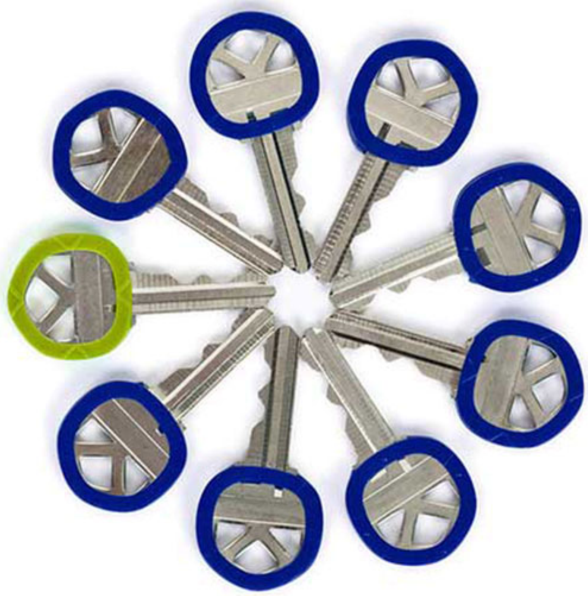

In this issue:

ATCL Conferencing Initiative Update

On May 1, 2017, the IRS Office of Appeals ("Appeals") implemented the Appeals Team Conferencing Initiative ("Initiative") under which some Appeals Team Case Leaders ("ATCLs") will hold Appeals conferences with representatives from IRS Compliance Examination teams ("Compliance") in attendance. On August 8, 2017, Appeals released Frequently Asked Questions ("FAQs"), which provide some insight into the Initiative. Recently, the IRS extended the Initiative until May 2020 and released an update on the Initiative.

The FAQs

The FAQs clarify that participation by Compliance will now be routine for certain types of Appeals cases. In these cases, the Compliance personnel directly related to any disagreed issues will be invited to discuss the IRS's position and answer questions, as well as listen to the taxpayer's position and answers. The procedures are designed to create an open forum whereby Compliance and the taxpayer will both participate to clarify factual or legal disputes. The FAQs reflect the IRS's belief that all parties could benefit from an open discussion of the issues, which in turn could facilitate resolution of the same or similar issues in future examinations. The FAQs further clarify that the conference attendance changes are not intended to impact the primary function of Appeals to be a fair and impartial forum and that Compliance will not be involved in any settlement negotiations between the taxpayer and Appeals.

ATCL conferencing initiative update

Recently, the IRS extended the Initiative until May 2020. The IRS noted that it received feedback requesting that the IRS clarify the roles and responsibilities of the parties to the Appeals conference. To that end, the IRS released an update on the Initiative that included three exhibits to provide further guidance on the Initiative. The three exhibits are:

1. A process and procedures outline;
2. A sample agenda for expectations call; and
3. A sample expectations letter.

The process and procedure outline discusses the responsibilities of the ATCL for planning and controlling the progress of the case. The sample agenda for expectations call provides guidelines for ATCLs to use in holding a call to prepare the case for the Appeals conference and to clarify the roles of the parties to the conference. The sample expectations letter can be customized and used by ATCLs to inform taxpayers that their case has been selected to participate in the Initiative.

IRS Large Business & International Division Announces the Opening of the 2020 CAP Program for New Applicants for the First Time Since 2015

On September 12, 2019, the IRS announced the opening of the application period for the 2020 CAP program ("Announcement"). For the first time since 2015, new corporate applicants who meet specified eligibility and suitability requirements could apply for admittance into the CAP program. The IRS plans to inform applicants about whether they were admitted to the program sometime around January 31, 2020. The announcement also contained important changes to the eligibility requirements, research credit questionnaire and included a new requirement, the Tax Control Framework questionnaire.
URL: https://www.irs.gov/newsroom/irs-expanding-the-compliance-assurance-process-for-2020-accepting-new-corporate-applicants

The CAP program began in 2005 as a way for resolving tax issues before the filing of a return through open, cooperative, and transparent interactions between the IRS and taxpayers. The program began with 17 taxpayers and has expanded to its current level of 161 taxpayer participants. The program is intended to provide taxpayers and IRS certainty on the treatment of certain tax issues even before the return is filed, while reducing the chance of potential disagreement and lengthy examinations.

On September 12, 2019, the IRS announced changes to the CAP program for 2019. In addition to being open to new applicants, the CAP program for 2020 includes some important changes on the following topics: eligibility requirements, research credit questionnaire, and tax control framework questionnaire. These changes were designed to improve operation of the program, make the best use of limited IRS resources, and to ensure the sustainability of the program.

New eligibility requirements

The IRS revamped the eligibility requirements for taxpayers to gain admission into the CAP program. Among other requirements to participate in CAP, eligible corporations must adhere to CAP program limits on the number of open years. If currently under examination, the taxpayer must not have more than one filed return and one unfiled return open on the first day of the applicant's CAP year.

