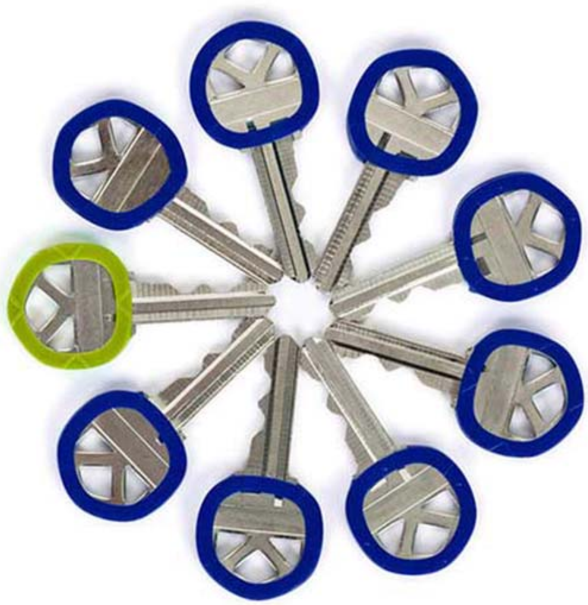

In this issue:

Tax Court Holds that Certain Tax Return Information May Be Disclosed to an Employer Asserting a Defense to Withholding Tax

In *Mescalero Apache Tribe v. Comm'r*, 148 T.C. 11 (April 5, 2017), the Tax Court held that information reported to the Internal Revenue Service ("IRS") by independent contractors of the Mescalero Apache Tribe ("Tribe") was disclosable and discoverable.

During the years 2009 through 2011, the Tribe hired both employees and independent contractors. Depending upon these workers classification (i.e. employee or independent contractor) the Tribe either issued a Form W-2 or Form 1099, respectively. The IRS examined the Tribe's classification of its workers for the years, and the IRS asserted that approximately several hundred independent contractors were more properly classified as employees. Based upon its conclusion, the IRS sought to assess withholding tax for those individuals under Section 3402(a).

Although the Tribe disagreed with the re-classification, it argued that regardless, it was not liable for withholding taxes as the independent contractors had reported and paid tax on their earnings. Section 3402(d) states:

> If the employer, in violation of the provisions of this chapter, fails to deduct and withhold the tax under this chapter, and thereafter the tax against which such tax may be credited is paid, the tax is required to be deducted and withheld shall not be collected from the employer.

One way to establish the workers paid the tax on their earnings is to obtain from each worker a Form 4669, *Statement of Payments Received*. The Tribe tried to get Forms 4669 from all of its independent contractors to support a Section 3402(d) assertion; however, it was unable to obtain forms for 70 of its independent contractors due to a variety of factors. In the decision, the Tax Court notes that many of the independent contractors had moved, or lived in hard to reach places where they lack cell service and basic utilities. Due to its failure to obtain information directly from its employees, the Tribe sought discovery of IRS' records to prove that the remaining seventy independent contractors had reported and paid taxes on amounts received from the Tribe during these tax periods.

The IRS refused the request and argued that dissemination of the individuals' information was barred under Section 6103(a), which provides that returns and information on returns should be kept confidential. The definition of "return" for purpose of Section 6103 includes, "any tax or information return…" and "return information" includes payments, receipts, deductions, assets. The Tax Court noted that no one could debate that the Tribe was seeking "return information," which was protected by Section 6103 barring a specific exception.

The Tribe asserted that its situation fell under the exception for disclosure in judicial or administrative tax proceedings contained in subsection (h)(4) of Section 6103. This provision states:

> (4) Disclosure in judicial and administrative tax proceedings. – A return or return information may be disclosed in a Federal or State judicial or administrative proceedings pertaining to tax administration, but only –
>
> > (B) if the treatment of an item reflected on such return is directly related to the resolution of an issue in the proceeding; [or]
> >
> > (C) if such return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding.

