No.

In the Supreme Court of the United States

QINETIQ U.S. HOLDINGS, INC. & SUBSIDIARIES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

A Notice of Deficiency issued by the Internal Revenue Service (IRS) is one of the most common ways that individuals and corporations come face-to-face with the federal government. Such a Notice represents the agency's final determination that a taxpayer has underpaid its taxes and is a sufficient basis for the IRS to launch collection efforts against the taxpayer that can result in the loss of income and property, unless the taxpayer brings suit in court within 90 days. *See* 26 U.S.C. § 6213. The question presented is whether an IRS Notice of Deficiency, just like any other final agency action, is subject to the reasoned-explanation requirement of the Administrative Procedure Act, 5 U.S.C. § 706(2).

RULE 29.6 STATEMENT

QinetiQ U.S. Holdings, Inc. & Subsidiaries is a U.S. company organized under the laws of Delaware with its principal place of business in Virginia. It is a wholly owned subsidiary of QinetiQ Overseas Holdings, Ltd. (a United Kingdom company), which is a wholly owned subsidiary of QinetiQ Holdings, Ltd. (a United Kingdom company), which is a wholly owned subsidiary of QinetiQ Group plc (a public company traded on the London Stock Exchange).

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PETITION FOR A WRIT OF CERTIORARI

QinetiQ U.S. Holdings, Inc. & Subsidiaries (QinetiQ) respectfully petitions this Court for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals for the Fourth Circuit (App. 1a-18a) is published at 845 F.3d 555. The Memorandum Opinion of the Tax Court regarding QinetiQ's entitlement to a Section 83 deduction (App. 25a-50a) is available at T.C. Memo. 2015-123. The Tax Court's Order denying QinetiQ's motion to dismiss (App. 19a-24a) is not available in electronic databases.

JURISDICTION

The Court of Appeals entered judgment on January 6, 2017. App. 1a-2a. QinetiQ timely filed a petition for rehearing or rehearing en banc, which the Fourth Circuit denied on March 7, 2017. App. 51a. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The Administrative Procedure Act (APA), 5 U.S.C. 706, provides in part that a "reviewing court shall . . . (2) hold unlawful and set aside agency action, findings, and conclusions found to be—(A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." Sections 551, 703, and 706 of the APA are reproduced in part at App. 52a-56a. Sections 83, 6212, 6213, and 6214 of the Internal Revenue Code are reproduced in part at App. 57a-63a.

INTRODUCTION

This Court has declared that it is "not inclined to carve out an approach to administrative review good for tax law only." *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 55 (2011). Not so the Fourth Circuit. In this case, the Fourth Circuit carved out an exemption to the Administrative Procedure Act (APA) good only for Notices of Deficiency issued by the Internal Revenue Service (IRS), illustrating that tax exceptionalism is alive and well in that circuit. Because the Fourth Circuit's decision disregards the teachings of this Court, contravenes the decisions of other courts of appeals, and concerns a matter of unquestioned importance respecting one of the most common ways everyday Americans and all taxpayers interact with the federal government, the petition should be granted.

The APA is plain in its terms and broad in its scope. Section 551 of the APA provides that "'agency action' includes the whole or a part of an agency rule, order, license, sanction, relief, or the equivalent or denial thereof, or failure to act." 5 U.S.C. § 551(13). It defines an "order" as "the whole or a part of a final disposition, whether affirmative, negative, injunctive, or declaratory in form, of an agency in a matter other than rule making but including licensing." *Id.* § 551(6). And it provides that a reviewing court "shall . . . hold unlawful and set aside agency action" that flunks certain requirements, including a prohibition against arbitrary or capricious decision-making. *Id.* § 706(2).

The IRS is, of course, an "agency." A Notice of Deficiency issued by the IRS easily qualifies as "agency action." It represents the agency's final determination as to a taxpayer's tax liability and,

unless timely challenged in the Tax Court, clears the way for the IRS to launch collection efforts—which may result in the seizure of one's wages, bank accounts, social security benefits, or property. And, as the legislative history to the APA itself indicates, the Tax Court is a "reviewing court." *Infra* at 16.

In this case, however, the Fourth Circuit held—squarely and categorically—that "the APA's requirement of a reasoned explanation . . . does not apply to a Notice of Deficiency." App. 10a-11a. That is a judicially created exemption of tremendous magnitude. The reasoned-explanation requirement is one of the APA's bedrock prerequisites for agency action. *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 513-14 (2009). It not only ensures that the subject is provided a meaningful explanation for the agency's action, but "ensure[s] that agencies follow constraints *even as they exercise their powers*." *Id.* at 537 (Kennedy, J., concurring in part and concurring in the judgment) (emphasis added). Sadly, the IRS's own conduct in recent years underscores the importance of this elemental prerequisite of sound decision-making.

The Fourth Circuit's decision warrants this Court's review—and reversal. The decision not only flouts this Court's admonition that courts should not "carve out an approach to administrative review good for tax law only," *Mayo*, 562 U.S. at 55, but creates a division in the lower courts over whether generally applicable APA principles apply to review of the IRS's decisionmaking processes as well. *Compare* App. 13a (holding that Notices of Deficiency are exempt from the APA's reasoned-explanation requirement), *with Cohen v. United States*, 650 F.3d 717, 736 (D.C. Cir. 2011) (en banc) (rejecting "a judicially created

exemption for the IRS from suit under the APA"); *Fisher v. Commissioner*, 45 F.3d 396, 397 (10th Cir. 1995) ("The IRS cannot make taxpayers haul it into Tax Court to . . . discover what the rationale for its decision is."). This case presents an opportunity to resolve that disagreement, making clear that there is no APA exemption for the IRS—regardless of the circuit in which a taxpayer resides.

But this is the kind of issue that would warrant this Court's review even in the absence of an entrenched conflict. Every unresolved disagreement between the IRS and a taxpayer in an income tax examination results in a Notice of Deficiency, making it one of the most common agency actions that impacts individuals and corporations. Yet, under the Fourth Circuit's decision, the IRS could issue a Notice of Deficiency that says nothing more than "We don't think you're entitled to the deduction," which is essentially all the IRS said in disallowing the $118 million deduction for wages at issue here. Indeed, under that decision, the IRS could just flip a coin and say, "Heads, no deduction," or worse, say nothing and deny a deduction based on an illegitimate consideration. Such a result should not be tolerated in a single circuit.

No matter where they reside, taxpayers should not be forced to sue the IRS, a costly endeavor, just to get a meaningful explanation for a deficiency notice. But that is exactly what the taxpayer had to do in this case to find out *why* the IRS disallowed the $118 million deduction at issue. Neither the Fourth Circuit nor even the IRS has seriously argued that the Notice of Deficiency that petitioner received from the IRS contained a reasoned explanation (and it didn't). Instead, the Fourth Circuit held that Notices of

Deficiency are categorically exempted from the APA's reasoned-explanation requirement. App. 10a-11a. That categorical rule now governs all taxpayers who reside in the States of Maryland, North Carolina, South Carolina, Virginia, and West Virginia.

This Court's review is warranted.

STATEMENT OF THE CASE

A. Factual Background

The tax dispute in this case arises from a start-up company's success story, but the question presented applies equally to individuals and can involve virtually any tax dispute. In March 2002, Thomas Hume formed a new defense contracting company that would become Dominion Technology Resources, Inc. (DTRI). Eight months later, Hume sought to attract a new partner, Julian Chin, to help grow the business.

Chin was offered the job of executive vice president and chief operating officer and the right to purchase 49.75% of the company's voting stock for a nominal $450 fee, while Hume acquired the remaining 50.25% (also for a nominal fee). That was a close split in one sense, but it nevertheless gave ultimate control of the company to Hume alone, which Hume used to select himself as the sole director, President, and Chief Executive Officer. As is common for start-up companies, Chin and Hume received stock incentives as senior employees to encourage them to stay with the company. Among other things, under the terms of their shareholders agreement, Chin and Hume each agreed that he would have to sell his stock back to DTRI at a substantial discount price if he left DTRI voluntarily before the end of a 20-year period, and that

the discount could be even steeper if he left to work for a competitor or was fired for cause. App. 2a-5a.

Chin took the job, and DTRI was a runaway success—such a success that Chin and Hume's original stock in DTRI was bought out in 2008 by another company, petitioner QinetiQ, for nearly $118 million, after DTRI waived the restrictions on stock owned by Chin, Hume, and its other employees. *Id.* at 5a-6a.

Under 26 U.S.C. § 83(a), an employee who receives stock in connection with the performance of services ordinarily need not pay tax on the stock until it is no longer "subject to a substantial risk of forfeiture." An employer who *pays* such compensation, meanwhile, is entitled to a corresponding deduction equivalent to the amount of income the employee recognizes in the year in which that income is recognized. 26 U.S.C. 83(h).

Because Chin or Hume would have had to sell their stock back to DTRI at a substantial discount if they had left the company, the stock was subject to a "substantial risk of forfeiture" under existing precedent until the stock restrictions were released when the company was sold. Accordingly, when Chin and Hume recognized the full value of the stock transferred ($118 million) and paid income tax thereon at ordinary income rates in 2009, QinetiQ took a Section 83 deduction for that amount.[1]

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[1] After QinetiQ acquired DTRI, it essentially stepped into the shoes of DTRI for federal tax purposes—with respect to both DTRI's tax liability and any deductions or offsets DTRI enjoyed. Also, to be clear, while QinetiQ's parent is a foreign corporation, QinetiQ is a U.S. corporation organized under the laws of Delaware with its principal place of business in Virginia. Accordingly, QinetiQ is a domestic taxpayer.

B. Procedural Background

In 2013, following a back-and-forth between the taxpayer and the agency in which various arguments and facts were raised and debated by petitioner and the IRS, the IRS issued a Notice of Deficiency to QinetiQ in which it asserted a $13,902,087 tax deficiency. CAJA 240 ¶ 5.[2] The Notice stated:

"It is determined that the deduction you claimed for Salaries and Wages in the amount of $117,777,501 under the provisions of IRC § 83 is disallowed in full as you have not established that you are entitled to such a deduction." *Id.* ¶ 7(a). That was the only "explanation" the Notice offered for the asserted deficiency.

The Internal Revenue Code gives a taxpayer that receives a Notice of Deficiency two options: Sue, or agree to pay. *See* 26 U.S.C. § 6213(c). Unless a domestic taxpayer brings suit against the Commissioner in Tax Court within 90 days, the deficiency amount identified in the Notice is assessed and must be paid by the taxpayer upon demand. *Id.* § 6213(a), (c). QinetiQ chose to sue.

QinetiQ filed a petition in the Tax Court challenging the Notice of Deficiency. *Id.* § 6213(a). QinetiQ initially asked that court to declare the Notice of Deficiency invalid and set it aside under the APA for lack of a reasoned explanation. The Tax Court refused to do so—holding that, under longstanding precedent of the Tax Court, "[i]t is well settled that the APA does not apply to deficiency cases" challenging Notices of Deficiency before the Tax Court, and that this Court's

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[2] "CAJA" refers to the Joint Appendix filed in the United States Court of Appeals for the Fourth Circuit.

decision in *Mayo* "does [not] overrule more than 85 years of jurisprudence and practice reviewing deficiency determinations de novo." App. 21a-22a (citing *Ewing v. Commissioner*, 122 T.C. 32 (2004)).

After a trial on a stipulated record with no live testimony, the Tax Court ruled that the IRS had properly denied the Section 83 deduction as to Chin's stock.[3] It grounded that decision in two of the four factors that courts commonly apply in Section 83 cases. First, it held that the stock was not transferred "in connection with the performance of services." CAJA 2266. And second, the court held that the stock was never subject to a "substantial risk of forfeiture" because (as it eventually turned out) Chin and Hume developed "a very close relationship" and had worked well together after Chin joined the company, such that it was—in the Tax Court's view, with the benefit of hindsight—"unlikely that Hume would have taken any actions to terminate his employment." CAJA 2269.

The Fourth Circuit affirmed in a published decision. As to the APA issue, the court recognized that the APA requires a "reasoned explanation" for agency action, and it accepted (or at least took as given) that the Notice of Deficiency in this case would flunk that requirement. App. 7a. But it reasoned that the "specific" judicial review provisions in the Internal Revenue Code trump "the APA's general procedures for judicial review, including the requirement of a reasoned explanation in a final agency decision." *Id.* at

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[3] On appeal, QinetiQ challenged the IRS's Section 83 determination only as to Hume's stock, *see* CAJA 1927-35; CAJA 1936-40a, though it continued to object to the lack of a reasoned-explanation as to both Chin and Hume's stock.

8a-10a. "Accordingly," the court "h[e]ld that the APA's requirement of a reasoned explanation . . . does not apply to a Notice of Deficiency." *Id.* at 10a-11a.[4]

Turning to the Section 83 issue, the Fourth Circuit declined to embrace the Tax Court's finding that the stock had not been transferred "in connection with the performance of services"—no doubt because the stock was transferred as part of Chin's agreement to come work for the company, and his continued ownership of the stock was expressly contingent on his continued service to DTRI. App. 15a. But the Fourth Circuit found no clear error in the Tax Court's "factual determination that Hume would have been unlikely to enforce the shareholder restrictions on the stock," which the Tax Court had based on facts that occurred after the stock acquisition (e.g., the "close work relationship" and "vital role" Chin played in growing the company). The Fourth Circuit therefore affirmed on the Section 83 issue as well. App. 17a.

The Fourth Circuit denied rehearing.

