2015 FEDERAL TAXATION

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The Fifth Circuit Federal Taxation reporting period was July 1, 2013, to June 30, 2014. During this period, the Fifth Circuit considered more cases involving federal taxation than it has in many prior years, but only seven cases were of interest for purposes of this Survey.

Tax shelters of an earlier time continue percolating through the system as taxpayers contest penalties—some of which derive from valuation errors—while the government imposes other penalties on account of the aggressive nature of the tax positions some entities adopt.[1] The inscrutable Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership provisions were the subject of one opinion.[2]

Other subjects seen in this collection of Fifth Circuit opinions are: limitations periods for refunds—involving the mitigation provisions of §§ 1311–1314—not often seen in decided cases;[3] tax accounting questions involving accrual or cash-basis accounting systems for a ranch;[4] qualified research tax credits;[5] and taxation of deemed income from a controlled foreign corporation as ordinary income or capital gain.[6]

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1. *See infra* Part II.
2. *See infra* Part III.
3. *See infra* Part IV.
4. *See infra* Part V.
5. *See infra* Part VI.
6. *See infra* Part VII.

I. *WHITEHOUSE HOTEL L.P. V. COMMISSIONER*

In *Whitehouse Hotel L.P. v. Commissioner*, the Fifth Circuit considered the matter of the New Orleans Ritz-Carlton Hotel and condominium complex for the second time.[7] The modern hotel was created by restoring two historical properties, the Maison Blanche building—built in 1906–1908—and the contiguous Kress building.[8] The prior case concerned the valuation of the qualified conservation easement donated to a non-profit historical preservation society.[9] The easement burdened the property with restrictions and conditions, mostly having to do with the ornate façade.[10]

The taxpayer was a Louisiana limited partnership that claimed a 1997 charitable deduction of $7.445 million for a charitable contribution of a historic-preservation façade easement.[11] The IRS allowed only a $1.15 million deduction for the easement and imposed a 40% gross undervaluation penalty.[12] In the first tax court case—which the tax court tried in 2006 and issued its opinion for in 2008—the taxpayer challenged the IRS both on the amount of the charitable contribution and the imposition of the penalty.[13] The taxpayer's appraisal valued the easement at $10 million, while the IRS's appraiser remarkably valued the easement at zero.[14] The two appraisers disagreed on nearly all aspects of the property.[15]

The tax court blended the analysis of the two appraisals.[16] The key points by the tax court were: (1) "there was no difference in the highest and best use before and after the [easement] conveyance"; (2) use of the reproduction-cost approach was inappropriate because the owners could not rebuild the façade if the property was destroyed; and (3) the income approach should not apply because it relied on various assumptions and did not contain an overall risk of error.[17]

The value of the conservation easement involved a calculation of the difference in the pre- and post-easement valuation of the building.[18] The first tax court trial was a contest between competing appraisers.[19] Ultimately, the

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7. Whitehouse Hotel L.P. v. Comm'r, 755 F.3d 236, 238 (5th Cir. June 2014); *see* Whitehouse Hotel L.P. v. Comm'r, 615 F.3d 321 (5th Cir. 2010); William D. Elliott, *2011 Review of Income Taxation*, 44 TEX. TECH L. REV. 717, 728 (2012).

8. *Whitehouse Hotel L.P.*, 755 F.3d at 239.

9. *See id.* (discussing the basis of the previous case and the Fifth Circuit's ruling in 2010).

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.* (citing Whitehouse Hotel L.P. v. Comm'r, 131 T.C. 112 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010)).

14. *Id.* at 240.

15. *See id.* at 239–40.

16. *Id.* at 240.

17. *Id.* (citing *Whitehouse Hotel L.P.*, 131 T.C. at 133–35).

18. *Id.* at 239.

19. *See id.* at 239–40 (illustrating the differing appraisals).

tax court valued the conservation easement at $1,792,301.[20] The taxpayer's value of $7,445,301 was 415% higher than the value the tax court calculated.[21] According to the Internal Revenue Code (I.R.C.), if a declaration is misstated by at least 400%—as was the taxpayer's declaration in this case—a 40% undervaluation penalty may be imposed.[22]

The taxpayer did not present any evidence demonstrating that the valuation came within a "reasonable cause exception" of I.R.C. § 6664(c)(3).[23] Therefore, the tax court upheld the penalty, concluding that the taxpayer failed to come within the good-faith exception.[24]

The 2010 Fifth Circuit opinion vacated the tax court's holding and remanded the case.[25] The Fifth Circuit's remand instructions required the tax court to: "(1) reconsider all valuation methods, not just the comparable sales method; (2) determine the parcel's 'highest and best use' for the purposes of its valuation," with a specific direction that the tax court find "whether the highest and best use would be as [a] luxury hotel actually being built or instead as a non-luxury hotel"; and "(3) consider the effect of the easement on the Kress building, even if the easement itself did not specifically burden that building under relevant Louisiana law."[26]

