

## MOST LITIGATED ISSUES: Introduction

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify in her Annual Report to Congress the ten tax issues most litigated in federal courts (Most Litigated Issues).<sup>1</sup> The National Taxpayer Advocate may analyze these issues to develop legislative recommendations to mitigate the disputes resulting in litigation.

TAS identified the Most Litigated Issues from June 1, 2017, through May 31, 2018, by using commercial legal research databases. For purposes of this section of the Annual Report, the term “litigated” means cases in which the court issued an opinion.<sup>2</sup> This year’s Most Litigated Issues are, in order from most to least cases:

- Accuracy-Related Penalty (IRC §§ 6662(b)(1) and (2));<sup>3</sup>
- Trade or Business Expenses (IRC § 162(a) and related Code sections);
- Summons Enforcement (IRC §§ 7602(a), 7604(a), and 7609(a));
- Gross Income (IRC § 61 and related Code sections);
- Collection Due Process (CDP) hearings (IRC §§ 6320 and 6330);
- Failure to File Penalty (IRC § 6651(a)(1)), Failure to Pay Penalty (IRC § 6651(a)(2)), and Failure to Pay Estimated Tax Penalty (IRC § 6654);
- Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax (IRC § 7403);
- Charitable Contribution Deductions (IRC § 170);
- Schedule A Deductions Under IRC §§ 211-224; and
- Frivolous issues penalty (IRC § 6673 and related appellate-level sanctions).

Two topics, Schedule A deductions and the frivolous issues penalty were not identified as Most Litigated Issues last year. These issues replaced the family status issues and relief from joint and several liability as Most Litigated Issues.<sup>4</sup> Frivolous issues last appeared in the Most Litigated Issues section in 2016<sup>5</sup> while itemized deductions reported on Schedule A of IRS Form 1040 did not appear in the National Taxpayer Advocate’s Annual Report to Congress since 2002.<sup>6</sup> Accuracy-related penalties remained the top litigated issue this year, and we identified 120 cases, 18 less than the 138 cases we identified last year

1 Federal tax cases are tried in the United States Tax Court, United States District Courts, the United States Court of Federal Claims, United States Bankruptcy Courts, United States Courts of Appeals, and the United States Supreme Court.

2 Many cases are resolved before the court issues an opinion. Some taxpayers reach a settlement with the IRS before trial, while the courts dismiss other taxpayers’ cases for a variety of reasons, including lack of jurisdiction and lack of prosecution. Courts can issue less formal “bench opinions,” which are not published or precedential.

3 Internal Revenue Code (IRC) § 6662 also includes (b)(3), (b)(4), (5), (6), (7), and (8), but because those types of accuracy-related penalties were not heavily litigated, we have only analyzed (b)(1), and (2).

4 See National Taxpayer Advocate 2017 Annual Report to Congress 345.

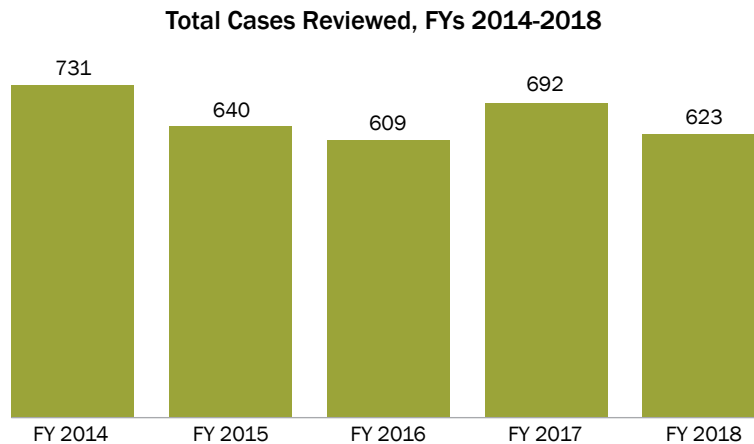
5 *Id.* at 410.

6 See National Taxpayer Advocate 2002 Annual Report to Congress 344-349. The Tax Cuts and Jobs Act (TCJA) suspended the overall limit on itemized deductions based on Adjusted Gross Income (AGI) for tax years 2018 through 2025. See Pub. L. No. 115-97, § 11046, 131 Stat. 2054, 2088 (2017). It remains to be seen how litigation in this area will change in the coming years due to the changes to itemized deductions under the TCJA.

(a 13 percent decrease).<sup>7</sup> Most case categories decreased in number of cases litigated this year except for trade or business expenses, which experienced an increase of seven percent.<sup>8</sup>

Overall, the total number of cases identified in the Most Litigated Issues section decreased from 692 in 2017 to 623 this year, a 10 percent decrease from last year.<sup>9</sup>

**FIGURE 3.0.1**



We also noticed a slight dip from last year in the percentage of cases involving *pro se* taxpayers who prevailed, as 13 percent of *pro se* taxpayers prevailed as compared to 15 percent in 2017.<sup>10</sup>

<sup>7</sup> See National Taxpayer Advocate 2017 Annual Report to Congress 348.

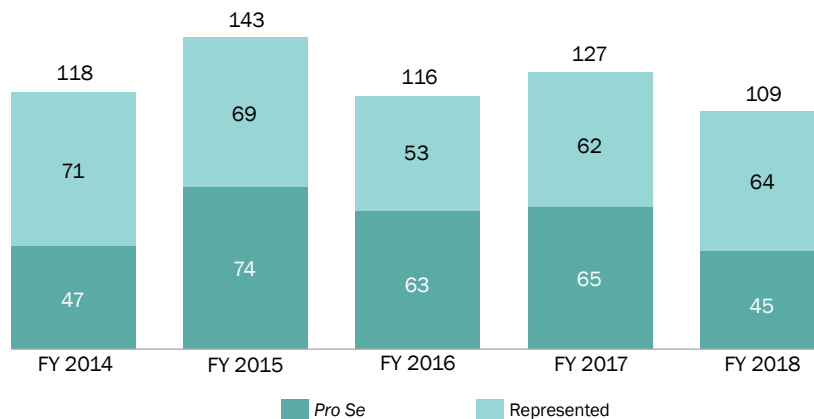
<sup>8</sup> *Id.*

<sup>9</sup> See National Taxpayer Advocate 2017 Annual Report to Congress 348. This decline may be attributed to the general decline in tax litigation in recent years. See, e.g., David McAfee, Tax Court: *Tax Court Caseload Drops as Enforcement Lags: Former Chief Judge 142 DTR 8* (Jul. 24, 2018) (former Chief Judge L. Paige Marvel noted that the Tax Court's inventory is dropping, due in part to lax enforcement).

<sup>10</sup> See National Taxpayer Advocate 2017 Annual Report to Congress 349.

**FIGURE 3.0.2**

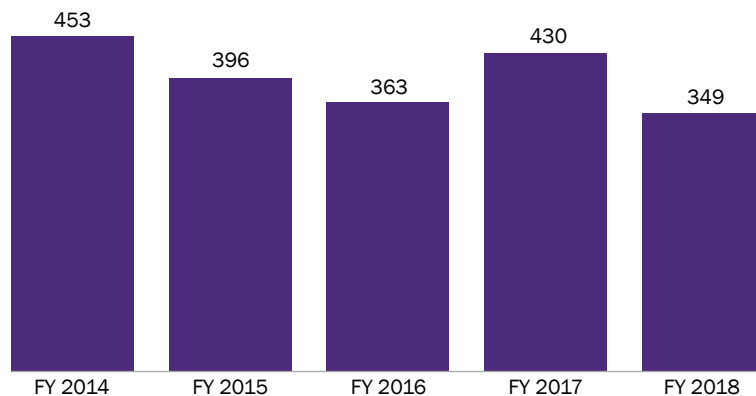
**Taxpayers Prevailing in Full or Part, FYs 2014-2018**



Overall, the percentage of *pro se* litigation decreased from 62 percent of cases to 56 percent.

