

JURISDICTION: THE FULL PAYMENT RULE FOR REFUND CLAIMS AND DIVISIBLE TAXES

Posted on **November 15, 2016** by **Jim Malone**



If a tax is not subject to Tax Court review, the taxpayer is free to pursue a refund claim, but full payment is a jurisdictional prerequisite. *Flora v. United States*, 362 U.S. 145, 150-51 (1960). In some contexts the full payment requirement is relaxed because the tax is divisible; for example, a corporate officer challenging a trust fund recovery penalty assessment need only pay the tax for one employee to establish jurisdiction. *Psaty v. United States*, 442 F.2d 1154, 1159 (3d Cir. 1971). While the trust fund recovery penalty is recognized as a divisible tax, the question whether a tax is divisible remains open in a number of other contexts.

Recently, the Federal Circuit addressed whether penalties assessed for failure to comply with tax shelter registration requirements were divisible taxes, affirming a prior Court of Federal Claims determination that they were not. *Diversified Group Inc. v. United States*, No. 2016-1014, 2016 U.S. App. LEXIS 20274 (Fed. Cir. Nov. 10, 2016).

Diversified Group was decided under the prior versions of section 6111 and 6707 of the Code: Section 6111 imposed a registration requirement for tax shelters on a tax shelter organizer, I.R.C. § 6111(a)(1) (1998); under section 6707, a penalty was imposed for a violation of section 6111. I.R.C. § 6707(a)(1) (1998). The penalty was calculated as the greater of one percent of investments or \$500. I.R.C. § 6707(a)(2) (1998). The penalty increased in cases where there were confidentiality provisions. I.R.C. § 6707(a)(3) (1998).

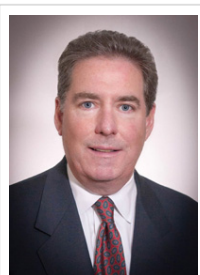
Diversified and its principal, James Haber, were the subject of an IRS penalty audit that commenced in 2002. In 2013, the IRS issued two notices assessing penalties based on a failure to register two tax shelters. *Diversified Group Inc. v. United States*, 2016 U.S. App. LEXIS 20274, *5. The penalties related to two programs that *Diversified* and Haber had offered between 1999 and 2001, the Option Partnership Strategy (OPS), and the Financial Derivatives Investment Strategy (FDIS). *Id.* at *2. The IRS assessed a penalty of \$24,868,451 for the failure to register OPS, and a separate penalty of \$17,241,032 for the failure to register FDIS. *Id.* at *5. The aggregate amount of \$42,109,483 was later reduced to \$24,920,904 due to payments by others. *Id.* at *5-*6.

In an effort to challenge the penalty determinations, Diversified made a payment of \$15,500, representing the penalty associated with a single client's investment in OPS plus interest, and Haber did the same for a single client's investment in FDIS. *Id.* at *6. The taxpayers then sought a refund, which the IRS rejected. Diversified and Haber file a refund action in the Court of Federal Claims; when that action was dismissed based upon the full payment rule, they appealed to the United States Court of Appeals for the Federal Circuit.

The Federal Circuit began its analysis by reviewing the Supreme Court's opinion in *Flora*, which included language recognizing that in situations such as excise taxes, the payment of a single individual assessment would suffice. *Id.* at *12. The Court of Appeals observed that a tax is generally divisible if it "is merely 'the sum of several independent assessments triggered by separate transactions.'" *Id.* at *12-*13 (quoting *Korobkin v. United States*, 988 F.2d 975, 976 (9th Cir. 1993)). The court emphasized that the divisibility exception was narrow, and it observed that the mere fact that liability rested on an aggregation of sums of money was not enough to establish divisibility. *Id.* at *14.

On the merits, the Federal Circuit concluded that the penalties were not divisible because former section 6707 tied the penalty to a single act, the failure to register a shelter. *Id.* at *16. While the taxpayers sought to portray each individual client transaction as a separate tax shelter, the court rejected that approach. Although the transactions at issue were tax shelters because their size and the numbers of investors made them "substantial investments," that merely changed the nature of the necessary paperwork; the penalty was still tied to the failure to register the shelter. *Id.* at *17-*18. Similarly, the court rejected the taxpayers' argument that each instance in which they implemented OPS or FDIS was a different shelter; in the court's view, the taxpayer's argument was inconsistent with the language of the statute, which required registration on or before the first offer to sell the shelter: "If 'tax shelter' was intended to refer to an individual implementation of a tax avoidance strategy instead of the tax avoidance strategy itself, it is hard to understand how one could register it 'not later than the day on which the first offering for sale of interests [occurs].'" *Id.* at *20 (quoting I.R.C. § 6111(a)(1) (1998)) (emphasis by the court). In contrast, the taxpayers' suggested construction would permit promoters to market shelters without any disclosure until the first sale was completed. *Id.* at *20-*21.

The Federal Circuit's reasoning appears to be sound. While the taxpayers made a clever argument, the penalty at issue does not appear to be a divisible one.



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