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[4] The Fourth Circuit separately considered whether the Notice of Deficiency satisfied the requirements of Section 7522(a) of the Internal Revenue Code. App. 10a. That provision indicates that a Notice of Deficiency should include certain specific information, such as the interest due, though it also states that "[a]n inadequate description *under the preceding sentence* shall not invalidate such notice." 26 U.S.C. § 7522(a) (emphasis added). The court concluded that the Notice issued here was not invalid under Section 7522(a), either. *See* App. 12a-13a. As the court's separate consideration of Section 7522(a) underscores, the "description" requirement in Section 7522(a) is distinct from the reasoned-explanation requirement imposed by Section 706 of the APA.

REASONS FOR GRANTING THE WRIT

For most of the past century, it was widely believed that "tax law" was not subject to the requirements imposed by the APA on the rest of the administrative state, notwithstanding the lack of any express exemption in the APA for tax issues. In *Mayo Foundation for Medical Education & Research v. United States*, 562 U.S. 44, 55 (2011), this Court laid that (mistaken) view to rest, declaring that courts had no license to "carve out an approach to administrative review good for tax law only." But the Fourth Circuit's decision in this case is a glaring reminder that tax exceptionalism still exists—and that further guidance is required by this Court to ensure that the APA's general requirements are indeed given effect.

Indeed, even though this Court presumably meant what it said in *Mayo*, and even though QinetiQ relied heavily on *Mayo* both in its briefs and at oral argument before the Fourth Circuit, the Fourth Circuit did not even *attempt* to harmonize its holding with this Court's emphatic rejection of tax exceptionalism in *Mayo*. Instead, the Fourth Circuit just ignored *Mayo* as if it did not exist—failing even to cite the case. The Tax Court, for its part, at least acknowledged *Mayo*. But it dismissed QinetiQ's reliance on *Mayo* on the ground that "*Mayo* dealt with agency rulemaking *only*." App. 21a (emphasis added). It's true, of course, that *Mayo* centered on agency rulemaking, rather than adjudication. But this Court hardly suggested that lower courts were free to "carve out an approach to administrative review good for tax law only"—as long as they did so for agency *adjudications*.

This case presents an ideal vehicle to provide the needed guidance. The Fourth Circuit's categorical

holding that Notices of Deficiency are exempt from the APA's reasoned-explanation requirement tees up the debate over tax exceptionalism in stark terms. And this case presents the issue in a context that could scarcely be more important to Americans: Whether an IRS Notice of Deficiency—one of the most common forms of agency action impacting everyday citizens, and a disposition that puts taxpayers to the choice of submitting to the government and paying the claimed deficiency or facing the full brunt of the government's collection efforts—must meet one of the most basic and important prerequisites of all agency action under the APA, the requirement of a reasoned explanation.

This case checks the conventional boxes of what this Court typically looks for in deciding whether to grant certiorari. *See* Sup. Ct. R. 10(a). But it also calls for review in an even more basic respect. Every taxpayer who receives a Notice of Deficiency is entitled to the reasoned explanation that the APA requires for all agency action. That is the least the IRS can do in taking an action that frequently uproots the lives of ordinary taxpayers. Unless this Court grants review, taxpayers in the Fourth Circuit will no longer enjoy that right. The petition should be granted.

I. THE FOURTH CIRCUIT'S DECISION WHOLE-HEARTEDLY EMBRACES A "TAX EXCEPTIONALISM" REPUDIATED BY THIS COURT AND OTHER CIRCUITS

As the administrative state has grown and grown, the APA has become an increasingly indispensable check on administrative abuse and instrument for sound administrative decision-making. Among other things, the APA makes clear that "[a] reviewing court shall . . . hold unlawful and set aside agency action" that

is "arbitrary" and "capricious." 5 U.S 706(2)(A). As this Court has held, that statutory command, in turn, requires an agency to provide a reasoned explanation for its actions. *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 513-14 (2009); *see Fisher v. Commissioner*, 45 F.3d 396, 397 (10th Cir. 1995) ("It is an elementary principle of administrative law that an administrative agency must provide reasons for its decisions." (citation omitted) (citing cases)).

At its core, the question presented in this case is whether the IRS is bound by that elemental requirement, or whether it is somehow exempt in a way that other federal agencies are not. Nothing in the APA suggests, much less explicitly states, that the IRS is different or exempt. Certainly the APA contains no exception for the IRS (or, for that matter, Notices of Deficiency[5]). Yet, "tax jurisprudence and scholarship have suffered" for "decades . . . from what has been labeled 'tax exceptionalism'—the perception that tax law is so different from the rest of the regulatory state that general administrative law doctrines and principles do not apply." Stephanie Hoffer &

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[5] The Fourth Circuit suggested that a Notice of Deficiency may not be "'final' within the meaning of the APA," App. 9a, and therefore not qualify as "agency action." That is incorrect. A Notice of Deficiency not only is subject to judicial review, but determines "rights or obligations." *Bennett v. Spear*, 520 U.S. 154, 178 (1997) (citation omitted); *see* 5 U.S.C. § 551(13). Indeed, it is undisputed that a Notice of Deficiency represents the agency's final determination of a taxpayer's tax liability and, if it is not challenged in court, enables the IRS to demand payment from the taxpayer in the amount assessed. 26 U.S.C. § 6213(c). A Notice of Deficiency therefore clearly qualifies as final agency action.

Christopher J. Walker, *The Death of Tax Court Exceptionalism*, 99 Minn. L. Rev. 221, 222 (2014).[6]

In recent years, courts have begun to push back, recognizing that "[t]he IRS is not special in this regard; no exception exists shielding it—unlike the rest of the Federal Government—from suit under the APA." *Cohen v. United States*, 650 F.3d 717, 723 (D.C. Cir. 2011) (en banc). Even if there are "good policy reasons to exempt IRS action from judicial review," the en banc D.C. Circuit has explained, "Congress has not made that call" and the courts "are in no position to usurp [its] choice." *Id.* at 736. Or, as this Court put it even more bluntly, there is simply no statutory basis for "carv[ing] out an approach to administrative review good for tax law only." *Mayo*, 562 U.S. at 55.

Fisher v. Commissioner, 45 F.3d 396 (10th Cir. 1995), was a trail blazer for the judiciary's growing rejection of tax exceptionalism. There, the Tenth

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[6] The Tax Court's specialization in tax issues has made it particularly susceptible to this tax-is-different mentality. Indeed, the Tax Court has declared "well established" the proposition "that the APA does not apply to deficiency cases in [the Tax] Court; that is, cases arising under sections 6213 or 6214 in which we may redetermine the taxpayer's tax liability." *Ewing v. Commissioner*, 122 T.C. 32, 37 (2004). Not all Tax Court Judges agree. *See, e.g.*, *id.* at 61 (Halpern & Holmes, JJ., dissenting) ("[T]he majority's premise that the judicial review provisions of the APA do not apply to deficiency cases in [the Tax C]ourt cannot stand."). But as a long line of Tax Court cases underscores, the Tax Court is stuck in a groove it is not likely to get out of without the intervention of a higher authority. *Cf. Ramaprakash v. FAA*, 346 F.3d 1121, 1122 (D.C. Cir. 2003) ("Learned Hand once remarked that agencies tend to 'fall into grooves, . . . and when they get into grooves, then God save you to get them out.'" (alteration in original) (citation omitted)).

Circuit applied generally applicable administrative law principles—and more particularly, the requirement that an agency provide a reasoned explanation for its actions—to set aside a Notice of Deficiency that the IRS had sent regarding a penalty for substantial understatement of tax. 45 F.3d at 396-97. Because the IRS had offered no explanation for its Notice of Deficiency, the Tenth Circuit ruled that the Notice could not stand. *Id.* at 397. "The IRS," it held, "cannot make taxpayers haul it into Tax Court . . . to discover what the rationale for its decision is." *Id.*

The Tenth Circuit's decision did not sit well with the IRS. Indeed, in the wake of *Fisher*, the IRS published an official notice stating that "[t]he Commissioner does NOT ACQUIESCE in . . . *Fisher v. Commissioner*, 45 F.3d 396 (10th Cir. 1995)." IRS Announcement Relating to Court Decisions: *Fisher*, 1996-2 C.B. 1 (July 15, 1996), 1996 WL 33370245. And it still doesn't. Before the Fourth Circuit in this case, the government declared that *Fisher* "should not be followed." U.S. CA4 Br. 37 n.11. And it wasn't. Whereas the Tenth Circuit in *Fisher* struck down a Notice of Deficiency for lack of any reasoned explanation, the Fourth Circuit in this case simply declared that "the APA's requirement of a reasoned explanation in support of a final agency action does not apply to a Notice of Deficiency." App. 10a-11a.[7]

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[7] The Fourth Circuit took a stab at distinguishing *Fisher* on the ground that it involved abuse-of-discretion review of the Commissioner's determination, rather than *de novo* review. App. 12a n.6. But nothing in *Fisher* suggests that the court would arrive at any different conclusion in this case, and the Fourth Circuit's holding that the "requirement of a reasoned explanation in support of a final agency action does not apply to a Notice of

That this Court's intervention and clarification is needed has been widely acknowledged. As Judge Bybee noted in a case presenting a related issue in which tax exceptionalism has reared its head, questions about "the scope of review—and, concomitantly, the standard of review" applied by the Tax Court have "splintered the Tax Court, which has proceeded along three different paths, dragging four circuit courts with them in the process." *Wilson v. Commissioner*, 705 F.3d 980, 994-95 (9th Cir. 2013) (Bybee, J., dissenting). The decision below "represents a new front on [that] 'tax exceptionalism' debate." Bryan Camp, *Tax Exceptionalism Lives?* QinetiQ v. CIR, Procedurally Taxing (Jan. 12, 2017), http://proceduralltytaxing.com/tax-exceptionalism-lives-qinetiq-v-cir/.

If this Court really intends to stop courts from "carv[ing] out an approach to administrative review good for tax law only," *Mayo*, 562 U.S. at 55, it is imperative that the Court grant review here.

II. THE FOURTH CIRCUIT OFFERED NO BASIS FOR EXEMPTING IRS NOTICES OF DEFICIENCY FROM GENERALLY APPLICABLE APA STANDARDS

The Fourth Circuit offered two justifications for its "good for tax law only" rule. Neither holds up.

First, the court cited *Bowen v. Massachusetts* for the proposition that "Congress did not intend for the APA 'to duplicate the previously established special

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Deficiency," App. 10a-11a, likewise would apply regardless of what other APA standards of review a court might also be applying. That is because Section 706 of the APA provides no basis for holding that a reasoned explanation is required in some cases but not others. *See infra* at 18-19.

statutory procedures relating to specific agencies.'" App. 10a (quoting *Bowen*, 487 U.S. 879, 903 (1988)). But *Bowen* concerned only the proper *forum* for claims—*i.e.*, the court in which a challenge to the agency's action could be brought. As this Court described it, "[t]he principal question presented" was "whether a *federal district court* has jurisdiction to review a final order of the Secretary of Health and Human Services refusing to reimburse a State for a category of expenditures under its Medicaid program." 487 U.S. at 882 (emphasis added); *see id.* at 903.

Here, the proper forum for the suit is undisputed. All agree that Congress has specified that challenges to Notices of Deficiency must be brought in the Tax Court. *See* 26 U.S.C. § 6213(a). Instead, the pertinent question is whether the APA's generally applicable *standards for judicial review* apply in that forum. The APA unambiguously answers that question: whereas Section 703 provides that "[t]he *form* of proceeding for judicial review" is generally governed by the special statute, Section 706 sets forth the specific *standards* to be applied by "[t]he reviewing court" designated in the special statute (the Internal Revenue Code here). 5 U.S.C. §§ 706 (emphasis added).

Thus, while the Internal Revenue Code designates where and how Notices of Deficiency may be challenged (in the Tax Court), it is Section 706 of the APA that supplies the *standards* of judicial review for that proceeding. In fact, the APA's legislative history expressly recognized that the APA's standard of review provision would apply to cases in Tax Court. H.R. Rep. No. 79-1980, at 45 (1946) (discussing standard for "a trial of the facts in The Tax Court"). And as the Solicitor General explained for the United

States in *Dickinson v. Zurko*, 527 U.S. 150 (1999), this Court "has made clear that, '[i]n the absence of a specific command in [a relevant statute] to employ a particular standard of review' of administrative action, that action 'must be reviewed solely under the . . . standard prescribed by the [APA].'" *Dickinson* U.S. Br. 20, 1998 WL 886731 (final alteration added) (citations omitted); *see* 5 U.S.C. § 559. The statute authorizing review in the Tax Court, 26 U.S.C. § 6214(a), does not express any intent to displace the APA's standards of review for cases brought in that court.[8]

In holding that Notices of Deficiency are excused from the APA's reasoned-explanation requirement, the Fourth Circuit also followed its own outmoded decision in *O'Dwyer v. Commissioner*, 266 F.2d 575 (4th Cir. 1959). In *O'Dwyer*, the court held that the standards of review set out in Section 706 of the APA are applicable only where the agency proceeded under the APA's provisions for *formal adjudication*, and therefore do not apply in Tax Court review. *Id.* at 580. But that holding has not survived the test of time.

