Federal Income Taxation

by Robert Beard[*]

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In 2016, federal courts in the United States Court of Appeals for the Eleventh Circuit handed down several notable opinions on federal tax issues. This Article surveys four of those opinions involving the collection of foreign taxes pursuant to a tax treaty, the characterization of income from the sale of real estate as capital gains, and self-employment taxes on deferred compensation.[1]

I. *Boree v. Commissioner*

The Internal Revenue Code (Code)[2] provides for different rates of individual income tax for ordinary income earned through business activities and long-term capital gain income. Capital gain is "[i]ncome representing proceeds from the sale or exchange of a capital asset. . . ."[3] "Capital asset" is not directly defined in the Code, but does not include "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[4] Thus, when a taxpayer disposes of some property that has been held for more than a year, the question arises as to whether that property was held for sale as part of the taxpayer's business, or was instead purchased as an investment. In the Eleventh Circuit, determining whether an asset is a capital asset requires

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1. For an analysis of federal taxation cases decided during the prior survey period, see Robert Beard & Gregory S. Lucas, *Federal Income Taxation, Eleventh Circuit Survey*, 67 MERCER L. REV. 929 (2016).

2. I.R.C. § 41 (2012). Unless otherwise indicated, all "section" references are to the Code, as amended.

3. Long v. Commissioner, 772 F.3d 670, 675 (11th Cir. 2014) (per curium).

4. *Id.* (quoting I.R.C. § 1221(a)(1)).

consideration of seven factors set out in the old United States Court of Appeals for the Fifth Circuit case of *United States v. Winthrop*.[5] These factors include the following:

> (1) The nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales.[6]

Although the third Winthrop factor is the "most important,"[7] no one factor is determinative.[8] This makes the determination of whether an asset is a capital asset necessarily a fact-intensive inquiry.[9]

Due to the more favorable tax rates applicable to long-term capital gain, individual taxpayers generally will prefer to characterize income as long-term capital gain rather than ordinary income. Because of the highly fact-specific nature of the determination, it is often difficult for a taxpayer to predict if the Internal Revenue Service (IRS) will accept the taxpayer's characterization. The Eleventh Circuit addressed one such failed attempt to characterize the sale of real estate as the sale of a capital asset in *Boree v. Commissioner*.[10]

This case originated in a 2002 purchase of 1,892 acres of vacant land located in Baker County, Florida by Glen Forest, LLC (Glen Forest), a tax partnership of Gregory Boree (Boree) and Daniel Dukes (Dukes).[11] The purchase price was approximately $3.2 million and was substantially debt-financed. Within a month of the initial purchase, Glen Forest began making occasional sales of portions of the land.[12]

In 2003, Glen Forest submitted a residential development plan for the property to the Baker County Planning and Zoning Department. The planned residential development of the property would be called West

5. 417 F.2d 905 (5th Cir. 1969). Decisions handed down by the Fifth Circuit prior to October 1, 1981 are binding precedent in the Eleventh Circuit. *See* Bonner v. City of Prichard, 661 F.2d 1206, 1207 (11th Cir. 1981) (en banc).

6. *Winthrop*, 417 F.2d at 910.

7. Biedenharn Realty Co. v. United States, 526 F.2d 409, 416 (5th Cir. 1976) (en banc).

8. *Id.* at 415.

9. *Id.*

10. 837 F.3d 1093 (11th Cir. 2016).

11. *Id.* at 1095.

12. *Id.* at 1096.

Glen Estates, and would contain more than 100 lots, which Glen Forest would develop and sell in stages. Baker County accepted the proposal and rezoned the property, and also granted Glen Forest's request for an exemption from county requirements that Glen Forest complete interior roads prior to selling lots. Soon after, Glen Forest created a homeowners' association for West Glen Estates.[13] The association documents referred to Glen Forest as the "developer" and gave it authority to appoint at least one member to the association's board so long as Glen Forest "holds for sale in the ordinary course of business at least five percent (5%) of the acreage in all phases of the property."[14] The documents made no distinctions among the lots that made up West Glen Estates.[15]

After gaining the initial approvals from Baker County and forming the homeowners' association, Glen Forest continued with its efforts to develop West Glen Estates. It applied for environmental permits, created easements for water and utilities, and constructed an unpaved road. Glen Forest did not, however, maintain a sales office or hire a broker to sell lots, although it did place occasional classified advertisements for West Glen Estates in local newspapers. Through these efforts, Glen Forest sold approximately twenty-six lots in 2004.[16]

