Current Federal Tax Developments

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SECTION: 162
REPAYMENT OF GAINS AS PART OF CRIMINAL PROSECUTION FOR INSIDER TRADING A NONDEDUCTIBLE AMOUNT UNDER IRC §162(F)

Citation: Nacchio et ux v. Commissioner, Nos. 2015-5114, 2015-5115, 6/10/16, cert denied, 6/12/17

The Court of Appeals for the Federal Circuit overturned a decision of the Federal Court of Claims in the case of *Nacchio et ux v. Commissioner*, Nos. 2015-5114, 2015-5115 and held that the taxpayer was barred from either claiming a credit under §1341 (the claim of right section) or a deduction under IRC §165 for repayment of gains received due to insider trading.

He had paid tax on a gain of over $44 million on the sale of stock of a public company of which he was the CEO. He was indicated on charges of insider trading with regard to these sales and eventually was convicted of the charges. In addition to paying a $19 million fine he was required to forfeit the net proceeds of his insider trading on which he had earlier paid tax.

The details of this forfeiture are summarized in the decision of the appellate panel:

> At the conclusion of the resentencing hearing, Nacchio's attorney inquired whether the district court would "direct that the [forfeited] money go to a fund . . . set up for distribution to [Nacchio's] victims." J.A. 494-95. In response, the prosecutor advised the court that "the Government's intention is for . . . the forfeiture funds[ ] to be used to compensate victims," but that the decision would be made by the Asset Forfeiture and Money Laundering Section ("AFMLS") in Washington pursuant to its regulations. Id.
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> In January 2011, Nacchio entered into a settlement of a concurrent action against him by the Securities and Exchange Commission. The settlement required that Nacchio disgorge the sum of $44,632,464, less any amounts forfeited and paid to the United States by Nacchio in connection with his criminal case. Nacchio's criminal forfeiture thus satisfied his disgorgement obligation in the SEC civil action. Nacchio's forfeited gain was subject to remission, pursuant to 18 U.S.C. § 981(e)(6). Thus, in September of 2011, the remission administrator retained by the Department of Justice ("DOJ") notified prior participants in private securities class action litigation or SEC civil litigation concerning Qwest stock that they were eligible to receive a remission from Nacchio's forfeiture. J.A. 508. In April of 2012, the Chief of the AFMLS authorized remission of the forfeited funds to eligible victims of Nacchio's fraud. J.A. 251-54.

The Court of Federal Claims had found that this payment did not constitute a fine or similar penalty paid to a government agency for which a deduction is barred by IRC §165(f) but rather a repayment to victims and thus was deductible using the logic in *Stephens v. Commissioner*, 905 F.2d 667, 671 (2d Cir. 1990). As well, the Court also found he had reasonably believed he had an unrestricted right to the funds, thus allowing him to electively claim a credit (in this case of $17,999,030) in lieu of a deduction in the year of repayment pursuant to IRC §1341.

The government appealed, arguing both that his repayment represented a fine paid to the government, not a repayment directly to victims and, as well, his criminal conviction in the insider

trader case meant he was blocked from claiming that he reasonably believed he legally had the unrestricted use of the funds, a key component of being able to claim a credit under IRC §1341.

Under IRC §1341:

> (a) General rule
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> If—
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> > (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
> >
> > (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
> >
> > (3) the amount of such deduction exceeds $3,000,
> >
> > then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
> >
> > (4) the tax for the taxable year computed with such deduction; or
> >
> > (5) an amount equal to—
> >
> > > (A) the tax for the taxable year computed without such deduction, minus
> > >
> > > (B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).
> >
> > For purposes of paragraph (5)(B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code (other than subchapter E, relating to self-employment income) and subchapter E of chapter 2 of such code.

So to qualify for this credit the taxpayer would have to show he received income for which it appeared he had an unrestricted right to in a prior year and that the current year's repayment would give rise to a deduction if the taxpayer decided not to elect to take the credit under IRC §1341. The Court of Appeals panel agreed with the IRS that the taxpayer did not meet either criteria.

