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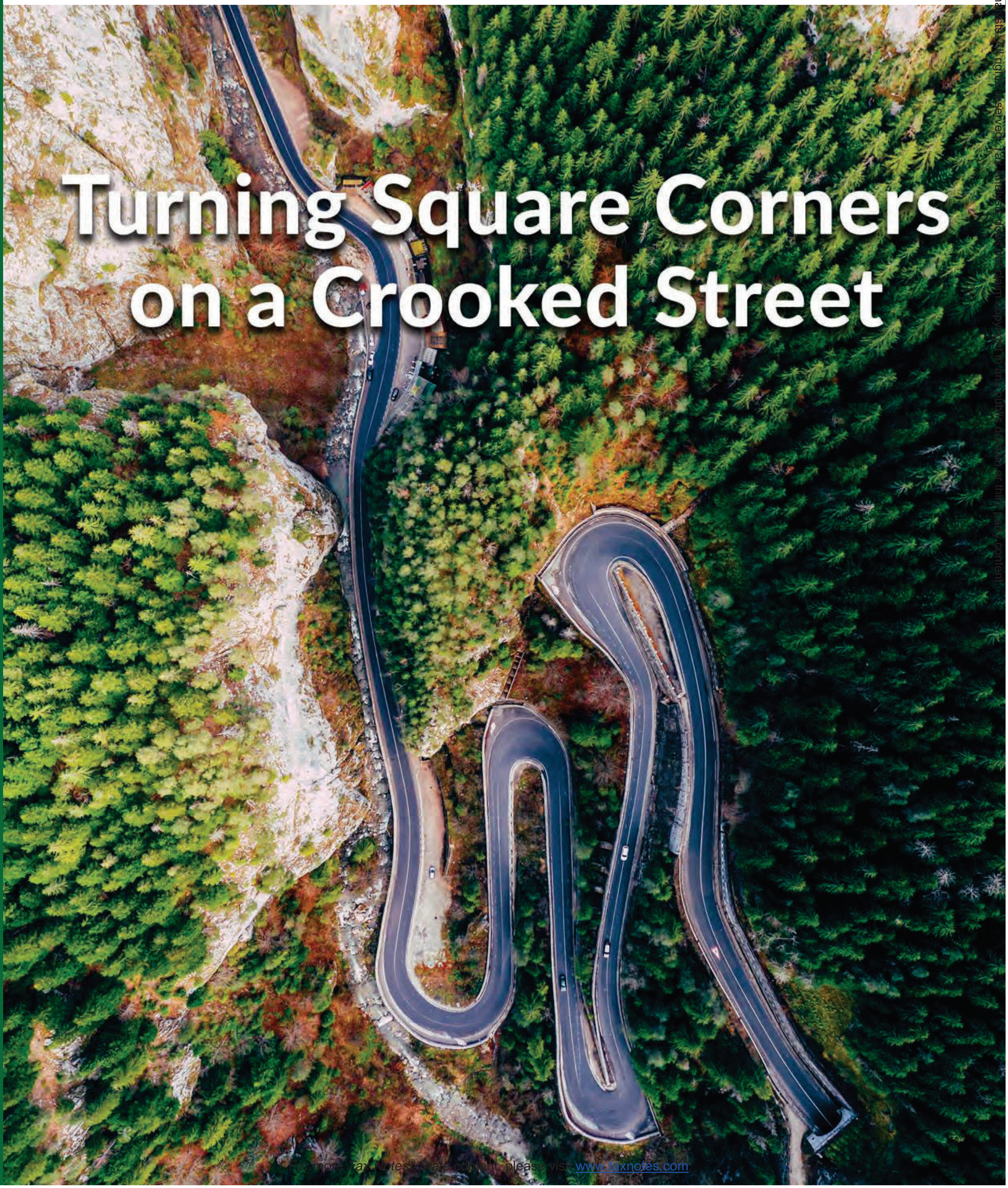

Turning Square Corners on a Crooked Street

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In this article, Ben Carmel continues the theme of seeking non-litigated resolutions to tax disputes, a subject that he has addressed in two previously published pieces.

"Men must turn square corners when they deal with the Government."

—Justice Oliver Wendell Holmes Jr.[1]

Some years ago, I assisted a client's accountants in the preparation of a state tax filing. The problem: a "gotcha" question on a required form. Analysis demonstrated that the question had no basis in the jurisdiction's law nor was it justified under the administrative body's enabling authority. But there it was.

