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No. 21-775

IN THE
Supreme Court of the United States

THOMAS E. RUBIN,

Petitioner,

v.

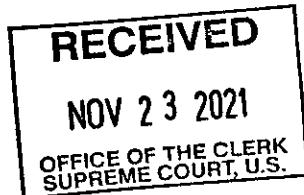
THE UNITED STATES OF AMERICA,

Respondent,

On Petition for Writ of Certiorari to The
United States Court of Appeals for the Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

On June 22, 2021 the Ninth Circuit departed from this Court and its sister circuits in a critical area of tax law. Despite national uniformity and consensus over the past 90 years, the Ninth Circuit adopted a discredited method that undermines the ability of taxpayers to report their tax obligations, adds costs, and distorts our national taxpaying system.

1. Did the Ninth Circuit err when, disregarding the precedential cases in the Ninth Circuit, in sister circuits, and in this Court, it disallowed a taxpayer from recognizing cancellation of debt income in tax year 2000 because a third party unsuccessfully attempted to collect the debt years later?
2. Did the Ninth Circuit err when it violated the exclusive right of Congress to enact federal income tax legislation set forth in U.S. Const. Amdt. 16 by imposing its criteria to calculate tax obligations that nullify 26 U.S.C. § 61(a)(12)?
3. Did the Ninth Circuit err by taking inferences against a taxpayer's interest as a non-movant in a summary judgment in violation of due process?

PARTIES TO THE PROCEEDING

The Petitioner is Thomas E. Rubin, an individual, Plaintiff and Appellant below, who filed the underlying action for tax refund.

The Respondent is the United States of America, Defendant and Respondent below.

There are no related proceedings.

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PETITION FOR WRIT OF CERTIORARI

The Ninth Circuit affirmed summary judgment in a tax refund case and created a conflict among the circuits when it failed to comply with well-established precedent and the IRS Code. According to federal income tax law, the Supreme Court and the circuit courts, cancellation-of-debt income is recognized in the year that it becomes clear that a debt will not be repaid. However, according to this Ninth Circuit panel, a taxpayer is barred from recognizing cancellation-of-debt income if future collection actions might occur, even if those efforts are ultimately unsuccessful. The Ninth Circuit applied this rule for the first time to deprive Petitioner of a \$10.1 million tax refund in violation of his Fifth Amendment right to due process.

For the past 90 years, since this Court issued its opinion in *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), businesses have been required to recognize cancellation-of-debt income in the year in which it became clear that a debt would not be repaid. In 1954 this rule was codified at 26 U.S.C. § 61(a)(11), and Congress has not changed this requirement. At the same time in 1954, Congress codified the procedure for a taxpayer to treat a discharged business debt that is partially repaid in the future at 26 U.S.C. § 166(a)(2). Without explanation, the Ninth Circuit panel replaced this well-established law with a test of its own.

Congress has the exclusive authority to “lay and collect” federal income taxes. U.S. Const. amdt. 16., *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1 (1916). The Ninth Circuit’s nullification of federal tax law violates the separation of powers doctrine and conflicts with precedent from this Court and the other circuits. Further, the argument that tax obligations cannot be recognized because of unknown collection actions that might occur in the future appears frivolous on its face. For example, the Fifth Circuit sanctioned the IRS when it tried to apply the same theory used by this Ninth Circuit panel:

Whether this failure [arguing that the intention to collect a debt in the future was relevant to cancellation-of-debt income] resulted from overwork, deliberate indifference, inability to distinguish intention to do something in the future from doing something in the present, or any reason, cause, or excuse, the fact remains that the IRS dropped the ball. ... Consequently, [taxpayers] were prevailing parties in the underlying litigation and are entitled to recover their administrative and litigation costs from the Commissioner on ... the cancellation-of-indebtedness issue.

Owens v. Commissioner, 67 F. App'x 253, 258 (5th Cir. 2003).

Ignoring this well-established precedent, the Ninth Circuit affirmed summary judgment denying Rubin's tax refund claim, holding that collection actions that were unknowable to Rubin at the time but were undertaken in subsequent years somehow, according to the Amended Memorandum, "show that it had not become clear that Focus's debts would never have to be paid as of December 31, 2000. Thus, this debt was not properly classified as cancellation of debt income for tax year 2000." App. 4. For reasons that are not explained, the panel adopted the argument that subsequent unsuccessful collection activity was relevant and controls when to recognize cancellation-of-debt income. This argument was emphatically rejected by the Fifth Circuit and is not warranted by existing law or by a non-frivolous argument for extending, modifying, or reversing existing law or establishing new law. A taxpayer using this frivolous argument as an excuse for not paying taxes would be subject to civil and/or criminal prosecution by the IRS. IRS Rev. Rul. 2007-19.

Other circuits that have considered cases with similar facts found the debt was discharged in the year in which it became clear that the debt would not be repaid. In no case was potential subsequent collection action a factor.

In *Exch. Sec. Bank v. United States*, 492 F.2d 1096 (5th Cir. 1974) the fact that a debt deducted in one year was partially satisfied in a subsequent year did not make the taxpayer's choice of when to take the deduction unreasonable. Instead, that court understood that the tax code provides for subsequent reallocation. *Id.* at 1099-1100. Unlike the Fifth Circuit holding, the Ninth Circuit panel held that, if a debt is deducted in one year, the possibility of future collection actions makes the choice to recognize cancellation-of-debt income unreasonable as a matter of law.

In *Textron, Inc. v. United States*, 561 F.2d 1023 (1st Cir. 1977) a \$6 million loan and capital investment was worthless and deductible in 1959 despite complete recovery in 1963. *Id.* at 1025. That court noted that the government's argument would make it impossible ever to take a worthless stock deduction. *Id. fn. 3* ("[b]ut a rule holding up the computation of taxes in one year for years to come would seem unworkable.") Unlike the 1st Circuit, the Ninth Circuit panel would not have recognized the write-off in that year because of the possibility of future collection actions.

In *Friedman v. Commissioner*, 216 F.3d 537, 547 (6th Cir. 2000) a case involving when to recognize cancellation-of-debt income, taxpayers failed to establish the reasonableness of their choice because they did not introduce evidence of "identifying events" to fix the loss in the year in question. *Id.* at 547. Here, the Amended Memorandum included evidence of "identifying events" but, unlike the 6th Circuit holding, the Ninth Circuit panel did not find Rubin's choice to recognize cancellation-of-debt income in that year to be reasonable because collection actions might occur in the future.