For prospective CAP applicants currently under exam to be eligible for participation in the CAP program, the current cycle must be closed, and the subsequent cycle not started on the first day of the applicant's CAP year. For all new applicants, any unexamined return with an open statute will be risk assessed as part of the required compliance check for the first CAP year. If the examination team determines that a material issue should be examined, the return with that issue may be placed under examination. Any unexamined returns that are placed under examination will be treated as "one filed" return for purposes of the return criterion. These returns must be closed by the end of the second CAP year or the applicant may not be eligible to participate in the third CAP year.

For 2020, the IRS expanded the list of open-year exceptions and developed a process for new applicants who are currently under examination. New additions to the list of open-year exceptions include a National Office exception, which provides that any return that is waiting for the National Office to issue published guidance or a ruling, such as Chief Counsel Advice, Private Letter Ruling or Change in Accounting Method Review will not prevent applicants from meeting the limitation on the number of open years. Additionally, the IRS provides a new exception for any return sent to Joint Committee on Taxation for review. Lastly, the IRS has introduced a new 2017 section 965 exception for any 2017 return that remains open solely because of a transition tax issue not being resolved.

Research credit questionnaire

Similar to the CAP process for 2019, as part of the application, taxpayers will be required to provide, if applicable, information on the research credit. The research credit questionnaire has been updated for the 2020 CAP tax year to include additional questions related to reporting research credit associated with software expenses.

Tax control framework questionnaire

All applicants for the 2020 CAP program will be required to provide certification of a tax control framework. This questionnaire will provide the IRS with an understanding of the corporation's tax governance processes and the system of internal controls that ensure the accuracy and completeness of its federal income tax returns, information reporting, tax reporting data, and other tax-related disclosures. The input received in response to this questionnaire will, in part, inform the CAP tax control framework requirements for future years.

IRS Office of Chief Counsel concludes that the doctrine of election precludes a taxpayer from relying on hindsight to make an election on amended returns and a subsequent year's original return that, if allowed, would have retroactively reduced the taxpayer's tax liability

In *Chief Counsel Memorandum 201939003*,[1] IRS Office of Chief Counsel considered the question of whether a taxpayer was allowed to make an election under IRC Section 807(d)(4)(A)(ii) on either amended or subsequent original returns that would result in a retroactive increase in deductions and effectively allow the taxpayer to engage in tax rate arbitrage. The Office of Chief Counsel concluded that a taxpayer was barred from making an IRC Section 807(d)(4)(A)(ii) election either on amended returns or a subsequent year's original return that purported to effect tax years five or more years before the date of the election. Chief Counsel determined that permitting the taxpayer to elect to do so would violate the doctrine of election by allowing the taxpayer to rely on hindsight. In addition, such a decision would impose an undue administrative burden on the Commissioner and would hinder the provision of an equitable and fair tax system by treating similarly situated taxpayer dissimilarly.

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[1] CCA 201939003 (June 27, 2019)

Background

The taxpayer is an affiliated group of life insurance companies that are subject to tax under §801, which defines taxable income for life insurance companies as gross income reduced by life insurance deductions.[2] Life insurance deductions include amounts that life insurance companies are required to keep as reserves, which are calculated by reference to either the applicable Federal Interest rate ("AFIR") or the prevailing State assume interest rate ("PSAIR").[3] Life insurance companies are required to calculate their reserves by using the higher rate in the year that the insurance contracts are issued.

However, §807 also provides life insurance companies the option of electing to recompute their reserves intermittently.[4] The election creates a recomputation period, a reoccurring five-year period that begins five years after the year the contract is issued. The reserves are recalculated during each five-year recomputation period by using the greater of either the AFIR applicable on the first year of the recomputation period, or the PSAIR rate applicable during the year in which the contract was issued. This election was repealed on December 31, 2017 by the Tax Cuts and Jobs Act.

In 2018, Taxpayer attempted to elect to recompute its reserves under §807(d)(4)(A)(ii) by filing amended returns that recomputed its life insurance reserves. As a result, Taxpayer's amended returns showed increased life insurance reserves, which resulted in a negative adjustment to Taxpayer's consolidated taxable income. Additionally, in case the amended returns were rejected by the IRS, the taxpayer attached a protective election under §807(d)(4)(A)(ii) to its originally filed 2017 tax return.

The IRS Office of Chief counsel applied the doctrine of election to determine whether the taxpayer's elections on its amended returns or on its 2017 original tax return were valid. The doctrine of election makes a choice between two or more alternative or inconsistent rights irrevocable.[5] Under the doctrine of election, an election has two essential elements:

1. A free choice between two or more alternatives, and
2. An overt act communicating the taxpayer's choice to the Commissioner.[6]

This over act element can be met by a taxpayer computing its taxable income on a tax return consistent with an elective choice.

