Federal Taxation

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I. Introduction

The courts in the the Eleventh Circuit heard a number of tax-related cases in 2008.¹ In *Wright v. Everson*,² the United States Court of Appeals for the Eleventh Circuit affirmed the validity of regulations that deny, in certain circumstances, an unenrolled tax preparer the right to practice before the Internal Revenue Service (the Service).³ In *Rose v. Commissioner*,⁴ the Eleventh Circuit reversed the United States Tax Court, holding that a shareholder of an S corporation may increase his basis in the shares of the S corporation by the amount of debt of the S corporation that the shareholder satisfied by forgiving amounts

This Article does not represent the views of King & Spalding LLP but solely reflects the views of its Authors.

- 2. 543 F.3d 649 (11th Cir. 2008).
- 3. Id. at 657.

4. Nos. 07-12245, 07-12246, 2008 WL 1823309 (11th Cir. Apr. 24, 2008).

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^{1.} In addition to the cases discussed below, in *United States v. Coastal Utilities, Inc.*, 514 F.3d 1184 (11th Cir. 2008), the Eleventh Circuit affirmed the decision of the United States District Court for the Southern District of Georgia and held that universal support payments from the federal government and access funds received from the State of Georgia were income to a telephone company, not tax-free contributions to capital. *Id.* at 1184. The court did not comment on its ruling but merely adopted the decision of the lower court. *Id.* For prior coverage of this case, see Michael H. Plowgian, Svetoslav S. Minkov & Mark S. Davis, *Federal Taxation*, 59 MERCER L. REV. 1193, 1211-19 (2008); *see also* United States v. Coastal Utils., Inc., 483 F. Supp. 2d 1232 (S.D. Ga. 2007).

previously lent by the shareholder to the S corporation's creditor.⁵ In another unpublished opinion, Estate of Greenfield v. Commissioner, 6 the Eleventh Circuit affirmed a Tax Court decision holding that the Service timely issued a notice of deficiency and that the waiver of the limitations period on tax assessments extended not only to the underlying tax liability, but also to any interest and penalties.⁷ The Eleventh Circuit also revisited a familiar case in Ballard v. Commissioner⁸ and determined that the Tax Court judge was not appropriately deferential to the report of the Special Trial judge and that the taxpayers, in fact, did not participate in a fraudulent kickback scheme.9 In Regions Financial Corp. v. United States, 10 the United States District Court for the Northern District of Alabama held that a taxpayer's tax accrual workpapers were protected by the work-product privilege and that the taxpayer's disclosure of tax accrual workpapers to an independent auditor did not waive the work-product privilege claim. 11 Finally, in United States v. Mount Sinai Medical Center of Florida, Inc., 12 the United States District Court for the Southern District of Florida determined that the Mount Sinai teaching hospital qualified as a "school, college, or university" under section 3121(b)(10) of the Internal Revenue Code (the Code)¹³ and that its medical residents were "students" within the meaning of the same section.¹⁴ Thus, the hospital was entitled to an exemption from taxation for the salaries or stipends paid to such residents under the Federal Insurance Contributions Act (FICA). 15

II. ELEVENTH CIRCUIT CASES

A. Regulations Denying an Unenrolled Tax Preparer the Right to Practice Before the IRS are valid

In Wright v. Everson, 16 the Eleventh Circuit affirmed the validity of regulations that deny, in certain circumstances, an unenrolled tax

- 5. Id. at *9.
- 6. 297 F. App'x 858 (11th Cir. 2008).
- 7. Id. at 863.
- 8. 522 F.3d 1229 (11th Cir. 2008).
- 9. Id. at 1254-55.
- 10. No. 2:06-CV-00895-RDP, 2008 WL 2139008 (N.D. Ala. May 8, 2008).
- 11. Id. at *8.
- 12. No. 02-22715-CIV-Gold, 2008 WL 2940669 (S.D. Fla. July 28, 2008).
- 13. I.R.C. § 3121(b)(10) (2006).
- 14. Mt. Sinai, 2008 WL 2940669, at *2008-5400.
- 15. Id.; I.R.C. §§ 3101-3128 (2006).
- 16. 543 F.3d 649 (11th Cir. 2008).

preparer the right to practice before the Service.¹⁷ In *Wright* a former revenue officer who was registered with the Service as an "unenrolled" tax return preparer sought to represent his customers before appeals officers and revenue officers of the Service. The Service often refused Wright permission for such representation, and he filed a declaratory judgment action in the United States District Court for the Middle District of Florida challenging the validity of 31 C.F.R. § 10.7 (Regulation 10.7).¹⁸ Wright argued that Regulation 10.7 violated his due process rights and section 7521(c)¹⁹ of the Code.²⁰

According to 31 U.S.C. § 330(a)(1),²¹ the Secretary of Treasury (Secretary) has the authority to regulate practice before the Department of Treasury.²² Regulation 10.7 implements this authority, in part, by allowing a tax preparer to represent a taxpayer before revenue agents, customer service representatives, or similar officers and employees of the Service during an examination with respect to tax returns that the preparer has prepared.²³ However, Regulation 10.7 prohibits a tax preparer from representing a taxpayer before appeals officers, revenue officers, counsel, or similar officers or employees of the Service, even if the preparer seeks to represent taxpayers concerning tax returns that the preparer has prepared.²⁴ In addition, section 7521(c) of the Code allows a representative of a taxpayer to represent the taxpayer in an interview with the Service.²⁵ When deciding the validity of a legislative regulation, courts apply the principles of Chevron deference.26 Under Chevron deference, if there "is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation," a resulting legislative regulation is invalid only if it is "arbitrary, capricious, or manifestly contrary to the statute."27

The district court granted the government's motion for summary judgment, finding that Congress delegated to the Department of Treasury the authority to regulate the practice of representatives to the Secretary, and therefore Regulation 10.7 was a legislative regulation.

^{17.} Id. at 657.

^{18. 31} C.F.R. § 10.7(c)(1)(viii) (2008).