In *Exxon Corp. v. United States*, 785 F.2d 277 (Fed. Cir. 1986) the government argued that a potential fraudulent conveyance action precludes recognition of cancellation-of-debt income. The court found that argument to be "unavailing" because the existence of a cause of action under a fraudulent conveyance theory does not impart value to an otherwise uncollectible debt. Here, the panel used that

same "unavailing" argument when it incorrectly relied on unsuccessful fraudulent conveyance actions to preclude recognition of cancellation-of-debt income.

In *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990), a controversial case, the court required a taxpayer to recognize cancellation-of-debt income when it is clear that the debt is undisputed, uncollectible, and will not be repaid. Unlike the Third Circuit holding, the Ninth Circuit panel would not have recognized cancellation-of-debt income at that time because of the possibility of future collection actions.

And in *Morton v. Commissioner*, 38 B.T.A. 1270 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940) the court recognized cancellation-of-debt income where the liabilities of a corporation so greatly exceeded its assets, and the nature of its assets and business was such that there was no reasonable hope and expectation that a continuation of the business would result in any realization of value for the assets. *Id.* at 1278-1279. Unlike the Seventh Circuit holding, the Ninth Circuit panel would not have recognized cancellation-of-debt in that year because of the possibility of future collection actions.

In any other circuit, a business taxpayer who introduces competent evidence of identifiable events of economic consequence that fixes a loss in a particular year is required to recognize cancellation-of-debt income in that year pursuant to 26 U.S.C. § 61(a)(11). The Ninth Circuit held that a business taxpayer who introduces evidence of identifiable events *cannot* recognize any portion of a cancelled debt if unsuccessful collection actions might be commenced in the future. The Amended Memorandum used an example of an unsuccessful collection action commenced five years after the relevant tax year. *Cf. Owens v. Commissioner*, at 258 (the intentions of third parties to collect a debt is not relevant to a taxpayer's choice of year within which to recognize cancellation-of-debt income).

The Ninth Circuit departed from well-established precedent by relying on the *post hoc*, subjective intentions of

third parties. On the facts of this case, neither this Court nor any other circuit would have found the taxpayer's choice of year to recognize cancellation-of-debt income to be unreasonable. *See e.g. National Federation of Independent Businesses v. Sebelius*, 567 U.S. 519, 545 (2012) ("[t]he proposition that Congress may dictate the conduct of an individual today because of prophesied future activity finds no support in our precedent"). For the same reason that this Court would not permit Congress to act based on prophesied future activity, the Ninth Circuit should not be permitted to do so. *See also Texas v. United States*, 523 U.S. 296, 300 (1998) ("A claim is not ripe for adjudication if it rests upon contingent future events that may not occur as anticipated, or indeed may not occur at all") (internal quotation marks omitted).

The Ninth Circuit also departed from its own precedent. In *Milenbach v. Commissioner*, 318 F.3d 924 (9th Cir. 2003), a key case on this issue, the Ninth Circuit held that a debt is discharged for tax purposes when it becomes clear that the debt will never have to be repaid. Determining the timing of a discharge of debt requires a practical assessment of the facts and circumstances relating to the likelihood of repayment. *Milenbach* at 935-36.

The *Milenbach* court looked at all the facts concerning repayment, requiring only that the time of discharge be fixed by some identifiable event demonstrating when the loss occurred. *Id.* The *Milenbach* court also rejected the notion that future collection actions were relevant to the determination of when to recognize cancellation-of-debt income when it stated: "[r]epayment of the loan need not become absolutely impossible before a debt is considered discharged. A slim possibility that a debt may still be enforced does not prevent a debt from being treated as discharged for federal tax purposes." *Id.* (internal citations omitted).

The Ninth Circuit also improperly weighed evidence and drew inferences against the interest of this taxpayer – a non-movant in the summary judgment – when it deprived

him of his property in clear violation of his constitutional due process rights in a Rule 56 motion. In its cursory and “Not for Publication” Amended Memorandum (*but see* FRAP 32.1(a)(i)), the panel articulated the procedural prohibition of drawing adverse inferences against a non-movant in a summary judgment. App. 2. Then, a mere four paragraphs later, it violated that prohibition. App. 4. The panel inferred, inconsistent with tax law, that future collection actions negated Rubin’s reasonable business judgment to recognize cancellation-of-debt income in the tax year when economic events occurred that made it likely that Focus’s debts would never be repaid, and they were not.

Tax reporting requirements regarding the condition of a business are predicated on actual income and losses, not on speculation about unrealized possibilities. Taxpayers face difficult challenges when self-assessing and reporting their tax obligation even when the rules of the road are standardized and regularly applied. Here, the panel has added to taxpayers’ burden by changing, without reason or restraint, the basis for recognizing cancellation-of-debt income and its corollary, bad debt write-offs.

The aftermath of the pandemic, involving the sudden failure of hundreds of thousands of companies, *see* Ruth Simon, *Covid-19’s Toll on U.S. Business? 200,000 Extra Closures in Pandemic’s First Year*, WALL STREET JOURNAL, April 16, 2021, dramatically increases the number of businesses confronting cancellation-of-debt income and bad debt issues. The change made to the law by the Ninth Circuit requires taxpayers to make sense of this irrational ruling. That ruling moves away from Congressionally-created predictable, well-reasoned, and GAAP-accepted practices for reporting tax obligations, replacing them instead with a judicially-created unworkable substitute.

This new rule exposes every tax return over the past three years filed in the Ninth Circuit where cancellation-of-debt income was recognized or bad debt was written-off, to audit and concomitant findings of deficiency, penalty, and interest. Additionally, every public company and GAAP-

compliant enterprise is required to create tax accrual workpapers and establish reserves for this new Ninth Circuit requirement. *See* Internal Revenue Manual 4.10.20, Requesting Audit, Tax Accrual or Tax Reconciliation Workpapers, December 8, 2020. Such documentation is required even if the business does not perceive any possibility of a successful challenge by the IRS. *Id.* The consequence to all businesses that are required to conform their tax reporting to GAAP standards, 17 CFR § 244.100(b), could reach many billions of dollars in reserves and other expenses.

