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Supreme Court
Supreme Court Opens New Term
With Three Tax Cases on Its Docket

By J.P. Finet

The U.S. Supreme Court opens its 2011-12 term with three tax cases on its docket, including a closely watched case that is expected to address the circuit split on the Internal Revenue Service's application of the extended assessment limitations period to tax shelters that operate by understating the basis in goods sold.

The high court made news before its term even started by granting certiorari Sept. 27 to an appeal of the U.S. Court of Appeals for the Fourth Circuit's ruling in *United States v. Home Concrete Supply LLC*, 634 F.3d 249 (4th Cir. 2011) (188 DTR K-1, 9/28/11). The case is being closely watched by practitioners because it deepened the 4-2 circuit split over whether a partnership's use of a tax shelter transaction to avoid capital gains taxes by understating its basis in goods sold is an omission from gross income triggering the extended assessment period.

The Fourth Circuit's *Home Concrete* ruling also allows the Supreme Court to address a controversial Treasury regulation (T.D. 9511) that was promulgated after a 2009 U.S. Tax Court decision found the regular three-year assessment period applied to overstatements of basis in tax shelter transactions. The retroactive regulation stipulates that an overstatements of basis triggers the extended six-year assessment period.

Other Tax Cases, Notable Appeals

The other two tax cases to which the Supreme Court has granted certiorari are *Kawashima v. Holder*, 615 F.3d 1043 (9th Cir. 2010), and *Hall v. United States*, 617 F.3d 1161 (9th Cir. 2010), both of which address issues that have split the federal circuits.

Kawashima is an appeal of a Ninth Circuit ruling that found taxpayers' guilty pleas related to false statements on a tax return constituted an aggravated felony allowing for removal under immigration laws. *Hall* is an appeal of a Ninth Circuit finding that capital gains taxes arising from the sale of a family farm during bankruptcy are not dischargeable.

There are also a number of notable tax-related petitions on the Supreme Court's certiorari docket. Among the most widely watched are two appeals of federal circuit court rulings that came down on opposite sides regarding the constitutionality of the Patient Protection and Affordable Care Act (Pub. L. No. 111-148), which imposes a penalty for noncompliance as part of an individual's income tax payment.

The Justice Department Sept. 28 filed a petition with the justices asking them to review the Eleventh Circuit's decision in *Florida v. Health and Human Services*, which declared the individual mandate was unconstitutional (189 DTR K-1, 9/29/11). The same day, they asked

**Tax Cases Accepted
for Supreme Court
Review**

*United States v. Home
Concrete Supply LLC*,
(No. 11-139)
(assessment periods)

Kawashima v. Holder,
(No. 10-577) (deportation
after tax plea)

Hall v. United States, (No.
10-875) (bankruptcy
dischargeability of capital
gains)

the justices to delay a decision on reviewing a Sixth Circuit decision, *Thomas More Law Center v. Obama*, which found PPACA constitutional (190 DTR K-1, 9/30/11).

Finally, some appeals of state tax decisions are being followed by practitioners, most notably the Iowa Supreme Court's finding that the state may impose its income tax on licence revenue KFC Corp. receives from its franchisees.

Speed of 'Home Concrete' Appeal Noted

Home Concrete is one of four petitions for certiorari that have asked the high court to address the 4-2 federal circuit split on the application of the extended assessment period to overstatements of basis.

The majority of the circuits have ruled in the government's favor.

The other three cases, which remain on the high court's certiorari docket, are the Seventh Circuit's ruling in *Beard v. Commissioner*, 633 F.3d 616 (7th Cir. 2011) (18 DTR K-2, 1/27/11), the Fifth Circuit's ruling in *United States v. Burks*, 633 F.3d 347 (5th Cir. 2011) (28 DTR K-5, 2/10/11), and the Federal Circuit's ruling in *Grapevine Imports Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011) (49 DTR K-5, 3/14/11).

Several practitioners have noted how quickly the Supreme Court granted certiorari to *Home Concrete*. The appeal was filed Aug. 3.

"The speed at which the issue of the regulations has traveled through the judiciary is nothing less than extraordinary," Anthony Daddino told BNA Sept. 27. "Within about two years of the Treasury issuing the regulations, five circuit courts opined on the regulations, with the issue now set to be heard by the Supreme Court."

Daddino is a partner with Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP in Dallas.

"Although the circuit split has recently favored the government, both the Tax Court and Fifth Circuit stood firmly on their pro-taxpayer decisions when the courts recently revisited the issue of the regulations, which likely was a factor in the Supreme Court agreeing to hear the six-year issue," Daddino said.

Case Will Settle Important Issues

Beard was the first of the assessment period cases appealed to the Supreme Court, but given that the Seventh Circuit chose not to address the IRS regulation in its ruling—which held that the statute was unambiguous, therefore the court need not look to the regulation—practitioners told BNA it was unlikely the high court would choose to grant certiorari to that decision.

