No. _____

In The

Supreme Court of the United States

INTERIOR GLASS SYSTEMS, INC.,

Petitioner,

v.

UNITED STATES,

Respondent.

On Petition For Writ Of Certiorari To The Ninth Circuit Court Of Appeals

PETITION FOR WRIT OF CERTIORARI

JOHN P. MCDONNELL, ESQ.
LAW OFFICES OF JOHN P. MCDONNELL
40 Main Street
Los Altos, CA 94022-2902
Telephone: 650-991-9909
JPMcDON@aol.com

Attorney for Petitioner

COCKLE LEGAL BRIEFS (800) 225-6964
WWW.COCKLELEGALBRIEFS.COM

QUESTIONS PRESENTED

1. Is the collection of tax penalties an exception to the requirements of due process, or does a citizen have a right to a hearing before the IRS seizes thousands, or even millions, of dollars in tax penalties?

2. If the citizen has a right to a hearing, does a meeting with an IRS Appeals Officer satisfy the requirement of a "meaningful" pre-collection hearing?

3. Does the IRS's broad interpretation of "substantially similar" render the penalty statute so vague and unpredictable that no person of "common intelligence" could anticipate what types of plans would need to be reported?

PARTIES TO THE PROCEEDING AND CORPORATE DISCLOSURE STATEMENT

Petitioner Interior Glass, Inc. is a subchapter S corporation that is wholly-owned by Michael Yates. Interior Glass was the Plaintiff in the District Court and the Appellant in the court of appeals proceeding. Respondent United States was the Defendant in the District Court and the Appellee in the court of appeals proceeding.

RELATED CASES

Michael Yates v. Comm. Internal Revenue, Tax Court docket number 015616-13. Pending, no judgment.

Yates v. United States, District Court, Northern District of California, docket number 19-cv-06384. Pending, no judgment.

Interior Glass Systems, Inc. v. United States, United States District Court, Northern District of California, Docket Number 13-cv-05563. Judgment entered for Plaintiff, August 15, 2016.

Interior Glass Systems Inc. v. United States, United States Court of Appeals for the Ninth Circuit, No. 17-15713. Affirmed judgment of the District Court, June 26, 2019, Petition for Rehearing and Rehearing en banc denied, August 2, 2019.

TABLE OF CONTENTS

TABLE OF CONTENTS—Continued

TABLE OF AUTHORITIES

Page

CASES

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

PETITION FOR CERTIORARI

Interior Glass, Inc. petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The Ninth Circuit's opinion is reported as *Interior Glass Systems, Inc. v. United States Corp*., 927 F.3d 1081 (9th Cir. 2018) and reproduced at App. 1-12. The Ninth Circuit's denial of petitioner's motion for rehearing and rehearing *en banc* is reproduced at App. 39. The opinion of the District Court for the Northern District of California is reproduced at App. 13-38.

JURISDICTION

The Court of Appeals entered judgment on June 26, 2019. App. 1-12. The court denied a timely petition for rehearing and rehearing *en banc* on August 2, 2019. App. 39. This Court has jurisdiction under 28 U.S.C. §1254(1).

STATUTES AND CONSTITUTIONAL PROVISIONS INVOLVED

The Fifth Amendment to the Constitution provides "No person shall . . . be deprived of life, liberty, or

property, without due process of law . . . " U.S. Const. amend. V.

IRC §6707A imposes a penalty for failing to report to the IRS certain transactions, including "listed transactions." IRC §6707A(c)(2) defines listed transaction as follows: "The term 'listed transaction' means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011."

The Department of the Treasury regulations at 26 CFR §1.6011-4(c)(4) defines "substantially similar," as follows: "The term substantially similar includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy."

INTRODUCTION AND STATEMENT OF THE CASE

Introduction

In 1955, there were 14 tax penalties in the Internal Revenue Code, and today there are over 10 times as many. Many of these penalty statutes allow the IRS to collect millions of dollars in tax penalties by merely sending the citizen a letter. The citizen must pay the full amount of the proposed penalty (which is

impossible in many cases) to obtain judicial review of the validity of the penalty.

This case presents two important due process issues concerning this process of collecting of tax penalties.

1. Due process generally requires a "meaningful" hearing prior to the time the government seizes property. However, the IRS has argued, and the courts in this case have accepted, that the collection of tax penalties is an *exception*, and a pre-collection hearing is never required. It is imperative that this Court speak on this issue, and rule that the standards of *Mathews v. Eldridge*, 424 U.S. 319 (1976) will always apply to determine if a pre-deprivation hearing is required.

2. Due process also requires that a statute provide adequate notice of what is required or prohibited. In this case, the statute requires that a taxpayer report participation in a transaction that is "substantially similar" to a "listed transaction." A transaction can be "substantially similar" if it is expected to "obtain the same or similar tax consequences." The IRS has argued, and the Ninth Circuit has accepted, that a tax deduction of $90 is "substantially similar" to a tax deduction of $50,000. The Petitioner was fined because it did not anticipate that the IRS would someday treat $90 as the same thing as $50,000.

