California Journal of Tax Litigation

A Publication of the Tax Procedure & Litigation Committee
Taxation Section of the State Bar of California

Q3 2015 Edition

Message from the Chair

Joseph P. Wilson, Wilson Tax Law Group

Greetings to the Tax Procedure and Litigation Committee!

During our last meeting at Greenberg Traurig LLP in Los Angeles, we heard a wonderful presentation involving the negotiation of plea agreements in criminal tax cases from Paul Rochmes (Assistant US Attorney, Tax Division, US Attorney's Office – LA), Sharyn M. Fisk (Law Office of Sharyn M. Fisk – El Segundo) and Robert S. Horwitz (Law Office of Robert S. Horwitz – Santa Monica). The presentation was extremely informative and well-received. I want to extend a warm thank you to the presenters and hope everyone who attended enjoyed the presentation as much as myself. If you have a criminal tax case this was the presentation to attend. If you missed it and want to obtain a copy of the meeting materials, please contact me at jwilson@wilsontaxlaw.com or www.wilsontaxlaw.com. I also want to thank Greenberg Traurig LLP for their graciousness in hosting us for the entire day.

Speakers at the Upcoming August 28th Meeting in San Francisco

The next meeting of the Tax Procedure and Litigation Committee will be Friday, August 28, 2015, in San Francisco at Greenberg Traurig LLP (address shown below) from 10:30 a.m. to 3:30 p.m.:

Greenberg Traurig, LLP
Four Embarcadero Center, Suite 3000
San Francisco, CA 94111
(Meeting and Reception)

Susan Maples of the Taxpayers' Rights Advocate with the Franchise Tax Board ("FTB") will be giving a presentation. Ms. Maples replaced Steve Simms, EA, who I understand is now a Director at KPMG and a member of the Advisory Board to the FTB.

Interested in learning more about the TPL Committee?
Send an email message to Chair Joseph P. Wilson, jwilson@wilsontaxlaw.com

IN THIS EDITION

Ms. Maples has been with the FTB for 20+ years working in both the Sacramento and the Southern California field offices. She started as an auditor and has experience with personal income tax and corporate tax law. Ms. Maples also has experience as a public affairs spokesperson and presenter with the education and outreach program. She reports directly to the Executive Officer of the Franchise Tax Board working independently throughout the department to ensure that taxpayers' rights are protected.

She will be making a presentation to the TPL members on updates and initiatives concerning the FTB Taxpayer Advocate Office. This is a great opportunity to shake her hand and get to know her.

I want to extend another thank you to the Greenberg Traurig law firm for allowing us to hold our meeting at their offices.

If you have not done so already, please RSVP to me at jwilson@wilsontaxlaw.com. If you cannot attend in-person, but still wish to participate, the call-in telephone number is (530) 881-1212 and meeting ID is 545-104-063.

Election of New Officer

This is my last meeting as the current Chair. It has been a terrific year and we had a lot of fun. At the upcoming San Francisco meeting, the plan is to elect a new officer for 2nd Vice-Chair & Editor position. This person will be the new editor of the California Journal of Tax Litigation.

Those interested in this position should let me know in advance and plan to attend the meeting. Those interested plan on making a short statement at the meeting and we will take a vote.

This has been a terrific year. I could not have made any of the meetings, programs and *California Journal of Tax Litigation* happen without my team. I would like to take this opportunity to again thank the standing officers of the Committee for their continued hard work and dedication. Chair-Elect Courtney Hopley, 1st Vice-Chair and Secretary Carolyn M. Lee and 2nd Vice-Chair and Editor Kevan P. McLaughlin are all doing outstanding jobs, and we are fortunate that they will be continuing in new roles next year.

Sacramento and Washington DC Delegations

The TPL Committee is seeking participation and paper proposals from our members for the 2016 Sacramento Delegation and the 2016 DC Delegation. The delegations provide tremendous opportunities to become more involved with our tax community. Participants are entrusted with a unique leadership opportunity to represent the Taxation Section of the California State Bar before important federal and state tax officials. It also provides participants an opportunity to be published in distinguished legal publications.

The 2016 Sacramento Delegation will take place on Friday, February 5, 2016, with the usual dinner the night before. The DEADLINE for members to submit paper proposals to Committee Chairs for the Sacramento Delegation is September 7, 2015.

The 2016 DC Delegation will take place on Monday - Wednesday, May 2-4, 2016. The DEADLINE to submit proposals to Committee Chairs for the DC Delegation is September 15, 2015.

Please send your paper proposals to myself at jwilson@wilsontaxlaw.com or Courtney Hopley (incoming TPL Chair) at Hopleyc@gtlaw.com.

Please do not hesitate to contact us if you have any questions.

Topic for the 2015 Annual Meeting of the California Tax Bard and California Tax Policy Conference (November 4-6, 2015 Hilton Torrey Pines, La Jolla, CA)

We hope that everyone is planning to attend the Annual Meeting in La Jolla. Our Committee is sponsoring and co-sponsoring the following programs at the 2015 Annual Meeting: (1) Criminal Tax Workshop; (2) Advanced Tax Court Litigation Boot Camp, Part 1: Qualifying and Effectively Using an Expert at Trial; (3) Transfer Pricing Hot Topics; (4) Partnership Liability Allocations; (5) Advanced Tax Court Litigation Boot Camp, Part 2: Advocating for Your Client at Trial; (6) Effective Resolution Strategies for Federal and State Audits and Appeals; (7) Federal Procedural Roundtable; (8) Life Insurance - Exchanges and Material Changes; (9) Like-Kind Exchanges - Updates/Hot Topics; and (10) International Tax Audit & Appeals Including Statute of Limitations in the International Context. Many are working very hard to make this program a success. We hope to see you there.

California Tax Lawyer

If you would like to have a "Quick Point" included in the upcoming issue of the *California Tax Lawyer*, send me any brief technical updates, procedural updates, observations on practice or policy matters, and commentaries you may want to include.

California Journal of Tax Litigation – A Publication of the TPL Committee

We continue to solicit articles for upcoming editions of our *California Journal of Tax Litigation*. Please contact Kevan P. McLaughlin at kevan@mclaughlinlegal.com if you would like more information about submitting articles for our next edition. The *Journal* continues to include wonderful information relevant to our members.

Bring Your Camera to The Quarterly Committee Meetings

The editors of the California Tax Lawyer and the California Journal of Tax Litigation would like to include pictures of our activities. Please send me, via e-mail at jwilson@wilsontaxlaw.com, any JPEGS you may have from our meetings, and be sure to identify each person in the photo and the event at which the photo was taken.

Hot Topics

Thanks to all those who have helped make Committee meetings successful and fun. Please come armed and dangerous with "Hot Topics" for our upcoming meeting. Our members continue to lead, teach and provide insight in our field, so there is much to discuss.

I hope to see you in San Francisco!

Joseph P. Wilson, Wilson Tax Law Group
Chair Tax Procedure and Litigation Committee

Minutes of the January Tax Procedure & Litigation Meeting

Carolyn Lee, Abkin Law LLP *
Tax Procedure & Litigation Committee Secretary

Carolyn's practice at Abkin Law LLP focuses on federal and state tax controversies, including audits, administrative appeals, collection matters and both Tax Court and U. S. District Court litigation. In addition to the Tax Procedure & Litigation Committee, she is an officer of the California Young Tax Lawyers. Carolyn is also an adjunct professor in Golden Gate University School of Law LL.M Tax program, teaching Professional Responsibility for Tax Professionals and Federal Tax Procedure.

The second 2015 quarterly meeting of the Tax Procedure & Litigation Committee was conducted on May 29, 2015 at the offices of Greenberg Traurig, LLP in Los Angeles, California.

Committee Chair Joe Wilson brought the meeting to order. Wilson noted the Committee's return to Los Angeles and welcomed all participants, especially the LA-based members. Wilson announced that the Committee's next meeting will be held on August 28, 2015 in San Francisco, again kindly hosted by Greenberg, Traurig. The featured speaker will be Susan Maples, director of the Franchise Tax Board's Taxpayers' Rights Advocate Office.

The meeting's continuing education program focused on negotiating pleas agreements in criminal tax matters. The distinguished panel of speakers included Sharyn M. Fisk (Law Office of Sharyn M. Fisk), Robert S. Horwitz (Former DOJ Tax Attorney and Chair-Elect, Executive Committee, Taxation Section, California State Bar) and Paul Rochmes (Assistant US Attorney, Tax Division, United States Attorney's Office – Los Angeles). In addition to providing substantive educational information, the panel brought the substantive educational content to life by discussing a hypothetical plea negotiation.

Following lunch, the meeting resumed. The following were discussed:

- Ideas for speakers and topics for future Tax Procedure and Litigation Committee meetings. Additional proposals should be submitted to the Committee officers.
- The success of the 2015 Washington DC Delegation, including the addition of meetings with the Department of Justice Tax division.
- The Committee's California Journal of Tax Litigation. Editor Kevan McLaughlin showcased the latest edition of the Journal. Members were encouraged to submit Journal articles to McLaughlin.
- Hot topics in tax procedure and litigation.

There being no other business, Wilson adjourned the meeting.

* Carolyn M. Lee, Abkin Law, San Francisco, CA, (415) 956-3280, clee@abkinlaw.com

KEY DATES

Quarterly Meeting of the Tax Procedure & Litigation Committee
Greenberg Traurig LLP, San Francisco, CA ..... **August 28, 2015, 10:30 a.m. – 3:00 p.m.**

Q3 2015 *California Journal of Tax Litigation* Submission Due Date ..... **October 15, 2015**

2015 Annual Meeting of the California Tax Bar and California Tax Policy Conference
La Jolla, CA ..... **November 4-6, 2015**

Tax Alerts:
Legislative and Judicial Changes Affecting FBAR's

Robert S. Horwitz, Law Offices of Robert S. Horwitz *

Robert S. Horwitz has over 35 years of experience as a tax attorney, having spent years with the Department of Justice Tax Division and in the U.S. Attorney's Office, where he successfully prosecuted the leading real estate tax shelter promoter in the western United States. He is also the Chair Elect of the Tax Section and the principal of The Law Office of Robert S. Horwitz in Santa Monica.

There have been several recent developments that affect the statute of limitations for assessment of tax, one judicial and one legislative, and a legislative change that affects the due dates for FBARs (and other returns and reports). The legislative changes were by stealth. I learned about them from Dennis Brager's email newsletter, to which you should consider subscribing.

Last week Congress passed H.R. 3236, "Surface Transportation and Veterans Health Care Choice Improvement Act of 2015." Sec. 2005 amends IRC § 6501(e) to effectively overrule the Supreme Court's decision in *U.S. v. Home Concrete & Supply, LLC*. *Home Concrete* held that an overstatement of basis is not an understatement of gross income for purposes of IRC § 6501(e)(1)(A). Under that section, the IRS has six years within which to assert a deficiency if the taxpayer omits more than 25% of gross income. Sec. 2005 of the Act inserts a new paragraph (e)(1)(B)(ii) to provide:

> (ii) An understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission from gross income….

This amendment applies to returns filed after July 31, 2015, and returns for which the statute of limitations on assessment had not yet expired as of that date. While *Home Concrete* dealt with a Son of BOSS shelter, the amendment will impact more than taxpayers who invested in bogus shelters that purport to generate large losses due to inflated asset basis. It will impact taxpayers who do not have adequate records for the basis of real property, securities and other assets that they sell. It may even impact businesses whose method of accounting for costs of goods sold is challenged (though that remains to be seen given the language of IRC § 6501(e)(1)(B)(i)).