"*Home Concrete* allows the court to address both the substantive Section 6501(e)(1)(A) definitional dispute as well as the recent 'self-help' regulation that attempted to influence the pending cases," Douglas Schaaf told BNA Sept. 27. "Consistent with the amicus brief filed by Bausch & Lomb, it is a far superior case than *Beard* for the court to review in order to settle two important issues: (1) what does 'omits' mean in Section 6501(e), and (2) what are the limits on the government's authority to attempt to influence an active case (that may have advanced as far as the circuit court of appeals) by issuing regulations favorable to its position."

Schaaf is the chairman of the tax department at Paul Hastings in Costa Mesa, Calif.

"The *Beard* decision is difficult to defend, as the Seventh Circuit reached its decision without the benefit of any self-serving interpretive regulation in a manner that would seem to be contrary to the *Colony* precedent," Schaaf said, referring to *Colony Inc. v. Commissioner*, 357 U.S. 28 (1958). "I am sure that the government would very much like the court to grant cert only in *Beard*, as it is a clear cut victory for the government, without the need to resort to the administrative law complications raised by the untimely issuance of the relevant regulation."

Judge Wilkinson's concurring opinion in Home

In all four of the appealed rulings, the

Concrete raises issues of separation of powers and due process that put the cases in the broader context of the proper scope and breadth of executive power.

Guy Bracuti of KPMG

circuit courts based their decisions on the Supreme Court's opinion in *Colony Inc.* In that case, the high court interpreted the phrase "omits from gross income" in Section 6501(e)(1)(A)'s predecessor to unambiguously exclude basis overstatements. However, *Colony* addressed the 1939 version of the tax

code and the dispute rests on its applicability to the 1954 code, which made changes to the provision that IRS has claimed were intended to limit *Colony* to cases involving a trade or business selling goods or services.

Schaaf said *Home Concrete* will allow the high court to address both the "omits" issue that arose in *Colony* and the impact of the recent interpretive regulation that purports to "interpret" the statutory language that was at issue in *Colony*.

Administrative Law Issues Also Raised

Guy Bracuti, a principal in the Washington National Tax Practice of KPMG LLP, told BNA Sept. 29 that the Supreme Court's decision to grant certiorari to *Home Concrete* will allow it to address several administrative law issues that were not addressed by *Beard*.

"First, the Fourth Circuit in *Home Concrete* addresses squarely the administrative law issues ... whereas the Seventh Circuit in *Beard* interprets only the statute and relegates the discussion of the regulation to a single paragraph of dictum," Bracuti said. "Second, *Home Concrete* involves the Section 6501 statute of limitations and the Section 6229 tolling provision (and the regulations under each section); *Beard* involves only the Section 6501 statute of limitations."

Finally, Bracuti noted that Judge J. Harvie Wilkinson III's concurring opinion in *Home Concrete* raises issues of separation of powers and due process that put the cases in the broader context of the proper scope and breadth of executive power. Wilkinson said that what IRS seeks to do in extending the statutory limitations period goes against what he believed were the plain instructions of Congress, which, along with the Supreme Court, has the last word on the law.

"Separation of powers and the proper role of government (not just the executive branch) have been subject to increasing public debate and are implicated in other cases that the court will hear this term," Bracuti said. "Whether these tax cases will become part of a larger tapestry of the court's views on governmental power is unknown but will be interesting."

Retroactivity of Regulation Also Challenged

In addition to challenging IRS's interpretation of the statute, the four Supreme Court petitions challenge the Treasury regulation, which stipulates that an overstatement of basis is an omission from gross income. The regulation, which applied retroactively, was promulgated after IRS lost *Intermountain Insurance Service of Vail LLC v. Commissioner*, 134 T.C. 2011 (2010), in the U.S. Tax Court. In that ruling, the Tax Court found an overstatement of basis was not an omission from gross income.

In a later ruling in the case, known as *Intermountain II*, the Tax Court again rejected IRS's position (87 DTR K-1, 5/7/10). Eventually, the D.C. Circuit addressed the issue and found both that an overstatement of basis triggered the extended limitations period and that the regulation was valid (120 DTR K-1, 6/22/11). *Intermountain* has not been appealed to the Supreme Court.

A number of tax practitioners have taken issue with the effective date of the regulations, which apply to tax years still open to assessment at the time they were issued, and are hoping the Supreme Court will address the issue.

"Many tax practitioners, myself included, believe that the regulations' effective date is the Achilles' heel of the government's argument for the regulations," Daddino said.