Factual Background

1. The Two Insurance Programs

In 2008, Petitioner Interior Glass, Inc. ("Interior Glass") participated in an employee insurance plan called the Insured Security Program ("ISP") plan. The ISP Plan permitted the employer to claim a deduction for the life insurance premiums it paid for the benefit of its employee, Michael Yates (who was also its sole shareholder). The ISP Plan allowed the employer to claim a full deduction under Internal Revenue Code ("IRC") §419, but the employee would never be required to report the value of this benefit in taxable income. Appendix ("App.") 14.

In Notice 2007-83, 2007-2 Cumm. Bull. 960, the IRS announced that a plan like the ISP Plan was a "listed transaction" if it contained the four "elements" listed in the Notice. App. 21. IRC §6707A provides that a taxpayer must report its participation in a "listed transaction." The statute defines a "listed transaction" as a "transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction." "Substantially similar" means a transaction that is expected to "obtain the same or similar tax consequences" as the listed transaction. 26 CFR §1.6011-4(c)(4).

The ISP Plan contained the "four elements" in the Notice, and was clearly a listed transaction. So Interior Glass properly reported the ISP to the IRS on Form 8886 with the company's 2008 tax return. App. 16 n.1.

In 2009, the promoter of the ISP Plan discontinued it, and developed a different plan called the "Group Term Life Plan" or "GTLP." This plan operated under the group term life insurance rules of IRC §79. The GTLP plan provided that the employer could continue to take a full deduction for the life insurance premium it paid on behalf of the employee, but the GTLP also required that the employee currently include the value of the premium in taxable income. The Group Term Life Plan only allowed the employee to exclude the small amount permitted by IRC §79. The promoter advised its customers that because the GTLP required the employee to report the employer's payment as taxable income (and also because it lacked one of the "four elements" in Notice 2007-83), the GTLP was not "substantially similar" to the type of plan described in Notice 2007-83. Based on this advice, Interior Glass did not report its participation in the Group Term Life Plan in 2009, 2010 or 2011. App. 15.

2. The IRS Audit

In October 2011, the IRS began its audit of Interior Glass. More than a year later, on November 13, 2012, the IRS proposed to impose non-disclosure penalties under IRC §6707A for 2008, 2009, 2010 and 2011, alleging that Interior Glass had participated in a "listed transaction" in each of those years and had failed to report it. App. 16. The IRS letter advised Interior Glass that it could seek a conference with the IRS Appeals Office. On December 13, 2013, Interior Glass,

through its CPA, requested an Appeals Conference, but the IRS did not respond.

In about December 2013, the IRS assessed $40,000 in penalties against Interior Glass: $10,000 per year for 2008, 2009, 2010 and 2011. Even though the IRS knew that Interior Glass had filed the disclosure Form 8886 for 2008, the IRS nevertheless imposed the $10,000 penalty for 2008. *Id.*

3. The Court Proceedings

A. District Court

Interior Glass paid the penalties and interest, and filed a request for refund, which the IRS denied. Interior Glass filed suit in the District Court in December 2013, seeking a refund of the $40,430.12 it had paid.

Interior Glass raised several issues, including the claim that the GTLP was not similar to the Notice 2007-83 plan, because the GTLP produced much different tax consequences. Interior Glass also raised two "due process" issues, which were: (1) that the collection of the penalties violated due process because the IRS did not give Interior Glass a meaningful opportunity to contest the penalties *prior* to collecting the penalties, and (2) the Government's expansive interpretation of the phrase "substantially similar" made the statute unconstitutionally vague, since the law did not provide notice of what transactions needed to be reported.

Both the government and the taxpayer filed motions for summary judgment.

The government argued that a "pre-collection" hearing was never required when the IRS collected tax penalties. The government relied upon case law stating that the government's need to collect tax revenue justifies collecting taxes with no pre-collection hearing.

Interior Glass agreed that the collection of *tax revenue* was a recognized "exception" to the requirement of a pre-deprivation hearing, as outlined by the Supreme Court in *Phillips v. Commissioner*, 283 U.S. 589, 595-99 (1931) (holding, "The underlying principle . . . [is] the need of the government promptly to secure its revenues." *Id.* at 596. "Property rights must yield provisionally to governmental need." *Id.* at 595). However, Interior Glass argued that this exception should not apply to tax *penalties*, because there is no urgent need for the government to promptly collect a penalty. The collection of tax penalties should provide the same due process protections as collection of other government penalties.

On the "vagueness" issue, Interior Glass argued that the Group Term Life Plan differed in many ways from the plan in Notice 2007-83, in particular because it did not allow the employee to permanently exclude income, and actually required the employee to currently include in income almost the entire amount (99.82%) of the premium paid on his behalf.