Neither the Internal Revenue Code nor the Treasury Regulations provide procedures or a timeframe for making an §807(d)(4)(A)(ii) election. Citing *Baylely v. Commissioner*, IRS Chief Counsel determined that in the absence of any explicit deadline, the appropriate time for making an election is when a taxpayer is faced with the necessity of making the election to compute its taxable income on a return.[7] IRS Chief Counsel reasoned that, in the context of a taxpayer applying AFIR or PSAIR to compute its life insurance reserves, this necessity arises in the fifth year after the issuance of the life insurance contract because, under the 807(d)(4)(A)(ii) election, the AFIR rate for the fifth year supplants the AFIR rate applicable during the initial year of the contract for purposes of the recomputation.

In its memorandum, IRS Chief Counsel noted that its interpretation is supported by all the rationales that underly the doctrine of election and that by allowing a taxpayer to make an election under section 807(d)(4)(A)(ii) subsequent to the fifth year would lead to distorted accounting and losses in revenues for the Treasury. The memorandum notes that the Tax Cuts and Jobs Act lowered tax rates in post-2017 tax years, and if the taxpayer was allowed to make this election on its amended returns, the taxpayer would have been able to engage in tax rate arbitrage. Specifically, the taxpayer could increase its deductions against income taxable at higher tax rates and recognize subsequent increases in taxable income from the reduction of its life insurance reserves at lower tax rates. The memorandum further noted that if the taxpayer is not bound by its choice at the time to not recompute using the fifth-year AFIR, Taxpayer could subsequently, after the enactment of the Tax Cuts and Jobs Act, reap the rewards of lower tax rates without bearing

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[2] *See* IRC § 801
[3] *See* IRC § 807(d), repealed as of Dec. 31, 2017.
[4] *See* 807(d)(4)(A)(ii), repealed as of Dec. 31, 2017
[5] *See Pac. Nat'l Co. v. Welch*, 304 U.S. 191, 194-95 (1938)
[6] *See Grynberg v. Commissioner*, 83 T.C. 255, 261 (1984)
[7] *See Bayley v. Commissioner*, 35 T.C. 288, 298 (1960)

any of the risk that the AFIR might increase in the future and decrease its taxable income. Moreover, in its memorandum, IRS Chief Counsel concluded that allowing elections more than five years after the year in which the contracts were issued would lead to disparate treatment of similarly situated taxpayers and create undue administrative burdens. For these reasons, Chief Counsel concluded that the taxpayer was bound by the choice it had made on its original tax return to forego the election and could not reap the benefit of hindsight by making its election on its subsequently filed amended or original tax returns.

Divided Sixth Circuit Holds that the Anti-Injunction Act Bars Pre-Enforcement Challenge to Reporting Requirement Enforced by a Penalty that is Statutorily Defined as a Tax

In *CIC Services, LLC v. IRS*,[8] a divided panel of the Sixth Circuit held that the Anti-Injunction Act[9] bars courts from considering a challenge to the validity of an IRS notice that imposes a reporting requirement enforced by a penalty that is statutorily defined as a tax. Subsequently, a narrowly divided Sixth Circuit denied the plaintiff's petition for rehearing *en banc*.[10] The denial of the petition for rehearing *en banc* was accompanied by a dissent and two concurrences.

The Anti-Injunction Act

The Anti-Injunction Act provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person."[11] In *Direct Marketing Association v. Brohl*,[12] the Supreme Court interpreted the similarly worded Tax Injunction Act,[13] which generally uses words "in the same way" as the Anti-Injunction Act.[14] First, the Supreme Court held that the terms "assessment" and "collection" do not include reporting requirements.[15] Second, the Court held that the term "restrain" means to "prohibit" or "stop" and not merely "inhibit."[16] Thus, the Supreme Court concluded that a suit to enjoin a state law that required retailers to report certain information to the state revenue service does not "restrain" the "assessment" or "collection" of a tax.[17]

After *Direct Marketing*, the question arose whether the Anti-Injunction Act bars pre-enforcement challenges to the validity of IRS administrative actions that purport to impose a reporting requirement enforced by a civil penalty that is statutorily defined as a tax. In 2015, a divided panel of the DC Circuit held that the Anti-Injunction Act barred a suit challenging the legality of a reporting requirement that the IRS enforced with a tax.[18] In *CIC Services*, the same issue came before the Sixth Circuit with respect to a pre-enforcement challenge to the validity of Notice 2016-66.[19]

Notice 2016-66

Section 6707A imposes significant civil penalties for each failure to disclose a reportable transaction as required by Treas. Reg. § 1.6011-4.[20] In addition, any material advisor who is required to maintain a list of the taxpayers that the

