2011 REVIEW OF INCOME TAXATION

William D. Elliott[*]

The July 1, 2010 to June 30, 2011 review period for the Fifth Circuit produced four cases concerning federal income taxation. One case concerns the requirements for the Internal Revenue Service (Service) to send notices to taxpayers, a routine step but critically important from a due process point of view. The second case is included because of what the Fifth Circuit did not do. It rejected application of the consumer credit regulations to tax collection. The third case places the Fifth Circuit squarely in the debate over whether the three-year or six-year limitations period for assessing the tax are applicable when adjusted basis is overstated. The final case deals with the important subject of whether third-party payments, or government payments, are income or capital contributions. Considering the importance of public–private partnerships, this case highlights a critical tax issue. For followers of the Fifth Circuit, these cases will not disappoint. The Fifth Circuit continues to chart its own path.

I. SENT TO LAST KNOWN ADDRESS: *TERRELL V. COMMISSIONER*

The decision of *Terrell v. Commissioner* concerns the important, but seemingly routine, issue of whether the Service sent a notice to the last known address of a taxpayer; this issue arises in several different contexts in the Internal Revenue Code (Code).[1] In the Saltzman & Book treatise, the notice to the last known address issue is described as follows in the context of a notice of deficiency:

---

* Attorney at Law, Dallas, Texas. J.D., SMU School of Law; L.L.M. (in taxation), New York University School of Law.

1. *See* Terrell v. Comm'r, 625 F.3d 254, 257 (5th Cir. Nov. 2010) (Prado, J., writing opinion, joined by Stewart & Elrod, JJ.).

> [T]he last known address issue has been perhaps one of the most vexatious issues in tax procedure. The "last known address" requirement is intended to assure that a taxpayer is given notice of the Service's impending assessment (unless the taxpayer files a petition in the Tax Court to challenge the Service's deficiency determination) and the rights and duties the taxpayer has under the Code. It follows that the requirement is intended to provide the taxpayer actual or constructive notice of the Service's notice of deficiency.[2]

The last known address in *Terrell* arises in an innocent spouse context but is the same last known address issue sprinkled throughout the Code.[3] In *Terrell*, there are two issues: 1) Whether the Tax Court clearly erred in finding that the Service exercised "reasonable diligence" in locating the taxpayer's correct address and that notice was sent to the taxpayer's "last known address"; and 2) When the 90-day period began to run within which the taxpayer had to file her petition, in light of the notice having been returned to the Service as undeliverable.[4]

The *Terrell* case arose from an innocent spouse claim combined with a mobile taxpayer.[5] Pamela Terrell and her husband divorced in 2003, preceded by years of the husband squandering the couple's community income and assets on his nascent acting career at age fifty-nine and on his female friends.[6] The husband left behind some $660,000 of delinquent tax liabilities.[7] Pamela appears also to have been victimized by her husband's abuse.[8] She appeared to know nothing of the facts behind their tax returns.[9]

Pamela filed a request for innocent spouse relief (Form 8857) on September 2, 2006, from her 77040 Bridlewood Ct., North Richland Hills, Texas 76180 address.[10] She moved shortly thereafter to 8510 Coppertowne Lane, Dallas, Texas 75234, and dutifully filed a Post Office Change of Address form sometime between October 10, 2006, and November 10, 2006.[11] Then began a series of IRS notices arising from Pamela's innocent spouse claim but

2. MICHAEL L. SALTZMAN & LESLIE BOOK, IRS PRACTICE AND PROCEDURE ¶ 10.03 [3][D] (2010).
3. *See Terrell*, 625 F.3d at 257. Examples of this issue in the Code include: formal document request for the production of foreign-based documentation (I.R.C. § 982(c)(1) (2011)); notice of disclosure proceedings (§ 6110(f)(3)(B)); notice of deficiency (§ 6212(b)); notice and demand for tax (§ 6303(a)); notice of revocation of a certificate of release of nonattachment of a lien (§ 6325(f)(2)(A)); notice of intention to levy (§ 6331(d)(2)(C)); copy of a notice of levy with respect to a life insurance or endowment contract (§ 6332(b)(1)); notices of seizure and sale (§ 6335(a)-(b)); notice of liability in transferee cases (§ 6901(g)); notice of a third-party summons (§ 7609(a)(2)).
4. *See Terrell*, 625 F.3d at 260-62.
5. *See id.* at 257-58.
6. Brief for Petitioner-Appellant at 3, Terrell v. Comm'r, 625 F.3d 254 (2010) (No. 9-60822).
7. *See id.*
8. *See id.*
9. *See id.*
10. *See Terrell*, 625 F.3d at 257; Brief for Petitioner-Appellant, *supra* note 6, at 4.
11. Brief for Petitioner-Appellant, *supra* note 6, at 4.

most of the notices did not reach her, and the notice that did reach her was late.[12] The actions of both Pamela and the Service are as follows:

Action	Response
Dec. 6, 2006: IRS sent letter mailed to the Bridlewood address confirming receipt of Form 8857.	The letter was returned to the IRS on Jan. 24, 2007, marked "UNDELIVERABLE AS ADDRESSED; UNABLE TO FORWARD."
Feb. 7, 2007: IRS sent Preliminary Determination of Denial of Innocent Spouse Relief to the Bridlewood address.	The Preliminary Determination was returned to the IRS on Feb. 28, 2007, marked "UNDELIVERABLE AS ADDRESSED; NO FORWARDING ORDER ON FILE."
Feb. 7, 2007: IRS also sent another Preliminary Determination letter to the Bridlewood address that was similar to, but slightly different from, the other determination letter.	The Preliminary Determination was also returned to the IRS on Feb. 28, 2007, marked as "UNDELIVERABLE AS ADDRESSED; NO FORWARDING ORDER ON FILE."
April 6, 2007: IRS mailed a Notice of Final Determination (denying innocent spouse relief) to the Bridlewood address.	The Notice of Final Determination was returned to the IRS as undeliverable on May 7, 2007. The envelope was marked "RETURN TO SENDER, NOT DELIVERABLE AS ADDRESSED, UNABLE TO FORWARD."
April 11, 2007: Taxpayer electronically filed her 2006 tax return listing the Coppertowne address as her then-current address.	
May 14, 2007: IRS re-mailed the Notice of Final Determination (originally sent April 6, 2007), this time to the taxpayer's Coppertowne address. This re-mailed Notice was received by the taxpayer over forty days after the date of the original Notice.	Pamela Terrell received the IRS notice in mid-May 2007.
July 13, 2007: Pamela Terrell filed a Tax Court petition.	The deadline was apparently July 6, 2007.

[13]

When a taxpayer claims innocent spouse relief and is denied, the Tax Court has jurisdiction to "determine the appropriate relief available . . . not later than the close of the 90th day after" the date the IRS "mails, by certified or

12. *Terrell*, 625 F.3d at 257-58.
13. *See* Brief for Petitioner-Appellant, *supra* note 6, at 4, 5, 7, 15.

registered mail to the taxpayer's last known address, notice of the Secretary's final determination of relief available to the individual."[14] A similar provision exists concerning the duty of the Service to send tax deficiency notices.[15] More cases arise under the "last known address" rule in tax deficiencies than under innocent spouse notices. The Fifth Circuit, therefore, looked for guidance from tax-deficiency cases, particularly its earlier decision in *Mulder v. Commissioner*, which stands for the following propositions:

> - "[L]ast known address" is a term of art and refers to that address which, in light of all relevant circumstances, the IRS reasonably may consider to be the address of the taxpayer at the time the notice of deficiency is mailed. . . .
> - [A]bsent a subsequent, clear and concise notification of an address change, the IRS is entitled to consider the address on the taxpayer's most recently filed return as the taxpayer's "last known address." . . .
> - When the IRS knows or should know at the time of mailing that the taxpayer's address on file may no longer be valid because of previously returned letters, "reasonable diligence" requires further investigation.[16]

The Fifth Circuit found an IRS error (and, accordingly, a Tax Court error) at the time the Service sent the taxpayer the relevant notice.[17] The relevant notice was the April 6, 2007 notice of determination of the innocent spouse request.[18] At that moment, as of April 6, 2007, the Service had received back as undelivered three separate mailings to the taxpayer.[19] In the words of the court, the Service did not exercise reasonable diligence in sending Pamela Terrell the April 6 notice to her last known address:

> Because the IRS failed to take *any* steps to determine Terrell's correct address after receiving the returned mail and before mailing the Notice, we are compelled to find it did not exercise reasonable diligence. The IRS could have done a computer search through the DMV, contacted Terrell's employer, searched using Terrell's social security number, or undertaken any number of actions that might have located the Dallas address. Because the

---

14. I.R.C. § 6015(e)(1)(A) (2011).

15. §§ 6212, 6213. Section 6212(b)(2) directs the IRS to send a notice of deficiency regarding a joint income tax return "by certified mail or registered mail to each spouse at his last known address." § 6212(b)(2). Section 6213(a) provides that the taxpayer may file a petition for redetermination of such deficiency within ninety days of the date the IRS mails the notice. § 6213(a).

16. *Terrell*, 625 F.3d at 259 (first alteration in original) (emphasis omitted) (first quote quoting Mulder v. Comm'r, 855 F.2d 208, 211 (5th Cir. 1988)) (second quote citing Pomeroy v. United States, 864 F.2d 1191, 1194 (5th Cir. 1989)).

17. *Id*. at 260.