This was neither the first nor the last time that I have encountered such an issue. Other examples (among quite a few) include department of revenue bulletins (or unpublished internal guidance) purporting to describe a binding interpretation of the law or prescribe an administrative policy without complying with the jurisdiction's Administrative Procedures Act; errant form instructions that are unsupported by or actually conflict with state law; and flawed audit notices naming another business even as the jurisdiction's representatives pressured my client demanding a "response" before a statute of limitations closes.

This listing of occurrences is not exhaustive. Nevertheless, a common thread is what to advise a law-abiding taxpayer confronting a tax compliance or tax planning issue created by an administrative action that does not follow the jurisdiction's laws. The ubiquity and power of the administrative state means that this issue extends far beyond subnational taxation to the many areas of life administered by agencies of the federal and subnational governments.

Court Chastised Administrative Agency

For multistate tax practitioners, consideration of relevant U.S. Supreme Court decisions is an appropriate starting point for understanding how to respond to governmental overreach. Fortunately, one need not look far, as in 2021 the Court clearly expressed its view of that government conduct.[2]

Niz-Chavez involved the federal government's notice practices relating to the removal of nonpermanent resident aliens from the United States. Under federal law, a nonpermanent resident alien may be eligible for relief from removal upon demonstrating continuous presence in the United States for at least 10 years. However, the period of continuous presence is "deemed to end . . . when the alien is served a

[1] *Rock Island, Arkansas & Louisiana R.R. Co. v. United States*, 254 U.S. 141, 143 (1920).

[2] *Niz-Chavez v. Garland*, 593 U.S. 155 (preliminary print), 141 S. Ct. 1474 (2021).

notice to appear" in a removal proceeding.[3] Federal law specifies the information that must be included in the notice. At issue was whether the requirement of *a* notice is satisfied when the government issues multiple notices, each of which contains a component of the information required by the notice law.

In a 6-3 decision cutting across ideological lines,[4] the Court rejected the government's position that multiple incomplete notices satisfy a statutory requirement that it provide *a* notice. Moreover, the Court expressed no sympathy for the government and, at times, seemed to mock its position. Here, for example, is the opinion's opening paragraph:

> Anyone who has applied for a passport, filed for Social Security benefits, or sought a license understands the government's affinity for forms. Make a mistake or skip a page? Go back and try again, sometimes with a penalty for the trouble. But it turns out the federal government finds some of its forms frustrating too. The Illegal Immigration Reform and Immigrant Responsibility Act of 1996 (IIRIRA), 110 Stat. 3009-546, requires the government to serve "a notice to appear" on individuals it wishes to remove from this country. At first blush, a notice to appear might seem to be just that — a single document containing all the information an individual needs to know about his removal hearing. But, the government says, supplying so much information in a single form is too taxing. It needs more flexibility, allowing its officials to provide information in separate mailings (as many as they wish) over time (as long as they find convenient). The question for us is whether the law Congress adopted tolerates the government's preferred practice.[5]

Life never got better for the government. In the balance of the opinion, the Court launched the following broadsides:

- "To trigger the stop-time rule, the government must serve 'a' notice containing all the information Congress has specified. To an ordinary reader — both in 1996 and today — 'a' notice would seem to suggest just that: 'a' single document containing the required information, not a mishmash of pieces with some assembly required."[6]
- "Someone who agrees to buy 'a car' would hardly expect to receive the chassis today, wheels next week, and an engine to follow."[7]
- "Ultimately, the government is forced to abandon any pretense of interpreting the statute's terms and retreat to policy arguments and pleas for deference. The government admits that producing compliant notices has proved taxing over time."[8]
- "Beyond all that, the government stresses, its own (current) regulations authorize its practice. The dissent expands on all these points at length. But as this Court has long made plain, pleas of administrative inconvenience and self-serving regulations never 'justify departing from the statute's clear text.'"[9]
- "Besides, even viewed in isolation the government's policy arguments are hardly unassailable. If the government finds filling out forms a chore, it has good company. The world is awash in forms, and rarely do agencies afford individuals the same latitude in completing them that the government seeks for itself today."[10]

[3] 8 U.S.C. section 1229b(d)(1).

[4] Justice Neil M. Gorsuch delivered the Court's opinion, which was joined by Justices Clarence Thomas, Stephen G. Breyer, Sonia Sotomayer, Elena Kagan, and Amy Coney Barrett.