^{19.} I.R.C. § 7521(c) (2006).

^{20.} Wright, 543 F.3d at 651.

^{21. 31} U.S.C. § 330(a)(1) (2006).

^{22.} *Id*.

^{23. 31} C.F.R. § 10.7(c)(1)(viii).

^{24.} Id.

^{25.} I.R.C. § 7521(c).

^{26.} Wright, 543 F.3d at 654 (citing Chevron USA, Inc. v. Natural Res. Def. Council, 467 U.S. 837 (1984)).

^{27.} Chevron USA, Inc., 467 U.S. at 843-44.

Because the court found Regulation 10.7 to be legislative, the court reviewed the regulation under *Chevron* deference. Under this deferential review, the district court found that the Secretary's implementation of his congressionally delegated authority was not arbitrary, capricious, or manifestly contrary to the delegating statute.²⁸

The Eleventh Circuit affirmed the district court's grant of summary judgment in favor of the government.²⁹ The Eleventh Circuit reasoned that Congress expressly delegated to the Secretary broad power to regulate who may practice before the Service by enacting 31 U.S.C. § 330.³⁰ Accordingly, the Secretary's regulation was entitled to *Chevron* deference.³¹ Using *Chevron* deference, the Eleventh Circuit held that Regulation 10.7 was not arbitrary, capricious, or manifestly contrary to the statute because the Secretary had valid reasons to limit who could practice before the Service.³² The Eleventh Circuit noted that Regulation 10.7 balanced a taxpayer's right to "choose his representative with the need for competent representation that protects the taxpayer, the IRS, and the general public."³³ The court also noted that Wright was not prevented from fully representing clients under Regulation 10.7 if he demonstrated his knowledge to the Service and became enrolled under 31 C.F.R. § 10.4(a).³⁴

The Eleventh Circuit's decision in *Wright* appears reasonable in light of the Regulation 10.7's statutory background and also ensures that taxpayers and the Service may expect a fundamental level of competence during the tax examination process.

B. Shareholder of an S Corporation May Increase his Basis in S Corporation Shares by an Amount of Debt Forgiven by the Shareholder that the Shareholder Lent to the Corporation's Predecessor C Corporation

In Rose v. Commissioner, 35 the Eleventh Circuit reversed the Tax Court and held, among other things, 36 that a shareholder of an S

^{28.} Wright, 543 F.3d at 653-54.

^{29.} Id. at 657.

^{30.} Id. at 656.

^{31.} *Id*.

^{32.} Id.

^{33.} Id.

^{34.} *Id.* at 657; 31 C.F.R § 10.4(a) (2008).

^{35.} Nos. 07-12245, 07-12246, 2008 WL 1823309 (11th Cir. Apr. 24, 2008).

^{36.} The Eleventh Circuit also remanded the case for the Tax Court to consider the factors in *Foman v. Davis*, 371 U.S. 178 (1962), and to decide whether Rose should be granted leave to amend his petition to add a Tax Equity and Fiscal Responsibility Act (TEFRA) related statute of limitations defense. *Rose*, 2008 WL 1823309, at *5-6 (citing

corporation may increase his basis in the shares of the S corporation by the amount of debt of the S corporation that the shareholder satisfied by forgiving amounts previously lent by the shareholder to the S corporation's creditor.³⁷

In 1992 and 1993, Rose, a majority shareholder of P.K. Ventures, Inc. (PKV), lent an aggregate of \$3,853,500 to PKV. At the beginning of 1994, PKV reorganized its corporate structure, resulting in two surviving Subchapter S corporations, St. Louis Pipline Co. (SLPC) and Tampa Pipline Co. (TPC). PKV merged itself into TPC, and TPC assumed PKV's debt to Rose. After the merger, Rose owned all the stock of SLPC and a portion of the stock of TPC, but SLPC still owed TPC approximately \$1.7 million. During 1994 and 1995, Rose paid a portion of SLPC's obligations to TPC by forgiving \$1.15 million of the debt that TPC assumed from PKV.³⁸ In 1994 SLPC incurred major losses, and Rose deducted \$455,151 of the SLPC losses on his 1994 individual tax return and \$322,973 of the SLPC losses on his 1995 individual income tax return. Rose claimed that his basis in SLPC stock had been increased as a result of the payment of \$1.15 million of SLPC's liability to TPC; therefore, he could deduct all of SLPC's losses in 1994 and $1995.^{39}$

In December 1999 the Internal Revenue Service (Service) issued a notice of deficiency to PKV and in March 1999 the Service issued a notice of deficiency to Rose. ⁴⁰ The Tax Court upheld most of the deficiencies alleged by the Service. Under section 1366(d)(1) of the Code, ⁴¹ a shareholder of an S corporation may deduct his pro rata share of the S corporation's net operating losses to the extent of the sharehold-

Foman, 371 U.S. at 182; 26 U.S.C. § 6229 (2006)). This Eleventh Circuit holding is not discussed in this Article because it concerns Tax Court procedural rules, which are generally outside the scope of this Article's federal income tax focus. Rose also made arguments to the Eleventh Circuit regarding his share of PKV partnership liabilities, the calculation of his basis in Zephyr Rock & Lime Co. stock, the deduction of Rose's compensation by P.K. Ventures, Inc. in 1992 and 1993, and the imposition of tax penalties against Rose. *Id.* at *4-5. However, the Eleventh Circuit remanded all of these issues in light of its holding regarding the TEFRA-related statute of limitations defense. *Id.* at *6.

^{37.} Rose, 2008 WL 1823309, at *3.

^{38.} Id. at *2-3.

^{39.} Id. at 7.

^{40.} *Id.* at *3. The Commissioner also issued a notice of deficiency to PKV. The Tax Court cases of PKV and Rose were consolidated in June 1999. The Tax Court first issued an opinion in the case in March 2005. However, after PKV and Rose moved to amend their pleadings, the Tax Court withdrew its first opinion and, on March 7, 2006, substituted the opinion discussed in this Article, leading to the Eleventh Circuit decision discussed herein. *Id.* at *2-3.

