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Federal Taxation

by Timothy J. Peaden*

Procedural issues once again dominated the federal tax cases decided by the Eleventh Circuit. During 1994, the court considered cases involving the assessment procedure, jurisdiction issues, transferee liability, priority of liens, and other procedural issues.

I. INCOME TAXES

A. Tax Assessments

The issue in *Hempel v. United States*¹ was whether the taxpayers had waived their right to a notice of deficiency.² The tangled facts of this case required the Eleventh Circuit to consider a number of the procedural provisions in the Internal Revenue Code ("IRC"). Seeking to tie the results of their case to another case being tried in the United States Tax Court, the taxpayers first executed a series of consents to waive the statute of limitations³ and then a closing agreement in which they

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1. 14 F.3d 572 (11th Cir. 1994).

2. *Id.* at 574. If the Internal Revenue Service determines that there is a deficiency in income, estate, or gift taxes, it will send a notice of deficiency to the taxpayer. 26 U.S.C. § 6212(a) (1988). Because the taxpayer has 90 days in which to file a petition with the United States Tax Court contesting the deficiency, the notice of deficiency is commonly referred to as the "90-day letter." 26 U.S.C. § 6213(a).

3. 14 F.3d at 574. The statute of limitations for assessing an income tax deficiency is typically three years (26 U.S.C. § 6501(a)), although that period can be extended by agreement of the taxpayer. 26 U.S.C. § 6501(c)(4). The taxpayers in this case executed a series of such consents, culminating with the execution of a Form 872-A (Special Consent to Extend the Time to Assess Tax). 14 F.3d at 575. The limitation period for assessing tax was thus extended to ninety days after the taxpayers terminated the extension by filing a Form 872-T (Notice of Termination of Special Consent to Extend the Time to Assess Tax).

agreed to be bound by the results of the other case.⁴ The closing agreement provided:

The amount of any federal income tax that becomes due from the taxpayers under the terms of this agreement may be assessed by the Commissioner of Internal Revenue on or before the expiration of the one year (365 days) period following the date on which the decision in the controlling cases become [sic] final, notwithstanding the expiration of any period of limitation on assessment and collection otherwise prescribed by the Internal Revenue Code section 6501. *This assessment shall be made without the issuance of the notice of deficiency authorized by . . . section 6212 and without regard to the restrictions otherwise imposed by . . . section 6213.*⁵

Two years after *Sutton* was decided, the taxpayers terminated their consent to the extension of the statute of limitations.⁶ The IRS assessed the taxes due under the closing agreement and did not send a notice of deficiency.⁷ The taxpayers then brought this action to enjoin the collection of taxes.⁸

The Eleventh Circuit upheld the district court's dismissal of the case, albeit for different reasons.⁹ The issue was whether, as contended by the taxpayers, the closing agreement required the IRS to issue a notice of deficiency unless the taxes were assessed within one year of the decision in the *Sutton* litigation.¹⁰ The Eleventh Circuit held that the taxpayer's interpretation was inconsistent with the plain language of the closing agreement and that it was illogical in view of the circumstances surrounding the agreement.¹¹

4. 14 F.3d at 574. Section 7121(a) of the Internal Revenue Code authorizes the Secretary of the Treasury to enter into a written agreement with any person regarding a tax liability. 14 F.3d at 574 n.10.

5. 14 F.3d at 575 (emphasis in original).

6. *Id.*

7. *Id.*

8. *Id.* Under the Anti-Injunction Act, courts cannot enjoin the Internal Revenue Service from collecting or assessing taxes. 26 U.S.C. § 7421(a) (1988). One exception, relied upon by the taxpayers in *Hempel*, is when the Internal Revenue Service fails to send the notice of deficiency. See 26 U.S.C. §§ 6212(a), 6212(c), 6213(a), 7421(a). Taxpayers, however, can waive the right to a notice of deficiency. 26 U.S.C. § 6213(d).

9. 14 F.3d at 576. The Eleventh Circuit agreed with the taxpayers that the district court's reliance on equitable grounds was misplaced when considering an issue of jurisdiction. *Id.* The Eleventh Circuit noted, however, that affirmance was proper if the lower court decision was correct for any reason. *Id.*

10. *Id.* at 576-77.