The District Court granted the bulk of the government's motion, holding that the GTLP was "substantially similar" to the transaction in Notice 2007-83. (App. 34). On the "pre-collection hearing" claim, the District Court accepted the IRS view that a pre-collection hearing was never required. The court ruled that the case law allowing collection of taxes without a hearing should apply:

> "[t]he right of the United States to collect its internal revenue by summary administrative proceedings has long been settled." *Phillips v. Comm'r*, 283 U.S. 589, 595 (1931); *Todd v. United States*, 849 F.2d 365, 369 (9th Cir. 1988). . . . App. 24.

On the "void for vagueness" claim, the District Court ruled that the statute was not vague, because it should be read in conjunction with Notice 2007-83, which provided a clear list of "four elements." App. 21-22, 27. The District Court did not address the fact that the Group Term Life Plan required the employee to currently report almost the entire value of the premium in income.

The District Court thus upheld the penalties for 2009, 2010 and 2011. However, the IRS conceded that it had made a mistake in assessing the penalty for 2008, so the District Court ordered that the 2008 penalty be refunded to Interior Glass. App. 37.

B. The Court of Appeals

Interior Glass continued to raise the two due process claims in its appeal to the Ninth Circuit.

On the pre-collection hearing issue, Interior Glass argued that the Ninth Circuit should follow its prior decision in *Jolly v. United States*, 764 F.2d 642 (9th Cir. 1985), and apply the three-factor test of *Mathews*. The IRS continued to argue that a pre-collection hearing was never required. In addition, the IRS argued for the first time in its Respondent's Brief, that if applying the *Mathews* factors required a hearing, then a pre-collection meeting with an IRS Appeals Officer would satisfy the due process hearing requirement.

The Ninth Circuit upheld the IRS position that a hearing was never required before collecting tax penalties:

> "[T]he government's vital interest in securing tax revenues justifies a pay-first, litigate-later scheme of judicial review. *Phillips v. Commissioner*, 283 U.S. 589, 595, 597-98 (1931). . . . Under that rule, Interior Glass' ability to obtain post-collection judicial review would suffice, without more, to satisfy due process." App. 10.

The Ninth Circuit also agreed with the IRS that a meeting with an Appeals Officer would be a sufficient pre-collection hearing.

However, the Ninth Circuit went further, and evaluated whether the three factors in *Mathews* would lead

to a hearing requirement. On the competing interests of the parties, the Court held that Interior Glass's interest in holding on to its $40,000 was "noteworthy but not substantial." In contrast, it held that the government's interest in encouraging voluntary disclosure of listed transactions would be jeopardized if a pre-collection hearing were required. App. 12.

On whether there was a risk of "erroneous deprivation," the Ninth Circuit stated that IRS mistakes were "unlikely," because,

"The IRS's listed-transaction determination turns on a side-by-side comparison of the listed transaction identified in an IRS notice or regulation and the transaction at issue." App. 11.

On the vagueness issue, Interior Glass stressed there was nothing in Notice 2007-83 or the tax regulations that gave it any notice that the Group Term Life Plan needed to be reported, particularly given the huge difference in tax consequences. Interior Glass pointed out that it always wanted to comply with the law, as evidenced by the fact that it properly reported the ISP in 2008.

The IRS continued to argue that the "substantially similar" language was broad enough to notify a reasonable person that the GTLP was reportable, because the GTLP had the "same or similar tax consequences" as the transaction in Notice 2007-83. The IRS did not specifically address that fact that the GTLP allowed the employee to exclude only $90, instead of the $50,000

that would have been excluded under the Notice 2007-83 plan.

The Ninth Circuit upheld the IRS position, and held that,

> " . . . the [GTLP] plan documents represented that "[c]ontributions [were] currently deductible" by Interior Glass and that only the cost of group-term life insurance (in contrast to the premium on the cash-value policy) may have been includible in [the employee's] income." App. 7.

The Ninth Circuit affirmed the District Court.

Interior Glass filed a petition for rehearing, arguing that the court failed to follow the *Mathews* case. The Petition focused on two issues: (1) that the "risk of erroneous deprivation" was in fact, very high, because the IRS had actually made several errors in the case, including *examining the wrong plan* during the audit; and (2) that a meeting with an IRS Appeals Officer can never qualify as a "meaningful" pre-collection hearing because the Appeals Office is not "independent" of the IRS, provides no meaningful protections, and in fact has no jurisdiction to reduce or revoke these tax penalties.

The Ninth Circuit denied the Petition for Rehearing on August 2, 2019.

REASONS FOR GRANTING THE PETITION

A Collection of Tax Penalties Should not be an Exception to the Requirements of Due Process.