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[8] *CIC Servs., LLC v. IRS*, 925 F.3d 247 (6th Cir. 2019).
[9] IRC § 7421(a).
[10] *CIC Servs.*, *LLC v. IRS*, No. 18-5019 (6th Cir. Aug. 28, 2019).
[11] IRC § 7421(a).
[12] 135 S. Ct. 1124 (2015).
[13] 28 U.S.C. § 1341.
[14] 135 S. Ct. at 1129.
[15] *See id.* at 1129 – 31.
[16] *Id.* at 1132.
[17] *See id.* at 1133.
[18] *See Fla. Bankers Ass'n v. U.S. Dep't of the Treasury*, 799 F.3d 1065, 1068 (DC Cir. 2015).
[19] 925 F.3d 247 (6th Cir. 2019), *and rehearing en banc denied*, No. 18-5019 (6th Cir. Aug. 28, 2019).
[20] Specifically, section 6707A provides for a penalty of 75 percent of the decrease in the tax shown on the taxpayer's return resulting from the taxpayer's participation in the reportable transaction, with a minimum civil penalty of

material advisor aided in carrying out reportable transactions can be assessed a civil penalty of $10,000 per day if the list is not produced within 20 business days of a request from the IRS.[21] These civil penalties are statutorily defined as taxes[22] and are therefore generally subject to the Anti-Injunction Act.[23] In addition, the willful failure to disclose a reportable transaction is a misdemeanor and is subject to imprisonment of not more than one year and criminal penalties of $100,000 if the material advisor is a corporation and $25,000 if the material advisor is an individual.[24]

On November 21, 2016, the IRS issued Notice 2016-66.[25] Notice 2016-66 identified certain "micro-captive transactions" as "transactions of interest." A "transaction of interest" is a type of reportable transaction.[26]

The panel opinions

CIC Services, LLC, a material advisor to taxpayers engaged in micro-captive transactions, challenged the procedural validity of Notice 2016-66. The district court dismissed the complaint, holding that the Anti-Injunction Act barred the court from enjoining the enforcement of Notice 2016-66 in a pre-enforcement proceeding.[27] CIC Services appealed to the Sixth Circuit, arguing that the district court's decision conflicted with the Supreme Court's decision in *Direct Marketing*.

The majority panel opinion: The majority panel opinion begins by examining the reasoning of the DC Circuit's majority opinion in *Florida Bankers*. The *Florida Bankers* majority opinion held that the appropriate tax to consider for purposes of the Anti-Injunction Act was the tax penalty that enforced the reporting requirement and not the additional tax that would be collected from third parties.[28] Thus, the *Florida Bankers* majority opinion held that a pre-enforcement challenge to a reporting requirement enforced by a penalty in Chapter 68, Subchapter B of the Internal Revenue Code was barred by the Anti-Injunction Act because, if successful, the suit would bar the collection of that penalty.[29] The *Florida Bankers* majority opinion explained that its decision did not conflict with the Supreme Court's decision in *Direct Marketing* because the penalty that enforced the reporting requirement in *Direct Marketing* was not statutorily defined as a tax.[30]

The majority panel opinion concluded that the same analysis applies to the reporting requirement imposed by Notice 2016-66.[31] The majority panel opinion rejected the CIC Services' argument that it was merely challenging the regulatory aspect of the tax because a challenge to the regulatory aspect of a tax necessarily challenges the validity of the tax as well.[32] The majority panel opinion acknowledged that a prior panel of the Sixth Circuit held that a challenge to the regulatory aspect of a tax is not a challenge to the tax itself. However, the majority panel opinion explained that it was not bound by the prior panel opinion because that opinion was vacated (for other reasons) by the Supreme Court and was no longer good law.[33]

Finally, the majority panel opinion held that none of the limited judicial exceptions to the Anti-Injunction Act applied because CIC Services has an alternate remedy of paying the penalty and suing for a refund.[34]

The dissenting panel opinion: The dissenting panel opinion begins by observing that administrative law generally does not require regulated parties to risk criminal prosecution to have the opportunity to challenge unlawful agency

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$10,000 ($5,000 in the case of a natural person). The maximum civil penalty for a failure to disclose a reportable transaction other than a listed transaction is $50,000 ($10,000 in the case of a natural person).

[21] *See* IRC §§ 6112(a), 6708(a).
[22] *See* IRC § 6671(a).
[23] *See NFIB v. Sebelius*, 567 U.S. 519, 544 (2012).
[24] *See* IRC § 7203.
[25] 2016-47 I.R.B. 745.
[26] *See* Treas. Reg. § 1.6011-4(b)(6).
[27] *See CIC Servs.*, 925 F.3d at 250.
[28] *See id.* at 253 (citing *Fla. Bankers*, 799 F.3d at 1068).
[29] *See id.* (citing *Fla. Bankers*, 799 F.3d at 1069).
[30] *See id.*
[31] *See id.* at 254.
[32] *See id.* at 256.
[33] *See id.* at 256 – 57.
[34] *See id.* at 258.

actions. But, according to the dissenting panel opinion, that is precisely what the majority opinion held to be true in this case.[35]

The dissenting panel opinion further noted that CIC Services is not seeking to enjoin the imposition of any tax; rather, they are seeking to avoid significant compliance costs. Thus, the dissenting opinion reasoned that *Direct Marketing* should require the court to hold that the Anti-Injunction Act does not bar the court from considering a pre-enforcement challenge to Notice 2016-66.[36]