Section 2006 of the Act modifies the due dates for various returns, including the FinCen Report 114. It requires the Secretary, by regulation, to change various filing dates. For years ending after December 31, 2015, FinCen Report 114 will be due on April 15, with a maximum extension for 6 months.

The judicial development affecting statutes of limitations is *BASR Partnership v. United States*, (Fed. Cir. July 29, 2015). The issue was whether fraud by a tax attorney extends the period of limitations on assessment due to fraud under IRC § 6501(c)(1). Under IRC § 6501(c)(1), if a taxpayer files a return that is "false or fraudulent return with the intent to evade tax," the IRS has an unlimited amount of time within which to assess tax. In *Allen v. Commissioner*, 128 T.C. 37 (2007), the Tax Court held that where a return preparer prepares a false return with intent to defraud, 6501(c)(1) applies, even if the taxpayer was unaware of the fraud and acted in good faith.

The taxpayer in *BASR Partnership* had invested in a shelter marketed by Jenkins & Gilcrist. The J&G partner who put the shelter together for the taxpayers pled guilty to charges of conspiracy and tax evasion in *United States v. Daugerdas*. The Government argued that even though the taxpayers and their CPA relied in good faith on the opinion letter from J&G, the fraud of the tax attorney sufficed to

trigger the fraud exception to the three-year statute of limitations. In a split decision, a three-judge panel of the Federal Circuit ruled against the Government. Each judge wrote a separate opinion.

The majority decision held that IRC § 6501(c)(1) applied rather than IRC § 6229(c) (SOL for fraud for a TEFRA partnership return). Although the majority decision recognized that IRC § 6501(c)(1) is silent as to whose fraud triggers the unlimited period of limitations, it reasoned that the language, structure, and history of the Code compelled the conclusion that the fraud necessary to trigger the extended statute of limitations was the fraud of the taxpayer.

The concurring opinion disagreed with the majority that IRC § 6501(c)(1) rather than IRC § 6229(c) controlled. Section 6229(c) provides that in case of a false or fraudulent return with intent to invade, the statute of limitation is unlimited as to any partner who "with the intent to evade tax, signed or participated directly or indirectly in the preparation of a partnership return which includes a false or fraudulent item." As to other partners, the statute of limitations is 6 years. The concurring opinion reasoned that since the return in question was a partnership return, the specific language of IRC § 6229(c) controls. Since none of the partners knew of the false items, the unlimited statute of limitations did not apply.

The dissent agreed with the majority that the applicable section was IRC § 6501(c)(1). It argued that the plain reading of the statute was clearly applicable to a situation where a return preparer or advisor acted with intent to defraud. Thus, the statute of limitations for fraud applied to the case before it.

The *BASR Partnership* case is the first circuit court decision that directly addresses this issue. The three opinions lay out the arguments for and against the application of the fraud exception in the case of return preparer fraud. If you are interested in the issue, it behooves you to read the opinion, available here: http://www.cafc.uscourts.gov/sites/default/files/opinions-orders/14-5037.Opinion.7-27-2015.1.PDF.

The only other published circuit court decision involving the application of sec. 6501(c)(1) to fraud by a third party was *City Wide Transit, Inc. v. Commissioner*, 709 F.3d 102, 107 (2d Cir. 2013), in which the taxpayer conceded that the fraud of a return preparer triggered IRC § 6501(c)(1). Thus, the Second Circuit did not have to decide the issue. This issue will undoubtedly arise in other cases, so it may be a question that is ultimately resolved by the Supreme Court, unless Congress acts to make IRC § 6501(c)(1) apply where the fraud with intent to evade is that of someone other than the taxpayer.

* Robert S. Horwitz, Law Offices of Robert S. Horwitz, Santa Monica, CA, (310) 439-5760, rsh@santamonicataxattorney.com

Practice Pointers: *Additional Thoughts on Audit Reconsiderations*

Brian M. Katusian, Seltzer Caplan McMahon Vitek *

Brian M. Katusian is an associate with Seltzer Caplan McMahon Vitek. His practice emphasizes tax law, tax exempt organizations, business law, and ERISA/Employee Benefits. He is certified by the State Bar of California as a Specialist in Taxation Law.

In the Q2 2014 Edition, "shining a light" on a client's request for audit reconsideration by including a cover sheet with large, bold letters to help increase visibility and the chances it will be timely "noticed" and processed was provided as a "practice tip." I find this to be sage advice and would take it a step further in using colored (e.g. red) ink, and underlining in addition to bolding, as well as including duplicate language as a "heading" to the cover

page of the client's request for audit reconsideration.

The practice of using large, bold, underlined, colored language in cover sheets and headings should also be extended to other contexts with other state and federal government agency filings should the situation warrant "expedited processing" and prompt attention. We have all been faced with clients who are "in a pinch" and/or need their claims addressed "yesterday," and as practitioners we should remember that even where there is no formal "rush processing program" (as exists in some circumstances), it "never hurts to ask."

More often than not I have found that including an explanation of why your client is "in a hurry" in the cover letter leads to a quicker response even where the agency has no formal program for granting one claim priority over the next.

Bases for Audit Reconsideration – Include "New Documentation" as a Basis if Possible

IRS Publication 3598 (Rev. 7-2012), and the Internal Revenue Manual (the "IRM") list various bases for requesting audit reconsideration. These include situations where the taxpayer: 1) did not appear for the audit; 2) moved and did not receive the correspondence from the IRS; 3) has new documentation to present; 4) disagrees with an audit assessment; 5) disagrees with a IRC § 6020(b) Substitute for Return assessment; and 6) has been denied tax credits such as the EITC, claimed during a prior examination. *See e.g.*, IRM 4.13.1.3 (12-31-2009). Although your client may have one or more applicable bases for requesting audit reconsideration, practically speaking if the "new documentation to present" category applies, it should be cited as a basis for audit reconsideration.

Since audit reconsideration is discretionary on the part of the IRS, and the IRS is, after all, a federal government bureaucracy, once an audit has been completed, the examination division may be inclined to deny an audit reconsideration request given the taxpayer's right to dispute the audit assessment with the IRS Appeals Division and/or in Tax Court by filing a petition for redetermination of the deficiency if and when a statutory notice of deficiency is issued. This may especially be the case if, for example, the sole basis for the audit reconsideration request is that your client "disagrees" with the audit assessment.

If there is new documentation that affects your client's assessment and was not presented at audit, IRS examination may "feel more inclined" to review the new information before the "can is kicked down the road" to IRS Appeals and/or Tax Court.

Audit Reconsideration after Issuance of a Statutory Notice of Deficiency

As a tax professional, once a statutory notice of deficiency has been issued and the 90/150-day clock has started ticking, the natural inclination may be to immediately inform the client of the deadline for filing a petition for redetermination of the deficiency with the Tax Court, advise the client that no extensions can be granted, and that if they wish to challenge the deficiency without paying it "up front" and suing for a refund, Tax Court is the "appropriate forum" to do so. However, Tax Litigation can be an expensive proposition and filing a petition in Tax Court may not be a cost-effective or practical solution for the client, depending on the facts and circumstances. Where, for example, the deficiency is such that anticipated legal fees will likely exceed the amount of the deficiency, the client may wish to know "do I have any other options?" Under such circumstances a practitioner should remember the audit reconsideration tool as a possible option.

For example, I recently received a "No Change Letter" from the IRS examination division in connection with an audit reconsideration request that was filed four (4) days after the letter date of the statutory notice of deficiency under circumstances where it was clear that certain documentation was not presented at audit that would have eliminated all or a substantial portion of the assessment, and anticipated legal fees in connection with prosecuting the claim in Tax Court could have easily eclipsed the deficiency. In this particular case, the "No Change Letter" was issued approximately seventy-five (75) days after the letter date of the statutory notice of deficiency, within the applicable 90-day timeframe. However, as an additional "practice pointer" I would recommend including a request that the IRS consent to a rescission of the statutory notice of deficiency by providing your client with the applicable IRS Form 8626 to "allow for sufficient time" for the IRS to process the audit reconsideration request. As with the audit reconsideration request itself, a rescission request is discretionary on the part of the IRS but it "never hurts to ask."

* Brian M. Katusian, Seltzer Caplan McMahon Vitek, San Diego, CA, (619) 685-3186, katusian@scmv.com

Interview: Victor S.O. Song

By Kevan P. McLaughlin

Mr. Song is the former Chief of the IRS's Criminal Investigation ("CI") Division. As Chief of CI, he oversaw a variety of issues, including the Simultaneous Criminal Investigation Program (SCIP) Agreements with Korea, Japan, Spain, and other countries. Mr. Song is currently an Executive Vice President of Compliance for a multi-national company, overseeing various compliance related matters.

Q. For those that don't know, you were the former Chief of the IRS's Criminal Investigation Division. Can you tell our readers about how you got into the field and your career with the IRS?

A. A career in law enforcement always interested me and I came on board with the IRS after graduating from the University of Hawai'i in 1980. I was a Special Agent for almost 10 years in Hawai'i where I worked mostly white-collar tax investigations. However, early on in my career, I took an interest in working on narcotics investigations. Back when I started, it was before any money laundering laws were passed and I investigated the narcotics traffickers on tax evasion, very similar to the way Al Capone was investigated. They were very labor-intensive forensic accounting investigations where each financial transaction had to be followed and documented. I left Hawai'i in 1992 and worked in various management positions that took my family and I to Seattle, WA; Washington, DC; Laguna Niguel, CA; Portland, OR; and Oakland, CA. I was the Special Agent in Charge of the Portland and Oakland Field Offices. In 2004 I became the Director Field Operations Pacific Area where I was responsible for all investigations and personnel west of Texas. In 2007 I returned to Washington DC as the Deputy Chief, CI and became the Chief in 2010 where I retired after over 30 years at the end of 2011.

Q. When you were with CI, where did most of your cases come from, and did you notice any change in source over your career?

A. There definitely has been a change over the years. When I first started, most of our cases came from the civil side of the IRS, usually from the Examination Division through audits. Through the years, many of the investigations were investigated via the Grand Jury process and therefore the source of the case usually came from the United States Attorney Office. Computer technology has also helped in the efficiency of analyzing computer data to ferret out wrong doing. Although computers definitely make the job easier, I have always been a proponent of getting the agents out in the field working their contacts, informants, and associates in developing their cases. I firmly believe that it allows the agents to keep their pulse on their communities to see what illegal activities are most prevalent.

Q. If you had any advice for a potential target, what would that be?

A. The one agency that you definitely don't want on your tail is IRS Criminal Investigation. They are extremely detailed oriented and hands down, they are the best financial investigators in the world. In fact, Financial Investigative Techniques have been taught by CI personnel throughout the world for many years to tax agencies in many countries. My advice would be to not say a word when they are contacted by CI and contact the best tax attorney that they know. They

will need it. By the time that they are contacted to be interviewed by the Special Agents, much work and intelligence has already been gathered unbeknownst to the taxpayer. Assets, bank accounts and past filing histories just to name a few have already been documented. And as you well know, the IRS has been making it much more difficult to have undeclared offshore financial accounts.