**FIGURE 3.0.3**

**Pro Se Litigants, FYs 2014-2018**



Once TAS identified the Most Litigated Issues, we analyzed each one in five sections: summary of findings, taxpayer rights impacted, description of present law, analysis of the litigated cases, and conclusion.<sup>11</sup> Each case is listed in Appendix 3, which categorizes the cases by type of taxpayer (*i.e.*, individual or business).<sup>12</sup> Appendix 3 also provides the citation for each case, indicates whether the

11 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).

12 Individuals filing Schedules C, E, or F are deemed business taxpayers for purposes of this discussion even if items reported on such schedules were not the subject of litigation.

taxpayer was represented at trial or argued the case *pro se* (*i.e.*, without representation), and lists the court's decision.<sup>13</sup>

We have also included a “Significant Cases” section summarizing decisions that are not among the top ten issues but are relevant to tax administration. In this section, we used the same reporting period, beginning on June 1, 2017, and ending on May 31, 2018, that we used for the ten Most Litigated Issues.

For the second year, we reviewed Tax Court summary judgments and bench orders, which are unpublished, which we discuss separately below, but did not include in the final counts for the Most Litigated Issues.<sup>14</sup> Unpublished litigation from the Tax Court has become available to the public in recent years through the court's website, but remains unavailable through electronic legal commercial databases.

## AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

Taxpayers can generally litigate a tax matter in four different types of courts:

- The United States Tax Court;
- United States District Courts;
- The United States Court of Federal Claims; and
- United States Bankruptcy Courts.

With limited exceptions, taxpayers have an automatic right of appeal from the decisions of any of these courts.<sup>15</sup>

The Tax Court is a “prepayment” forum. In other words, taxpayers can access the Tax Court without having to pay the disputed tax in advance. The Tax Court has jurisdiction over a variety of issues, including deficiencies, certain declaratory judgment actions, appeals from CDP hearings, relief from joint and several liability, and determination of employment status.<sup>16</sup>

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13 “*Pro se*” means “for oneself; on one’s own behalf; without a lawyer.” BLACK’S LAW DICTIONARY (10th ed. 2014). For purposes of this analysis, we considered the court’s decision with respect to the issue analyzed only. A “split” decision is defined as a partial allowance on the specific issue analyzed. The citations also indicate whether decisions were on appeal at the time this report went to print.

14 In prior years our review of litigation in federal courts was generally limited to discussing Tax Court opinions published in commercial databases. Each division or memorandum opinion goes through a legislatively mandated pre-issuance review by the Chief Judge. IRC §§ 7459(b); 7460(a). While division opinions are precedential, orders are not, being issued “in the exercise of discretion” by a single judge. See § 7463(b); Rule 50(f), Tax Court Rules of Practice and Procedure (denying precedential status to orders) and § 152(c) (denying precedential status to bench opinions).

15 See IRC § 7482, which provides that the United States Courts of Appeals (other than the United States Court of Appeals for the Federal Circuit) have jurisdiction to review the decisions of the Tax Court. There are exceptions to this general rule. For example, IRC § 7463 provides special procedures for small Tax Court cases (where the amount of deficiency or claimed overpayment totals \$50,000 or less) for which appellate review is not available. See also 28 U.S.C. § 1294 (appeals from a United States District Court are to the appropriate United States Court of Appeals); 28 U.S.C. § 1295 (appeals from the United States Court of Federal Claims are heard in the United States Court of Appeals for the Federal Circuit); 28 U.S.C. § 1254 (appeals from the United States Courts of Appeals may be reviewed by the United States Supreme Court).

16 IRC §§ 6214; 7476-7479; 6330(d); 6015(e); 7436.

The United States District Courts and the United States Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in full<sup>17</sup> and (2) the taxpayer has filed an administrative claim for refund.<sup>18</sup> The United States District Courts, along with the bankruptcy courts in very limited circumstances, provide the only fora in which a taxpayer can receive a jury trial.<sup>19</sup> Bankruptcy courts can adjudicate tax matters that were not adjudicated prior to the initiation of a bankruptcy case.<sup>20</sup>

### ANALYSIS OF PRO SE LITIGATION

As in previous years, many taxpayers appeared before the courts *pro se*. Figure 3.0.4 lists the Most Litigated Issues for the review period June 1, 2017, through May 31, 2018, and identifies the number of cases, categorized by issue, in which taxpayers appeared without representation. As the figure illustrates, the issues with the highest rates of *pro se* appearance are frivolous issues and civil actions to enforce tax liens or subject property to tax.

**FIGURE 3.0.4, Pro Se Cases by Issue**

Most Litigated Issue	Litigated Cases Reviewed	Pro Se Litigation	Percentage of Pro Se Cases
Accuracy-Related Penalty	120	60	50%
Trade or Business Expenses	106	60	57%
Summons Enforcement	85	51	60%
Gross Income	79	42	53%
Collection Due Process	74	46	62%
Failure to File, Failure to Pay, and Estimated Tax Penalties	47	19	40%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	39	26	67%
Charitable Deductions	29	10	34%
Schedule A Deductions	23	15	65%
Frivolous Issues	21	20	95%
<b>Total</b>	<b>623</b>	<b>349</b>	<b>56%</b>

Figure 3.0.5 affirms our contention that taxpayers are more likely to prevail if they are represented. *Pro se* taxpayers prevailed in 13 percent of cases this year as compared to 15 percent last year. Thus, for this year, the success rate for represented taxpayers was ten percentage points greater than that of *pro se* taxpayers.

17 28 U.S.C. § 1346(a)(1). See *Flora v. United States*, 362 U.S. 145 (1960), *reh'g denied*, 362 U.S. 972 (1960). For the National Taxpayer Advocate's Legislative Recommendation regarding the *Flora* rule, see Legislative Recommendation: *Fix the Flora Rule: Give Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can*, *supra*.

18 IRC § 7422(a).

19 The bankruptcy court may only conduct a jury trial if the right to a trial by jury applies, all parties expressly consent, and the district court specifically designates the bankruptcy judge to exercise such jurisdiction. 28 U.S.C. § 157(e).