In *Florida Power & Light Co. v. Lorion*, this Court held that "[t]he APA specifically contemplates judicial review on the basis of the agency record compiled in the course of informal agency action in which a hearing has not occurred." 470 U.S. 729, 744 (1985). And the government itself has previously criticized *O'Dwyer* on

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[8] As Judge Bybee put it in *Wilson v. Commissioner*, "[u]nless the special statutory review provided for in the agency's enabling act specifies a different scope of review, § 706 of the APA supplies both the scope of review and the standard of review." 705 F.3d at 997 (Bybee, J., dissenting) (citing 5 U.S.C. § 559).

precisely that basis, calling the decision "poorly reasoned" and stating that the *O'Dwyer* "court made the flawed assumption that the judicial review provisions of the APA apply only to formal agency action, and not informal agency action." Reply Brief for the Appellant 6, *Robinette v. Commissioner*, 439 F.3d 455 (8th Cir. 2006) (No. 04-360), 2005 WL 5627779. In *Robinette*, the Eighth Circuit agreed, holding that *O'Dwyer* "was premised on a now-outmoded understanding that informal agency action cannot be reviewed based on an administrative record." 439 F.3d 455, 461 (8th Cir. 2006); *see also Wilson*, 705 F.3d at 998 (Bybee, J., dissenting) (explaining that *O'Dwyer* has been overridden in an additional respect).

Nevertheless, here the Fourth Circuit simply doubled down on *O'Dwyer*. Not only did it invoke *O'Dwyer* in reaching its decision, it held that "the central holding of *O'Dwyer* remains valid." App. 11a. The Fourth Circuit's defiant adherence to *O'Dwyer* is alone a strong reason for granting review.

Second, the Fourth Circuit reasoned that applying the APA's arbitrary-and-capricious standard is "incompatible with" the Internal Revenue Code's "provisions for de novo review in the tax court." App. 9a (citing *O'Dwyer*, 266 F.2d at 580); *see also id.* at 10a. Again, though, the APA's text and this Court's precedent compels a contrary conclusion. There is simply no way to reconcile the text of the APA with the Fourth Circuit's conclusion that the *de novo* and arbitrary-and-capricious standards are "incompatible." Indeed, the APA expressly calls for the application of *both* standards of review and specifies that the agency action must be set aside if it fails *either* one. *See* 5 U.S.C. § 706(2)(B), (F). This Court has likewise

confirmed that the arbitrary-and-capricious standard applies "[i]n *all* cases"—including, therefore, cases in which *de novo* review applies. *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 413-14 (1971) (emphasis added). And even the Fourth Circuit recognized that *de novo* review is not completely incompatible with other standards. App. 11a n.4.

As then-Judge Scalia explained, the arbitrary-and-capricious standard was intended to apply "cumulative[ly]" with the other standards of review. *Association of Data Processing Serv. Orgs., Inc. v. Board of Governors of the Fed. Reserve Sys.*, 745 F.2d 677, 683 (D.C. Cir. 1984) (Scalia, J.); *see also Olenhouse v. Commodity Credit Corp.*, 42 F.3d 1560, 1575 n.25 (10th Cir. 1994) (same). Here, for example, the Tax Court should have first determined whether the Notice of Deficiency should be set aside for lack of a reasoned explanation, and proceeded to a *de novo* review of the Section 83 questions only if the Notice was valid. In refusing to give the APA's standards that cumulative effect, the Fourth Circuit ignored plain statutory text and departed from the considered approach of its sister circuits without any legitimate justification.

In short, the Fourth Circuit's reasoning is not only wrong, but the epitome of tax exceptionalism. Without identifying any provision expressly exempting the APA's standards of review in the Tax Court (or for Notices of Deficiency), the Fourth Circuit simply held that the APA's general requirements could not apply.

III. THE QUESTION PRESENTED IS EXCEPTIONALLY IMPORTANT AND WARRANTS THIS COURT'S REVIEW

The importance of the question presented cannot be disputed. The IRS swung for the fences below, and its strategy paid off: it secured a categorical ruling with enormous consequences for the citizens of this country. A Notice of Deficiency is one of the most common ways that ordinary Americans come face-to-face with agency action. A meaningful explanation allows a taxpayer to evaluate the *basis* for the IRS's action. Without one, a taxpayer must bring the IRS to court just "to discover what the rationale for its decision is." *Fisher*, 45 F.3d at 397. The corporate taxpayer here could afford to file suit and take on the IRS. Most taxpayers, however, will lack the practical means to pursue costly litigation, and in some cases the amount of a deficiency will not justify the costs of litigating against the IRS. As a result, taxpayers will be forced to pay the asserted deficiency solely on the basis of the IRS's *ipse dixit*.

The Fourth Circuit's elimination of the reasoned-explanation requirement also negates a critical safeguard for sound decision-making. The reasoned-explanation requirement does not simply ensure a record for reviewing agency action, but it constrains agencies *as they act*—requiring the agency to at least identify a legitimate basis for acting, *when it is acting*. *See Fox Television Stations, Inc.*, 556 U.S. at 537 (Kennedy, J., concurring in part and concurring in judgment). That in itself creates a powerful check on agency—and IRS—abuse. One can no longer dismiss the possibility that the IRS, in particular, will act for illegitimate reasons. *Cf. United States v. NorCal Tea Party Patriots*, 817 F.3d 953 (6th Cir. 2016).

This Court long ago observed that taxpayers "must turn square corners when dealing with the Government" in filing refund claims. *Rock Island, Ark. & La. R.R. Co. v. United States*, 254 U.S. 141, 143 (1920). In a sense, the question in this case is whether this is a two-way street—and, more fundamentally, whether the IRS has to travel the same road as other agencies under the APA. Under the Fourth Circuit's decision, the IRS could mail out Notices of Deficiency to disfavored taxpayers disallowing all claimed deductions without any explanation at all, and those taxpayers' only option would be to file individual suits in which they would have the burden of proving their tax liability down to the last dime. Whereas the Tenth Circuit would hold that such Notices could be set aside at the outset through a procedural motion, the Fourth Circuit would require the taxpayer either to capitulate and pay or litigate just to get a (post hac) explanation.

Tax Court procedures only magnify the prejudice caused by the Fourth Circuit's tax exceptionalism. Tax Court Rule 142(a)(1) provides that a taxpayer bears the burden of proof on issues identified in the Notice of Deficiency, but that the IRS bears the burden of proof on any "new matter" that it pleads in response to the taxpayer's petition that was not set forth in the Notice. Under this rule, the burden remains on the taxpayer so long as the IRS's responses are not "inconsistent" with the original determination. *Achiro v. Commissioner*, 77 T.C. 881, 890 (1981). "However, if the assertion in the [IRS's] amended answer alters the original deficiency or requires the presentation of different evidence," then the burden shifts to the IRS. *Id.*

Under that rule, the IRS's failure to include a meaningful explanation in a Notice of Deficiency puts a

taxpayer at a double disadvantage. Not only is the taxpayer left in the dark about why the IRS has determined a deficiency, but the burden of proof remains with the taxpayer on *all* issues because nothing the IRS might offer in response will be "inconsistent" with its prior, non-existent explanation. The Fourth Circuit's approach, therefore, gives the IRS an incentive to say next to nothing in a Notice of Deficiency, thereby preserving maximum flexibility to assert whatever arguments it wants right up until trial while keeping the burden of proof on the taxpayer.

Here, for example, if the IRS had based the Notice of Deficiency on the position that Chin's stock was not transferred "in connection with the performance of services," 26 U.S.C. § 83(a), then it would have borne the burden of proof on any later-introduced questions about whether and when Chin's stock was truly subject to a substantial risk of forfeiture. Given the Fourth Circuit's (understandable) refusal to embrace the IRS's position on the "in connection with the performance of services" issue, *see supra* at 9, that burden shift likely would have been dispositive. The IRS would have needed to prove not only that Chin was unlikely to be fired (the issue on which the Tax Court focused) but also that even if Chin quit voluntarily, the company would still have waived the binding legal restrictions that it had negotiated for its own protection. But the Tax Court pointed to no evidence that could have supported such a finding—and there was none.[9]

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[9] The Tax Court engaged in a hindsight analysis that relied on the "very close work relationship" that it thought had developed between Chin and Hume after Chin joined the company, and Chin's work "help[ing to] determine the company's overall direction." App. 17a, 48a. But those considerations were

The IRS holds enough advantages over taxpayers. There is no basis for exempting it from the fundamental requirements that the APA imposes on all "agency action" in order to promote sound decisions.

IV. THIS CASE PRESENTS AN IDEAL VEHICLE FOR RESOLVING THE QUESTION PRESENTED

This case presents an ideal vehicle for resolving the applicability of the APA and its reasoned-explanation requirement to Notices of Deficiency. As commentators have recognized, the "[t]he explanation that the IRS gave QinetiQ in the notice was 'really bare bones.'" Marie Sapirie, *News Analysis: How Detailed Should Deficiency Notices Be*, Tax Notes, Feb. 15, 2016, at 745 (quoting Professor Steven R. Johnson). The Notice of Deficiency simply stated that "the deduction you claimed . . . under the provisions of IRC § 83 is disallowed in full as you have not established that you are entitled to such a deduction." CAJA 240 ¶ 7(a). Neither the Fourth Circuit nor even the IRS seriously suggested that that statement would be sufficient to satisfy the APA's reasoned explanation requirement. Instead, the Fourth Circuit's ruling turned on its categorical holding "that the APA's requirement of a reasoned explanation . . . does not apply to a Notice of Deficiency." App. 10a-11a.

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irrelevant to the proper subject of its review, which was whether "*at the time of transfer* the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced." Treas. Reg. § 1.83-3(c)(1) (emphasis added). Neither the Tax Court nor the Fourth Circuit offered any justification for gauging the risk of forfeiture on a post hac basis from the time that the deduction was claimed rather than upfront from the "time of the transfer."

That universally applicable legal holding can only embolden the IRS in refusing to provide taxpayers in the Fourth Circuit with even minimal explanations for its determinations: If the Notice *here* could pass muster with the circuit court, then as a practical matter *any* Notice will. There is no basis, however, for the millions of taxpayers in the Fourth Circuit to be denied the kind of explanation that taxpayers in, say, the Tenth Circuit may insist upon. And there is no reason for this Court to tolerate the result below in a single circuit in this country. Americans already struggle more than enough to understand their taxes. If allowed to stand, the decision below clears the way for the IRS to issue Notices of Deficiency that simply declare the amounts due and leave taxpayers in the dark about how the IRS arrived at that determination.

This Court's review is needed.

CONCLUSION

The petition for certiorari should be granted.

Respectfully submitted,

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April 4, 2017

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UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 15-2192

QINETIQ US HOLDINGS, INC. & SUBSIDIARIES,

Petitioner – Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent – Appellee.

Appeal from the United States Tax Court.
(Tax Ct. No. 14122-13)

Argued: October 26, 2016 Decided: January 6, 2017

Before KING, KEENAN, and DIAZ, Circuit Judges

845 F.3d 555

Opinion

BARBARA MILANO KEENAN, Circuit Judge:

This appeal from a decision of the United States Tax Court (the tax court) involves the federal income tax treatment of shares of stock issued to an executive employee of Dominion Technology Resources, Inc. (DTRI), around the time of DTRI's founding. The company's successor in interest, QinetiQ U.S. Holdings, Inc. & Subsidiaries (QinetiQ), contends that the stock was issued in connection with the executive's employment and was subject to a substantial risk of forfeiture until 2008. On this basis, QinetiQ argues that

it is entitled to a tax deduction for the value of the stock as a trade or business expense in the tax year ending March 31, 2009.

After reviewing QinetiQ's tax return, the Internal Revenue Service (IRS) issued a Notice of Deficiency concluding that QinetiQ had not shown its entitlement to the claimed deduction. QinetiQ later filed suit in the tax court, raising both a procedural and a substantive argument. QinetiQ argued that the IRS failed to give a reasoned explanation in the Notice of Deficiency for denying the tax deduction. QinetiQ also argued that the stock qualified as a deductible trade or business expense in tax year 2008, because the stock was issued in connection with services and was subject to a substantial risk of forfeiture until that year. The tax court rejected the procedural argument, holding that the Notice of Deficiency provided sufficient explanation. The tax court also held that QinetiQ failed to show that the stock was issued in connection with services and was subject to a substantial risk of forfeiture. Accordingly, the tax court entered judgment in favor of the IRS.

Upon our review, we conclude that the IRS complied with all applicable procedural requirements in issuing the Notice of Deficiency to QinetiQ. We further hold that the tax court did not err in concluding that the stock failed to qualify as a deductible expense for the tax year ending March 31, 2009, because the stock was not issued subject to a substantial risk of forfeiture. We therefore affirm the tax court's judgment.

I.

In March 2002, Thomas G. Hume (Hume) formed "Thomas G. Hume, Inc." as a corporation organized

under the laws of Virginia. Hume was the sole shareholder, and served with his wife, Karyn Hume, as the initial directors of the corporation. Hume filed federal tax forms electing for the corporation to be treated as an "S corporation," in order to permit the corporation's profits and losses to be passed through to him individually. See 26 U.S.C. § 1366(b). Thomas G. Hume, Inc. appears not to have engaged in any business before November 2002.

In November 2002, Hume and Julian Chin took certain actions to facilitate Chin's joining the business enterprise. On December 6, 2002, Hume and Karyn Hume, as directors, filed articles of amendment with the Commonwealth of Virginia changing the name of the corporation to Dominion Technology Resources, Inc. and creating two classes of shares, class A voting stock and class B nonvoting stock. The next day, Karyn Hume resigned from DTRI's board of directors, leaving Hume as the sole director. On December 9, 2002, Hume paid a par value[1] of $450 in exchange for 4,500 shares of DTRI class A voting stock, and Chin paid the same par value in exchange for 4,455 shares of DTRI class A voting stock and 45 shares of DTRI class B nonvoting stock.

