions of Interest

On November 1, 2016, the IRS released Notice 2016-66 (the "Notice"), which alerts taxpayers and their representatives that certain "Micro-Captive" transactions have been identified as transactions of interest, for purposes of Treas. Reg. § 1.6011-4(b)(6) and Internal Revenue Code ("IRC") §§ 6111 and 6112.

The IRS Notice covers certain captive insurance transactions designed to take advantage of the IRC section 831(b) election to be taxed on investment income only. Previously, in IR-2016-25, issued on February 16, 2016, the IRS identified certain Micro-Captive transactions as abusive schemes in its Dirty Dozen list of tax scams for the 2016 filing season. However, the Notice indicates that the Treasury Department and the IRS lack sufficient information to identify which IRC § 831(b) arrangements should be identified specifically as a tax avoidance transaction and, accordingly, they are designating the transactions identified in the Notice as "transactions of interest" in an effort to gather such information.

In the Notice, the IRS describes a transaction in which a taxpayer attempts to reduce the aggregate taxable income of the taxpayer, related persons, or both, using contracts that the parties treat as insurance contracts and a related company that the parties treat as a captive insurance company. In this type of transaction, each entity that the parties treat as an insured entity under the contracts claims deductions for premiums for insurance coverage, and the related company that the parties treat as a captive insurance company elects, under IRC § 831(b), to be taxed only on investment income. In this way, the entity that the parties treat as a captive insurance company excludes the payments directly or indirectly received under the contracts from its taxable income. See p.1 of the Notice.

The IRS states in the Notice that the "manner in which the contracts are interpreted, administered, and applied is inconsistent with arm's length transactions and sound business practices." Because the IRS believes that certain Micro-Captive transactions have the potential for tax avoidance or evasion, taxpayers who have entered into transactions described in the Notice, or substantially similar transactions, are now subject to reporting requirements under Treas. Reg. § 1.6011-4(d). If a taxpayer is required to file a disclosure statement with respect to a transaction described in the Notice after November 1, 2016, and prior to January 30, 2017, that disclosure statement will be considered timely filed if filed with Office of Tax Shelter Analysis by January 30, 2017. Note that the relevant reporting obligations can

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[9] *Id.* at 395.
[10] *Standard Oil*, 158 F.2d at 128.

reach back ten years (i.e., they apply to transactions entered into on or after November 2, 2006), but reporting is required only for taxable years for which the statute of limitations on assessment is still open, i.e., "open" tax years.

Court of Federal Claims Examines Skidmore Deference in Two Recent Cases

In *Skidmore v. Swift & Co*, the Supreme Court was tasked with determining whether time spent by employees waiting to respond to fire alarms constituted working hours under the Fair Labor Standards Act (the "Act").[11] The Administrator of the Wage and Hour Division of US Department of Labor (the "Administrator") had created certain tests to determine whether a particular inactive duty was within the Act. In analyzing the Administrator's pronouncements, the Supreme Court noted that "[t]here is no statutory provision as to what, if any, deference courts should pay to the Administrator's conclusions."[12] However, even though the Court held that the Administrator's rulings "do not constitute an interpretation of the Act or a standard for judging factual situations which binds a district court's processes, as an authoritative pronouncement of a higher court might do," they were nonetheless "based upon more specialized experience and broader investigations and information than is likely to come to a judge in a particular case."[13] As a result, the Court held that:

> We consider that the rulings, interpretations and opinions of the Administrator under this Act, while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance. The weight of such a judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.[14]

This holding formed the basis of what is now known as *Skidmore* deference, which has come to stand for the notion that courts should pay attention to an agency's construction of a statute that it administers and give the agency's analysis whatever weight it reasonably deserves. Depending on the balance of the factors enumerated above, courts may give a range of deference from "great respect" to "near indifference."[15]

In *Sunoco v. United States*, the taxpayer brought suit to recover refunds based on excise taxes against which it had applied the Alcohol Fuel Mixture Credit (the "Credit").[16] After Sunoco filed its refund suit, the IRS issued Notice 2015-56 (the "Notice"), which directly addressed the question at issue.[17] Sunoco issued discovery requests to the Government and filed a motion to compel the production of documents that Sunoco contended would help the court determine whether the Notice was entitled to *Skidmore* deference.