[5] *Niz-Chavez*, 593 U.S. at 157-158.

[6] *Id.* at 161.

[7] *Id.* at 162.

[8] *Id.* at 165.

[9] *Id.* at 169 (internal citations omitted).

[10] *Id.* at 169.

The Court concluded with a paragraph that subnational tax administrators should take to heart:

> At one level, today's dispute may seem semantic, focused on a single word, a small one at that. *But words are how the law constrains power.* In this case, the law's terms ensure that, when the federal government seeks a procedural advantage against an individual, it will at least supply him with a single and reasonably comprehensive statement of the nature of the proceedings against him. *If men must turn square corners when they deal with the government, it cannot be too much to expect the government to turn square corners when it deals with them.*[11]

Surprisingly, in the two and a half years after *Niz-Chavez* was decided, it appears to have been cited in only two subnational tax cases or administrative decisions. Also, in items reported by *Tax Notes State*, *Niz-Chavez* was cited in only one petition to a court and has not been discussed in any articles. While other factors might be at work, the lack of citations raises the possibility that *Niz-Chavez* is being under-used by state tax practitioners.

One cannot know how often the case was cited in briefs or communications with state departments of revenue. Nevertheless, the near-invisibility of *Niz-Chavez* in the state and local tax world contrasts with the numerous citations to *Kisor*.[12] *Kisor*, like *Niz-Chavez*, was a nontax case involving federal agency powers. (*Kisor* involved deference to agency interpretations.) In the two and a half years after the Court decided *Kisor*, it was cited in no fewer than five subnational tax cases and administrative decisions. It was also cited in no fewer than seven briefs or petitions reported in these pages and in four *Tax Notes State* articles.[13]

Decisions Demonstrate 'Square Corners' Challenges

Minnesota and California rulings provide excellent platforms for demonstrating the type of challenges addressed here. The first decision was issued by the Minnesota Supreme Court.[14] *Cities Management* is an income tax case involving an S corporation, a nonresident shareholder, an election to treat the sale of stock as an asset sale under IRC section 338(h)(10), and Minnesota law relating to such federal elections. Substantively, multistate tax planning involving sales of passthrough entities by shareholders one or more levels removed from the sold entity may be complex, as are the multistate income tax consequences of IRC section 338(h)(10) elections. When a proposed sale involves both areas of state income taxation, taxpayers and practitioners are well-advised to carefully examine — and reexamine — the relevant jurisdiction's statutes, regulations, case law, and published guidance to identify a proper treatment of the sale.

In *Cities Management*, the parties disputed the treatment of the gain of a 2015 sale of an S corporation's goodwill.[15] Understandably, the tax advisers in *Cities Management* relied on a 2006 Minnesota Tax Court decision involving Minnesota income taxation of goodwill when sold in a transaction qualifying for IRC section 338(h)(10).[16] In *Nadler*, the tax court determined that a sale of goodwill constituted nonbusiness income. The Department of Revenue did not appeal *Nadler*.

In *Cities Management*, the Minnesota Supreme Court succinctly described the *Nadler*-related occurrences in the case before it:

> Based on *Nadler*, the public accounting firm advised [the S corporation and one of its shareholders] that gain on the portion of sale proceeds considered [the S corporation's] goodwill would be taxed under Minn. Stat. section 290.17, subd.

[11] *Id.* at 172 (emphasis added).

[12] *Kisor v. Wilkie*, No. 18-15, 588 U.S. ___, 139 S. Ct. 2400 (2019).

[13] An aside: A version of the deference issue is again before the U.S. Supreme Court in *Loper Bright Enterprises v. Raimondo*, No. 22-451 (2023), and *Relentless Inc. v. Department of Commerce*, No. 22-1219, which were argued in tandem on January 17. The eventual decision in those cases is certain to generate much discussion among state tax practitioners.

[14] *Cities Management Inc. v. Commissioner of Revenue*, A23-0222 (Minn. Nov. 22, 2023).

[15] The remainder of the S corporation was also sold, but only the treatment of the goodwill was at issue before the Minnesota Supreme Court.

[16] *Nadler v. Commissioner of Revenue*, No. 7736R (Minn. T.C. Apr. 21, 2006).

2(c). This provision directs that gain on the sale of goodwill "that is connected with a business operating all or partially in Minnesota is allocated to this state to the extent that the income from the business in the year preceding the year of sale was assignable to Minnesota under subdivision 3."