Development and selling slowed after a series of land use restrictions were adopted by Baker County in late 2004. These restrictions included moratoria on development along certain roads adjacent to West Glen Estates and on the development of subdivisions containing unpaved roads. It later required that internal subdivision roads be paved, a restriction from which Glen Forest sought, but failed to secure, an exemption. Boree estimated that complying with the paving requirement would cost approximately $7 million. Perhaps because of these new restrictions, Glen Forest sold only eight lots in 2005. Dukes also sold his interest in Glen Forest to Boree in 2005, and Boree's wife replaced Dukes as Glen Forest's second member.[17]

Faced with the new restrictions, Glen Forest attempted to get Baker County to approve higher-density development in order to help cover the costs of paving the roads. The new development plan would include a commercial zone and a recreational parcel for equestrian and other activities. Although Glen Forest won approval for this plan, Baker County

13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.* at 1096-97.

also adopted, in early 2006, a requirement that roads leading to subdivisions be paved, which would cost Glen Forest an estimated $4.4 million. Glen Forest sold no lots in 2006.[18]

Faced with the new paving requirement, Glen Forest turned to a developer, Adrian Development (Adrian), that was planning a development adjacent to West Glen Estates, in an attempt to sell West Glen Estates. An agreement was reached under which Adrian would purchase almost all of the remaining property (over 1,067 acres) for at least $9,000 per acre. The transaction closed in early 2007, and included property in various stages of development.[19]

The Borees' tax returns had been prepared by the same accounting firm since 1998. Glen Forest's Schedules K-1 for the years 2002 to 2004 reported ordinary losses from the sale of West Glen Estates lots. For the years 2005 to 2007, the costs incurred for the West Glen Estates property were deducted as ordinary and necessary business expenses. As those costs exceeded the Borees' business income, they also claimed ordinary losses in those years. The reporting of these gains, expenses, and losses as ordinary is consistent with the Borees being engaged in the business of developing real estate. However, the gain from the sale of the West Glen Estates property in 2007 was reported as long-term capital gain, rather than as ordinary gain.[20] That is consistent with the Borees being real estate investors, rather than developers.

In 2011, the IRS issued the Borees a deficiency notice relating to the characterization of the West Glen Estates income as long-term capital gains rather than ordinary income.[21] The IRS determined that the income from the sale should have been reported as ordinary income.[22] The IRS also imposed a 20% understatement of income tax penalty on the resulting underpayment.[23] The Borees challenged the deficiency notice and penalty in the Tax Court.[24]

At trial, the Borees contended that West Glen Estates was intended to be held as an investment, and that the sales were made only to service the debt incurred in the original purchase of the land. The Tax Court, however, noted that the evidence contradicted that testimony, and instead supported the IRS's position that the Borees purchased the property to develop in the ordinary course of business. Specifically, the Tax

18. *Id.* at 1097.
19. *Id.* at 1097-98.
20. *Id.* at 1098-99.
21. *Id.* at 1099.
22. *Id.*
23. *Id.*
24. *Id.*

Court noted that the Borees engaged in business activities that included the following: (1) subdividing the property; (2) building roads; (3) engaging in zoning activities; (4) presenting Glen Forest as a real estate business to prospective buyers, government bodies, and on their earlier tax returns; and (5) making frequent and substantial sales of property. All of these weighed against treating West Glen Estates as a capital asset under *Winthrop*. The Tax Court concluded that the Borees were engaged in the business of developing and selling residential real estate, and therefore should have reported the income from the sale of West Glen Estates as ordinary income.[25] Thereupon, the Tax Court found that the Borees were liable for $1,784,242 in unpaid taxes arising from that mischaracterization.[26]

The Tax Court also imposed the 20% penalty for understatement of tax, pursuant to § 6662.[27] That section of the Code imposes a penalty for "[a]ny substantial understatement of income tax."[28] However, the penalty should not apply to any portion of the underpayment "if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion."[29] "Reasonable cause" is determined "on a case-by-case basis, taking into account all pertinent facts and circumstances."[30] If the taxpayer relies on the advice of a professional, that reliance must be reasonable and have been made in good faith,[31] and the professional must have acted based on "all pertinent facts and circumstances and the law as it relates to those facts and circumstances."[32] In applying the § 6662 penalty, the Tax Court did not provide specific reasons for its determination that the Borees had not acted reasonably and in good faith.[33]

On appeal to the Eleventh Circuit, the Borees argued that the Tax Court made various errors in its determination of the character of the income from the West Glen Estates sale. First, the Borees contended that the Tax Court erred in considering their intent in purchasing and holding the West Glen Estates property over the years leading up to the sale in

25. *Id.*
26. *Id.* at 1095.
27. *Id.* at 1099.
28. I.R.C. § 6662(b)(2) (2012).
29. I.R.C. § 6664(c)(1) (2012).
30. Treas. Reg. § 1.6664-4(b)(1) (2014).
31. *Id.*
32. Treas. Reg. § 1.6664-4(c)(1)(i) (2014).
33. *See Boree*, 837 F.3d at 1093.