Finally, the dissenting panel opinion rejected the panel majority's holding that the Anti-Injunction Act applies in this case because the penalty that enforces the reporting requirement is statutorily defined as a tax. The dissenting panel opinion reasoned that the reportable transaction penalties only apply if the taxpayer violates the reporting requirement. Thus, enjoining the reporting requirement only restrains the assessment of the tax in the sense that the taxpayer cannot first violate the requirement and become liable for the tax.[37]

The petition for *en banc* opinions

Dissatisfied with the panel decision, CIC Services filed a petition for rehearing *en banc* before the Sixth Circuit. On August 28, 2019 the Sixth Circuit issued an order noting that a (slim) majority of the judges on the Sixth Circuit voted not to grant the petition. The order was accompanied by a dissent and two concurrences.

The dissenting opinion in denial of rehearing *en banc*: The dissent noted that the panel majority's decision required taxpayers to risk prison time to be able to challenge the lawfulness of government action. In fact, the government's brief in this case stated that it "is not clear" whether the government would criminally prosecute someone who "demonstrates a good-faith intent to submit its challenge for judicial resolution."[38] The dissent further noted that the Sixth Circuit, and two other courts, had earlier held that the Anti-Injunction Act did not bar a pre-enforcement suit challenging the regulatory aspects of a tax. Thus, the dissent would have granted the petition for rehearing *en banc* and held that the Anti-Injunction Act does not bar a pre-enforcement challenge to the validity of Notice 2016-66.[39]

The first concurring opinion in denial of rehearing *en banc*: The first concurring *en banc* opinion reiterated the reasoning of the majority panel opinion and argued that petitioners and dissent did not raise any new arguments supporting granting of *en banc* rehearing. The first concurring *en banc* opinion referred to the dissenting *en banc* opinion as an instance of "textbook judicial activism" that is based on policy concerns.[40]

The second concurring opinion in denial of rehearing *en banc*: The second concurring *en banc* opinion concurs with the denial of the petition for rehearing *en banc* but only because the relevant Supreme Court precedents produced no clear answer to the issues raised in this case, the issue is fully developed in this case and in *Florida Bankers* for the Supreme Court to consider, and nothing would be gained by *en-banc*ing the case to create a disagreement between the circuit courts of appeal on this issue.[41]

Tax Court Holds that Copies of Return Not Filed in Service Center Did Not Begin the Running of the Period of Limitations on Assessment

In *Seaview Trading, LLC v. Commissioner*,[42] the Tax Court held that copies of a tax return provided to an IRS agent and an IRS attorney did not begin the running of the relevant period of limitations on assessment because:

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35 *See id.* at 259.
36 *See id.* at 260.
37 *See id.* at 261 – 62.
38 *See CIC Servs.*, No. 18-5019, Slip Op. at 10.
39 *See id.*, Slip. Op. at 12.
40 *See id.*, Slip. Op. at 4.
41 *See id.*, Slip. Op. at 6 – 7.
42 T.C. Memo. 2019-122.

1. The copies of the return were not submitted to the proper service center and the revenue agent and IRS attorney did not forward the copies of the return to the service center; and
2. The copies of the return purported to be copies of an earlier filed return and not the taxpayer's return.

Background

In November 2001, Seaview Trading, LLC (the "Taxpayer") entered into a straddle transaction through a common trust fund.[43] The trust fund terminated the transaction in December 2001 and allocated a $35,496,542 loss to two limited liability companies that, together, owned 100% of the interests in the Taxpayer. The Taxpayer alleges that it filed its Form 1065, *U.S. Return of Partnership Income*, for 2001 on July 3, 2002.

In a letter dated July 27, 2005, the IRS informed the Taxpayer that the IRS never received the Taxpayer's 2001 Form 1065.[44] On September 23, 2005, the Taxpayer faxed a purported copy of Seaview's 2001 Form 1065, and a certified mail receipt purporting to show that the return was initially sent to the IRS on July 3, 2002, to the revenue agent who sent the letter. And on July 24, 2007, the Taxpayer's attorney sent a purported copy of its 2001 Form 1065 to an IRS attorney. The cover letter stated that the document was a "copy of * * * [Taxpayer's] 2001 Form 1065." None of the purported copies of the Taxpayer's 2001 Form 1065 were forwarded to the relevant IRS service center for processing. On October 26, 2010, the IRS issued a final partnership administrative adjustment ("FPAA") for the 2001 tax year.

The Taxpayer petitioned the Tax Court to review the FPAA and moved for summary judgment, alleging that the FPAA was issued after the expiration of the statute of limitations.

The tax court's analysis

Because the Tax Court's opinion was issued to resolve the Taxpayer's motion for summary judgment, the court did not address whether the Taxpayer actually filed a return in July 2002. Rather, the court addressed whether the Taxpayer filed its return in 2005 or 2007 when it provided copies of the purported 2001 Form 1065 to an IRS agent and an IRS attorney.