18. *See id.*

19. *Id.*

IRS failed to exercise reasonable diligence, the IRS did not mail the Notice to Terrell's "last known address."[20]

The second issue in the case is arguably the more important of the two issues considered and the issue for which the *Terrell* case will be remembered. In light of the fact that Terrell ultimately received the notice, should the cases from other circuits holding for the "no prejudice" rule be applied in the Fifth Circuit? The "no prejudice" rule provides that "despite failing to mail the notice to the taxpayer's 'last known address,' the IRS satisfies the statutory notice requirement if the taxpayer actually receives the notice without delay prejudicial to her ability to petition the Tax Court."[21]

Terrell ultimately received the April 6 notice.[22] The Service argued that Terrell was not prejudiced from the delay in getting the April 6 notice to her because she had ample time to file a Tax Court petition after receiving the April 6 notice re-sent to her on May 14.[23]

Terrell urged that the 90-day period began to run from actual receipt of the April 6 notice.[24] Coming close to the Ninth Circuit decision of *Mulvania v. Commissioner*, the Fifth Circuit found the April 6 notice null and void; the

---

20. *Id.* (citation omitted).

21. *Id.* The court referred to a considerable array of precedent:

> *See Sicari v. Comm'r*, 136 F.3d 925, 930 (2d Cir. 1998) (holding that the IRS satisfies its duties under § 6212 if it can prove "that the envelope containing the notice was in fact delivered . . . ." (citation omitted)); *Patmon & Young Prof'l Corp. v. Comm'r*, 55 F.3d 216, 217 (6th Cir. 1995) ("[N]otice of deficiency that is actually received without delay prejudicial to the taxpayer's ability to petition the Tax Court is sufficient [to meet the conditions of § 6212(a)]." (internal quotation marks and citations omitted) (alteration in original)); *Borgman v. Comm'r*, 888 F.2d 916, 917 (1st Cir. 1989) ("A notice of deficiency that is actually received without delay prejudicial to the taxpayer's ability to petition the Tax Court is sufficient to toll the statute of limitations as of the date of mailing." (citations omitted)); *Mulvania v. Comm'r*, 769 F.2d 1376, 1378 (9th Cir. 1985) ("[A] notice of deficiency actually, physically received by a taxpayer is valid under § 6212(a) if it is received in sufficient time to permit the taxpayer, without prejudice, to file a petition in the Tax Court . . . . "); *Pugsley v. Comm'r,* 749 F.2d 691, 692-93 (11th Cir. 1985) ("We do not determine whether the notice was sent to Pugsley's 'last known address,' since even if it was not, Pugsley was not prejudiced because he 'received actual notice of the deficiency with ample time remaining to file a petition.'" (footnote and citation omitted)); *Delman v. Comm'r*, 384 F.2d 929, 934 (3d Cir. 1967) (holding that where the taxpayer actually received the notice of deficiency despite the IRS failing to mail the notice to his last known address, "the date of mailing by the [IRS] commenced the running of the time for filing the petition for redetermination.").

Id. at 260 n.3.

22. *See id.* at 260-61.

23. *See id.*

24. *See id.* at 261. The court cited the following:

> *Gaw v. Comm'r*, 45 F.3d 461, 468 (D.C. Cir. 1995) ("[B]ecause the IRS failed to . . . use reasonable diligence to ascertain an address at which the Gaws would receive the deficiency notice, . . . the time for the Gaws to file a petition for redetermination did not begin to run until the Gaws actually received that notice." (citations omitted)); *Powell v. Comm'r*, 958 F.2d 53, 57 (4th Cir. 1992) ("When notice of a deficiency is not sent to a taxpayer's last known address, subsequent actual notice of the deficiency will commence the running of the ninety-day period." (citations omitted)); *McPartlin v. Comm'r*, 653 F.2d 1185, 1192 (7th Cir. 1981) ("When notice of a deficiency is not sent to the taxpayer's 'last known address,' subsequent actual notice of the determined deficiency will commence the running of the 90 day period." (citations omitted)).

notice was returned to the Service undeliverable.[25] Therefore, the court would not consider those cases invoking the "no prejudice" rule.[26] The fact that the notice intended for Pamela Terrell was returned undeliverable takes the situation out of the "no prejudice" rule context, which involves the taxpayer or taxpayer's agent ultimately receiving the original notice in time to take the requisite action—i.e., the taxpayer is not prejudiced by delay in notice.[27] The court characterized its opinion as a narrow holding and did not take a position on whether the "no prejudice" rule or the actual notice rule is to be adopted.[28]

II. CONSUMER CREDIT PROTECTION ACT'S RESTRICTION ON GARNISHMENT INAPPLICABLE TO TAX DEBT: *UNITED STATES V. CLAYTON*

The decision of *United States v. Clayton* is eligible to be included in this review because of what the court did not decide.[29] Treading where no court has gone,[30] the court held that the restrictions of the Consumer Credit Protection Act (CCPA), which restrict garnishments to twenty-five percent of an individual's disposable weekly earnings, was inapplicable when the United States enforces a tax debt.[31]