1. This Court Should Apply the Due Process Standards of *Mathews v. Eldridge* to the Collection of Tax Penalties.

This Court has held that due process generally requires a "meaningful" hearing prior to the time Government seizes the property of a citizen. *Fuentes v. Shevin*, 407 U.S. 67, 80-82 (1972). This Court has also recognized that there are "extraordinary" exceptions to this requirement, including the need to, "collect internal revenue of the United States." *Id.* at 92. As noted in *Fuentes*, this exception is based on *Phillips v. Commissioner*, 283 U.S. 589 (1931) which pointed to, "the need of the government promptly to secure its revenues," (p. 596) and held that a pre-collection hearing was not required, "where it is essential that governmental needs be immediately satisfied." (p. 597). This exception for collection of tax revenue has been confirmed many times, *e.g.*, *Bull v. United States*, 295 U.S. 247, 259 (1935) (" . . . taxes are the life-blood of government, and their prompt and certain availability an imperious need."); *G. M. Leasing Corp. v. United States*, 429 U.S. 338, 352 n.18 (1977) (" . . . the very existence of government depends upon the prompt collection of the revenues."); *McKesson Corp. v. Div. of Alcoholic Bevs. & Tobacco*, 496 U.S. 18, 37 (1990) (pre-collection litigation of tax liabilities, " . . . might threaten a government's financial security.")

Interior Glass agrees that the Government's "vital interest in collecting tax revenue" justifies this "extraordinary" exception to the normal due process requirement. But that rule does not apply to collecting *penalties*. From the very beginning of this case, Interior Glass has argued that the *Phillips* rule is limited to the collection of *tax revenue*, and should not apply to penalties. The IRS has never offered any reason for extending this special exception to penalties. And as the Court can see from the above discussion, neither the District Court nor the Ninth Circuit could offer any reason for extending the *Phillips* rule to tax penalties.

In fact, there is an inherent difference between income taxes and penalties. Income taxes are a percentage of income, so the seizure will never confiscate the citizen's entire income. Penalties, however, are not connected to income, and many penalties are intended to be draconian. Prior to 2010, the $10,000 per year penalty on Interior Glass for failure to report the "listed transaction" was $200,000 per year. Some other tax penalties are astronomical. In *Diversified Group Inc. v. United States*, 841 F.3d 975 (Fed. Cir. 2016), the IRS imposed penalties of $42 million under IRC §6707 for failure to register a "tax shelter" that involved a "listed transaction." Similarly, in *Larson v. United States*, 888 F.3d 578 (2d Cir. 2018) the IRS imposed a $68 million penalty for failure to report a tax shelter that involved a "listed transaction." Both cases denied the right to a pre-collection hearing (but the Second Circuit in *Larson* did find this result "troubling"). The penalties in *Diversified* and *Larson*, like the "failure to

report" penalty in the instant case, are all imposed independent of any tax deficiency, so a citizen cannot contest the penalties in Tax Court. *Smith v. Comm.*, 133 T.C. 424 (2009).

Unlike taxes, these penalties are not essential to the "existence" or "financial security" of the country. Penalties are *not* imposed to raise revenue; they exist solely to encourage compliance with the law. *Thompson v. Commissioner*, 148 T.C. 59, 64 (2017). As pointed out in the 2016 Report of the Internal Revenue Service Advisory Council ("IRSAC") at https://www.irs.gov/tax-professionals/2016-irsac-general-report, in 1989 Congress passed the Improved Penalty Administration and Compliance Tax Act of 1989 which confirmed that, " . . . tax penalties exist for the purpose of encouraging voluntary compliance." Congress required the IRS to implement policies that confirm and support this. The Internal Revenue Manual ("IRM") itself states at 20.1.1 that penalties exist to enhance compliance. *See Custom Stairs & Trim, Ltd. v. Comm'r*, T.C. Memo 2011-155, 102 T.C.M. (CCH) 1.

Despite its own statements, the IRS has repeatedly claimed that the purpose of penalties is generating revenue, and has urged courts to apply the *Phillips* line of cases to collection of tax penalties. Yet the IRS has never presented any *reason* for treating collection of penalties the same as collection of tax revenue. There is none.

Further proof that collection of tax penalties is not urgent, is found in IRC §6662A, which imposes a

second penalty (in addition to the §6707A penalty) on a taxpayer for failing to report the *same transaction*. As the IRS has observed, the §6662A penalty is potentially *higher* than the §6707A penalty, as it is for Mr. Yates in the related Tax Court case. Yet this higher penalty is collected only *after* the end of a Tax Court case that determines both the validity of the penalties and the total tax savings generated by the "listed transaction." So the *larger* penalty is not imposed until after a court hearing, but the IRS argues it is imperative to collect the *smaller* penalty without a hearing. This makes no sense.

The Federal Government imposes and collects civil penalties in a variety of areas. It seems these other penalties manage to provide a pre-collection review before seizing private property. For example, in an investigation by the Securities and Exchange Commission, the Commission will either file a complaint in district court or initiate an administrative action before an administrative law judge. *See* https://www.sec.gov/enforce/how-investigations-work.html. There is no reason to treat tax penalties for failing to file an IRS report as more important than civil penalties for securities fraud.

