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TAX LITIGATION ISSUES

Expert Analysis

Anticipating Justice Amy Coney Barrett's Role in Tax Jurisprudence

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On Oct. 27, 2020, following a swift yet politically fraught confirmation, Amy Coney Barrett replaced the late Ruth Bader Ginsberg as the ninth sitting justice on the Supreme Court. In 2017 and 2018, this column reviewed Circuit Court opinions authored by Justices Neil Gorsuch and Brett Kavanaugh in an attempt to foresee how each might approach criminal tax cases that come before the court. In her brief tenure on the U.S. Court of Appeals for the Seventh Circuit, Justice Barrett sat on panels that decided five criminal tax cases. Unfortunately, Justice Barrett did not write any majority, concurring or dissenting opinions in those cases and none of them addressed controversial issues.

Justice Barrett did, however, write unanimous opinions in two civil tax cases: *A.F. Moore & Associates v. Maria Pappas*, 948 F.3d 889 (7th Cir. 2020), in which the court concluded that the Tax Injunction Act did not bar a Constitutional challenge to Cook County's tax assessment scheme, and *VHC v. Commissioner of Internal Revenue*, 968 F.3d 839 (7th Cir. 2020), in which the court rejected a family business's attempt to deduct as bad debts payments made to a family member. Although these decisions do not foreshadow how Justice Barrett will address "hot button" issues that will come before the court in the years to come, they are noteworthy for the thoughtful approach taken to the issues presented.

'A.F. Moore'

In *A.F. Moore*, the plaintiffs initially filed a lawsuit in Illinois state court contending that Cook County violated the Equal Protection Clause of the United States Constitution by assessing properties that they owned at rates mandated by local ordinance, while applying lower rates to similarly situated properties. After their state court action was tied up in litigation for over ten years, the taxpayers brought an

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action in federal district court alleging, among other things, that the Illinois "tax-objection procedures" violated the due process clauses of the United States and Illinois Constitutions. The district court dismissed the lawsuit under the Tax Injunction Act, 28 U.S.C. §1341,

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which bars federal district courts from "enjoin[ing], suspend[ing] or restrain[ing] the assessment, levy or collection of any tax under State law where a plain speedy and efficient remedy may be had in the courts of such State."

Under the Supreme Court's decision in *Rosewell v. LaSalle Nat'l Bank*, 450 U.S. 503, 514 (1981), the taxpayers could only avoid the Tax Injunction Act's jurisdictional bar by demonstrating that the state law denied them a complete hearing on any and all constitutional objections. Writing for a unanimous panel of the Seventh Circuit, then-Judge Barrett noted that the taxpayers' "particular constitutional objection is that the Assessor violated the Equal Protection Clause by valuing their properties correctly under the Cook County ordinance but cutting everyone else a break with a lower de facto tax rate." The plaintiffs argued that because Illinois state law limited them to challenging the correctness of the valuation and prevented them from probing into the Assessor's methodology or intent, they were deprived of a forum to litigate their Equal Protection claim, which required that they establish that there was no rational basis for the disparate treatment.

Instead of countering the plaintiffs' assertions, the defendants argued that, by dispensing with an examination of the Assessor's methodology or intent, the Illinois procedures for raising objections was more "plain, speedy and efficient." Then-Judge Barrett rejected this argument, writing that although this may be true for many taxpayers asserting claims, such efficiency "is no good to the taxpayers if it means that they cannot bring their equal protection claim in state court."

'VHC'

In *VHC*, a family-held corporation advanced a total of $132 million to Ron Van Den Heuvel, a shareholder and executive. Ron used these payments primarily to support his business ventures, but also used some of the funds to pay personal expenses. Ron repaid only a small portion of the advances, and VHC ultimately wrote-off $95 million as "bad debts."