As a threshold question, the Tax Court examined whether the above exception, if applicable, would permit the disclosure to the Tribe, *i.e.* a third-party, or whether disclosure was only permissible to another government actor. The court noted that although there is a split in the Circuit Courts of Appeals on this question, the case would likely be appealable to the Tenth Circuit Court of Appeals. Accordingly, the Tax Court adopted the Tenth Circuit's standard allowing for disclosure to non-government officials if meeting the other requirements of the section.

The Tax Court noted that there was a debate regarding whether return information could be subject to subsection (B), as the language specified "return". Accordingly, it declined to pursue an analysis under the provision and instead focused on subsection (C). In evaluating Section 6103(h)(4)(C), the court analyzed the following factors: (1) whether the relationship between the Tribe and its employees meet the transactional relationship requirement, (2) whether the information sought "directly relates" to the relationship, and (3) whether the information directly affects the resolution of the issue.

With regards to the first factor, the Tax Court noted that many courts have allowed a wide variety of business relationships, such as investors and promoters and participants in business dealings, to satisfy Section 6103(h)(4)(C). Accordingly, the Tax Court held that the relationship between the Tribe and its independent contractors was clearly under the requisite type of relationship.

Secondly, the Tax Court examined whether the information sought "directly related" to the relationship between the Tribe and independent contractors. In evaluating this question, the Tax Court held that whether the Tribe's workers paid their full tax liability, which was the information sought by the Tribe, has a direct correlation on whether the individuals considered themselves to be independent contractors or employees. Accordingly, it was "directly related" to the relationship.

Thirdly, the Tax Court examined whether the information sought would impact the resolution of the case. The Tax Court noted that while the workers classification, per their tax reporting, would be a factor in a determination of employee versus independent, in this situation it is definitive. The Tax Court stated:

> We also shouldn't overlook the big issue here: If the Tribe's workers did indeed pay their tax liabilities, then the Tribe's section 3402(d) defense would be proved and would be entirely resolved.

As the Tribe had proven all the elements of Section 6103(h)(4)(C), the Tax Court held that the requested return information could be disclosed by the IRS.

In addition to an argument under Section 6103, the IRS also argued that the information was not discoverable as the request unfairly shifted the burden of proof from the Tribe to the IRS for the Tribe's defense under Section 3402. Additionally, the IRS asserted that it would be burdensome to comply. The Tax Court dismissed the IRS' burden of proof argument and noted that the relevant rule of evidence, Rule 70(b), states that burden of proof is not an element of whether it is discoverable. Further, this rule allows for discovery of any matter not privileged and which is relevant to the subject matter at issue. Accordingly, the Tax Court held that the information sought by the Tribe on its independent contractors was not barred from either disclosure or discovery.

The Ninth Circuit Court of Appeals Holds Reportable Transaction Penalty Timely Due to the Taxpayer's Failure to File a Form 8886

In an unpublished opinion, the Ninth Circuit held that the IRS had timely assessed a penalty under Section 6707A as the taxpayer failed to file a Form 8886, *Reportable Transaction Disclosure Statement*, which was necessary to start the statute of limitations under Section 6501(c)(10).[1]

For tax year 2004, Stephen T. May ("Taxpayer") failed to file a Form 8886 to report participation in a listed transaction. The IRS subsequently discovered this error and issued notification in March 10, 2010 that the Taxpayer would be subject to a penalty under Section 6707A for failure to timely disclose his participation. The IRS subsequently assessed the penalty on February 6, 2012. The Taxpayer paid the penalty and sued for a refund arguing that the IRS had failed to timely assess the penalty under Section 6501(c)(10). Specific to listed transactions, Section 6501(c)(10) provides the assessment statute of limitations will remain open for one year after either:

> (A) the date on which the Secretary is furnished the information so required, or
> (B) the date that a material advisor meets the requirements of section 6112 with respect to a request by the Secretary under section 6112(b) relating to [a listed] transaction with respect to such taxpayer.