^{41.} I.R.C. § 1366(d)(1) (2006).

er's basis in S corporation stock and debt.⁴² To increase his basis in S corporation stock, however, the shareholder must make an actual "'economic outlay'" that leaves the shareholder "'poorer in a material sense.'" The Service argued, and the Tax Court agreed, that Rose did not make an actual economic outlay that left him poorer in a material sense because the 1994 and 1995 transactions cancelled debt owed to TPC rather than debt owed to Rose.⁴⁴

The Tax Court analogized Rose's case to other similar cases, such as *Underwood v. Commissioner*, ⁴⁵ in which a controlling shareholder and two controlled corporations exchanged loans to increase the shareholder's basis in stock of a controlled S corporation. ⁴⁶ In *Underwood* the shareholder controlled a profitable C corporation and an unprofitable S corporation. To increase his basis in the S corporation's stock, the shareholder caused the C corporation to substitute the shareholder's personal note for a note owed by the S corporation to the C corporation. At the same time, the S corporation issued a demand note to the taxpayer, which the taxpayer claimed caused his basis in the S corporation stock to increase. ⁴⁷ The United States Court of Appeals for the Fifth Circuit held that the shareholder was not entitled to increase his S corporation stock basis. ⁴⁸ As in *Underwood*, the Tax Court denied Rose's claimed increase of his basis in SLPC stock and the corresponding losses he deducted on his 1994 and 1995 individual tax returns. ⁴⁹

The Eleventh Circuit reversed the decision of the Tax Court and held for Rose. The Eleventh Circuit noted that the Tax Court's analysis ignored its own findings of fact that, in 1992 and 1993, Rose made a real cash transfer to PKV which gave rise to the obligations of TPC that were eventually forgiven by Rose in 1994 and 1995. The Eleventh Circuit reasoned that the Tax Court emphasized the lack of actual cash outflow in the 1994 and 1995 cancellation of debt but disregarded the 1992 and 1993 transactions, which were actual cash transfers and not "merely book entries, lacking economic substance," as the Tax Court character-

^{42.} Rose, 2008 WL 1823309, at *7; see also Selfe v. United States, 778 F.2d 769, 771 (11th Cir. 1985) (interpreting previous version of statute).

^{43.} Rose, 2008 WL 1823309, at *7 (quoting Selfe, 778 F.2d at 772; Underwood v. Comm'r, 535 F.2d 309, 311 (5th Cir. 1976)).

^{44.} Id. at *7-8.

^{45. 535} F.2d 309 (5th Cir. 1976).

^{46.} See id. at 310.

^{47.} Id. at 311-13.

^{48.} Id. at 313.

^{49.} Rose, 2008 WL 1823309, at *9.

^{50.} Id.

^{51.} Id. at *8.

ized them.⁵² Further, the 1992 and 1993 cash transfers constituted an actual economic outlay which left Rose poorer in a material sense when he forgave them in 1994 and 1995.⁵³ The Eleventh Circuit distinguished *Underwood* by noting that the *Underwood* parties exchanged only notes and not actual cash.⁵⁴ Consequently, the Eleventh Circuit held that Rose was entitled to increase his basis in SLPC stock and was therefore entitled to deduct his share of SLPC's losses.⁵⁵

C. Extention of Statute of Limitations for Assessment of Taxes Also Applies to Assessment of Penalties and Interest

In its unpublished opinion Estate of Greenfield v. Commissioner, 56 the Eleventh Circuit affirmed a Tax Court decision holding that the Service timely issued a notice of deficiency and that the waiver of the limitations period on tax assessments extended not only to the underlying tax liability but also to any interest and penalties.⁵⁷ Marvin and Barbara Greenfield timely filed their joint income tax return for the taxable year 1982, which included flow-through losses from various partnerships collectively known as the Mast Realty Associates Partnership (the Partnership). The Partnership's 1982 tax return was audited and upon request by the Service, the Greenfields signed a Form 872-A extending the time to assess the tax for that year pursuant to § 6501 of the Code.⁵⁸ By its express terms, Form 872-A may only be terminated, and the statute of limitations resumed, by either the taxpayer filing a Form 872-T or by the Service issuing a notice of deficiency. Because the Greenfields never filed a Form 872-T, the statute of limitations remained open for assessment of the 1982 taxable year. More than twenty years later in 2004, after a determination that the Greenfields' distributive share of income from the Partnership should have been increased, the Service issued a notice of deficiency for 1982 in the amount of \$29,063 plus interest. The interest rate was increased pursuant to § 6621(c) of the Code⁵⁹ because of the Service's determination that the substantial tax understatement was attributable to a tax-motivated transaction. Over two decades, the increased interest rate resulted in a liability

^{52.} Id.

^{53.} Id.

^{54.} Id. at *9 n.16.

^{55.} Id. at *8-9.

^{56. 297} F. App'x 858 (11th Cir. 2008).

^{57.} Id. at 863.

^{58.} I.R.C. § 6501 (2006).

^{59.} I.R.C. § 6621(c) (2006).

exceeding \$350,000.⁶⁰ Upon petition to the Tax Court for a redetermination of the deficiency, the court upheld the Commissioner's determination. The Greenfields appealed to the Eleventh Circuit.⁶¹

The Greenfields argued on appeal that the Form 872-A waiver should be considered an executory contract and, because the Service and the Greenfields never reached a "meeting of the minds" on the meaning of "tax" as used in the form, the assessment of interest under § 6621 should not be permitted. The Eleventh Circuit rejected this argument, holding that Form 872-A was not an executory contract. The court also held that a waiver of the statute of limitations for assessment of tax also waives the statute of limitations for the assessment of interest related to the tax. The court reasoned that § 6601 imposes the assessment of interest rates for late tax payments and references the increased rates provided in § 6621. Further, § 6601(g) of the Code states that any interest prescribed by § 6601 "may be assessed and collected at any time during the period within which the tax to which such interest relates may be collected." Finally, Tax Court precedents also held that the term "tax" includes both the underlying tax and any