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After a lengthy audit, the IRS disallowed the bad debt deduction, concluding that VHC never intended that the payments to Ron (or on his behalf) would be repaid, and thus that the payments did not qualify as bona fide debts. After a 10-day trial, the Tax Court rejected VHC's challenge to the assessment and agreed that the payments were not deductible because VHC and Ron "lacked a bona fide debtor-creditor relationship." The Tax Court also rejected VHC's alternative argument that the payments to Ron were deductible as ordinary and necessary business expenses because a creditor, Associated Bank, had conditioned the continuation of VHC's line of credit on VHC guaranteeing Ron's separate debts to Associated Bank. The Tax Court, however, provided some relief, concluding that the determination that the payments were not bona fide debts precluded treating unpaid accrued interest on the outstanding balance as taxable income to VHC.

On appeal, VHC argued that the Tax Court had erred in determining that the unrepaid advances were not deductible. Writing for a unanimous panel, then-Judge Barrett agreed with the IRS that VHC's payments to Ron were neither bona fide debts nor ordinary and necessary business expenses and thus that they were not deductible under either theory.

At the outset of her analysis, then-Judge Barrett described the "steep climb" that VHC faced in disputing the assessment. She emphasized the taxpayer's burden to prove that the assessment was erroneous and that, given the "presumption of correctness" accorded to IRS assessments, VHC was required to show that the challenged determination "lacks a rational foundation or is arbitrary and excessive."

The court then noted that while the Internal Revenue Code permits taxpayers to deduct the non-recoverable part of worthless debt written off during a tax year, the regulations provide that "[o]nly bona fide debt qualifies" for a deduction and defines "bona fide debt" as debt that "arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money," and excludes any "gift or contribution to capital." Then-Judge Barrett decided that it was unnecessary to "belabor" an analysis of the factors considered by the Tax Court in rejecting the purported debtor-creditor relationship, and agreed with the Tax Court's conclusion that "the way that VHC described the advances does not match the way VHC and Ron treated [the] payments," including the fact that VHC routinely deferred payment or renewed the notes without any receipt of payment and acted to suggest that it did not expect to be repaid unless Ron secured additional investments and projects. Based on this evidence, then-Judge Barrett concluded that VHC appeared to be an investor in Ron's ventures, rather than a creditor.

With respect to VHC's alternative argument that the payments to Ron were deductible as "ordinary and necessary business expenses" because Associated Bank had threatened to terminate VHC's line of credit, forcing VHC into bankruptcy, if it did not lend Ron money to pay his own debts to Associated, then-Judge Barrett focused on VHC's failure both to substantiate its claimed business expenses and to establish that the expenditures were, in fact, ordinary and necessary for the purpose of carrying on its business. Most critically, she determined that VHC "made no showing whatsoever" that payments such as those to Ron ordinarily occur in VHC's industry, and rejected VHC's argument that securing a line of credit comprises an ordinary part of any business as an oversimplification and highlighted the unusual nature of VHC's arrangement with Associated, whereby VHC's credit depended on its support of a third party.

Conclusion

Justice Barrett's decisions in *A.F. Moore* and *VHC* reflect a careful, analytical approach to the civil tax issues presented. While *A.F. Moore* was a "rare case" in which the Tax Injunction Act was found inapplicable, the defendants' concessions that Illinois state law did not provide a forum made "a potentially complex issue a great deal simpler" and thus the business-friendly result in that case may not reveal much about Justice Barrett's willingness to delve into matters of state tax law. Similarly, while the Seventh Circuit ultimately sided with the IRS and rejected the favorable tax treatment sought by the small, family-owned business in *VHC*, nothing in that decision suggests that Justice Barrett will pursue a broader policy agenda in civil tax disputes.

While it will be of little comfort to those who questioned the timing of Justice Barrett's appointment and confirmation, much of the work of the Supreme Court falls outside of the high-profile, politically charged issues that serve as the focal point of confirmation fights. At 48 years old, Justice Barrett will have a significant impact on the development of the law for many years to come and, based on her decisions in *A.F. Moore* and *VHC*, there is no reason to doubt that, at a minimum, she will ably contribute to the "blocking and tackling" that makes up much of the court's docket.