20 See 11 U.S.C. §§ 505(a)(1) and (a)(2)(A).

FIGURE 3.0.5, Outcomes for Pro Se and Represented Taxpayers

Most Litigated Issue	Pro Se Taxpayers			Represented Taxpayers		
	Total Cases	Taxpayer Prevailed In Whole or In Part	Percent	Total Cases	Taxpayer Prevailed In Whole or In Part	Percent
Accuracy-Related Penalty	60	13	22%	60	21	35%
Trade or Business Expenses	60	10	17%	46	15	33%
Summons Enforcement	51	0	0%	34	7	21%
Gross Income	42	7	17%	37	9	24%
Collection Due Process	46	4	9%	28	5	18%
Failure to File, Failure to Pay, and Estimated Tax Penalties	19	2	11%	28	4	14%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	26	0	0%	13	2	15%
Charitable Deductions	10	0	0%	19	5	26%
Schedule A Deductions	15	6	40%	8	1	13%
Frivolous Issues	20	3	15%	1	0	0%
<b>Total</b>	<b>349</b>	<b>45</b>	<b>13%</b>	<b>274</b>	<b>69</b>	<b>25%</b>

## ANALYSIS OF UNPUBLISHED OPINIONS

We identified 107 bench orders and 203 summary judgments<sup>21</sup> by searching the Tax Court orders on its website.<sup>22</sup> We listed the selected cases in Appendix 3. We selected cases in which either a decision was entered on the merits of a substantive issue, or there was a substantive discussion of a distinct tax law matter.<sup>23</sup> The most prevalent issues discussed in the bench opinions reviewed (which also appear in this year's Most Litigated Issues) were accuracy-related penalty (43 cases or about 40 percent), trade or business expenses (39 cases or about 36 percent), and gross income (22 cases or 21 percent).<sup>24</sup>

Eighty-two percent of the 1,120 summary judgment orders we reviewed were procedural and did not discuss a substantive tax law issue, leaving 203 substantive decisions. In contrast to bench opinions, CDP matters dominated this category of unpublished litigation, with 81 percent (165 cases) of the

21 Unlike bench orders, summary judgments are decisions without trial. U.S. Tax Court Rules of Practice and Procedure, Title XII. Denying summary judgment in full or in part leaves issues in play for litigation and is not a final disposition on the merits of the litigated issue, which is a prerequisite for including a case in the counts for the Most Litigated Issues.

22 We utilized the orders search tab applying the reporting period date restriction and key search phrases: "summary judgment" and "7459(b)." We did not analyze summary judgments and bench orders in other federal courts. See Public Access to Court Electronic Records (PACER) User Manual for ECF Courts, Sept. 2014, <https://www.pacer.gov/documents/pacermanual.pdf> (explaining PACER search functions). We limited our search to the Tax Court as most tax litigation occurs in Tax Court.

23 Under Rule 121(d), if the adverse party does not respond to the motion for summary judgment, then the Tax Court may enter a decision against that party, when appropriate, and in light of the evidence contained within the administrative record. See Rule 121(d), Tax Court Rules of Practice and Procedure. We included summary judgments entered upon default in situations where the order discussed the merits.

24 Cases often discuss more than one substantive issue and as a result these reported percentages do not total 100. In 2017, the same issues were in the top three, with different frequency. Gross income was the most frequent, followed by trade and business expenses, then the accuracy related penalty. National Taxpayer Advocate 2017 Annual Report to Congress 349.

substantive, non-procedural summary judgments. The next largest category consisted of gross income issues which made up about six percent (13 cases).

Overall the IRS prevailed in 91 percent of motions for summary judgment in the substantive, non-procedural cases (184 cases) and in about 68 percent of bench opinions (73 cases). Split decisions resulted in four percent (nine of 203) of summary judgment orders and in 21 percent (22 of 107) of bench opinions. Overall, 85 percent (262 cases) of taxpayers appeared pro se in the unpublished opinions reviewed.<sup>25</sup>

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<sup>25</sup> See Appendix 3, *infra*.

## Significant Cases

This section describes cases that generally do not involve any of the ten most litigated issues, but nonetheless highlight important issues relevant to tax administration.<sup>1</sup> These decisions are summarized below.

**In *Larson v. United States*, the U.S. Court of Appeals for the Second Circuit held that it lacked jurisdiction to review assessable penalties under 28 U.S.C. § 1346(a) because the taxpayer had not fully paid them, as required under the *Flora* rule, and also lacked jurisdiction under the Administrative Procedure Act (APA).<sup>2</sup>**

Following Mr. Larson’s conviction for promoting tax shelters, the IRS proposed over \$160 million in civil penalties under IRC § 6707 for failure to timely register the shelters. The IRS’s Appeals function reduced the penalty by the amounts paid by alleged co-promoters who were jointly and severally liable, leaving an assessment of over \$65 million. Mr. Larson could not pay the full assessment, so he only paid about \$1.4 million. He then filed a refund claim, which the IRS rejected.

Mr. Larson petitioned the U.S. District Court for the Southern District of New York. The court granted the IRS’s motion to dismiss because Mr. Larson had not fully paid the assessment, as required by the *Flora* rule (also called the “full payment” rule).<sup>3</sup> In 1960, the Supreme Court held in *Flora* that because the government had waived its sovereign immunity under 28 U.S.C. § 1346(a)(1) only with respect to refund claims that were fully paid, it lacked jurisdiction to review unpaid or partially paid claims.<sup>4</sup>

Mr. Larson appealed, arguing that: (1) the full payment rule only applies in deficiency cases, such as *Flora*, that could have been brought in the U.S. Tax Court before being paid; (2) the full payment rule violates his Fifth Amendment right to due process because he cannot fully pay and seek review; (3) the Administrative Procedure Act (APA) grants jurisdiction because there are no other avenues for judicial review; and (4) the penalty violates the excessive fines clause of the Eighth Amendment.

The U.S. Court of Appeals for the Second Circuit said that because 28 U.S.C. § 1346(a)(1) does not distinguish between deficiencies and assessable penalties, both are subject to the full payment rule. It observed that following the enactment of 28 U.S.C. § 1346(a), Congress provided limited exceptions to the rule for some penalties (*e.g.*, IRC §§ 6694(c) and 6703(c)), but not for the penalties at issue.

While acknowledging that the *Flora* decision had assumed the full payment rule would not result in hardship because taxpayers could “appeal the deficiency to the Tax Court without paying a cent,”<sup>5</sup> the Second Circuit said the availability of Tax Court review was not essential to the *Flora* court’s

1 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2017, and ending on May 31, 2018. For purposes of this section, we used the same period.

2 *Larson v. United States*, 888 F.3d 578 (2d Cir. 2018), *aff’g* 118 A.F.T.R.2d (RIA) 7004 (S.D.N.Y. 2016), *petition for rehearing and rehearing en banc filed*, Docket No. 16-CV-00245 (June 8, 2018).

3 *Flora v. United States (Flora)*, 362 U.S. 145 (1960), *reaff’g Flora v. United States*, 357 U.S. 63 (1958). Mr. Larson may have paid \$1.4 million because he thought he was fully paying a “divisible” portion of the penalty, which could trigger jurisdiction under *Flora*, 362 U.S. at 175, n. 37-38. A penalty is divisible if portions can be allocated to separate transactions or violations. After he filed suit, however, the Federal Circuit held in *Diversified Group Inc. v. United States*, 841 F.3d 975 (Fed. Cir. 2016), that the penalty under IRC § 6707 is not divisible.

4 28 U.S.C. § 1346(a)(1) grants jurisdiction “for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws.”