This Court has summarized the law as follows: "We tolerate some exceptions to the general rule requiring pre-deprivation notice and hearing, but only in 'extraordinary situations where some valid governmental interest is at stake that justifies postponing the hearing until after the event.'" *United States v. James Daniel Good Real Prop.*, 510 U.S. 43, 53 (1993). Tax

penalties are not an "extraordinary situation" that justifies denial of due process.

2. A meeting with an IRS Appeals Officer Does Not Satisfy the Requirement of a "Meaningful" Pre-Collection Hearing.

In *Mathews*, *supra*, this Court confirmed the *Fuentes* rule that due process normally requires a meaningful pre-deprivation hearing, and set forth a three-factor balancing test to determine when an administrative review can meet this requirement. The IRS argued to the Ninth Circuit that it was unnecessary to even look at the three factors in *Mathews*, because a meeting with an IRS Appeals Officer *always* satisfies the requirement of a "meaningful" pre-deprivation hearing. The Ninth Circuit agreed.

> "If the taxpayer files a timely protest, an appeals officer will review the taxpayer's arguments and determine whether the taxpayer engaged in a listed transaction. . . . The combination of pre-collection administrative review plus post-collection judicial review satisfies the requirements of the Due Process Clause."

Thus, the IRS can collect tens of thousands, or *millions*, of dollars in tax penalties with nothing more than an informal meeting with an IRS employee. This is an alarming destruction of individual rights. Until 2018, no court had ever held that the IRS had unlimited power to seize property after only a short IRS meeting. Now, both this case and *Larson v. United*

States, 888 F.3d 578 (2d Cir. 2018) have granted that power. This Court must halt this dangerous trend. An Appeals Conference is *not* meaningful protection; an Appeals Conference is essentially worthless.[1]

First, contrary to the oft-repeated bromide, the Appeals Office is far from an "independent" part to the IRS. The Appeals Office is under the control of the IRS, and it lacks any authority to settle a broad range of issues, *including the §6707A penalty in this case*.

Rev. Proc. 79-34, 1979-2 C.B. 498, states that if the National Office requires uniform settlement of an issue, the Appeals Office cannot settle that issue. National Office control is expansive. The Internal Revenue Manual contains detailed rules that limit the authority of the Appeals Office. IRM 8.1.1.2.1 contains many exceptions to the authority of the Appeals Office to settle cases, including the category of "coordinated issues." IRM 8.7.3.1 specifically states that "Appeals Coordinated Issues" must be referred to the National Office, which completely removes these issues from Appeals Office authority.

The key factor is that IRM 8.11.7.6.2 states that the §6707A penalty issue has been an Appeals Coordinated Issue *since Feb. 23, 2006*.

---

[1] As pointed out to the Ninth Circuit, Interior Glass requested an Appeals Conference but the IRS never responded to that request.

IRM 8.7.3.4.2 states that as soon as an Appeals Officer sees that a case involves an Appeals Coordinated Issue, the Officer must, "Advise the taxpayer the issue is coordinated and *any settlement of the issue requires the review and concurrence of the Technical Specialist*." [emphasis added]. That IRM further states that the Appeals Officer must obtain the approval of the Technical Specialist in the National Office for any settlement. Thus, there is one unseen IRS employee in Washington D.C. that will decide the matter. The Appeals Office has no say.

So even if Interior Glass had been granted an Appeals Conference, it would have been worthless. The Appeals Officer had no power to do anything in this case.

Even if the IRS changed its rules to allow the Appeals Office to look at penalties, this would not provide any protection to citizens. The mission of the Appeals Office is to try to settle cases, and the conference resembles a civil settlement conference, but without an impartial third-party to facilitate negotiations. Compare ADR Rule 7-1 of the Northern District of California. This IRS settlement conference provides *far less protection* than a regular civil settlement conference. The taxpayer has no opportunity to conduct discovery, no ability to subpoena witnesses or documents, and cannot present witnesses. *Davis v. Commissioner*, 115 T.C. 35, 42 (2000). The IRS is not required to provide assessment records to the taxpayer. *Nestor v. Commissioner*, 118 T.C. 162, 166-67 (2002). The "conference" can be handled with an informal phone call. *Katz v.*

Commissioner, 115 T.C. 329, 337 (2000). In some cases, the Appeals Officer does not have to provide any conference at all, but can make the determination based merely on the records provided by the IRS. *Lunsford v. Commissioner*, 117 T.C. 183, 189 (2001).

The deck is stacked against the taxpayer. The Appeals Conference takes place after a lengthy IRS audit and the preparation of a large audit file by the examining agent. The IRS obtains all the documents and all the witness interviews it needs during the audit. The taxpayer goes in blind. This prevents any type of "fair" resolution.