In fact, the Court questioned a more basic point—although the IRS had conceded that the loss would be deductible under IRC §165(c)(2) if not blocked the fine or penalty rule of IRC §165(f), the panel questioned that concession, noting:

> To begin with, it is questionable whether § 165(c)(2) is even applicable where, as here, the "loss" sustained arose from a mandatory forfeiture of profit pursuant to a criminal conviction. Instead, the "losses" that § 165(c)(2) generally seems to contemplate are losses in the value of assets purchased for investment that failed to bear fruit. See, e.g., *Nathel v. Comm'r,* 615 F.3d 83, 94 (2d Cir. 2010)(involving deductibility of capital contributions allegedly made to obtain releases from loan guarantees); *Chen v. Comm'r,* No. 12982-12S,

> 2014 Tax Ct. Summary LEXIS 6,at *11 (T.C. 2014) (involving deductibility of allegedly abandoned investment property); *Seed v. Comm'r,* 52 T.C. 880, 884-85 (1969) (involving deductibility of financial contributions to an abandoned venture).
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> In any event, the government conceded before the Court of Federal Claims that Nacchio's forfeiture was a "loss" under § 165(c)(2), and we do not revisit that question on appeal. *Nacchio*, 115 Fed. Cl. At 201.

So the Court moved on to the question of whether the payment was in the nature of a fine or if the taxpayer reasonably believed he had unrestricted use of the funds.

Looking at the statute under which the taxpayer was convicted and under which he paid back the proceeds, the panel found that Congress intended the payment to be made with after-tax dollars, just his fine. The Court notes:

> First, the plain language of the statutory provision under which the amount Nacchio forfeited was calculated supports the view that Congress intended the forfeiture to be paid with after-tax dollars. The Tenth Circuit held on remand that Nacchio's forfeiture should be calculated in accordance with § 981(a)(2)(B), not § 981(a)(2)(A). *Nacchio*, 573 F.3d at 1090. Section 981(a)(2)(B) states that:
>
>> [T]he term "proceeds" means the amount of money acquired through the illegal transactions resulting in the forfeiture, less the direct costs incurred in providing the goods or services. . . . The direct costs shall not include . . . any part of the income taxes paid by the entity.
>
> 18 U.S.C. § 981(a)(2)(B) (emphases added). Thus, the language of the statute suggests that -- by design -- the forfeiture amount does not account for taxes paid on the amount of money acquired through the illegal transactions.

As well, the Court found that the Treasury regulation governing this provision would also treat this payment as a fine:

> Next, Treasury Regulation § 1.162-21(b)(1) defines "fine or similar penalty" for the purposes of § 162(f) as including, inter alia, "an amount -- (i) Paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding." 26 C.F.R. § 1.162-21. In *Colt Industries, Inc. v. United States,* we looked to the Treasury Regulation's definition of a "fine or similar penalty" in denying deductions a taxpayer sought under § 162(a) for civil penalties it had paid to the state for violations of the Clean Water Act and the Clean Air Act. 880 F.2d 1311, 1313 (Fed. Cir. 1989) ("If there were any doubt about the meaning of the phrase 'fine or similar penalty', it is readily removed by reference to Treasury regulations promulgated in interpretation of the provision.").
>
> Similarly, in this case, Nacchio's criminal forfeiture meets the definition of a "fine or similar penalty" under Treasury Regulation § 1.162-21(b)(1). Nacchio's criminal forfeiture was imposed pursuant to 18 U.S.C. § 981(a)(1)(C) and 28 U.S.C. § 2461(c), as part of his

> sentence in a criminal case. Section 981(a)(1)(C), as amended by the Civil Asset Forfeiture Reform Act of 2000, Pub. L. No. 106-185, § 20, 114 Stat. 202, 224, authorizes the forfeiture of "proceeds" traceable to numerous felony offenses, including any offense constituting "specified unlawful activity" as defined by 18 U.S.C. § 1956(c)(7)(A). Section 1956(c)(7)(A), in turn, defines "specified unlawful activity" as any act or activity constituting an offense under 18 U.S.C. § 1961(1)(D), which includes "any offense involving . . . fraud in the sale of securities."

But the taxpayer argues that the *Stephens* decision points out that all repayments in a criminal matter should be treated as a nondeductible fine. But the Appeals panel found that *Stephens* can be distinguished. In *Stephens* the payment was made directly back to the affected party as part of the agreement for his partially suspended sentence and that the court specifically set the restitution amount at $0 under the statute because, having already restored the victim, the restitution provision was inapplicable.