Q. What is the most memorable case you've handled, and why?

A. Throughout my career, there were so many impactful investigations that came across my desk that it is hard to pick the most memorable. Two come to mind although they were very different investigations. First, when I was the Special Agent in Charge of the Oakland Field Office, my agents worked the BALCO investigation that involved the use of steroids in professional sports. Athletes involved were from many of the major sports such as Major League Baseball, the National Football League, Cycling and Olympic Track and Field. Some athletes as young as high school age were taking steroids and human growth hormones. Unfortunately, some of them lost their lives to complications. Although it seems so long ago now, this investigation changed sports forever. I am very proud of that.

The second was the Voluntary Compliance Initiative and the Swiss Bank investigations. When the IRS began looking closer at international tax evasion and offshore bank accounts that belonged to U.S. citizens, IRS Criminal Investigations very quickly began working with the Department of Justice to investigate the banks for any wrongdoing. Many of the banks paid huge fines and or entered into deferred prosecution agreements. As many of these cases were highlighted in the media, the Voluntary Disclosure Initiative began. This program enabled taxpayers who previously had undeclared foreign bank accounts to come forward, pay the fines and taxes and avoid criminal prosecution. They no longer had to look over their shoulder for an IRS Special Agent. During my tenure as the Chief, over 30,000 taxpayers came into the program and paid in excess of $5 billion dollars.

Q. Any last advice for those defending targets of a CI investigation?

A. Defending a target is never easy and least of all when Criminal Investigations is involved. Since its formation in 1919, they have enjoyed a conviction rate of 92% or better. I don't know of a federal agency that can match that record throughout the years. Hey, now that I am retired from CI, who better to give you advice. Give me a call, maybe I can help!

DOJ Clamps Down on Employment Tax Violations Through Criminal Enforcement

Robert S. Horwitz, Law Offices of Robert S. Horwitz *
Joseph P. Wilson, Wilson Tax Law Group, APLC **

The Department of Justice Tax Division is headed by an Assistant Attorney General. The mission of the Tax Division is to enforce the nation's tax laws fully, fairly, and consistently, through both criminal and civil litigation in federal district courts, the Court of Federal Claims and in federal appeals courts. The Tax Division is responsible for handling or supervising most federal criminal tax prosecutions. Attorneys in the Tax Division's three regional Criminal Enforcement Sections investigate and prosecute tax crimes with the assistance of IRS Criminal Investigation and the Treasury Inspector

General for Tax Administration. In the past, the Tax Division has focused its criminal enforcement efforts on violations of the income tax. Criminal prosecutions for employment tax violations were rare. Things, however, are changing.

On May 5, 2015, during a meeting with representatives from the California Tax Bar's D.C. Delegation, Caroline D. Ciraolo,[1] the Acting Assistant Attorney General, Tax Division, announced that a major priority of the Tax Division will be the criminal and civil enforcement of employment taxes. Subsequently, at the June, 2015, NYU Tax Controversy Forum, Ms. Ciraolo repeated that a major focus of criminal tax enforcement will be the failure to pay employment withholding tax.

While the duties of employers have not changed, the intensity of enforcement is increasing. Employers are required to withhold from wages paid to each employee the employee's portion of Federal Insurance Contribution Act (FICA) taxes and income taxes on the employee's wages. 26 U.S.C. §§ 3102(a) (FICA tax), 3402(a) (income tax). The two FICA taxes include Social Security tax and Medicare tax. Social Security tax, also known as the Old Age, Survivors, and Disability Insurance (OASDI) tax, is levied at a rate of 12.4 percent (split evenly between employees and employers) up to a maximum amount of an employee's wages ($118,500 in calendar year 2015). Medicare tax, also known as the Medicare hospital insurance (HI) tax, is levied at a rate of 2.9 percent of wages (split evenly between employees and employers). The employer is legally deemed to hold these withheld taxes "in trust for the United States," 26 U.S.C. § 7501(a), and is required to pay these withheld taxes to the IRS. These taxes are commonly referred to as "trust fund taxes." Even if the employer does not pay over the tax, the employee is credited with having paid the tax. *See United States v. Gilbert*, 266 F.3d 1180 (9th Cir. 2001). As a result, collection of these taxes has always been a legitimate concern of the tax authorities.

In the past, if a business fell behind with its employment tax responsibilities, the IRS would normally pursue a civil trust fund recovery penalty investigation to collect from the owners and managers of the business. The criminal enforcement of withholding tax violations was relatively infrequent. This no longer appears to be the case. Ms. Ciraolo's statements about criminal enforcement of employment tax violations are not idle threats, as can be seen from the following recent press releases posted on the US Department of Justice's website:

> July 10, 2015: A Detroit-area businessman and other co-conspirators were sentenced to prison this week for income and employment tax fraud in the U.S. District Court for the Eastern District of Michigan, announced Acting Assistant Attorney General Caroline D. Ciraolo of the Justice Department's Tax Division. http://www.justice.gov/opa/pr/happys-pizza-founder-and-co-conspirators-sentenced-prison-multi-million-dollar-income-and
>
> July 8, 2015: A Burbank, Washington, businesswoman was sentenced yesterday to serve more than three years in prison following her February 2015 conviction of 10 counts of failing to pay over federal employment taxes to the Internal Revenue Service (IRS) after a five-day jury trial in U.S. District Court for the Eastern District of Washington, announced Acting Assistant Attorney General Caroline D. Ciraolo of the Justice Department's Tax Division and U.S. Attorney Michael C. Ormsby of the Eastern District of Washington.
> http://www.justice.gov/opa/pr/former-president-townsend-controls-inc-sentenced-prison-failing-pay-over-33-million-federal

[1] Caroline D. Ciraolo was appointed Principal Deputy Assistant Attorney General and Deputy Assistant Attorney General of Policy & Planning of the Tax Division on January 12, 2015. By virtue of the February 25, 2015 nomination of Cono R. Namorato to be Assistant Attorney General, under the Vacancies Reform Act (5 U.S. Code § 3345), Principal Deputy Assistant Attorney General Ciraolo became the Acting Assistant Attorney General. See http://www.justice.gov/tax/meet-assistant-attorney-general.

> June 5, 2015: A Dix Hills, New York, resident and business owner was sentenced to serve more than one year in prison today in the Eastern District of New York for employment tax fraud, announced Acting Assistant Attorney General Caroline D. Ciraolo of the Justice Department's Tax Division.
> http://www.justice.gov/opa/pr/new-york-business-owner-sentenced-prison-failure-pay-employment-taxes

Many attorneys who have a tax controversy practice are familiar with the civil trust fund recovery penalty, 26 U.S.C. § 6672. That section provides, in pertinent part:

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

What most practitioners are less familiar with is the criminal counterpart of 26 U.S.C. § 6672: 26 U.S.C. § 7202. Like section 6672, section 7202 penalizes persons who fail to "collect, account for, and pay over" withholding tax. Section 7202 provides:

> *Any person required under this title to collect, account for, and pay over any tax imposed by this title who willfully fails to collect or truthfully account for and pay over such tax shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.*

Up to the end of the phrase "in addition to other penalties provided by law" the two sections are virtually identical. The parallel nature of the civil and criminal provisions was noted by the Supreme Court over 35 years ago in *Slodov v. United States*, 436 U.S. 238 (1978):

> *Third, penalties may be assessed against the delinquent employer. Section 6656 of the Code imposes a penalty of 5% of the underpayment of any tax required to be deposited, and 26 U.S.C. §§ 7202 and 7215 provide criminal penalties respectively for willful failure to "collect or truthfully account for and pay over" trust fund taxes, and for failure to comply with the requirements of § 7512, discussed supra, regarding special accounting requirements upon notice by the Secretary.*

436 U.S. at 244.

> *Sections 6672 and 7202 were designed to assure compliance by the employer with its obligation to withhold and pay the sums withheld, by subjecting the employer's officials responsible for the employer's decisions regarding withholding and payment to civil and criminal penalties for the employer's delinquency.*

436 U.S. at 247.

The same elements are needed to impose criminal liability under section 7202 that are needed to impose civil liability under sec. 6672: a) a duty to collect and/or truthfully account for and/or pay over withholding tax; b) the failure to fulfill that duty; c) the failure was willful. *Gilbert*, supra (sec. 7202 prosecution); *Purcell v. United States*, 1 F.3d 932 (9th Cir. 1993) (sec. 6672 refund case).

Under section 6672 a person with a duty to collect, account for or pay over the tax acts willfully if he "knows that withholding taxes are delinquent, and uses corporate funds to pay other expenses, even to meet the payroll out of personal funds he lends the corporation." *Phillips v. United States*, 73 F.3d 939 (9th Cir. 1996).

For a number of years, there was a general belief that the willfulness element for purposes of section 7202 required a showing of bad intent. "Bad intent" generally implies that a responsible person used the unpaid taxes for personal gain instead of using the funds to pay for necessary and legitimate expenses of the underlying business.

A review of the case history on the subject indicates that the bar for criminal culpability has become lower over time. The earlier cases held that in order for it to be a violation of section 7202, there needed to be "evil motive" or "bad intent". In *Wilson v. United States*, 250 F.2nd 312 (9th Cir. 1958), the district court instructed the jury that the knowing and intentional disbursement to others of funds withheld from employees for the payment of tax was "willful" under the predecessor of section 7202. The Ninth Circuit reversed on the ground that for purposes of a criminal violation of section 7202 the Government had to prove that the defendant acted with "evil motive, bad purpose, or corrupt design." 250 F.2nd at 319; *see also, United States v. Poll*, 521 F.2nd 329, 332 (9th Cir. 1975) (a conviction under section 7202 requires proof that the defendant had the necessary funds to pay the Government; evidence that the business did not have funds to pay all its expenses and that the defendant intended to pay the tax at a later time was therefore relevant to the issue of willfulness).

In more recent cases, the Ninth Circuit rejected this requirement. In *Gilbert*, supra, the Court held that willfulness "in the context of criminal tax cases is defined as a voluntary, intentional violation of a known legal duty . . . [it] need not include bad faith or bad purpose." *Gilbert* did not discuss either *Wilson* or *Poll*. In *United States v. Easterday*, 564 F.3d 1004 (9th Cir. 2008), the Ninth Circuit explicitly rejected *Wilson* and *Poll*, holding that the willfulness requirement under section 7202 requires the Government to prove that there was a voluntary and intentional violation of a known legal duty without the need to show evil motive or bad purpose. "In other words, if you know that you owe taxes and you do not pay them, you have acted willfully." *Id*. at 1005. As a result, when a business fails to pay withholding tax, the owners and managers may not only owe the taxes personally, but they may now also face jail.

Because the legal standard for criminal culpability closely mirrors that standard for civil liability, prosecutorial discretion is an even greater responsibility. While the willful failure to collect, account for and pay over withholding tax is a crime under section 7202, not every person who willfully fails to fulfill their duty will be prosecuted. The Tax Division gives prosecutors broad discretion in determining whether to prosecute under section 7202. Although this article focuses on section 7202, the government has a number of statutes under Title 26 and Title 18 in its arsenal to prosecute employment tax matters.[2] Tax Division policy regarding prosecutions under section 7202 is contained in Criminal Tax Manual ¶ 9.02:

> *Section 7202 should be used to prosecute persons who fail to comply with their legal obligations to collect, account for, and pay over taxes. Prosecutors also should consider charges under 18 U.S.C. § 1341 (mail fraud) or § 1343 (wire fraud) if the defendant embezzled funds that were held in trust.*

The reported decisions and DOJ press releases concerning convictions under section 7202 have one consistent element: the pyramiding of unpaid payroll taxes over a number of taxable periods. Many of these cases also involve lavish spending by the defendant during the period the withholding tax was accruing, either through taking large salaries or through the payment of personal expenses directly by the business. But lavish spending is not necessary to transform a civil trust fund recovery penalty case into a criminal trust fund case.