The facts of the case are simple: Defendant Clayton, a riverboat pilot, was convicted of failure to file three years of federal tax returns and, as part of his sentence, was ordered to pay restitution to the Service.[32] The Government obtained a court order to enforce this criminal restitution order against the New Orleans Baton Rouge Steamship Pilots Association, which led to the Government capturing Clayton's entire monthly retirement benefit.[33] Clayton sought protection under § 303 of the CCPA, which limits garnishments to twenty-five percent of Clayton's earnings.[34] The district court upheld the full garnishment, relying on an exception in the CCPA for enforcement of a state or federal tax debt: "Specifically, § 1673(b) of the CCPA—which provides exceptions to the exemptions enumerated in subsection (a), including the 'earnings' ex[em]ption—specifically indicates that '[t]he restrictions of

25. *See* Mulvania v. Comm'r, 769 F.2d 1376, 1378 (9th Cir. 1985); *Terrell*, 625 F.3d at 261.
26. *See Terrell*, 625 F.3d at 261.
27. *See id.* The court also distinguished a situation in which a notice is misaddressed, but the postal authorities deliver it to the recipient anyway. *Id.* Then, the recipient is not prejudiced. *See Mulvania*, 769 F.2d at 1379. This is a variation of the "no prejudice" rule. *Id.*
28. *Terrell*, 625 F.3d at 262.
29. United States v. Clayton, 613 F.3d 592 (5th Cir. Aug. 2010) (Haynes, J., joined by Davis & Smith, JJ.).
30. *Id.* at 596 ("[N]o state or federal court has apparently ever addressed this provision before.").
31. *Id.* at 595-96.
32. *Id.* at 593.
33. *Id.* at 594. The Government utilized the garnishment provisions of the Federal Debt Collection Procedures Act (FDCPA). 28 U.S.C. § 3205 (2006).
34. *Terrell*, 625 F.3d at 593; *see* 15 U.S.C. § 1673 (2006).

subsection (a) of this section do not apply in the case of . . . (C) any debt due for any State or Federal tax.'"[35]

The core obligation was a restitution order arising from a criminal conviction for failing to file federal tax returns.[36] The restitution order was in favor of the Service, not the federal government generally.[37] Therefore, the restitution order is a tax debt and comes squarely under the exception for tax debts in the CCPA.[38]

III. OVERSTATEMENT OF BASIS AS TRIGGERING SIX-YEAR STATUTE OF LIMITATIONS: *BURKS V. UNITED STATES*

In *Burks v. United States*, the Fifth Circuit contributed to the current dust-up over whether the Service has three years or six years to assess an income tax arising from a tax deficiency attributable to overstated asset basis.[39] The issue has occupied considerable judicial resources and is currently pending before the Supreme Court.[40]

The issue in the pending cases is whether a substantial understatement of taxable gain in a nonbusiness context, arising from an overstatement of the taxpayer's tax basis in property sold or exchanged, constitutes an omission of gross income.[41] If there is a requisite omission from gross income, and the

---

35. *Clayton*, 613 F.3d at 594 (alterations and omission in original) (citing United States v. Clayton, 646 F. Supp. 2d 827, 838 (E.D. La. 2009)); *see* § 1673(b)(1)(C).

36. *Clayton*, 613 F.3d at 596.

37. *Id*.

38. *See id.* (citing United States v. Helmsley, 941 F.2d 71, 102 (2d Cir. 1991)) ("[A]ny amount paid as restitution for taxes owed must be deducted from any judgment entered for unpaid taxes in . . . a [parallel] civil proceeding. Restitution is in fact and law a payment of unpaid taxes." (omission and alterations in original)); United States v. Tucker, 217 F.3d 960, 962 (8th Cir. 2000) (explaining that criminal restitution for a tax crime should be ordered in favor of the IRS and calculated based on the tax owed) ("[A]ny amounts paid to the IRS as restitution must be deducted from any civil judgment [the] IRS obtains to collect the same tax deficiency.").

39. Burks v. United States, 633 F.3d 347 (5th Cir. Feb. 2011) (DeMoss, J., writing opinion, joined by Benavides & Elrod, JJ.).