In this case the payment was made under the restitution provision and, while the government had indicated it planned to attempt to return these funds to victims, the Court notes the government was under no obligation to do so. As the Court holds:

> The Attorney General's post-hoc decision to use the forfeited funds for remission did not transform the character of the forfeiture so that it was no longer a "fine or similar penalty" under § 162(f). The decision to use the forfeited funds to compensate the victims was discretionary. Section 981(e) authorizes the Attorney General to "retain property forfeited pursuant to this section, or to transfer such property on such terms and conditions as he may determine" "(6) as restoration to any victim of the offense giving rise to the forfeiture." 18 U.S.C. § 981 (emphases added). In addition, 21 U.S.C. § 853(i), which describes criminal forfeiture procedures applicable to § 2461(c), empowers the Attorney General to "grant petitions for . . . remission of forfeiture . . . or take any other action to protect the rights of innocent persons" with respect to forfeited property. 21 U.S.C. § 853(i) …
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> Allowing Nacchio to deduct his forfeiture because the AFMLS decided to distribute it to victims through remission would mean that whether two people convicted of the same crimes could deduct their criminal forfeiture would turn not on their actions, or the statutes governing their sentencings, but on the after-the-fact discretionary decisions of a third party. This is not the law. Instead, "[t]he characterization of a payment for purposes of § 162(f) turns on the origin of the liability giving rise to it." *Bailey v. Comm'r,* 756 F.2d 44, 47 (6th Cir. 1985) (citing *Middle Atl. Distribs. v. Comm'r,* 72 T.C. 1136, 1145 (1979); *Uhlenbrock v. Comm'r,* 67 T.C. 818, 823 (1977)). We think Congress could not have intended to create a scheme in which the applicability of § 162(f) would depend upon how the government, in its discretion, later decided to use the funds generated by a fine or similar penalty.

Having found that no deduction is allowed for this repayment, the Court declined to rule on the question of whether the taxpayer was blocked from claiming he believed he had unrestricted use of the funds due to his criminal conviction, since it was no longer a relevant issue—the available credit is zero because the taxpayer fails to meet the basic condition imposed by IRC §1341(a).

Given the amount of money involved, it's not surprising that Mr. Nacchio pursued appeals all the way to the U.S. Supreme Court. But on June 12, 2017 his hopes to have this decision overturned were dashed when the U.S. Supreme Court denied certiorari in the case.

SECTION: 267
ESOP PARTICIPANTS ACCRUED COMPENSATION FOUND NOT DEDUCTIBLE UNTIL PAID

Citation: Petersen v. Commissioner, 148 TC No. 22, 6/13/17

The Tax Court found, in the case of *Petersen v. Commissioner,* 148 TC No. 22, found that participants in an ESOP that owned shares of an S corporation were related individuals for purposes of the deduction deferral rules of IRC §267(a)(2).

IRC §267 generally requires deferring a deduction by a taxpayer to a "related person" until such time as the income in includable in income of the related person. Thus, if a calendar year accrual basis taxpayer has accrued but unpaid compensation in existence at December 31 payable to a cash basis related person, no deduction will be allowed until the following year when the cash basis related person, having received payment, includes that amount in income.

For S corporations, every shareholder, no matter how small their interest in the corporation, is a related party. As the Tax Court notes:

> I.R.C. sec. 267(e) provides that, for purposes of applying subsec. (a)(2), an S corporation and "any person who owns (directly or indirectly) any of the stock of such corporation" shall be "treated as persons specified in a paragraph of subsection (b)." I.R.C. sec. 267(e) thus deems S corporations and their shareholders to be "related persons" regardless of how much or how little stock each shareholder individually owns. I.R.C. sec. 267(c), which provides rules for constructive ownership of stock, provides that stock owned by a "trust" is deemed constructively owned by the beneficiaries of the trust.

In this case, some or all of the corporation's stock for the years in question were owned by an employee stock ownership plan (ESOP) trust. The IRS contended that, for purposes of IRC §267, an ESOP trust should be treated as a trust, and the participants in the ESOP treated as beneficiaries of the trust. Since the corporation reported it income on the accrual basis, the IRS sought to disallow a deduction for any accrued compensation at year end payable to an employee who was a participant in the ESOP.