On December 12, 2002, Hume executed a "Consent in Lieu of the Organizational Meeting of the Board of Directors of [DTRI]" (December Consent), which offered for sale and issuance 4,500 shares of class A stock to Hume, and 4,455 shares of class A and 45 shares of class B stock to Chin. Attached to the

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[1] Par value is an "arbitrary dollar amount assigned to a stock share by the corporate charter." Par Value, Black's Law Dictionary 1298 (10th ed. 2014).

December Consent were letters signed by Hume and Chin acknowledging their intent to subscribe to the stated stock shares. Also included in the December Consent was authorization for DTRI to enter into a Shareholders Agreement and employment agreements with Hume and Chin. In a separate paragraph, the December Consent further authorized DTRI to enter into individual employment agreements and restrictive stock agreements with other employees.

The Shareholders Agreement entered into by DTRI, Hume, and Chin stated that the parties

> believe that it is in their mutual best interest to make provisions for the future disposition of all of the shares of common stock of the Corporation to the end that continuity of harmonious management is assured, and a fair process is established by which said shares of common stock may be transferred, conveyed, assigned or sold[.]

To that end, the Shareholders Agreement prescribed provisions for restricting the sale or transfer of stock and for returning stock to the corporation in the event of either Hume's or Chin's death, disability, or termination of employment with DTRI.

The Shareholders Agreement contained provisions for calculating the "Agreement Value" of the shares upon the occurrence of any of these events, and gave the corporation the option of repurchasing Hume's or Chin's shares at the calculated value in the event of such death, disability, or termination without cause. Additionally, in the event of voluntary resignation by the employee, the Shareholders Agreement provided DTRI the option of purchasing the shares at 5% of the

Agreement Value for every year of the departing employee's employment, up to a maximum of 100% after twenty years. However, in the event that the employee voluntarily resigned and engaged in competition with DTRI, or that DTRI terminated the employee for cause, the corporation would have the option to purchase the shares at 5% of the Agreement Value for every year of employment, up to a maximum of 25% of the Agreement Value.

Also in December 2002, DTRI entered into stock agreements with other employees that were far more restrictive than the terms of the Shareholders Agreement executed by Hume and Chin. The stock agreements with the other employees contained greater limitations on the transfer of stock and a less generous method for calculating stock value for purposes of DTRI's repurchase of a departing employee's stock. Also, unlike Hume and Chin, the other employees did not receive any voting rights in the stock they received.

DTRI entered into employment agreements with Hume, Chin, and other employees in December 2002. The employment agreements with Hume and Chin bore no reference to stock issued as compensation. In contrast, the employment agreements for the other employees who received stock in December 2002 explicitly referenced, under a contract section labeled "Compensation," nonvoting stock that was issued subject to restrictions.

DTRI, Hume, and Chin filed yearly tax documents treating DTRI as a pass-through entity between tax years 2002 and 2006, with Hume and Chin identified as the shareholders. In DTRI's tax filings from 2002 to 2006, DTRI allocated its net income or loss to Hume

and Chin, based on their respective percentage of stock ownership in DTRI in each taxable year. In December 2006, DTRI revoked its S corporation election, effective January 1, 2007. From 2002 through 2007, DTRI did not report the stock issued in 2002 to Hume and Chin as employment compensation, and therefore did not withhold federal payroll taxes on the issued stock. In contrast, DTRI, Hume, and Chin reported as employment compensation shares later granted to Hume and Chin.

In 2008, QinetiQ entered into negotiations to purchase DTRI. On August 4, 2008, QinetiQ, Project Black Acquisition Corp., DTRI, Hume, and Chin entered into a final agreement and plan of merger, with QinetiQ paying $123 million in exchange for all outstanding stock in DTRI. Immediately before the transaction closed, Hume and Chin executed consent agreements waiving DTRI's rights with respect to stock transfer restrictions or partially vested stock. The merger transaction closed in October 2008.

For the tax year ending on March 31, 2009, QinetiQ withheld payroll taxes in accordance with the value of the stock received by Hume and Chin in 2002, and claimed deductions under 26 U.S.C. § 83(h), as wages paid to Hume and Chin for the fair market value of the shares originally issued to them in December 2002. Hume and Chin filed personal income tax returns for tax year 2008 claiming as wage income the 2008 value of their respective shares issued in December 2002.

The IRS transmitted to QinetiQ a Notice of Deficiency stating that the IRS had determined that QinetiQ "ha[d] not established that [it was] entitled" to a deduction "under the provisions of [26 U.S.C.] § 83," and that QinetiQ's taxable income for the year thereby

was increased by "$117,777,501." The IRS did not give a further explanation of its decision in its Notice of Deficiency.

QinetiQ filed a petition in the tax court challenging the sufficiency of the Notice of Deficiency, as well as the IRS's substantive determination with respect to Chin's shares.[2] The tax court ruled that QinetiQ had not demonstrated entitlement to the deduction on two independent bases, namely, that the stock was not property "transferred in connection with the performance of services" and was not "subject to a substantial risk of forfeiture" at the time Chin acquired the shares. QinetiQ appeals from the tax court's judgment.

II.

We first address QinetiQ's argument that the Notice of Deficiency is invalid because it failed to provide a reasoned explanation for the agency's final decision, as required by the Administrative Procedure Act (APA), 5 U.S.C. §§ 701–06. This issue presents a question of law that we consider de novo. Starnes v. Comm'r, 680 F.3d 417, 425 (4th Cir. 2012).

A.

The APA authorizes district courts to review agency actions with a "focal point" on the "administrative record already in existence." Camp v. Pitts, 411 U.S. 138, 142 (1973) (per curiam). The Supreme Court has held that a required component of

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[2] Originally, QinetiQ challenged the classification of the shares issued to both Hume and Chin but, during the pendency of the tax court case, QinetiQ conceded that the stock shares issued to Hume did not qualify as Section 83 property.

this administrative record is a "reasoned explanation for [the agency] action." FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515–16 (2009). QinetiQ anchors its argument on this principle, maintaining that this requirement of a reasoned explanation necessarily applies to a Notice of Deficiency, because that notice is a final agency action within the meaning of the APA. Thus, according to QinetiQ, failure by the IRS to comply with this APA requirement rendered the Notice of Deficiency invalid.

We disagree with QinetiQ's argument, which fails to consider the unique system of judicial review provided by the Internal Revenue Code for adjudication of the merits of a Notice of Deficiency. It is that specific body of law, rather than the more general provisions for judicial review authorized by the APA, that governs the content requirements of a Notice of Deficiency.

Under the APA, the "task of the reviewing court is to apply the appropriate APA standard of review . . . to the agency decision based on the record the agency presents to the reviewing court." Fla. Power & Light Co. v. Lorion, 470 U.S. 729, 743–44 (1985) (internal citation omitted). The reviewing court in such a case generally is not authorized to conduct a de novo evaluation of the record or to "reach its own conclusions" regarding the subject matter before the agency. Id. at 744.

Some agency-specific statutes, however, provide materially different procedures for judicial review that predate the APA's enactment. One such example is the Internal Revenue Code (the Code), which authorizes de novo review in the tax court of a Notice of Deficiency. See 26 U.S.C. § 6214; Eren v. Comm'r, 180 F.3d 594, 597 (4th Cir. 1999). We discussed this

unique system of judicial review in our decision in O'Dwyer v. Commissioner, 266 F.2d 575 (4th Cir. 1959). We explained that because the Code's provisions for de novo review in the tax court permit consideration of new evidence and new issues not presented at the agency level, those provisions are incompatible with the limited judicial review of final agency actions allowed under the APA.[3] Id. at 580; see also 26 U.S.C. § 6214(a).

Additionally, we observe that for an agency action to be deemed "final" within the meaning of the APA and, thus, subject to the APA's requirement of a reasoned explanation, the agency "action must be one by which rights or obligations have been determined, or from which legal consequences will flow." Bennett v. Spear, 520 U.S. 154, 178 (1997) (internal citation and quotation marks omitted). "[L]egal consequences" include agency determinations that restrict the government's power to take contrary litigation positions in subsequent proceedings. See U.S. Army Corps of Eng'rs. v. Hawkes Co., 136 S. Ct. 1807, 1814 (2016) (holding that agency determinations effectively giving a five-year "safe harbor" from government suits

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[3] QinetiQ argues that this Court's opinion in O'Dwyer no longer is "good law" because O'Dwyer relied on an outmoded line of reasoning that the APA's procedures for judicial review apply only to formal adjudications, to the exclusion of informal agency actions. Although the APA's judicial review procedures have since been held to apply to informal agency actions, as well as to formal adjudications, see Fla. Power & Light Co., 470 U.S. at 744, 105 S.Ct. 1598, we observe that the central holding of O'Dwyer remains valid, namely, that the de novo review procedures provided by the Internal Revenue Code, rather than the judicial review procedures under the APA, govern judicial review of deficiency proceedings.

create "legal consequences" within the meaning of the Bennett test).

After issuing a Notice of Deficiency, however, the IRS may later assert in the tax court new legal theories and allege additional deficiencies. See 26 U.S.C. § 6214(a); Tax Ct. R. 142(a)(1). Likewise, a taxpayer may raise new matters before the tax court not previously considered during the administrative process. 26 U.S.C. § 6214(a). In contrast to these fluid procedures, the APA's "arbitrary" and "capricious" standard requires that judicial review of an agency action be confined to the static administrative record with deference accorded to the agency's decision, and that the agency action be final in all respects before judicial review commences. See 5 U.S.C. §§ 704, 706(2)(A); Pitts, 411 U.S. at 142.

Given these significant variations in the scope of judicial review under the two statutory schemes, we conclude that the APA's general procedures for judicial review, including the requirement of a reasoned explanation in a final agency decision, were not intended by Congress to be superimposed on the Internal Revenue Code's specific procedures for de novo judicial review of the merits of a Notice of Deficiency. As the Supreme Court has emphasized, Congress did not intend for the APA "to duplicate the previously established special statutory procedures relating to specific agencies." Bowen v. Massachusetts, 487 U.S. 879, 903 (1988); see also Hinck v. United States, 550 U.S. 501, 506 (2007) ("[I]n most contexts, a precisely drawn, detailed statute pre-empts more general remedies.") (internal citation and quotation marks omitted). Accordingly, we hold that the APA's requirement of a reasoned explanation in support of a

final agency action does not apply to a Notice of Deficiency issued by the IRS and that, therefore, the Notice of Deficiency issued to QinetiQ in this case was not subject to that APA requirement.[4]

B.

We next consider whether the Notice of Deficiency in this case was insufficient to satisfy the requirement of Section 7522(a) of the Code that the IRS "describe [in the Notice] the basis for, and identify the amounts (if any) of, the tax due, interest, additional amounts, additions to the tax, and assessable penalties." 26 U.S.C. § 7522(a). The statute further provides that "an inadequate description under the preceding sentence shall not invalidate such notice." Id. However, the statute is silent regarding the circumstances, if any, that will cause a Notice of Deficiency to be invalidated. Id.

Some federal courts of appeal have held that a Notice of Deficiency may be invalidated for the failure to include certain information. For example, before the 1988 enactment of Section 7522,[5] we held that a Notice of Deficiency must contain a statement that the IRS

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[4] We acknowledge that the APA anticipates that "de novo" determination of facts by the reviewing court may sometimes be appropriate. 5 U.S.C. § 706(2)(F). However, this is not such a case, because application of the APA would simply "duplicate the previously established special statutory procedures" of the Internal Revenue Code. Bowen, 487 U.S. at 903.

[5] The language now codified at 26 U.S.C. § 7522 was originally codified at Section 7521 in 1988 and renumbered as Section 7522 in 1990. See Omnibus Taxpayer Bill of Rights, Pub. L. No. 100–647, § 6233, 102 Stat. 3342, 3735 (1988); Revenue Reconciliation Act of 1990, Pub. L. No. 101–508, § 11704, 104 Stat. 1388, 1388-519 (1990).

has examined a return and has determined a deficiency in an "exact amount." Abrams v. Comm'r, 787 F.2d 939, 941 (4th Cir. 1986). And, after the enactment of Section 7522, the Ninth Circuit implicitly has endorsed application of a rule that major errors in a Notice of Deficiency causing prejudice to a taxpayer will render that determination invalid. See Elings v. Comm'r, 324 F.3d 1110, 1113 (9th Cir. 2003). Also, the Tenth Circuit has held that a Notice of Deficiency may not be used to implicitly deny without explanation a taxpayer's request for discretionary relief.[6] See Fisher v. Comm'r, 45 F.3d 396, 397 (10th Cir. 1995). In contrast, some of our sister circuits have held that minor, nonprejudicial flaws in a Notice of Deficiency will not cause such notice to be invalidated. Elings, 324 F.3d at 1113; Smith v. Comm'r, 275 F.3d 912, 915 & n.2 (10th Cir. 2001).