11. See 14 F.3d 572, 577-79. The taxpayers in this case did not argue that the taxes were incorrect, but rather that they were entitled to a notice of deficiency prior to assessment. *Id.* at 575. The Eleventh Circuit could not discern a rational explanation why

In *Feldman v. Commissioner*,¹² the Eleventh Circuit considered the validity of consents to waive the statute of limitations.¹³ It was uncontroverted that the taxpayers had entered into the consents and had not terminated their consents by filing a Form 872-T for the years at issue.¹⁴ After the IRS issued a notice of deficiency, the taxpayers filed a petition in the Tax Court challenging the deficiency.¹⁵ The Tax Court rejected the taxpayers' argument that the consents were invalid and, after a trial, upheld the deficiencies.¹⁶

The Eleventh Circuit rejected the taxpayers' argument that the consents were invalid due to fraud and misrepresentation.¹⁷ Relying on a Seventh Circuit decision in *Borg-Warner Corp. v. Commissioner*,¹⁸ the taxpayers argued they signed the consents based upon the understanding that "meaningful" settlement negotiations would ensue.¹⁹ The court found first that there were settlement negotiations and second that *Borg-Warner* was inapposite.²⁰ In particular, the issue in *Borg-Warner* was whether the IRS terminated the consent by mailing a letter stating that no mutually satisfactory basis for settling the matter was reached and that a notice of deficiency would be sent.²¹ In *Feldman* it was clear that the consent was not terminated until the taxpayers filed Form 872-T.²²

B. "Innocent Spouse" Defense

Although frequently claimed, courts rarely allow the "innocent spouse" defense to a taxpayer.²³ In *Kistner v. Commissioner*,²⁴ the Eleventh

the closing agreement would require a notice of deficiency after the one year period, given that the purpose of the closing agreement was to bind the parties to the result in *Sutton*. *Id.* at 578.

12. 20 F.3d 1128 (11th Cir. 1994).

13. *Id.* at 1133.

14. *Id.* at 1131.

15. *Id.*

16. *Id.*

17. *Id.* at 1132.

18. 660 F.2d 324 (7th Cir. 1981).

19. 20 F.3d at 1132.

20. *See id.* at 1132-34.

21. *Id.* at 1133.

22. *Id.*

23. Although both parties to a joint return are liable for any deficiency, § 6013(e) of the Internal Revenue Code provides that relief may be granted to the "innocent spouse" if each of the following is established: (a) a joint return is filed; (b) there is a substantial understatement of tax attributable to the grossly erroneous items of one spouse; (c) the other spouse establishes that he or she did not know, and had no reason to know, that there was a substantial understatement of tax; and (d) it is inequitable to hold the spouse

Circuit reversed the Tax Court and found the defense to be applicable.²⁵ Lucille Kistner and George W. Weasel, Jr. were married for twenty-four years, divorced for a two-year period, remarried for four more years, and then divorced again.²⁶ Throughout these years the taxpayers enjoyed an affluent lifestyle.²⁷ The Commissioner determined that for years 1979 and 1980, during the second marriage, the couple received additional income of \$1,142,681 and \$1,386,134 relating to personal expenses paid by their corporation.²⁸ The Tax Court rejected Kistner's "innocent spouse" claim, finding that while she may have been unaware of the "precise tax implications of the payments . . . she was or should have been aware of the payments, and she had a duty to make further inquiry as to the proper tax treatment thereof."²⁹

The Eleventh Circuit disagreed that the taxpayer had "reason to know" of the tax deficiency.³⁰ Relying on *Stevens v. Commissioner*,³¹ the Eleventh Circuit enumerated a four-part test to determine whether a taxpayer had a "reason to know": (1) the taxpayer's level of education; (2) the taxpayer's involvement in the family's business and financial affairs; (3) lavish or unusual expenditures as compared with the past; and (4) the culpable spouse's evasiveness and deceit regarding the couple's finances.³² In this case, the Tax Court found that the taxpayer was not a high school graduate and was not significantly involved in the financial affairs of the couple, thus satisfying the first two criteria.³³ While the Tax Court found that the third criterion was unsatisfied, it "seemed to determine lavishness based on the dollar value of the expenditure rather than evaluating the rarity of the expense."³⁴ Noting that "one person's luxury may be another's necessity," the Eleventh Circuit stated that the "lavishness of any expense must be measured

liable for the tax attributable to the substantial understatement. See 26 U.S.C. § 6013(e)(1).

24. 18 F.3d 1521 (11th Cir. 1994).

25. *Id.* at 1522.

26. *Id.* at 1523-24.

27. *Id.* at 1523. In the initial divorce the taxpayer received the 10-acre estate, complete with swimming pool, tennis court, clubhouse, and airplane landing strip, and annual income of \$225,000. *Id.* at 1522. During the remarriage the taxpayer received a monthly cash allowance of \$15,000. *Id.* at 1523. Following the second divorce the taxpayer received a lump sum alimony payment of \$4,280,000. *Id.*

28. *Id.*

29. *Id.*

30. *Id.* at 1525.

