Flawed Analysis Supports Common Law Tax Deficiency Ruling

By **Loren Opper and Christie Galinski** (July 11, 2023)

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In June, the U.S. District Court for the District of Colorado ruled in the high profile case Liberty Global Inc. v. U.S.,[1] that the U.S. Department of Justice may rely on common law rather than the Internal Revenue Code's statutory notice of tax deficiency to assert a federal income tax deficiency.[2]

In the court's view, the government has two alternative procedures to establish federal income tax liability above the tax amount that the taxpayer shows on its tax return.

The first alternative is the commonly known procedure of examination of the taxpayer's federal income tax return by the commissioner of Internal Revenue, followed by the commissioner's issuance of a notice of deficiency, which the taxpayer may challenge in U.S. Tax Court, and on which the commissioner may not act until a decision in the Tax Court proceeding is final.[3]

The second alternative that the ruling identifies allows the government — meaning the Justice Department — to sue a taxpayer at common law in federal district court for a federal income tax debt that the commissioner did not determine and never assessed.

The court supports this ruling by contorting a provision of the IRC that expressly prohibits a court proceeding in these circumstances.[4] The court does so by relying on case law of doubtful relevance, and by finding a gap in the IRC that the Justice Department — and not the commissioner — can fill with an action at common law even though no such gap likely exists.

The ruling is novel, profoundly complicates an analysis of how to manage tax controversies and is worthy of close attention.

Internal Revenue Code Restriction on Court Proceedings

The IRC authorizes the commissioner to "determine" a federal income tax deficiency.[5] If the commissioner determines a deficiency, he must send a notice of deficiency to the taxpayer.[6]

Until that notice is sent to the taxpayer, no assessment of a deficiency may be made nor court proceeding be prosecuted to collect it.[7] Moreover, if the taxpayer timely files a petition in Tax Court, the deficiency cannot be assessed or a collection proceeding prosecuted until the Tax Court decision becomes final.[8]

The taxpayer in Liberty Global argued that this tax procedure expressly restricted the Justice Department from prosecuting an action at common law in district court to establish a federal income tax deficiency and collect it.

The court rejected the argument. The court dismissed the importance of the commissioner's issuance of a statutory notice as a precondition to a deficiency assessment or prosecution of a judicial collection proceeding.

Instead, the court found that the Justice Department summons and complaint served on the taxpayer in the common law proceeding was legally sufficient, and that requiring the commissioner to serve a deficiency notice was merely duplicative. But it is not duplicative.

Concerned about taxpayer relations and avoidance of heavy-handed treatment of taxpayers, Congress requires the commissioner to assist the taxpayer by providing information about contacting the taxpayer advocate as part of a notice of deficiency. The Justice Department's common law complaint is not legally required to assist the taxpayer and most probably did not offer any assistance.

Next, the court interpreted the statutory restriction on a court proceeding as applying only to collection of an assessment, but not to collection of a deficiency. Thus, the ruling permitted the Justice Department to prosecute its common law action to collect the deficiency, restricting the department only from collecting an assessment.

But the statutory language restricts the making of an "assessment of a deficiency" and no court proceeding may be prosecuted to collect it.[9] The court's reading unmoored "deficiency" from the phrase "assessment of a deficiency."

"Deficiency" defines the type of assessment, meaning a "deficiency assessment" and a court proceeding to collect a deficiency assessment cannot be prosecuted until the commissioner issues a deficiency notice, and, if the taxpayer petitions the court to redetermine the deficiency, the Tax Court decision becomes final. These steps were not performed.

Reliance on Inapplicable Case Law

Existence of a cause of action at federal common law depends on whether Congress enacted legislation intending to supplant the common law. For example, in Samantar v. Yousuf, Somalis who were tortured by a Somali official sued the official in federal court for damages. The official argued that the Federal Sovereign Immunities Act immunized him from a damage claim in federal court.

In 2010, the U.S. Supreme Court ruled that the scope of FSIA immunity did not include an individual, stating: "Whether he may be entitled to immunity under the federal common law is a matter to be addressed in the first instance by the District Court on remand."[10]

In contrast, in its 2011 City of Milwaukee v. Illinois and Michigan decision,[11] the Supreme Court ruled that the Federal Water Pollution Act supplanted any federal common law cause of action against Milwaukee for discharging raw sewage into Lake Michigan because the federal law was all-encompassing. The court stated that Congress treated the subject so comprehensively that no statutory gap existed.

Based on these cases, the question in Liberty Global should have been whether Congress intended the statutory notice of a tax deficiency to determine a federal income tax deficiency to be all-encompassing or left a gap in the IRC to be filled with a common law cause of action brought by the Justice Department to determine the existence of such a liability.

The court cited case authorities for the proposition that the Justice Department has a common law right to sue a taxpayer for a tax debt as an alternative to the IRC-based procedure. None of the cases cited discussed a gap in the commissioner's federal income tax deficiency procedure, and none involved a claim by the Justice Department of an as-yet undetermined and unassessed federal income tax liability. These cases were not on point, which the government admitted in its brief.[12]

Conflation of Determination of Tax Deficiency and Collection of Assessed Tax

The court equated the commissioner's summary collection procedures, such as a tax lien or levy, with the Justice Department's common law right to sue for an outstanding tax debt. The commissioner's notice of deficiency is not, however, a summary collection procedure. It is a deficiency determination procedure.