5 *Flora*, 362 U.S. at 175.



conclusion.<sup>6</sup> Rather, *Flora* was based on Congress's understanding that full payment was required, as evidenced by the statutory scheme that Congress fashioned around 28 U.S.C. § 1346(a).<sup>7</sup> *Flora* did not rewrite the statute to engraft the requirement that an alternate forum be available, according to the court.<sup>8</sup>

Next, the Second Circuit evaluated Larson's due process claims. In evaluating such claims, courts consider three factors: (1) the private interest that will be affected by the official action; (2) the risk of an erroneous deprivation of such interest through the procedures used, and the probable value, if any, of additional or substitute procedural safeguards; and (3) the government's interest, including the function involved and the fiscal and administrative burdens that the additional or substitute procedural requirement would entail.<sup>9</sup> After weighing these factors, the court concluded that the full payment rule did not violate Mr. Larson's right to due process because of his opportunity to be heard by the IRS Office of Appeals, which had reduced the assessment, and the government's interest in protecting the public purse.<sup>10</sup>

Finally, the Second Circuit concluded it had no jurisdiction under the APA. By providing an exception to the full payment rule for some penalties but not others, Congress had implicitly precluded prepayment review. Even if it had not implicitly precluded prepayment review, it provided specific and adequate review procedures by providing for post-payment review, according to the court.<sup>11</sup> Although Mr. Larson cited cases in which other courts found post-payment review inadequate, the court distinguished them as involving challenges to regulations or claims of bad faith. Moreover, the court observed that Mr. Larson's case was reviewed by Appeals.<sup>12</sup>

6 *Larson*, 888 F.3d at 582. Supreme Court Justice Blackmun had interpreted *Flora* as indicating that “the full-payment rule applies only where... the taxpayer has access to the Tax Court for redetermination prior to payment,” but the Second Circuit explained that Justice Blackmun's view did not garner majority support. *Larson*, 888 F.3d at 582, n.8 (citing *Laing v. United States*, 423 U.S. 161, 208-209 (1976) (Blackmun, J., dissenting)). Critics have pointed out that the Second Circuit brushed off the fact that the majority did not disagree with J. Blackmun on this point and that the Solicitor General made the same argument. See, e.g., Andrew Velarde, *Taxpayer Asks Circuit for Do-Over on Full Payment Rule Holding*, 2018 TNT 113-5 (June 12, 2018) (quoting Carlton Smith).

7 *Larson*, 888 F.3d at 582.

8 *Id.* The Supreme Court had remarked in *Flora* that it was vexed by “statutory language [of § 1346(a)] which is inconclusive and legislative history which is irrelevant.” *Flora*, 362 U.S. at 152. This may suggest that the Supreme Court felt it was, in fact, rewriting an inconclusive statute.

9 *Mathews v. Eldridge*, 424 U.S. 319, 335 (1976).

10 The court mentioned the “public purse,” “efficient administration,” and the “government need ... [to promptly] secure its revenues” as justifications for the lack of a pre-payment forum for judicial review of an assessable tax penalty, quoting an old case that cited older decisions that expressed concerns, which carried more force before 1913. See *Larson*, 888 F.3d at 583-584 (quoting *Phillips v. Comm’r*, 283 U.S. 589, 595-96 (1931) (citing *Cheatham v. United States*, 92 U.S. 85, 89 (1876) (worrying the “very existence of the government might be placed in the power of a hostile judiciary” if taxpayers could dispute liabilities before paying))). Before 1913 when the 16th Amendment was ratified, there were legitimate concerns that a “hostile judiciary” would block the federal government from collecting various taxes, such as the income tax, which the Supreme Court had held was largely unconstitutional. See *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895). By 1924 such concerns must have subsided because Congress authorized pre-payment review of most tax deficiencies by a predecessor of the Tax Court. Revenue Act of 1924, 43 Stat. 253, 297-336 (1924). However, the court did not revisit the underlying analysis. For a discussion of how Congress has increasingly provided taxpayers with procedural protections, overriding the sovereign's ancient power to require immediate payment of taxes, see Nina E. Olson, 2010 Erwin N. Griswold Lecture Before the American College of Tax Counsel, *Taking the Bull by Its Horns: Some Thoughts on Constitutional Due Process in Tax Collection*, 63 TAX LAW. 227 (2010).

11 The court also noted that the Anti-Injunction Act (AIA) bars APA claims unless there is no alternative avenue for judicial review. *Larson*, 888 F.3d at 585, n.11.

12 Critics have argued that the opportunity to present a case to the IRS's Appeals function does not provide sufficient due process. See, e.g., Lawrence Hill & Richard Nessler, *IRS Penalty Assessments Without Due Process?*, 159 TAX NOTES 1763 (June 18, 2018).

Because the court had no jurisdiction, it did not evaluate whether the penalty violated the excessive fines clause of the Eighth Amendment. The court acknowledged that a \$61 million penalty assessment that is not subject to judicial review unless the taxpayer fully pays it “seems troubling,” particularly where the taxpayer cannot pay.<sup>13</sup> But, the court remarked that “it is Congress’ responsibility to amend the law.”<sup>14</sup>

This case is significant because it highlights that taxpayers do not have the unabridged right to judicial review, especially when the IRS’s penalty determination is so severe or the taxpayer is so poor that the assessment cannot be paid.<sup>15</sup> This report includes a specific legislative recommendation to address the problems highlighted by this case.<sup>16</sup>

**In *United States v. Stein*, the U.S. Court of Appeals for the Eleventh Circuit held a taxpayer’s affidavit may create an issue of material fact sufficient to preclude summary judgment in a collection case even if it is self-serving and uncorroborated, notwithstanding the presumption of correctness afforded to IRS assessments.<sup>17</sup>**

In 2015, the government sued Ms. Stein in district court to collect approximately \$220,000 in unpaid tax assessments, late penalties, and interest owed for tax years 1996, 1999, 2000, 2001, and 2002.<sup>18</sup> The government introduced her tax returns and account transcripts, but had not deposed Ms. Stein.

In response, Ms. Stein offered a sworn affidavit which listed the amounts she owed and paid for a number of years, including specific amounts the IRS acknowledged that it had misapplied, and declared “[I]t is my unwavering contention that I paid the taxes due, including late filing penalties, at such time as I filed the returns for each of the tax years in question.”<sup>19</sup> The district court granted the IRS’s motion for summary judgment because it said that self-serving assertions cannot rebut the presumption of correctness given to tax assessments under *Mays v. United States*.<sup>20</sup>

A panel of the U.S. Court of Appeals for the Eleventh Circuit affirmed,<sup>21</sup> but after reconsidering the case *en banc*, the court vacated the panel’s decision and overruled *Mays*. It reasoned that Federal Rule of Civil Procedure (FRCP) 56(a) authorizes summary judgment only when “there is no genuine dispute as to any material fact” and the moving party is “entitled to judgment as a matter of law,” rather than a trial by jury. Because the nonmoving party can dispute a material fact using an affidavit under FRCP 56(c), an affidavit can be enough to permit the case to survive summary judgment.

Although an affidavit cannot be conclusory, it can be self-serving and based solely on personal knowledge or observation. Such affidavits are routinely used to defeat summary judgment. The court reasoned there is no basis to treat affidavits in tax cases any differently under FRCP 56. Thus, it held

13 *Larson*, 888 F.3d at 587.

14 *Id.* (internal quotation omitted).

15 The court did not discuss the “right to appeal a decision of the Internal Revenue Service in an independent forum” under IRC § 7803(a)(3)(D).

16 See Legislative Recommendation: Fix the *Flora* Rule: Give Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can, *supra*.

17 *United States v. Stein*, 881 F.3d 853 (11th Cir. 2018).

18 District courts have jurisdiction under IRC § 7402(a) to “render such judgments and decrees as may be necessary or appropriate for the enforcement of the internal revenue laws.”

19 *Stein*, 881 F.3d at 856.

20 763 F.2d 1295, 1297 (11th Cir. 1985).