2007. Rather, the Tax Court should have looked at the intent of the Borees in holding the property only at the time of the sale.[34] In support, the Borees relied on the case of *Sanders v. United States*,[35] which stated that "it was the taxpayer's intent at the time of the sales that is relevant for an inquiry as to whether capital gains treatment is justified."[36] The Eleventh Circuit noted that the Borees' proposed analysis was nonsensical, and cited another precedent, *Suburban Realty Co. v. United States*,[37] for the principal that "[a]t the very moment of sale, the property is certainly being held 'for sale.' The appropriate question certainly must be the taxpayer's primary holding purpose at some point before he decided to make the sale in dispute."[38] Further, the court noted that in *Sanders*, despite the apparently favorable language, the court did look at the years preceding the taxpayer's sale of the property to determine the taxpayer's intent.[39] Thus, the court determined that the Tax Court was correct in looking to the previous years in determining the Borees' intent with the West Glen Estates property.[40]

As for the Tax Court's analysis of the Borees' intent, the Eleventh Circuit stated that "[t]here is no real dispute at this point that prior to the enactment of the county land use restrictions, Glen Forest held the West Glen Estates property for sale in the ordinary course of the business of developing a subdivision."[41] The court noted that sales of lots began immediately after the initial purchase, as did efforts to gain approval for subdivision and development of the property.[42] The Borees held out West Glen Estates as a subdivision development and took concrete steps to make it such by creating roads, easements, and a homeowners' association. The Borees, however, pointed to the Baker County ordinance requiring the West Glen Estates roads to be paved as an "adverse government action" that forced them to change their original intent with the property.[43] Although the court recognized that some government actions (such as condemnation) can render an intent to develop the property unrealistic, it noted that in this case the government restrictions "merely placed

34. *Id.*

35. 740 F.2d 886 (11th Cir. 1984).

36. *Id.* at 889.

37. 615 F.2d 171 (5th Cir. 1980).

38. *Id.* at 182.

39. *Boree*, 837 F.3d at 1101. *Boree* explained that "the 'sales' the *Sanders* court referred to . . . were the taxpayer's 'continuous and frequent sales of the lots'" over a several-year period. *Id.* (quoting *Sanders*, 740 F.2d at 889).

40. *Id.* at 1101-02.

41. *Id.* at 1102.

42. *Id.*

43. *Id.*

additional costs on developers interested in pursuing certain types of development" and "did not foreclose all development."[44] Moreover, even after the restrictions were imposed in 2004 and 2005, the Borees' actions demonstrated a continuing intent to develop the property. Notably, the Borees sought exemptions from the restrictions and hired a lawyer to help get approval to rezone the property to permit denser development (to fund the road paving costs).[45] The court concluded that the actions were "evidence of strategic and thorough involvement in pursuit of developing the property [and] indicates that the Borees were holding the property for sale in the ordinary course of business right up until they sold it to Adrian and not merely as an investment property."[46]

The Borees alternatively argued that the lots sold to Adrian had been segregated from the lots that Glen Forest had sold over the previous years. Thus, although the other lots had been sold in the ordinary course of business, those sold to Adrian were an investment asset. As evidence, the Borees noted that the sales agreement with Adrian described that property as "unimproved" and the portion sold to Adrian had not been platted. The Tax Court had rejected this argument, noting for instance that the maps and development plans the Borees submitted to the Baker County Board of Commissioners did not segregate the properties in that way, and the Eleventh Circuit found no fault in the Tax Court's conclusion.[47]

Although the Eleventh Circuit affirmed the Tax Court with respect to the tax liability, it reversed on the matter of the penalty for understatement of tax.[48] The court noted that the Tax Court had not given reasons supporting its determination that the Borees lacked reasonable cause in characterizing the income from the sale of West Glen Estates as long-term capital gain on their 2007 tax return or had not acted in good faith in the preparation of their tax return.[49] In reversing the Tax Court on this issue, the Eleventh Circuit noted that the record showed that the Borees had no sophisticated knowledge of taxes and had long relied on their accounting firm—a reputable firm headed by a professor of tax law—to prepare their taxes.[50] The Borees provided complete and accurate records to the firm, and the IRS conceded that the Borees did not

44. *Id.* at 1103.
45. *Id.*
46. *Id.*
47. *Id.* at 1103-04.
48. *Id.* at 1107.
49. *Id.* at 1106-07.
50. *Id.* at 1107.