40. *See* Home Concrete & Supply, LLC v. United States, 634 F.3d 249 (4th Cir. 2011), *cert. granted*, 132 S. Ct. 71, 80 U.S.L.W. 3078 (U.S. Sept. 27, 2011) (No. 11-139). Recent cases involving similar issues include: *Intermountain Ins. Serv. of Vail, L.L.C. v. Comm'r*, 650 F.3d 691 (D.C. Cir. 2011), *rev'g* 134 T.C. 211 (2010); *UTAM, Ltd. v. Comm'r*, 645 F.3d 415 (D.C. Cir. 2011); *Grapevine Imports, Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011); *Burks*, 633 F.3d at 354 ("'[T]he meaning of "omits" in today's parlance appears to be no different than its meaning at the time of the Colony decision' and . . . in the years since *Colony* had been decided, Congress had not indicated that its holding was inapplicable to the revised statute despite ongoing debate surrounding the decision."); *Home Concrete & Supply LLC*, 634 F.3d at 255 (finding that because the legislative history of IRC § 275(c) of the 1939 Code is "equally compelling" with respect to I.R.C. § 6501(e)(1)(A) and that because there are no material differences in the language of the statutes, "we are not free to construe an omission from gross income as something other than a failure to report 'some income receipt or accrual'"); *Bakersfield Energy Partners, LP v. Comm'r*, 568 F.3d 767, 771 (9th Cir. 2009) (finding that the 1939 Code was so substantially similar to the 1954 Code that *Colony* was controlling). *But see* Beard v. Comm'r, 633 F.3d 616, 620 (7th Cir. 2011) (creating a circuit split by finding that *Colony* was not controlling and holding that "an overstatement of basis can be treated as an omission from gross income."); Carpenter Family Investments LLC v. Comm'r, 136 T.C. 17 (2011).

41. *See Burks*, 633 F.3d at 355.

taxpayer is an individual or corporation, the normal three-year limitations period is extended to six years when the taxpayer "omits from gross income an amount properly includible therein . . . in excess of 25 percent of the amount of gross income stated in the return."[42]

Burks, like most of the decided cases, focused on the meaning of the phrase "omits from gross income" in § 6501(e)(1)(A).[43] In 1958 in *Colony, Inc. v. Commissioner*, the Supreme Court held that the identical language in a predecessor provision did not include overstatement of basis.[44] In 2011, the Supreme Court held in *Mayo Foundation for Medical Education and Research v. United States* that the Treasury Department has the authority to change long-standing judicial interpretations of statutory language as long as the underlying statute is ambiguous and the Treasury's interpretation is reasonable.[45] The cases to date have focused on whether the phrase "omits from gross income" was ambiguous when § 6501(e) was enacted in 1954, and, if so, whether Treasury regulations issued in 2010 can overrule the Supreme Court's long-standing interpretation of that language.[46]

Burks involves gain that flows through to the taxpayers from partnerships subject to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership audit rules.[47] The TEFRA rules were enacted in 1982 to provide "a single unified procedure for determining the tax treatment of all partnership items at the partnership level, rather than separately at the partner level" on the

---

42. I.R.C. § 6501(e)(1)(A) (2011).

> **(e) Substantial omission of items.**—Except as otherwise provided in subsection (c)—
>
> **(1) Income taxes.**—In the case of any tax imposed by subtitle A—
>
> **(A) General rule.**—If the taxpayer omits from gross income an amount properly includible therein and . . . [which] is in excess of 25 percent of the amount of gross income stated in the return, . . . the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.
>
> **(B) Determination of gross income.**—For purposes of [this subparagraph]—
>
> **(i)** In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and
>
> **(ii)** In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

Id.

43. *See Burks*, 633 F.3d at 355. "Section 6501(e)(1)(A) was first enacted as § 275(c) of the Revenue Act of 1934, 48 Stat. 745. Congress amended the statute in 1954, renumbering it as § 6501(e)(1)(A) and adding two subsections." *Id.* (citation omitted).

44. Colony, Inc. v. Comm'r, 357 U.S. 28, 36 (1958).

45. Mayo Found. for Medical Educ. & Research v. United States, 131 S. Ct. 704, 714 (2011), *aff'g* 568 F.3d 675 (8th Cir. 2009).

46. *See Burks*, 633 F.3d at 355.

47. *See id*. at 349.

tax returns of large partnerships, which generally include any partnership with more than ten partners, or any tiered partnership.[48]

If a partner in a TEFRA partnership is believed to have underpaid taxes because of an error or omission in the partnership return, the Service must pursue the matter at the partnership level.[49] If the Service succeeds at the partnership level, the statute of limitations for the partner's tax return, as applied to items corrected at the partnership level, remains open for a period.[50] That allows the Service to assess or collect tax underpayments attributable to partnership items at the partner level, even if the partner's tax year is otherwise closed.[51]

The Fifth Circuit opinion in *Burks* was a consolidated appeal of district court and Tax Court cases.[52] Importantly, the issue before the court was the pure legal question of the limitations period for assessment, not the merits of the transactions.[53] The Service issued Final Partnership Administrative Adjustments (FPPAs) adjusting the partnership tax returns filed by the taxpayers on the grounds that the challenged transactions lacked economic substance.[54] "The FPPAs were filed more than three years but less than six years after the taxpayers's individual tax returns were filed with the Service."[55] In both matters, the Government conceded that the three-year limitations period had expired but asserted that an extended six-year limitations period applied because the partners had omitted gross income in excess of twenty-five percent from their tax returns in violation of § 6501(e)(1)(A) when they overstated their basis.[56]