This Court should grant the Petition on the questions presented or reverse the Ninth Circuit's refusal to follow clearly established precedent governing when to recognize cancellation-of-debt income.

OPINIONS BELOW

The panel's unpublished Amended Memorandum, and its unpublished Order denying rehearing *en banc*, 859 Fed.Appx. 992, are attached as Appendix A. The Ninth Circuit panel's unpublished original Memorandum, 843 Fed.Appx. 992, is attached as Appendix B. The district court's unpublished Order, 2019 WL 7205995, is attached as Appendix C.

STATEMENT OF JURISDICTION

The Ninth Circuit Court of Appeals issued its original Memorandum on April 16, 2021. It amended its Memorandum and denied Petitioner's petition for *en banc* rehearing on June 22, 2021. This Court has jurisdiction under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS

The Fifth and Sixteenth Amendments to the United States Constitution; 26 U.S.C. §§ 61, 108, and 166; and Federal Rules of Civil Procedure Rule 56 are included in Appendix D.

STATEMENT OF THE CASE

I. The following facts are undisputed and are repeated here to provide context.

A. Business Background of Focus.

Rubin founded Focus, a national media agency, in 1975. Rubin served as CEO of Focus until July 2000. Rubin remains the sole shareholder of Focus, a subchapter S corporation.

By 1998, Focus had grown to approximately \$40,000,000 per month in revenue and employed approximately 150 people. In 1998, Rubin entered negotiations with Havas of France, an international advertising holding company, to sell Focus for approximately \$400,000,000.

B. Focus Became Insolvent, its Accounts Receivable Became Uncollectable, Making it Unable to Pay its Accounts Payable Debts, and it Terminated its Business Operations Before 12/31/2000.

By the end of 1999, Focus suffered serious financial difficulties. Focus lost three major accounts when 20th Century Fox, DreamWorks, and Universal Studios decided to stop doing business with Focus.

In the fall of 1999, Focus's relationship with its largest remaining customer, Sears, soured when Sears cut the fee it paid Focus, threatened not to renew its contract, and withheld payments that Focus needed to pay television stations for advertising.

In March 2000, Sears filed suit against Focus for

breach of contract. Sears disclaimed any obligation to pay Focus any of the accounts receivable Focus claimed were owed by Sears, totaling approximately \$20.5 million.

In April 2000, Universal followed Sears and filed suit against Focus. Universal also disclaimed any obligation to pay Focus the accounts receivable Focus claimed were owed by Universal, totaling approximately \$557,000.

In May 2000, Sears obtained an injunction preventing Focus from using its cash. Universal also obtained a preliminary injunction against Focus in May 2000, compounding the issues created by the injunction entered in the Sears litigation.

After the issuance of the injunctions, other customers of Focus, including DreamWorks and Fox, announced that they would not pay any outstanding amounts owed to Focus. Focus became unable to collect its outstanding accounts receivable in 2000.

Without its accounts receivable revenue, Focus was unable to pay its accounts payable debts or to continue its business, and the company wound down and ceased operations. Between April and June 2000, approximately 135 of Focus's 150 employees resigned. Prior to October 2000, Focus lost all its remaining customers.

In October 2000, three of Focus's creditors, including NBC and ABC filed an involuntary Chapter 7 bankruptcy petition against Focus. Sears filed a motion in the involuntary bankruptcy case to appoint an interim trustee and the motion was granted. On October 28, 2000, all of Focus's remaining employees resigned.

One year later, in October 2001, an Order for Relief was entered in the involuntary bankruptcy case, including a finding that Focus was insolvent in the year 2000.

In September 2003 Focus's trustee advised the bankruptcy court that, as of June 2000, Focus's accounts receivable were worthless and "should be abandoned," citing the issuance of injunctions in the Sears and Universal cases.

The Ninth Circuit sustained the Order for Relief and associated finding of insolvency. *In re Focus Media, Inc.*, 378

F.3d 916, 925-29 (9th Cir. 2004).

The trustee of Focus's involuntary bankruptcy estate and various courts that have analyzed the facts, correctly concluding that Focus was insolvent, out of business, and unable to collect its outstanding accounts receivable or to pay its accounts payable debts in 2000.

C. The *Gitlitz* Decision.

On January 9, 2001, this Court issued its opinion in *Gitlitz*, holding that under then-applicable statutory authority, an S corporation's discharge of indebtedness constitutes an item of income that passes through to shareholders and increases their basis in their stock of the corporation, even in cases where that income was never actually recognized by the corporation as a result of its insolvency. *Gitlitz* at 209, 213-16, 220; 26 U.S.C. §§ 108(a)(1)(B) and 1366(a)(1)(A).

The *Gitlitz* decision resulted in retroactive application of the holding. *See Gitlitz* at 209 (holding applied to a 1991 tax return). Many businesses have adjusted their taxes based on the *Gitlitz* holding without controversy. Here, however, the characterization by the district court and the Ninth Circuit of the nearly-unanimous *Gitlitz* decision as a "loophole" reveals their antipathy toward this Court's opinion. To avoid applying *Gitlitz*, the panel adopted a rule based on inchoate future possibilities creating uncertainty and room for abuse. *Cf. Textron* at 1026 ("a rule with so much uncertainty and room for abuse should not be judicially created to close a loophole that is apparently used so seldom").

By the end of tax year 2000 Focus was insolvent by \$67 million, the corporation had ceased business operations, had no remaining employees, and was unable to collect its accounts receivable. Focus, therefore, experienced a discharge of indebtedness under 26 U.S.C. § 108(a)(1)(B) (insolvency). The tax return filed for Focus by the interim bankruptcy trustee did not recognize \$66,696,211 of

cancellation-of-debt income and \$23,110,349 of bad debt expenses that Focus/Rubin was entitled to recognize due to application of the *Gitlitz* holding. The net income for Focus was therefore overstated and Rubin consequently paid personal income taxes in amounts that exceeded what he actually owed for that year.

Prior to *Gitlitz*, and with the advice of expert tax attorneys and accountants, Rubin received distributions totaling \$30,379,112 from Focus, that were fully accounted for in his tax return for 2000. The disbursement was required and made in early 2000 due to a recharacterization of an earlier \$11,685,000 loan owed by Rubin to Focus into a distribution. Additional disbursements were made to permit Rubin to fund his resulting tax obligations. Prior to *Gitlitz*, these distributions to Rubin had no effect on his basis in Focus's stock, and therefore on his ability to have benefitted from any pass-through losses.