[The S corporation's shareholders] agreed to make a federal section 338(h)(10) election as part of the sale. . . . In preparing [the S corporation's] 2015 Minnesota tax return, [its] accountants again followed and relied on *Nadler*, characterizing the gain on the sale of [the S corporation's] goodwill as income "not derived from the conduct of a trade or business," Minn. Stat. section 290.17, subd. 2, and assigned the income from the sale of [the] goodwill to Minnesota in accordance with subdivision 2(c).

Unbeknownst to [the S corporation, the shareholder, or their accountants], the (Minnesota) Department of Revenue had internally taken the position that it "[did] not acquiesce" to the tax court's decision in *Nadler*. Minn. Dep't of Revenue, Technical Advice Memorandum (May 4, 2007). As early as 2007, the Department was circulating non-public *internal* technical advice memoranda and other documents in which it informed auditors that the Department would not follow the tax court's reasoning in *Nadler*. The Commissioner did not make the Department's disagreement with the tax court's decision public until July 2017, when [Minn. Dep't of Revenue Notice No. 17-02 (July 3, 2017)] was issued.[17]

The DOR audited the S corporation and its shareholders. Based on the department's rejection of *Nadler*, it assessed taxes, interest, and penalties.

This article will not critique the substantive merits of the DOR's interpretation, nor will it address whether the tax court's decision in *Nadler* should have been treated as binding on the department. Rather, the starting point for the analysis here is the state supreme court's statement that:

> We are troubled by the Commissioner's conduct that this case has brought to light. Rather than appealing the tax court's interpretation of tax law with which the Department disagreed, the Commissioner decided internally — apparently without notice to the public — that the Department would "not acquiesce" to the tax court's interpretation of the law. We fear that such actions do little to inspire the trust and confidence of taxpayers in Minnesota's tax system. *See Mauer v. Comm'r of Revenue*, 829 N.W.2d 59, 76 n.2 (Minn. 2013) ("For taxpayers to have trust and confidence that Minnesota's tax system is fairly and equitably applied to all, it is vitally important that taxpayers be able to understand the Department's [position]. . . . Such an understanding is important so that taxpayers can adjust their expectations, intentions, and actions accordingly.").[18]

That statement notwithstanding, the state supreme court decided in favor of the commissioner.

Nevertheless, the court included a footnote acknowledging what it characterized as the dissent's "frustration" with the commissioner's conduct. Actually, the dissent was beyond frustrated — classifying the conduct as "outrageous" and wanting to saddle the commissioner with the consequences. The dissent wrote that:

> The actions of the Commissioner of Revenue here — namely, the decision to disregard the tax court's interpretation of a

[17] *Cities Management*, A23-0222 at 4-5 (emphasis in original).

[18] *Id.* at 9-10. The Minnesota Supreme Court could have included a reference to the U.S. Supreme Court's 2012 decision in *FCC v. Fox Television Station Inc.*, 567 U.S. 239, 253 (2012), stating that: "A fundamental principle of our legal system is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required." The Minnesota court might then have adopted or distinguished the reasoning of the case, as occurred in the January 24, 2024, decision of the South Carolina Court of Appeals in *Amazon Services LLC v. South Carolina Department of Revenue*, No. 2019-001706, Op. 6047, at 18 (S.C. Ct. App. 2020) (distinguishing the case and its due process analysis from the circumstances presented by Amazon). The dissent cited two Minnesota cases addressing fairness and due process, but not *Fox Television*.

> statute and adopt the Commissioner's own interpretation without notice to the public — raise serious concerns about the fundamental fairness of the underlying audit that led to this appeal. . . .
>
> At no point during any of these events were [the shareholder] and her tax advisors aware that the Commissioner had rejected the tax court's interpretation of section 290.17 in the *Nadler* opinion. As the record produced during discovery demonstrates, the Commissioner decided within a year of the tax court's issuance of *Nadler* that the Department of Revenue would not accept the tax court's interpretation of section 290.17. For instance, a technical advice memorandum dated May 4, 2007, noted that "the Department of Revenue decided not to appeal the Tax Court decision in *Nadler v. Comm'r of Revenue* . . . but does not acquiesce to that decision regarding the treatment of goodwill under Minn. Stat. section 290.17 in that case." Other documents lay out the Department's instructions to its employees to apply the Commissioner's own interpretation of section 290.17 rather than the *Nadler* interpretation of the statute.[19]