31. 872 F.2d 1499 (11th Cir. 1989).

32. 18 F.3d at 1525.

33. *Id.*

34. *Id.*

from each family's relative level of ordinary support."³⁵ In this case, the expenditures in question were no more lavish than those to which the taxpayer was accustomed.³⁶

By contrast, the Eleventh Circuit in *Feldman v. Commissioner*,³⁷ rejected the taxpayers' "innocent spouse" defense.³⁸ As noted previously, each of the requirements of section 6013(e) must be met in order for the defense to be applicable, and the issue in this case was whether the deductions claimed were "grossly erroneous."³⁹ Although the Tax Court had denied the deductions in question, it further held that the deductions were not "grossly erroneous."⁴⁰ The Eleventh Circuit agreed.⁴¹

II. ESTATE AND GIFT TAXES

In *Baptiste v. Commissioner*,⁴² the Eleventh Circuit upheld the Tax Court's grant of summary judgment to the government.⁴³ The taxpayer was the beneficiary of an estate which was previously found to owe a tax deficiency.⁴⁴ The Commissioner asserted transferee liability against the taxpayer, relying on section 6324(a)(2) of the Internal Revenue Code.⁴⁵ Given the specific statutory provision imposing transferee liability, the Eleventh Circuit first rejected the taxpayer's argument that transferee status should be based on state law.⁴⁶ Next, the court found that the amount of the tax liability had been properly determined in the prior proceeding, and the taxpayer's attempt to recompute the amount was barred by *res judicata*.⁴⁷ Finally, the court found the taxpayer was liable for interest on the tax deficiency, and that the limitation on

35. *Id.*

36. *Id.*

37. 20 F.3d 1128 (11th Cir. 1994).

38. *Id.* at 1137.

39. *Id.* at 1135.

40. *Id.* at 1137. This requirement of "grossly erroneous" often results in a denial of the innocent spouse defense while the taxpayers are held liable for the tax.

41. *Id.*

42. 29 F.3d 1533 (11th Cir. 1994).

43. *Id.* at 1535.

44. *Id.* at 1535-36.

45. *Id.* at 1536. 26 U.S.C. § 6324(a)(2) provides:

If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, trustee . . . , or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time the decedent's death, of such property, shall be personally liable for such tax.

29 F.3d at 1538.

46. 29 F.3d at 1538-39.

47. *See id.* at 1539-41.

transferee liability found in section 6324(a)(2) is inapplicable to the interest obligation.⁴⁸

III. OTHER PROCEDURAL ISSUES

A. Tax Court Jurisdiction

In *McMullen v. Commissioner*,⁴⁹ the Eleventh Circuit affirmed the Tax Court's denial of a motion for redetermination of interest following a stipulated decision as to the amount of the tax deficiency.⁵⁰ Following decisions in other circuits, the court determined that the taxpayer must pay the interest before the Tax Court has jurisdiction to decide the dispute.⁵¹

B. Litigation Fees

*In re Rasbury*⁵² was a case of first impression. After Chapter 11 debtors successfully defeated a claim for withholding taxes, they requested attorney fees pursuant to 26 U.S.C. § 7430.⁵³ The Eleventh Circuit, faced with the question for the first time,⁵⁴ held that abuse of discretion was the standard of review for the denial of attorney fees.⁵⁵ The court found unpersuasive the debtors' argument that a different rule

48. *Id.* at 1541-42. The court determined that § 6601 imposes interest on the transferees' liability. *Id.* at 1541. The more vexing issue is whether the § 6324(a)(2) limitation, which prevents the tax liability of a transferee being greater than the assets received, is applicable to the interest obligation. Finding that the interest obligation is that of the transferee, and that the purpose of interest is to compensate the government for the use of its money, the court ruled against the taxpayer. 29 F.3d at 1541. This result can lead to a situation where the beneficiary owes the government more than what was received from the estate.

49. 27 F.3d 510 (11th Cir. 1994).

50. *Id.* at 511.

51. *Id.* at 510-11. *Accord* *Asciutto v. Commissioner*, 26 F.3d 108 (9th Cir. 1994); *Littfin v. Commissioner*, 17 F.3d 1345 (10th Cir. 1994); *Bax v. Commissioner*, 13 F.3d 54 (2d Cir. 1993); *Amlie v. Commissioner*, 73 A.F.T.R. 2d 416 (P-H) (1993); *Frantz v. Commissioner*, 4 F.3d 990 (5th Cir. 1993).