21 *United States v. Stein*, 840 F.3d 1355 (11th Cir. 2016), *aff’g* 117 A.F.T.R.2d (RIA) 800 (S.D. Fla. 2016).

that a non-conclusory affidavit which complies with FRCP 56 can create a genuine dispute concerning an issue of material fact, even if it is self-serving and uncorroborated.<sup>22</sup>

The Eleventh Circuit cautioned, however, that a self-serving and uncorroborated affidavit would not always preclude summary judgment. Although *Mays* was a refund case, the court also cautioned that it was not expressing a view as to whether something other than uncorroborated oral testimony would be necessary to withstand summary judgment in a tax refund case.<sup>23</sup>

This case is significant because it may prompt the IRS to solicit and consider the taxpayer's position before filing a collection suit, even if the taxpayer's position includes statements that are self-serving and uncorroborated. Such an outcome would be consistent with several taxpayer rights, including the rights *to pay no more than the correct amount of tax* and *to challenge the IRS position and be heard*.<sup>24</sup> Indeed, this case has already prompted other courts to reject the IRS's motion for summary judgment where the IRS has declined to consider the taxpayer's position.<sup>25</sup>

**In *Chamber of Commerce v. IRS*, the U.S. District Court for the Western District of Texas held that the Anti-Injunction Act (AIA) did not bar a pre-enforcement challenge to a temporary regulation, and the temporary regulation was invalid because the IRS did not comply with the APA's notice and comment requirements.**<sup>26</sup>

In April 2016, the IRS issued both temporary and proposed regulations to inhibit inversions.<sup>27</sup> The plaintiffs argued the regulations exceeded the IRS's statutory authority, were arbitrary and capricious, and were issued without notice and opportunity for comment in violation of the APA.<sup>28</sup> The IRS argued the plaintiffs lacked standing and that the suit was barred by the AIA.<sup>29</sup>

First, the court held that the plaintiff associations had standing because Allergan, which was one of their members, had standing. Allergan had standing because it was injured by the regulations. Allergan had agreed to merge with Pfizer under the assumption that the combined company would not be subject to tax in the U.S. (*i.e.*, it was an inversion). The court found that the regulations were promulgated, in part, to prevent the Pfizer-Allergan inversion, which they did, and Allergan was facing continuing injury because it would have pursued other inversions but for the regulations. It did not need to engage in negotiations for deals that were economically impracticable just so that it could establish standing.

22 A thoughtful concurrence by Justice Pryor framed the historical context of the decision. See *Stein*, 881 F.3d at 859-860 (Pryor, J., concurring). He noted that after hearing that local juries in America were rendering biased decisions in customs litigation, the British Parliament shifted revenue litigation to courts sitting without juries. This led the colonists to adopt the Seventh Amendment right to a jury trial in civil cases. Therefore, he noted that *Mays* had "ousted the jury from its historical role in the exact context—the enforcement of tax laws—that prompted the founding generation to adopt the Seventh Amendment in the first place." *Id.* at 860.

23 *Stein*, 881 F.3d at 858, n.2.

24 See IRC § 7803(a)(3).

25 See, e.g., *McClendon v. United States*, No. 17-20174, 2018 U.S. App. LEXIS 16030 (5th Cir. June 14, 2018); *United States v. Wilkins*, No. 8:14-CV-993-EAK-JSS, 2018 WL 1988872 (M.D. Fla. Mar. 2, 2018).

26 *Chamber of Commerce v. IRS*, No. 1:16-cv-944-LY, 2017 WL 4682050 (W.D. Tex. Oct. 6, 2017).

27 Treas. Reg. § 1.7874-8T; Prop. Treas. Reg. § 1.7874-8; *Inversions and Related Transactions*, 81 Fed. Reg. 20,588-591 (Apr. 8, 2016).

28 See 5 U.S.C. § 706.

29 See IRC § 7421.

Next, the court held the AIA did not bar the suit. The AIA precludes taxpayers from filing “suit for the purpose of restraining the assessment or collection of any tax.”<sup>30</sup> The court concluded that the plaintiffs were challenging the validity of a temporary regulation governing who is subject to taxation under the IRC. It reasoned that the AIA does not insulate from challenge every rule that might eventually assist the government in assessing or collecting a tax. Enforcement of the regulation would precede any assessment or collection of tax.

The court quoted from the Supreme Court’s analysis in *Direct Marketing*, which held that the Tax Injunction Act (TIA), a state analogue to the AIA, did not bar a pre-enforcement challenge to a Colorado law, which required out-of-state retailers to report purchases by Colorado customers.<sup>31</sup> *Direct Marketing* analyzed whether enforcement of the reporting requirements was an act of assessment or collection as those terms are used in the IRC. Because it was not, the TIA did not apply. By analogy, because enforcement of the anti-inversion regulations was not an act of assessment or collection, the court concluded that the AIA did not bar a pre-assessment challenge to them.

In addition, the court held that the temporary regulations were invalid because the IRS failed to comply with the notice and comment requirements of the APA. The APA generally requires agencies to publish a notice of proposed rulemaking in the Federal Register and give interested persons an opportunity to comment at least 30 days before the effective date.<sup>32</sup> However, the temporary regulations were effective immediately.

First, the IRS argued that the temporary regulations were exempt from the notice and comment requirement under IRC § 7805(e) and its legislative history. According to the IRS, Congress’s intention was to codify the practice of allowing temporary regulations to be effective immediately (*i.e.*, before notice and comment). However, IRC § 7805(e) merely states that “[a]ny temporary regulation issued by the Secretary shall also be issued as a proposed regulation.” Further, the APA provides that a “[s]ubsequent statute may not be held to supersede or modify [the notice-and-comment procedure] ... except to the extent that it does so expressly.”<sup>33</sup>

The court reasoned that IRC § 7805(e) does not expressly provide an exception to the notice and comment procedure, and legislative history cannot override the explicit directives of the APA. Moreover, IRC § 7805(b) places limits on when tax regulations can be effective and does not carve out a special rule for temporary regulations.<sup>34</sup> Thus, the court concluded that IRC § 7805 did not authorize the IRS to modify the notice and comment procedure for temporary regulations.

The IRS also argued that the temporary regulations were exempt (under 5 U.S.C. § 553(b)(3)(A)) from the notice and comment requirement because they were merely “interpretive” and not “legislative,” but the court was not convinced. According to the court, legislative rules create law and affect individual rights and obligations, whereas interpretative rules are statements as to what the agency thinks the statute or regulation means. The statute authorized regulations to provide a computation that would trigger the anti-inversion rules, and the temporary regulations provided the substantive adjustments

30 IRC § 7421(a). As the Declaratory Judgment Act (28 U.S.C. § 2201) is generally interpreted as barring the same suits as the AIA (*i.e.*, the statutes are “coterminous”), it is common practice not to analyze them separately.

31 *Direct Mktg. Ass’n v. Brohl*, 135 S. Ct. 1124 (2015).

32 5 U.S.C. § 553.

33 5 U.S.C. § 559.

34 IRC § 7805(b) (“[N]o temporary, proposed, or final regulation relating to the internal revenue laws shall apply to any taxable period ending before the earliest of the following dates: ... In the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register....”).

needed to implement the statute.<sup>35</sup> Thus, the court determined they were legislative and not exempt from the notice and comment requirement.<sup>36</sup>

This case is significant because it suggests that rules that are effective immediately (before the agency has proposed the rule and considered public comments) are at greater risk of being challenged and held invalid on the basis that they did not comply with the APA.<sup>37</sup> It is also significant because it interprets the AIA more narrowly than the U.S. Court of Appeals for the District of Columbia Circuit, potentially making it easier to obtain pre-enforcement judicial review of regulations.<sup>38</sup>

**In *Facebook, Inc. v. IRS*, the U.S. District Court for the Northern District of California held that Facebook had no enforceable right to take its case to the IRS Office of Appeals and the court had no authority to review the IRS's unexplained decision.<sup>39</sup>**

The IRS audited Facebook over a five-year period, interviewing employees, issuing more than 200 requests for documents, and asking it to agree to five extensions of the statutory period of limitations. When Facebook declined to extend the period for a sixth time, the IRS issued a statutory notice of deficiency. Facebook petitioned the Tax Court and asked the IRS to transfer the case to the IRS's independent Appeals function. The IRS refused. It determined that doing so was “not in the interest of sound tax administration,” as it was permitted to do by Rev. Proc. 2016-22.<sup>40</sup> It did not explain why.