The manner in which the tax court and the Fifth Circuit disagreed with each other is surprising, especially considering the usual restraint seen in judicial opinions—even opinions involving disagreement. Not so here. On remand, the tax court continued to disagree with the Fifth Circuit about whether the easement prevented construction on top of the Kress Building. The Fifth Circuit called the tax court's actions "judicial insubordination"—quite a remarkable expression from a court of appeals.[27] The tax court—after going out of its way to continue to openly announce that it considered the Fifth Circuit's holding an error, as it did in the first remand—nevertheless complied with the Fifth Circuit's instruction and determined the effect of the easement assuming no development was possible atop the Kress Building.[28] In this 2014 case, the Fifth Circuit noted the disagreeable manner in which the tax court undertook its remand instructions; nevertheless, the Fifth Circuit did not find error.[29]

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20. *Id.* at 240.
21. *Id.* (citing *Whitehouse Hotel L.P.*, 131 T.C. at 172).
22. *Id.* (citing I.R.C. § 6662(h)(2)(A)(i) (amended 2014)).
23. *Id.* at 240–41.
24. *Id.* (citing *Whitehouse Hotel L.P.*, 131 T.C. at 175).
25. Whitehouse Hotel L.P. v. Comm'r, 615 F.3d 321, 330–31 (5th Cir. 2010), *vacating*, 131 T.C. 112 (2008).
26. *Whitehouse Hotel L.P.*, 755 F.3d at 241 (citing *Whitehouse Hotel L.P.*, 615 F.3d at 343).
27. *Id.* at 243.
28. Whitehouse Hotel L.P. v. Comm'r, 139 T.C. 304, 340 (2012), *aff'd in part*, *vacated in part*, 755 F.3d 236 (5th Cir. June 2014).
29. *Whitehouse Hotel L.P.*, 755 F.3d at 243.

The Fifth Circuit instructed the tax court to find the highest and best use of the property, but the tax court continued its quarrelsome way by stating that "the highest and best use of property does not itself identify the fair market value."[30] The tax court nevertheless did what the Fifth Circuit asked, though reluctantly, and concluded that the highest and best use of the property was either as a luxury hotel or as a non-luxury hotel, and that the property value would not be increased either way.[31] The Fifth Circuit, in this 2014 opinion, concluded that the tax court gave the necessary weight to the highest and best use of the property and, thus, did not find error.[32]

On remand, the tax court continued to reject the value of the reproduction-cost method, reasoning that rebuilding a historic structure to its historic form would not make business sense.[33] In its 2014 opinion, the Fifth Circuit did not find error in the tax court's conclusion with regard to the reproduction-cost method; although the court acknowledged that limited repairs might make sense, this was not enough to reverse.[34]

The tax court rejected again—as it did the first time—the income approach.[35] The tax court found that the taxpayer's appraiser used unreliable evidence, and thus the appraisal did not need to consider non-local comparable sales.[36] In a broader context, the tax court found the taxpayer's appraisal report prone to error and based on unverifiable assumptions.[37] In its 2014 opinion, the Fifth Circuit did not find error.[38]

The most prominent issue in this 2014 Fifth Circuit case is relief from the accuracy-related penalty imposed when a taxpayer reasonably relies on professionals.[39] The taxpayer claimed that because it relied on professionals in good faith, it should not be charged with a 40% gross undervaluation penalty.[40] The tax court originally rejected this claim.[41] The 2010 Fifth Circuit decision did not address this issue because it remanded the case back to the tax court to address the easement valuation issue.[42] In its 2014 decision, the Fifth Circuit upheld the valuation the tax court reached on remand.[43] Thus, the Fifth Circuit's consideration of the good-faith-reliance defense was the heart of the case.

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30. *Whitehouse Hotel L.P.*, 139 T.C. at 331 (citing APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 277–78 (13th ed. 2008)).
31. *Id.* at 336–37.
32. *Whitehouse Hotel L.P.*, 755 F.3d at 244.
33. *Whitehouse Hotel L.P.*, 139 T.C. at 316.
34. *Whitehouse Hotel L.P.*, 755 F.3d at 246.
35. *Whitehouse Hotel L.P.*, 139 T.C. at 326–27.
36. *Id.* at 337 n.15.
37. *Id.* at 323.
38. *Whitehouse Hotel L.P.*, 755 F.3d at 247.
39. *Id.* at 249.
40. *Id.* at 239, 242.
41. *Whitehouse Hotel L.P.*, 139 T.C. at 361.
42. Whitehouse Hotel L.P. v. Comm'r, 615 F.3d 321, 334–35 (5th Cir. 2010).
43. *Whitehouse Hotel L.P>*, 755 F.3d at 250.