^{60.} Estate of Greenfield, 297 F. App'x at 860. In the nearly twenty-two years between the signing of the limitations period waiver and the issuance of the deficiency notice, the Greenfields initiated and completed a bankruptcy proceeding. During this proceeding, the Service filed several proofs of claim relating to outstanding tax liabilities. None of those claims included the 1982 deficiency referenced in the 2004 notice. In the discharge of the bankruptcy case, the Service received approximately \$30,000 of its priority claim, which exceeded \$200,000. The Service made several other claims for which it received no recompense. *Id.*

^{61.} *Id.* The Greenfields asserted several arguments why the Service's assessment should not be allowed. One argument centered on the theory that Form 872-A is an executory contract and, because it was not expressly assumed by the trustee in bankruptcy, it should be deemed rejected. *Id.* at 861. However, the Eleventh Circuit concluded that statute of limitations waivers are unilateral waivers of a defense and not a contract. *Id.* The Greenfields also claimed that the assessment should be barred under res judicata. *Id.* The court rejected this theory, noting that income tax debts are not dischargeable in bankruptcy. *Id.* at 861-62.

^{62.} *Id.* at 862. The Greenfields also argued under a contract theory that the \$350,000 in interest (which had accrued on a tax deficiency of less than \$30,000) based on the finding of a tax-motivated transaction was unconscionable because there had been no bargaining between the parties. *Id.* The Eleventh Circuit dismissed this argument as well based on its prior holding that Form 872-A was not a contract, but a unilateral waiver. *Id.* at 862-63.

^{63.} Id. at 861.

^{64.} *Id*.

^{65.} Id. (citing I.R.C. § 6621).

^{66.} I.R.C. § 6601(g) (2006).

^{67.} Id.

penalties and interest.⁶⁸ Therefore, the court held that the Greenfields waived the statute of limitations on the assessment for 1982, that the interest related to the tax was still assessable, and that the Commissioner's notice was timely and applied to both the tax deficiency and the increased interest rate.⁶⁹

D. Eleventh Circuit Upholds the Original Finding of No Fraud by the Special Trial Judge

This year, the Eleventh Circuit also revisited a familiar case in Ballard v. Commissioner, 70 determining that a United States Tax Court judge was not appropriately deferential to the report of the Special Trial Judge (STJ report) and that the taxpavers did not participate in a fraudulent kickback scheme.⁷¹ Claude Ballard,⁷² Joseph Kanter, and Robert Lisle (the taxpayers), now all deceased, were issued notices of deficiency for a tax underpayment resulting from improper reporting of income received in an allegedly fraudulent kickback scheme. In 1994 the case was heard by Special Trial Judge Couvillon, who prepared and submitted a written report to Tax Court Judge Dawson which was favorable to the taxpayers. Pursuant to Rule 183(b) of the Tax Court Rules of Practice and Procedure,73 the STJ report was not made available to the taxpayers. Sometime thereafter, Judge Couvillon and Judge Dawson substituted the original STJ report for a new, collaborative report that Judge Dawson approved and adopted as the opinion of the Tax Court. Judge Dawson then entered a final order assessing tax deficiencies and penalties against the taxpayers for participation in a fraudulent kickback scheme. The taxpayers were not informed of the substitution but were given access to the collaborative report which was presented to them as the original STJ report.74

In 2000, before issuance of the final order, the taxpayers motioned to see all reports relating to their case. The motion was denied by Judge

^{68.} Estate of Greenfield, 297 F. App'x at 862.

^{69.} Id. at 862-63.

^{70.} Ballard IV, 522 F.3d 1229 (11th Cir. 2008).

^{71.} *Id.* at 1254-55. For more detailed discussions of the history of this case, see Michael H. Plowgian, Svetoslav S. Minkov & Mark S. Davis, *Federal Taxation*, 59 MERCER L. REV. 1193, 1207 (2008); Michael H. Plowgian, Svetoslav S. Minkov & T. Wesley Brinkley, *Federal Taxation*, 57 MERCER L. REV. 1115, 1116 (2006); Donald R. Bly & Michael H. Plowgian, *Federal Taxation*, 55 MERCER L. REV. 1313, 1318 (2004).

^{72.} Ballard's wife, Mary, was also implicated in the scheme by virtue of filing a joint return with her husband for the relevant taxable years. *Ballard IV*, 522 F.3d at 1231 n.2.

^{73.} TAX. Ct. R. 183(b).

^{74.} Ballard IV, 522 F.3d at 1231-32.

Dawson, who stated that he had given the STJ report "due regard." ⁷⁵ The taxpayers then moved that the original STJ report and other documents be unsealed and made available for subsequent appellate review. Again, they were denied. The taxpayers moved yet again to view the original STJ report or, alternatively, to have a new trial. Submitted with the motions were affidavits alleging that the original STJ report had been altered. The request was denied by an order signed by Judge Couvillon, Judge Dawson, and the Chief Judge of the Tax Court confirming that the report adopted by the Tax Court was, in fact, the original report of Special Trial Judge Couvillon.76 The Eleventh Circuit affirmed the denial of the request following a petition by the taxpayers for writ of mandamus.⁷⁷ The United States Supreme Court reversed, vacating the judgment and remanding with instructions.⁷⁸ The Supreme Court disapproved of the procedure used by the Tax Court in refusing to make the original STJ report available and secretly creating the collaborative report adopted by the Tax Court. 79 Eleventh Circuit remanded to the Tax Court with instructions to "(1) [s]trike the collaborative report; (2) [r]einstate the [original STJ report]; (3) [a]ssign the case to a regular Tax Court Judge with no prior involvement; [and] (4) [r]eview the case in accord with its revised Rules 182 and 183."80 The case was assigned to Judge Haines, who entered an opinion that the taxpayers were guilty of participating in a kickback scheme resulting in an underpayment of income tax.81 The taxpayers appealed, and the Eleventh Circuit reviewed the findings of Special Trial Judge Couvillon to determine whether Judge Haines gave appropriate deference to the original STJ report. 82

According to Tax Court Rule 183(d), "the Tax Court judge '[shall give] [d]ue regard . . . to the circumstance that the Special Trial Judge had the opportunity to evaluate the credibility of witnesses' and must '[presume to be correct] the findings of fact recommended by the Special Trial Judge.'" The Eleventh Circuit in particular requires that a Tax Court judge may only disturb the findings and determinations of the

^{75.} Id. at 1232.