The determination of whether a federal income tax deficiency exists is different from collection of a previously determined, outstanding tax debt. A federal income tax deficiency does not become an assessable, outstanding tax debt until the period for filing a Tax Court petition expires or, if the taxpayer petitions the Tax Court for relief from the deficiency, when the court's decision becomes final.

Aggressive Use of Refund Claim Proceeding

The court noted that the taxpayer used the refund claim procedure to accelerate the commissioner's examination of the tax treatment of a transaction with Telenet Group Holding, which was the substantive issue in the proceeding. The commissioner may, however, issue a deficiency notice even if the taxpayer filed a refund claim in federal district court.[13] Doing so does not violate a policy of avoiding piecemeal litigation if the statute of limitations for determining a deficiency has not expired.

In Liberty Global, the commissioner did not timely issue a notice of deficiency, but a limitations statute should not be considered a gap in a statutory procedure allowing a common law cause of action.[14]

If the commissioner had timely issued a notice of deficiency after the taxpayer filed its refund claim in federal district court, the taxpayer could have petitioned the Tax Court to challenge the notice of deficiency. The Tax Court then would have acquired jurisdiction over the refund litigation in federal district court.[15] The statutory procedure for the commissioner to protect the government's interest was available, but the commissioner did not avail himself of it, perhaps intentionally wanting the district court to retain jurisdiction.

The Justice Department's Reliance on Statute

The Justice Department's complaint in Liberty Global alleges that the action is commenced under IRC Section 7401:

> No civil action for the collection or recovery of taxes, or of any fine, penalty, or forfeiture, shall be commenced unless the Secretary authorizes or sanctions the proceedings and the Attorney General or his delegate directs that the action be commenced.

First, this theory seems to be self-contradictory. If the action is code based, it would not appear to be an action at common law.

Second, Section 7401 applies to an action to collect or recover a tax. A collection action for income taxes is predicated on an assessment.[16] Without an assessment, the Justice Department has no tax to collect under Section 7401.

Third, recovery of a tax also does not appear to be a basis on which the Justice Department can sue a taxpayer to establish an income tax deficiency.[17] A federal income tax proceeding to redetermine a deficiency asserted by the commissioner is not a recovery of taxes for the reason that the commissioner did not remit a tax refund to the taxpayer or allow a credit against the taxpayer's liability that the commissioner thereafter sued to recover.

Substantive Issues in District Court Litigation

The taxpayer in Liberty Global filed a refund claim in federal district court seeking a tax refund of $96 million, which it paid with its original 2018 return with respect to its international restructuring transaction, the TGH transaction.[18] The Justice Department thereafter filed its complaint based on a common law right to sue for an outstanding tax debt for the same tax year.

The Justice Department alleged that the taxpayer did not pay $284 million in tax on the TGH transaction in its 2018 original return. The taxpayer then moved to dismiss the Justice Department complaint on the theory that federal tax law has only one method for assertion of an income tax deficiency: timely issuance of notice of deficiency by the commissioner, which he did not issue.

The court denied the taxpayer's motion, concluding that the United States had a common law right to sue a taxpayer in federal district court for an income tax debt.

TGH Transaction

According to the Justice Department complaint, the taxpayer formulated a plan to restructure its foreign operations in a manner that recharacterized $2.4 billion of gain, otherwise reportable domestically by the taxpayer's federal consolidated group as dividend income that was deductible pursuant to newly enacted provisions of the Tax Cut and Jobs Act.[19] The restructuring sought to exploit a mismatch in effective dates of provisions in the TCJA.

The Temporary Regulations

The Treasury Department published retroactively effective temporary income tax regulations to address the mismatch.[20] The taxpayer challenged the validity of the temporary regulations, alleging that they violated the Administrative Procedure Act because the Treasury Department published them without notice and an opportunity of the public to comment. The court agreed with the taxpayer that the regulations were invalid.[21]

The taxpayer apparently filed its original 2018 income tax return in a manner consistent with the temporary regulation, which limited its dividends received deduction. Two months later, the taxpayer filed an amended return claiming the $96 million refund based its correct expectation that the temporary regulations were invalid.

Attitudinal Issues Possibly Affecting Court Decision

The court said that the taxpayer unfairly exploited the tax refund procedure by forcing the commissioner to stay his administrative examination of the taxpayer's 2018 income tax return:

> Defendant cannot seek to profit by compelling litigation in one forum [federal district court] and then complain that it has been deprived of some benefit provided by the other forum [U.S. Tax Court].

Yet, the refund procedure was lawful. The taxpayer should not be subject to criticism for using it.

Taxpayer Concerns About Common Law Proceedings

Litigation in federal district court differs from litigation in Tax Court. For example, the Tax Court uses a forced stipulation procedure to streamline trials and control litigation costs. Discovery may be more extensive and expensive in federal district court.