The district court in *May v. United States*, 2015 US Dist. LEXIS 76962 (D. Ariz., June 23, 2015) held that the IRS had sufficient information to start the running of the statute of limitations in 2010, thus the IRS was barred from assessing the penalty during 2012.[2]

In its decision, the Ninth Circuit reversed the decision of the district court. The Ninth Circuit concluded that "information so required" language in Section 6501(c)(10) required the filing of a Form 8886 to start the statute of limitations. The Ninth Circuit noted that Section 6501 referenced Section 6011, which requires that taxpayers make a return or statement according to the forms and regulations prescribed by the IRS. Specifically, Treas. Reg. § 1.6011-4 provides that a reportable transaction must be disclosed on a Form 8886, as well as sent to the IRS' Office of Tax Shelter Analysis in certain instances.[3] Thus, the Ninth Circuit concluded that Section 6501(c)(10) required the furnishing of a Form 8886 to trigger the one year assessment statute of limitations.

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[1] *May. v. US*; No. 15-16599 (9th Cir. 2017).
[2] For additional discussion, *see A District Court Holds IRS's Assessment of a Reportable Transaction Penalty was Untimely under Section 6501(c)(10) as IRS Had Been Furnished the Required Information More Than One Year before Assessment*, IRS Insights July 2015.
[3] A taxpayer is required to submit a copy of the Form 8886 to the IRS' Office of Tax Shelter Analysis when disclosing a reportable transaction for the first time. *See* Treas. Reg. § 1.6011-4(e).

As the Taxpayer did not file a Form 8886, either with his original return or at any juncture, the Ninth Circuit held that the assessment statute of limitations for the penalty under Section 6707A had not yet started. According, the IRS' assessment of the penalty in 2012 was timely, despite the IRS having the requisite information in 2010.

Tax Court Determines that Accuracy-Related Penalty, Asserted As a Result of Taxpayers' Failure to Report Their Share of Partnership Items, Is Subject to Deficiency Procedures

In *Malone v. Comm'r*, 148 T.C. No. 16, the Tax Court considered whether it had jurisdiction to determine the applicability of an accuracy-related penalty asserted by the IRS.

During 2005, Bernard Malone was a partner in a partnership, MBJ Mortgage Services America, Ltd. ("MBJ"), which was subject to the unified audit and litigation procedures enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). On MBJ's 2005 Form 1065, *US Return of Partnership Income*, it reported that Mr. Malone's distributive share from certain installment sales was approximately $3.2 million of ordinary income and approximately $3.5 million of net long-term capital gain.

On the their joint Form 1040, *US Individual Income Tax Return*, Bernard Malone and Mary Ellen Malone (collectively, "the Malones") did not report Mr. Malone's distributive share from the installment sales; instead, they reported approximately $4.5 million of long-term capital gain from the sale of Mr. Malone's partnership interest in MBJ. The Malones did not file Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*. In addition, they did not otherwise provide notice to the IRS that they were taking a position inconsistent with MBJ's reporting.

The IRS issued a notice of deficiency to the Malones in which it adjusted the Malones' return to include the partnership items reported by MBJ but omitted by the Malones, disallowed the reported net long-term capital gain because Mr. Malone did not sell his partnership interest in 2005, and disallowed the claimed repairs and maintenance and bad debt deductions. In response, the Malones petitioned the Tax Court. In its amended answer, the IRS asserted an accuracy-related penalty under IRC § 6662. The penalty was asserted based on the Malones' failure to report Mr. Malone's distributive share of the MBJ partnership items. The Malones filed a motion to dismiss, asserting that the Tax Court lacked jurisdiction over the penalty because it was not subject to deficiency procedures.

The requirement for partners to treat partnership items in a manner consistent with the partnership's treatment of the partnership item on the partnership's return is found in IRC § 6222(a). If a partner reports partnership items inconsistently with the partnership's treatment of the items, the partner may be subject to a penalty, in accordance with IRC § 6222(d), IRC § 6662(a) and (b)(1), and Treas. Reg. § 1.6662-3(b)(1). In this case, the Tax Court had to determine whether deficiency procedures apply with respect to a determination of an accuracy-related penalty under IRC § 6662(a) for negligence solely attributable to a partner's inconsistent reporting of partnership items.