^{76.} *Id*.

^{77.} Id. at 1233 (citing Ballard v. Comm'r (Ballard I), 321 F.3d 1037 (11th Cir. 2003)).

^{78.} Ballard v. Comm'r (Ballard II), 544 U.S. 40, 65 (2005).

^{79.} See id. at 59-61

^{80.} $Ballard\ IV$, 522 F.3d at 1233 (citing Ballard v. Comm'r ($Ballard\ III$), 429 F.3d 1026 (11th Cir. 2005)).

^{81.} Id. at 1234.

^{82.} See id. at 1234-35.

^{83.} Id. at 1234 (alterations and ellipsis in original) (quoting TAX. Ct. R. 183(d)).

Special Trial Judge if they are "'manifestly unreasonable.'"⁸⁴ The court also found guidance from the United States Supreme Court's explanation of the "clear error" standard.⁸⁵ Under that standard, a court may not reverse a finding if it is "'plausible in light of the record viewed in its entirety.'"⁸⁶ In addition, credibility determinations should not be disturbed if the story told is "'coherent and facially plausible,'" not contradicted by extrinsic evidence, and not internally inconsistent.⁸⁷

After reciting the standard of review, the Eleventh Circuit embarked on a lengthy discussion, comparing each finding of the Special Trial Judge with the findings of the Tax Court judge.⁸⁸ In every instance, the court determined that the Tax Court judge did not give the STJ report due deference.⁸⁹ Judge Haines generally disagreed with Judge Couvillon's determination that the testimonies of the taxpayers were credible. 90 The Eleventh Circuit, however, reasoned that only Judge Couvillon was present when the witnesses were testifying and was able to observe their demeanor. 91 Unless the explanations given by the witnesses were completely implausible, the court saw no valid reason for challenging Judge Couvillon's credibility determination. 92 additional facts were cited by Judge Haines that were equally as plausible as those found by Judge Couvillon based on the record, the court rejected the additional facts.⁹³ Under the court's reasoning, if both sets of facts were equally plausible, then neither could be clearly erroneous, and the Special Trial Judge's findings must receive deference. 94 Accordingly, the court held that Judge Haines did not give due deference to the original STJ report and that the STJ report (concluding that Ballard had not committed fraud and was not liable for any tax deficiency) should be entered as the opinion of the Tax Court. 95

^{84.} Id. (quoting Ballard III, 429 F.3d at 1031).

^{85.} Id. (citing Anderson v. City of Bessemer City, 470 U.S. 564 (1985)).

^{86.} Id. (quoting Anderson, 470 U.S. at 574).

^{87.} Id. at 1235 (quoting Anderson, 470 U.S. at 575).

^{88.} See id. at 1235-49.

^{89.} See id.

^{90.} See id. at 1254.

^{91.} Id. at 1254-55.

^{92.} See id. at 1241-42, 1244, 1246.

^{93.} Id. at 1249.

^{94.} See id. at 1239, 1241, 1249.

^{95.} Id. at 1254-55.

III. DISTRICT COURT CASES

A. Taxpayer's Disclosure of Tax Accrual Workpapers to Accounting Firm that Served as Both Tax Counsel and Independent Auditor Did Not Waive Work-Product Privilege

In Regions Financial Corp. v. United States, ⁹⁶ the United States District Court for the Northern District of Alabama held that a taxpayer's tax accrual workpapers are protected by the work-product privilege and that the taxpayer's disclosure of tax accrual workpapers to an independent auditor did not waive the work-product privilege claim. ⁹⁷ In 2000 Regions Bank obtained professional opinions, three from the law firm of Alston & Bird and one from Ernst & Young (E&Y), that evaluated the merits of Regions' tax positions in the event that the IRS audited a listed transaction that Regions was then contemplating and soon thereafter entered into. Regions then provided the professional opinions to E&Y, which also served as Regions' independent auditor. The Service audited the transaction and served a summons on E&Y, demanding the opinions. E&Y withheld the opinions (and corresponding derivative documents that discussed the opinions), and Regions filed a motion to quash the summons. ⁹⁸

The district court first determined that the opinions were privileged under the work-product doctrine as a matter of law. 99 The work-product doctrine provides a privilege for documents that are prepared in anticipation of litigation. 100 In the context of a summons from the Service, the United States Courts of Appeals for the Second and Fifth Circuits have split concerning the standard for what constitutes "anticipation of litigation." While refraining from explicitly holding which standard is controlling in the Eleventh Circuit, 102 the district

^{96.} No. 2:06-CV-00895-RDP, 2008 WL 2139008 (N.D. Ala. May 8, 2008).

^{97.} *Id.* at *8. Tax accrual workpapers are defined as "audit workpapers, whether prepared by the taxpayer, the taxpayer's accountant, or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax reserves on audited financial statements." INTERNAL REVENUE MANUAL § 4.10.20.2 (2004). Taxpayers generally prepare a tax accrual workpaper to estimate the potential tax costs of an IRS challenge to a transaction entered into by the taxpayer.

^{98.} Regions Fin., 2008 WL 2139008, at *1.

^{99.} Id. at *7.

Id. at *2-3 (citing FED. R. CIV. P. 26(b)(3)).

^{101.} Id. at *3.

