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Tax Litigation Issues

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Recent Second Circuit Tax Cases

Over the past 12 months, the U.S. Court of Appeals for the Second Circuit has issued a limited number of tax decisions. While the court's opinion in *Raymond v. United States* addressed an issue of national import,[1] those making less noise still have a significant impact and are worthy of review.

Two of these decisions address jurisdictional issues, specifically (i) a district court's ability to hear disputes regarding summonses issued by the Internal Revenue Service (IRS) and (ii) the Tax Court's authority to hear a challenge to a ruling that a former spouse qualifies for "innocent spouse" treatment. A third significant case adopted a longstanding rule of law to limit a corporate taxpayer's ability to obtain favorable treatment of a complex transaction under the Internal Revenue Code (the code).

Subject Matter Jurisdiction

1. Use of Courts' Subject Matter Jurisdiction to Limit Review.

• *Review of IRS Summonses*. The statutory authority for the IRS to serve summonses on taxpayers derives from §7602 of the code. Section 7604 authorizes the IRS to seek enforcement of summonses

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through court orders, the disobedience of which would be punishable through contempt proceedings. Furthermore, §7210 makes it a crime for a person summoned by the IRS to neglect to appear or produce records as requested. Historically, the courts of this circuit extended their jurisdiction to entertain motions brought with respect to §7602 summonses, such as motions to vacate brought by the individual summoned, despite the fact that no §7604 enforcement action had been initiated by the government.[2]

On Jan. 25, 2005, the Second Circuit issued its decision in *Schulz v. Internal Revenue Service*, ruling that under the U.S. Supreme Court's decision in *Reisman v. Caplin*, IRS summonses have "no force or effect unless the Service seeks to enforce them through a §7604 proceeding."[3]

The facts of *Schulz* are simple. The IRS served a series of summonses seeking testimony and documents from Mr. Schulz, the subject of an IRS investigation. Mr. Schulz filed a motion to quash the summonses, which was denied by the district court for lack of subject matter jurisdiction. The Second Circuit affirmed this decision stating that there was no case or controversy, as required by Article III of the Constitution. In so holding, the court stated that once the IRS initiated a §7604 enforcement proceeding, the statute would afford the taxpayer a sufficient opportunity to seek judicial review of the summonses.

The *Schulz* decision reversed circuit precedent, dating from the early-1960s, as it had been articulated in *Application of Colton* and *In re Turner*. In reversing these decisions, the court stated that its prior holdings had been weakened by the Supreme Court's decision in *Reisman*. Indeed, Judge Henry J. Friendly, the author of *Colton* and *Turner*, recognized as much in *United States v. Kulukundis*. There, Judge Friendly observed that the *Reisman* decision construed the civil and criminal penalty provisions, as set forth in §§7604 and 7210, respectively, as applicable only to persons who "wholly" default or "contumaciously" refuse to comply with a summons, but not those who appear and challenge the summons in good faith. He further wrote that *Reisman's* ruling "seems to destroy the basis underlying decisions of this court which authorized applications to vacate [an IRS] summons (and appeals from their denial) in advance of any judicial proceeding by the Government for their enforcement."[4]

Accordingly, in *Schulz*, the Second Circuit viewed itself as merely "completing a task begun forty years ago," holding that "absent an effort to seek enforcement through a federal court, IRS summonses apply no force to taxpayers, and no consequence whatever can befall a taxpayer who refuses, ignores, or otherwise does not comply with an IRS summons until that summons is backed by a federal court order."

In addition, *Schulz* clarified that, where enforcement of an IRS summons is sought, those subject to the summons must be given ample opportunity to contest the enforcement proceeding. Moreover, once such enforcement is sought, the subject of the summons must be given further opportunity to comply before facing any penalty.

Thus, after *Schulz,* the IRS is authorized to issue summonses under §7602 seeking the appearance of an individual or the production of documents. Such summonses are not self-enforceable, however, and the government must seek its enforcement pursuant to §7604. Furthermore, "if the IRS seeks enforcement of a summons through the courts, those subject to the proposed order must be given a reasonable opportunity to contest the government's request. If a court grants a government request for an order of enforcement … any individual subject to that order must be given a reasonable opportunity to comply and cannot be held in contempt, arrested, detained, or otherwise punished for refusing to comply with the original IRS summons, no matter the taxpayer's reasons or lack of reasons for so refusing."

Currently, a taxpayer has no obligation to produce documents or give testimony in response to an IRS summons prior to its being enforced by the court. While there are limited objections to such enforcement, as a practical matter, the IRS' ability to obtain records or testimony in carrying out its investigations is weakened, as it must seek assistance from the Department of Justice in pursuing enforcement proceedings to effectuate their summonses.

