

Tax Litigation Issues

Expert Analysis

The Full-Payment Rule Strikes Hard: A Look at a Recent Decision

It has long been settled law that a taxpayer challenging a tax deficiency assessed by the Internal Revenue Service in federal district court is required to “pay first and litigate later.” Thus, under the “full-payment rule” taxpayers have the choice of either paying such a deficiency and suing for a refund in district court or disputing it in Tax Court. However, an April 25, decision by the U.S. Court of Appeals for the Second Circuit in *Larson v. United States*, 888 F.3d 578, applied the so-called “full-payment rule” to preclude pre-payment judicial review of a civil penalty in excess of \$60 million. While the precise factual scenario giving rise to *Larson* may be rare, the rule applied in that case also impacts numerous penalty regimes, and the result was sufficiently troubling to the court that it encouraged Congress to redress the anomaly.

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The Full-Payment Rule

The statutory basis for the full-payment rule is 28 U.S.C. Section 1346(a)(1), which provides federal district courts with original jurisdiction over any civil action against the United States for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws.

In *Flora v. United States*, 357 U.S. 63 (1958) (*Flora I*), the Supreme Court held that Section 1346(a)(1) did not alter the well-established

principle of “pay first and litigate later.” Two years later, in *Flora v. United States*, 362 U.S. 145 (1960) (*Flora II*), the court affirmed *Flora I* on rehearing and reiterated that full payment is required before a taxpayer may bring an income tax refund suit in federal court. In both *Flora I* and *Flora II*, the court pointed to the existence of the Board

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of Tax Appeals—now known as the Tax Court—as “ameliorating the hardship” caused by the full-payment rule.

Flora I and *Flora II* also recognized a narrow exception to the full-payment rule for taxes that may be “divisible” based on separate transactions or events. For example, the Court in *Flora II* suggested that excise taxes—which are assessed per item—are divisible

and therefore exempt from the full payment rule.

'Larson'

In 2005, John Larson was indicted in the Southern District of New York in connection with his participation in the design, implementation, and marketing of fraudulent tax shelters developed by KPMG in the 1990s. In December 2008, he was convicted of 12 counts of tax evasion following a 10-week jury trial, and he was subsequently sentenced to 121 months imprisonment and a \$6 million fine. The Second Circuit affirmed the conviction and term of imprisonment in October 2010, see *United States v. Pfaff*, 407 F. App'x 506 (2d Cir. 2010), but vacated the fine, see *United States v. Pfaff*, 619 F.3d 172 (2d Cir. 2010).

In February 2011, the IRS notified Larson that it was initiating proceedings relating to his failure to register two of the tax shelters at issue in the criminal case in violation of Section 6111(a) of the Internal Revenue Code, see *Larson v. United States*, No. 16 Civ. 245 (VEC), 2016 WL 7471338 (S.D.N.Y. Dec. 28, 2016). 26 U.S.C. Section 6707(a)(1) provides that an individual who is required to register a tax shelter, but fails to do so without reasonable cause, is liable for a penalty, and the IRS subsequently assessed a total of \$160,232,026 in penalties. Larson sought review of the assessment by the IRS Office of

Appeals, which reduced the penalty by nearly \$100 million in light of payments received from other promoters who were jointly and severally liable with Larson. The IRS then informed Larson that his case was ineligible for Tax Court review since he was not entitled to receive a notice of deficiency with respect to the Section 6707 penalty, and that he would have to pay the assessed penalty before he could file suit in either district court or the Court of Federal Claims.

Larson made a partial payment of \$1,432,735 in February 2015, and then submitted a claim for refund and request for abatement to the IRS, seeking a refund of his partial payment and full abatement of the assessed penalty. The IRS denied this request, stating that the penalty was "nondivisible" and must be paid in full before Larson could commence a refund suit.