In October 2004, approximately 18 years ago, following consideration of the application of the *Gitlitz* decision, Rubin timely filed an amended tax return for the year 2000 seeking to obtain a refund of his overpayments. Rubin also filed amended personal income tax returns for the years 1998 and 1999 seeking refunds resulting from carrying losses back to those years based on the revised figures in his amended return for tax year 2000. Rubin made claims for tax refunds with the IRS for the years 1998, 1999, and 2000 in the amounts of not less than \$2,564,260, \$595,218, and \$6,957,293, respectively. After deducting these amounts from his taxes, Rubin will still have paid \$779,889, \$1,484,655, and \$184,411 in taxes for those years.

In his opposition to the Rule 56 motion, Rubin provided competent evidence that the calculations of his refund claim were correct. Neither the government nor the district court disputed the accuracy of Rubin's calculations.

In April 2014, the IRS disallowed Rubin's refund claim stating, "[t]his letter is your legal notice that your claim is fully disallowed," citing as relevant evidence simply that unidentified "[b]ankruptcy documents states [sic] that

the debt was discharged after year 2000 and as such no discharge occurred in the year 2000." Although Rubin was proceeding based on a discharge due to insolvency under 26 U.S.C. § 108(a)(1)(B), the IRS incorrectly assumed instead that Rubin was arguing that Focus's debts were discharged due to bankruptcy under 26 U.S.C. § 108(a)(1)(A).

In April 2016, Rubin timely filed the current action seeking a proper adjudication of his refund claims for tax years 1998, 1999, and 2000.

The record presented to the district court and to the Ninth Circuit for *de novo* review included competent evidence to support each factual allegation made by Rubin in his opposition to the Rule 56 motion. This evidence included declarations and depositions from Rubin and from Focus's CFO, Focus's VP Business Affairs, Rubin's accountant, and from William Wolf, a forensic accountant and financial expert on the timing of cancellation-of-debt income recognition. A copy of Wolf's Declaration is attached as Appendix E. According to Wolf:

Based on the facts and identifiable events described in my report, as a matter of tax accounting, as of December 31, 2000, it was clear that the accounts receivable ("AR") of Focus Media, Inc., a subchapter S corporation ("Focus"), in the amount of approximately \$23.1 million, were worthless, uncollectible, and should have been written off, thereby generating bad debt expense in that amount.

...

Based on the facts and identifiable events described in my report, including the fact that the accounts receivable comprised Focus's largest asset of material value, as a matter of tax accounting, as of December 31, 2000, it was clear that Focus never would be able to pay its accounts payable ("AP") in the amount of at least \$66 million. Accordingly, Focus was entitled to and should have recognized

cancellation of indebtedness ("COD") income in tax year 2000 in the amount of at least \$66 million.

App. 40, para. 3(a) and (b).

Exhibits to the declarations included Rubin's refund requests, relevant portions of Focus's books and records, copies of all relevant judicial rulings and litigation documents, and copies of all relevant documents from the involuntary bankruptcy, including the trustee's Final Report. The district court did not sustain objections to any declaration. Rubin did not rely on his Complaint in support of any allegation of fact.

The government submitted one declaration, from Focus's involuntary bankruptcy trustee. In the record submitted to the district court and the Ninth Circuit, the trustee admitted that Focus was insolvent and out of business when he was appointed in October 2000; that he never operated Focus as a business; that he relied on Focus's books and records that included accounts payable of \$67 million; that Focus's accounts receivable of \$23 million was worthless as of June 2000; that he collected and used an insurance payment to pay administrative costs, not to reduce Focus's accounts payable; and that he closed the involuntary bankruptcy case in 2018 without reducing Focus's accounts payable after collecting accounts receivable of less than \$38,000, which he also used to pay administrative costs. After 20 years, the government did not produce any evidence, or even a suggestion, that a year other than 2000 was a more reasonable choice to recognize Focus's cancellation-of-debt income.

REASONS FOR GRANTING THE WRIT

Rubin originally filed his year 2000 tax return prior to when this Court issued its 8-1 decision in *Gitlitz*. Applying *Gitlitz*, Rubin's basis in the stock of Focus increased by \$67 million, the amount of cancellation-of-debt income that was

excluded from the gross income of Focus pursuant to 26 U.S.C. § 108(a)(1)(B).

The district court Order stated “*Gitlitz* remains the applicable law for the years of the tax returns at issue.” App. 15. The Order acknowledged that Focus was insolvent in 2000, its accounts receivable became worthless during that year, that Focus therefore could not pay its debts as of that year, and that Rubin introduced evidence of identifying events fixing the timing of the discharge of Focus’s debts in that year. App. 13, 16, 27-28.

Without explaining its reasoning or providing a logical connection, the Amended Memorandum cherry-picked future unsuccessful collection actions from the record, App. 4, and incorrectly concluded that “[t]hese actions show that it had not become clear that Focus’s debts would never have to be paid as of December 31, 2000.” *Id.*

Where the panel suggests that the continuing administration of Focus’s involuntary bankruptcy by the trustee is somehow relevant to the decision when to recognize cancellation-of-debt income, Treasury Regulations and Ninth Circuit precedent state the opposite. Treas. Reg. § 1.166-2(c)(1-2) (“the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming the conclusion that the debt is worthless, shall not authorize the shifting of the deduction under section 166 to such later year”); *see also Patten Davies Lumber Co. v. Commissioner*, 45 F.2d 556, 557-58 (9th Cir. 1930). The current treasury regulation on this issue is virtually identical to the language from the 1930 Ninth Circuit *Patten Davies* case, demonstrating the well settled nature of this issue.

Where the panel relies on the subsequent recovery of an insurance claim to imply that accounts payable could be repaid, the trustee predictably absorbed the insurance payment into his compensation rather than reducing Focus’s debts. Furthermore, the amount of the insurance recovery was insignificant, approximately 1.3% of Focus’s liabilities.

Where the panel relies on lawsuits filed up to 5 years after tax year 2000, it is also undisputed that the trustee abandoned the litigation he brought against Rubin and Focus's customers without ever collecting anything, and that the trustee admitted under oath that Focus's accounts receivable were worthless as of June 2000. Both the district court and the panel acknowledged that Focus used its accounts receivable as the sole source to pay its accounts payable debts and that those accounts receivable became worthless in 2000. App. 13; App. 3.