The legal requirements for the good-faith exception are found in § 6664(c)(3)(A)–(B) of the I.R.C.[44] The deduction for charitable contribution of a conservation easement requires a taxpayer to base the claimed deduction on a qualified appraisal, and in addition, to ensure that a good-faith investigation of the easement's value be made.[45] The tax court found that "the record [was] bare of any evidence supporting" a conclusion that Whitehouse undertook any investigation of the amount of the deduction for the conveyance of the easement, and the tax court presumed that the tax professionals did not undertake any such investigation either.[46] The Fifth Circuit disagreed and found a good-faith investigation existed.[47]

The Fifth Circuit looked at the totality of the facts and circumstances.[48] The taxpayer obtained two appraisals, with the second appraisal acting as a check on the first appraisal.[49] The taxpayer's accountants prepared the partnership tax return.[50] The Fifth Circuit held these steps were sufficient to show a good-faith investigation as required by § 6664(c)(3)(B) of the I.R.C.[51] Thus, the Fifth Circuit vacated the tax court's holding, finding that imposition of the gross valuation penalty was clearly erroneous.[52]

The Fifth Circuit's 2014 *Whitehouse* decision illustrates the complexity and expensive nature of litigating a valuation case.[53] Considerable resources were expended in this case with two tax court cases and two Fifth Circuit appeals.[54] All the taxpayer really got out of the litigation was relief from the gross undervaluation penalty.

II. *KLAMATH STRATEGIC INVESTMENT FUND, LLC EX REL. ST. CROIX VENTURES, LLC V. UNITED STATES*

The Fifth Circuit decision in *Klamath Strategic Investment Fund, LLC ex rel. St. Croix Ventures, LLC v. United States*, dated March 3, 2014, is a sequel to a larger set of cases arising from an investment in a tax shelter by some rich Texas plaintiff lawyers and involved the deductibility of

44. I.R.C. §§ 6664(c)(3)(A)–(B) (2014). The location of the reasonable-cause exception in § 6664(c) changed in the time between the 2010 Fifth Circuit opinion and the 2014 Fifth Circuit opinion. *Compare id.* (demonstrating the current placement of the reasonable-cause exception), *with* I.R.C. § 6664 (c)(2) (2010) (showing that in 2010, the correct reference was I.R.C. § 6664(c)(2), which is different from the 2014 reference of I.R.C. § 6664(c)(3)).
45. I.R.C. §§ 6664(c)(3)(A)–(B).
46. *Whitehouse Hotel L.P.*, 139 T.C. at 361.
47. *Whitehouse Hotel L.P.*, 755 F.3d at 250.
48. *Id.* at 249.
49. *Id.* at 250.
50. *Id.*
51. *Id.*
52. *Id.*
53. *See supra* Part I.
54. *Id.*

accounting fees incurred in a so-called Bond Linked Issue Premium Structure (BLIPS) transaction.[55]

The extensive litigation history of the case is briefly summarized here, but the convoluted case history is confusing:

(*Klamath I*): *Klamath Strategic Investment Fund, LLC ex rel. St. Croix Ventures, LLC v. United States*.[56] The district court found a contingent obligation, and not a fixed and determined liability, within § 752 for a premium portion of the loans received from the bank in connection with the funding of the instruments contributed to a partnership.[57] The transaction predated Notice 2000-44, an IRS tax-shelter blacklist that extended to Son-of-BOSS transactions.[58] The district court held a contrary regulation, Treasury Regulation § 1.752-6, to be invalid.[59] The court also found that clear authority existing at the time of the transaction stated that the premium portion of the loan did not reduce the taxpayer's basis in the partnership.[60]

(*Klamath II*): *Klamath Strategic Investment Fund, LLC v. United States*.[61] The district court found a lack of economic substance because the loans "would not be used to provide leverage for foreign currency transactions."[62] The district court did not apply any penalties because the taxpayers did not make a 1999 investment, the taxpayers thought they were investing in foreign currencies, and the tax opinions supporting the transactions—which relied on relevant authorities set forth in the district court's earlier opinion—provided "substantial authority" for the taxpayers' treatment of their basis in their partnerships.[63]

(*Klamath III*): *Klamath Strategic Investment Fund, LLC v. United States*.[64] The district court held that even though the loans lacked economic substance, the transactions still existed, and thus, the district court's grant of summary judgment on the non-retroactivity of the regulations under § 752

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55. Klamath Strategic Inv. Fund, LLC *ex rel.* St. Croix Ventures, LLC v. United States (*Klamath VI*), 557 F. App'x 368, 369 (5th Cir. Mar. 2014) (per curiam); *see also* NPR Invs., L.L.C. *ex rel.* Roach v. United States, 740 F.3d 998, 1001–02 (5th Cir. Jan. 2014) (involving the same Texas plaintiff lawyers and their investment in a variation of a Son-of-BOSS tax shelter). Basically, the Fifth Circuit held that the district court had jurisdiction to determine the applicability of the 40% gross valuation misstatement penalty but overruled the district court's taxpayer-friendly rulings on penalties and the reasonable cause defense. *NPR Invs., LLC*, 740 F.3d at 1000.