52. 24 F.3d 159 (11th Cir. 1994).

53. *Id.* at 161.

54. *Id.* at 165. The six circuits previously considering the issue applied the abuse of discretion standard. *See* *TKB Int'l, Inc. v. United States*, 995 F.2d 1460 (9th Cir. 1993); *Wilfong v. United States*, 991 F.2d 359 (7th Cir. 1993); *Pate v. United States*, 982 F.2d 457 (10th Cir. 1993); *Cassuto v. Commissioner*, 936 F.2d 736 (2d Cir. 1991); *Bowles v. United States*, 947 F.2d 91 (4th Cir. 1991); *In re Arthur Andersen & Co.*, 832 F.2d 1057 (8th Cir. 1987).

55. 24 F.3d at 166.

should apply because the district court reviewed the bankruptcy court's determination de novo.⁵⁶

C. Tax Liens

Another case arising in a bankruptcy context, *In re Haas*,⁵⁷ considered the priority of a federal tax lien filed after a mortgagee's erroneous release of mortgage, but before it was reinstated.⁵⁸ The bankruptcy court and the district court, relying on Alabama law, held that the reinstated mortgage had priority.⁵⁹ The Eleventh Circuit reversed.⁶⁰ After determining that a judgment creditor without notice of an erroneously released lien would have priority under Alabama law,⁶¹ the Eleventh Circuit adopted the reasoning of the Seventh Circuit in *Dragstrem v. Obermeyer*.⁶² The IRS should enjoy the status of a "hypothetical judgment creditor."⁶³ Moreover, the court found "that the Treasury Regulations forbid application of a relation back principle to award an unperfected tax lien priority over the tax lien."⁶⁴

IV. CIVIL AND CRIMINAL PENALTIES

A. "Responsible Person" Penalty

"Responsible persons" who "willfully" fail to pay withholding taxes for employees are personally liable for those taxes.⁶⁵ In *Malloy v. United States*,⁶⁶ the Eleventh Circuit considered whether the "willful" requirement can be satisfied only by actual knowledge of the failure to pay.⁶⁷

56. *See id.* at 166-68.

57. 31 F.3d 1081 (11th Cir. 1994).

58. *Id.* at 1082.

59. *Id.*

60. *Id.* at 1092.

61. *Id.* at 1086.

62. 549 F.2d 20 (7th Cir. 1977).

63. 31 F.3d at 1087. The court reasoned that this result was consistent with the language of 26 U.S.C. § 6323(h)(1) and the Federal Tax Lien Act. 31 F.3d at 1087.

64. 31 F.3d at 1091 (citing Treas. Reg. § 301.6323(h)-1(a)(2) (1976)).

65. *See* 26 U.S.C. § 6672(a). Section 6672(a) provides that:

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payments thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

26 U.S.C. § 6672(a).

66. 17 F.3d 329 (11th Cir. 1994).

67. *Id.* at 332.

John Malloy, a fifty percent owner of a condominium management company, was assessed the withholding taxes for the fourth quarter of 1982 and the first two quarters of 1983.⁶⁸ Malloy did not contest the finding that he was a "responsible person."⁶⁹ He instead challenged the assessment based on his lack of actual knowledge of the unpaid withholding tax liability until July 1983.⁷⁰ He argued that the "willful" requirement could only be satisfied if there was a finding of actual knowledge of the tax deficiency.⁷¹

Relying on the former Fifth Circuit decision in *Mazo v. United States*,⁷² the Eleventh Circuit found that actual knowledge was unnecessary.⁷³ Instead, "a reckless disregard of a known or obvious risk of nonpayment" is sufficient to satisfy the "willful" criteria.⁷⁴ The court found that Malloy was aware of the corporation's financial difficulties by February 1983, and that he failed to make any inquiry regarding the payment of taxes.⁷⁵ These facts were sufficient to uphold the district court's finding that Malloy acted with "reckless disregard" concerning the nonpayment of the taxes.⁷⁶

The Eleventh Circuit also rejected Malloy's argument that he should not be held liable for the 1982 taxes because those taxes predated his knowledge of the corporation's financial difficulties.⁷⁷ The court instead applied the general rule that once a responsible person becomes aware (or should have become aware) of unpaid taxes, the failure to pay those taxes while paying other creditors constitutes a "willful" failure to pay the taxes.⁷⁸

68. *Id.* at 331.