The amounts in question are described by the Court as follows:

> Petersen generally paid its employees every second Friday. At year-end 2009 and 2010 Petersen had accrued but unpaid wage expenses of $1,059,767 and $825,185, respectively. These amounts were paid to its employees by January 31 of the following year. Approximately 89% of these amounts was attributable to employees who participated in the ESOP.
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> Petersen's employees accrued vacation time as they worked. They were required to use this accrued vacation time during the year accrued or during the next calendar year. At year-end 2009 and 2010 Petersen had accrued but unpaid vacation pay expenses of $473,744 and

> $503,896, respectively. These amounts were paid to its employees by December 31 of the following year. Roughly 94.5% of these amounts was attributable to employees who participated in the ESOP.

The taxpayers first argued that IRC §318, which provides for the constructive ownership of stock, should apply in this case and, under IRC §318, participants in an ESOP are not deemed to constructively own stock held by the ESOP. But the Court found that IRC §318 did not apply.

The opinion notes:

> Section 318 is one of several Code provisions that set forth rules for constructive ownership of stock. By its terms, however, it applies only "[f]or purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable." Sec. 318(a).
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> Section 318 does not apply here for two reasons. First, section 318 is in subchapter C, whereas section 267 is in subchapter B, of title 26, subtitle A, chapter 1. Thus, section 267 is not a "provision[ ] of this subchapter" within the meaning of section 318(a). Second, the rules of section 318 are not "expressly made applicable" by section 267. Quite the contrary: Section 267(c) provides its own rules for constructive ownership of stock, demonstrating Congress' intent that these latter rules should apply. Cf. I*n re S. Beach Sec., Inc.*, 606 F.3d 366, 375 (7th Cir. 2010) (Posner, J.) (ruling that the attribution rules of section 318 "don't apply to section 269; for section 318 applies only when expressly made applicable * * *, and it hasn't been made expressly applicable to section 269, which anyway is not in subchapter C").

Next, they advance a somewhat odd argument—that since they have over $5 million in revenue, IRC §448 requires the corporation to report on the accrual basis. Thus, they argue, §267 cannot required them to report on the cash basis. The Court (and likely many readers) found a number of flaws in the logic.

As the opinion continues:

> Section 448 applies only to C corporations, tax shelters, and partnerships with a C corporation as a partner. See sec. 448(a). In any event, section 267(a) does not deny Petersen use of the accrual method generally; it simply defers deductions for a limited universe of expenses payable to related cash basis parties.

The taxpayers argue that the treatment the IRS seeks to impose is contrary to U.S. GAAP. But the Court points out that GAAP compliance isn't relevant to tax matters. As the Court notes:

> As has often been noted, however, tax accounting differs in many respects from GAAP financial accounting. See, e.g., *United States v. Hughes Props., Inc.*, 476 U.S. 593, 603 (1986); *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) (disallowing writedown of excess inventory for tax purposes even though it conformed to GAAP); *Hamilton Indus., Inc. v. Commissioner*, 97 T.C. 120, 128 (1991). Especially is that so where (as here) a Code

> provision explicitly requires a treatment that differs from GAAP. Petersen has no greater claim than any other accrual basis taxpayer to exemption from the operation of section 267.

Having dealt with those objections, the Court moves on to consider if the ESOP is a trust for purposes of IRC §267 and, if so, does that mean the participants will be treated as shareholders for purposes of disallowing the deduction.

The Court notes that under IRC §267 the reference is merely to a "trust" with no additional definition or restriction. The opinion notes that IRC §318, the section the Court has already ruled does not apply, also treats trust as "related" for purposes of attribution, but §318(a)(2)(B)(i) specifically excludes from attribution a "an employees' trust described in Section 401(a) which is exempt from tax under IRC §501(a)." This, the Court holds, "shows that Congress knew how to limit the scope of the term "trust" when it intended to do so" and it notably did not do so with regard to IRC §267.