At this point, the dissent minced no words in attacking the commissioner's conduct:

> But what is perhaps most troubling about this conduct is the Commissioner's lack of transparency. For more than 10 years after the *Nadler* opinion was issued, the Commissioner did not make public the Department of Revenue's position on the interpretation of section 290.17. Public notice of the Commissioner's disagreement was not provided until July 2017 when the Department issued Revenue Notice 17-02. In this revenue notice, the Commissioner publicly advised taxpayers for the first time that "the department does not administer the income allocation provisions in [section 290.17] using the Minnesota Tax Court's reasoning in *Nadler v. Commissioner*." Minn. Dep't of Revenue Notice No. 17-02 (July 3, 2017).
>
> This [2017] revenue notice was, of course, no use to [the S corporation]; the business was sold and the 2015 tax return was filed relying on *Nadler* before the Commissioner issued the revenue notice. The Department itself acknowledged the basic unfairness of this situation when [the S corporation] administratively appealed the audit. In removing the substantial understatement penalty initially assessed against [the S corporation], the Department noted that [the S corporation] "reasonably relied on *Nadler* and the Department had issued no written guidance until 2017 (Revenue Notice 17-02) disputing the *Nadler* decision" . . .
>
> Given the outrageous conduct of the Commissioner, I would instead announce an equitable rule that the Commissioner is bound by tax court decisions that are not appealed unless the Department of Revenue provides public notice of its disagreement with the tax court opinion.[20]

The commissioner's concealment of its nonacquiescence to *Nadler* was an egregious error. And punishing taxpayers who *the commissioner admits acted reasonably* in following *Nadler* was, as the dissent observed, outrageous.

Obviously, no one should receive the treatment meted out to the taxpayers in *Cities Management*. "No one" includes the commissioner and DOR employees who, as much as the rest of us, are unavoidably exposed to that treatment by the innumerable agencies at all levels of government with which they and we interact. Fortunately, this type of conduct is atypical of departments of revenue.[21]

[19] *Cities Management*, A23-0222 at D-1 and D-2.

[20] *Cities Management*, A23-0222 at D-2 and D-3.

[21] In my years of practice, I can recall only two circumstances rivaling what transpired in Minnesota. In the first, a long-time employee of a state revenue department lost track of his role of honestly and fairly administering the state's income tax and was called to account by a court. In the second, bureaucratic barriers, an incredible amount of turnover among revenue department employees, and a federal investigation of the agency made concluding a matter impossible. With those exceptions, I have found that the departments will cooperate in a sincere effort to avoid a patently unjust result.

Much more common is a revenue agency failing to follow the jurisdiction's APA. Throughout the country, state APAs protect constituents by requiring administrative agencies to comply with processes before adopting or revising regulations. These processes increase transparency and, if outside comments are received, can improve the regulations ultimately adopted.

Departments of revenue sometimes make legal interpretations of broad applicability without complying with requirements of the jurisdiction's APA. They do so at their peril and at the expense of all who have no choice but to rely on their administrative probity. A California superior court's December 2023 decision in *American Catalog* provides an example.[22]

American Catalog involved the Franchise Tax Board's published interpretations of how federal Public Law 86-272 (15 U.S.C. sections 381-384) applies to "the current economy due to technological advancement."[23] The FTB asserted that posting the guidance on its website provided taxpayers with transparency and "access to information that taxpayers may find helpful in determining whether and how to file a California tax return."[24]

The FTB's assertion was relevant only if the guidance is not a regulation within the meaning of the state's APA (Cal. Gov't Code sections 11340-11361). However, if the guidance is a regulation within the meaning of California's APA, the FTB's mere posting of the effective versions of the guidance on its website would fail to satisfy the APA requirements.

California's APA defines regulation as "every rule, regulation, order, or standard of general application . . . adopted by any state agency to implement, interpret, or make specific the law enforced or administered by it, or to govern its procedure."[25] The court further observed that "absent an express exception, the APA applies to all generally applicable interpretations of a statute. . . . Indeed, a regulation subject to the APA may exist even if the agency never promulgates a written policy setting forth the rule at all."[26]

The court concluded that the "TAM and Publication 1050 [that is, the guidance] was a regulation within the meaning of the APA. As the FTB concedes, neither was enacted in compliance with the APA's requirements. As a result, the TAM and Publication are void."[27]

Resolving Square-Corners Issues Without Litigating

Each of the above examples involves litigation, and for good reason: There is no place to look for issues that were quietly resolved without involving a tax authority. However, these silent resolutions are the truly successful responses to square-corners issues.[28] Therefore, bearing in mind that litigation is always an option, it is the quiet internal resolutions that are the primary subject of the remainder of this article.