Upon consideration of this authority, we hold that the Notice of Deficiency issued to QinetiQ satisfied the basic requirements of the Internal Revenue Code. The Notice of Deficiency informed QinetiQ that the IRS had determined a deficiency in an exact amount for a

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[6] We do not read Fisher, as QinetiQ urges, as requiring a reasoned explanation in all Notices of Deficiency. The court in Fisher was asked to review the Commissioner's implicit denial, through inaction, of a discretionary waiver of a tax penalty. See Fisher, 45 F.3d at 396–97 (citing 26 U.S.C. § 6661(c)). The court in Fisher held that without an explicit agency ruling to review, the tax court "had no basis for determining what reasons the Commissioner may have relied upon," and that, therefore, the Commissioner "failed to demonstrate that she had exercised her discretion." Id. at 397. The rationale of Fisher thus applies only to cases in which courts review agency action for abuse of discretion, rather than cases in which the tax court applies a de novo standard of review. See id.

particular tax year, and incorporated by reference an enclosed statement that "the deduction you claimed for Salaries and Wages in the amount of $117,777,501 under the provisions of [Code] § 83 is disallowed in full as you have not established that you are entitled to such a deduction." The Notice of Deficiency further informed QinetiQ that it had the right to contest this deficiency determination in the tax court. In light of the taxpayer's burden to show entitlement to a particular deduction, INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992), we discern no prejudice to QinetiQ due to the absence of additional information in the Notice of Deficiency. Accordingly, we hold that its content was sufficient to satisfy the requirements of the Internal Revenue Code.

III.

Finally, we turn to the merits of QinetiQ's claim that QinetiQ was entitled to a tax deduction in tax year 2008 for the stock Chin acquired from DTRI in 2002. In addressing this issue, we apply an established standard of review. Decisions of the tax court are subject on appeal to the same standard we apply to civil bench trials on appeal from the district courts. Estate of Waters v. Comm'r, 48 F.3d 838, 841–42 (4th Cir. 1995). Under this standard, we review factual findings for clear error, legal questions de novo, and mixed questions of law and fact de novo. Waterman v. Comm'r, 179 F.3d 123, 126 (4th Cir. 1999); Waters, 48 F.3d at 842.

QinetiQ argues that the stock Chin acquired from DTRI in 2002 qualified as a trade or business expense in 2008, because the stock was transferred "in connection with" Chin's employment with DTRI, and was "subject to a substantial risk of forfeiture" until

Chin sold the shares in 2008 as part of DTRI's merger with QinetiQ. See 26 U.S.C. §§ 83(h), 162. The IRS responds that the tax court properly rejected QinetiQ's claim because the evidence showed that Chin subscribed to the stock for investment, rather than in connection with his employment with DTRI, and that the stock was not issued subject to a substantial risk of forfeiture.

We agree with the IRS that the tax court did not err in rejecting QinetiQ's claimed deduction. Section 83(a) of the Code, in relevant part, generally treats property transferred "in connection with the performance of services" as "gross income of the person who performed such services." 26 U.S.C. § 83(a). Because a transfer of this nature is treated as gross income of the individual providing such services, the employer ordinarily is entitled to a deduction for the equivalent value as a trade or business expense. 26 U.S.C. §§ 83(h), 162(a).

This rule is modified, however, when property transferred "in connection with the performance of services" is "subject to a substantial risk of forfeiture." 26 U.S.C. § 83(a). Property transferred under such circumstances is not treated as gross income of the individual providing services until the first taxable year in which the property was no longer subject to a substantial risk of forfeiture. Id. Therefore, an employer seeking to establish entitlement to a deduction for property transferred to an employee in a prior tax year must show both: (1) that the property was transferred "in connection with the performance of services"; and (2) that the property was "subject to a substantial risk of forfeiture" from the time the property was transferred until the tax year for which

the deduction is claimed. Id.; see also Strom v. United States, 641 F.3d 1051, 1055–56 (9th Cir. 2011); United States v. Bergbauer, 602 F.3d 569, 580 (4th Cir. 2010). Thus, if the employer fails to establish either of these two required elements, the employer is not entitled to claim the property transferred in an earlier tax year as a trade or business expense. See 26 U.S.C. §§ 83(a), 83(h), 162(a).

In the present case, the tax court found that QinetiQ had failed to prove either requirement for establishing its claimed deduction. We conclude that the record supports the tax court's determination that the stock transferred to Chin in 2002 was not issued subject to a substantial risk of forfeiture. Because this factor is a required element of proof for establishing entitlement to the claimed deduction in the tax year in dispute, we limit our analysis to this single element and do not address the other statutorily required element that the stock have been transferred in connection with the performance of services.

Under Treasury regulations implementing Section 83(a), the term "substantial risk of forfeiture" is applied in the context of the "facts and circumstances" of each individual case. 26 C.F.R. § 1.83–3(c)(1). The relevant regulation further clarifies that property is not "subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of such property to the employee upon the return of such property." Id. In addition, property is not subject to a substantial risk of forfeiture if "at the time of the transfer the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced." Id. § 1.83–3(c)(1), (3). Likewise, conditions imposed at the time of transfer that require

the return of property "if the employee is discharged for cause or for committing a crime," or "if the employee accepts a job with a competing firm," will not be sufficient to constitute a substantial risk of forfeiture. Id. § 1.83–3(c)(2).

Here, the terms of the Shareholders Agreement between DTRI, Hume, and Chin recited certain conditions that would require Chin to return the stock to DTRI. In the event of Chin's death, disability, or termination without cause, the Shareholders Agreement provided a formula for DTRI to repurchase Chin's stock that corresponded with "one hundred percent (100%) [of] the Agreement Value."[7] Given this requirement of fair market value, the repurchase of Chin's stock under those circumstances would not be considered a "forfeiture" within the meaning of the relevant regulation. 26 C.F.R. § 1.83–3(c)(1).

In the event of Chin's voluntary resignation, the Shareholders Agreement would have provided for DTRI to repurchase the stock at "five percent (5%) [of the Agreement Value] for every full year of service" by Chin, up to the full Agreement Value after 20 years of service. However, if Chin were terminated for cause or voluntarily resigned and engaged in competition with DTRI, the stock repurchase price would be 5% of the Agreement Value for each year of service, up to a maximum of 25% of the Agreement Value.

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[7] The Shareholders Agreement prescribed an objective method for calculating the value of the corporation, based on four times the earnings of the corporation in the fiscal year immediately preceding the event requiring valuation. Nothing in the record indicates that this formula would not result in the fair market value of the stock.

Read together, these additional provisions of the Shareholders Agreement indicate that the only circumstances in which Chin would be required to forfeit his stock at a below-market price would be if Chin voluntarily resigned before 20 years of employment, if Chin voluntarily resigned and entered into competition with DTRI, or if Chin were terminated for cause. Because the regulation provides that forfeiture provisions triggered by termination for cause or by engaging in competition do not constitute a "substantial risk of forfeiture," 26 C.F.R. § 1.83–3(c)(2), the only remaining ground for forfeiture would be the circumstance of Chin's voluntary resignation.

With respect to this sole remaining ground for forfeiture, the tax court concluded that the likelihood of forfeiture due to Chin's voluntary resignation did not amount to a "substantial risk." The tax court made a factual determination that Hume would have been unlikely to enforce the shareholder restrictions on the stock in the event of Chin's voluntary departure. In concluding that Chin's stock was not subject to a substantial risk of forfeiture but was intended to be treated as "fully vested and outstanding stock" without restrictions, the tax court cited Chin's role as an initial investor in DTRI, Chin's "very close work relationship" with Hume, and Chin's "vital role within DTRI as the executive vice president, COO, and a 49.75% shareholder in voting stock."

Based on our review, we conclude that the tax court's factual conclusion, that Chin's significant ownership position in DTRI and his strong relationship with Hume demonstrated that the stock was not transferred in 2002 subject to a "substantial risk of forfeiture," is not clearly erroneous and was supported

by the record. We therefore hold that the tax court did not err in concluding that QinetiQ failed to establish its entitlement to the claimed deduction.

IV.

For these reasons, we affirm the tax court's judgment.

AFFIRMED

UNITED STATES TAX COURT
Washington, DC 20217

QINETIQ U.S. HOLDINGS, INC. & SUBSIDIARIES, Petitioner,	)	
v.	)	Docket No. 14122-13
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

ORDER

On August 28, 2013, petitioner filed a Motion to Dismiss, accompanied by a Memorandum of Law in Support thereof. By Order dated August 28, 2013, the Court requested respondent to file a response to petitioner's motion by September 18, 2013. On September 6, 2013, respondent filed a Motion for Extension of Time to file a response until November 4, 2013, which this Court stamped as granted on September 6, 2013. On November 4, 2013, respondent filed a response to petitioner's Motion to Dismiss.

On November 8, 2013, petitioner filed a Motion to Strike portions of respondent's response, accompanied by a Memorandum in Support thereof. By Order dated November 12, 2013, the Court requested respondent to file a response to petitioner's motion by December 3, 2013. On December 3, 2013, respondent filed a response to petitioner's Motion to Strike.

On November 8, 2013, respondent filed a Motion for Summary Judgment, accompanied by a Memorandum in Support thereof, with supporting Declarations. By

Order dated November 12, 2013, the Court requested petitioner to file a response to respondent's motion by December 3, 2013. On December 3, 2013, petitioner filed a response to respondent's Motion for Summary Judgment. On December 4, 2013, respondent filed a Supplemental Memorandum in Support of Respondent's Motion for Summary Judgment.

Petitioner argues that the Administrative Procedure Act (APA), 5 U.S.C. secs. 551-559, 701-706, requires this Court to set aside the notice of deficiency here because it's "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law". However, we do not believe the notice here was arbitrary and capricious, nor do we believe the APA judicial review procedures supplant this Court's longstanding de novo review procedures.

Petitioner argues that the notice of deficiency was arbitrary and capricious because, despite the substantial sum involved, the notice consisted of only a couple sentences explaining the basis for the deficiency. However, the size of the deficiency is irrelevant to the size of the notice's explanation of adjustments. We have procedures for analyzing the validity of notices of deficiency, but we do not hold a notice invalid just because it is succinct. See sec. 7522; Estate of Abraham v. Commissioner, 408 F.3d 26, 36 (1st Cir. 2005) (rejecting such a requirement because it "would amount to a requirement that the Notice of Deficiency be as detailed as trial briefs."); Pasternak v. Commissioner, 990 F.2d 893, 898-99 (6th Cir. 1993) ("the commission need not explain how the deficiencies were determined. All that is required is that the notice advise taxpayers that the commission has in fact determined a deficiency."); Hom & Assoc. v.

Commissioner, 140 T.C. 11 (2013) ("Although the adequacy of the content of a notice of deficiency has frequently been litigated, courts have held repeatedly that a notice of deficiency is valid if it notifies the taxpayer that a deficiency has been determined and gives the taxpayer the opportunity to petition the Tax Court for redetermination of the proposed deficiency"). Therefore, we do not agree the notice is arbitrary and capricious because we believe the notice served its purpose by notifying the petitioner that a deficiency had been determined and giving the petitioner the opportunity to petition this Court for redetermination of the proposed deficiency.

Despite the above, petitioner's arbitrary and capricious argument is irrelevant because the APA judicial review procedures do not supplant this Court's longstanding de novo review procedures. We explain as follows.

Petitioner argues the APA is controlling here because the APA applies to the Internal Revenue Service (IRS) as it does to all other agencies. Petitioner relies on Mayo Found. for Med. Educ. and Research v. U.S., 131 S.Ct. 704 (2011), for the quote: "we [the Supreme Court] are not inclined to carve out an approach to administrative review good for tax law only". Petitioner's reliance on Mayo, however, is misplaced because Mayo dealt with agency rulemaking only. The Court's holding in Mayo that Chevron deference applies to Treasury regulations has no relevance in this case, nor does it overrule more than 85 years of jurisprudence and practice reviewing deficiency determinations de novo. See e.g., Ewing v. Commissioner, 122 T.C. 2 (2004) ("Under section 6213(a) and its predecessors, we (and earlier, the Board

of Tax Appeals [est. 1924]) have 'redetermined' deficiencies de novo * * *"). It is well settled that the APA does not apply to deficiency cases in this Court; that is, cases arising under sections 6213 or 6214 in which we may redetermine the taxpayer's tax liability. Id. See O'Dwyer v. Commissioner, 266 F.2d 575, 580 (4th Cir. 1959), aff'g 28 T.C. 698 (1957); Clapp v. Commissioner, 875 F.2d 1396, 1403 (9th Cir. 1989); Raheja v. Commissioner, 725 F.2d 64, 66 (7th Cir. 1984), aff'g T.C. Memo. 1981-690; Greenberg's Express, Inc. v. Commissioner, 62 T.C. 324, 327-28 (1974); Jones v. Commissioner, 97 T.C. 7, 18 (1991) ("a trial before this Court is a proceeding de novo; hence our determination of a taxpayer's liability must be based on the merits of the case and not on any previous record developed at the administrative level"); Ewing v. Commissioner, 122 T.C. 2 (Thornton, J., concurring) ("As a statute of general application, the APA does not supersede specific statutory provisions for judicial review.").

Petitioner moved to strike portions of respondent's response to petitioner's motion to dismiss. Those portions involved communications made between the two parties that respondent produced as proof that petitioner was aware of the basis underlying the deficiency adjustments. Both parties recognize the well-settled principle that this Court will not look behind a notice of deficiency to examine the evidence used. See Greenberg's Express v. Commissioner, 62 T.C. 324, 327 (1974). Petitioner argued that these documents are immaterial, irrelevant, and unauthenticated. However, these documents were not offered for the truth stated therein. Moreover, we find it noteworthy that petitioner referred to some of these

same communications in its motion to dismiss, but now asks this Court to prohibit respondent from also referring to them. Because we do not consider these documents for what they say, but rather for the fact that the parties were in communication regarding the deficiency in dispute, and both parties independently referred to the same documents, we will not order them stricken.