Furthermore, the inference against Rubin's interest that future collection actions might result in the repayment of Focus's accounts payable is not material to this case. Rubin demonstrated in his Petition for Rehearing that, if the trustee's collection actions had been successful, Rubin's resulting stepped-up basis would still have been sufficient for the full amount of his refund claim. The government did not contest the validity of this fact and the panel inexplicably ignored a decisive issue in this case, violating Rubin's Fifth Amendment due process rights in a Rule 56 context:

[A]t the end of tax year 2000, the balance of Focus's accounts payable was \$67 million; the Trustee's adversary judgment obtained against Taxpayer in 2007 was for \$36 million; and if, instead of abandoning the judgment – which the Trustee did – the Trustee collected the entire amount of the adversary complaint against Taxpayer and used it to reduce Focus's [accounts payable] – which the Trustee did not – the remaining balance would be \$31 million.

\$67 million (AP) – \$36 million (judgment) = \$31 million (basis).

\$31 million (basis) is greater than \$23 million (loss).

According to the law applicable to this case (*Gitlitz*), the remaining balance of Focus's accounts payable provided Taxpayer with a step-up in his basis permitting Focus's losses to

pass through to Taxpayer – here the loss of its accounts receivable of \$23 million. Just as Taxpayer was able to ‘take’ the loss of \$23 million because his step-upped basis was \$67 million, he would still be able to ‘take’ the loss of \$23 million if his step-upped basis was reduced to \$31 million. Therefore, this inference – against the interest of non-movant/Taxpayer – is not even relevant to the outcome of this refund claim.

Petition for Rehearing, p. 9. The trustee’s collection action, whether successful or not, leaves Rubin’s tax refund claim undisturbed.

This Ninth Circuit panel changed the criteria for when to recognize cancellation-of-debt income and ignored the law governing Rule 56 motions. Under its new law of negation, cancellation-of-debt income and its corollary, bad debt write-off, cannot be recognized if future collection actions might occur. The panel placed no standards or restraints, or even time limits, on future collection actions to determine the reasonableness of when to recognize cancellation-of-debt income or to write-off bad debt. Refusing to recognize cancellation-of-debt income based on prophesied future collection actions is frivolous on its face.

II. Proceedings.

A. The District Court Erred Both Procedurally and Substantively.

The district court granted the government’s summary judgment motion denying Rubin’s refund claim without a hearing. Rather than follow the incorrect justification used by the IRS, the district court created its own incorrect reason to deny Rubin’s refund claim: it inferred that a possibility existed at the end of the tax year that future collection actions might reduce the amount of Focus’s accounts payable debt. App. 24-25. The district court did not consider whether

its hypothetical possibility was material to Rubin's refund claim.

The district court acknowledged Rubin's evidence of identifiable events that fixed the cancellation-of-debt in tax year 2000. Pursuant to *Milenbach*, that was all he was required to do to establish the reasonableness of his choice of when to recognize cancellation-of-debt income. *Milenbach* at 935-36. The finding by the district court that Rubin provided competent evidence of identifying events should have ended the inquiry on this issue in his favor at this stage of a Rule 56 motion. However, the district court erred when it incorrectly substituted the inference of possible future collection actions in place of the evidence that it was unlikely and improbable that Focus would ever make repayment.

The district court held that Rubin could not meet the recognition of cancellation-of-debt prong of his *prima facia* case because the court confused future collection possibilities with actual identifying events to establish the timing to recognize cancellation-of-debt income. App. 22. The district court weighed Rubin's evidence supporting the reasonableness of his choice to recognize cancellation-of-debt income in tax year 2000 against the "prospect that funds might be recovered," holding that such prospect was sufficient to make Rubin's choice to recognize cancellation-of-debt income in 2000 unreasonable as a matter of law.

The district court found Rubin's choice of tax year to be unreasonable because it was possible for collection actions to occur in the future, the proceeds of which might be used to reduce Focus's debts. However, as set forth above, the trustee's possible adversary action against Rubin, even if successful, would have had no impact whatever on the amount of his refund claim since Rubin's remaining basis in Focus would have been sufficient for him to still realize the loss of Focus's \$23 million of accounts receivable. For this reason, even if the inference was permissible, it did not pertain to a fact that was material to the outcome of the tax refund case. *Anderson v. Liberty Lobby*, 477 U.S. 242, 247-252 (1986).

The inference drawn by the district court is also contrary to tax regulations and precedential case authority in the Ninth Circuit, and sister circuits, that hold future collection actions are not relevant to the reasonableness of a taxpayer's choice when to recognize cancellation-of-debt income. Treas. Reg. § 1.166-2(c)(1-2); *Patten Davies* at 557-58; *Milenbach*, at 935-36.

When, as here, the liabilities of a corporation so greatly exceed its assets, and the nature of its assets and business provide no reasonable hope and expectation that a continuation of the business will result in any realization of value for an asset, the IRS has prevailed on the argument that evidence of identifiable events is not necessary, for already "its value had become finally extinct." *Morton* at 1278-1279; *see also Kirby, supra*. The test set out in *Morton* applies to Focus.

Given Focus's overall economic infirmities in 2000, its accounts receivable lost all value before the end of that year. Due to the refusal of its customers to pay and the cessation of Focus's business operations during 2000, Focus's accounts receivable were without value and could not serve as a "bankable asset" in 2000. *See Textron* at 1026. The evidence was uncontested that Focus's accounts receivable would never recover any value, and they did not. Also, as the court stated in *Exxon, supra*, a fraudulent conveyance action will not create value in an asset that has lost all value, and such an argument is "unavailing."

The identifiable events that occurred in 2000 demonstrated the worthlessness of the accounts receivable and fixed the loss of value of this asset by the end of 2000. As the district court agreed, this is consistent with the involuntary bankruptcy trustee's choice to abandon Focus's accounts receivable because the accounts receivable ceased to have value and/or potential future value by June 2000. App 12.