[2] Title 26 employment tax crimes may also be prosecuted under 26 USC secs. 7201, 7203, 7204, 7206, 7207, and 7215, among others. Title 18 employment tax crimes may be prosecuted under 18 USC sec. 371 (conspiracy), 18 USC § 1341 (mail fraud), 18 USC §1343 (wire fraud) and more. Subject to certain limitations, when a person violates more than one criminal statute, the government is free to charge the person under either or both the relevant statutes.

Although the two section 7202 cases the authors worked on involved false withholding tax returns, filing scrupulously accurate returns will not shield one from liability. And at least one case held it is no defense that every penny available to the business was used to pay legitimate business expenses. *See Easterday*, supra, 564 F.3rd at 1011 (evidence "to show how and why he spent money owed to the IRS to pay other business expenses" had no bearing on liability under sec. 7202 and, thus, was irrelevant).

With the Tax Division's new emphasis on criminal enforcement, it is important to get the word out to your clients and other tax professionals that **a failure to pay trust fund tax not only has civil ramifications but also can result in a criminal prosecution of the owners and officers of a business**.

There is also a dilemma facing attorneys representing clients who are potentially candidates for a trust fund recovery penalty under section 6672. It is necessary to emphasize to clients that any responsible person is potentially at risk of criminal prosecution if he or she allowed other creditors to be paid after learning that withholding taxes were not paid. Whether an individual client is a realistic target for a criminal withholding tax investigation is something that counsel will need to consider in advising a client in an employment tax case. An informed practitioner can do no more than advise the client on the risk of criminal prosecution based upon an analysis of all of the evidence; there is no guarantee that the client will not become a criminal target. If the client is not forthcoming and you do not do a diligent investigation, you cannot give realistic advice to the client.

Your evaluation of the risk of criminal prosecution will also determine your advice to the client on how to respond to IRS requests for information. In conducting a trust fund recovery penalty investigation, revenue officers are required to attempt to interview potentially responsible persons and to secure at least one Form 4180, "Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes." In both agreeing to an interview and signing the form, the client is waiving his privilege against self-incrimination. Tax practitioners will need to carefully evaluate all available information to determine whether the risk of criminal prosecution is sufficiently low to advice the client to submit to an interview.

If the risk is high, it may be best to advise the client not to submit to an interview or to assert the privilege against self-incrimination if he or she is summoned to give an interview or provide personal records. Indicators to evaluate should include, but are not limited to, the amount of tax collected but not paid over, the number of periods of non-compliance, the status of current compliance, how the funds were used, the nature of the business activity, who controlled the funds, the excuse for non-compliance, intervening factors, the person's individual tax compliance history, and more. No one factor is determinative as the risks are evaluated. All practitioners must advise their client of the potential risks regardless. Any client that admits to being a responsible person who acted willfully under section 6672 has admitted to a section 7202 criminal violation.

These are only some of the issues that will be raised as the landscape for enforcement of trust fund taxes changes. While you can never advise a client that she will not become a criminal target as a result of a past violation, there is one thing you can advise the client: withhold the tax, pay it to the IRS and file accurate employment tax returns.

* Robert S. Horwitz, Law Offices of Robert S. Horwitz, Santa Monica, CA, (310) 439-5760, rsh@santamonicataxattorney.com
** Joseph P. Wilson, Wilson Tax Law Group, APLC, Newport Beach, CA, (949) 397-2292, jwilson@wilsontaxlaw.com

Recent Cases of Interest

Robert S. Horwitz, Law Offices of Robert S. Horwitz *

Robert S. Horwitz has over 35 years of experience as a tax attorney, having spent years with the Department of Justice Tax Division and in the U.S. Attorney's Office, where he successfully prosecuted the leading real estate tax shelter promoter in the western United States. He is also the Chair Elect of the Tax Section and the principal of The Law Office of Robert S. Horwitz in Santa Monica.

There were so many interesting and important cases in the past few months that it was impossible to summarize more than a handful. The cases that I did not have room for included the Seventh Circuit's decision affirming the district court's sentence in the *Ty Warner* case, the Second Circuit's reversal of the district court's denial of a motion for a new trial in *Perse* (the one defendant in the *Daugerdas* case who did not get a new trial due to juror misconduct), the Ninth Circuit's decision in *Olive* that affirmed the disallowance of business expenses of a medical marijuana dispensary under 26 U.S.C. § 280A, the Ninth Circuit's decision in *Slone* concerning transferee liability, and a number of others.

On May 18, 2015, the Supreme Court issued its third opinion of this term on the constitutionality of a state tax scheme: the highly-anticipated ***Maryland Comptroller v. Wynne*, 567 U.S. __**. Unlike the two other opinions, *Wynne* applied the "dormant" Commerce Clause to hold that a state's income tax scheme failed to pass muster. More about the dormant Commerce Clause later.

Maryland taxes all income of its residents, whether sourced inside Maryland or outside Maryland. It taxes non-residents only on income from Maryland sources. Maryland's income tax scheme has several components. First, there is a "State" income tax set at a graduated rate. It applies to both residents and non-residents. Second, there is a "county" income tax, set at a rate that varies county to county but is capped at 3.2%. Third, non-residents, who are not subject to the county tax, pay a special tax equal to the lowest county tax rate. Maryland allows a credit paid to other states against the state tax but not the county tax. All three of these taxes are collected by the Maryland Comptroller.

The Wynnes were Maryland residents in 2006. They filed a joint return for that year. They owned stock in an S Corporation that had income from Maryland sources and from sources in other states. They reported their flow-through income and claimed a credit for tax paid to other states. The Maryland Comptroller denied the credit as to the county portion. The Comptroller assessed additional tax against the Wynnes. The Maryland Tax Court upheld the Comptroller's assessment. The county court reversed the Tax Court. The Maryland Court of Appeals affirmed the county court. The ground for affirmance was that the statutory scheme violated the Commerce Clause because it failed to fairly apportion and was not non-discriminatory. In a 5-4 decision, the Supreme Court affirmed.

Justice Alito, writing for the majority, started the opinion by noting that the Commerce Clause, which allows Congress to regulate commerce between the states, has consistently been held by the Court "to contain a further negative command, known as the dormant Commerce Clause, prohibiting certain state taxation even when Congress has fails to legislate on the subject." Although disputed, the majority opinion characterized the dormant clause as having "deep roots" going back to Justice Marshall. The dormant Commerce Clause "strikes at one of the chief evils that led to the adoption of the Constitution, namely state tariffs and other laws that burdened interstate commerce." The dormant commerce clause prohibits states from discriminating between transactions on the basis of some interstate element "so a state cannot impose

a tax that provides a direct commercial advantage to intrastate business or subjects interstate commerce to double taxation."

The majority opinion discussed three cases that struck down state taxing schemes for violating the dormant commerce clause: 1) *J. D. Adams Mfg. Co. v. Stormer*, 304 U.S. 307 (1938) [striking down an Indiana tax on sales made out of state without apportionment]; 2) *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 307 (1939) [a Washington state tax on all income of persons doing business in the state contravened the dormant Commerce Clause because it imposed a risk of a multiple tax burden to which local commerce was not subjected]; 3) *Central Greyhound Lines, Inc. v. Mealy,* 334 U.S. 653 (1948) [a New York tax on gross receipts of domicile bus companies for trips in other states violated the dormant Commerce Clause since it imposed an unfair burden on interstate commerce]. The dissenting opinions distinguished these cases on the ground that they dealt with gross receipts rather than income taxes. According to the majority, this distinction was insignificant and had been rejected "some time ago." The distinction had been based on the "notion" that a gross receipts tax was a direct burden while a tax on net income was an indirect burden on commerce. This distinction had been replaced with a "more practical approach that looked to the economic impact of the tax." In any event, the majority viewed a tax on gross receipts as a variety of income tax.

The majority opinion then addressed the Comptroller's argument that the *Adams, Gwin White* and *Central Greyhound* cases dealt with taxes on corporations and not on individuals. According to the majority, there was no valid basis for this distinction since both individuals and corporations benefit from services performed by state and local governments.

The majority also rejected as irrelevant the argument advanced by Justice Scalia's dissent that individual residents can vote and therefore work to change a state tax regime. If the tax unfairly discriminates it doesn't matter whether the taxpayer is a resident or a nonresident of the state. The majority also claimed that it was not true that state residents have recourse through the vote to change the law, since few people in the state earned out of state income. The majority then noted that the income in the case before it flowed through to the Wynnes from a subchapter S corporation. Thus, the distinction between a tax on individuals and a tax on corporations is incongruous, since it would provide more protection to large subchapter C corporations than to small subchapter S corporations.

The majority then turned to the dissents' argument that the dormant Commerce Clause cannot constrain Maryland's ability to expose its own residents to the threat of a double tax. According to the majority, the dissent was confusing what a state may do without violating due process with what it may do without violating the dormant Commerce Clause. A state's power to tax its residents does not insulate a tax scheme from scrutiny under the dormant Commerce Clause. The majority stated that the dissent could not point to a single case that "endorses its essential premise, namely, that the Commerce Clause places no constraint on a state's power to tax the income of its residents wherever earned." In a number of cases, the Court had scrutinized a state tax under both due process and the Commerce Clause.

In the *Adams* line of cases, the Court held that state tax schemes could be measured by an "internal consistency test." This test looks at the structure of the tax at issue to see whether its identical application by every state would place interstate commerce at a disadvantage *vis a vis* intrastate commerce. This test allows courts to distinguish between tax schemes that inherently discriminate against interstate commerce without regard to the tax policies of other states (which are unconstitutional) and tax schemes that create disparate incentives to engage in interstate commerce only because of the interaction of two different but nondiscriminatory and internally consistent tax schemes.

The majority gave as an example of an inherently discriminatory tax scheme one that imposes a 1.25% tax on income a) earned by residents in state, b) earned by residents out of state and c) earned by nonresidents in state. If there are two residents and one earns income in state and the other out of state, the person who earns income out of state would be subject to tax twice on the same income if all states had the same tax scheme. According to the majority this is Maryland's scheme and it is "inherently discriminatory and operates as a tariff." Tariffs on interstate commerce are inherently unconstitutional.

According to the majority, the dissents dispute is that other schemes could result in double taxation, such as between a state tax based on residence and a state tax based on source. The majority also claimed that the dissent "misunderstands" the critical distinction between discriminatory tax schemes and double taxation that could result from the interaction of two different but nondiscriminatory tax schemes."

The Comptroller and the Solicitor General argued that the tax is not discriminatory but neutral because it applies equally to all three categories of income. According to the majority, the practical effect of the tax, as shown by the internal consistency test and economic analysis, is to "operate as a tariff and discriminate against interstate commerce." That Maryland's tax scheme may result in it getting less tax from interstate as opposed to intrastate commerce is irrelevant since the tax unconstitutionally discriminates against interstate commerce. The majority rejected the dissents' arguments as inconsistent and against Supreme Court precedent.

First, according to the majority, the dissent argues that the majority's analysis requires A state tax scheme based on residence to accede to a state tax scheme based on source. The majority rejects this, claiming that Maryland could cure its tax scheme by offering a credit based on tax paid to other jurisdictions, but this is not required. While it is possible that Maryland could comply with the Commerce Clause by other schemes, those schemes are not before the Court.