In seeking a quiet resolution, the following points are essential:

1. **Never lie or evade.** In a perfect world, this would always be obvious to all taxpayers and practitioners. However, the combination of an improper requirement, a belief that one will not get caught, rationalization, and general temptation can make these appear to be plausible options. They are not.[29]
2. **Avoid a conflict with the government to the extent possible.** Maintaining taxpayer

[22] *American Catalog Mailers Association v. Franchise Tax Board*, No. CGC-22-601363 (Cal. Super. Ct. Dec. 13, 2023).

[23] FTB TAM 2022-01 (Feb. 14, 2022) and FTB Publication 1050 ("Application and Interpretation of P.L. 86-272" (rev. May 2022)) (jointly referred to as the "guidance").

[24] *American Catalog*, No. CGC-22-601373 at 8.

[25] Cal. Gov't Code section 11342.600.

[26] *American Catalog*, No. CGC-22-601373 at 9 (citations omitted).

[27] *Id.* at 11.

[28] A contrary conclusion — viz, that the repeated citations to case law demonstrate that litigation is necessary to resolve these issues — is an example of survivorship bias. Brittanica.com defines survivorship bias as "a logical error in which attention is paid only to those entities that have passed through (or 'survived') a selective filter, which often leads to incorrect conclusions." Here, litigated matters are the survivors that provide us with useful examples, while every quiet resolution is unknown except to the few involved. Every taxpayer would prefer to resolve its square-corners problem quietly.

[29] As a junior associate I was part of a team of lawyers participating in a trial-level proceeding. During a break, an adult son was hinting to his father to lie on the witness stand. Both were tall men, and the image burned into my brain is of lead counsel — a much shorter man — jumping up and down between them waving his arms and stating very assertively, "No! No! No!"

anonymity for as long as possible is essential to avoiding such a conflict.

3. **Hope is not a strategy.** Therefore, place little confidence in making full disclosure and thereby receiving the goodwill and, for lack of a better word, mercy of government officials. Solving problems requires understanding the law and circumstances, then measuring the taxpayer's facts against that understanding. Whether to communicate the understanding to the relevant department of revenue is a late-stage consideration. On a related note, connections and local desks might ease access to government officials (which is usually available anyway), but access does not solve problems.
4. **Experience proves that compliance with an off-kilter administrative "requirement" may be accomplished without making harmful disclosures or concessions.** Accomplishing this requires an understanding of the jurisdiction's laws, legislative history, regulations, relevant publications, and the circumstances surrounding the asserted requirement. Further, it is often necessary to analyze this information as it existed in periods preceding the one at issue. Of particular interest is whether the jurisdiction made a relevant change to its laws before a new administrative interpretation or requirement was issued. If the law remained unchanged, there is an increased probability that the administrative revision is unauthorized. This step can involve a lot of work, but this is where outside tax practitioners add the greatest value. Success here requires tenacity, creativity, careful reading, and researching source materials that might be decades-old. Obviously, the amount at issue will guide how much digging is appropriate.
5. **If a satisfactory quiet resolution is identified, the supporting analysis should be documented in a privileged communication and retained by the taxpayer.**
6. **If, after working through the steps above, no quiet resolution has been identified, the taxpayer should consider again whether compliance with the new interpretation or requirement reaches an unacceptable result.** If the result is reconfirmed to be unacceptable, the company tax director can confidently report to senior management the efforts made to resolve the issue and advise that a direct challenge should be considered.

Concluding Thoughts

Tax minimization is a proper objective for every taxpayer and typically involves entity-structuring, transaction-planning, and other proactive measures. These can be accomplished with a degree of attention to right-angles that would do Justice Holmes proud.

However, when a tax authority paves a winding path, taxpayers must respond accordingly. The best results in these circumstances are achieved when a taxpayer quietly reconciles the new interpretation or requirement with what the law requires. Even if that "best" result is not possible, the effort might still yield a good quiet result. If that too is not possible, the tax director can report the efforts made to management. Management — with input from an outside expert — can then decide whether to pursue a more open, more confrontational stance. ■