The Court then looks at the documents used to establish the ESOP, one of which is labeled a trust. The Court notes that the ESOP trust has language that is consistent with that expected to be found in a trust. As the Court finds:

> These provisions show that the entity holding the Petersen stock for the benefit of the ESOP participants was a "trust" in the ordinary sense of that word. The regulations describe a trust as an arrangement "whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries." Sec. 301.7701-4(a), Proced. & Admin. Regs. "Generally speaking, an arrangement will be treated as a trust * * * if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries." Ibid.8
>
> The arrangement involved here closely resembles an ordinary trust whereby a settlor (here, the company) establishes a trust for the benefit of specified beneficiaries (the ESOP participants), contributes property to the trust (Petersen stock and cash), and designates a trustee to hold the property for the beneficiaries and act in their best interest. The ESOP trust easily qualifies as a "trust" under the regulatory definition and the common law definitions appearing in the case law.

The Court goes on to note that if the assets are not held by a trust, the ESOP could not qualify under ERISA. The Court notes that there is a difference between the ESOP agreement (the plan) and the trust that holds the ESOP assets—while the former is not a trust, the latter is—and the latter holds the stock.

The Court notes that conceivably the failure to exclude employee benefit plan trusts from §267 might be an oversight by Congress, as ESOPs were not eligible shareholders when Congress revised §267. But, the Court states, it is bound by what Congress has written into the law. Presumably if Congress now finds it made an error, Congress will enact legislation to solve the problem.

Because of this the opinion concludes:

> Section 267(c)(1) thus deems the Petersen stock held by the trust to be owned by the trust's beneficiaries, viz., the Petersen employees who participated in the ESOP. As a result the ESOP participants and the company are deemed "related persons" for purposes of section 267(b). See sec. 267(e)(1)(B)(ii). Section 267(a) accordingly operates to defer Petersen's deductions for the accrued but unpaid payroll expenses to the year in which such pay was received by the ESOP participants and includible in their gross income.

SECTION: 6103
TAXPAYER CAN OBTAIN INFORMATION ON PAYMENT OF TAX BY CONTRACTORS FROM THE IRS IN EMPLOYMENT TAX DISPUTE, BUT ONLY DURING TAX COURT DISPUTE

Citation: Mescalero Apache Tribe v. Commissioner, 148 TC No. 11, 4/5/17, Chief Counsel Email 201723020, 6/9/17

In the case of the *Mescalero Apache Tribe v. Commissioner*, 148 TC No. 11 the Tax Court had to consider the taxpayer's request to obtain information from the IRS regarding other taxpayers, specifically if those taxpayers had reported income received from the Tribe on their income tax returns. Or, as the IRS claimed, did the law (specifically IRC §6103) prevent the agency from disclosing such information about other taxpayers.

The question arose because the IRS had decided in an examination that the Tribe had failed to treat certain individuals as employees that were, in the agency's view, truly employees. While the Tribe is still contesting that fact, the Tribe sought information from the IRS to reduce the amount due. Specifically, the Tribe wished to know if contractors they had been unable to contact had paid their taxes.

That is important because, while the Tribe is "on the hook" generally for payroll taxes if these individuals are found to truly be employees, IRC §3402 removes the employer's liability if the employer can show the person had included the amounts on their return for the year in question. [IRC §3402(d)]

The Tribe had used the method outlined in the Internal Revenue Manual (IRM 4.23.8.4) and attempted to contact the individuals in question. While it located many of the individuals, the Tribe was unable to locate 70 of the individuals in question. Some had moved and the Tribe had no current address, while others were in hard to reach areas that lacked utilities or cell phone service.

While the Tribe was unable to obtain the information from the individuals regarding whether they had included the amounts in their income, clearly there was one other source that could answer that question. The IRS clearly had the tax returns for these individuals (or knew they had not filed returns) and thus could provide information that likely would show that some of those 70 that the Tribe could not contact had paid their taxes.

As the Court writes:

> The Tribe wants to take advantage of section 3402(d) in this case. But how? It tried to find its old workers and get them to fill out the form the IRS wants employers in this situation to use, but the Tribe argues that the information is just sitting there in the IRS's records.
>
> Isn't that what discovery is for?

The IRS objected to providing this information for two reasons. First, as noted above, the IRS claimed that IRC §6103(a) prohibited the IRS from releasing this information to another taxpayer. Second, the agency argued this created an impermissible shift in the burden of proof from the taxpayer to the agency to gain the benefits of IRC §3402(d).

The Court agrees that the information the Tribe seeks is "return information" as defined by IRC §6103 and that the general rule bars such disclosure. But, as the Court notes "general rules usually have exceptions in trail, and section 6103 is no different."