In the frequently cited case, *Cozzi v. Commissioner*, 88 T.C. 435 (1987), the IRS argued that the year in which the revenue source used by the taxpayer to pay its debts became

worthless was a reasonable choice of year to recognize cancellation-of-debt income because the taxpayer was no longer able to pay its debts:

The Commissioner argues that the production agreement constituted the sole means of paying the loan ..., that the production agreement became worthless and was abandoned ... and that therefore, [taxpayer] was released from the debt in that year and realized [cancellation-of-debt] income as a result of such release.

Cozzi at 446.

Here, the panel and the district court acknowledged that Focus relied on its accounts receivable as the source of payment for its accounts payable. When Focus was enjoined from collecting those accounts receivable it was put out of business because, as stated in the Order, "it needed those unpaid receivables to continue its operations." Just as the IRS successfully argued in *Cozzi*, the worthlessness of Focus's accounts receivable and the final payment to creditors in June 2000 were economic events that fixed the moment it became clear that Focus's accounts payable would never be repaid, and they were not.

Rather than using the undisputed fact that Focus lost the source of funds actually available during 2000 to pay its debts – its accounts receivable – and that the final payment made by Focus on those debts was in June 2000, the district court concluded that an unfiled speculative unrealized cause of action against Rubin for fraudulent conveyance negated Rubin's choice of the year 2000 as reasonable. In *Cozzi*, the court adopted the argument of the IRS and specifically held that the final payment was an "identifiable event," and that the "failure to make such payment is clear evidence of [recognition of cancellation-of-debt income]."*Cozzi* at 447.

No event of economic significance for Focus took place after 2000. Neither Focus nor the involuntary trustee operated its business again after that year. The amount of Focus's accounts payable and accounts receivable did not change after that year. Nothing happened after 2000 that

actually changed the likelihood or the probability by the end of 2000 that Focus's debts would ever be repaid. The district court and the panel both agreed that these facts are undisputed. Notwithstanding, both courts impermissibly drew the inference against Rubin's interest that unsuccessful future collection actions somehow affected whether it was clear at the end of 2000 that Focus's debts would be repaid.

In his Rule 56 Opposition, Rubin addressed the reasonableness of his choice of tax year 2000 to recognize cancellation-of-debt income by introducing competent evidence of thirteen identifiable events of economic significance fixing the time and amount of the loss of Focus's accounts receivable, and the corresponding inability of Focus to ever repay its accounts payable in tax year 2000. This evidence, in the form of written declarations supported by personal knowledge, expert witnesses, and Focus's books and records, should have been viewed in the light most favorable to Rubin in the context of a Rule 56 motion.

The district court's Order acknowledged that Rubin provided the necessary evidence to carry his burden of proof that his choice of tax year within which to recognize cancellation-of-debt income was reasonable. The district court granted summary judgment because it created a new requirement, contradicted both by precedent and statutory authority, incorrectly placing unjustified emphasis on the speculative possibility of successful collection actions in future years, ignoring Focus's actual inability and the improbability of making such payments.

Congress has not authorized nor enacted such a change, nor have this Court nor other circuit courts found a need for this change. The cost of this new requirement to GAAP-compliant enterprises will entail thousands of hours from accountants and lawyers to conform each business to its new risk profile. Tax accrual workpapers must be prepared to calculate and demonstrate to auditors the accuracy of reserve accounts for this new deferred and contingent tax liability, at substantial cost.

Rubin appealed from the Order for four reasons. First, the Order was based on impermissible inferences against Rubin's interest that funds might be recovered or used to reduce Focus's debt in the future. Second, as set forth above, the Order violated both statutory and case law. Third, the Order was based on an inference that, even if true, was not material to his refund claim. And fourth, the 21-year look back completely supports the reasonableness of Rubin's choice to recognize cancellation-of-debt income in tax year 2000.

Rubin pointed out in his Opening Brief to the Ninth Circuit that the district court engaged in prohibited weighing of evidence and made critical inferences against his interest as the non-movant:

The Order granting the Government's motion for summary judgment, on page 9, 4th paragraph, continuing to page 10, was instead based on evidence weighed by the District Court and on inferences made by the District Court that were against the interest of the Appellant/nonmovant. AR 3472, 3473 ("Given accusations in 2000 ... it was not **unreasonable to believe** that claims against its sole shareholder **might be** forthcoming, as they in fact were. The **prospect** that funds **might be** recovered from [Appellant] by the Trustee **and used** to pay Focus' creditors was **hardly** a '**remote possibility**,' regardless of how it may have ultimately resolved seven years later.")

Plaintiff-Appellant's Opening Brief, p. 4 (emphasis in Opening Brief).

This inference is against Rubin's interest. No evidence was introduced that Rubin had the financial capability to pay the trustee's judgment, and it was undisputed the trustee abandoned the lawsuit. Regardless, the district court treated Rubin as a potential alternative source of available funds to pay Focus's debts. The inference

is also not reasonable because, as set forth above, it pertains to a fact that is not material to Rubin's refund claim. Even if the trustee's collection action was successful, Rubin would maintain sufficient basis of over \$31 million, more than enough to take the loss of the accounts receivable of \$23 million, thus validating his refund claim.

At the summary judgment stage the judge's function is not to weigh the evidence and determine the truth of the matter, but to determine whether there is a genuine issue for trial. *See Tolan v. Cotton*, 572, U.S. 650 (2014); *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986); *Anderson v. Liberty Lobby, Inc.*, *supra*; *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986); *First National Bank of Arizona v. Cities Service Co.*, 391 U.S. 253, 288-89 (1968).

B. The Original Memorandum Violated the Constitution, Created Circuit Conflicts, and Has National Implications.

The Ninth Circuit panel affirmed the Order. App. 10. It also acknowledged that Rubin had introduced evidence on the cancellation-of-debt prong of his case. App. 9. However, without explanation, and in the Rule 56 context, the panel held that the possibility that funds might be recovered in the future was sufficient to make Rubin's choice of tax year to recognize cancellation-of-debt income unreasonable regardless of existing tax law and precedent.

As with the Order, the Memorandum rejected the 90-year old consensus for when a taxpayer must recognize cancellation-of-debt income from one based on the likelihood that a debt will be repaid using evidence available during the tax year in question. According to the panel's Memorandum, the mere possibility that collection actions might occur in later years, even if such activity is unsuccessful, is the controlling factor. According to the panel, the possibility of collection actions in the future "show that there was still a possibility that Focus's accounts payable could be paid as of December 31, 2000." App. 10.