^{102.} See id. at *5. The district court, however, stated that "[i]f it were forced to decide the question, the court concludes that the Eleventh Circuit would align itself with the

court held that the professional opinions met both the narrow "primary motivating purpose" standard of the Fifth Circuit and the broader "because of litigation" standard of the Second Circuit because the taxpayer's primary reason in soliciting the opinions was to analyze the likely results of any audit or litigation with the Service. The Service argued that the opinions were not privileged because E&Y could have used them in its work as independent auditor in addition to its work as tax advisor, and therefore the taxpayer's motivation in soliciting the opinions could be for auditing purposes, as well as for litigation purposes. The district court, however, reasoned that under both the Fifth Circuit and Second Circuit standards, the opinions did not have to be used solely for litigation purposes to be privileged. The second Circuit standards and the privileged of the second Circuit standards are privileged.

After determining that the opinions were privileged as a matter of law, the court held that disclosure of the opinions to E&Y did not waive the privilege. The work-product privilege is waived if a party discloses privileged documents to an adversary or potential conduit of an adversary. The court reasoned that, as an independent auditor, E&Y's role was to aid the taxpayer's compliance with financial reporting requirements. Further, the court noted that E&Y's opinions never left the protection of work-product confidentiality because E&Y had a confidentiality agreement in place with the taxpayer. The court noted that taxpayer.

In their briefs on this issue, both parties cited *United States v. MIT*, ¹¹⁰ in which MIT disclosed its expenses to the Defense Contract Audit Agency (DCAA) in connection with MIT's work with the Department of Defense. ¹¹¹ In a separate audit by the Service, the Service argued that this disclosure to the DCAA waived any work-product privilege. ¹¹² The United States Court of Appeals for the First Circuit held that the DCAA was a potential adversary because, depending on its audit results, the DCAA may have engaged in litigation with MIT on behalf of the Department of Defense. ¹¹³ The district court in *Regions* reasoned that *MIT* was distinguishable because there was "no conceiv-

majority of the other courts of appeal[s] and adopt the 'because of litigation' test." Id.

^{103.} Id. at *7.

^{104.} *Id.* at *5.

^{105.} Id. at *5-6.

^{106.} Id. at *8.

^{107.} *Id*. at *7.

^{108.} Id. at *7-8.

^{109.} Id. at *8.

^{110.} Id.; 129 F.3d 681 (1st Cir. 1997).

^{111.} MIT, 129 F.3d at 683.

^{112.} See id.

^{113.} Id. at 687.

able scenario" in which E&Y could become the taxpayer's litigation adversary. 114

In its opinion, the district court cited with approval the holding and reasoning of *United States v. Textron*, *Inc.* 115 In *Textron* the taxpayers' internal attorneys and accountants authored tax accrual workpapers in a collaborative process. The taxpayer then disclosed these workpapers to its independent auditor, an accounting firm. 116 The court held these workpapers were privileged under the work-product doctrine and the privilege was not waived by disclosing the workpapers to the accounting firm. 117 Like the court in Regions, the court in Textron reasoned that an independent auditor was not in an adversarial relationship with the party it audits. 118 For support, the court cited the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct, which imposes a duty on an auditor not to disclose confidential information without client consent. 119 A panel from the First Circuit affirmed this portion of the Textron holding, but that decision was withdrawn and vacated after the First Circuit voted to hear this case en banc.120

In its *Regions* brief, the government relied upon the United States Supreme Court's holding in *United States v. Arthur Young & Co.*¹²¹ In *Arthur Young* an accountant prepared tax accrual workpapers in connection with his role as independent auditor of a public corporation. The Second Circuit held that the workpapers were privileged under the work-product doctrine, citing the corporation's need to comply with federal securities law.¹²² The Supreme Court reversed, holding that

^{114.} Regions Fin., 2008 WL 2139008, at *8.

^{115.} Id. at *6-7; 507 F. Supp. 2d 138 (D.R.I. 2007).

^{116.} Textron, 509 F. Supp. 2d at 153-55.

^{117.} *Id.* The court in *Textron* also considered whether these workpapers were privileged under I.R.C. § 7525 (2006), which expands the common law attorney-client privilege to authorized tax practitioners (including accountants). *Textron*, 509 F. Supp. 2d at 151; *see* I.R.C. § 7525. The court held that this privilege applied but that the taxpayer waived the privilege when it disclosed the workpapers to the outside auditing firm. *Textron*, 509 F. Supp. 2d at 152.

^{118.} Id. at 154.

^{119.} *Id.* at 153 (citing CODE OF PROF'L CONDUCT, Confidential Client Information, No. 1, § 301 (Am. Inst. of Certified Pub. Accountants (1972)).

^{120.} See Textron, 553 F.3d 87 (1st Cir. 2009) withdrawn and vacated No. 07-2631, 2009 WL 775439 (1st Cir. Mar. 25, 2009). At time of publishing, the First Circuit had not yet issued its en banc decision.

^{121. 465} U.S. 805 (1984); see Brief of United States in Support of Its Opposition to Regions' Petition to Quash and Its Counter-Petition to Enforce IRS Summons, Regions Fin. Corp. v. United States, 2008 WL 2139008 (N.D. Ala. 2008), 2007 WL 4351609.

^{122.} Arthur Young, 465 U.S. at 809-10.

tax accrual workpapers authored by an independent auditor were not privileged under the work-product doctrine. The Supreme Court stated that "the Court of Appeals' effort to foster candid communication between accountant and client by creating a self-styled work-product privilege was misplaced, and conflicts with what we see as the clear intent of Congress." The Supreme Court reasoned that an independent auditor serves as a "public watchdog" who accurately reports a corporation's financial status and owes an "allegiance to the corporation's creditors and stockholders, as well as to the investing public." 125

Although *Arthur Young* concerns the establishment of a work-product privilege for documents authored by an independent auditor, rather than the waiver of a work-product privilege by providing documents to an independent auditor as in *Regions*, the policies underlying *Arthur Young* may be as applicable to waiver of the doctrine as they are to its establishment. ¹²⁶ It is not difficult to imagine a scenario in which an independent auditor must engage in an adversarial relationship with its client to protect the investing public at large. Future courts may have to grapple more explicitly with the application, if any, of *Arthur Young* on this issue.