There is a potential exception found at IRC §6103(h)(4) which provides:

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

The opinion first notes that the title of IRC §6103(h) is "Disclosure to Certain Federal Officers and Employees For Purposes of Tax Administration, Etc." and that the first Circuit Court to look at the issue (the Fifth Circuit Court of Appeals in the case of *Chamberlain v. Kurtz,* 589 F.2d 827, 837-38 (5th Cir. 1979)) had used that title to limit such disclosure only to Treasury officials. But the Court goes on to note that most other circuits have rejected that view, instead following the Tenth Circuit's reasoning in the case of *First W. Gov't Sec., Inc. v. United States,* 796 F.2d 356, 360 (10th Cir. 1986) that the specific discussion of judicial proceedings broadens the application of the provision.

Since this case would be appealable to the Tenth Circuit, the Tax Court is bound by that Circuit's view.

The Court concludes that subsection (B) may be a problem because it does not provide for release of "return information" but rather just a return. Whether an item had been included in income would not necessarily be clear from merely looking at the return in question, although the IRS could have other information related to the return (such as all 1099MISC issued to the taxpayer) that would allow for answering the question.

However, the Court notes that subsection (C) does allow for disclosure of return information. But there are a couple of hurdles to be overcome.

As the opinion notes:

> First, what is a "transactional relationship" under section 6103, and is the employer/worker relationship included within it? Next, does the return information that the Tribe wants "directly relate" to this relationship? And, finally, does the information related to the transactional relationship directly affect the resolution of the issue in this case?

The opinion notes that historically courts have taken a broad view of what is a transactional relationship:

> To "transact" means simply "to carry on business." Webster's Third New International Dictionary 2425 (2002). And the wide variety of business relationships that other courts have held are included in the general phrase lead us now to hold that the relationship between an employer and his worker is one that pertains to the carrying on of business.

But is the information sought directly related to the transactional relationship, the next requirement of (C)? Here the Court turns to a Nebraska District Court opinion:

> Here we have some help from a district court in Nebraska. In *Guarantee Mut. Life*, 42 A.F.T.R.2d (RIA) 78-5915, a company sued for a tax refund by establishing that its workers were independent contractors and not employees. The district court there found that the workers' tax records would contain evidence of how the workers viewed their status — a significant factor in a worker-classification case — and allowed disclosure under section 6103(h)(4)(C). Id. We agree that whether the Tribe's workers paid their tax liabilities in full tends to show whether they considered themselves independent contractors or employees and thus directly relates to their relationship with the Tribe.

Finally, does that information directly affect the resolution of the issue in this case? The Court finds several cases on this issue and, not surprising, this information is found to directly affect the resolution of the case.

As the opinion notes:

> For example, in *Texture Source, Inc. v. United States,* 851 F. Supp. 2d 1260, 1267 (D. Nev. 2012), the court found that discovery of relevant return information relating to tax treatment of drywall workers was directly related to the tax treatment of those workers as contractors. In *Davidson*, 559 F. Supp. at 461, the court found that financial statements between a debtor and a creditor directly related to whether the creditor made a material misstatement to a probation officer. This information directly related to the sentencing court's ability to resolve an issue crucial in arriving at a just sentence for the creditor. Id. at 461-62. And in *First Western*, 796 F.2d at 359-60, the court found that audit information relating to a transactional relationship between investors and their broker directly affected the investors' tax liabilities. How the Tribe's workers viewed themselves — as employees or independent contractors — is a factor in worker-classification cases. See *Weber v. Commissioner*, 103 T.C.

> 378, 387 (1994) (whether a worker is a common-law employee or an independent contractor depends in part on the relationship the parties believed they were creating), aff'd, 60 F.3d 1104 (4th Cir. 1995); see also *Ewens & Miller, Inc. v. Commissioner*, 117 T.C. 263, 270 (2001). And whether the Tribe's workers paid their income-tax liabilities as independent contractors would tend to prove or disprove the Tribe's case, which would directly relate to the resolution of one of the issues here. We also shouldn't overlook the big issue here: If the Tribe's workers did indeed pay their tax liabilities, then the Tribe's section 3402(d) defense would be proved and would be entirely resolved.