give any false information.[51] The court concluded on this basis that "[a]lthough the Borees' accountant prepared the 2007 tax return claiming deductions of $46,360 for business expenses while claiming a capital gain from the same activity, we find that it was reasonable for the Borees, who were untrained in tax matters, to have relied in good faith on that decision."[52]

II. *Peterson v. Commissioner*

The taxpayers in *Peterson v. Commissioner*[53] were a married couple (the Petersons). Mrs. Peterson, was a high-level sales executive, a National Sales Director, in Mary Kay, a large cosmetics company that relies upon commission-compensated independent sellers. In that role, Peterson was no longer involved in direct sales to customers, but rather focused on incubating new sales organizations. For tax purposes, Peterson was classified as an independent contractor, not as an employee.[54]

As a National Sales Director, Peterson was entitled to participate in two long-term compensation schemes: the Family Security Program (the Family Program) and the Great Futures Program (the Futures Program).[55] The Family Program functioned much like a conventional defined-benefit pension plan. Participating National Sales Directors were entitled to receive a series of payments in the event of their death, disability, or qualifying retirement, based on their average commissions for the five years preceding the triggering event.[56] The Futures Program was a more narrowly tailored incentive program. Under this program, a National Sales Director that established sales organizations in designated foreign countries was entitled to receive a specified percentage of the commissions generated by those foreign sales organizations for a fixed period after her retirement, death, or disability.[57]

Both the Family Program and the Futures Program included clauses that permitted Mary Kay to unilaterally amend, modify, or terminate the programs at any time.[58] In 2008, Mary Kay did amend both programs to respond to new section 409A,[59] which imposes harsh penalties on de-

51. *Id.*
52. *Id.*
53. 827 F.3d 968 (11th Cir. 2016).
54. *Id.* at 970.
55. *Id.* at 973.
56. *Id.* at 976.
57. *Id.* at 977-78.
58. *Id.* at 978-79.
59. I.R.C. § 409A (2012).

ferred compensation arrangements that fail to satisfy certain requirements. The amendments provided that each program was "intended to be a non-qualified deferred compensation arrangement" and that each program was "intended to meet the requirements of § 409A . . . and shall be construed and interpreted in accordance with such intent."[60] A disclosure document provided to the taxpayer stated that the amendments were intended to "make no substantive change" to the Programs, but rather to "simply clarify the language of the Programs to make it absolutely clear that all provisions are in compliance with section 409A."[61] The disclosure explained the necessity for the amendments by noting that "[s]ection 409A is broad in its application" and that "it appears that these Programs likely fall within the broad definitions applied to section 409A . . . ."[62]

Peterson retired from Mary Kay in 2009 and received payments under both programs in that year. The IRS asserted that under § 1401[63] these payments were subject to self-employment tax.[64] That section imposes a tax on an individual's "self-employment income," which is defined as an individual's net earnings derived from a non-employee trade or business carried on by the taxpayer, subject to a number of exceptions.[65] Courts have held that self-employment income can derive from a trade or business carried on in a previous taxable year, but there must be "a nexus between the income received and a trade or business that is, or was, actually carried on."[66] In the case of deferred compensation payments, the United States Court of Appeals for the Ninth Circuit in *Milligan v. Commissioner*[67] stated the required nexus exists where the payments are "tied to the quantity or quality of the taxpayer's prior labor, rather than the mere fact that the taxpayer worked or works for the payor."[68] In that case, the court concluded that post-retirement payments made to an independent contractor insurance agent were not self-employment income where the payments were conditioned on a non-compete covenant and were tied to the cancellation rate of policies written by him, as well as the insurance company's income from those policies.[69]

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60. *Peterson*, 827 F.3d at 978-79.
61. *Id.* at 981.
62. *Id.*
63. I.R.C. § 1401 (2012).
64. *Peterson*, 827 F.3d at 981, 983.
65. I.R.C. §1401.
66. Newberry v. Commissioner, 76 T.C. 441, 444 (1981).
67. 38 F.3d 1094 (9th Cir. 1994).
68. *Id.* at 1098.
69. *Id.* at 1099.