For adjustments to affected items that are merely computational and can be made without the IRS making any additional determinations at the partner level, the IRS is permitted to directly assess tax without the requirement to follow the deficiency procedures, pursuant to IRC § 6230(a) and Treas. Reg. § 301.6231(a)(6)-1(a)(2). However, to the extent that the adjustment to an affected item requires factual determinations to be made at the partner level, then the IRS is obligated to follow deficiency procedures, pursuant to IRC § 6230(a)(2)(A)(i).

There are, however, special rules with respect to penalties. IRC § 6221 provides that the tax treatment of any partnership item, including the applicability of any penalty that relates to an adjustment to a partnership item shall be determined at the partnership level. Likewise, IRC § 6230(a)(2)(A)(i) excludes from deficiency procedures penalties that relate to adjustments to partnership items irrespective of their status as affected items. Therefore, for the deficiency procedures to apply, the penalty must not be related to adjustments to partnership items.

In its analysis, the Tax Court noted that partnership items are limited to items arising under subtitle A of Title 26, and the IRC § 6662(a) negligence penalty is in subtitle F of Title 26. In reviewing the facts of this case, the Tax Court determined that there were no adjustments to partnership items, as required for the TEFRA exclusion from deficiency procedures (which references "penalties, additions to tax, and additional amounts that relate to adjustments to partnership items"). Specifically, the IRS did not make any adjustments to the partnership items reported by MBJ. Instead, the IRS made computational adjustments to the Malones' tax liability to account for Mr. Malone's distributive share of the MBJ partnership items, as reported by MBJ. Because the accuracy-related penalty asserted was neither a partnership item nor an affected item, the Tax Court concluded that the IRC § 6230(a)(2)(A)(i) exclusion from deficiency procedures did not apply, and the court had jurisdiction to determine the applicability of the IRC § 6662(a) and (b)(1) negligence penalty.

Ninth Circuit Concludes that a Taxpayer Is Entitled to a Refund, Even Though the Initial Claim was Made on the Wrong Form and Did Not Identify the Relevant Tax Year

Internal Revenue Code ("IRC") § 6511(a) requires a taxpayer seeking a refund to file a claim within three years from the time of filing the relevant return or two years from the time of payment of the tax, whichever period expires later. Treas. Reg. § 301.6402-2 sets forth the requirements for a valid refund claim, including the requirements that the taxpayer submit the claim on the proper form and set forth in detail all grounds upon which the credit or refund is claimed and all facts sufficient to apprise the IRS of their exact basis.

Notwithstanding these requirements for making a refund claim, courts have held that, under certain circumstances, it is sufficient if the taxpayer submits an informal claim within the refund limitation period and later submits a formal claim outside of the refund statute of limitations period. To determine whether a taxpayer has made a timely informal refund claim, the Tax Court applies a three-factor test. First, there must be a written component to the claim that is delivered to the IRS before the expiration of the refund statute. Second, the writing, in conjunction with the surrounding circumstances, must adequately notify the IRS that the taxpayer is claiming a refund and the basis for it. Third, either the IRS waives the procedural defects of the informal refund claim by considering the claim on its merits, or the taxpayer subsequently perfects it by filing a formal refund claim before the IRS rejects the informal refund claim.[4]

In *Palomares v. Comm'r*, T.C. Memo 2014-243, the Tax Court considered whether a taxpayer, Teresa Palomares, filed a timely refund claim when she attempted to request a refund of overpaid tax withheld from her wages during 2006 and 2007 (and applied against her 1996 joint tax liability) by filing Form 8379, *Injured Spouse Allocation*. The Form 8379, on its face, only requested an allocation of items reported on a joint return for 2007. In response to Palomares' Form 8379, the IRS sent her a letter advising that the correct form to use to request innocent spouse relief is Form 8857, *Request for Innocent Spouse Relief*.

Palomares did not file the proper refund claim form until after the refund statute of limitations had expired for the 2006 and 2007 overpayments. Specifically, she did not file the Form 8857 within two years from the time that the tax was paid for 2006 and 2007. Because the request on Form 8379 was the only request that Palomares filed prior to the expiration of the refund statute of limitations, she requested that the court treat it as an informal refund claim. The Tax Court concluded that the Form 8379 was not a valid informal refund claim because it did not convey sufficient information to notify the IRS that she was seeking relief from liability for the 1996 tax year and a refund of amounts that had been applied against the liability for that year and, therefore, it did not adequately apprise the IRS of the refund requested.