The IRS had issued three pieces of guidance regarding the tax treatment of the Credit, the first of which agreed with Sunoco's position[18] and the second of which reversed course and came to the opposite conclusion.[19] The third item was the Notice, which, as discussed, had been issued after Sunoco filed its refund suit, and which was in line with the second piece of guidance the IRS had issued, but which contained no authority for its conclusion and which conflicted with the first piece of guidance without any explanation. The court determined that the Notice was the only piece of IRS guidance that may be treated as binding, since the two previous items were merely Chief Counsel Advices and explicitly stated that they could not be used or cited as precedent.

The court noted that under *Skidmore*, "courts may give deference to an agency's interpretation of its governing laws even when the agency does not use its rulemaking authority." As explained above, in deciding whether to give

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[11] 323 U.S. 134 (1944).
[12] *Id.* at 139.
[13] *Id.*
[14] *Id.* at 140.
[15] *United States v. Mead Corp.*, 533 U.S. 218, 288 (2001).
[16] 128 Fed. Cl. 345 (Oct. 6, 2016).
[17] 2015-35 I.R.B. 235 (2015).
[18] Chief Counsel Advice 201342010 (Oct. 18, 2013).
[19] Chief Counsel Advice 201406001 (Feb. 7, 2014).

deference to an agency interpretation, a court should weigh "the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control."[20] The court looked to a case from the Federal Circuit, which held that "[a] revenue ruling issued at a time when the IRS is preparing to litigate is often self-serving and not generally entitled to deference by the courts."[21] Additionally, the Federal Circuit found that less deference was due to a revenue ruling that cited no authority and was inconsistent with other IRS pronouncements. In this case, the Court of Federal Claims held that the timing of the Notice, the lack of authority contained in the Notice, and the Notice's inconsistency with prior IRS advice meant that the Notice was not entitled to *Skidmore* deference. As a result, the court denied Sunoco's motion to compel as moot.

One month after issuing its opinion in the *Sunoco* case, the Court of Federal Claims was again faced with a motion to compel discovery requests in *Nippon Paper Industries USA Co. Ltd. V. United States*.[22] In that case, Nippon filed a refund suit seeking the entire amount of the grant it had requested under section 1603 of the American Recovery and Reinvestment Act of 2009 ("ARRA"), which was administered by the Treasury Department, and which provided a cash grant to an eligible facility based on its cost basis. Nippon issued discovery requests regarding the Government's processing of grants to other taxpayers under section 1603, and filed a motion to compel their production.

The Treasury Department had published guidance for section 1603 applicants to assist in preparing applications in July 2009 (the "Guidance"), which was revised in March 2010 and April 2011. The Guidance provided that the cost basis of an eligible facility did not include the portion of the facility's cost attributable to a non-qualifying activity, and that basis had to be allocated according to qualifying activities and non-qualifying activities.

Nippon learned that other dual-use facilities similar to Nippon's had received the entire amount of the cash grants they had requested under section 1603 and, therefore, argued that the Guidance did not warrant *Skidmore* deference given its inconsistent application. The Government argued that the information pertaining to the other grants was irrelevant to the court's determination under *Skidmore*, but the court held that whether the Guidance had been applied consistently is relevant to whether the court should strongly defer to it. Additionally, the Government argued that the court could only consider whether the Guidance was consistent with formal and public declarations, which did not include section 1603 grant decisions, but the court found that *Skidmore* allowed a court to consider "all factors which give [the Guidance] the power to persuade," and that there was no authority limiting the court's consideration only to public pronouncements. Indeed, the Court of Federal Claims had previously held that internal, non-public agency documents could be relevant to a determination of *Skidmore* deference.[23] As a result, the court granted the motion to compel certain of the discovery requests that it determined would be relevant to an analysis under *Skidmore*.

[20] *Skidmore*, 323 U.S. at 140.
[21] *AMP Inc. v. United States*, 185 F.3d 1333, 1338-39 (Fed. Cir. 1999).
[22] 2016 U.S. Claims LEXIS 1691, No. 1:15-cv-1535 (Nov. 7, 2016).
[23] *Jade Trading, LLC v. United States*, 65 Fed. Cl. 487, 493 (2005).