Even if the law allowed future collection activity to be relevant, there are no facts that would change the results in this case. Focus's accounts receivable were worthless as of June 2000 according to the trustee and all other witnesses, documents, and prior judicial findings. Also, Rubin was not a source of available funds in 2000 or thereafter to repay Focus's accounts payable debt. The panel's negative inferences listed above are contradicted by the fact that the trustee abandoned all litigation without collecting anything.

Whether intentionally or not the panel's new test created a legal absurdity for taxpayers in the Ninth Circuit. The ruling moves away from Congressionally-created, predictable, well-reasoned, and GAAP-accepted practices for reporting tax obligations, replacing them with a judicially-created unworkable substitute.

Since there always is a possibility that collection actions might occur in the future, if taxpayers in the Ninth Circuit recognize cancellation-of-debt income or, on the flip side of that tax equation, take a deduction for bad debt, they are exposed to litigation with the IRS. By applying this new test to Rubin's refund request, the panel committed error. The new test is not supported by legal authority. This new test is not in alignment with other tax rules, it violates GAAP, securities law, banking regulations and practices, and even creates conflicts with the federal bank fraud statute prohibiting overstating assets for purposes of securing a loan. 18 U.S.C. § 1344; *Westpac Pacific Food v. Comm.*, 457 F.3d 970, fn.4 (9th Cir. 2006) (if a taxpayer attempted to use "the prospect that funds might be recovered" regardless of whether funds were actually recovered, as an asset to secure a loan from a bank, that taxpayer would violate section 1344, a felony punishable by up to 30-years imprisonment). The holding of *Westpac* was adopted by the IRS. In. Rev. Proc. 2007-53.

The Memorandum resulted in a windfall for the IRS, confiscation of Rubin's property, and chaos for taxpayers who try to comply with this new test. And by doing so, it created

a conflict with its sister circuits, none of which have reached the same conclusion.

Not only does the Memorandum erroneously substitute “possibility” for “likelihood,” it erroneously emphasized the subsequent actions of creditors to collect a debt instead of the inability of the debtor to pay, as required by *Milenbach*. This conflicts with the decisions of other courts of appeal, and substantially affects federal tax rules of national application in which there is an overriding need for uniformity, including rules requiring the creation of reserves for deferred and contingent tax liabilities. And this new rule for when to recognize cancellation-of-debt income improperly invades the exclusive jurisdiction of Congress as mandated by the 16th Amendment to the Constitution.

Milenbach cited to *Friedman* for the requirement that, in a case involving when to recognize cancellation-of-debt income, a taxpayer must introduce evidence of identifiable events to fix the loss in the year in question. *Friedman* involved shareholders of an S corporation that was in bankruptcy. There, taxpayers lost – at trial – because they failed to introduce competent evidence of any identifiable events. *Friedman* at 547-48. The Sixth Circuit affirmed, holding that then-applicable pre-*Gitlitz* law in that circuit prevented a step-up in basis for those taxpayers. In *dicta*, that circuit reviewed subsequent actions by the bankruptcy trustee, but did so only because taxpayers failed to carry their burden to introduce evidence of identifiable events. Those are not the facts here. The panel acknowledged that Rubin introduced evidence of identifiable events.

In contrast to *Friedman*, it is undisputed that Rubin introduced competent evidence of identifiable events of economic consequence that fixed the date when Focus was no longer able to pay its \$67 million accounts payable prior to 12/31/2000.

In its original Memorandum, the panel made several mistakes, including getting wrong the years for which Rubin

seeks a tax refund. The panel included 2001, a year that is not part of the case, and excluded 1999, a year that leaves Rubin with a sizeable refund claim unadjudicated. App. 7. An earlier Ninth Circuit panel unanimously reversed a ruling by the same district court in this case, and correctly noted the years in question are 1998, 1999, and 2000. *Rubin v. United States*, No. 16-56633, p. 8, 14 (9th Cir. 2018). Because this panel made *prima facia* material mistakes, wrongly denied Rubin's right to trial for a tax refund claim, undermined the due process rights of each taxpayer in the Ninth Circuit, and created unnecessary confusion in the administration of tax law, Rubin petitioned for a rehearing or *en banc* review of this wrongly decided case with national implications.

C. The Amended Memorandum Also Creates Circuit Conflicts, Violates the Constitution, and Has National Implications.

The Ninth Circuit denied rehearing, and the panel simultaneously amended the Memorandum. The Amended Memorandum changed one sentence without explanation. In the original Memorandum, the panel inferred from unsuccessful collection actions, all of which occurred after the end of the tax year in question: "These actions show that there was still a possibility that Focus's accounts payable could be paid as of December 31, 2000." In the Amended Memorandum, the panel inferred from the same unsuccessful future collection actions: "These actions show that it had not become clear that Focus's debts would never have to be paid as of December 31, 2000." App. 4.

This superficial change did not fix any of the infirmities with the Memorandum. Instead, the panel suggests that after-the-fact events could somehow be knowable to a taxpayer before the events happen. According to the panel, the possibility that collection activity might occur in future years precludes a taxpayer's reasonable choice to recognize cancellation-of-debt income in a

particular year, nullifying 26 U.S.C. § 61(a)(11). This was regardless of evidence of identifiable events, insolvency, and immateriality, not to mention a prior national consensus for 90 years that future events are not relevant to the issue of when to recognize cancellation-of-debt income.

Despite a second chance, the Amended Memorandum still conflicts with tax law, Ninth Circuit precedent, its sister circuits, and this Court. Ninth Circuit taxpayers are currently precluded from recognizing cancellation-of-debt income if collection activity might occur in years after the tax year in question. The panel did not even bother to correct its mistake regarding which tax years it was considering, leaving Rubin's refund claim for 1999 unadjudicated. The panel's reasoning justifying the above was not provided in the Amended Memorandum.

**1. The Amended Memorandum
conflicts with precedent and affects
tax rules of national application for which there is a
need for uniformity.**

Milenbach adopted a rational and predictable test for when to recognize cancellation-of-debt income for federal tax purposes. That well-reasoned test requires the fact-finder to conduct a practical assessment of the facts and circumstances as to the "likelihood of repayment" of debts; the moment it becomes unlikely that debts will ever be repaid there is recognition of cancellation-of-debt income. *Milenbach* at 935-36. Instead, according to the panel's new test for the Ninth Circuit, where there is a possibility for subsequent collection action, as opposed to a likelihood of repayment, cancellation-of-debt income cannot be recognized even where, as here, the collection action was not successful. The panel adopted an ill-conceived and impractical test that nullifies the statutory requirement that taxpayer recognize cancellation-of-debt income in the year in which discharge occurred.