The two lower court opinions in *Burks* reached conflicting results.[57] The district court held that the 1968 Fifth Circuit decision in *Phinney v. Chambers* established that an overstatement of basis was an omission from gross income for purposes of § 6501(e)(1)(A).[58] The district court thus denied Burks's motion for summary judgment.[59] In *Commissioner v. M.I.T.A.*, the Tax Court found that the three-year limitations applied, relying on *Colony* and cases construing that decision to support its finding that an overstatement of basis did not constitute an omission from gross income for purposes of

48. Kornman & Assocs., Inc. v. United States, 527 F.3d 443, 446 n.1 (5th Cir. 2008) (quoting Callaway v. Comm'r, 231 F.3d 106, 108 (2d Cir. 2000)); I.R.C. § 6221 (2011); § 6213(a)(1)(B).

49. § 6225.

50. *Id.*

51. *See id.* § 6229.

52. *See Burks*, 633 F.3d at 348-49.

53. *Id.* at 349 n.2.

54. *Id.* at 349.

55. *Id.* at 350.

56. *Id.*

57. *Id.*

58. *Id.*; Phinney v. Chambers, 392 F.2d 680, 686 (5th Cir. 1968).

59. *Burks*, 633 F.3d at 349.

§ 6501(e)(1)(A).[60] "The tax court further found that *Phinney* did not directly address the issue facing the court."[61]

The Fifth Circuit in *Burks* concluded "that *Colony*'s holding with respect to the definition of 'omits from gross income' remains applicable in light of the statutory revisions to the Code."[62] The taxpayer misstated its income but did not misrepresent the nature of the item reported.[63] The taxpayers had "disclosed the nature of the items on their tax returns sufficient to notify the Commissioner of the item being reported."[64] Thus, the Service could have reasonably known what was actually being reported.[65] In the words of the court:

> The taxpayers in the present matters did not misstate the nature of an item such that the IRS was at a disadvantage in detecting the error because it could not reasonably know what was actually being reported. Rather, the nature of the item—the basis—was included in the tax return, albeit in an incorrect amount. This circumstance provides the IRS with sufficient notice to inquire into the correctness and validity of the item being reported. . . . Absent a fundamental alteration to the nature of the item reported, disclosure of the item, despite the correctness of the amount, provides the IRS with reasonable notice of the item being reported and the general limitations period should apply pursuant to Colony.[66]

The court also did not decide whether to defer to IRS regulations, which attempt to define the phrase "omits from gross income."[67] On September 28, 2009, the Treasury promulgated regulations to provide that overstatement of basis is an omission from gross income.[68] The regulations limit application of the *Colony* decision to taxpayers in a trade or business engaged in the sale of goods or services.[69] In the court's view, the statute, § 6501(e)(1)(A), was unambiguous, and the regulations "are an unreasonable interpretation of settled law" and thus, no deference to regulations was required.[70]

60. *Id.* at 349-51.
61. *Id.* at 350.
62. *Id.* at 355.
63. *Id.* at 353.
64. *Id.* at 355.
65. *See id.* at 353.
66. *Id.*
67. *Id.* at 355.
68. *See id.* at 359.
69. *See* Treas. Reg. § 301.6501(e)-1(a)(ii), (iii) (2010); 75 Fed. Reg. 78,897 (Dec. 17, 2010). The regulations also expressly disagree with the recent decisions in *Bakersfield* and *Salman Ranch (II)*, applying *Colony* to the revised statute. *See* 75 Fed. Reg. 78,897; *Burks*, 633 F.3d at 359.
70. *Burks*, 633 F.3d at 360.

IV. TAXATION OF GOVERNMENT PAYMENTS: *AT&T, INC. V. UNITED STATES*

In *AT&T, Inc. v. United States*, the issue was whether AT&T, Inc. must pay income taxes on the funds it received from federal and state governmental entities for providing "universal service"—viz., affordable telephone service mainly for lower income consumers and those in high-cost rural, remote, or isolated areas—or whether it is entitled to treat those funds as nonshareholder contributions to capital under the Code.[71] The Fifth Circuit affirmed the district court in holding that the payments were income.[72]

The numbers in the case are substantial. In 1998 and 1999, AT&T received $723.5 million and $831.3 million in payments amounting to a subsidy from a universal service fund (USF), which was a state fund designed to encourage universal telephone service, a long-developed national policy goal.[73] USF was established to support telephone service for low-income customers, schools, libraries, and health care providers.[74] AT&T did not report the 1998 and 1999 payments as income, claiming that they represented nonshareholder contributions to capital within § 118(a), which provides: "In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer."[75]

The Supreme Court has explained that often government payments to a corporation can be contributions or gifts to subsidize capital expenditures—such as the construction of a railroad—and therefore constitute capital contributions, not income.[76] Government payments can also be for subsidizing income, such as subsidizing operations, operational expenses, or any operating revenue, in which case the government payments are income to the recipient corporation.[77] The determinant over whether a third party or government payment to a corporation is income or contribution to capital is the intent of the transferor.[78] The Supreme Court has used a multi-factor test:

> [1] It certainly must become a permanent part of the transferee's working capital structure. [2] It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. [3] It must be bargained for. [4] The asset transferred foreseeably must result in benefit to the transferee in an amount commensurate with its value. [5] And the asset ordinarily, if not always, will be employed in or

71. AT&T, Inc. v. United States, 629 F.3d 505, 507 (5th Cir. Jan. 2011) (Dennis, J., writing opinion, joined by Barksdale & Owen, JJ.).