The majority also claims that according to the dissent there is a deep flaw with the possibility that Maryland could eliminate the inconsistency by termination of the special nonresident tax, which would not help the Wynnes, but asserts that this claim refutes the first claim. Whenever a state discriminates against interstate commerce by taxing it at a higher rate, in violation of the dormant Commerce Clause, it can cure the violation by either "leveling up" or "leveling down" or a combination of both, *i.e.*, it can raise the lower rate, lower the higher rate, or both.

The majority next addressed Justice Scalia's dissent that the dormant Commerce Clause jurisprudence is a "judicial fraud" by pointing to the Justice Marshal's application of the theory in *Gibbons v Ogden* and the fact that it has been applied in dozens of other opinions. The majority claims that Justice Scalia does not dispute that tariffs are inherently unconstitutional or that Maryland's scheme does not constitute a tariff, but claims that the problem should be addressed by the Constitutional prohibition against states imposing imposts and duties on imports and exports. The majority says that the dormant Commerce Clause overlaps the prohibition on imposts on imports and exports.

The majority then addressed Justice Thomas' dissent that at the time of ratification several states imposed income tax and ratified the Constitution with the understanding that they could do what Maryland does. According to the majority, there is no evidence that there was double taxation on large numbers of persons who had income from out of state sources and there is evidence that in 1789 the states only taxed residents' income. Even if there was some double taxation, there was no evidence it was common knowledge to the delegates of the Constitutional Convention.

The Supreme Court therefore affirmed the decision of the state court.

In his dissent, Justice Scalia states that he joins Justice Ginsburg's dissent that points out the incompatibility of the Court's decision with its prior "negative" Commerce Clause cases but he writes separately because of "how wrong our negative Commerce Clause jurisprudence is in the first place and how well today's decision illustrates its errors." First, the Constitution does not contain a negative Commerce Clause, but only a Commerce Clause that empowers Congress to regulate commerce with foreign nations, among the states and with Indian tribes. Nothing in the Commerce Clause prohibits a state law that burdens commerce, let alone authorizes "judges to set aside state laws they believe burden Commerce." While the majority wrote that the negative Commerce Clause "has deep roots," according to Justice Scalia so do "many weeds." This alone is not enough to justify it and the earliest case relying on a negative Commerce Clause was after the Civil War. Ever since, the Court has revamped the doctrine every few decades.

There is no doubt that the Constitution is concerned with tariffs and other laws that burden interstate commerce, but these are addressed under Article I, sec. 10, clauses 2 and 3, which allow Congress to prohibit burdensome taxes and laws, not the judiciary. Justice Scalia points out what he considers to be several other flaws in the Court's negative Commerce

Clause jurisprudence: 1) there is a lack of a governing principle, which results in a series of ad hoc tests; 2) the negative Commerce Clause is unstable, since it is never clear when the Court will adopt a new rule or throw away an old rule and the Court's decision is contrary to several prior negative Commerce Clause cases; 3) finally, the "Synthetic Commerce Clause" cases are incompatible with the judicial role, since the Court does not interpret a legal text, discern a legal tradition or apply a stable body of precedent; rather, it performs a legislative function of balancing the needs of commerce against the needs of state governments. While the Court could eliminate double taxation by prescribing a national tax code for the states or by considering whether a state's tax "in practice" overlaps too much with the taxes in other states, the majority chooses a hypothetical world in which all states have the same tax scheme, thus ignoring the real world.

Justice Scalia's dissent ends by noting that for "reasons of stare decisis" he would vote to set aside a tax under the negative Commerce Clause only if 1) the tax discriminates on its face against interstate commerce or 2) it cannot be distinguished from a tax the Court previously held unconstitutional. Because this case presents neither scenario, Justice Scalia dissents. He would uphold the Maryland tax scheme.

Justice Thomas would uphold the Maryland tax scheme. He views the negative Commerce Clause as having no basis in the Constitutional text. He also views the majority's decision as being inconsistent with prior negative Commerce Clause precedent.

Justice Ginsburg's dissent was joined by Justices Scalia and Kagan. She notes that nothing in the dormant Commerce Clause requires one state tax scheme to recede just because another state has a tax regime that taxes the same income. Since residents receive more benefit from a state than nonresidents, more can be demanded of them by the state. And unlike nonresidents, residents have political means to ensure that the tax power of the state is not abused.

Contrary to the majority, Justice Ginsburg does not claim that the Commerce Clause places no constraints upon a state's power to tax. The Court has struck down state laws that have taxed out-of-state activities at a higher rate than in-state activities, but the Court has upheld "even-handed taxes" despite an adverse effect on interstate commerce. She points out that there is nothing wrong with a state electing to tax residents on their world-wide income when other states tax residents on income sourced within the state. A person who resides in one state and works in another gets benefits from both states and there is nothing wrong with the person being required to pay tax to both. She then reviews prior cases that have upheld tax schemes similar to that of Maryland. Contrary to the majority, these cases do not rely solely on a due process analysis; several also had a Commerce Clause analysis. The Court previously had not struck down a tax under the internal consistency test, and had upheld taxes that failed that test. As to the majority's claim that the Maryland tax was a tariff, a tariff exists when out of state activities are taxed at a higher rate than in state activities. Here, both in-state and out-of-state sourced income is taxed at the same rate.

Justice Ginsburg concludes by noting that the issue before the Court is really a policy one: whether a state should prioritize ensuring that all who live and work in the state pay their fair share or whether a state should eliminate the possibility of double taxation. This is something that is beyond the Court's competence. Therefore, Justice Ginsburg would uphold Maryland's tax scheme.

***Z Street v. Koskinen*, ___ F.3rd ____ (D.C. Cir. 2015)**, posed the question of whether a suit challenging an alleged policy of the IRS was barred by the Anti-Injunction Act ("AIA"), 28 U.S.C. § 2283. Z Street is an organization that promotes itself as "tirelessly and fearlessly defending Israel." In 2009 it applied for an exemption under 501(c)(3). Under IRC § 7428, if the IRS denies an application for exempt status or fails to act on such an exemption within 270 days, the applicant can file a declaratory relief action in Tax Court, the Court of Federal Claims, or the District Court for the District of Columbia seeking a determination of whether it is entitled to an exemption. Thirty-two days before the running of the 270-day period, Z Street filed a complaint in district court alleging that an IRS agent informed its attorney that the IRS had an "Israel Special Policy" under which organizations with views contrary to the Obama Administration's policy on Israel received increased scrutiny and that their applications for exempt status took longer to process than those of other applicants. Z Street sought a declaration that the IRS's alleged "Israel Special Policy" violated its First Amendment rights. The Commissioner moved to dismiss under the AIA and on the ground that there was no waiver of sovereign

immunity. The district court denied the motion. On application by the Commissioner, the district court certified the question for immediate appeal and the Court of Appeals accepted the case.

After reciting the background of the case, the D.C. Circuit briefly set out the purpose of the AIA and the three routes by which an organization can challenge an IRS determination that it is not exempt: 1) by paying the tax and suing for a refund; 2) if the IRS determines there is a deficiency and issues a 90-day letter, by filing a petition with the Tax Court; and 3) if the IRS denies an application or fails to act within 270 days, by suing for a declaratory judgment. In its complaint, Z Street did not seek a determination of whether it was exempt. It sought instead a determination that the alleged "Israel Special Policy" was unconstitutional and that the IRS should act on its application without regard to its views on Israel. The district court's denial of the motion to dismiss was based on the grounds that Z Street's suit did not implicate the assessment or collection of tax and that it sought only to ensure that a constitutionally valid process was used for acting on its application. Because the appeal was from a motion to dismiss, the D.C. Circuit assumed that the allegations in Z Street's complaint were true and that it was to decide the legal issues *de novo*.

The court reviewed the relevant case law concerning the AIA. In *Bob Jones University v. Simon*, 416 U.S. 725 (1974) and *Simon v. Americans United, Inc.,* 416 U.S. 752 (1974), the Supreme Court held that the AIA barred an organization from challenging the revocation or reclassification of its exempt status and that the constitutional nature of the organization's claims were "of no consequence under the Anti-Injunction Act." In so ruling, the Supreme Court noted that in the cases before it the aggrieved parties had access to judicial review and left open the door to whether the AIA applied if there was no avenue for judicial review.

In *South Carolina v. Regan*, 465 U.S. 367, the Supreme Court addressed the issue left open in *Bob Jones Univ*. and *Americans United*. The State of South Carolina challenged a change in the Internal Revenue Code that affected the taxation of certain types of state-issued bonds. Since South Carolina was not a taxpayer, it could not challenge the change through either of the traditional routes: a refund suit or a Tax Court petition. The Supreme Court held that the AIA was not meant to apply to aggrieved parties who had no alternate avenue to litigate their claims. The D. C. Circuit applied *South Carolina v. Regan* in *Cohen v. United States*, 626 F.3rd 717, a case in which a taxpayer challenged the special procedure the IRS had adopted for handling refund claims for telephone excise taxes. The Court rejected the IRS's argument that the AIA had broad application and held that the AIA "requires a careful inquiry into the remedy sought, the statutory basis for that remedy, and any implication that the remedy may have on assessment and collection." Since the taxpayer was challenging the procedures adopted by the IRS for the refund of a tax that had been assessed and collected, the lawsuit was not barred by the AIA. Finally, in *Taxation with Representation*, 461 U.S. 540 (1983), the Supreme Court held that the tax code may not "discriminate invidiously . . . in such a way as to aim at the suppression of dangerous ideas."

The D.C. Circuit distilled the teaching of these cases to the following three propositions:

> First, outside of certain statutorily authorized actions, like those brought pursuant to section 7428, the Anti- Injunction Act bars suits to litigate an organization's tax status (*Bob Jones* and *"Americans United"*).
>
> Second, the Act does not apply in situations where the plaintiff has no alternative means to challenge the IRS's action (*South Carolina*) or where the claim has no "implication[s]" for tax assessment or collection (*Cohen*).
>
> Third, in administering the tax code, the IRS may not discriminate on the basis of viewpoint (*Regan*).

The court distinguished *Bob Jones* and *Americans United* on the ground that in both cases the taxpayer sought to litigate its taxable status, which Z Street did not seek to do. Z Street only sought to prevent the IRS from unconstitutionally delaying action on its application. In *Cohen*, the court had rejected the Commissioner's claim that the AIA is a broad prohibition against tax litigation. In support of its view, the D.C. Circuit looked to the Supreme Court's recent decision in

Direct Marketing Ass'n, 135 S.Ct. 1124 (2015). There, the Supreme Court dealt with the Tax Injunction Act, which bars federal jurisdiction over an action to restrain the assessment, levy or collection of a state tax. The Supreme Court interpreted "restrain" as having "a narrow meaning … captur[ing] only those orders that stop … assessment, levy and collection" rather than "merely inhibit those activities."

The D.C. Circuit rejected, however, Z Street's claim that *Cohen* squarely permits its lawsuit. Unlike *Cohen*, where the remedy sought had "no implication" on assessment and collection, since the IRS had already assessed and collected the tax, Z Street's suit could implicate assessment and collection, since it if it prevailed and obtained exempt status earlier than it otherwise would have, donations to it would be tax exempt and, thus, deductible, earlier. This could reduce the assessment and collection of tax. This question did not have to be decided, according to the court, since under *South Carolina v. Regan* the AIA did not apply if there was no other remedy for the alleged injury, which was the case before it.