56. Klamath Strategic Inv. Fund, LLC *ex rel.* St. Croix Ventures, LLC v. United States (*Klamath I*), 440 F. Supp. 2d 608 (E.D. Tex. 2006).

57. *Id.* at 617.

58. *Id.* at 622–26 (citing I.R.S. Notice 2000-44, 2000-36 I.R.B. 255 (Aug. 13, 2000)).

59. *Id.* at 623–25.

60. *Id.* at 623–26.

61. Klamath Strategic Inv. Fund, LLC v. United States (*Klamath II*), 472 F. Supp. 2d 885 (E.D. Tex. 2007), *aff'd*, 568 F.3d 537 (5th Cir. 2009).

62. *Id.* at 896.

63. *Id.* at 892.

64. Klamath Strategic Inv. Fund, LLC v. United States (*Klamath III*), Nos. 5:04-CV-278, 5:04-CV-279, 2007 WL 1051766 (E.D. Tex. Apr. 3, 2007), *vacated*, 568 F.3d 537 (5th Cir. 2009).

was not premised on invalid factual assumptions.[65] Also, the district court found that the existence of profit motive for deduction of operational expenses was based on the purposes of the individual taxpayers and not on the motives of the managing partner.[66]

(*Klamath IV*): *Klamath Strategic Investment Fund ex rel. St. Croix Ventures v. United States*.[67] The Fifth Circuit issued a ruling that was adverse to the taxpayers on their cross-appeal of the holding that the transaction lacked economic substance; the court followed the majority rule, which "is that a lack of economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance."[68] The Fifth Circuit opinion stated, "Thus, if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations."[69]

The Fifth Circuit ruled against the IRS on the Government's appeal of the non-imposition of penalties and stated the following:

> The district court found that Patterson and Nix sought legal advice from qualified accountants and tax attorneys concerning the legal implications of their investments and the resulting tax deductions. They hired attorneys to write a detailed tax opinion, providing the attorneys with access to all relevant transactional documents. This tax opinion concluded that the tax treatment at issue complied with reasonable interpretations of the tax laws. At trial, the Partnerships' tax expert [Stuart Smith] concluded that the opinion complied with standards established by Treasury Circular 230, which addresses conduct of practitioners who provide tax opinions. Overall, the district court found that the Partnerships proved by a preponderance of the evidence that they relied in good faith on the advice of qualified accountants and tax lawyers.[70]

The Fifth Circuit's decision arose from an appeal from the district court's opinion that allowed the partners in the partnership and those who controlled the partnership, when certain operating expenses were incurred, to personally deduct the accounting fees paid to explore investment opportunities.[71] The partnership initially paid a fee of $250,000 to the

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65. *Id.* at *1.
66. *Id.* at *3.
67. Klamath Strategic Inv. Fund, LLC *ex rel.* St. Croix Ventures, LLC v. United States (*Klamath IV*), 568 F.3d 537 (5th Cir. 2009).
68. *Id.* at 544.
69. *Id.*
70. *Id.* at 548.
71. Klamath Strategic Inv. Fund, LLC v. United States (*Klamath V*), Nos. 5:04-CV-278, 5:04-CV-279, 2012 WL 4889805, at *5 (E.D. Tex. Sept. 24, 2012), *aff'd*, 557 F. App'x 368 (5th Cir. Mar. 2014).

accounting firm that made the referral to the company that organized the currency strategy.[72]

In *Klamath III*, the district court allowed the deduction of operational and interest expenses because it found that the individual partners had a profit motive.[73] In *Klamath IV*, the Fifth Circuit vacated the district court's opinion, reasoning that the district court erred when it failed to find whether the two individuals controlled the partnerships at the time the expenses were incurred.[74] The Fifth Circuit remanded the case to the district court to answer this question.[75] On remand, the district court found, based on various facts that the two individuals did effectively control the partnership: the two individuals established parameters for the partnership to operate, confined the partnership to the chosen investment strategy, and controlled the ending of the partnership.[76]

The district court held it had jurisdiction because the Fifth Circuit remanded the question to the district court and would not have done so if the district court did not have the requisite jurisdiction.[77]

The Fifth Circuit upheld the district court's opinion.[78] In deciding that the two individuals effectively controlled the partnership, the district court used factual findings, which the Fifth Circuit accepted.[79] Previously, the Fifth Circuit had identified the district court's factors as insufficient.[80] This time, however, the district court utilized acceptable factual findings.[81] The Fifth Circuit found the factors used were legally relevant factors.[82]

The Fifth Circuit resolved the jurisdiction issue by using a law of the case doctrine.[83] The doctrine applied because courts in earlier case proceedings had considered jurisdiction questions and exercised jurisdiction without explanation.[84] Thus, the law of the case was that the district court had jurisdiction.[85]

The best comment about this final chapter in the *Klamath* saga may be, perhaps, that the case is now concluded.