72. *See id.* at 520.

73. *See id.* at 508.

74. *See id.* at 509.

75. *Id.* at 512.

76. *See, e.g.*, Edwards v. Cuba R.R. Co., 268 U.S. 628, 629-31 (1925).

77. *See, e.g.*, Tex. & Pac. Ry. v. United States, 286 U.S. 285, 289 (1932).

78. *See* United States v. Chicago, Burlington & Quincy R.R. Co., 412 U.S. 401, 413 (1973) ("[T]he intent or motive of the transferor . . . determined the tax character of the transaction.").

> contribute to the production of additional income and its value assured in that respect.[79]

The Fifth Circuit examined these factors and concluded that the USF payments to AT&T were income.[80] There was no intent for the government to make capital contributions to the company.[81] In the court's words, "the USF payments were not intended to be capital contributions to AT&T, but to be supplements to AT&T's gross income to enable it to provide universal service programs while meeting competition newly introduced by the 1996 Act."[82]

V. DEDUCTION FOR CONSERVATION EASEMENT: *WHITEHOUSE HOTEL, L.P. V. COMMISSIONER*

In *Whitehouse Hotel L.P. v. Commissioner*, the issue before the Fifth Circuit was the amount of a charitable contribution deduction of a historic-preservation façade easement, also known as a conservation easement.[83] The court vacated and remanded the Tax Court opinion on the grounds that the Tax Court erred in failing to consider the proposed combination of two buildings into a condominium in determining the effect of the easement on the fair market value of the second building.[84] Also, the court found error in the Tax Court's failure to rule on the highest and best use of the buildings, an error that precluded appellate review.[85]

The taxpayer was a Louisiana limited partnership that claimed a 1997 charitable deduction in the amount of $7.445 million for a charitable contribution of a historic-preservation façade easement.[86] The Service challenged the amount of the deduction and disallowed $6.295 million of the amount claimed.[87] Further, the Service imposed a 40% penalty for the underpayment of taxes arising from the disallowance.[88]

The taxpayer acquired and renovated New Orleans historical property, which comprised the Maison Blanche building, the contiguous Kress Building, and a parking garage contiguous to the Kress Building.[89] The business plan was to renovate the buildings into a Ritz-Carlton hotel with a spa and parking garage, an Iberville Suites hotel, and a Maison Orleans hotel and retail space.[90]

---

79. *Id.*
80. *See AT&T*, 629 F.3d at 511.
81. *See id.*
82. *Id.* at 514 (referencing the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56).
83. Whitehouse Hotel L.P. v. Comm'r, 615 F.3d 321, 324 (5th Cir. Aug. 2010) (Barksdale, J., writing opinion) (Garza & Dennis, JJ., concurring).
84. *See id.* at 340.
85. *See id.* at 329-30.
86. *Id.* at 324.
87. *Id.*
88. *Id.* at 326.
89. *See id.* at 325.
90. *See id.* at 324.

The Maison Blanche building, built in 1906–1908, consisted of a base "with six floors, a U-shaped tower with eight floors, and two subsequently constructed annexes with five and six floors."[91] The easement prohibited alterations to the façade of the Maison Blanche building.[92] The historical commission approved the easement and the development plans and imposed numerous specific requirements on the easement.[93] The development plans "did not include construction on top of the Kress building."[94] After contributing the easement, the taxpayer combined the Maison Blanche and Kress buildings into one condominium.[95]

The only issue in the case was the valuation of the easement, not the qualification as a qualified conservation easement.[96] The taxpayer and Service presented dueling valuation experts, but the Tax Court undertook its own valuation analysis.[97] The taxpayer's expert considered comparable sales information from across the United States, using luxury property pricing information.[98] The Tax Court disagreed with this point.[99] Luxury hotel developers, according to the Tax Court, would not pay more than local market price.[100] Further, the Tax Court would not consider any use of the nonlocal comparable sales that represents diminished reliance on the local market data.[101] The Fifth Circuit stated that the valuation method for preservation easements is a "complex and difficult undertaking that continues to challenge appraisers and the IRS."[102]

The taxpayer challenged the Tax Court by first claiming that the Tax Court erred in admitting into evidence the Service's expert appraiser on the ground that his qualifications as a real-estate appraiser did not qualify him to value historic-preservation façade easements.[103] The Fifth Circuit rejected this argument.[104] The court determined that the IRS's appraiser was a sufficient expert.[105]