By way of background, since 1955, the IRS's statement of procedural rules have provided that a taxpayer has the right to an administrative appeal.<sup>41</sup> However, courts have held that the IRS is not bound by its statement of procedural rules.<sup>42</sup> In addition, Rev. Proc. 87-24 clarified that certain IRS officials could “determine that a case, or an issue or issues in a case, should not be considered by Appeals.”<sup>43</sup> Subsequently, the Internal Revenue Service Restructuring and Reform Act of 1998 granted taxpayers

35 Compare IRC § 7874(c)(6) (authorizing “regulations to treat stock as not stock.”) and IRC § 7874(a)(2)(B)(ii) (providing a computation) with Treas. Reg. § 1.7874-8T(b) (providing a somewhat different computation).

36 The court did not cite the Supreme Court's decision in *Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44, 55 (2011), which implied that both interpretive and legislative regulations are entitled to so-called *Chevron* deference if (and maybe only if) they are issued after notice and comment. For a discussion of this issue, see, e.g., Elizabeth Chorvat, *Anti-Inversion Regulation Invalidated in Federal Court*, 157 TAX NOTES 401 (Oct. 16, 2017).

37 For helpful analysis, see Andrew Velarde, *Chamber of Commerce Throws Door Open for More Reg Challenges*, 2017 TNT 190-1 (Oct. 3, 2017). The IRS should have been on notice in 2010 that its arguments might not be accepted because a concurring opinion in the Tax Court would have come out the same way. See National Taxpayer Advocate 2010 Annual Report to Congress 418, 423 (discussing the concurring opinion in *Intermountain Ins. Serv. of Vail, LLC v. Comm'r*, 134 T.C. 211 (2010), *rev'd* by 2011-1 U.S.T.C. (CCH) ¶50,468 (D.C. Cir. 2011)). Moreover, the IRS could have avoided the effective date problem by merely expressing a “good cause” to make the regulations effective immediately, as permitted under the APA, particularly if the good cause is to “prevent abuse.” IRC § 7805(b)(3) expressly states that “[T]he Secretary may provide that any regulation may take effect or apply retroactively to prevent abuse.”

38 See *Florida Bankers Assoc. v. U.S. Dep't of Treasury*, 799 F.3d 1065 (D.C. Cir. 2015) (holding the AIA barred a challenge to information reporting regulations). For further discussion of this case, see National Taxpayer Advocate 2016 Annual Report to Congress 415, 418-20 (Most Litigated Issue: *Significant Cases*). For comprehensive analysis that lends support to a narrow interpretation of the AIA, see Kristin E. Hickman & Gerald Kerska, *Restoring the Lost Anti-Injunction Act*, 103 Va. L. Rev. 1683 (2017).

39 *Facebook, Inc. & Subsidiaries v. IRS*, 2018-1 U.S.T.C. (CCH) ¶50,248 (N.D. Cal. 2018).

40 Rev. Proc. 2016-22, 2016-15 I.R.B. 577, *superseding* Rev. Proc. 87-24, 1987-1 C.B. 720.

41 20 Fed. Reg. 4621, 4626 (June 30, 1955) (codified at 26 C.F.R. § 601.106(b), which provided that if the IRS “has issued a preliminary or ‘30-day letter’” and the taxpayer has filed a timely protest, “the taxpayer has the right (and will be so advised by the district director) of administrative appeal.”).

42 See *Ward v. Comm'r*, 784 F.2d 1424, 1431 (9th Cir. 1986); *Estate of Weiss v. Comm'r*, T.C. Memo. 2005-284 (2005). *But see, Richardson v. Joslin*, 501 F.3d 415, 418 (5th Cir. 2007) (“[A]n agency must abide by its own regulations.”) (citing *Accardi v. Shaughnessy*, 347 U.S. 260 (1954)); *United States v. Heffner*, 420 F.2d 809 (4th Cir. 1969) (IRS bound by instructions given to Special Agents); *Rauenhorst v. Comm'r*, 119 T.C. 157 (2002) (IRS bound by revenue rulings).

43 Rev. Proc. 87-24, 1987-1 C.B. 720, *superseded* by Rev. Proc. 2016-22, 2016-15 I.R.B. 577.



the statutory right to an administrative appeal in specific circumstances, but did not address whether taxpayers always have the right to an administrative appeal.<sup>44</sup>

In her 2007 Annual Report to Congress and in subsequent reports, the National Taxpayer Advocate recommended that the IRS adopt or that Congress codify a taxpayer bill of rights (TBOR) that included, among other things, the right to an appeal in an independent forum.<sup>45</sup> On June 10, 2014, the IRS adopted the TBOR and incorporated it into Publication 1.<sup>46</sup> On December 18, 2015, the Protecting Americans from Tax Hikes (PATH) Act codified the TBOR.<sup>47</sup> IRC § 7803(a)(3) now provides that the “Commissioner shall ensure that employees of the Internal Revenue Service are familiar with and act in accord with taxpayer rights as afforded by *other provisions* of this title, including—... the right to appeal a decision of the Internal Revenue Service in an independent forum.” (Emphasis added.)<sup>48</sup>

In late 2015, the IRS requested public comments on procedures that would deny taxpayers the right to go to Appeals if the “referral is not in the interest of sound tax administration,” even in cases not designated for litigation.<sup>49</sup> The American Bar Association Section of Taxation suggested the IRS “elaborate and clarify the limited circumstances in which docketed cases will be ineligible to be returned to Appeals due to ‘sound tax administration.’”<sup>50</sup> However, the IRS finalized these procedures as Rev. Proc. 2016-22 without addressing this comment. The IRS did not explain why it declined to elaborate on or clarify this standard.<sup>51</sup>

In this case, Facebook responded to the IRS’s refusal to refer its case to Appeals by filing suit in district court, alleging the IRS (1) violated its “right to appeal a decision of the Internal Revenue Service in an independent forum,” under IRC § 7803(a)(3)(E), and (2) violated the APA when it promulgated Rev. Proc. 2016-22, and when it denied Facebook access to Appeals. It requested *mandamus*-like relief.

44 Pub. L. No. 105-206, §§ 1001(a)(4), 3401, 112 Stat. 685, 689, 746 (1998) (establishing Appeals, and granting taxpayers a statutory right to a hearing before Appeals in connection with liens and levies, codified at IRC §§ 6320(b) (lien), 6330(b) (levy)). Section 3462 also directed the IRS to establish procedures for administrative appeals of IRS rejections of proposed installment agreements or offers-in-compromise under IRC §§ 6159 and 7122, respectively. In addition, other provisions assume that taxpayers have access to Appeals. See, e.g., IRC §§ 6015(c)(4), 7430(c)(2), 6621(c)(2)(A).

45 See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress 478-489 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis “Apology” Payments*) (recommending, in relevant part, that the right to appeal include the right “to be advised of and avail themselves of a prompt administrative appeal that provides an impartial review of *all* compliance actions (unless expressly barred by statute) and an explanation of the appeals decision”); National Taxpayer Advocate, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration* (2013); National Taxpayer Advocate 2013 Annual Report to Congress 5-19 (Most Serious Problem: *The IRS Should Adopt a Taxpayer Bill of Rights as a Framework for Effective Tax Administration*).