Respondent filed a motion for summary judgment. The party moving for summary judgment has the burden of showing the absence of a genuine issue of material fact. See Marshall v. Commissioner, 85 T.C. 267, 271 (1985). The nonmoving party is afforded the benefit of all reasonable doubt, and any inferences to be drawn from the facts must be viewed in the light most favorable to the nonmoving party. At this point, the parties have not had a chance to stipulate the facts under Rule 122. Therefore, we believe there remain genuine issues of material fact and a motion for summary judgment is premature.

Giving due consideration to the foregoing, it is hereby

ORDERED that petitioner's Motion to Dismiss, filed August 28, 2013, is denied. It is further

ORDERED that petitioner's Motion to Strike, filed November 8, 2013, is denied. It is further

ORDERED that respondent's motion for summary judgment, filed November 8, 2013, is denied without prejudice to the underlying legal argument. It is further

ORDERED that the parties shall attempt to fully stipulate the facts of this case and submit a status report on or before March 14, 2014.

(Signed) Joseph Robert Goeke
Judge

DATED: Washington, D.C.
December 27, 2013

UNITED STATES TAX COURT

QINETIQ U.S. HOLDINGS, INC. & SUBSIDIARIES, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 14122–13.

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Filed July 2, 2015.

T.C. Memo. 2015-123

MEMORANDUM OPINION

GOEKE, Judge: Respondent determined a deficiency in QinetiQ U.S. Holdings, Inc. & Subsidiaries' (petitioner) Federal income tax of $13,902,087 for the taxable year ended (TYE) March 31, 2009, due to a disallowance of a portion of petitioner's claimed deduction for salary and wage compensation pursuant to section 83.[1] The disallowance relates to class A and class B shares of stock issued by Dominion Technology Resources, Inc. (DTRI), to Thomas G. Hume and Julian Chin in 2002.[2] However, petitioner conceded that the

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the year at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure

[2] In addition to disallowing the $117,777,501 deduction petitioner claimed for salaries and wages under sec. 83, the notice of deficiency determined the following: (1) petitioner is not entitled to a deduction in regard to Apogen restricted stock; (2) the deduction petitioner claimed for amortization expenses is reduced by $111,498; (3) because of other adjustments in the

portion of the adjustment attributable to the class A shares of stock of DTRI subscribed to by Hume was not subject to a substantial risk of forfeiture within the meaning of section 1.83-3(c)(3), Income Tax Regs. Accordingly, petitioner disputes only the portion of the adjustment attributable to the class A and class B shares of stock of DTRI subscribed to by Chin in 2002 (Chin stock).[3]

The issue presented for our decision is whether petitioner is entitled to a deduction, pursuant to section 83, for salary and wage compensation paid in connection with the Chin stock for petitioner's TYE March 31, 2009. We hold that petitioner is not entitled to the deduction under section 83.[4]

Background

Petitioner timely filed a petition with this Court for redetermination of the deficiency for TYE March 31, 2009. The parties simultaneously filed a Joint Submission of Case Without Trial pursuant to Tax

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notice, the amount applied to M-3 under sec. 163(j) is recomputed; and (4) the amount petitioner can deduct under sec. 199 is increased by $2,007,202. Petitioner does not dispute the Apogen restricted stock adjustment or the amortization adjustment. However, petitioner disputes that it is not entitled to the sec. 163(j) applied M-3 adjustment and the sec. 199 adjustment. These issues are correlative and depend upon whether respondent's disallowance of petitioner's claimed sec. 83 deduction is sustained in part or in full. Therefore, these issues are not before this Court.

[3] Petitioner also filed protective claims to carry back a portion of net operating losses to Forms 1120, U.S. Corporation Income Tax Return, filed by DTRI for TYE December 31, 2007 and 2008. However, these claims are not before this Court.

[4] As a result of this holding, we do not address respondent's duty of consistency affirmative defense.

Court Rule 122. Certain facts in evidence have been stipulated and are so found. The parties' stipulations of facts and the accompanying exhibits are incorporated herein by this reference. When petitioner filed the petition, its principal place of business was in Reston, Virginia. Petitioner is engaged in the defense, aerospace, and security business.

I. Incorporation of DTRI

On March 13, 2002, Hume incorporated Thomas G. Hume, Inc. (TGH), under the laws of the Commonwealth of Virginia to provide Government contracting services. Hume and Karyn Hume, Hume's wife, served as the initial directors of TGH.

At the time of incorporation, TGH was authorized to issue 5,000 shares of common stock with a par value of 10 cents per share. Although authorized to do so, TGH did not issue certificates for shares of stock nor offer to sell or issue shares of stock at the time of its incorporation. On March 26, 2002, on Form 2553, Election by a Small Business Corporation, Hume elected for TGH to be treated as an S corporation under section 1362(a), indicating that he was the sole shareholder of TGH. The Internal Revenue Service approved the S corporation election on April 6, 2002.

In November 2002 Hume and Chin engaged in discussions regarding Chin's joining the business enterprise. The law firm that represented Hume sent him a memorandum on November 27, 2002, listing certain action items, including: amending the name of the corporation, amending the articles of incorporation, and authorizing new shares of stock. On December 6, 2002, Hume and Karyn Hume, as directors of TGH, filed articles of amendment with the Commonwealth of Virginia changing the name of TGH to DTRI. The

articles of amendment also authorized an increase in the common stock of DTRI from 5,000 to 20,000 shares and divided the shares into two classes: 15,000 shares of class A voting and 5,000 shares of class B nonvoting stock.[5] On December 7, 2002, Karyn Hume resigned from DTRI's board of directors, leaving Hume as the sole director. Hume was also employed as the president and chief executive officer of DTRI while Chin was employed as its executive vice president and chief operating officer.

On December 9, 2002, DTRI deposited $1,000 into a bank account at Cardinal Bank, N.A. Hume provided $450 as par value consideration for 4,500 shares of DTRI class A common voting stock. Chin provided $450 as par value consideration for 4,455 shares of DTRI class A common voting stock and 45 shares of DTRI class B common nonvoting stock.

II. Consents, Agreements, and Bylaws

A. December 12 Consent

On December 12, 2002, Hume, in his capacity as director of DTRI, executed a "Consent in Lieu of the Organizational Meeting of the Board of Directors of DTRI" (consent), which stated that the board wished to offer for sale and issue shares of class A and class B common stock of DTRI. Attached to the consent were copies of letters signed by Hume and Chin acknowledging that they were willing to subscribe to the number of shares of common stock for which they had paid on December 9, 2002, and representing that

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[5] The class A stock was subject to a 100-for-1 stock split effective January 15, 2004, and a 5-for-1 stock split effective December 22, 2005.

the stock was purchased for "investment and not for the purpose of distribution or resale." The consent authorized DTRI to enter into both an employment agreement and a shareholders agreement with each of Hume and Chin in the future. The consent also authorized DTRI to enter into an employment agreement and a restrictive stock agreement with each of Thomas E. Bove, Richard L. White, and Gordon G. Hastings at a later date. The consent did not specify a time for entering into either an employment agreement or a shareholders agreement. Nor did the consent contain any provisions regarding forfeiture of the previously issued stock in the event that either Hume or Chin failed to enter into either an employment agreement or a shareholders agreement.

B. Shareholders Agreement

Hume and Chin each entered into a shareholders agreement with DTRI on December 18, 2002. The shareholders agreement stated that "the Corporation has nine thousand (9,000) shares of common stock issued and outstanding." The shareholders agreement also stated that "Hume and Chin each own the number of shares of common stock of the Corporation, all stock being fully paid and non-assessable, as is set out beside their names". The shareholders agreement defined "stock" as "all of the interest of each of the Shareholders in all of the issued and outstanding common stock of the Corporation." The shareholders agreement contained provisions with respect to Hume's and Chin's ability to voluntarily transfer the class A and class B shares of stock either as gifts or for value with prior notice and consent of DTRI and the other shareholders.

The shareholders agreement stated that Hume and Chin

> believe that it is in their mutual best interest to make provisions for the future disposition of all of the shares of common stock of the Corporation to the end that continuity of harmonious management is assured, and a fair process is established by which said shares of common stock may be transferred, conveyed, assigned or sold.

Additionally, the shareholders agreement stated that "[t]he parties desire to limit the ownership of the Stock to Shareholders who are employees of the Corporation" and further stated that a shareholder who "terminates his employment with the Corporation with or without cause, or whose employment with the Corporation is terminated by the Corporation with or without cause, shall be deemed to have offered to sell all of his Stock to the Corporation for the Agreement price". The "Agreement price" to be paid to a deceased or terminating shareholder was set forth in the shareholders agreement as follows:

> 7.1 Voluntary Termination of Employment without Competition: In the event that a Shareholder voluntarily terminates his employment and does not engage in Competition, then the Agreement Price shall be determined by reducing the Agreement Value by five percent (5%) for every full year of service by the Terminating Shareholder as an employee of the Corporation less than twenty (20) years. For example, if the Terminating Shareholder voluntarily terminates his employment after

> seventeen full years of service and does not engage in Competition, the Agreement Price will be eighty five percent (85%) [100% minus 15%] of the Agreement Value.
>
> 7.2 Voluntary Termination of Employment with Competition; Termination of Employment With Cause By the Corporation: In the event that a Shareholder voluntarily terminates his employment and engages in Competition or is terminated by the Corporation for cause, the Agreement Price shall be (i) The Agreement Price calculated as set forth in paragraph 7.1; or (ii) twenty five percent (25%) of the Agreement Value, whichever is less.
>
> 7.3 Disability; Termination of Employment Without Cause By the Corporation: In the event of the Disability of a Shareholder or the termination of the employment of a Shareholder by the Corporation without cause, the Agreement price shall be one hundred percent (100%) the Agreement Value.

The shareholders agreement also required that any "change, alteration, or modification" be "in writing and signed by all of the parties hereto."

C. Employment Agreements and Stock Agreements

On December 18, 2002, Hume and Chin separately entered into employment agreements with DTRI. The employment agreements stated:

> This Agreement contains the entire understanding of the parties with respect to the subject matter hereof. All prior promises,

> understandings or agreements are merged herein. It may not be changed orally, but only by an agreement in writing, signed by the party against whom enforcement of any waiver, change, modification or discharge is sought.

The employment agreements did not contain a provision regarding the transfer of any stock to Hume or Chin in connection with their performance of services for DTRI or any other entity. Also on December 18, 2002, Hume and Chin executed the original stock certificates. The original stock certificates bore a legend that stated: "The sale and/or transfer of this stock is restricted in accordance with the provisions of a Shareholders Agreement dated effective the ___ day of _____, 2002, a copy of which is filed in the corporate book." DTRI did not enter into restrictive stock agreements with Hume or Chin relating to the ownership of the class A and class B shares of stock transferred on December 18, 2002.

Between December 2002 and January 2004, DTRI entered into employment agreements and restrictive stock agreements with White, Hastings, Bove, Edouard Granstedt, and Wesley E. McDonald, Jr. In consideration of the covenants and undertakings of the employees as stated in their respective employment agreements, and subject to their execution of restrictive stock agreements, DTRI granted shares of Class B common stock to each employee. Each employment agreement explicitly stated the number of shares of class B common stock granted to the employee in consideration of his employment. Each of the stock grants vested annually over five years beginning one year after the grant date. The restrictive stock agreements set forth various terms

and conditions relating to the ownership of stock, including: the requirement that shareholders give DTRI written notice of any intention to transfer the class B common stock for value; DTRI's rights of first refusal; and DTRI's right to repurchase stock at a predetermined purchase price upon the occurrence of certain triggering events.

Between December 2005 and December 2007, DTRI granted shares of restricted class B common stock to certain key employees at no cost to the employees. Each of the restricted stock grants vested annually over five years beginning one year after the grant date. The restricted stock was subject to restrictions imposed pursuant to a restrictive stock agreement between DTRI and the employee receiving the class B common stock. On December 31, 2007, DTRI granted each of Hume and Chin 275,000 shares of DTRI's class B common stock, subject to terms and restrictions set forth in restricted stock grants. Chin's restricted stock grant explicitly stated that "[t]he shares of Granted Stock acquired by you under this restricted stock grant will vest so long as you remain an employee of DTRI." Chin's restricted stock grant also included the following restrictions:

> (i) Prior to Vesting. Prior to the vesting of the Granted Stock * * * you will have no rights as a shareholder of DTRI. All shares of Granted Stock that have not yet vested shall be held by DTRI in the form of non-certificated shares until they are fully vested or, in the event that your employment terminates prior to vesting, such Granted Stock shall be cancelled on the books of DTRI.

> (ii) After Vesting. Subject to the provisions hereof and to the provisions of the Restrictive Stock Agreement, after vesting of the Granted Stock * * * you will have all of the rights of a stockholder of Class B stock with respect to all of the Granted Stock, including the right to receive a certificate reflecting your ownership of the shares and all dividends or other distributions with respect to such Granted Stock. In connection with the payment of such dividends or other distributions, DTRI will be entitled to deduct any taxes or other amounts required by any governmental authority to be withheld and paid over to such authority for your account. As soon as practicable after the vesting of the Granted Stock * * * DTRI will release the certificate(s) representing such Granted Stock to you subject to the terms of the Restrictive Stock Agreement.

D. Bylaws

The bylaws of DTRI provided that "certificates representing shares of the corporation shall be issued to every shareholder for the fully paid shares owned by him in such form as the Board of Directors shall determine." The bylaws also provided that "[t]he shareholders may restrict the transfer of stock between themselves through written agreement." Finally, the bylaws state that shareholders

> cannot dispose of their shares in the corporation otherwise than by gift, bequest, or intestacy or to a trust for the benefit of the shareholder, or spouse or lineal descendants, without first giving the corporation and all other shareholders

written notice of their intention to make such disposition, and further providing DTRI and its shareholders with a right of first refusal.