This absence of discovery would have damaged Interior Glass in this case, particularly with respect to the erroneous 2008 penalty. Interior Glass had filed the proper disclosure form in 2008, but did not have evidence of this (the CPA filed the 2008 return electronically, and there was no paper record). However, during discovery in the District Court, Interior Glass obtained *the IRS copy* of the electronically filed return, which included the disclosure form. At this point, the IRS conceded that it had erroneously imposed the penalty for 2008. The critical fact is that Interior Glass could not obtain this information until deep into the District Court litigation—it would never have had this evidence at an Appeals Conference and would have conceded this issue.

This perfunctory IRS process should be contrasted with the "carefully structured procedures" for terminating Social Security disability benefits, approved by

this Court in *Mathews v. Eldridge*, *supra*, at 337-38 and 345-46. First, the review of benefits is conducted by a "team" consisting of a physician and a non-medical person trained in disability evaluations. The reviewing agency periodically sends a detailed questionnaire to the recipient to obtain an update on his current medical condition. The questionnaire advises the recipient that he can obtain assistance from the local Social Security office in completing the questionnaire. The agency also obtains information from the recipient's treating physician, which is often supported by X-rays and the results of lab tests. If there is a conflict between the medical information, the agency may arrange for an examination by an independent physician. The recipient's representative is given full access to all of the information relied upon by the agency. Prior to termination, the agency informs the recipient of its tentative decision and provides a summary of the evidence that the agency considers most relevant. The recipient can review all the medical reports and other evidence in the file. The recipient is then given an opportunity to submit additional evidence and arguments, which can be tailored to the precise issues that the agency considers crucial.

Mathews established that, "[t]he ultimate balance involves a determination as to when, under our constitutional system, judicial-type procedures must be imposed upon administrative action to assure *fairness*." [emphasis added] *Id.* at 348. There is nothing fair about the IRS process.

3. The Proper Application of the Matthews Factors Mandates a Pre-Collection Hearing.

a. The Private and Public Interest Factors Cancel Out in the Case of Tax Penalties

The Ninth Circuit purported to balance the three factors from *Mathews*, and concluded that a pre-collection hearing was not required. But the *proper* application of the *Mathews* factors demonstrates that a pre-deprivation hearing is required.

The first and third factors in *Mathews* involve weighing the private interest of the taxpayer against the public interest of the government. In this case, they appear to cancel.

Initially, it must be noted that the Ninth Circuit was correct in stating that the taking of $40,000 from Interior Glass would not deprive it of "necessities," or threaten its ability to survive, as in *Goldberg v. Kelly*, 397 U.S. 254, 264 (1970). But courts have never held that the Fifth Amendment prohibition on government "taking" only applies if the taking results in deprivation of life necessities. *Fuentes v. Shevin, supra*, at 88-89. The proper analysis is that the deprivation of life necessities is a factor that weighs extremely heavily in the citizen's favor in the "balancing" test of *Mathews*. But since that factor is not present here, the Court should balance the private and public interest without any special weight to either.

In terms of economic loss, there appears to be no difference to either side, since there is simply a "timing difference" on when the money is collected. The taxpayer would prefer to hold on to its money, and only pay later if found liable. The Government would prefer to have the money sooner, and refund it later only if the taxpayer prevails. Neither party gains any economic advantage, since the taxpayer must pay interest during the time it held money owed to the government (just as it does at the end of a Tax Court case), and the government will refund a similar amount of interest on any amount erroneously collected.

While the economic factors seem to balance, having temporary use of $40,000 is certainly more important to the taxpayer than it is to a Government agency that collects $2 trillion in income taxes (2018 IRS Data Book, p. 3).

The other economic factor in *Mathews* is cost of the proceeding, but these costs also seem to cancel out, because only the *timing* of the proceeding on liability changes. Currently, the money is seized first, and the determination of liability occurs later in a refund suit. If the hearing comes earlier than the seizure of funds, the costs of determining liability stay the same.

The Ninth Circuit avoided the issue of administrative cost, and instead stated that the government interest in tax penalties was promoting voluntary compliance. The court failed to offer any explanation as to how or why voluntary compliance would be affected by a pre-collection proceeding, as opposed to the

current post-collection proceeding. It is the existence of and the amount of the penalties that promotes compliance, and the timing of the hearing has no effect on a person's decision to comply with the law. In a broad sense, the purpose of *all* civil penalties is to promote compliance with the law (by imposing a fine for non-compliance), and most penalties provide pre-collection review. There is no government interest in the timing of the hearing.

b. The IRS is Prone to Make Mistakes in Tax Penalty Cases, and Made Two Massive Blunders in This Case.

The determining factor is the second factor; the risk of error in the seizure of the money. *Mathews*, 424 U.S. at 343-44. The Ninth Circuit dismissed the risk of IRS errors as virtually non-existent:

"The IRS's listed-transaction determination turns on a side-by-side comparison of the listed transaction identified in an IRS notice or regulation and the transaction at issue."