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72. *Id.*
73. *Id.* at *6.
74. *Klamath IV*, 568 F.3d at 551.
75. *Id.* at 553.
76. *Klamath V*, 2012 WL 4889805, at *5.
77. *Id.* at *6.
78. Klamath Strategic Inv. Fund, LLC *ex rel.* St. Croix Ventures, LLC v. United States (*Klamath VI*), 557 F. App'x 368, 376 (5th Cir. Mar. 2014) (per curiam).
79. *Id.* at 373.
80. *Klamath IV*, 568 F.3d at 551.
81. *Klamath VI*, 557 F. App'x at 373.
82. *Id.* at 373–74.
83. *Id.* at 376.
84. *Id.* (citing USPPS, Ltd. v. Avery Dennison Corp., 647 F.3d 274, 283 (5th Cir. 2011)).
85. *Id.* (citing *USPPS, Ltd.*, 647 F.3d at 283).

III. *IRVINE V. UNITED STATES* & *KERCHER V. UNITED STATES*

In addition to the cases involving remnants of tax shelters of the 1999–2000 time period, such as *Klamath*, two cases decided on the same day, *Irvine v. United States*[86] and *Kercher v. United States*,[87] presented more questions arising from TEFRA[88] litigation involving AMCOR partnership transactions, which like tax-shelter litigation in general, seems endless.[89] These cases were brought by experienced tax counsel who were among the most knowledgeable of TEFRA-proceedings rules.[90] Taxpayers in both cases "assert[ed] that the IRS's assessment of additional taxes fell outside the applicable statute of limitations and that the IRS erroneously applied penalty interest."[91] In *Irvine*, the taxpayers successfully turned back an attempt to impose enhanced interest, authorized by § 6621(c), for tax-motivated transactions.[92] In *Kercher*, the Fifth Circuit held that "the district court[] lacked jurisdiction over both the statute of limitations claims and the penalty interest claims" and that the argument that the assessment for one tax year was invalid as a mere estimate of liability was not timely.[93]

A leading tax litigation treatise describes the confusing circumstances present in many of the TEFRA-level partnership proceeding cases as follows: "The bifurcation between partnership-level penalty determinations and partner-level penalty defenses has spawned considerable litigation and confusion as to what constitutes a partner-level defense."[94] The *Irvine* and *Kercher* cases present such circumstances.[95]

The taxpayers in *Irvine* argued that as a matter of law § 6621(c) cannot be imposed absent a finding that partnership transactions were tax motivated, which they argued had not occurred in this case, either in the applicable partnership proceedings or in settlements of the case.[96] The Fifth Circuit held for the taxpayers on this issue.[97]

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86. Irvine v. United States, 729 F.3d 455, 455 (5th Cir. Sept. 2013), *cert. denied*, 134 S. Ct. 1777 (2014).

87. Kercher v. United States, 539 F. App'x 517, 517 (5th Cir. Sept. 2013) (per curiam), *cert. denied*, 134 S. Ct. 1776 (2014).

88. *See* I.R.C. §§ 6221–6234 (2014).

89. *See generally* Weiner v. United States, 389 F.3d 152 (5th Cir. 2004) (describing the TEFRA provisions).

90. *See generally* Josh N. Wheeler, *Rough Sailing for TEFRA Partnerships*, AICPA (Sept. 1, 2013), http://www.aicpa.org/Publications/TaxAdviser/2013/September/Pages/clinic-story-09.aspx (describing the complexity of the TEFRA rules).

91. *Irvine*, 729 F.3d at 457; *Kercher*, 539 F. App'x at 519.

92. *Irvine*, 729 F.3d at 465.

93. *Kercher*, 539 F. App'x at 519.

94. GERALD A. KAFKA ET AL., LITIGATION OF FEDERAL CIVIL TAX CONTROVERSIES ¶ 9.03[1] (Thompson Reuters Tax & Accounting 2015).

95. *See Irvine*, 729 F.3d at 455; *Kercher*, 539 F. App'x at 517.

96. *Irvine*, 729 F.3d at 463.

97. *Id.* at 465.

The Government, in *Irvine*, did not succeed in asserting its various arguments. First, the Government argued that the district court lacked jurisdiction to determine whether a partnership's transaction was tax motivated, reasoning that the issue was a partnership item that a refund court does not have jurisdiction over.[98] The Fifth Circuit agreed with this statement, but observed that the taxpayers instead argued that no determination of a tax-motivated transaction was made in any applicable partnership proceeding or in settlement.[99] The Government cited *Duffie v. United States* to argue that the district court lacked jurisdiction to make this determination, but the Fifth Circuit found *Duffie* did not extend this far.[100] The Fifth Circuit distinguished *Duffie*, saying:

> The district court does not have jurisdiction to revisit whether a partnership's transactions were actually tax-motivated, nor could the district court make that determination in the first instance. However, the district court does have jurisdiction to determine whether such a finding has previously been made, either in the partnership-level proceedings or in a settlement. We thus find that § 7422(h) does not bar jurisdiction over Taxpayers' claims that there was no tax-motivated determination supporting § 6621(c) penalty interest.[101]