The Court also does not find this creates an impermissible burden shift for the IRS. The burden remains on the taxpayer, but one way for the taxpayer to obtain information to satisfy that burden is via discovery.

As the opinion states:

> The Commissioner still objects that, even if the information is *disclosable*, it is still not *discoverable*. It is true that section 3402(d) seems to place the burden on the taxpayer to show that the income tax is paid. And each party in civil litigation must bear "the ordinary burden of financing his own suit." *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 179 (1974). But that doesn't mean discovery cannot be had of his opponent. Our Rule 70(b) says that information is discoverable or not "regardless of the burden of proof involved." We've read our Rule to mean what it says. *Piscatelli v. Commissioner*, 64 T.C. 424, 426 (1975). "Who bears the burden of proof on an issue has no effect on the obligation to comply with appropriate discovery requests." *Guillo v. Commissioner*, T.C. Memo. 1998-40, 1998 WL 42189 at *4, aff'd, 165 F.3d 915 (9th Cir. 1998).

The IRS Chief Counsel's office reacted shortly after this decision in an email (Chief Counsel Email 201723020), indicating that in its view this case does not grant taxpayers facing such liability may not require the IRS to provide worker tax information during the exam. Rather the agency's position is that the case only holds that such disclosure may be required by the Court during discovery, not that employers facing potential liability have the right to obtain that information directly from the service immediately upon the issue being raised in exam.

The email notes:

> In worker classification employment tax examinations where examiners have concluded that the use of a mandatory reduced rate provided in Code section 3509(a) or 3509(b) is not applicable because intentional disregard has occurred, and thus abatement of income tax withholding under Code section 3402(d) may be available, and in employment tax examinations where worker classification is not at issue, the Service should continue to follow the procedures outlined in Internal Revenue Manual section 4.23.8.4.3, *Procedures for Relief Under IRC 3402(d) and/or IRC 3102(f)(3) in Examination*. These procedures authorize examiners to accept original Forms 4669 (Statement of Payments Received) before an examination is closed and to consider such forms "prima facie" evidence of the reporting and payment of tax. These procedures do not authorize examiners to disclose worker return information to the taxpayer or its representative during an examination.

The email bases this on the facts of the case:

> It is important to note that the court's determination that the workers' return information was discoverable was based largely on the representation by the Tribe that it has already made a significant effort to locate the workers and that it had failed only with respect to a relatively small number. It is also important to note that IRC 6103(h)(4) authorizes disclosure, but does not require it; thus the court's determination that the workers' return information "is disclosable under section 6103(h)(4)(C)" does not create a requirement that the Service disclose the information.
>
> Thus, *Mescalero* does not stand for the proposition that taxpayers and/or their representatives are entitled to workers' return information during the conduct of an employment tax audit or at the Appeals consideration level. Instead, the *Mescalero* decision is limited to discovery requests made by a taxpayer during the pendency of a Tax Court proceeding, where the Tax Court has the ability to determine whether the requested information is disclosable pursuant to IRC 6103(h)(4), AND has balanced the relevancy of the requested information against the burden placed on the Service pursuant to Tax Court Rules 70(b) and 70(c).

SECTION: 6221
ON SECOND ATTEMPT, IRS PUBLISHES PROPOSED REGULATIONS FOR BBA PARTNERSHIP AUDIT REGIME TAKING EFFECT NEXT YEAR

Citation: REG-136118-15, 6/14/17

The IRS, after pulling back a version in January in light of President Trump's executive order limiting the issuance of new regulations, has finally released the important proposed guidance on the implementation of the revised partnership audit regime enacted as part of the Bipartisan Budget Act of 2015. This version was published in the *Federal Register* on June 14, 2017. [REG-136118-15].

This second pass is little changed from the version the IRS was set to release in January of 2017. Aside from fixing minor typographical errors in the original, this version removes a single example that dealt with the imputed underpayment and added some additional discussion in the preamble of the issues the IRS continues to consider regarding tiered partnerships and these regulations.

When the original, "not quite" proposed, regulations were issued in January, the items in those regulations were discussed on this site in the post *IRS Releases, Then Pulls Back, Proposed Regulations Implementing BBA Partnership Audit Regime* (January 27, 2017). We also provided an analysis of those regulations (*Analysis of Not Quite Proposed Regulations for BBA Partnership Audit Regime*) which, due to the limited changes in the final regulations, remains useful aside from Example 3 for the imputed underpayment on page 31 of that document. That example is not found in the version that was printed in the *Federal Register*.