The Tax Court noted that limitations periods only begin to run against the government if and when the government assents and all conditions are met.[45] One of the requirements to begin the running of the period of limitations on assessment is that a return is filed at the designated place of filing.[46] If a taxpayer submits a return to the wrong place and the return is forwarded to the correct place, the period of limitations begins to run from the date that the return is received in the correct place for filing.[47] The proper place for filing a tax return is the "service center prescribed in the relevant IRS revenue procedure, publication, form, or instructions to the form."[48] In this case, the proper service center was in Ogden, Utah.

The Taxpayer argued that, although it did not submit the returns to the proper service center, the revenue agent who received the 2005 copy was required to forward the return for filing at the correct service center. The Tax Court rejected this argument because the copies of the Form 1065 were not actually forwarded to the proper service center. The Tax Court distinguished the facts in this case from the facts in *Dingman v. Commission*.[49] In *Dingman*, the taxpayer provided delinquent returns to the IRS Criminal Investigation Division, which the Tax Court held was the correct place to file delinquent returns.[50] Here, by contrast, a revenue agent and an IRS attorney are not the correct place for filing a delinquent Form 1065.[51]

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[43] *See id.* at *4.
[44] *See id.* at *4 – *5.
[45] *See id.* at *7 (citing *Lucas v. Pillord Lumber Co.*, 281 U.S. 245 (1930)).
[46] *See id.* (citing *Winnet v. Comm'r*, 96 T.C. 802 (1991)).
[47] *See id.* at *7 – *8.
[48] *Id.* at *8 (quoting Treas. Reg. § 1.6031(a)-1(e)(1)).
[49] T.C. Memo. 2011-116.
[50] *See Seaview Trading*, T.C. Memo. 2019-122, at *9 (citing *Dingman*, T.C. Memo. 2011-116).
[51] *See id.*

Alternatively, the Tax Court held that copies of the 2001 Form 1065 did not purport to be returns because the copies of the Form 1065 were not provided by the Taxpayer for the purpose of filing a return.[52] Rather, the Taxpayer claimed that it timely filed its Form 1065 and was merely providing copies of that return to the IRS.

Because the 2005 and 2007 copies of the Form 1065 were not valid returns, the court held that they did not cause the period of limitations on assessments to begin to run. Accordingly, the Tax Court denied the Taxpayer's motion for summary judgment.

District Court rules that there are factual issues to be resolved in order to determine whether taxpayer was subject to a penalty under Section 6721 for intentional disregard and further rules that the taxpayer's assertion of reasonable cause as a defense was untimely as it was not raised in its Administrative Refund claim

In *Mycles Cycles v. United States*, the United States District Court for the Southern District of California recently released an order granting and denying in part a motion for summary judgment.[53] The order is instructive in its discussion and application of the Section 6721 penalty for intentional disregard and for its ruling on a Taxpayer's ability to raise a reasonable cause claim as a defense to a penalty for the first time in a suit for refund. The order underlined the importance of raising all potential arguments for refund in an administrative refund claim as taxpayers do not have the ability to introduce new arguments or defenses in court that were not previously set forth in the its administrative refund claim.

The facts

Mycles Cycles ("Taxpayer") is a family owned motorcycle dealership. Taxpayer was audited three times in the span of eight years. During the course of the first audit, the revenue agent noted that Forms 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*, required by Section 6050I were incomplete. The revenue agent provided Taxpayer with Section 6050I instructional materials and assessed no penalties against Taxpayer. A year later, the IRS audited Taxpayer again, and again found incomplete Forms 8300. The revenue agent conducted an in-person closing conference outlining the compliance issues and assessed a $600 negligence penalty against Taxpayer. A manager for Taxpayer sent a letter to the IRS acknowledging the Form 8300 compliance failures and outlined new procedures that were designed to ensure future compliance. Seven years later, the IRS audited Taxpayer for a third time. This time the revenue agent found compliance irregularities with customer taxpayer identification numbers ("TINS") missing on nine out of the ten required Forms 8300. Based on these incomplete filings and Taxpayer's history, the revenue agent assessed an intentional disregard penalty under IRC Section 6721(e) totaling $225,000 for the nine incomplete Forms 8300. The IRS denied Taxpayer's administrative appeal of the penalties. Taxpayer then paid one of the penalties and requested a refund. After the refund request was denied, Taxpayer sued for refund in the district court.

The law

A failure to comply with the reporting requirements under Section 6050I is penalized under Section 6721. The ordinary penalty for both sections is $50 dollars per failure. Sections 6721 also provide for enhanced penalties when the failure is due to intentional disregard of the filing or notification requirements.[54]

Section 6721 does not define intentional disregard. The definition is set forth in the Treasury Regulations ("Regulations"), which defines a failure due to intentional disregard as a knowing or willful failure to timely file or

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[52] *See id.* at *10 – *11.
[53] *Mycles Cycles, Inc. v. United States*, No. 3:2018cv00314 (S.D. Cal. 2019)
[54] *See* §6721(e)

include the correct information.[55] The Regulations also provide facts and circumstances for courts to consider when determining if a failure is due to intentional disregard. These factors include:[56]

1. Whether the failure to file timely or to include correct information is part of a pattern of conduct;
2. Whether a correction was promptly made upon the discovery of the failure;
3. Whether the filer corrects a failure to file or a failure to include correct information within 30 days of a written request from the IRS; and
4. Whether the amount of the information reporting penalties is less than the cost of complying.