But the IRS completely *failed* this simple test. The IRS never compared the listed transaction with the Interior Glass Group Term Life Plan. *The IRS examined the wrong plan.*

This was made abundantly clear to the Ninth Circuit in the Opening Brief at pp. 13-16, which included the following information.

"The audit report sent to Interior Glass . . . [at ER-0135] states:

> "**[T]he arrangements adopted by employers under the Plan incorporate all four of the elements described in Notice 2007-83:**
>
> **(1) Element One: . . .**
>
> **The Plan involves a trust fund described in §419(e)(3) that purports to constitute a welfare benefit fund. The Plan document states:**
>
> **"The primary object of the Plan is to provide . . . welfare benefits for eligible employees of the Employer. . . . This is not a multiple employer welfare benefits plan, but merely a trust established to facilitate welfare benefit plan funding and services. No attempt is made to meet the requirements of a multiple employer plan described in Code Section 419A(f)(6). . . ."**
>
> However, *none* of the foregoing language appears anywhere in the GTLP plan or related documents. None of these documents ever refer to §419 in any manner. The "Purpose of the Plan" is stated on page 1 of the GTLP "Term Life Insurance Plan" [ER-0227] as follows: "The purpose of this Plan is to provide death benefits to the Employer's eligible current employees." Nowhere in any of the Plan documents does the GTLP claim to be a

> "trust." The term "multiple employer" does not appear anywhere in the plan documents."

The Opening Brief then showed that the IRS was actually looking at a plan by a company named "xélan."

> . . . .[T]he audit report itself shows that the IRS was *not* looking at the GTLP, but was instead looking at a plan by a company named "xélan." At footnote 6 on page 24 of the report [ER-0127], the IRS outlines the §419 definitions of "welfare benefit fund" and "fund." The footnote then states:
>
> "**The xélan Disability Trust would meet this basic definition of a "fund." As discussed herein, whether or not the Trust really provides valid employee welfare benefits is another question and it is likely that the Service will argue that in actuality it provides constructive dividends or deferred compensation."**
>
> [Moreover] *none* of the language in the two paragraphs at the bottom of page 33 of the report [ER-0136] ("**The Plan shall provide Death Benefits payable by reason of the death** . . . " and "**Death Benefits payable under this Section 4.01 shall be provided through the purchase of whole life insurance policies . . .** ") appears in the GTLP documents.

Quite simply, during the entire year-long audit, the IRS was examining the *wrong plan*! The IRS has never disputed that it made this error in the audit.

The Ninth Circuit states that the "listed transaction determination" is as simple as the 30-second review of a frivolous tax return in *Jolly v. United States*, 764 F.2d 642 (9th Cir. 1985). In *Jolly*, a mere glance showed that the tax return was either completely blank or contained only zeroes. The "listed transaction determination," is exponentially more complicated, as proven by both the complex 86-page IRS audit report, and the multiple "Information and Document Requests" in the record (referenced at page 50 of the Opening Brief).

The second major error in the IRS audit was imposing the "non-reporting" penalty in 2008, even though Interior Glass had properly reported the 2008 transaction on Form 8886 filed with its 2008 tax return. The IRS had the disclosure form in the IRS records, but the IRS imposed the penalty anyhow.

The Internal Revenue Manual at Section 4.32.4, contains a lengthy list of steps involved in proposing a §6707A penalty. Not surprisingly, the Manual states that the penalty file must contain "[A] statement of whether the taxpayer filed a Form 8886." IRM 4.32.4.3.2.3.

The Ninth Circuit decision incorrectly states that the entire §6707A process is a simple side-by-side comparison of two plans. It is far from simple, and the IRS bungled that task and reviewed the wrong plan. However, for 2008 the job really *was* simple; all the IRS had to do was *look at the tax return*. But they bungled that,

too. The IRS audit took over a year, and yet it produced two major errors.

The suggestion that the IRS hardly ever makes an error during the course of an audit defies common sense, and is readily disproved by the significant number of Tax Court cases that overturn all or part of an IRS determination.

Given that the IRS makes errors in its audits, and the Appeals Conference provides no likelihood of reversing those errors, the rules set forth in *Mathews* mandate a pre-collection hearing.

B. The IRS's Vague and Overbroad Interpretation of "Substantially Similar" Violates Due Process Because the Regulations Fail To Provide Notice as To What Transactions Need To Be Reported.

The IRS has repeatedly changed and expanded the meaning of "substantially similar" in this case.

During the audit, the IRS applied the "four factor" test of Notice 2007-83, and claimed that the GTLP was "substantially similar" to the listed transaction because the GTLP had the same four required elements. That was incorrect. Unlike the Notice 2007-83 transaction, the GTLP did not involve a trust and did not claim tax benefits under IRC §419.