The Government argued that the refund claim was untimely, which was a jurisdictional defect.[102] The Fifth Circuit held that the normal refund period of § 6511(a) for claims arising from erroneous computations is supplanted by § 6230(a) to six months instead of two years.[103] The court stated enhanced interest under § 6621(c) is a substantive affected item, not computational.[104] Different assessment procedures exist for substantive versus computational items.[105] Computational items do not require notices of deficiency.[106] By contrast, if the adjustment is substantive then the IRS must follow normal deficiency procedures.[107] In this case, the court found that the refund claim was dependent upon whether there was a sufficient tax-motivated transaction and whether the underpayment was attributable to a tax-motivated transaction.[108] The Fifth Circuit held that the taxpayers' refund claims were timely filed.[109]

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98. *Id.* at 463–64 (citing Duffie v. United States, 600 F.3d 362, 378–79 (5th Cir. 2010)).
99. *Id.*
100. *Id.* (citing *Duffie*, 600 F.3d at 378–79).
101. *Id.* at 464.
102. *Id.* at 464–65 (citing *Duffie*, 600 F.3d at 384).
103. *Id.* (citing I.R.C. § 6230(a), (c)(2)(A)).
104. *Id.*
105. *Id.* (citing *Duffie*, 600 F.3d at 385).
106. *Id.* (citing *Duffie*, 600 F.3d at 385).
107. *Id.* (citing *Duffie*, 600 F.3d at 385).
108. *Id.* (citing Weiner v. United States, 389 F.3d 152, 159–60 (5th Cir. 2004)).
109. *Id.* at 465.

Under authority of *Weiner v. United States*, the Fifth Circuit in *Irvine* held the assessment of penalty interest under § 6621(c) to be erroneous as a matter of law.[110] The *Kercher* decision reached "a different outcome than in *Irvine*, because the taxpayers in *Irvine* settled individually with the IRS and were no longer parties to the Tax Court partnership-level proceedings at the time of the stipulated decisions and were instead bound by their individual settlements."[111] In *Kercher*, however, the Fifth Circuit held the taxpayers were "bound by the partnership-level stipulated decisions entered in the Tax Court" and "conclude[d] that under *Duffie*, the Tax Court decisions included findings that the partnerships' transactions were tax-motivated as required to impose § 6621(c) interest, the Taxpayers [were] bound by those decisions, and the district courts lacked jurisdiction to revisit those partnership-level determinations under § 7422(h)."[112]

IV. *BURNETT RANCHES, LTD. V. UNITED STATES*

Burnett Ranches, Ltd. v. United States is a single-issue case involving the iconic 6666 Ranch, commonly called the "Four Sixes Ranch," located in Guthrie, Texas.[113] The Fifth Circuit held that an individual who actively participated in management of farming operations for at least five years was within the active participation exemption of § 464(c)(2)(A), even though that individual held legal title to her interest in her wholly-owned S corporation entity rather than individually.[114]

The Government sought to tax the ranch as a farming-syndicate tax shelter under § 464, requiring the ranch to report its income under the accrual accounting method rather than the cash-basis method of accounting.[115] The farming syndicate rules of § 464 were enacted to close a perceived loophole of forming limited partnerships to acquire interests in farming operations that had net operating losses.[116] Fractional interests were sold to investors who used the losses to offset other income.[117]

The exceptions from the statute were provided for bona fide interest holders who have long-term, active management in farming enterprises.[118] Excluded from the § 464 rules are holdings attributable to active management for a period of not less than five years.[119] The Government argued that this

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110. *Id.*
111. Kercher v. United States, 539 F. App'x 517, 523 (5th Cir. Sept. 2013) (per curiam), *cert. denied*, 134 S. Ct. 1776 (2014) (citing *Irvine*, 729 F.3d at 458–59, 465).
112. *Id.*
113. Burnett Ranches, Ltd. v. United States, 753 F.3d 143, 145 (5th Cir. May 2014).
114. *Id.* at 150.
115. *Id.* at 146.
116. *Id.* at 146–47.
117. *Id.* at 147.
118. *Id.*
119. *See* I.R.C. § 464(c)(2)(A) (2014).

exception was unavailable to the taxpayer in the case because she held her interest in the ranch in a Subchapter S corporation.[120] The Fifth Circuit adopted the conclusion of the district court that § 464 does not distinguish those who own their ranching interest individually from a Subchapter S corporation.[121]

V. *EL PASO CGP CO. V. UNITED STATES*

El Paso CGP Co. v. United States is a tax procedure case that involves the mitigation provisions of §§ 1311–1314.[122] Since this case is a tax procedure case, involving limitations periods, the facts become particularly important. El Paso CGP (El Paso) claimed tax credits in its 1986 corporate tax return, which resulted in a credit carried forward to the 1987–1990 tax years.[123] Upon audit, the IRS disallowed some credits.[124] The increase in tax liability resulting from the disallowance of the credits was some $51 million.[125] In April 2000, El Paso paid the deficiency and brought a refund action in December 2002.[126] In March 2002, El Paso waived restrictions on assessment using Form 870–AD, Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment.[127]