• *Review of Innocent Spouse Status.* In *Maier v. Commissioner,* the Second Circuit considered its authority to hear a petition brought by a husband for review of an IRS ruling according his ex-wife status as an innocent spouse under §6015 of the code.

Section 6015 allows a spouse to request Innocent Spouse Relief from the joint and several liability of joint tax returns. In December 2001, the petitioner's wife sought and obtained innocent spouse status from the IRS. Petitioner claimed this determination was contrary to the couple's agreement, incorporated into their divorce decree, that existing, joint debts of the couple were to remain joint obligations. He sought to object to her innocent spouse classification by filing a petition with the Tax Court appealing the IRS' decision. The Tax Court dismissed the petition for lack of jurisdiction and the Second Circuit affirmed.[5]

It appears there is no external limitation that would preclude New York's commissioner from requiring taxpayers to disclose some federally targeted arrangements.

The court determined that the plain language of the statute did not confer jurisdiction on the Tax Court to hear petitions brought by nonelecting spouses regarding an innocent spouse determination. Acknowledging that legislative action may be required to remedy a "flaw in the controlling statutory provisions," the court nonetheless rejected the petitioner's arguments that he was deprived of various constitutional rights because the Tax Court refused to hear his case.[6] While the court recognized that its holding raised questions about the sufficiency of a statutory scheme, it found itself constrained by the Tax Court's statutory jurisdiction: "Because we cannot read §6015 any other way than to preclude jurisdiction, and because our judicial role does not permit us to rewrite legislation, we agree with the Tax Court that it is without jurisdiction to entertain Mr. Maier's appeal."

'Firm and Fixed Plan' Test

2. Adoption of 'Firm and Fixed Plan' Test to Determine Integration of Multiple Transactions for Tax Purposes. In *Merrill Lynch & Co. v. Commissioner,* the Second Circuit adopted the "firm and fixed plan" test as the appropriate method for determining whether two transactions conducted at different times may be integrated for purposes of §302(b)(3) of the Internal Revenue Code.[7] The "firm and fixed plan" test has been around for some time, but had not yet been reviewed or given the stamp of approval by the Second Circuit.

The facts of the case are as follows. Merrill Lynch & Co. (Merrill) served as the parent corporation to a number of subsidiaries, including Merrill Lynch Capital Resources (Resources). At some point in early-1987, Merrill decided to sell Resources and its multi-million-dollar leasing portfolio by selling its stock in Resources. To allow Merrill to retain certain assets of Resources before the sale, in three "cross-chain sale" transactions, Resources sold stock in some of its subsidiaries to other Merrill subsidiaries for approximately $334 million. These transactions occurred in the spring 1987, according to a plan set in place by a Merrill project team handling the Resources divestiture.

Meanwhile, potential buyers for the remaining Resources business were identified by the Merrill project team and confidentiality agreements were executed with certain of the prospective buyers. On April 23, 1987, Merrill management presented the potential sale of Resources, a profile of the potential buyers and the tax consequences of the sale to the Merrill board. Shortly thereafter, a likely buyer emerged, and the sale ultimately was finalized on June 25, 1987.

The Consolidated Tax Return

In its consolidated tax return, by classifying the cross-chain transactions as dividends pursuant to an interpretation of the code, Merrill increased its basis in Resources and was able to claim a long-term capital loss from the sale of Resources. The commissioner took issue with Merrill's interpretation and corresponding calculations, arguing that the transactions between Merrill subsidiaries were not dividends, but exchanges. As a result, the commissioner concluded that Merrill owed more than $25 million in taxes.

Section 304 of the Internal Revenue Code provides that the sale of stock between companies owned by the same entity is to be treated as a distribution of property in redemption of the stock of the acquiring company for tax purposes. The code further provides that a distribution of property is generally treated as a dividend.[8] However, §302(b) sets forth certain statutory exceptions to this default rule, one of which applies to certain distributions in redemption of stock. Under this exception, when the redemption falls into one of four scenarios, it is to be treated as an exchange rather than a dividend.[9]

In its case against Merrill Lynch, the commissioner argued that the transactions at issue fit the scenario of a selling company completely terminating its interest in the stock of the company being sold through a complete redemption of its stock.[10] In reaching this conclusion, the commissioner determined that the cross-chain sales, which occurred in spring 1987, were part of an overall plan by Merrill to completely terminate its interest in Resources, rather than isolated transactions between Merrill subsidiaries.