With respect to the Petersons, the Tax Court concluded with relatively little analysis that, within the meaning of § 1402,[70] Mrs. Peterson's distributions from the Programs were "derived" from her self-employment at Mary Kay[71] The court applied the *Milligan* court's interpretation of the nexus standard for deferred compensation: whether the payments are "'tied to' the quantity or quality of [the taxpayer's] prior labor."[72] The court concluded that payments under both Programs were tied to the quantity or quality of the taxpayer's prior labor.[73] In the case of the Family Program, payments keyed off of the prior commission levels attained by the taxpayer.[74] In the case of the Futures Program, payments were based on sales generated by the taxpayer's sales network, which the court viewed as a measure of "how well the network performed based on her prior services."[75]

As a separate basis for its decision, the court noted that both Programs referred to themselves as "deferred compensation" arrangements in the 2008 § 409A-related amendments.[76] The court indicated that this characterization created a nexus between the payments under the Programs and the taxpayer's prior self-employment and that the taxpayer had failed to provide the necessary proof to disclaim this characterization under the restrictive rule from *Commissioner v. Danielson*,[77] which limits the ability of taxpayers to challenge their own contractual form.[78]

The United States Court of Appeals for the Eleventh Circuit gave much greater prominence to the *Danielson* question. In *Danielson*, the taxpayers were shareholders in a loan company. In connection with the sale of the business, the taxpayers entered into a non-compete agreement with the buyer. The purchase agreement governing the transaction set forth a specific allocation of the consideration between the stock and the non-compete agreement. Nevertheless, the taxpayers reported all of the consideration they received as proceeds from the sale of stock giving rise to capital gain.[79] The court in *Danielson* refused to allow the taxpayer to challenge the contractual allocation on the grounds that it was inconsistent with the substance of the transaction, holding that a taxpayer-

70. I.R.C. § 1402 (2012).
71. Peterson v. Commissioner, T.C.M. (CCH) 619, 619 (2013).
72. *Id.* at 621.
73. *Id.*
74. *Id.*
75. *Id.*
76. *Id.*
77. Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967).
78. *Peterson*, T.C.M. (CCH) at 621 (citing *Danielson*, 378 F.2d at 775 (en banc)).
79. *Danielson*, 378 F.2d at 773.

initiated challenge to the form of a transaction is only permissible where the taxpayer can bring "proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."[80] In addition to pointing to the inherent equity of permitting the government to "hold a party to his agreement," the court identified two important policy reasons supporting its rule.[81] First, allowing challenges to the tax treatment agreed to by the parties "would be in effect to grant, at the instance of a party, a unilateral reformation of the contract with a resulting unjust enrichment."[82] Further, the absence of a rule against taxpayer-initiated challenges would expose the government to the risk of a "whipsaw," that is, inconsistent treatment of the different parties to a transaction.[83] Avoiding a whipsaw could require the government to pursue enforcement proceedings against multiple parties to ensure consistency.[84] The *Danielson* rule has been adopted in the Eleventh Circuit.[85]

In the view of the majority, the *Danielson* issue resolved the case.[86] The taxpayer conceded that the 2008 amendments to the Programs explicitly described the payments as "deferred compensation," and no evidence was produced that would permit a deviation from the contractual form under *Danielson*.[87] Judge Rosenbaum, dissenting, argued that applying the *Danielson* rule in this context was far afield from its original purpose and policy justifications.[88] The dissent focused on the fact that the taxpayer never agreed specifically to the characterization of payments under the Programs.[89] Rather, this characterization was included in a subsequent unilateral amendment made by Mary Kay.[90] While this amendment was concededly binding as a contractual matter, Judge Rosenbaum argued that, unlike in *Danielson*, the taxpayer was clearly not initiating a "unilateral reformation" of the contract that could produce unjust enrichment.[91] Rather, the taxpayer was a party to a contract that

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80. *Id.* at 775.
81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.*
85. *See, e.g.*, Plante v. Commissioner, 168 F.3d 1279, 1280 (11th Cir. 1999) (applying the *Danielson* rule).
86. *Peterson*, 827 F.3d at 987.
87. *Id.*
88. *Id.* at 994 (Rosenbaum, J., dissenting).
89. *Id.* at 996.
90. *Id.*
91. *Id.* at 997.

had already been unilaterally reformed by Mary Kay.[92] In addition, the dissent was not troubled by the idea that a failure to apply *Danielson* could force the IRS to pursue litigation against both the taxpayer and Mary Kay to protect its interests.[93] In a case like this, Judge Rosenbaum found there to be a "genuine dispute" on the merits.[94] Since the taxpayer was "not attempting to pull a fast one on the IRS by backtracking on an initial, mutual characterization," the dissent saw no reason to apply the preclusive *Danielson* rule in favor of the IRS.[95]

Although it found the *Danielson* rule sufficient grounds to dispose of the case, the majority also considered the merits.[96] The taxpayer contended that payments under the Programs should be viewed, not as compensation but as payments for the sale of her Mary Kay business or payments for a non-compete agreement.[97] The taxpayer also pointed to a subsequently codified line of cases dealing with retirement payments to insurance agents, many of which concluded that such payments were not self-employment income.[98] The majority dismissed both of these arguments.[99] The Programs did not contain any evidence that the intended transaction was the sale of a business, and the facts did not support the conclusion that payments were intended to be for a non-compete agreement.[100] The court took the view that the insurance cases were distinguishable from the facts at hand on a number of grounds.[101]