The government appealed *Regions* to the Eleventh Circuit, but the case was subsequently settled.¹²⁷ The Service's Chief Counsel, however, has publicly announced that the Service intends to fight similar work-product privilege issues "all the way to the Supreme Court if necessary." Therefore, the applicability and waiver of work-product privilege in regards to tax accrual workpapers may continue to be a hotly litigated issue. ¹²⁹

^{123.} Id. at 821.

^{124.} Id. at 817.

^{125.} Id. at 818.

^{126.} See Textron, 553 F.3d at 106-09 (Boudin, J., dissenting); see also Claudine Pease-Wingenter, The Application of the Attorney-Client Privilege to Tax Accrual Workpapers: The Real Legacy of United States v. Textron, 8 HOUS. BUS. & TAX L.J. 337 (2008); Dennis J. Ventry, Jr., Protecting Abusive Tax Avoidance, 120 TAX NOTES 857 (2008).

^{127.} See Amy Elliott, Regions Financial Settles With IRS, But Work Product Issue May Remain Unanswered, 2008 TAX NOTES TODAY 284-2 (Dec. 24, 2008).

^{128.} See Jeremiah Coder, IRS Loses Second Work Product Case, 2008 TAX NOTES TODAY 93-1 (May 13, 2008).

^{129.} Id.

B. Teaching Hospitals May Be Considered Schools and Medical Residents May Be Considered Students for Purposes of a Student Exemption

In an earlier decision in *United States v. Mount Sinai Medical Center of Florida*, Inc., 130 the Eleventh Circuit held that a case-by-case analysis was necessary to determine whether a medical student enrolled in a graduate medical education program qualifies for the student exemption from the federal Social Security and Medicare taxes imposed by the Federal Insurance Contributions Act (FICA). 131 The Eleventh Circuit remanded the case to the United States District Court for the Southern District of Florida to make the required analysis and determination. 132 Applying the test established in the Eleventh Circuit's holding, the district court determined that the Mount Sinai teaching hospital qualified as a "school, college, or university" and its medical residents were "students" within the meaning of the student exemption. 133 Therefore, the salaries or stipends paid to such residents were entitled to an exemption from taxation under FICA. 134

To make its determination the court looked to the United States Treasury Regulations underlying the student exemption provision which provide as follows:

"The statutory tests are (1) the character of the organization in the employ of which the services are performed as a school, college, or university, . . . and (2) the status of the employee as a student enrolled and regularly attending classes at the school, college, or university by which he is employed or with which his employer is affiliated." ¹³⁵

When determining whether an organization is a "school, college, or university" the terms are to take their "commonly or generally accepted sense." The court, relying on its own precedent, determined that common or generally accepted definitions are found in the dictionary and listed the definitions of school, college, and university. Citing the opinion of the United States District Court for the District of Minnesota

^{130. 486} F.3d 1248 (11th Cir. 2007).

^{131.} Id. at 1253; I.R.C. §§ 3101-3128 (2006).

^{132.} See United States v. Mount Sinai Med. Ctr., No. 02-22715-CIV-Gold, 2008 WL 2940669 (S.D. Fla. July 28, 2008).

^{133.} Id. at *2008-5400 (citing I.R.C. § 3121(b)(10) (2006)).

^{134.} Id.

^{135.} Id. at *2008-5388 (ellipsis in original) (quoting 26 C.F.R. § 31.3121(b)(10)-2(b) (1999)).

^{136.} Id. (quoting 26 C.F.R. § 31.3121(b)(10)-2(d) (1999)).

^{137.} Id. at *2008-5389.

in *United States v. Mayo Foundation for Medical Education & Research*, ¹³⁸ the court rejected the government's contention that the terms should be defined as they are in other sections of the Code. ¹³⁹ The court determined that because those sections were not cross-referenced by the student exemption regulations, they should not necessarily be used to interpret that provision. ¹⁴⁰

The court also rejected the government's arguments that Mount Sinai never referred to itself as a school, college, or university and that it should not be considered to be such an institution because it does not grant formal degrees. The court pointed to both expert trial testimony and the testimony of actual students stating that residency at a teaching hospital is a continuation of medical school. Residency programs, the court noted, differ very little from the third and fourth years of medical school when students begin treating patients. The court also noted, again citing *Mayo*, that a degree is not a necessary component to achieve the status of a school, college, or university. The court continued that students receive a certificate of completion and participate in a yearly graduation ceremony once the residency program has been completed. Most importantly, students are not eligible to take the board certification examination in the area of their specialty or subspecialty until they have completed the program.

The government also presented expert testimony relating to the "profitable nature" of residency programs and the compensation of residents for patient care. The court did not find the expert credible, noting that he examined neither the financial books of Mount Sinai nor the books of the residency programs specifically. Furthermore, the court noted that Medicare regularly provides subsidies to hospitals that qualify as teaching hospitals in order to foster graduate medical

^{138. 282} F. Supp. 2d 997 (D. Minn. 2003).

^{139.} Mount Sinai, 2008 WL 2940669, at *2008-5389. I.R.C. § 170(b)(1)(A)(ii) (2006) contains a definition of "educational organization" which is referenced throughout the Code as a definition of both "educational organization" and "educational institution." Mount Sinai, 2008 WL 2940669, at *2008-5389 to 5390. However, neither § 3121 nor the regulations under it make any such reference. See I.R.C. § 3121 (2006).

^{140.} Mount Sinai, 2008 WL 2940669, at *2008-5390.

^{141.} See id. at *2008-5390 to 5391.

^{142.} Id.

^{143.} Id. at *2008-5390.

^{144.} Id. at *2008-5391 (citing Mayo, 252 F. Supp. 2d at 1016).

^{145.} Id.

^{146.} Id.

^{147.} Id. at *2008-5391.