Both parties agreed that if the court determined that the cross-chain sales were integrated with the sale of Resources, the commissioner's ruling was accurate and the transactions could not be treated as dividends. The disagreement was whether the transactions could be integrated. The Second Circuit had not yet adopted a test for the integration of transactions when analyzing cases under §302(b)(3). However, the Tax Court and other circuits had uniformly applied the "firm and fixed plan" test. Recognizing that the test had a long history of use in the Tax Court and "provid[ed] the court with a relatively objective measure to consider in reaching its decision," the Second Circuit adopted the test.[11]

The application of the test to the facts of the case was, however, not as clear-cut. Both Merrill and the commissioner agreed that the court had to evaluate the plan in place at the time the cross-chain sales were executed. Merrill argued that the plan to sell Resources was not "firm and fixed" at that time because it had not yet settled on a final buyer. The commissioner countered that Merrill's failure to identify an actual buyer did not prevent the plan from being firm and fixed where there was "objective evidence of an overall plan by Merrill to terminate its interest in Resources, and that this evidence sufficiently supported a finding that the Cross-Chain Sales were an integrated step in Merrill's overall plan to sell Resources."

Second Circuit Decision

In reaching its own conclusion, the Second Circuit focused on numerous Tax Court cases that had been affirmed by other circuits to determine how the "firm and fixed plan" test was applied. In *Niedermeyer v. Commissioner,* the first case to identify the "firm and fixed plan" test by name, the Tax Court had found that a plan by the taxpayers to divest themselves of their holdings in a particular company was not "firm and fixed" where (a) there was no written record of the plan, (b) the only evidence presented by the taxpayers to prove the existence of a plan was their own self-serving testimony, and (c) if such a plan existed at the time of the transactions in question, it was not binding on the taxpayers. Merrill asserted that this language in the *Niedermeyer* case supported their position by requiring that a plan be binding in order to be "firm and fixed." The Second Circuit noted, however, that the *Niedermeyer* Court did not so hold. Rather, the binding nature of the agreement is only one factor to be considered in determining whether a plan is "firm and fixed." Examining all the factors, the Second Circuit found that despite the fact that a binding agreement was not in place in the Merrill sale of Resources, there was "ample" written documentation of Merrill's plan and much of this information had been widely communicated to third-parties.[12] Accordingly, the Second Circuit affirmed the Tax Court's holding that a "firm and fixed plan" was in place at the time the cross-chain sales were made. Therefore, §302(b)(3) excepted the transactions from the default rule that the distribution of property be treated as a dividend, and the deficiencies entered against Merrill based on the sale of Resources were upheld.

1. See John J. Tigue and Jeremy H. Temkin, Tax Litigation Issues: "Question: Who Pays the Tax on Attorney's Fees Awards?", New York Law Journal, Nov. 18, 2004.

2. *Application of Colton,* 291 F.2d 487 (2nd Cir. 1961); *In re Turner,* 309 F.2d 69 (2nd Cir. 1962).

3. 395 F.3d 463 (2nd Cir. 2005); *Reisman v. Caplin,* 375 U.S. 440 (1964).

4. 329 F.2d 197, 199 (2nd Cir. 1964).

5. 360 F.3d 361 (2nd Cir. 2004).

6. The court also noted that the issue of whether the Tax Court has jurisdiction over an appeal by an electing spouse from an adverse determination by the IRS is still open. Id. at 363.

7. 386 F.3d 464, 475 (2nd Cir. 2004).

8. 26 U.S.C. §§301, 316.

9. See 386 F.3d at 468 (describing statutory scheme).

10. Id. at 468-69 (referring to §§302(b)(3) of the Code).

11. Id. at 470-71 (citing *Zenz v. Quinlivan,* 213 F.2d 914 (6th Cir. 1954); *Monson v. Comm'r,* 79 T.C. 827, 1982 WL 11184 (1982); *Roebling v. Comm'r,* 77 T.C. 30, 1981 WL 11263 (1981); *Bleily & Collishaw, Inc. v. Comm'r,* 72 T.C. 751, 1979 WL 3746 (1979), aff'd, 647 F.2d 169 (9th Cir. 1981); *Paparo v. Comm'r,* 71 T.C. 692, 1979 WL 3754 (1979); *Benjamin v. Comm'r,* 66 T.C. 1084, 1976 WL 3648 (1976), aff'd, 592 F.2d 1259 (5th Cir. 1979); *Niedermeyer v. Comm'r,* 62 T.C. 280, 1974 WL 2738 (1974), aff'd, 535 F.2d 500 (9th Cir. 1976)).

12. 386 F.3d at 473. The court also examined the facts of *Bleily & Collishaw, Inc. v. Commissioner,* 72 T.C. 751, 1979 WL 3746 (1979), aff'd, 647 F.2d 169 (9th Cir. 1981), where the majority shareholder of a company bought out the minority shareholder over a series of transactions that took place over almost two years. The Tax Court held that the plan for the buy-out was firm and fixed despite the length of time that had passed. Similarly, although Merrill did not know the exact date of its divestiture in Resources and did not have a binding agreement to sell at the time the cross-chain sales occurred, the Second Circuit stated that the evidence showed Merrill's subjective intent to sell Resources at the time the cross-chain transactions occurred.