One of the taxpayer's arguments that registered with the Fifth Circuit was the valuation method adopted by the Tax Court, which was the comparable-sales method, not the income method or the replacement-cost method.[106] On

91. *Id.* at 325.
92. *Id.*
93. *See id.*
94. *Id.* (emphasis omitted).
95. *Id.*
96. *See id.* at 328.
97. *See id.* at 327.
98. *See id.* at 336.
99. *Id.*
100. *Id.*
101. *See id.*
102. *Id.* at 329.
103. *Id.* at 330.
104. *See id.* at 331.
105. *See id.*
106. *See id.* at 333-35.

remand, the court instructed the Tax Court to reconsider all three methods in determining the easement's value.[107]

The most significant Tax Court's finding was the failure to determine the highest and best use of the property.[108] The taxpayer's expert testified that the property's highest and best use was as a Ritz-Carlton hotel.[109] In contrast, the IRS expert opined that the property's highest and best use was merely as a non-luxury hotel.[110] The Tax Court did not rule on this issue.[111] In the words of the Fifth Circuit:

> Needless to say, finding a property's highest and best use is a critical aspect for determining its fair market value. . . . The key inquiry is what a hypothetical willing buyer would consider in deciding how much to pay for the property. In other words, "[i]f a hypothetical buyer would not reasonably have taken into account that potential use in agreeing to purchase the property, such potential use should not be considered in valuing the property."[112]

The Fifth Circuit instructed the Tax Court to consider national sales data in valuing the easement.[113] The court considered the taxpayer's expert's argument that luxury property developers have their own criteria for rates of return and are not tied to the local market.[114]

Next, the Fifth Circuit instructed the Tax Court on remand to make subsidiary findings on whether it would be reasonably possible for the property to be developed into a non-luxury hotel, a proposition critical to the IRS's expert's opinion.[115] Because the Ritz-Carlton hotel was well underway when the easement was granted, the court thought the IRS's expert opinion that the project could fail to come to fruition was "implausible."[116] But the court did instruct the Tax Court to decide this point.[117]

Finally, the Fifth Circuit took exception to the manner in which the Tax Court dealt with the effect of the easement on the Kress building.[118] "[T]he tax court limited its inquiry to whether the easement legally bound the Kress building; it merely considered a snapshot of the property's legal status as at the date of the conveyance."[119] Noting that the easement does not mention the

---

107. *Id.* at 335.
108. *See id.*
109. *Id.*
110. *See id.*
111. *Id.*
112. *Id.* (alteration in original) (emphasis omitted).
113. *See id.* at 336.
114. *Id.*
115. *See id.* at 337.
116. *Id.*
117. *See id.*
118. *See id.* at 337-38.
119. *Id.* at 338.

Kress building, the Tax Court ruled that Whitehouse had "failed to show how [its easement contractual] promise binds anyone who does not undertake it; e.g., a person acquiring ownership of the Kress Building by eminent domain or as a result of the owner of the building's bankruptcy."[120]

The Fifth Circuit concluded that the Tax Court failed to consider:

> [T]he easement's effect on fair market value in the light of the imminent legal and functional consolidation of the two buildings. In other words, the tax court was correct that, because, on the day of donation, the condominium regime was not yet in effect, a successor could have purchased the Kress building separately that day and would not have been bound by the easement; but, as a matter of valuation, the tax court erred by not considering the effect on market value of the buildings' pending combination.[121]

A buyer, therefore, would have considered the legal consolidation of the two buildings.[122] The condominium declaration was filed the day following the easement contribution, a factor important to the Tax Court.[123] But the Fifth Circuit found error:

> The tax court erred in failing to consider the effect on fair market value of the pending condominium regime's precluding any future legal separation between ownership of the two buildings.
>
> . . . [A] prospective buyer would have been aware that the renovation plans, which were already in place, involved the Kress building's containing, among other things, the *porte cochere* and air-conditioning supply units necessary to operate a hotel in the Maison Blanche building.[124]

The court determined that the easement affected the fair market value of the two buildings and that it was error for the Tax Court not to consider this fact.[125] In the court's words:

> The effect of the easement's impact on the property's fair market value, such as prohibiting building 60 additional rooms on top of the Kress building, is a question of fact for the tax court to decide on remand. Therefore, we vacate its valuation and remand for reconsideration of the easement's value. As discussed *supra*, in making this valuation on remand, the tax court should, among other things, reconsider the experts' reports and valuation methods

120. *Id.* (alteration in original) (emphasis omitted).
121. *Id.* at 338-39 (emphasis omitted).
122. *Id.* at 339.
123. *See id.*
124. *Id.*
125. *Id.*

(including, *inter alia*, using non-local comparables) and their conclusions regarding highest and best use as a luxury or non-luxury hotel.[126]

126. *Id.* at 340.