III. DTRI's Federal Tax Filings

DTRI filed Forms 1120S, U.S. Income Tax Return for an S Corporation, that allocated income and losses to Hume, Chin, and other shareholders according to DTRI stock ownership for TYE December 31, 2002 through 2006. DTRI also issued yearly Schedules K-1, Shareholder's Share of Income, Deductions, Credits, etc., that reported the distributable share of income and losses to DTRI shareholders, including Hume and Chin, according to their percentages of DTRI stock ownership for TYE December 31, 2002 through 2006.

Respondent did not assess Federal income tax against DTRI for TYE December 31, 2002 through 2006, because DTRI elected to be treated as a pass-through entity. However, respondent timely assessed Federal income tax against each of DTRI's shareholders individually, including Hume and Chin, for TYE December 31, 2002 through 2006. DTRI did not report the value of any portion of the stock at issue as wages for Federal employment tax purposes during TYE December 31, 2002 through 2007, and paid no employment taxes thereon.

IV. DTRI's Revocation of S Corporation Election

By letter dated December 8, 2006, DTRI revoked its S corporation election effective January 1, 2007. On or about March 14, 2008, DTRI filed its Form 1120 for TYE December 31, 2007. On June 19, 2008, DTRI filed with respondent a request for a private letter ruling, seeking relief from an inadvertent termination of its S corporation status under section 1362(f). On December

15, 2008, respondent issued a private letter ruling concluding that if the erroneous failure to treat the class B Restricted stock as outstanding stock of DTRI caused its S election to terminate, the termination was an inadvertent termination and DTRI would be treated as continuing to be an S corporation from March 13, 2002, through January 1, 2007.

V. 2008 Execution of the Agreement and Plan of Merger

By letter dated January 3, 2008, petitioner proposed to DTRI the terms of a nonbinding agreement for the sale of DTRI to petitioner for a purchase price in the range of $70 million to $80 million. Petitioner increased its proposal to a purchase price in the range of $85 million to $100 million, followed by an aggregate purchase price of $115 million. On August 4, 2008, petitioner, Project Black Acquisition Corp., DTRI, Hume, and Chin entered into a final agreement and plan of merger wherein petitioner paid $123 million as merger consideration. The merger transaction closed on October 17, 2008, with petitioner acquiring all of the outstanding shares of DTRI.

On September 3, 2008, Hume, in his capacity as both Director and shareholder of DTRI, Chin as shareholder, and Brian D. Hume as trustee for the Thomas G. Hume Irrevocable Trust as shareholder, executed a "Consent in Lieu of a Special Meeting of the Voting Shareholders of DTRI" (September 3 consent). The September 3 consent stated that certain shares of DTRI stock held by employees were subject to the shareholders agreement or restrictive stock agreements that provide for a redemption option or obligation with respect to such stock on the part of DTRI at a price that was less than the fair market

value of the stock in the event that the employee's employment with DTRI terminated in certain instances. The September 3 consent also stated that the redemption option or obligation constituted a substantial risk of forfeiture within the meaning of section 83.

On October 17, 2008, Hume, as director of DTRI, executed a "Consent in Lieu of a Special Meeting of the Board of Directors of DTRI" (first October 17 consent) that stated that DTRI had entered into an agreement and plan of merger with petitioner and Project Black Acquisition Corp. for the exchange of all issued and outstanding shares of class A and class B common stock of DTRI for cash. The first October 17 consent waived all of DTRI's rights with respect to the stock transfer restrictions effective immediately before the closing of the transaction.

Also on October 17, 2008, all of the shareholders of class A common stock of DTRI executed a "Consent in Lieu of the Organizational Meeting of the Board of Directors of DTRI" (second October 17 consent). The second October 17 consent authorized the waiver of the class A shareholders' rights with respect to the stock transfer restrictions effective immediately before the closing of the transaction.

A third "Consent in Lieu of the Organizational Meeting of the Board of Directors of DTRI" was executed on October 17, 2008 (third October 17 consent). The third October 17 consent stated that certain employees of DTRI had been granted class B restricted common stock that remained only partially vested. It further stated that those shares were to be vested immediately before the closing of the transaction.

VI. Hume's and Chin's Federal Tax Filings

Hume and Chin filed Federal income tax returns for TYE December 31, 2002 through 2006, reporting allocations and distributions of profits and losses. For TYE December 31, 2008, Hume and Chin reported as ordinary income on their Federal income tax returns their respective shares of the $117,777,501 of wage income at issue consistent with petitioner's reported wage and compensation deduction. By letter dated January 19, 2012, Hume and Chin filed protective refund claims for the 2008 taxable year as a result of respondent's proposed disallowance of petitioner's claimed salary and wage deduction at issue. The protective refund claims assert that the $117,777,501 received by Hume and Chin was long-term capital gain rather than ordinary income from wages. The protective refund claims, if allowed, would result in overpayments of Federal income tax for Hume and Chin of $11,011,381 and $11,259,241, respectively.

The parties stipulated the following:

> [i]f called to testify, Hume and Chin would testify that, during the period beginning in December 2002 until the merger of DTRI with petitioner in August 2008 ("the pre-merger period"), their ownership interests in the Class A and Class B stock of DTRI subscribed to in December 2002, is consistent with representations made by DTRI, Hume and Chin of outstanding ownership in such stock on all Federal tax filings made by DTRI, Hume and Chin during the pre-merger period.

Discussion

Petitioner claimed a salary and wage deduction of $117,777,501 under section 83 partly on the argument that the Chin stock was transferred to Chin in 2002 in connection with the performance of services and did not vest until petitioner's TYE March 31, 2009. Respondent challenged the deduction, arguing that the Chin stock was not transferred in connection with the performance of services under section 83 but rather was considered fully vested and outstanding capital stock of an S corporation immediately upon issuance in 2002. Additionally, respondent argued that treatment of the Chin stock as fully vested and outstanding capital stock of DTRI is consistent with seven years of multiple representations of outstanding stock ownership made by DTRI, Hume, and Chin for Federal tax and other corporate purposes. Therefore, the principal issue we must decide is whether section 83 applies to the Chin stock so as to entitle petitioner to the claimed deduction.

According to the general rule, petitioner bears the burden of proving, by a preponderance of the evidence, that respondent's determinations are incorrect. See Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933). Moreover, deductions are a matter of legislative grace, and petitioner bears the burden of proving entitlement to any claimed deductions. See Rule 142(a)(1); INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). We conclude on the basis of the record that petitioner has failed to carry this burden.

Section 83(a) governs the tax treatment of property transferred "in connection with the performance of services" and generally provides that the value of such property is taxable "in the first taxable year in which

the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture". "The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual." Sec. 83(c)(1). "The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture." Sec. 83(c)(2). Accordingly, section 83(h) allows a deduction under section 162 to the person for whom such services were performed in an amount equal to the amount included under section 83(a) in the gross income of the person who performed such services. The statute permits a taxpayer to defer recognition of any gain until his rights in the restricted property become "substantially vested". Sec. 1.83-1(a)(1), Income Tax Regs.; see Strom v. United States, 641 F.3d 1051, 1056 (9th Cir. 2011).

Therefore, in order for section 83 to apply in the manner that petitioner asserts, petitioner must show that: (1) the Chin stock was transferred in connection with the performance of services and (2) the Chin stock was subject to a substantial risk of forfeiture until October 17, 2008. Petitioner believes the stipulated facts and exhibits establish that DTRI issued the Chin stock to compel his continued employment with DTRI, and had that employment terminated, Chin would have been required to sell the Chin stock back to DTRI at a below-market rate. However, for the reasons stated below, we conclude that petitioner failed to meet either requirement of section 83 and, therefore, section 83 does not apply in this case.

A. Transferred in Connection With the Performance of Services

The determination of whether the Chin stock was transferred "in connection with the performance of services" is essentially a question of fact. Centel Commc'ns Co. v. Commissioner, 92 T.C. 612, 627 (1989) (citing Bagley v. Commissioner, 85 T.C. 663, 669, aff'd, 806 F.2d 169 (8th Cir. 1986)), aff'd, 920 F.2d 1335 (7th Cir. 1990). In order for section 83 to apply in this matter, it must be shown that the stock was transferred in connection with the performance of services by Chin. The following factors have been considered in such an analysis:

(1) whether the property right is granted at the time the employee or independent contractor signs his employment contract;

(2) whether the property restrictions are linked explicitly to the employee's or independent contractor's tenure with the employing company;

(3) whether the consideration furnished by the employee or independent contractor in exchange for the transferred property is services; and

(4) the employer's intent in transferring the property.

See Bagley v. Commissioner, 806 F.2d at 170-171; Alves v. Commissioner, 734 F.2d 478, 481-482 (9th Cir. 1984), aff'g 79 T.C. 864 (1982); Montelepre Systemed, Inc. v. Commissioner, T.C. Memo. 1991-46 (citing Centel Commc'ns Co. v. Commissioner, 92 T.C. 612, aff'd, 956 F.2d 496 (5th Cir. 1992).

Petitioner asserts that the Chin stock was transferred in connection with the performance of services because: (1) the Chin stock was granted when

Chin began his employment at DTRI; (2) the Chin stock was restricted in a manner that linked the stock to Chin's continued performance of services; (3) Chin's services served as the consideration for the stock; and (4) DTRI intended to limit the transfer of stock exclusively to employees as compensation for services.

The first and second factors appear to be met. It is evident that the Chin stock was transferred near the time when DTRI entered into the shareholders agreement and the employment agreement with Chin. The consent authorizing the issuance of the shares is dated December 12, 2002. The stock certificates, shareholders agreement, and employment agreements are all dated December 18, 2002. In consideration of the second factor, petitioner points to the shareholders agreement and argues that the Chin stock was restricted and conditioned on Chin's continued employment with DTRI. Petitioner also contends that if Chin's employment had ended, he would have been required to relinquish the shares of DTRI at a discounted price based on the duration of his employment at DTRI. It is evident that the shareholders agreement contains terms that protect against ownership by nonemployees of DTRI. However, the question of whether those terms provide a substantial risk of forfeiture in regard to the Chin stock remains, as discussed infra part B.

Whether petitioner has met the third factor is less evident. Petitioner argues that Chin's services served as the consideration furnished in exchange for the Chin stock. Petitioner believes that the $450 that Chin deposited into the bank account was a nominal amount that would correspond to the par value of the shares subsequently issued and was less than the intrinsic

value of the services that he had devoted to the enterprise by that time. However, petitioner did not provide evidence to support this contention. Petitioner has failed to show that Chin's $450 deposit should not be considered an entrepreneurial investment, thereby representing the true consideration for the issuance of the Chin stock.

Whether petitioner has met the fourth factor is also less evident. Petitioner had no ownership interest in DTRI until October 2008 and was not a party to either the shareholders agreement or the employment agreements upon which it relies to establish intent. Neither was petitioner a party to discussions between DTRI, Hume, and Chin in 2002 in connection with the organization of DTRI and the issuance of DTRI's capital stock. Therefore, petitioner cannot speak with certainty to DTRI's intent.

However, Hume and Chin were parties to both the shareholders agreement and the employment agreements. Both Hume and Chin participated in discussions regarding the issuance of DTRI's capital stock and had personal knowledge regarding the transfer of the Chin stock. Hume, as director of DTRI, executed the consent and participated in discussions regarding both the organization of DTRI and the issuance of DTRI's capital stock. From 2002 through 2008, DTRI, Hume, and Chin made representations that Chin had outright unrestricted ownership of the Chin stock.

From 2002 through 2006 DTRI also distributed income and losses to Chin as if he was the owner of the Chin stock as fully vested and outstanding stock. Chin, in turn, received his share of the profits of DTRI and reported those distributions on his individual income

tax returns. DTRI, Hume, and Chin also consistently treated the Chin stock as outstanding stock of DTRI for corporate purposes as evidenced by the DTRI bylaws and other corporate documents.

Article 2 of DTRI's bylaws (Capital Stock) provides:

> The authorized number of shares, the classes, and the par value of stock of the corporation shall be established by the Articles of Incorporation and amendments thereto; that each outstanding share having voting rights shall be entitled to one vote on each matter submitted to a vote at the meeting of the shareholders; and that certificates representing shares of the corporation shall be issued to every shareholder for the fully paid shares owned by him in such form as the Board of Directors shall determine.

Additionally, Chin voted and signed corporate documents as an outstanding owner of class A stock in DTRI from 2002 through 2008.

In all other situations where DTRI transferred stock to employees in connection with the performance of services, the restrictive stock agreements specifically state that the stock grants were made "in consideration of the employment." The respective employment agreements also explicitly tie the stock grants to the performance of services. In contrast, neither the shareholders agreement nor Chin's employment agreement explicitly ties the granting of the Chin stock to the performance of services.

We acknowledge there are cases suggesting that a broad reading of the applicability of section 83 is

appropriate. See, e.g., Alves v. Commissioner, 79 T.C. at 876 ("Congress * * * has clearly expressed the intention that section 83 is to have the broadest application"); *Montelepre Systemed, Inc. v. Commissioner*, T.C. Memo. 1991-46, 1991 Tax Ct. Memo LEXIS 65, at *19 ("[T]he statute only envisions some sort of relationship between the services performed and the property transferred."). However, on the facts and circumstances of this case, we conclude that petitioner has failed to prove the Chin stock was transferred in connection with the performance of services pursuant to section 83. Nonetheless, in this matter we believe the crux of our section 83 analysis is whether the Chin stock was subject to a substantial risk of forfeiture.