69. *Id.* at 332. The term "responsible person" is not defined in the statute. Typically, the term includes anyone in a position or with authority to ensure the payment of the taxes. *See, e.g., Haffa v. United States*, 516 F.2d 931 (7th Cir. 1975) (defined as persons who have the power to control the decision-making process regarding the allocation of funds to the creditors). It is unclear whether Mr. Malloy held a formal position of authority within the corporation. It is clear that he took certain management actions, including the firing of one employee because of the shortage of funds and the signing of checks to creditors. 17 F.3d at 331.

70. 17 F.3d at 332. Mr. Malloy's testimony on this point was contradicted by the other co-owner of the business. *Id.* at 331. It was unnecessary for the court to resolve this conflict because of its holding that the statute did not require actual knowledge.

71. *Id.* at 332.

72. 591 F.2d 1151 (5th Cir.), *cert. denied*, 444 U.S. 842 (1979).

73. 17 F.3d at 332.

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.* at 332-33.

Although not addressed in *Malloy*, it is often an issue whether a shareholder is a "responsible person" within the meaning of Section 6672. Most courts have required that the shareholder actually exercise some authority regarding the disbursement of funds,⁷⁹ while other courts have held that the existence of the authority was sufficient.⁸⁰ The court in *Malloy* did not have to consider this issue because the shareholder did exercise management authority including the disbursement of funds, which courts typically have found to be the most important fact when determining whether a person was a "responsible person."

B. Tax Crimes

In *United States v. Morris*,⁸¹ the Eleventh Circuit found that the trial court erred when it failed to give a jury instruction concerning the defendants' good faith defense.⁸² Charged with filing false income tax returns in violation of Section 7206(1) of the Internal Revenue Code, the defendants admitted that the returns were erroneous, but asserted that the returns were filed with the belief that they were correct.⁸³ In *Cheek v. United States*,⁸⁴ the Supreme Court defined the statutory "willfulness" requirement as the voluntary, intentional violation of a known legal duty.⁸⁵ The Eleventh Circuit noted that *Cheek* "clearly articulates the requirements of a good-faith defense . . . and as such serves as the basis for determining the sufficiency of jury instructions."⁸⁶ The Eleventh Circuit found the given jury instruction to be deficient in two respects. First, it defined the term "knowingly" as meaning "that the act was done voluntarily and intentionally and not because of mistake or accident."⁸⁷ This was error because, under the *Cheek* standard, "mistake" can be the basis of a good faith defense.⁸⁸ Second, *Cheek* does not require the good faith of a defendant to be objectively reasonable.⁸⁹ Here, the Eleventh Circuit held "[a]lthough

79. See generally *In re Premo*, 116 B.R. 515 (Bkrcty. E.D. Mich. 1990) (reviewing a number of cases on this subject).

80. See, e.g., *Cassidento v. United States*, 90-1 USTC (CCH) ¶ 50,171 (D. Conn. 1990).

81. 20 F.3d 1111 (11th Cir. 1994).

82. *Id.* at 1114.

83. *Id.* at 1115.

84. 498 U.S. 192 (1991).

85. *Id.* at 202.

86. 20 F.3d at 1115.

87. *Id.* at 1117.

88. *Id.*

89. *Id.* The court noted that this is a "notable departure from the more traditional crime, where mistake of the law is no defense." *Id.*

there is no requirement in this circuit that jury instructions specifically note that a good-faith defense need not be objectively reasonable, when viewed as a whole the charge here is insufficient to convey the permissible breadth of the appellants' *Cheek* good-faith defense.⁹⁰

In *United States v. Paul*,⁹¹ the Eleventh Circuit held that a defendant was not entitled to a jury instruction that multiple cash withdrawals exceeding \$10,000 must be performed in a single day.⁹² The defendant was convicted of unlawful currency structuring when he converted a cashier's check into cash over a period of days.⁹³ The court rejected the defendant's arguments that the currency statute did not cover multiple days prior to the enactment of a Treasury Regulation defining "structuring" to include transactions over a period of time.⁹⁴ The defendant also was not entitled to rely on regulations which would not require *banks* to aggregate transactions for reporting purposes.⁹⁵

V. CONCLUSION

Perhaps the most striking aspect of the 1994 year was the utter lack of attention to substantive tax issues. Even in the income and estate and gift tax areas, the Eleventh Circuit's decisions centered on the procedural sections of the Internal Revenue Code. This trend, occurring in other circuits as well, simply tracks the increasing complexity of the procedures for assessing and collecting the tax.

90. *Id.* at 1118.

91. 23 F.3d 365 (11th Cir. 1994).

92. *Id.* at 367.

93. *Id.* at 366. Defendant was charged with violating 31 U.S.C. §§ 5322 and 5324(3). 23 F.3d at 366.

94. 23 F.3d at 367.

95. *Id.* at 367-68.