Circuits Split Over PPACA's Constitutionality

While the Sixth Circuit's June ruling in *Thomas More Law Center v. Obama*, 80 U.S.L.W. 9 (6th Cir. 2011), upheld the PPACA, the U.S. Court of Appeals for the Eleventh Circuit's *Florida v. HHS* decision struck down the entire statute as unconstitutional in August. The resulting circuit split is seen by many commenters as making a Supreme Court grant of certiorari all but certain.

The Thomas More Law Center petitioned the Supreme Court for review of the Sixth Circuit's ruling in July (145 DTR K-3, 7/28/11). The Department of Justice filed a petition with the high court Sept. 28 that asked it to review the Eleventh Circuit's ruling (189 DTR K-1, 9/29/11).

The DOJ petition was the third filed that day, with the National Federation of Independent Business also having filed two separate petitions.

The Eleventh Circuit found that Congress exceeded its powers under the Commerce Clause when it enacted the PPACA's individual mandate, which would require most Americans to buy health insurance or pay a penalty as part of his or her federal income tax payment (157 DTR K-6, 8/15/11). The Sixth Circuit, by contrast, said the individual mandate falls within Congress's power to regulate activities that substantially affect interstate commerce (126 DTR K-2, 6/30/11).

The Sixth Circuit said Congress can regulate even wholly intrastate economic activity, so long as it would substantially affect interstate commerce. Congress can also regulate non-economic intrastate activity if doing so would be essential to a larger scheme that regulates interstate economic activity, it said. The individual mandate passes muster under both tests, the court said.

The individual mandate is facially constitutional because it regulates economic activity—the practice of self-insuring for health care costs—that Congress had a rational basis to believe substantially affects interstate commerce, the Sixth Circuit said. Alternatively, the court said that, even if self-insuring for health care costs were not economic activity having a substantial effect on interstate commerce, Congress could still regulate it because failure to do so would undermine its regulation of the larger interstate health care and health insurance markets.

Defendants Fight Deportation After Tax Plea

The appeal of the Ninth Circuit's *Kawashima v. Holder* (150 DTR K-4, 8/6/10) presents the Supreme Court with the issue of whether a guilty plea to charges of filing, and aiding and abetting in filing, a false statement on a corporate tax return are aggravated felonies that should subject the defendant to deportation. The Ninth Circuit finding that the defendants should be removed is in direct conflict with a previous ruling by the Third Circuit.

Akio and Fusako Kawashima are Japanese citizens who were admitted to the United States as lawful permanent residents in 1984. They established a successful Japanese restaurant, Cho Cho San, in which Akio owned shares.

Akio Kawashima was charged with subscribing to a false statement on a corporate tax return in 1997. His wife was charged with aiding and assisting in the preparation of a false statement on a tax return. That year, they both entered guilty pleas to the charges.

The Immigration and Naturalization Service concluded that the Kawashimas' convictions of the tax offenses were aggravated felonies and ordered their removal to Japan pursuant to 8 U.S. Code Section 1101(a)(43)(M)(i). Following years of protracted litigation, the Ninth Circuit eventually determined that the crimes for which the couple were convicted were aggravated felonies, but remanded the case to the district court to determine whether the evidence was sufficient to establish the total loss to the government as a result of Fusako Kawashima's crime.

"The crimes to which the Kawashimas pled guilty did not have fraud or deceit as an element of the crime of conviction and, therefore, cannot fall within the ambit of M(i)," the couple said in

their petition for certiorari.

Oral argument is slated for Nov. 7.

Tax Implications of Farm's Sale in Bankruptcy

The other case to which the Supreme Court has granted certiorari, *Hall v. United States* (157 DTR K-3, 8/17/10), asks the high court whether Internal Revenue Code Section 1399 provides that the capital gains income tax incurred due to the sale of a family farm in a Chapter 12 bankruptcy is not an administrative expense under the Bankruptcy Code that is owed by the estate and payable under the reorganization plan. Section 1399 provides that a bankruptcy filing, other than individual Chapter 7 or Chapter 11 filings, does not give rise to a "separate taxable entity."

The Ninth Circuit found that Chapter 12 bankruptcy debtors may not treat capital gains taxes arising from the post-petition sale of their farm as an unsecured claim because the estate cannot incur tax. Chapter 12 of the Bankruptcy Code governs family farm bankruptcies.

The Ninth Circuit ruling is at odds with the Eighth Circuit's ruling in *Knudsen v. IRS*, 581 F.3d 696 (8th Cir. 2009), which found that the income taxes arising from the post-petition sale of assets are unsecured claims and dischargeable (178 DTR K-1, 9/17/09).

In an opinion written by Judge Diarmuid O'Scannlain, the Ninth Circuit in *Hall* said Section 1399 provides that a Chapter 12 estate cannot incur taxes. Because the estate cannot incur a tax, he said that it does not get the benefit of Bankruptcy Code Section 1222(a)(2)(A), which provides that claims owed to a governmental unit arising as a result of the sale, transfer, exchange, or other disposition of any farm asset do not receive priority.