On appeal, the Ninth Circuit reached a contrary conclusion, holding that Palomares was entitled to a refund of the 2006 and 2007 overpayments applied to her 1996 joint tax liability because the Form 8379 sufficiently apprised the IRS that Palomares was seeking innocent spouse relief from her 1996 tax liability. *See Palomares v. Comm'r*, 2017 US App. LEXIS 9585 (cautioning that this disposition is not appropriate for publication and is not precedent). The Ninth Circuit noted that the IRS had been crediting Palomares' 2006 and 2007 tax overpayments to the liability on her joint income tax return for 1996, and that the IRS was on notice of her intention to request innocent spouse relief, where the IRS informed Palomares of the proper form to use to request that relief. In addition, the court determined that the

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[4] *Jackson v. Comm'r*, T.C. Memo 2002-44.

equities weighed in favor of granting the taxpayer relief in this case because Palomares was not a sophisticated taxpayer and the improper filing of the Form 8379 was the result of incorrect advice that she received from a volunteer attorney.

District Court holds that Wells Fargo can deduct loan interest in STARS transaction, but upholds negligence penalty

On May 24, 2017, a US District Court for Minnesota decided the fourth in a series of similar cases involving a Structured Trust Advantaged Repackaged Securities (STARS) transaction,[5] in *Wells Fargo & Co. v. United States*, 2017 US Dist. LEXIS 80401, although it is the first of the series appealable to the Eighth Circuit.

Wells Fargo & Co (Wells Fargo) entered into a STARS transaction with a UK financial institution. The transaction was structured to produce both foreign tax credits (FTCs) and interest expense deductions for Wells Fargo for US Federal income tax purposes. The IRS disallowed both the FTCs and interest deduction on the grounds that the STARS transaction was a sham, and assessed a negligence penalty for the underpayment of tax attributable to its disallowance of the claimed FTCs.

Like the preceding STARS cases, a jury found that the STARS transaction was most appropriately bifurcated into a trust structure and a loan structure. The jury then determined whether each structure should be disregarded under the established sham transaction doctrine. Generally speaking, a transaction will be characterized as a sham if: (1) "it is not motivated by any economic purpose outside of tax considerations," (commonly referred to as the *Business Purpose Test*); and (2) "it is without economic substance because no real potential for profit exists apart from tax benefits," (commonly referred to as the *Economic Substance Test*).[6] Also like the preceding STARS cases, the jury found that the trust structure lacked both a non-tax business purpose and a reasonable possibility of pre-tax profit, and should be disregarded as a sham, but found that the loan structure actually held a reasonable possibility of pre-tax profit, though it lacked a non-tax business purpose. As such, the district court had to decide whether a transaction should be treated as a sham if it satisfied the Economic Substance Test yet failed the Business Purpose Test.

Not a Sham if a Transaction has Objective Economic Substance, but Lacks Subjective Business Purpose

The district court began its analysis by stating that the Eighth Circuit had yet to decide whether a transaction will be characterized as a sham if it fails only one of the two prongs of the sham transaction doctrine. The district court concluded that the Eighth Circuit is likely to treat "the objective and subjective components of the sham-transaction test as two factors in a single flexible analysis rather than two separate, rigid tests."[7] The district court reasoned that, to accomplish its purpose, the sham transaction doctrine needs flexibility. According to the district court, a flexible approach to apply the sham transaction doctrine allows for taxpayers to engage in tax planning, which is permitted by law.[8] The district court also illustrated that while courts have stated that a lack of business purpose will invalidate a transaction, actual results show a reluctance to disregard it.[9] Finally, the district court noted that the Eighth Circuit has previously applied a flexible approach to the sham transaction doctrine, such that it focuses on the relative size of the business profit versus the tax benefit, rather than just the existence of a non-tax related profit.[10] Applying this flexible approach, the district court held that the loan was not a sham and Wells Fargo was entitled to a deduction for the interest expenses associated with the loan.