In its order, the court noted that the Regulations define "intentional disregard" as synonymous with "willfulness" and that the Second Circuit, along with other courts that have examined this issue, treats the intentional disregard standard and willfulness as rough equivalents standards.[57] In *Lefcourt v. United States*, intentional disregard was regarded as synonymous with willfulness, a term that requires voluntary action as opposed to just accidental or unconscious action. The district court then applied the Regulations intentional disregard factors in light of the relevant precedent to determine if Taxpayer's conduct rose to the standard of intentional disregard.

The court examined whether Taxpayer's audit history demonstrated a pattern of conduct that amounts to intentional disregard. The court counterbalanced the fact that Taxpayer had been uncompliant in three audits against Taxpayer's contentions that TINS were never mentioned by revenue agents in discussing Taxpayer's prior compliance failures. The court determined that there was enough conflicting evidence that a trier of fact could potentially conclude that Taxpayer did not intentionally disregard its obligations to file complete Forms 8300. In looking at the second and third factors set forth in the Regulations, the court noted that neither party had introduced any evidence concerning corrective actions taken or not taken by the Taxpayer. The court then examined the fourth factor, the cost of compliance, and once again found there was a material dispute of fact.

Finally, the court turned to the question of whether Taxpayer could avoid penalties under Section 6724 by raising a reasonable cause defense. Section 6724 provides that no penalty shall be imposed with respect to any failure if it is shown that such failure is due to reasonable cause and not willful neglect.[58] Section 7522(a) requires as a prerequisite that taxpayers file an administrative refund claim before filing a refund suit. The administrative refund claim must set forth each ground upon which a credit or refund is claimed and the sufficient facts to apprise the Commissioner of Internal Revenue of the exact basis for the taxpayer's claim.[59] Courts have found that these claims need not provide detailed explanations of legal theories nor the "full factual background" but that the administrative refund claim, on its face, must apprise the IRS of the points to which it must direct its attention.[60]

In this case, the first time Taxpayer raised its reasonable cause defense was in its opposition to the Government's motion for summary judgment. The district court held that this was too late, and, thus, Taxpayer was barred from raising a reasonable cause defense because it failed to raise a reasonable cause argument or offer any grounds to support such an argument in its administrative refund claim. Therefore, Taxpayer was precluded from raising this argument at such a late stage.

The Federal Circuit Applies the Codified Economic Substance Doctrine to Disregard Purported Payments Made to Claim Alternative Fuel Tax Credits and Upholds the Imposition of Penalties

The Federal Circuit held that a taxpayer was not entitled to claim an alternative fuel mixture credit under section 6426(e). The court held that the purported payments for the sale of the alternative fuel mixture should be disregarded

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[55] *See* Treas. Reg. 301.6721-1(f)(2)
[56] *See* Treas. Reg. 301.6721-1(f)(3)
[57] *Lefcourt v. United States*, 125 F.3d 79, 83 (2nd Cir. 1997)
[58] *See* Treas. Reg. 301.6724-1(d)
[59] *See* Treas. Reg. 301.6402-2(b)(1)
[60] *See*, *e.g.*, *Boyd v. United States*, 762 F.2d 1369, 1371-72 (9th Cir. 1985)

under the codified economic substance doctrine because the purported payments did not affect the taxpayer's economic position and were made solely for tax purposes. In addition, the court held that the taxpayer lacked reasonable cause for claiming the excessive credit and was, therefore, liable for a 200% penalty under section 6675(a).

Sections 6426(e) and 6675(a)

Section 6426(e) provides a tax credit for the production of "any alternative fuel mixture for sale or use in a trade or business." Section 6426(e) further defines an "alternative fuel mixture" as a "mixture of alternative fuel and taxable fuel" that is either "sold by the taxpayer…for use as fuel" or "used as a fuel by the taxpayer producing such mixture." Section 6675(a) provides that a taxpayer who claims a refund of an alternative fuel mixture credit that is excessive in amount is liable for a penalty of 200% of the excessively claimed credit. The penalty under section 6675(a) does not apply if the taxpayer establishes that "the claim for such excessive amount is due to reasonable cause."