Taxpayers often agree to extend the limitation period on income tax assessments to guard against endless examinations. Taxpayers should now consider whether refusing a request by the commissioner to extend the limitations period raises the risk of a Justice Department common law proceeding in federal district court.

Congress wants the Internal Revenue Service Appeals Office to play a significant role in tax administration. The role of the IRS Appeals Office, if any, would have to be clarified in the context of a common law action to establish a tax deficiency. Undoubtedly, many more taxpayer questions and concerns will emerge if the government decides to increase use of common law actions to assert federal income tax deficiencies.

Next Steps

The Justice Department is arguing that the TGH transaction lacked economic substance, is not respected for tax purposes and therefore did not shelter the taxpayer's gain.[23] That issue remains to be litigated in the district court proceeding. A final decision in the case on whether the Justice Department may sue a taxpayer in an action at common law, the temporary regulations were invalid and the TGH transaction lacked economic substance will be appealable to the U.S. Court of Appeals for the Tenth Circuit.

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[1] No. 1:22-cv-02622-RBJ (D. Colo. June 1, 2023).

[2] IRC §6212(a).

[3] IRC §6213(a).

[4] Id.

[5] IRC §6212(a).

[6] Id.

[7] IRC §6213(a).

[8] Id.

[9] Id.

[10] Samantar v. Yousuf, 560 U.S. 305, 325–26 (2010). See also Turkiye Halk Bank v. United States, 143 S.Ct. 940 (April 19, 2023), holding that although FSIA does not immunize a foreign bank owned by Turkey from criminal prosecution because FSIA applies only to civil litigation, the court is to consider on remand whether litigation may be barred by FISA under the common law.

[11] 451 U.S. 304, 312–20 (1981)

[12] The court cited Shelter Mutual Insurance Mutual Ins. Co. v. Gregory, 555 F. Supp. 2d 922 (2008) (notice of deficiency in fact issued for 2004 and 2005); Jersey Shore State Bank v. United States, 107 S. Ct. 782 (1987)(employment tax case for which a notice of deficiency cannot be issued); United States v. Erie Forge Co., 191 F.2d 627 (3rd Cir. 1951)(delinquency penalty for which a notice of deficiency could not be issued); United States v. Sarubin, 507 F.3d 811 4th Cir. 2007)(deficiency interest on assessed taxes accrued as a matter of law and was not subject to notice of deficiency procedure); Damsky v. Zavatt, 289 F.2d 46 (2nd Cir. 1961) (taxes were previously assessed in this lien foreclosure proceeding); Marvel v. United States, 719 F.2d 1507 (10th Cir.1983)) (employment tax case which is not subject to the notice of deficiency procedure); Macatee v. United States, 214 F.2d 717 (5th Cir. 1954)(employment tax case not subject to the notice of deficiency procedure). In its brief, the Government admits "[n]one of the authorities cited above address the precise situation – though they lay out the general principles the Court should apply."

[13] Hemmings v. Commissioner, 104 T.C. 221 (1995).

[14] The Commissioner generally has three years to assess a tax deficiency after the return is filed. IRC §6501(a).

[15] IRC §7422(e).

[16] IRC §6303.

[17] A recovery of a tax occurs when, for example, an estate claims a foreign tax credit under IRC §2014 and then recovers the credit from the foreign tax authority. The estate then is obligated to notify the Commissioner of the recovered tax, who redetermines the estate's tax liability and requires payment from the estate for the recovered tax. The Commissioner also may recover an erroneous refund under IRC §7405, but that presupposes that the Commissioner refunded tax to the taxpayer.

[18] A taxpayer may sue for refund in federal district court if the IRS does not act on the claim within six months of filing the claim. IRC §6532(a)(1).

[19] Pub. L. No. 115-97, 131 Stat. 2054 (2017). Gain from the sale of stock in a controlled foreign corporation generally is included in the United States shareholder's income as dividend income to the extent of the earnings and profits of the stock in the controlled

foreign corporation. The TGH transaction appears to maximize earnings and profits in TGH, which would be available for recharacterization as dividends and then be deductible. An affiliate of the taxpayer sold its interest in TGH, a Belgian company, in December 2018. The taxpayer was required to recognize income on its share of the gain from the sale. It recharacterized the gain as a dividend and deducted the dividend under using IRC §245A, enacted by the Tax Cuts and Jobs Act of 2017 (TCJA). Reliance on the repeal in the TCJA of IRC §958(b)(4), a constructive ownership provision, was intended to prevent the flow of gain to the taxpayer's domestic consolidated tax group.

[20] 84 Fed. Reg. 28398 (June 18, 2019) (currently codified as Treas. Reg. §§1.245A-5, -11). The effective date mismatch was between IRC §951A that includes "global intangible low taxed income" ["GILTI"] and IRC §951A, which allows a taxpayer to deduct foreign dividend distributions.

[21] Liberty Global Inc. v. United States, 129 AFTR 2d 2022-1373, (D. Colo. Apr. 4, 2022).