The dissent took a different approach. First, the dissent concluded that, absent the *Danielson* presumption, the facts of the case did not support treating the payments under the Programs as "deferred compensation."[102] This conclusion was supported by the facts that the taxpayer was not required to defer receipt of any income to participate in the program, that the payments received by the taxpayer while she was employed were adequate to fully compensate her, and that payments under the Programs were not vested since Mary Kay could terminate the Programs at

92. *Id.*

93. *Id.* at 998.

94. *Id.* at 999-1000.

95. *Id.* at 1000 n.6.

96. *Id.* at 989 (majority opinion).

97. *Id.*

98. *Id.* at 992-93.

99. *Id.* at 993-94.

100. *Id.* at 989-90. In fact, the taxpayer took a consulting position with a competitor firm of Mary Kay. The company complained about the breach to the taxpayer and did not allow her to participate in a cruise, but it did not take any other action (such as terminating payments under the Programs). *Id.* at 982.

101. *Id.*

102. *Id.* at 996 (Rosenbaum, J., dissenting).

any time.[103] Having concluded that the payments were not deferred compensation, the dissent went on to examine whether they satisfied the "nexus" test generally applicable under § 1402(a).[104] The dissent concluded that the payments under the Family Program, which were a fixed percentage of the taxpayer's annual commissions for a pre-retirement period, were tied to "the quantity or quality" of her prior labor, as required by *Milligan*.[105] On the other hand, the payments under the Futures Program were keyed off of the performance of sales units organized by the taxpayer.[106] The dissent concluded that these payments were not sufficiently related to the taxpayer's prior employment to constitute self-employment income.[107]

While the narrow technical issue regarding the application of the self-employment tax to deferred compensation arrangements that was at issue in *Peterson* may be of limited interest, the court's expansive interpretation of the *Danielson* rule deserves attention. It is clear from the facts that the 2004 amendments to the Programs were intended to ensure compliance with the new requirements of § 409A and were not thought of as substantive changes. Moreover, the taxpayer was not involved in negotiating the amendments, was not required to consent to them, and may not even have read them. Nevertheless, the court seized on a sentence in those amendments referring to the Programs as non-qualified deferred compensation arrangements (a defined term under § 409A) and forced the taxpayer to accept that characterization for an entirely different purpose (computation of self-employment income under § 1402).[108]

III. *Dileng v. Commissioner*

The United States is party to numerous bilateral tax treaties, which have as their principal purpose the prevention of double taxation on those persons who receive income that would otherwise be taxable by both countries under their domestic tax laws. These treaties also typically contain information sharing and administrative assistance provisions to aid in the collection of taxes. Article 27 of the United States tax treaty with

103. *Id.* at 1001.
104. *Id.* at 1002.
105. *Id.* at 1002-03.
106. *Id.* at 1007-08.
107. *Id.* at 1009.
108. *Id.*

Denmark[109] (the Treaty) is typical of these administrative assistance provisions and provides that the two states will "lend assistance to each other in the collection of taxes" covered under the Treaty, upon the filing of a "revenue claim" by the state requesting collection assistance.[110] When one of the two countries submits a revenue claim to the other, it "shall include a certification by the competent authority of the applicant State that, under the laws of that State, the revenue claim has been finally determined."[111] The "revenue claim is finally determined when the applicant State has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the taxpayer to restrain collection in the applicant State have lapsed or been exhausted."[112] Thus, when one of the contracting states conclusively determines under its domestic tax laws that a taxpayer has an unpaid tax liability, it may submit a revenue claim to the other state where the taxpayer or the taxpayer's property can be found, and that other state is bound to collect and turn over that tax liability. What is less clear from Article 27 is what, if any, rights a taxpayer has to challenge the execution of a revenue claim. The case of *Dileng v. Commissioner*,[113] decided in 2016 in the Northern District of Georgia, provides a rare occasion in which the IRS's actions taken pursuant to a revenue claim were challenged in court. The case emphasizes that there are strict limitations imposed by United States statutory law on a taxpayer's power to challenge a revenue claim.[114]

The Danish Ministry of Taxation, the Skatteministeriet, made a revenue claim to the United States with respect to Torben Dileng, a Danish citizen residing in the United States, requesting assistance in collecting approximately $2.5 million in unpaid taxes. The IRS subsequently informed Dileng that it intended to levy his U.S. assets to satisfy his Danish tax liability. In response, Dileng filed an action in Denmark to forbear or postpone the collection of the tax, filed a Collection Appeal Request with the IRS, petitioning the IRS to refrain from the levy until the Danish action was resolved, and, upon denial of that request, filed a complaint in the United States District Court for the Northern District of Georgia against the Commissioner of the IRS. Dileng's complaint requested a declaratory judgment and injunction to the effect that the IRS may not levy

109. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with Protocol, U.S.-Den., Aug. 19, 1999, T.I.A.S. No. 13056 [hereinafter Treaty].