B. Substantial Risk of Forfeiture

Petitioner contends that the initial issuance of the Chin stock was subject to a substantial risk of forfeiture under section 83 and, therefore, deductible as compensation under section 162. Shares of stock are subject to a substantial risk of forfeiture when the owner's rights to their full enjoyment are conditioned upon the future performance of substantial services by any individual. See sec. 1.83-3(c)(1), Income Tax Regs.; see also Facq v. Commissioner, T.C. Memo. 2006-111. Whether a risk of forfeiture is substantial depends on the facts and circumstances. Sec. 1.83-3(c)(1), Income Tax Regs. Property is not transferred subject to a substantial risk of forfeiture if at the time of transfer the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced. Id.

Section 1.83-3(c)(3), Income Tax Regs., governs enforcement of forfeiture provisions and provides five factors to consider "[i]n determining whether the

possibility of forfeiture is substantial in the case of rights in property transferred to an employee of a corporation who owns a significant amount of the total combined voting power or value of all classes of stock of the employer corporation." Those factors are: (i) the employee's relationship to other stockholders and the extent of their control, potential control and possible loss of control of the corporation; (ii) the employee's position in the corporation and the extent to which he is subordinate to other employees; (iii) the employee's relationship to the officers and directors of the corporation; (iv) the person who must approve the employee's discharge; and (v) the employer's prior actions in enforcing the provisions of the restrictions. Id.

Petitioner contends that the first three factors leave little doubt that Chin did not have sufficient control over DTRI to modify, cancel, or waive the restrictions on the Chin stock. Petitioner argues that the Chin stock was subject to a substantial risk of forfeiture because the shareholders agreement contains provisions that: (1) could not be waived unilaterally by Chin; (2) require Chin to sell his stock back to DTRI at a price below fair market value if he terminated employment within 20 years of execution of the shareholders agreement; and (3) preclude Chin from transferring or selling his stock without first offering it to DTRI. Petitioner contends that Chin was subordinate to Hume because Hume owned 50.25% of the voting shares and served as DTRI's president, CEO, and sole director. Petitioner argues that Chin's risk of forfeiture is governed by the first example in section 1.83-3(c)(3), Income Tax Regs., which establishes that if a majority of a corporation's voting

stock "is owned by an unrelated individual * * * so that the possibility of the corporation enforcing a restriction on * * * [another shareholder's property] rights is substantial, then such rights are subject to a substantial risk of forfeiture."

Alternatively, respondent argues that the shareholders agreement does not contain substantial risk of forfeiture provisions for purposes of section 83. Respondent contends that the record contains no evidence that: (1) DTRI transferred class A common voting stock to any other employees in connection with the performance of services; (2) any class A common voting stock was subject to a substantial risk of forfeiture; and (3) any restrictions on class A stock were ever actually enforced. Respondent argues that the shareholders agreement provides an agreed-upon price for the repurchase by DTRI of the capital stock owned by Hume and Chin based upon a formula contingent upon years of service. Respondent further argues that because Chin was the executive vice president, COO, and a 49.75% shareholder in voting stock of DTRI, it is unlikely Hume would have taken any actions to terminate Chin's employment. Finally, respondent states that petitioner failed to demonstrate the existence of any enforcement history by DTRI of restrictions in connection with class A common voting stock. Respondent contends that the stipulation of facts contains information regarding the enforcement of forfeiture provisions only with respect to employees owning small percentages of DTRI class B common nonvoting stock.

We believe that petitioner failed to show that the Chin stock was subject to a substantial risk of forfeiture. The facts and circumstances support this

position. Hume and Chin had a very close work relationship. They were DTRI's initial investors, and together they built the company from its early stages of incorporation. Along with Hume, Chin voted on all company matters and helped determine the company's overall direction. Since Chin held such a vital role within DTRI as the executive vice president, COO, and a 49.75% shareholder in voting stock, it is unlikely that Hume would have taken any actions to terminate his employment.

Additionally, the parties stipulated the following:

> If called to testify, Hume and Chin would testify that, during the period beginning in December 2002 until the merger of DTRI with petitioner in August 2008 ("the pre-merger period"), their ownership interests in the Class A and Class B stock of DTRI subscribed to in December 2002, is consistent with representations made by DTRI, Hume and Chin of outstanding ownership in such stock on all Federal tax filings made by DTRI, Hume and Chin during the pre-merger period.

Petitioner argues that the stipulation regarding Hume's and Chin's testimony caused respondent to confuse legal ownership of outstanding shares with tax ownership under section 83. Petitioner contends that the dispute involves whether the legally owned shares were subject to restrictions that make clear they were issued in connection with the performance of services and subject to a substantial risk of forfeiture. Petitioner believes that the stipulation does not negate the manner in which Hume, Chin, and DTRI structured and documented their interactions. Petitioner submits that the DTRI documents are

controlling and establish its entitlement to the section 83 deduction. However, respondent contends that the stipulation directly contradicts petitioner's interpretation of the agreements and the basis for the claimed deduction. We agree. In addition to Hume, Chin, and DTRI's representation and treatment of the Chin stock as outstanding stock, we believe that Hume's and Chin's statement establish that the intent of the parties in 2002 was to transfer the Chin stock as fully vested and outstanding stock in DTRI.

Chin's actions make it evident that the risk of forfeiture was not significant. Chin treated the Chin stock as if he had full ownership rights and control from the initial issuance in 2002. The Chin stock was issued subject to the shareholders agreement. From 2002 through 2006 Chin reported all allocations and distributions of profits and losses arising from his ownership of the Chin stock on his Federal income tax returns. In contrast, the subsequent issuances of class B common nonvoting stock were issued subject to restricted stock grants. These grants explicitly provide guidelines for the treatment of such stock both before and after vesting. Chin's restricted stock grant on the class B common nonvoting stock issued on December 31, 2007, specifies that

> [p]rior to vesting of the Granted Stock * * * you will have no rights as a shareholder of DTRI. All shares of Granted Stock that have not yet vested shall be held by DTRI in the form of non-certificated shares until they are fully vested or, in the event that your employment terminates prior to vesting, such Granted Stock shall be cancelled on the books of DTRI.

Petitioner failed to provide any evidence of the method of recourse intended to recover any nonvested Chin stock in the event that Chin violated the terms of the shareholders agreement. Moreover, petitioner failed to demonstrate that DTRI had ever enforced any restrictions in connection with class A common voting stock.

This Court has previously determined that "[t]he regulations make clear that an earnout restriction creates 'a substantial risk of forfeiture' if there is a sufficient likelihood that the restriction will actually be enforced." Austin v. Commissioner, 141 T.C. 551, 568 (2013) (quoting section 1.83-3(c)(4) and (3), Income Tax Regs.). Petitioner has failed to show proof of the likelihood of enforcement of the forfeiture provisions on the Chin stock. Therefore, we conclude that petitioner has failed to carry its burden of proof with respect to this issue. Accordingly, we hold that the Chin stock was not subject to a substantial risk of forfeiture under section 83. Consequently, petitioner is not entitled to a deduction, pursuant to section 83, for salary and wage compensation with regard to the Chin stock.

In reaching our holding herein, we have considered all arguments the parties made, and to the extent we did not mention them above, we conclude they are moot, irrelevant, or without merit.

To reflect the foregoing,

Decision will be entered for respondent.

FILED: March 7, 2017

UNITED STATES COURT OF APPEAL FOR THE FEDERAL CIRCUIT

No. 15-2192
(14122-13)

QINETIQ US HOLDINGS, INC. & SUBSIDIARIES

Petitioner - Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent - Appellee

ORDER

The court denies the petition for rehearing and rehearing en banc. No judge requested a poll under Fed. R. App. P. 35 on the petition for rehearing en banc.

Entered at the direction of the panel: Judge King, Judge Keenan, and Judge Diaz.

For the Court

/s/ Patricia S. Connor, Clerk

5 U.S.C. § 551

§ 551. Definitions

For the purpose of this subchapter—

(1) "agency" means each authority of the Government of the United States, whether or not it is within or subject to review by another agency, but does not include—

(A) the Congress;

(B) the courts of the United States;

(C) the governments of the territories or possessions of the United States;

(D) the government of the District of Columbia;

or except as to the requirements of section 552 of this title—

(E) agencies composed of representatives of the parties or of representatives of organizations of the parties to the disputes determined by them;

(F) courts martial and military commissions;

(G) military authority exercised in the field in time of war or in occupied territory; or

(H) functions conferred by sections 1738, 1739, 1743, and 1744 of title 12; subchapter II of chapter 471 of title 49; or sections 1884, 1891-1902, and former section 1641(b)(2), of title 50, appendix;

* * *

(6) "order" means the whole or a part of a final disposition, whether affirmative, negative, injunctive, or declaratory in form, of an agency in a matter other than rule making but including licensing;

* * *

(13) "agency action" includes the whole or a part of an agency rule, order, license, sanction, relief, or the equivalent or denial thereof, or failure to act . . .

* * *

5 U.S.C. § 703

§ 703. Form and venue of proceeding

The form of proceeding for judicial review is the special statutory review proceeding relevant to the subject matter in a court specified by statute or, in the absence or inadequacy thereof, any applicable form of legal action, including actions for declaratory judgments or writs of prohibitory or mandatory injunction or habeas corpus, in a court of competent jurisdiction. If no special statutory review proceeding is applicable, the action for judicial review may be brought against the United States, the agency by its official title, or the appropriate officer. Except to the extent that prior, adequate, and exclusive opportunity for judicial review is provided by law, agency action is subject to judicial review in civil or criminal proceedings for judicial enforcement.

5 U.S.C. § 706

§ 706. Scope of review

To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall—

(1) compel agency action unlawfully withheld or unreasonably delayed; and

(2) hold unlawful and set aside agency action, findings, and conclusions found to be—

(A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;

(B) contrary to constitutional right, power, privilege, or immunity;

(C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right;

(D) without observance of procedure required by law;

(E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or

(F) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.

In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error.

26 U.S.C. § 83

§ 83. Property transferred in connection with performance of services

(a) General rule

If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

* * *

(c) Special rules

For purposes of this section—

(1) Substantial risk of forfeiture

The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

(2) Transferability of property

The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture.

* * *

(h) Deduction by employer

In the case of a transfer of property to which this section applies or a cancellation of a restriction described in subsection (d), there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.

26 U.S.C. § 6212

§ 6212. Notice of deficiency

(a) In general

If the Secretary determines that there is a deficiency in respect of any tax imposed by subtitles A or B or chapter 41, 42, 43, or 44 he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail. Such notice shall include a notice to the taxpayer of the taxpayer's right to contact a local office of the taxpayer advocate and the location and phone number of the appropriate office.

* * *

(c) Further deficiency letters restricted

(1) General rule

If the Secretary has mailed to the taxpayer a notice of deficiency as provided in subsection (a), and the taxpayer files a petition with the Tax Court within the time prescribed in section 6213(a), the Secretary shall have no right to determine any additional deficiency of income tax for the same taxable year, of gift tax for the same calendar year, of estate tax in respect of the taxable estate of the same decedent, of chapter 41 tax for the same taxable year, of chapter 43 tax for the same taxable year, of chapter 44 tax for the same taxable year, of section 4940 tax for the same taxable year, or of chapter 42 tax, (other than under section 4940) with respect to any act (or failure to act) to which such petition relates, except in the case of fraud, and except as provided in section 6214(a) (relating to assertion of

greater deficiencies before the Tax Court), in section 6213(b)(1) (relating to mathematical or clerical errors), in section 6851 or 6852 (relating to termination assessments), or in section 6861(c) (relating to the making of jeopardy assessments).

* * *

26 U.S.C. § 6213

§ 6213. Restrictions applicable to deficiencies; petition to Tax Court

(a) Time for filing petition and restriction on assessment

Within 90 days, or 150 days if the notice is addressed to a person outside the United States, after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. Except as otherwise provided in section 6851, 6852 or 6861 no assessment of a deficiency in respect of any tax imposed by subtitle A, or B, chapter 41, 42, 43, or 44 and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day period, as the case may be, nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final. Notwithstanding the provisions of section 7421(a), the making of such assessment or the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court, including the Tax Court, and a refund may be ordered by such court of any amount collected within the period during which the Secretary is prohibited from collecting by levy or through a proceeding in court under the provisions of this subsection. The Tax Court shall have no jurisdiction to enjoin any action or proceeding or order any refund under this subsection unless a timely

petition for a redetermination of the deficiency has been filed and then only in respect of the deficiency that is the subject of such petition. Any petition filed with the Tax Court on or before the last date specified for filing such petition by the Secretary in the notice of deficiency shall be treated as timely filed.

* * *

(c) Failure to file petition

If the taxpayer does not file a petition with the Tax Court within the time prescribed in subsection (a), the deficiency, notice of which has been mailed to the taxpayer, shall be assessed, and shall be paid upon notice and demand from the Secretary.

* * *

26 U.S.C. § 6214

§ 6214. Determinations by Tax Court

(a) Jurisdiction as to increase of deficiency, additional amounts, or additions to the tax

Except as provided by section 7463, the Tax Court shall have jurisdiction to redetermine the correct amount of the deficiency even if the amount so redetermined is greater than the amount of the deficiency, notice of which has been mailed to the taxpayer, and to determine whether any additional amount, or any addition to the tax should be assessed, if claim therefor is asserted by the Secretary at or before the hearing or a rehearing.

* * *