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[5] *See generally Santander Holdings USA, Inc. v. United States*, 844 F.2d 15 (1st Cir. 2016); *Bank of N.Y. Mellon Corp. v. Comm'r*, 801 F.3d 104 (2d Cir. 2015); *Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015).
[6] *IES Indus., Inc. v. United States*, 253 F.3d 350, 353 (8th Cir. 2001) (quoting *Shriver v. Comm'r*, 899 F.2d 724, 725-26 (8th Cir. 1990)).
[7] *Wells Fargo & Co. v. United States*, 2017 US Dist. LEXIS 80401 *5.
[8] *See Gregory v. Helvering*, 29s3 US 465, 469 (1935).
[9] *See United Parcel Serv. of Am., Inc. v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001).
[10] *See WFC Holdings Corp. v. United States*, 728 F.3d 736, 746 (8th Cir. 2013).

Taxpayers Must *Actually Consult* Authorities to Establish a Reasonable Basis Return Position

Wells Fargo challenged the IRS's assessment of a negligence penalty associated with its claimed FTCs. The negligence penalty, under section 6662(b)(1), imposes a 20-percent penalty on any portion of underpayment attributable to negligence. Section 6662(c) defines "negligence" to include any failure to make a reasonable attempt to comply with the provisions of [the income tax laws], and the term "disregard" to include any careless, reckless, or intentional disregard. However, Treas. Reg. § 1.6662-3(b)(1) provides that a return position that has a reasonable basis as defined in (b)(3) is not attributable to negligence. Treas. Reg. § 1.6662-3(b)(3) further provides that a return position will generally satisfy the reasonable basis standard if it is reasonably based on one more of the authorities of Treas. Reg. § 1.6662-4(d)(3)(iii).

In response to the IRS's assessment of a negligence penalty, Wells Fargo stipulated that it would only raise two defenses to an accuracy-related penalty: (1) that its STARS transaction was not a sham and therefore Wells Fargo is not liable at all, and (2) that, even if its STARS transaction was a sham, there was an objectively reasonable basis for Wells Fargo's return position under the authorities referenced in Treas. Reg. § 1.6662-3(b)(3). Wells Fargo further asserted that it would not make "[a]ny contention that relies upon Wells Fargo's efforts to exercise ordinary and reasonable care in the preparation of its tax return, or Wells Fargo's efforts to determine its proper tax liability…to establish reasonable basis[.]"[11]

As a result of this stipulation, the district court then had to decide whether a taxpayer must prove that it *actually consulted* the authorities referenced in Treas. Reg. § 1.6662-3(b)(3) when preparing its tax return to establish it had a reasonable basis for a tax return position. The government argued that the plain meaning of "negligence" focused on the exercise of due care and the conduct of the taxpayer, and the line of negligence penalty cases confirms that a taxpayer's conduct is the focus in determining whether the negligence penalty applies. However, Wells Fargo argued that the reasonable-basis standard is an objective legal defense to the negligence penalty, citing Treas. Reg. § 1.6662-3(b)(1), "a return position that has a reasonable basis is not attributable to negligence."

The district court determined that Treas. Reg. § 1.6662-3(b) is ambiguous as to whether a taxpayer must have actually relied on authorities, at the time of preparing a return. However, Treasury's interpretation of its own regulation is controlling, absent an exception or a past inconsistent interpretation. The district court found that neither were the case, and that Treasury has consistently focused on the conduct of a taxpayer in forwarding a reasonable-basis defense. The district court concluded that in order to establish the reasonable-basis defense, Wells Fargo would have to prove that it actually relied on the authorities that form the basis of that defense. As Wells Fargo stipulated it would not raise such a defense to the penalty, the district court upheld the section 6662(b)(1) negligence penalty on Wells Fargo's underpayment attributable to the FTCs claimed in the STARS transaction.

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[11] *Wells Fargo & Co. v. United States*, 2017 US Dist. LEXIS 80401 *5.