46 IRS News Release IR-2014-72 (June 10, 2014).

47 Pub. L. No. 114-113, 129 Stat. 2242 (2015). For a discussion of the effect of the TBOR, see, e.g., Alice Abreu & Richard Greenstein, *Embracing the TBOR*, 157 *Tax Notes* 1281 (Nov. 27, 2017).

48 IRC § 7803(a)(3), (a)(3)(E).

49 Notice 2015-72, 2015-44 I.R.B. 613.

50 Letter from Am. Bar Ass’n Section of Taxation to Comm’r, IRS, *Comments on Notice 2015-72* (Nov. 16, 2015), [https://www.americanbar.org/groups/taxation/policy/policy\\_2015.html](https://www.americanbar.org/groups/taxation/policy/policy_2015.html).

51 The IRS’s request for comments may suggest it was seeking to increase the deference given to the final rule. However, the revenue procedure did not purport to establish “legislative” rules. If it had, the IRS would have been required to consider comments and provide a concise statement explaining the basis and purpose for a final rule under 5 U.S.C. § 553(c). The rule could have been challenged on the basis that the IRS did not address the comment and provide a reasoned explanation and that it was arbitrary and capricious under 5 U.S.C. § 706(2)(A). The Tax Court held in *Altera Corp. & Subs. v. Comm’r*, 145 T.C. 91 (2015) that a regulation was invalid because, in promulgating the regulation, the Treasury did not “adequately respond to commentators,” citing *Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983) (requiring rules to be the product of reasoned decision-making). The Tax Court’s decision was recently reversed, but the reversal was withdrawn. See *Altera Corp. & Subs. v. Comm’r*, No. 16-70496, 2018 WL 3542989 (9th Cir. July 24, 2018), *rev’g*, 145 T.C. 91 (2015), *withdrawn by*, 2018 WL 3734216 (9th Cir. Aug. 7, 2018).

The IRS moved to dismiss, countering that Facebook lacked standing and that its determination to deny Facebook access to Appeals was not reviewable under the APA because it was not a final agency action. The U.S. District Court for the Northern District of California granted the IRS's motion to dismiss. First, it reasoned that Facebook did not have an enforceable right to take its case to Appeals. The IRS's Statement of Procedural rules did not create enforceable rights and neither did the PATH Act. By its terms, the PATH Act required the Commissioner to train employees and ensure they act in accord with rights granted under "other provisions." Because of this training requirement, the TBOR was not a nullity. Even if the PATH Act had created enforceable rights, it was not clear that the "right to appeal in an independent forum" refers to a right to take a case to IRS Appeals, as opposed to the Tax Court.<sup>52</sup> Because deprivation of a nonexistent right does not constitute an injury, the court concluded that Facebook lacked standing.

The court also concluded that the IRS decision not to refer Facebook's case to Appeals was not reviewable under the APA. Unless another statute provides for review, only "final agency action for which there is no other adequate remedy in a court" is reviewable under the APA.<sup>53</sup> To be final, an action must (1) consummate the agency's decision-making process, and (2) establish rights and obligations or create binding legal consequences. The court concluded that neither the IRS's promulgation of Rev. Proc. 2016-22, nor its denial of Facebook's request to take its case to Appeals were final agency actions. The court reasoned that Rev. Proc. 2016-22 was not a final action because it did not create or determine any rights, obligations, or legal consequences.<sup>54</sup> Similarly, the IRS's decision not to refer the case to Appeals was not reviewable because Facebook's rights, obligations, and legal consequences will flow from judicial review, rather than from the IRS's decision not to refer its case to Appeals, according to the court.<sup>55</sup>

This case is significant because it suggests that the TBOR did not abrogate pre-existing limits on a taxpayer's right to an appeal. Perhaps more significantly, however, it suggests that when the IRS promulgates a revenue procedure that ignores stakeholder comments, ignores its own longstanding procedural rules, and then singles out one taxpayer for special treatment by withholding procedural protections afforded to other taxpayers without explanation, courts are helpless to review its actions.<sup>56</sup>

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- 52 However, IRS Pub. 1, *Your Rights as a Taxpayer*, suggests the right encompasses both administrative and judicial appeal rights. It provides that "[T]axpayers are entitled to a fair and impartial administrative appeal of most IRS decisions... [and] Taxpayers generally have the right to take their cases to court." This language was heavily negotiated with the IRS by the National Taxpayer Advocate.
- 53 5 U.S.C. § 704. Facebook did not allege that the IRS's action was reviewable under another statute.
- 54 The court apparently did not consider the potential for the IRS to deny an administrative appeal to be a legal consequence. Nor did it discuss *Cohen v. United States*, 650 F.3d 717 (D.C. Cir. 2011), which held that a procedural notice that established excise tax refund procedures was reviewable under the APA as a final agency action.
- 55 A final decision by Appeals would seem to be a final agency action, but a decision to deny access to Appeals is not a final agency action, according to the court. As noted above, the IRS did not explain the basis for its decision to deny access to Appeals. However, the court did not discuss other cases where the IRS's determinations have been deemed arbitrary and capricious on the basis that they were inadequately explained. See, e.g., *Fisher v. Comm'r*, 45 F.3d 396, 397 (10th Cir. 1995), *non acq.* 1996-2 C.B. 2 (holding a supplemental notice of deficiency that did not provide reasons for declining to waive a penalty was invalid because "[i]t is an elementary principle of administrative law that an administrative agency must provide reasons for its decisions," quoting *Harberson v. NLRB*, 810 F.2d 977, 984 (10th Cir. 1987) and citing *SEC v. Chenery Corp.*, 318 U.S. 80, 94 (1943)).
- 56 This case illustrates how the IRS can issue and apply some procedural rules (*i.e.*, Rev. Proc. 2016-22, which provides a limited right to go to Appeals) in a way that burdens taxpayers and taxpayer rights, while at the same time ignoring other procedural rules (*e.g.*, 26 C.F.R. § 601.106(b)(3), which provides an unlimited right to go to Appeals) that would lessen this burden and be consistent with taxpayer rights.

**In *United States v. Colliot*, the U.S. District Court for the Western District of Texas held that the IRS could not impose the maximum penalty provided by law for a willful failure to file a Report of Foreign Bank and Financial Accounts (FBAR) because it had not updated regulations which provided a lower maximum penalty.<sup>57</sup>**

The IRS filed suit against Mr. Colliot to collect civil penalties assessed for the willful failure to report foreign accounts on a Report of Foreign Bank and Financial Accounts (FBAR) for years 2007-2010. The IRS's penalty assessments included \$548,773 for four FBAR violations in 2007, and another \$196,082 for four violations in 2008.

Mr. Colliot argued that the IRS's penalty assessments were arbitrary and capricious and an abuse of discretion because they exceeded the \$100,000 limit set forth in a regulation that was validly issued in 1987 after public notice and comment and that was still in force.<sup>58</sup> The IRS countered that the maximum penalty provided by the 1987 regulation was superseded by a change to 31 U.S.C. § 5321(a)(5) in the American Jobs Creation Act (AJCA) of 2004.<sup>59</sup> The ACJA increased the maximum FBAR penalty from \$100,000 to 50 percent of the amount in the unreported account (with no fixed cap).<sup>60</sup>

The court agreed with Mr. Colliot. When the statute sets a ceiling (but not a floor) for a penalty, it vests the Secretary with discretion to determine the penalty amount so long as it does not exceed the ceiling. By leaving the 1987 regulations in place, the Secretary used this discretion to limit the penalties the IRS would impose to amounts below the maximum provided by the statute (both before and after the AJCA). Thus, the 1987 regulation was consistent with the statute, as amended by the AJCA. Moreover, an agency can only repeal a regulation issued via notice-and-comment rulemaking by using the notice-and-comment rulemaking process.<sup>61</sup> Consequently, the IRS acted arbitrarily and capriciously when it failed to apply the regulation in assessing penalties against Mr. Colliot.<sup>62</sup>

This case is significant because it suggests that until the 1987 regulation is updated or repealed, it may limit the maximum penalty the IRS can impose for FBAR violations.<sup>63</sup> At the very least, this case

57 *United States v. Colliot*, 2018-1 U.S.T.C. (CCH) ¶150,259 (W.D. Tex. May 16, 2018).