Background

Alternative Carbon Resources (the "Taxpayer") bought feedstock from an ethanol producer, paid a trucking company to transport the feedstock and to mix in a minimal amount of diesel fuel, and paid companies that owned anaerobic digestion tanks to accept the feedstock/diesel mixture. The fee paid by the Taxpayer to the anaerobic digestion companies was based on the volume of feedstock/diesel mixture that they received. The anaerobic digestion tank companies also paid a fixed, annual fee to Taxpayer. Throughout 2011, the Taxpayer paid fees to the anaerobic digestion tank companies of $1,678,029 and received annual fees from the anaerobic digestion tank companies of $8,950.[61]

The Taxpayer was advised by a tax advisor, an attorney, that it was entitled to claim the section 6426(e) alternative fuel mixture credit. However, the tax advisor repeatedly hedged his advice by stating that he did not fully understand the nature of the Taxpayer's business. In addition, the tax advisor advised Taxpayer to charge the anaerobic digestion tank companies for the value of the fuel that it was providing to them.[62]

The Taxpayer claimed approximately $19.8 million in alternative fuel mixture credits for 2011.[63] The IRS subsequently determined that the Taxpayer was not entitled to claim the credits and assessed the full amount of the claimed credits and excessive claim penalties under section 6675(a). The Taxpayer submitted partial payments, requested a refund of such payments, and sued for a refund in the Court of Federal Claims. The Claims Court held that the Taxpayer was not entitled to claim the alternative fuel mixture credit for several reasons, and the Taxpayer appealed to the Court of Appeals for the Federal Circuit.

The Federal Circuit's analysis

The validity of the alternative fuel mixture credit claimed by the Taxpayer depends on whether the feedstock/diesel mixture was sold by the Taxpayer. The Federal Circuit noted, and the parties agreed, that the term "sale" is defined by the relevant Treasury Regulations as "an agreement whereby the seller transfers the property (that is, the title or the substantial incidents of ownership) in goods to the buyer for a consideration called the price, which may consist of money, services, or other things."[64]

The Taxpayer argued that it sold the feedstock/diesel mixture because it was paid an annual fee and was relieved of its obligation to dispose of the hazardous feedstock/diesel mixture itself. The court rejected this argument because the transactions were indistinguishable from the purchase of waste disposal services and the annual fee did not reflect in any way the value of the feedstock/diesel mixture.[65] Because there was no consideration, the court concluded that there was no sale.

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[61] *Alternative Carbon Res., LLC v. United States*, No. 2018-1948 (Fed. Cir. Sept. 26, 2019), Slip Op. at 4 – 6.
[62] See *id.*, Slip Op. at 6 – 8.
[63] *See id.*, Slip Op. at 9.
[64] Treas. Reg. § 48.0-2(a)(5).
[65] *Alternative Carbon*, No. 2018-1948, Slip Op. at 15.

Moreover, even if the annual fee could technically be considered consideration for the feedstock/diesel mixture, the court concluded that the transactions lacked economic substance. The court considered the codified economic substance doctrine, which requires a transaction to:

1. Meaningfully change a taxpayer's economic position; and
2. Have a substantial business purpose.[66]

The court held that the transactions lacked economic substance for two reasons. First, the transactions did not meaningfully change the Taxpayer's economic position because the annual fee was nominal and charged right back to the Taxpayer in the form of disposal fees.[67] Second, the record showed that the annual fees were only added for tax purposes.[68] The court rejected the Taxpayer's argument that applying the economic substance doctrine in this case punished it for not being profitable because there was no evidence that Taxpayer's business model could be reasonably be expected to be profitable apart from tax considerations.

The Taxpayer further argued that the economic substance doctrine was inapplicable in this case because the alternative fuel mixture credit was designed to alter economic incentives. The court rejected this argument because the legislative history did not support Taxpayer's contention that Congress intended for the alternative fuel mixture credit to be exempt from the application of the economic substance doctrine. In addition, the court held that the codified economic substance doctrine applied because the judicial economic substance doctrine is "relevant" to the transactions at issue.[69] Indeed, the Federal Circuit had previously held that "if a taxpayer engages in a transaction that is otherwise unprofitable in order to collect tax credits 'that situation demands careful review' under the economic substance doctrine."[70]

Having determined that the Taxpayer was not entitled to claim the section 6426(e) alternative fuel mixture credit, the court considered whether the Taxpayer had reasonable cause for claiming the credit because it relied on its tax advisor. The court held that the Taxpayer lacked reasonable cause because the Taxpayer's tax advisor repeatedly hedged his advice by stating that he did not fully understand the nature of the Taxpayer's business, the Taxpayer did not follow the tax advisor's advice because it charged a flat-fee for the feedstock/diesel mixture instead of one that depended on the amount of fuel provided to the anaerobic digestion tank companies, and the Taxpayer should have realized that the advice was too good to be true.[71]

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[66] *See* IRC § 7701(o)(1).
[67] *Alternative Carbon*, No. 2018-1948, Slip Op. at 17.
[68] *See id.*
[69] *See id.*, Slip Op. at 20.
[70] *Id.* (citing *Salem Fin., Inc. v. United States*, 786 F.3d 932, 950 (Fed. Cir. 2015)).
[71] *See id.*, Slip Op. at 24 – 26.