^{148.} Id.

education.¹⁴⁹ These payments supplement losses resulting from operating a hospital that trains and supervises student doctors as well as treats patients.¹⁵⁰ The financial statements verified that in the aggregate, during the years at issue in the case, Mount Sinai operated at a loss.¹⁵¹

In determining that the Mount Sinai Medical Center was in fact a school, college, or university, the court described numerous aspects of the residency programs at the hospital. The court was particularly persuaded by the mission statement of the teaching hospital, which stated that the hospital's purpose was "to provide quality health care enhanced through education, research, teaching and volunteer servic-The court went on to discuss how the hospital created an independent Department of Medical Education with its own full-time director which handled the undergraduate, graduate, and continuing medical education programs operating within the hospital.¹⁵⁴ court also mentioned Mount Sinai's affiliation agreements, which allowed Mount Sinai residents to perform rotations and learn from physicians at other hospitals while allowing residents from other teaching hospitals to learn at Mount Sinai. 155 Furthermore, the court noted that Mount Sinai had certain facilities considered to be educational in nature, such as lecture halls and an extensive medical library.¹⁵⁶

The court also discussed the integral role of patient care in the education of the residents. 157 While residents did engage in patient care, it was always supervised and tailored toward the individualized curricula set for the different residency programs. 158 Citing the court in Mayo and the testimony of students who had participated in Mount Sinai's various residency programs, the district court concluded that Mount Sinai was a "school" within the common meaning of the term. 159

In determining whether the residents of Mount Sinai should be considered students, the court again turned to the regulations and also to the United States Court of Appeals for the Eighth Circuit's decision

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149. Id.
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^{150.} *Id*.

^{151.} Id. at *2008-5392.

 $^{152. \ \} See \ id.$

^{153.} *Id.* (internal quotation marks omitted).

^{154.} Id.

^{155.} Id.

^{156.} Id. at *2008-5394.

^{157.} See id. at *2008-5393 to 5394.

^{158.} Id. at *2008-5393.

^{159.} Id. at *2008-5393 to 5394 (citing Mayo, 252 F. Supp. 2d at 1013).

in *Minnesota v. Apfel*.¹⁶⁰ The district court relied on three criteria: "(1) whether Mount Sinai's residents were enrolled and regularly attending classes, (2) whether the residents' relationship with Mount Sinai was primarily for educational purposes or primarily to earn a living, and (3) whether the services performed by residents were 'incident to and for the purpose of pursuing a course of study."¹⁶¹

The court cited many aspects of the program as being indicative that the residents were actually enrolled and attended classes. 162 Residents were required to apply and were accepted based on many factors, including merit, personal background, educational achievements, letters of recommendation, and interviews. 163 Once accepted, the residents signed an agreement as evidence of their enrollment and began participation in a mandatory curriculum. 164 Rejecting the government's rigid definition of classes as only pertaining to lectures in a classroom, the court determined that patient care and operations were "hands-on" classes. 165 In addition to those less traditional forms of learning, residents also attended conferences and lectures that were mandatory and enforced by attendance policies.¹⁶⁶ Finally, residents received regular evaluations, quizzes, and tests on which their performances were graded and kept on file. 167 Residents, including those that did not participate in the programs that were accredited by the particular board responsible for a certain specialty, were subject to the same standards as residents who participated in the nationally accredited programs.168

The court also determined, contrary to the government's argument, that a position as a resident in a hospital was not a "livelihood" because patient care and education are not mutually exclusive. ¹⁶⁹ The court noted a number of reasons why residents are not typical employees. For instance, most residents are assigned through a National Match

^{160. 151} F.3d 742 (8th Cir. 1998); see Mount Sinai, 2008 WL 2940669, at *2008-5394 to 5395.

^{161.} Mount Sinai, 2008 WL 2940669, at *2008-5395 (quoting Mayo, 282 F. Supp. 2d at 1015-18).

^{162.} See id. at *2008-5395 to 5397.

^{163.} Id. at *2008-5395.

^{164.} Id.

^{165.} Id.

^{166.} Id. at *2008-5395 to 5396.

^{167.} Id. at *2008-5396.

^{168.} Id.

^{169.} Id. at *2008-5397 to 5398.

^{170.} See id.

program¹⁷¹ and therefore are not "hired" in the traditional sense of the word.¹⁷² Also, all patient care by the residents was supervised and subject to the judgment of an attending physician.¹⁷³ Residents were also required to meet the individualized curricula of their respective programs.¹⁷⁴ In addition, the students themselves described the experience as primarily educational.¹⁷⁵

Finally, the government's primary argument with respect to the third criterion was that the "tipping point" with regard to student status was the first day of residency. The court held that this was not the generally accepted point of view in the medical community and that there was little distinction between a first year resident and a third or fourth year medical student. Patient care, which began in the third year of medical school, was part of the learning model of "progressive responsibility," in which a resident is allowed more and more independence in treating patients. This responsibility, however, is always subject to the supervision of the attending physician. 179

Accordingly, the court concluded that Mount Sinai Medical Center was a school, college, or university, and that the residents of Mount Sinai were students. Therefore the hospital was entitled to an exemption from FICA taxes. 181

^{171.} Under the National Resident Matching Program, a medical student chooses hospitals that offer programs in his or her selected specialty. The student then visits the hospitals and, if interested in the program, fills out an entrance application, takes tests, and possibly submits to interview, according to the program's requirements. The student's medical school then sends transcripts, performance evaluations, and letters of recommendation to the directors of the hospital programs to which the student has applied. After the visitation and interviewing period has expired, each medical student ranks the hospital programs in order of preference. Correspondingly, each hospital program ranks the students it has interviewed. The preferences of the hospitals and students are then matched in order of preference by computer, resulting in a "match" between a student and a hospital. See id. at *2008-5377 to 5379 (describing the National Resident Matching Program).

^{172.} Id. at *2008-5397.

^{173.} Id. at *2008-5398.

^{174.} Id.

^{175.} Id. at *2008-5398 to 5399.

^{176.} Id.

^{177.} Id.

^{178.} *Id*.

^{179.} Id. at *2008-5399 to 5400.

^{180.} Id. at *2008-5400.

^{181.} Id.