110. *Id.* art. 27(1).

111. *Id.* art. 27(2).

112. *Id.*

113. 157 F. Supp. 3d 1336 (N.D. Ga. 2016).

114. *See id.* at 1338.

his assets until the Danish courts make a final determination about his tax liability. Because of his pending suit in Denmark, Dileng contended that no final determination had been reached.[115]

The United States took the position that Denmark had already reached a final determination as required under Article 27 of the Treaty and further contended that the district court lacked jurisdiction over the suit, due to the limits imposed by the Declaratory Judgment Act (the DJA)[116] and the Anti-Injunction Act[117] (the AIA).[118] Under the DJA, "[i]n a case of actual controversy within its jurisdiction . . . any court of the United States, upon the filing of an appropriate pleading, may declare the rights and other legal relations of any interested party seeking such declaration, whether or not further relief is or could be sought."[119] However, there are a few exceptions listed in the statute, including declaratory judgments sought "with respect to Federal taxes."[120] The AIA provides, with some exceptions not relevant here, that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed."[121] Under Federal Rules of Civil Procedure 12(b)(1),[122] the United States moved for dismissal based on the Treaty, the DJA, and the AIA.[123]

In resolving the United States' motion to dismiss, the court first looked at two possible bases for its subject matter jurisdiction: 28 U.S.C. § 1346(a)[124] and the Treaty itself.[125] Section 1346(a), the statutory basis for tax refund suits, grants original jurisdiction to the district courts over

> [a]ny civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws.[126]

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115. *Id.* at 1339-40.
116. 28 U.S.C. § 2201 (2012).
117. I.R.C. § 7421 (2012).
118. *Dileng*, 157 F. Supp. 3d at 1339.
119. 28 U.S.C. § 2201(a).
120. *Id.* An exception to this exception applies to declaratory judgments relating to nonprofit status under I.R.C. § 7428 (2012).
121. I.R.C. § 7421(a).
122. FED. R. CIV. P. 12(b)(1).
123. *Dileng*, 157 F. Supp. 3d at 1340.
124. 28 U.S.C. § 1346(a) (2012).
125. *Dileng*, 157 F. Supp. 3d at 1340-42.
126. 28 U.S.C. § 1346(a)(1).

Under the Treaty, a "revenue claim shall be treated by the United States as an assessment under United States laws against the taxpayer as of the time the application is received."[127] Thus, if the revenue claim is an assessment for United States tax purposes, there is some basis for the position that § 1346(a) would provide jurisdiction for Dileng's suit.

The court explained, however, that the Treaty "does not provide that a citizen of the applicant country against whom collection efforts for foreign taxes are directed is afforded all of the rights and challenge mechanisms that a citizen of the requested country might have to challenge the assessed tax in the requested country."[128] Rather, the court noted, "the Treaty requires the requested country to accept that the taxes are due upon certification by the applicant country."[129] The court therefore concluded that "[e]ven treating the accepted revenue claim from Denmark as if it were an assessment of United States internal-revenue taxes, Section 1346(a)(1) does not apply[.]"[130]

As an alternative to jurisdiction under § 1346(a), Dileng contended that the court's subject matter jurisdiction arose from the Treaty itself.[131] There are two portions of Article 27 of the Treaty that the court found relevant to its analysis.[132] Under Paragraph 2:

> An application for assistance in the collection of a revenue claim shall include a certification by the competent authority of the applicant State that, under the laws of that State, the revenue claim has been finally determined. For the purposes of this Article, a revenue claim is finally determined when the applicant State has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the taxpayer to restrain collection in the applicant State have lapsed or been exhausted.[133]

Paragraph 5, however, clarifies that Article 27 does not:

> Creat[e] or provid[e] any rights of administrative or judicial review of the applicant State's finally determined revenue claim by the requested State, based on any such rights that may be available under the laws of either Contracting State. If, at any time pending execution of a request for assistance under this Article, the applicant State loses

127. *Dileng*, 157 F. Supp. 3d at 1341 (quoting Treaty, art. 27(4)(a)).
128. *Id.* at 1341-42.
129. *Id.* at 1342.
130. *Id.*
131. *Id.*
132. *Id.* at 1342-43.
133. *Id.*

> the right under its internal law to collect the revenue claim, the competent authority of the applicant State shall promptly withdraw the request for assistance in collection.[134]

From this, the court drew the conclusion that, "a revenue claim, if accepted, is treated by the United States as if it were an assessment of taxes owed to the United States itself, subject to the laws of the United States in collecting its own taxes, including the DJA and the AIA."[135] Thus, for the Treaty to provide jurisdiction for Dileng's action, those obstacles would have to be overcome.