Next, the IRS claimed the two transactions were "substantially similar" because they produced the similar tax consequences. The IRS stated that both plans

permitted the employee to *permanently* exclude the value of employer's payment from taxable income. But that claim was also wrong. The GTLP did not allow the employee to permanently avoid reporting the income and paying tax on it.

The IRS next claimed that even if there was no *permanent* exclusion from income, the two plans were substantially similar because the GTLP permitted the employee to *defer* tax on the full value of the payment several years into the future. But this claim was also wrong. The Group Term Life Plan provided only the tax benefit allowed by §79 of the Code. The GTLP plan repeatedly advised the employee that he could exclude *only* the small amount permitted by §79, and he would have to *currently* include any excess in taxable income. Section 79 permits an employee to exclude the cost of $50,000 of group-term life insurance paid by the employer. This value is determined by Table I in the tax regulations at 26 CFR §1.79-3. The Table provides that for a 47-year-old man like Mr. Yates, the value on each $1,000 of coverage is 15 cents per month, or $1.80 per year. For a $50,000 policy the excludable amount is $90 per year.

The GTLP involved a $500,000 insurance policy, and the employer paid a $50,000 annual premium. Under §79, Mr. Yates could exclude only $90 and was required to report and pay tax on the remaining $49,910. Despite this huge difference, the Ninth Circuit accepted the IRS view that the two plans were "substantially similar." The court ruled that the GTLP provided

that only the cost of group-term life insurance was required to be included in the employee's income. App. 7.

So the regulations mean that $90 is substantially similar to $50,000. That is nonsense. No reasonable person would conclude that a plan that allows a $90 deduction is substantially similar to a plan that allows a $50,000 deduction. When $90 is the same as $50,0000, where does "similarity" end?

A statute that uses, "terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application violates the first essential of due process of law." *Connally v. General Construction Co*., 269 U.S. 385, 391 (1926). Although this Court has at times indicated that the standard for civil penalties may be more lenient, the current law is clear that the "persons of ordinary intelligence" standard applies to civil penalties:

> "Today's "civil" penalties include confiscatory rather than compensatory fines, forfeiture provisions that allow homes to be taken, [and] remedies that strip persons of their professional licenses and livelihoods. . . ."

Sessions v. Dimaya, 138 S. Ct. 1204, 1229 (2018) (Gorsuch, concurring).

Justice Kagan applied the *Connally* standard in the majority opinion at 138 S. Ct. 1212.

As this Court explained in *Grayned v. City of Rockford*, 408 U.S. 104 (1972), the primary danger is, "vague

laws may trap the innocent by not providing fair warning."

Interior Glass certainly had no "fair warning" in 2009. The company could see that the Group Term Life Plan lacked the four specific elements in Notice 2007-83, that it lacked the permanent deferral of income in Notice 2007-83, and that it produced immensely different tax consequences for the employee.

In 2009, even the IRS guidelines viewed the GTLP as different from the Notice 2007-83 transaction. At that time, the test used by the IRS was whether the taxpayer's plan had the four elements in the Notice 2007-83. Every change in the IRS interpretation of "substantially similar" since that time has been a "post hoc rationalization" to defend the incorrect penalties from attack. *See Christopher v. SmithKline Beecham Corp*., 567 U.S. 142, 155 (2012).

> "It is one thing to expect regulated parties to conform their conduct to an agency's interpretations once the agency announces them; it is quite another to require regulated parties to divine the agency's interpretations in advance or else be held liable when the agency announces its interpretations for the first time in [litigation]." *Id.* at 158-59.

Finally, all the vagueness, overbreadth, and shifting litigation positions were completely unnecessary. If the IRS wanted to get reports on all the plans that might involve tax abuses involving life insurance, all it had to do was issue a notice saying that every employer who pays a premium for life insurance on an employee

for a policy amount greater than $50,000 must report the transaction. Mission accomplished. As soon as that Notice came out, Interior Glass would have known it had to report the GTLP, and it would have done so. Interior Glass is a responsible, law-abiding taxpayer. It properly reported the ISP in 2008 and it would have reported the GTLP in 2009-2011 if it had any notice that reporting was required. There was none.

CONCLUSION

This Court should rule that collection of tax penalties is not an exception to the requirement of a meaningful due process proceeding prior to the seizure of a citizen's property. This Court should also rule that a meeting with an IRS Appeals Officer is not a meaningful pre-collection hearing. Finally, the Court should rule that the phrases "substantially similar" and "same or similar tax consequences" in the statute and regulations have been improperly interpreted and expanded to the point where they fail to provide adequate notice of what transactions need to be reported.

Respectfully submitted,

JOHN P. MCDONNELL, ESQ.
LAW OFFICES OF JOHN P. MCDONNELL
40 Main Street
Los Altos, CA 94022-2902
Telephone: 650-991-9909
JPMcDON@aol.com

Attorney for Petitioner