Addressing the argument that section 7428 was an adequate remedy, the D.C. Circuit noted that a court under that section only decides whether the organization is qualified for an exemption under 501(c)(3). Z Street did not seek to establish its exempt status in this suit but sought instead an order prohibiting the IRS from delaying consideration of its application based on its views about Israel. Thus section 7428 does not address Z Street's alleged injury. Similarly, a refund suit or a Tax Court petition in response to a deficiency notice would not be adequate, since they would only address Z Street's exempt status and not whether there was unconstitutional delay.

Since there was no statutory provision to contest the constitutionality of the delay caused by the IRS's alleged "Israel Special Policy," the Court held that the AIA does not bar the suit. As to the Commissioner's sovereign immunity claim, the Court held that section 702 of the Administrative Procedures Act waives sovereign immunity for suits for nonmonetary damages alleging wrongful action by an agency or its employees. Thus, the district court's decision was affirmed.

In ***Whistleblower 21276-13 v. Commissioner*, 144 T.C. 15 (2015)**, the Tax Court was not receptive to the IRS's argument that a whistleblower had to file a claim with the Whistleblower Office before providing information in order to be eligible for an award. The Commissioner filed a motion *in limine* after a partial trial asserting that since the claims were not filed before the claimants provided information to the IRS, they were not entitled to an award.

There were two separate whistleblower claims filed by husband and wife, seeking awards under IRC § 7623(b) for allegedly bringing to the IRS's attention information resulting in the collection of unpaid income tax. Husband (H) and Wife (W) each filed a separate Form 211, Application for Award for Original Information, after learning of the whistleblower award program from Federal agents to whom they provided information. Based on the facts, the whistleblowers appear to have been involved in the investigation of Wegelin & Co., the now defunct Swiss bank.

H was arrested and indicted for conspiracy to launder funds from the sale of pirated CDs. To minimize punishment, he agreed to provide information to the IRS and the FBI on the structures of various entities his clients used for illegal activities. He began to provide information on a foreign business entity that was formed as a general partnership that helped U.S. taxpayers evade federal income tax. The entity did not conduct business operations in the United States and instructed its partners, officers and employees not to come to the United States. H knew a senior officer (X) of the entity whom he believed could be lured to the United States by personal greed and, if arrested, would turn informant.

H contacted X and set up a meeting in London between X and W to discuss a purported client of H who had $1.2 million in untaxed funds. W met with X at a hotel and informed X that the beneficial owner of the funds wanted to move them from a Bahamian account and would pay a $40,000 fee. A meeting was arranged between H and X in the Cayman Islands, where H got X to agree to meet the beneficial owner. After a series of meetings, in which X was informed that the $1.2 million were embezzled funds that had not been taxed, X agreed to help move the money to a new bank account. H contacted X and enticed him to come to Florida to meet the beneficial owner and receive an initial payment of $15,000. When X arrived in Florida, he was arrested. H persuaded X to agree to help the Government investigate the target

business. X provided information to the U.S. Attorney and H provided information to confirm the accuracy of X's information.

Based in large part on the information provided by X and H, the target business was indicted and pled guilty to conspiring with U.S. taxpayers to hide from the IRS more than $1.2 billion in secret accounts. As part of the plea, the target business paid the U.S. $74 million in restitution. Following the guilty plea, the federal agents involved in the case advised H of the whistleblower program and suggested that he file a claim. H and W filed claims with the Whistleblower Office. On May 17, 2013, the IRS notified H and W that their claims had been received. The claims were sent to the Ogden Service Center for processing. The IRS denied the claims on the ground that the claims were filed after the settlement of the criminal case. The denial letters had boilerplate language that the information provided did not result in the collection of any proceeds.

The issue before the Court was whether a whistleblower claim must be filed with the Whistleblower Office before information is provided to the IRS in order to qualify for an award under IRC § 7623(b). Section 7623(b) provides in pertinent part:

> (b) Awards to whistleblowers
> (1) In general -- If the Secretary proceeds with any administrative or judicial action described in subsection (a) based on information brought to the Secretary's attention by an individual, such individual shall, subject to paragraph (2), receive as an award at least 15 percent but not more than 30 percent of the collected proceeds (including penalties, interest, additions to tax, and additional amounts) resulting from the action (including any related actions) or from any settlement in response to such action. The determination of the amount of such award by the Whistleblower Office shall depend upon the extent to which the individual substantially contributed to such action.

The Whistleblower Office was established by sec. 406 of the Tax Relief and Health Care Act of 2006 ("TRHCA"). The Commissioner argued that the purpose of the Whistleblower Office was to act as a gatekeeper to determine who is eligible for an award and that to perform its gate-keeping function, an informant must submit information to the Whistleblower Office before any IRS investigation or audit is commenced based on the information.

The Court reviewed the history of the Whistleblower Program and the Whistleblower Office. Prior to the enactment of section 406 of TRHCA, a TIGTA report determined that the Whistleblower Program needed standardized procedures and centralized oversight, that there were lengthy delays and that the IRS failed to monitor taxpayer accounts for more than one year for payment activity. TIGTA's report recommended that standardized procedures be adopted, that there be centralized management of the Whistleblower Program and a nationwide database of informant claims. Based on this recommendation, Congress enacted section 406, including subpart 406(b), which is not codified. Section 406(b) provides:

> (b) Whistleblower Office.--
> (1) In general.--Not later than the date which is 12 months after the date of the enactment of this Act, the Secretary of the Treasury shall issue guidance for the operation of a whistleblower program to be administered in the Internal Revenue Service by an office to be known as the "Whistleblower Office" which--
> (A) shall at all times operate at the direction of the Commissioner of Internal Revenue and coordinate and consult with other divisions in the Internal Revenue Service as directed by the Commissioner of Internal Revenue,
> (B) shall analyze information received from any individual described in section 7623(b) of the Internal Revenue Code of 1986 and either investigate the matter itself or assign it to the appropriate Internal Revenue Service office, and
> (C) in its sole discretion, may ask for additional assistance from such individual or any legal representative of such individual.

> (2) Request for assistance.--The guidance issued under paragraph (1) shall specify that any assistance requested under paragraph (1)(C) shall be under the direction and control of the Whistleblower Office or the office assigned to investigate the matter under paragraph (1)(A). No individual or legal representative whose assistance is so requested may by reason of such request represent himself or herself as an employee of the Federal Government.

The Court rejected the IRS's argument that the Whistleblower Office is to act as a gatekeeper. TIGTA found that the audit of whistleblower claims under the old program was effective. The problem was with the process of issuing awards. According to the Court, the purpose of the Whistleblower Office is to act as "the central office for investigating the legitimacy of a whistleblower's award claim, not necessarily the underlying tax issue." Under the Commissioner's interpretation, the Whistleblower Office would be authorized to open up examinations of taxpayers, something it is not equipped or trained to do. Even if the Whistleblower's Office were equipped to do this, having it open an exam would alert a taxpayer to the involvement of a whistleblower and could expose the whistleblower to retaliation.

Looking at Form 211, the Whistleblower claim form, the Court noted that it anticipates that the whistleblower approached an IRS operating division with information before filing a claim. The revised form, adopted after H and W submitted their claims, is even more explicit about the whistleblower providing information to an operating division of the IRS before submitting the claim. The Court found that there was no reason for the Whistleblower Office to contact IRS employees except to evaluate the claim. There was no requirement in the statute or regulations that the whistleblower has to provide information to the Whistleblower Office first in order to be eligible for an award.

Having ruled against the Commissioner on his motion *in limine*, the Court rejected his claim that it should adopt an abuse of discretion standard of review and remand the case to the Whistleblower Office for further consideration. The Court stated that the parties "did not fully explore the standard and review to be used" and it was not necessary that issue. The Court ordered the parties to attempt to resolve the case on the basis of the Court's holding and to submit a status report.

The Tax Division of the Department of Justice represents the United States in civil and criminal tax cases in district court, state court, the Court of Federal Claims and circuit courts of appeal. Sections 515 *et seq.* of Title 28 vest authority to conduct litigation in these courts to the Attorney General and officers of the Department of Justice. District court judges rarely raise an issue about the authority of a Tax Division attorney to represent the United States regardless of whether the attorney is admitted to practice in the state where the district court sits. One judge, however, routinely refuses to allow Department of Justice attorneys, in general, and Tax Division attorneys in particular, to represent the United States in his courtroom.

In ***United States v. United States District Court***, the Ninth Circuit addressed the conduct of United States District Judge Robert Jones of Nevada. Judge Jones had a policy of denying *pro hac vice* appearances by Tax Division and other Department of Justice attorneys who were not admitted to practice in the State of Nevada unless there was a showing that attorneys from the United States Attorney's Office in Nevada were incapable of handling the case. *United States v. Malikowski* was a tax collection action filed by the United States. The Tax Division attorney assigned to the case was Virginia Lowe, a member of the Massachusetts bar. Judge Jones denied her application for *pro hac vice* admission in the case. He had previously denied *pro hac vice* admission to Department of Justice attorneys in other cases. The United States therefore filed a petition for writ of mandamus with the Ninth Circuit. While the petition was pending, Judge Jones granted Ms. Lowe's motion to appear. The Ninth Circuit nonetheless issued an opinion in the case.

The first question it faced was whether Judge Jones' granting the motion for *pro hac vice* admission made the case moot. A case is moot if the issues are no longer alive or if the parties no longer have a legally cognizable interest in the outcome. Normally, a petition for writ of mandamus is moot when the judge performs the act that the party seeks to compel through the writ. Nonetheless, according to the Ninth Circuit, the normal exceptions to mootness apply to mandamus cases. A case is not moot if the allegedly wrongful behavior can be reasonably expected to recur. In Judge Jones' case, not only had he denied *pro hac vice* admission to Government attorneys in prior cases, but on at least one occasion after he granted

the motion in *Malikowski* he denied a motion for *pro hac vice* admission on the same grounds in another case. Thus, the case was not moot.

This however did not make a writ of mandamus an effective remedy, since there was no specific act that Judge Jones could be compelled to do in the *Malikowski* case. To provide the assurances that the United States sought, the Ninth Circuit felt it had to opine on the merits of the issue with confidence that the district court would follow its guidance in future cases. The Ninth Circuit's prior mandamus cases "establish that we are not categorically precluded from opining on the merits of a mandamus petition when issuance of the writ would no longer be effective." The Court stated that it would offer guidance only if it was clear that the writ would have been the appropriate remedy when the petition was filed and there was "a compelling reason to review the district court's decision for error when the specific relief sought has already been granted."

The Court next set out the elements that need to be established for mandamus to be granted: 1) there was no other adequate means to obtain the relief desired; 2) the right to issuance of the writ was "clear and indisputable" and 3) the issuing court was satisfied that the writ is appropriate under the circumstances. According to the Court, appropriateness is determined by weighing five factors:

1. Whether there are other means to obtain the desired relief
2. Whether the petitioner will be damaged or prejudiced in a way that could not be remedied on appeal
3. Whether the district court's order was clearly erroneous as a matter of law
4. Whether the district court's order is an oft-repeated error or manifests a persistent disregard of federal rules
5. Whether the petition raises new or important problems or issues of law of first impression

These five factors need not all be present for a writ to issue. (As you may have noticed, the five factors used to determine appropriateness overlap the three factors used to determine whether a writ should issue.)