After a discussion with the IRS and an adjustment of credits in July 2005, El Paso and the IRS agreed to a Closing Agreement for the 1986 year, which resulted in an overpayment, and the 1987–1990 years, which were deficiency years.[128] The IRS withheld the 1986 overpayment to satisfy the 1987–1990 deficiencies.[129] This withdrawal is referred to as the 2005 set-off.[130]

In August 2006, one year after the Closing Agreement, El Paso sent a memorandum to the IRS claiming a refund of the allocation of refund monies to the 1987–1990 years on the ground that the IRS had not assessed the deficiencies for 1987–1990 and that those years were barred from assessment.[131] El Paso asserted that the IRS had one year from the Closing Agreement to reopen a closed year and that the IRS's failure to do so barred

120. *Burnett Ranches, Ltd.*, 753 F.3d at 150.
121. *Id.* at 149.
122. El Paso CGP Co. v. United States, 748 F.3d 225, 225 (5th Cir. Mar. 2014).
123. *Id.* at 226.
124. *Id.*
125. *Id.*
126. *Id.* at 226–27.
127. *Id.* at 226.
128. *Id.* at 227.
129. *Id.*
130. *See id.*
131. *Id.*

the 1987–1990 years from assessment.[132] The IRS denied this informal refund claim.[133]

The district court, adopting the findings and conclusions of a magistrate judge, rejected El Paso's refund claim, primarily on jurisdictional grounds: (1) El Paso's 2002 refund claim was disposed of in the Closing Agreement, and (2) the IRS set-off occurred more than three years after the 2002 refund claim.[134] The Fifth Circuit found jurisdiction by interpreting this case as a suit to enforce a closing agreement.[135]

On the merits, the IRS's power to offset liabilities for tax periods outside the period of limitations, 1987–1990, is limited; but the IRS could open the closed years through use of the mitigation provisions of §§ 1311–1314.[136] Section 1314(b) provides that an adjustment, reopening of a closed year, can be made by "assessing and collecting, or refunding or crediting" the amount of the adjustment within one year of the Closing Agreement.[137]

The disagreement in the case was whether the "assess and collect" language in § 1314(b) meant that the IRS could look at the period of the Closing Agreement and determine whether there was a net deficiency or net overpayment, and then apply the mitigation provisions, which the IRS argued that it did by refunding within one year from the Closing Agreement.[138] El Paso contested that the IRS must treat each year separately, not collectively.[139]

The Fifth Circuit came down on the IRS's side by finding that § 1314(b) allows an adjustment to cover multiple tax years; however, the adjustment amount must be determined on the basis of each tax year separately.[140] Because the Closing Agreement provided for a net overpayment, the IRS did not have to collect deficiencies for the individual years because the IRS held the taxpayer's money to cover the deficiency.[141] The Fifth Circuit drew its ultimate conclusion as follows: "an assessment is unnecessary when the IRS, as here, already holds adequate money from the taxpayer to cover the deficiencies."[142]

The Fifth Circuit concluded that the Closing Agreement permitted the IRS to pay out only the net overpayment and not initiate separate collection procedures for each year.[143] A year-by-year assessment was not required.[144]

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132. *Id.*
133. *Id.*
134. *Id.* at 227–28.
135. *Id.* at 228.
136. *Id.* at 230; *see* I.R.C. §§ 1311–1314 (2014).
137. I.R.C. § 1314(b).
138. *El Paso CGP Co.*, 748 F.3d at 230.
139. *Id.* at 231.
140. *Id.*
141. *Id.* at 232.
142. *Id.*
143. *Id.* at 233.
144. *See id.*

VI. *TRINITY INDUSTRIES, INC. V. UNITED STATES*

The decision of *Trinity Industries, Inc. v. United States* concerned qualified research expenditure tax credit for ocean-going vessels.[145] A Trinity subsidiary designed and built six prototype ships.[146] Trinity claimed the credit on amended returns for the years 1994 and 1995.[147]

Section 41 permits a credit for research expenses.[148] The credit is a 20% credit for qualified research expenses that exceed a base year.[149] The base amount is a percentage of average annual gross receipts for the four preceding years.[150] The tax court held in favor of the IRS.[151]

To qualify for the § 41 research credit, substantially all of the research activities undertaken for the discovery of technological information must constitute elements of a process that relates to a new or improved function.[152] Section 41 is applied to each "business component" of the taxpayer, which is a product or process held for sale or used in the business.[153]