Application of the Full-Payment Rule

In January 2016, Larson filed suit in the U.S. District Court for the Southern District of New York seeking, among other relief, a refund of his partial payment and abatement of the entire penalty amount. The government moved to dismiss Larson's complaint on the grounds that the court lacked subject matter jurisdiction because Larson had not paid the full assessed penalty.

Agreeing with the government, Judge Valerie Caproni found that the full-payment rule prevented the court from exercising jurisdiction. Noting that no court in the Second Circuit had addressed the question previously, Judge Caproni held that penalties assessed under Section 6707 are not divisible because liability under that provision was triggered by the "single act" of failing to register a tax shelter. As a result, Judge Caproni barred Larson from taking advantage of the narrow exception to the full-payment rule.

Larson also argued that, under *Flora I* and *Flora II*, the full-payment rule was not intended to apply to cases like his, where prepayment review by the Tax Court was unavailable. Judge Caproni declined to create the exception to the full-payment rule urged by Larson, observing that the Tax Court was created by Congress's "legislative grace" rather than by constitutional requirement. She went on to find Larson's other arguments to be without merit and granted the government's motion to dismiss the complaint.

Larson fared no better on his appeal to the Second Circuit. Specifically, the court rejected Larson's argument that the full-payment rule only applies to tax deficiency cases where relief in the Tax Court is available, noting that Section 1346(a)(1) does not differentiate between penalties and other assessments

resulting from deficiencies. The court held that the full-payment rule was appropriately applied in Larson's case in light of the plain language of Section 6707, which does not provide for judicial review after partial payment of penalties thereunder, and the fact that Congress expressly provided for such review for certain other assessable penalties.

The court also rejected Larson's argument that the Supreme Court's reliance in *Flora I* and *Flora II* on the availability of pre-payment review in Tax Court supports his position that the full-payment rule is limited to challenges to tax deficiencies. Rather, the Second Circuit found that the availability of Tax Court review was not essential to the conclusion in the *Flora* cases, and emphasized that those cases recognized the government's "substantial interest" in maintaining the smooth functioning of the taxation system that Congress designed. As such, the Second Circuit declined to create a requirement that an alternative review forum be available for the full-payment rule to apply.

The Second Circuit also rejected Larson's further argument that application of the full-payment rule violated his Fifth Amendment right to due process. Quoting the U.S. Supreme Court's decision in *Morrissey v. Brewer*, 408 U.S. 471 (1972), the court noted that "due process is flexible and calls for such proce-

dural protections as the particular circumstance demands." Rather, under *Mathews v. Eldridge*, 424 U.S. 319 (1976), "the ultimate balance involves a determination as to when, under our constitutional system, judicial-type procedures must be imposed upon administrative action to assure fairness." While acknowledging that "Larson's interest is not insignificant," the court concluded that the government's right to collect internal revenue through administrative proceedings is well established and permissible,

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so long as adequate post-payment judicial review is available. The court also observed that Larson's penalty was reduced by nearly \$100 million by the IRS Office of Appeals, and that he raised no complaints about the appeal procedure itself.

Despite affirming the dismissal of Larson's complaint, in its conclusion, the Second Circuit noted that the idea that a taxpayer could be assessed a large penalty that must be paid before judicial review is available was "troubling"—particularly where the taxpayer is unable to pay the full amount of the penalty, as Larson claimed to be.

Nonetheless, the court observed that "it is Congress' responsibility to amend the law" to cure any hardship.

Conclusion

While the hurdles facing a tax shelter promoter fighting a multimillion penalty might seem irrelevant to most taxpayers, *Larson* has potentially far-reaching implications. Acknowledging the oddity of its "weighing in on a case involving a tax shelter promoter," the Legal Services Center of Harvard Law School's Federal Tax Clinic filed an amicus brief with the Second Circuit arguing that, given the wide range of assessable civil penalties available to the IRS, the application of the full-payment rule in *Larson* could have wide-ranging impact on low-income taxpayers. Absent Supreme Court review, however, it will be up to Congress to provide a forum for taxpayers to obtain meaningful judicial review of such penalties in the future.