The first factor the Ninth Circuit discussed was whether there was clear error. First, it looked to Nevada District Court Local Rule IA1-3, governing *pro hac vice* admission of government attorneys. That rule provides that "unless otherwise ordered" by the district judge, motions for the *pro hac vice* admission of government attorneys is to be granted. This appeared to allow a district judge to deny the *pro hac vice* admission of a government attorney who was not a member of the Nevada bar. While there is discretion, however, the Ninth Circuit stated that it "is not unbounded." There must be a valid reason for exercise of the discretion.

Noting that it had given little guidance on *pro hac vice* admission, the Ninth Circuit briefly reviewed the guidance given by several of its sister circuits. The Ninth Circuit decided not to give detailed guidance beyond "a court's decision to deny *pro hac vice* admission must be based on criteria reasonably related to promoting the orderly administration of justice… or some other legitimate policy of the court." If a court has doubts about an attorney's ethics, it must "articulate a reasonable basis for those doubts before denying the attorney's application for *pro hac vice* admission." The denial of Ms. Lowe's application was arbitrary. Judge Jones gave no reason for denying admission other than his stated policy. This was not enough.

The Ninth Circuit then looked to 28 U.S.C. §§ 515 *et seq*. Under these statutes, the Attorney General has clear statutory authority to choose which attorneys will represent the United States in litigation. This authority does not mandate that district courts automatically grant the *pro hac vice* applications of government attorneys, but the federal government is in a unique position as a litigant and courts should avoid arbitrary interference with the government's choice of counsel in a case since to do so risks impinging on the executive branch in the discharge of its duties and of giving the impression that the courts were intruding upon the traditional prerogatives of the "political branches." The Ninth Circuit pointed out that in some cases where he denied *pro hac vice* admission, Judge Jones indicated he disagreed with the enforcement priorities

of the IRS and the Tax Division and the latter's exercise of prosecutorial discretion. Thus, his denial of *pro hac vice* admission to Ms. Lowe was clear error.

The Ninth Circuit then went through the other factors in short order. First, according to the Court, there was no other adequate avenue by which the United States could obtain the requested relief. An order denying *pro hoc vice* admission was not a final appealable order nor was it an appealable interlocutory order under 28 U.S.C. §1292. The Court also dismissed the availability of relief through a complaint with the Ninth Circuit Judicial Council since it would be difficult to characterize Judge Jones' denial of *pro hac vice* admissions as "misconduct." Since a denial of *pro hac vice* admission was not appealable, the harm could not be corrected by appeal. Second, Judge Jones' error in the *Malikowski* case was not an isolated incident. Third, Judge Jones' order raises important problems. Fourth, but for Judge Jones' voluntary cessation in this case, the writ would have been appropriate. Thus, the Ninth Circuit held that this was an appropriate case to issue guidance to the district court.

Judge Wallace concurred in the denial of the writ, but disagreed that it was appropriate to give guidance to the district court. According to Judge Wallace, non-binding guidance was not an appropriate vehicle to ensure that Judge Jones would discontinue his policy. Judge Wallace also opined that it would be appropriate for the United States to seek relief from the Circuit Council, which is specifically established to administer and discipline the federal judiciary in the circuit. Judge Wallace stated that since a complaint with the Circuit Council would be an available remedy, it was inappropriate to issue guidance. He then criticized the Ninth Circuit for expanding the traditional scope of mandamus authority from "truly extraordinary circumstances in which no alternative remedy – judicial or administrative – is available." Thus, Judge Wallace would not have issued guidance to the district court. It will be interesting to see if Judge Jones continues to deny *pro hac vice* admission to government attorneys, especially those from the Tax Division.

The deference to be given revenue rulings was addressed by the Tax Court in ***Webber v. Commissioner*, 147 T.C. 17 (2015)**, where the Tax Court determined that the taxpayer, Jeffrey Webber, was to be treated as the owner of assets held in a specific account that was to fund variable life insurance policies. By way of background, the taxpayer was a venture capitalist who provided consulting services through R. B. Webber & Co., and formed private-equity partnerships to provide funding to high-tech startups. He personally invested in startups either directly in his own name, through trusts, IRAs and private-equity partnerships that he managed. As a result of his expertise, knowledge of technology and status as the manager of a number of private-equity partnerships, he was a director of over 100 corporations.

By 1998, the taxpayer's net worth was more than $20 million. His tax advisor suggested that he get help from an estate planner. He retained William Lipkind, an estate planning attorney in New Jersey, who proposed that the taxpayer set up a grantor trust and purchase private placement life insurance policies from Lighthouse Capital Insurance Company. Mr. Lipkind told the taxpayer that the strategy was not without tax risks, but that he believed that it was sound. The taxpayer took Mr. Lipkind's advice. He established a grantor trust sited in Alaska of which Mr. Lipkind and a corporate trustee were trustees. The beneficiaries were the taxpayer's children, his brother and his brother's children. The taxpayer funded the trust with $700,000, which the trust used to purchase two life insurance policies from Lighthouse. The insured on one of the policies was the taxpayer's 77-year-old aunt and on the other policy was the 78-year-old step-grandmother of his wife. Each policy had a minimum death benefit of $2.72 million. The maximum death benefit was the value of the assets held in the special account set up for that policy.

In 2003, due to a pending divorce proceeding, fear of possible lawsuits resulting from the bursting of the dotcom bubble, and financial problems being experienced by R. B. Webber & Co., the taxpayer directed Mr. Lipkind to move the trust's assets to an offshore trust. Although Mr. Lipkind advised against the use of an offshore trust, at the taxpayer's insistence, Chalk Hill Trust was formed in the Bahamas and the assets of the Alaska trust were transferred to the Chalk Hill Trust. Mr. Lipkind and a Bahamian trust company were trustees. The taxpayer and his children were beneficiaries of the Chalk Hill Trust. In 2008, believing that his financial risks had ended, the taxpayer had a Delaware trust formed and had the assets transferred from the Chalk Hill Trust to the Delaware trust. The terms and beneficiaries of the Delaware trust were the same as those of the Chalk Hill trust.

Lighthouse is a Cayman Islands life insurance company that is part of the London-based AON insurance group. Lighthouse specializes in private placement variable life insurance policies. It retains the risk on the first $10,000 of each policy and reinsures the rest through Hannover Re, a highly-regarded reinsurer. Before it issues any policy, Lighthouse does the standard underwriting and, where the insured is not the policyholder, it does due diligence.

Each of the policies issued to the taxpayer's trust required Lighthouse to set up a separate account to fund the death benefit. The initial $700,000 in premiums was debited against first year policy charges and mortality risk premiums. Most of the mortality risk premiums for the year were paid to Hannover Re. The remainder of the $700,000 premium was split between the two separate accounts. Each year Lighthouse debited the separate accounts for its policy charges and the mortality risk premium. The policyholder was permitted to pay additional premiums if they were needed to keep the policy in force. This only occurred once, in 2000, when $35,046 in additional premiums was paid. The policies allowed the policyholder to assign, borrow against or surrender the policy. The amount that could be borrowed or paid upon surrender was the total premiums paid over the life of the policy. Thus, the trusts could not get more than $735,046 from Lighthouse prior to the death of an insured.

Lighthouse did not provide investment management services. Instead, a policyholder could choose an investment manager from a list of managers acceptable to Lighthouse. Under the terms of the policy, the policyholder could set overall investment objectives and guidelines but could not require Lighthouse to make specific investments. The policyholder could offer investment recommendations to the investment manager, who on paper was free to ignore the recommendations and was to conduct due diligence before investing in any securities that were not publicly traded. The trust instrument provided that 100% of trust assets could be held in "high risk" investments, including private equity and venture capital investments.

The evidence presented at trial was that the investment manager received an annual fee of $500. There was no evidence that either Lighthouse or the investment manager conducted independent research or due diligence before investing any of the funds in the special accounts. Lighthouse set up special purpose companies to fund the death benefits under the policies. The 1999 Fund was the company initially used for this purpose. During 2006 and 2007, the years in issue, Boiler Riffle was the company used for this purpose.

Mr. Lipkind advised the taxpayer that, for tax purposes, he should not appear to exercise control over the investments made by Lighthouse for the two policies. The taxpayer therefore did not send directives directly to either Lighthouse or the investment manager. Instead, directives were sent to Mr. Lipkind, who would then make a recommendation to Lighthouse or the investment manager. Between the purchase of the policies and the years involved in the Tax Court case, thousands of emails were exchanged between the taxpayer and Mr. Lipkind and between Mr. Lipkind and Lighthouse and the investment manager concerning "recommendations" for investment. Neither Lighthouse nor the investment manager ever made an investment that was not recommended and always made investments that were recommended. Each investment made was in a startup in which the taxpayer had a personal financial interest.

While Mr. Lipkind was careful to insulate the taxpayer from direct communications regarding investments with the investment manager and Lighthouse, in discussions with the representatives of potential investors, he informed them that Boiler Riffle was controlled by the taxpayer and was his pocketbook.

Mr. Lipkind advised the taxpayer about "investor control" issues as they concerned Lighthouse. He did not, however, give him a written legal opinion. Mr. Lipkind and his firm charged the taxpayer their standard hourly rates for services performed, did not receive any bonus and did not receive any fees or kickbacks from Lighhouse, the investment manager, 1999 Fund or Boiler Riffle.

The IRS audited the taxpayer's 2006 and 2007 income tax returns. During the course of the audit, the taxpayer refused to make his personal accountant available for interview. When she was summoned, he unsuccessfully attempted to quash the summons. The IRS determined that the net income of the two accounts, $1,828,122 in 2006 and $558,640 in 2007,

was taxable to the taxpayer. As of the end of 2006, the value of the assets in the accounts was $7.2 million and as of the end of 2007 it was $12.3 million.

The Tax Court initially addressed the burden of proof. Normally, the Commissioner's determination is entitled to a presumption of correctness. The burden of proof is on the taxpayer to establish that the Commissioner's determination is incorrect and what the correct tax liability is. The taxpayer can shift the burden of proof to the Commissioner if a) he comes forward with credible evidence that, if unrebutted, would be sufficient for a decision if no contrary evidence were submitted and b) he cooperated with reasonable requests by the IRS for information, interviews, witnesses, meetings and documents. 26 U.S.C. §7491. The Court found that the taxpayer did not meet either prong. First, he did not submit credible evidence that, if not contradicted, would be sufficient for a decision on the issue. Second, he had attempted to keep the IRS from interviewing his personal accountant, including seeking to quash a summons issued to her.

The Court next addressed the "investor control" doctrine. Under the doctrine, if a taxpayer's control over assets in a separate account is sufficiently "capacious and comprehensive," the taxpayer rather than the insurer will be deemed to be the owner of the assets for federal tax purposes. Such a result causes the major tax benefits of the insurance/annuity structure to be lost, since the investor will be taxed on investment income as realized.

The "investor control" doctrine has its genesis in a series of early Supreme Court income tax cases: *Poe v. Seaborn*, 282 U.S. 1010, *Blair v. Commissioner*, 300 U.S. 5, *Griffiths v. Helvering*, 308 U.S. 355, and *Helvering v. Clifford*, 309 U.S. 331. These cases held that control by a taxpayer over assets that had been placed in a trust made the taxpayer the true owner of the assets for tax purposes. Based on these and other cases, the IRS beginning in 1977 issued revenue rulings that developed the "investor control" doctrine. The IRS argued to the Tax Court that these rulings, having been consistently applied for 38 years, are entitled to deference under *Skidmore* and must be given weight based on their persuasiveness and the consistency of the IRS's position. The Tax Court noted that the Ninth Circuit, to which the case is appealable, had not yet determined whether revenue rulings are entitled to *Chevron* deference or *Skidmore* deference.