Prior to the Amended Memorandum, the Ninth Circuit and sister circuits were in agreement, and cases regarding cancellation-of-debt income have consistently emphasized the “probability” of repayment. *See e.g. Merkel v. Commissioner*, 192 F.3d 844, 849 (9th Cir. 1999) (“under § 108(d)(3), inclusion of all contingent liabilities, no matter how remote, could lead to the absurd result of the insolvency exception swallowing the general rule that discharge of indebtedness be included in gross income.”) Until now, the mere intention to collect a debt in the future was considered inherently remote leading to absurd results.

According to the panel’s Amended Memorandum, a taxpayer who deducts a debt or recognizes cancellation-of-debt income becomes subject to future litigation with the IRS if anyone tries to collect that debt in later tax years. The panel used the same examples of collection activities it used in its original Memorandum, continuing administration of the bankruptcy, collection of an insurance policy, lawsuit against Rubin, and lawsuits against Focus’s customers, even though they had not yet occurred and were immaterial. Nevertheless, the panel relied on these four future actions to “show that it had not become clear that Focus’s debts would never have to be paid as of the end of December 31, 2000.” A taxpayer would have to be clairvoyant to know whether future unsuccessful collection actions might occur five years (or more) after the tax year he chose to recognize cancellation-of-debt income. If the Amended Memorandum is permitted to stand, it will require a massive change to auditing standards and practices including GAAP, requiring reserves for these new deferred and contingent tax liabilities, and other related and significant financial reporting costs.

2. The Panel Violated Rule 56.

The panel inferred that the possibility of future collection activity, regardless of its success, entirely prohibits Rubin’s refund claim. As set forth above, this

analysis is contrary to the holding of *Anderson v. Liberty Lobby* at 247 (only disputes over facts that might affect the outcome of Rubin's refund claim under the governing law will properly be considered in the context of a Rule 56 motion; factual disputes that are irrelevant or unnecessary will not be counted).

Despite knowing Focus's accounts payable were not reduced after June 2000, the panel sustained the Order based on the possibility of future collection actions that the panel knew had failed. No money was ever obtained nor used by the trustee to reduce Focus's accounts payable. The reasonableness of Rubin's choice to recognize cancellation-of-debt income in tax year 2000 was not diminished by anything that actually happened. The IRS Code and the administration of tax law by the IRS was never intended to be a "gotcha game" nor does it authorize the IRS to keep money that was overpaid to it by taxpayers. No self-assessing self-reporting tax system could survive such unfairness or arbitrariness.

The standard to which the panel held itself was not the standard established by statute and by *Milenbach*, the leading Ninth Circuit case that requires a practical assessment of the facts and circumstances relating to the likelihood of repayment during the year in which identifiable events fixing the loss occurred. *Milenbach* at 935-36. The panel erred when it inferred against Rubin's interest that subsequent collection actions undermine Rubin's reasonable choice of tax year 2000 for recognition of cancellation-of-debt income. This rationale not only defies precedent and statutes, but logic itself, holding taxpayers accountable for knowing events that have not yet occurred.

Taxpayers faced with cancellation-of-debt issues are obligated to pick a tax year within which to recognize that income. The issue is whether a taxpayer's choice of year within which to recognize such income is a reasonable choice. The potential for subsequent collection actions does not undermine the reasonableness or sufficient certainty necessary to select the proper time and amount of debt

forgiveness. Instead, if such future collection actions are successful, the taxpayer is required to report and account for the change in the future. 26 U.S.C. § 166(a)(2). Without explanation, the Ninth Circuit discarded a system that has worked for decades, the consequences of which will, at a minimum, burden taxpayers with enormous costs and uncertainty.

The Amended Memorandum is wrong as a matter of both procedural and substantive law. The panel violated the procedural prohibition in Rule 56 by taking inferences against the interest of a non-movant: “[t]hese actions show that it had not become clear that Focus’s debts would never have to be paid as of December 31, 2000.” And the panel violated substantive law when it held that subsequent collection actions were relevant to when to recognize cancellation-of-debt income. In this regard, the panel would require tax law and prior opinions from this Court, the Ninth Circuit, and its sister circuits to be overturned. When the Ninth Circuit panel held that “these [future unsuccessful collection] actions show” Rubin’s choice to recognize cancellation-of-debt income in tax year 2000 was not reasonable, it also violated exclusive Congressional jurisdiction, the statutes they enacted, and 90 years of consistent judicial precedent without providing any insight into their reason for doing so. This panel failed at its duty to either follow precedent and statutory authority or provide a workable substitute.

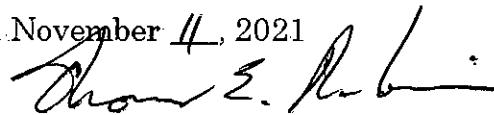
Beyond the damage inflicted on Petitioner, if the holding in the Amended Memorandum is not rejected, it will undermine the ability of taxpayers to come to practical resolution of business tax issues and makes taxpayers hostages to speculative possibilities that may be raised by the IRS. The SEC requires all publicly listed companies to provide auditors with GAAP-compliant rationale for dealing with IRS contentions related to this panel’s ruling on cancellation-of-debt income recognition and write-offs. To comply with the new rules for calculating tax obligations, including the possibility that future collection actions might

occur, public corporations must reserve for adverse findings and incur accounting and administrative costs associated with being GAAP-compliant. These costs could conceivably total billions of dollars. Due to the current economic hardships caused by the pandemic, numerous business owners will be confronting cancellation-of-debt income recognition and/or accounts receivable write-offs. Making these determinations subject to this unnecessary new rule will multiply the difficulties taxpayers will endure, and will not make our self-assessing self-reporting tax system more fair or efficient.

CONCLUSION

The Amended Memorandum by the Ninth Circuit violates substantive and procedural law, creates a conflict among the circuits, and creates unnecessary cost and confusion. The Court should grant the Petition.

Dated November 4, 2021



Thomas E. Rubin, In Pro Per