"We recognize that our conclusion that the chapter 12 estate cannot 'incur' a tax necessarily implies that the debtor is responsible for any taxes incurred after the bankruptcy petition is filed in a chapter 12 case because the chapter 12 trustee, the only other potentially responsible party, is not liable for the tax," O'Scannlain concluded.

Oral argument is planned for Nov. 29.

Iowa Ruling Has Broad Implications

The most widely watched state tax case that has been petitioned to the Supreme Court is an appeal of the Iowa Supreme Court's ruling in *KFC Corp. v. Iowa Department of Revenue*, 792 N.W.2d 308 (Iowa 2011). In that decision, the court found Iowa may impose an income tax on revenue received by a foreign corporation that has no tangible physical presence within the state, but which receives revenues from the use of KFC's intangible property within the state (1 DTR K-1, 1/3/11).

According to the Iowa court, under the U.S. Supreme Court's ruling in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), a physical presence in a state is not required under the U.S. Constitution's dormant Commerce Clause in order for the Iowa Legislature to impose an income tax on revenue earned by an out-of-state corporation arising from the use of its intangibles by franchises located in the state.

The Iowa court said that by licensing franchises within the state, KFC has received the benefit of an orderly society within the state and, as a result, is subject to the payment of income taxes that otherwise meet the requirements of the dormant Commerce Clause.

"[KFC]'s the furthest reach by a court so far and, essentially, states that a business is subject to state income tax in any state where it has customers."

Cass Vickers, Institute for Professionals in Taxation

Cass Vickers, deputy executive director and state tax counsel for the Institute for Professionals in Taxation, told BNA Sept. 22 that the case presents a great opportunity to address the economic nexus issue. The institute submitted a petition supporting Supreme Court review of *KFC*.

Vickers said state tax practitioners have

been hoping that the high court would address the question of whether the Commerce Clause prohibits the taxation of companies without a physical presence since shortly after *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), was decided.

"This is a particularly good case because it presents the economic nexus issue in kind of the most stark terms to date," Vickers said of *KFC*. "It's the furthest reach by a court so far and, essentially, states that a business is subject to state income tax in any state where it has customers. If you are deriving receipts from customers in a state, you are subject to state income tax."

Vickers said the Institute for Professionals in Taxation is primarily an educational organization and the state tax nexus issue is a frequent topic at its sessions.

"We address the question: 'Am I subject to the sales tax in a state?' " said Vickers. "In this context it's just the furthest reach so far by the states. Of course, they're reaching far these days because so many coffers are in trouble."

Ohio Court Case Raises Commerce Clause Issues

DIRECTV v. Levin, 941 N.E.2d 1187 (Ohio 2010), is an appeal of an Ohio Supreme Court finding that the state's imposition of a sales tax on the retail sale of satellite broadcasting services, but not cable broadcasting services, does not violate the Commerce Clause (248 DTR K-1, 12/29/10).

According to the Ohio Supreme Court, the U.S. Constitution's Commerce Clause protects the interstate market, not particular interstate firms or particular structures or methods of operation in a retail market. It added that the state's imposition of a sales tax on satellite broadcasting services, but not on cable broadcasting services, does not violate the Commerce Clause because the tax is based on the differences between the nature of those businesses, not the location of their activities, and does not favor in-state interests at the expense of out-of-state interests.

Among the groups that have asked the U.S. Supreme Court to review the ruling are a group of constitutional law professors. The group contends that the Commerce Clause principles reflected in the Ohio decision cannot be squared with the U.S. Supreme Court's existing dormant Commerce Clause precedent.

"The Ohio court's flawed analysis matters greatly," the professors said in their brief. "The two broad per se dormant Commerce Clause principles announced below will allow discriminatory taxation that would be impermissible under traditional dormant Commerce Clause doctrine. Increased use of discriminatory taxes, in turn, could result in economic inefficiencies, as companies seek to avoid tax penalties."

The counsel of record for the group's amicus curiae brief is Douglas Cole, a partner with Jones Day in Columbus, Ohio. He is also Ohio's former solicitor general and a former Ohio State University law professor.

Cole told BNA Sept. 21 that the issue presented in *DIRECTV* is one of differential taxation that has arisen in state courts around the country. He said the constitutional law professors have an interest in the sound development of constitutional law and saw the *DIRECTV* decision as undermining some of the U.S. Supreme Court's dormant Commerce Clause precedent.

"The concern that we identify in our brief is that this decision puts a thumb on the scales of the competition between satellite and cable television in a manner that advances the interest in a technology that inherently has an in-state presence," Cole said.

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