Dileng apparently did not raise any argument as to why the DJA should not bar his request for a declaratory judgment, and the court disposed of that summarily.[136] As for his request for an injunction, Dileng argued, however, that two exceptions to the AIA applied to his case.[137] The first exception, created by the Supreme Court of the United States in *Enochs v. Williams Packing & Navigation Co.*,[138] allows a taxpayer to challenge the collection of tax where "it is clear that under no circumstances could the Government ultimately prevail" and "equity jurisdiction otherwise exists."[139] Dileng contended that because Denmark had made no final determination prior to filing the revenue claim, the United States had no authority under the Treaty to collect the Danish tax liability.[140] But the court rejected this argument, explaining that:

> The exception allows a challenge to a tax assessment only where a plaintiff can show that the United States will not prevail on the tax assessed. Plaintiff here does not challenge the underlying *validity* of the Taxes in the United States, and does not assert . . . that there are no circumstances under which he can be found liable for the Taxes in Denmark.[141]

That is, Dileng's action in Denmark was not about the validity of the tax liability, but was rather a request to delay the collection of that liability. Even if he had challenged the validity of the tax in Denmark, he had not alleged that there was no way that the Skatteministeriet would have prevailed in that suit. Thus, the court concluded that Dileng had not met the first requirement of *Williams Packing*, because he had not

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134. *Id.* at 1343.
135. *Id.*
136. *Id.*
137. *Id.*
138. 370 U.S. 1 (1962).
139. *Id.* at 7.
140. *Dileng*, 157 F. Supp. 3d at 1344.
141. *Id.*

alleged any facts that would support the notion that the assessment was "without foundation."[142]

The court nonetheless continued its analysis, addressing Dileng's argument that his Danish tax liability was not "finally determined" for purposes of the Treaty.[143] The court again pointed out that Dileng's suit in Denmark was an action to forbear or postpone the collection of the tax liability and was not a challenge to the validity of the tax.[144] Moreover, under the Treaty, the authority to determine that a tax is "finally determined" was with Denmark, not the United States.[145] Thus, the fact that Denmark asserted that the liability was finally determined was sufficient for purposes of the Treaty.

The second exception that Dileng raised to the AIA is based on the Supreme Court's holding in *South Carolina v. Regan*.[146] *Regan* provides an exception to the AIA where "Congress has not provided the plaintiff with an alternative legal way to challenge the validity of a tax."[147] Although this might seem to provide a more feasible approach for Dileng's challenge, the court again noted, as it had in its discussion of *Williams Packing*, that the *Regan* exception applies to challenges to the validity of the tax, whereas Dileng's challenge was to the collection of the tax.[148] Having disposed of Dileng's arguments in favor of the court's jurisdiction, the court granted the United States' motion to dismiss.[149]

Dileng illustrates the difficulty facing a challenge to a revenue claim. Prior to a levy to collect the foreign tax, the taxpayer faces considerable obstacles under the Treaty (and similar tax treaties), the DJA, and the AIA. It might seem that a taxpayer would have better luck waiting until the property has been levied and then filing suit under § 1346 to recover the property, thereby avoiding the limits imposed by the DJA and AIA. At that point, however, the property may no longer be in the hands of the United States, having been turned over to the country making the revenue claim. The taxpayer would then be, as Dileng was, in the position of challenging the tax in Denmark or whatever foreign state filed the reve-

142. *Id.* (quoting *Williams Packing*, 370 U.S. at 8).

143. *Id.* at 1345.

144. *Id.*

145. *Id.* ("nothing in Article 27 'shall be construed as creating or providing any rights of administrative or judicial review of the applicant State's finally determined revenue claim by the requested State, based on any such right that may be available under the laws of either Contracting state.'") (quoting Treaty, art. 27(5)).

146. 465 U.S. 367 (1984).

147. *Id.* at 373.

148. *Dileng*, 157 F. Supp. 3d at 1348.

149. *Id.* at 1398.

nue claim. That, of course, is likely the intended result under such administrative assistance provisions, as it keeps the United States courts out of the job of adjudicating tax disputes between foreign states and their taxpayers, even when those taxpayers may be residents in the United States.