The IRS argued that the special-order ships were not held for sale because they were not sold out of inventory.[154] The Fifth Circuit rejected this argument.[155] The Fifth Circuit also rejected the argument that, because each ship consisted of numerous existing subassemblies incorporated into a ship design, the total development cost of each ship did not constitute a qualified research expense.[156] Citing Treasury Regulation § 1.41–4(a)(6), the Fifth Circuit held that as long as the taxpayer can demonstrate that 80% of a first-in-class ship was part of a process of experimentation, the entire cost is a research expenditure.[157] The court also indicated that the taxpayer failed to offer evidence from which the court could determine the amount of research expenditure relating to any business component smaller than the entire ship.[158] The Fifth Circuit concluded that only two of the six projects for which the taxpayer claimed the research credit met the 80% threshold and qualified as research expenditures.[159]

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145. Trinity Indus., Inc. v. United States, 757 F.3d 400, 403 (5th Cir. 2014).
146. Trinity Indus., Inc. v. United States, 691 F. Supp. 2d 688, 690 (N.D. Tex. 2010), *aff'd*, 757 F.3d 400 (5th Cir. 2014).
147. *Trinity Indus. Inc.*, 757 F.3d at 403.
148. I.R.C. § 41 (2014).
149. *Id.* § 41(a)(1).
150. *Id.* § 41(c)(1).
151. Trinity Indus., Inc. & Subsidiaries v. Comm'r, 132 T.C. 6, 21 (2009).
152. I.R.C. § 41(d)(2).
153. *Id.* § 41(d)(2).
154. *See* Trinity Indus., Inc. v. United States, 691 F. Supp. 2d 688, 690 (N.D. Tex. 2010), *aff'd*, 757 F.3d 400 (5th Cir. 2014).
155. *Trinity Indus.*, 757 F.3d at 416 (affirming the district court, which rejected the argument).
156. *Id.* at 409–10.
157. *Id.* at 412 (citing Treas. Reg. § 1.41–4(a)(6) (2014)).
158. *Id.* at 416.
159. *Id.*

VII. *RODRIGUEZ V. COMMISSIONER*

The Fifth Circuit's decision in *Rodriguez v. Commissioner* concerned the issue of taxation of a deemed dividend, not an actual dividend, from a controlled foreign corporation (CFC).[160] The taxpayers, Mexican citizens, were permanent residents of the United States.[161] The taxpayers reported as qualifying dividend income—taxed at 15%—gross income attributable to their ownership of the controlled foreign corporation for the tax years 2003 and 2004.[162] The IRS challenged this reporting, claiming that the correct reporting of the income should have been ordinary income.[163]

The relevant statutes are §§ 951 and 956.[164] Section 951(a)(1)(B) requires that United States shareholders of CFCs "shall include in [their] gross income . . . the amount determined under section 956 with respect to such shareholder for such year."[165] Section 956 describes how to determine a shareholder's pro rata share of United States property held by the CFC for inclusion as gross income.[166]

The issue in *Rodriguez* was whether the amount determined in § 956, and included in income in § 951, constituted "qualifying dividend income" under § 1(h)(11).[167] Qualifying dividend income is defined as "dividends received during the taxable year from . . . qualified foreign corporations."[168] A dividend is "any distribution of property made by a corporation to its shareholders" out of its earnings and profits.[169]

The Fifth Circuit affirmed the tax court and held that the § 951 inclusions are taxed as ordinary income, not capital gains.[170] The inclusions in income dictated by § 951 are not actual dividends.[171] The inclusions in income of § 951 are calculated on the basis of CFC-owned United States property—they do not constitute actual dividends.[172] The analysis was a straightforward statutory analysis.[173] The Fifth Circuit pointed out that the taxpayer could have declared actual dividends and achieved the rate of taxation desired but did not do so.[174]

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160. Rodriguez v. Comm'r, 722 F.3d 306, 308 (5th Cir. July 2013).
161. *Id.*
162. *Id.*
163. *Id.*
164. *Id.* at 309.
165. I.R.C. § 951(a)(1) (2014).
166. I.R.C. § 956(a) (2014).
167. *Rodriguez*, 722 F.3d at 309.
168. I.R.C. § 1(h)(11)(B)(i) (2014).
169. I.R.C. § 316(a) (2014).
170. *Rodriguez*, 722 F.3d at 312.
171. *Id.* at 309.
172. *Id.* at 310.
173. *Id.*
174. *Id.*

In a straightforward analysis, the Fifth Circuit also rejected the taxpayer's argument to the effect that § 951 inclusions were deemed dividends.[175] The Fifth Circuit said that when Congress declares a § 951 inclusion to be deemed a dividend, it has done so, but Congress has not declared so here.[176]

VIII. CONCLUSION

The Fifth Circuit's federal tax cases this year involved intricate questions of procedure or other arcane issues. Tax shelters from over a decade ago are still present in this assortment of cases but hopefully will cease to be seen. The Fifth Circuit did not tilt one way or the other in outcome, with taxpayers being somewhat successful.

175. *Id.* at 311.
176. *Id.*