As well, the audio and video presentation posted to this site for the week of January 30, 2017 discusses these regulations in detail (*2017-01-30 Not Quite Proposed Partnership Audit Regulations*, January 27, 2017). The audio and video there provides a 35-minute summary of these proposed rules.

SECTION: 7508A
DISASTER RELIEF DELAY FOR ACTIONS DOES NOT PROVIDE FOR RELIEF FROM PENALTIES OR INTEREST FOR ACTS WITH DUE DATE BEFORE DISASTER

Citation: Chief Counsel Email 201723023, 6/9/17

IRC §7508A allows the IRS, for taxpayers affected by a federally declared disaster, terrorist, or military action, to delay for up to one year the period for performing certain acts under the IRC and, in such cases, disregarding such period for the imposition of interest, penalties, etc. related to that act. In Chief Counsel Email 201723023, the question raised was whether who had failed to, say, file a return before the disaster took place would have penalties and interest waived for the period in question.

The memorandum concludes that the provision only grants relief from such penalties and interest if the date for taking the action took place after the disaster. As the email notes:

> Taxpayers who didn't pay before the due date don't get the benefit of IRC § 7508A with regard to the failure to pay penalties and interest that began accruing before the disaster hit. Under Treas. Reg. § 301.7508A-1(b)(2), an affected taxpayer is eligible for postponement of time to perform an act until the last day of the relief period if "the affected taxpayer is required to perform [the] tax-related act by a due date that falls within the postponement period." The tax-related act at issue here (the paying of tax) falls outside the postponement period — the postponement period began August 11, 2016, and ended January 17, 2017. Payment of tax would have been due April 15, 2016, which was before the postponement period began. So in the fact pattern Cong. Graves' office is asking us to consider, the penalties/interest began to accrue before the postponement period began. Consequently, taxpayers do not get a suspension of penalties/interest between August 11, 2016, and January 17, 2017. (If any of the affected taxpayers had valid extensions of time to pay, then the tax would have been due during the postponement period and the result would be different).

The memorandum directs the reader to Example 6 of Treas. Reg. §301.7508A-1(f). That example provides:

Example 6.

> *(i) A is an unmarried, calendar year taxpayer whose principal residence is located in County W in State Q. A intends to file a Form 1040 for the 2008 taxable year. The return is due on April 15, 2009. A timely files Form 4868, "Application for Automatic Extension of Time to File U.S. Individual Income Tax Return." Due to A's timely filing of Form 4868, the extended filing deadline for A's 2008 tax return is October 15, 2009. Because A timely requested an extension of time to file, A will not be subject to the failure to file penalty under section 6651(a)(1), if A files the 2008 Form 1040 on or before October 15, 2009. However, A failed to pay the tax due on the return by April 15, 2009 and did not receive an extension of time to pay under section 6161. Absent reasonable cause, A is subject to the failure to pay penalty under section 6651(a)(2) and accrual of interest.*

(ii) On September 30, 2009, a blizzard strikes County W. On October 5, 2009, certain counties in State Q (including County W) are determined to be disaster areas within the meaning of section 1033(h)(3) that are eligible for assistance by the Federal government under the Stafford Act. Also on October 5, 2009, the IRS determines that County W in State Q is a covered disaster area and announces that the time period for affected taxpayers to file returns, pay taxes, and perform other time-sensitive acts falling on or after September 30, 2009, and on or before December 2, 2009, has been postponed to December 2, 2009.

(iii) Because A's principal residence is in County W, A is an affected taxpayer. Because October 15, 2009, the extended due date to file A's 2008 Form 1040, falls within the postponement period described in the IRS's published guidance, A's return is timely if filed on or before December 2, 2009. However, the payment due date, April 15, 2009, preceded the postponement period. Thus, A will continue to be subject to failure to pay penalties and accrual of interest during the postponement period.

Since the memorandum appears to have been written in response to a query from a Congressman, the agency does offer the possibility of other relief for such individual, indicating that when answering the query, the IRS should "suggest instead that his constituents (or their representatives) should advocate for abatement based on reasonable cause due to the particular facts/circumstances in each case."