The IRS first enunciated the "investor control" doctrine in Rev. Rul. 77-85, where the taxpayer had purchased an investment annuity contract under which the premium was deposited into a separate account and invested as directed by the taxpayer in assets that were on an approved list. The IRS ruled that the taxpayer exercised sufficient control over the assets to be treated as the owner for tax purposes. The IRS applied the "investor control" doctrine consistently in Rev. Rul. 80-274, 81-225, 82-54, and 2003-91 (which dealt with a variable life insurance contract). In these rulings, the IRS held that where the taxpayer made the decisions on investments in the account he was the owner for tax purposes but where the insurer exercised the ultimate decisions on how funds in the separate account were invested, it was the owner. The Tax Court's discussion of deference to be given the IRS position enunciated in these rulings is set out below:

> The "investor control" doctrine posits that, if a policyholder has sufficient "incidents of ownership" over the assets in a separate account underlying a variable life insurance or annuity policy, the policyholder rather than the insurance company will be considered the owner of those assets for Federal income tax purposes. The critical "incident of ownership" that emerges from these rulings is the power to decide what specific investments will be held in the account. As the Commissioner stated in Revenue Ruling 82-54, 1982-1 C.B. at 12, "control over individual investment decisions must not be in the hands of the policyholders." Other "incidents of ownership" emerging from these rulings include the powers to vote securities in the separate account; to exercise other rights or options relative to these investments; to extract money from the account by withdrawal or otherwise; and to derive, in other ways, what the Supreme Court has termed "effective benefit" from the underlying assets.
>
> We believe that the IRS rulings enunciating these principles deserve deference. The rulings are grounded in long-settled jurisprudence holding that formalities of title must yield to a practical assessment of whether "control over investment remained," *Clifford*, 309 U.S. at 335, and that ownership for tax purposes follows "actual command over the property taxed." *N. Trust Co. v. United States*, 193 F.2d 127, 129 (7th Cir. 1951) (quoting *Griffiths*, 308 U.S. at 355-358). These revenue

> rulings span a 38-year period and reflect a consistent and well-considered process of development. After stating bedrock principles in Revenue Ruling 77- 85, the IRS examined more complex scenarios corresponding to newer products being offered in the financial markets. The Commissioner's consideration of these scenarios appears nuanced and reasonable, resolving particular fact patterns favorably or unfavorably to taxpayers in light of the bedrock principles initially set forth. Cf. *Sewards v. Commissioner*, __ F.3d __, 2015 WL 2214705, at *3-*4 (9th Cir. Apr. 10, 2015) (affording "substantial deference" to interpretation of regulations "adopted by the IRS in Revenue Rulings issued over the last 40 years"), aff'g 138 T.C. 320 (2012).
>
> The "investor control" doctrine reflects a "body of experience and informed judgment" that the IRS has developed over four decades. *Skidmore*, 323 U.S. at 140; *Fed. Express Corp. v. Holowecki*, 552 U.S. 389, 299 (2008); see *Kasten v. Saint-Gobain Performance Plastics Corp*., 563 U.S. __, __, 131 S. Ct. 1325, 1335 (2011) ("The length of time the agencies have held * * * [these views] suggests that they reflect careful consideration[.]"). As evidenced by the absence of litigation in this area during the past 30 years, these rulings have engendered stability and long-term reliance through the private ruling process and otherwise. See *Taproot Admin. Servs., Inc. v. Commissioner*, 133 T.C. 202, 212 (2009) (history of consistent private letter rulings based on published ruling favors a finding of deference under *Skidmore*), aff'd, 679 F.3d 1109 (9th Cir. 2012). The relative expertise of the IRS in administering a complex statutory scheme and its longstanding, unchanging policy regarding these issues amply justify deference to the IRS under *Skidmore*.

Applying the principles contained in the revenue rulings, the Tax Court held that the taxpayer should be treated as the owner of the assets held in the separate accounts. In doing so, it stated that it need not decide if he would be treated as the owner had the parties adhered strictly to the policy provisions, since they did not do so. The taxpayer exercised the following powers over the assets in the separate accounts, as demonstrated by specific transactions during the years in issue:

1. The power to direct investments
2. The power to vote shares and exercise other options, since neither the insurer nor Boiler Riffle would take any action unless directed in writing by either Mr. Lipkind or the taxpayer's personal accountant, both of whom took directions from the taxpayer.
3. The power to extract cash. Although the policies stipulated that the taxpayer could not borrow in excess of the amount of premiums paid, he was able to extract cash from the separate accounts by requiring them to purchase specific assets from him. Between November, 2006, and October, 2007, the taxpayer had gotten over $1 million in cash from the separate accounts by causing Boiler Riffle to purchase various investment assets from him.
4. The power to derive other benefits. The taxpayer caused Boiler Riffle to invest in a winery, a resort in Big Sur and a hunting lodge in Canada, from all of which the taxpayer could derive personal pleasure. The investments made by the separate accounts mirrored the taxpayer's personal investments. This bolstered his power and position in the startups in which he invested.

Based on the facts and circumstances of the case, the Tax Court concluded that the taxpayer had sufficient rights of ownership over the assets to be considered their owner for tax purposes. Thus, he was taxable on the income associated with those assets for 2006 and 2007.

The Tax Court then addressed the taxpayer's counterarguments. The first was that he was not in "constructive receipt" of the income generated by the assets since his ability to control the receipt of income is subject to substantial limitations and restrictions. The Tax Court rejected this assertion, since constructive receipt is not part of the investor control doctrine. If the taxpayer is the tax owner of the assets in the separate accounts he is treated as actually receiving the income that the assets received. He was the owner in this case.

The taxpayer next argued that the investor control doctrine should not be applied to life insurance. This argument was based on the fact that prior to 2003, the revenue rulings discussing investor control did not apply the doctrine to variable life insurance contracts. As a result, the application of the doctrine to variable insurance contracts was not "thoroughly considered" and the doctrine was not entitled to *Skidmore* deference in this case. The Tax Court did not agree. That the contract was for insurance and that the insurer had insurance risk, since it would be obligated to pay the minimum policy benefit if the separate accounts were insufficient, did not make Lighthouse the owner of the assets in the separate accounts. Additionally, Lighthouse reinsured all but $10,000 of the risk per policy, so its actual insurance risk was negligible. The investor control doctrine was developed in part to limit misuse of tax-favored investment assets.

The taxpayer's next argument was that IRC §§7702 and 7702A, which define insurance, were enacted by Congress to impose restrictions on life insurance contracts with sufficient investment aspects. Accordingly, an insurance policy that qualifies as insurance under these sections cannot be subject to the investor control doctrine. The Tax Court found this argument wanting. The fact that a contract fits the definition of a life insurance contract does not determine who should be treated as the owner of the account assets supporting the contract.

The taxpayer's final attack on the application of the investor control doctrine was IRC § 817(h). The taxpayer argued that since the contracts are diversified within the meaning of this section, he should not be treated as the owner. The taxpayer reasoned that enactment of this section was meant to eliminate application of the investor control doctrine to insurance. The Tax Court disagreed. There was nothing on the face of the statute or the legislative history indicating that Congress meant to displace the investor control doctrine. In fact, Congress left the diversification requirements to be determined by the Secretary and in the preamble to the regulations concerning diversification the Secretary made it clear that the regulations do not address other issues, including investor control and after issuance of the regulations the IRS issued revenue rulings invoking the investor control doctrine.

After discussing objections the taxpayer made to the amount of income attributed to him by the IRS, the Tax Court addressed the accuracy penalties asserted against him by the IRS. The IRS had the burden of proof. The Court found that the taxpayer reasonably relied on Mr. Lipkind's advice and was not liable for the penalty. Mr. Lipkind was a qualified tax professional who reviewed opinion letters by other attorneys on the tax treatment of variable life insurance contracts similar to the one in which the taxpayer invested. At the time of the advice, 1998, the IRS had not issued any ruling applying the investor control doctrine to variable life insurance contracts. As a result, the outer limits of the doctrine were not definitively marked. Mr. Lipkind attempted to insulate the taxpayer from the possible impact of the investor control doctrine by acting as the conduit for communications with Boiler Riffle and Lighthouse concerning investments. Although this attempt was unsuccessful, the Tax Court did not fault the taxpayer, who had no expertise in tax matters and relied on his lawyer's advice. Thus, the penalty determinations were not sustained.

* Robert S. Howwitz, Law Offices of Robert S. Horwitz, Santa Monica, CA, (310) 439-5760, rsh@santamonicataxattorney.com

Are you reading someone else's copy of this issue of the California Journal of Tax Litigation?

Receive your own copy as well as all the announcements and updates from the Tax Procedure & Litigation Committee of the Taxation Section of the California State Bar Association.

Join the Tax Procedure & Litigation Committee!

Send an email message to Chair Joseph P. Wilson, jwilson@wilsontaxlaw.com

Committee Officers:

Chair
Joseph P. Wilson
Attorney at Law
Wilson Tax Law Group
1401 Dove Street, Suite 630
Newport Beach, California 92660
JWilson@WilsonTaxLaw.com
www.WilsonTaxLaw.com
Tel: 714-463-4430

Chair-elect
Courtney A. Hopley
Attorney at Law
Greenberg, Traurig LLP
Four Embarcadero Center, Suite 3000
San Francisco, California 94111
hopleyc@gtlaw.com
www.gtlaw.com
Tel: 415-655-1314

Secretary
Carolyn M. Lee
Attorney at Law
Abkin Law LLP
150 California Street, Suite 2100
San Francisco, California 94111
clee@abkinlaw.com
www.abkinlaw.com
Tel: 415-956-3280

California Journal of Tax Litigation Editor
Kevan P. McLaughlin
Attorney at Law
McLaughlin Legal
5151 Shoreham Place, Suite 265
San Diego, California 92122
kevan@mclaughlinlegal.com
www.mclaughlinlegal.com
Tel: 858-678-0061

Past Committee Chairpersons:

2014 LaVonne D. Lawson
2013 David Warren Klasing
2012 Michel R. Stein
2011 Robert Horwitz
2010 Michael R. E. Sanders
2009 Kornelia Davidson
2008 LaVonne D. Lawson
2007 Cathy Stahler
2006 Joseph A. Broyles
2005 David B. Porter
2004 Steve Blanc
2003 Edward T. Perry
2002 Abraham Brown
2001 Dennis Perez
2000 Dennis Brager
1999 Woody Rowland
1998 Judy Hamilton
1997 Charlene Woodward
1996 David Lee Rice
1995 R. Todd Luoma
1994 A. Lavar Taylor
1993 Jennifer Miller Moss
1992 Evan Smith
1991 Mark Ericsson
1990 Jennifer Miller Moss

Send Your California Journal of Tax Litigation Submissions To:

Kevan P. McLaughlin
McLaughlin Legal
5151 Shoreham Place, Suite 265
San Diego, California 92122
kevan@mclaughlinlegal.com
Tel: 858-678-0061

California Journal of Tax Litigation Submission Due Date:

Q4 2015 Issue: October 15, 2015