58 *Amendments to Implementing Regulations Under the Bank Secrecy Act*, 52 Fed. Reg. 11436, 11445-46 (1987) (codified as 31 C.F.R. § 103.57(g)(2), and later re-codified as 31 C.F.R. § 1010.820(g)(2)) (authorizing Report of Foreign Bank and Financial Accounts (FBAR) penalties "not to exceed the greater of the amount (not to exceed \$100,000) equal to the balance in the account at the time of the violation, or \$25,000," an upper limit that reiterated what was then provided by 31 U.S.C. § 5321(a)(5)(C)).

59 American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, § 821, 118 Stat. 1418, 1586 (2004) (codified at 31 U.S.C. § 5321(a)(5)(C)).

60 Before the American Jobs Creation Act (ACJA) of 2004 the maximum FBAR penalty under was the greater of (1) \$25,000 or (2) 100 percent of the unreported account at the time of the violation, but not to exceed \$100,000. 31 U.S.C. § 5321(a)(5)(C) (2003). The ACJA increased the maximum penalty to the greater of (1) \$100,000, or (2) 50 percent of the amount in the account at the time of the violation (with no upper limit). 31 U.S.C. § 5321(a)(5)(C) (2018).

61 See *Perez v. Mortgage Bankers Ass'n*, 135 S. Ct. 1199, 1206 (2015) (requiring agencies to "use the same procedures when they amend or repeal a rule as they used to issue the rule in the first instance").

62 See 5 U.S.C. § 706(2) (requiring agency action to be "in accordance with law"). See also *Richardson v. Joslin*, 501 F.3d 415, 418 (5th Cir. 2007) ("[A]n agency must abide by its own regulations.") (citing *Accardi v. Shaughnessy*, 347 U.S. 260 (1954)). In lieu of dismissing the case with prejudice, on August 16, 2018 the court reformed (reduced) the amount of the FBAR penalty assessments to conform to the threshold set by 31 C.F.R. § 1010.820. *United States v. Colliot*, Order 1:16-cv-01281-SS (W.D. Tex. Aug. 16, 2018).

63 Compare *United States v. Urayb Wadhan et al.*, No. 17-CV-1287-MSK, 2018 WL 3454973 (D. Colo. July 18, 2018) (citing *Colliot* and limiting the penalty to \$100,000), with *Norman v. United States*, No. 15-872T, 2018 U.S. Claims LEXIS 888 (Fed. Cl. July 31, 2018) (disagreeing with *Colliot* and allowing a penalty of more than \$100,000 on the basis that the statute said the maximum penalty "shall be increased"). For additional discussion, see, e.g., Robert Goulder, *Hurling F-Bombs at FBAR*, 91 TAX NOTES INT'L 1083 (Sept. 3, 2018).



suggests the IRS faces litigating hazards if it continues to ignore the limits provided by the regulation. The government may also expect to receive claims for refund from taxpayers who have paid FBAR penalties of more than the maximums set forth in the 1987 regulation.

**In *Estate of Stauffer v. IRS*, the United States District Court for the District of Massachusetts held that a taxpayer’s “financial disability” suspended the period for filing a claim for refund because the IRS’s refusal to consider a psychologist’s diagnosis was unreasonable.<sup>64</sup>**

Mr. Stauffer died at the age of 90. In 2013, his estate discovered that he had overpaid his taxes in 2006 when he was being treated by Dr. Schneider, Ed.D., a psychologist. The Estate sought a refund beyond the normal limitations period for filing refund claims under IRC § 6511(a).<sup>65</sup> It argued that the claim was timely because the period was suspended while Mr. Stauffer was “financially disabled.” The Estate submitted a statement by Mr. Schneider as proof of Mr. Stauffer’s disability.

With certain exceptions, IRC § 6511(h)(2) provides that a person is “financially disabled” when he or she “is unable to manage his [or her] financial affairs by reason of a medically determinable physical or mental impairment...” To establish a “financial disability,” IRC § 6511(h)(2) requires the claimant to provide proof “in such form and manner as the Secretary may require.” Pursuant to Rev. Proc. 99-21 the Secretary requires that the proof include a statement from a “physician,” which it defines by reference to section “1861(r)(1) of the Social Security Act, 42 U.S.C. § 1395x(r).”<sup>66</sup> This definition excludes psychologists. Thus, the IRS denied the claim without determining whether Mr. Stauffer was financially disabled during the relevant period.

The Estate argued that the IRS unreasonably limited the proof it would consider. The IRS filed a motion to dismiss for lack of jurisdiction because the Estate had not filed a timely administrative claim with the IRS.<sup>67</sup> According to the court, IRC § 6511(h) authorized the IRS to establish a procedural rule as to the “form and manner” of offering proof of financial disability. Although 5 U.S.C. § 553 generally requires agencies to adopt rules only after providing the public with an opportunity for notice and comment, this requirement does not apply to “procedural” rules. The Estate did not argue that the IRS had exceeded its authority by using Rev. Proc. 99-21 to adopt a substantive rule without notice and comment. Thus, the court reviewed the “reasonableness” of the rule established by Rev. Proc. 99-21 according to the deferential “arbitrary and capricious” standard provided by 5 U.S.C. § 706(2)(A).<sup>68</sup>

Even under this deferential standard, however, the agency must provide a “reasoned explanation” for rejecting the “reasonably obvious alternatives” available to it.<sup>69</sup> The court said that it was not obvious

64 *Estate of Stauffer v. IRS*, 285 F. Supp. 3d 474 (D. Mass. 2017). A subsequent decision found the taxpayer was not financially disabled because a power of attorney was in effect. See *Stauffer v. IRS*, 2018 U.S. Dist. LEXIS 180954 (D. Mass. 2018).

65 IRC § 6511(a) (explaining the limitations period generally expires “within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later.”).

66 Rev. Proc. 99-21, § 4, 1999-1 C.B. 960.

67 See IRC § 7422(a) (“no suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax ... until a claim for refund or credit has been duly filed with the Secretary...”).

68 In other words, the court essentially gave *Chevron* deference to Rev. Proc. 99-21, even though the government had announced it would no longer take the position that its revenue procedures were entitled to such deference. See Marie Sapirie, *DOJ Won’t Argue for Chevron Deference for Revenue Rulings and Procedures*, Official Says, 131 TAX NOTES 674 (2011). By contrast, a Magistrate Judge who had reviewed the case recommended giving mere *Skidmore* deference to Rev. Proc. 99-21 (*i.e.*, upholding it only to the extent it has the power to persuade) and concluded it was an unpersuasive interpretation of the law.

69 *Estate of Stauffer*, 285 F. Supp. 3d at 484.

why the IRS would refuse to consider the statement of a psychologist who contemporaneously diagnosed and treated the individual. Even in Social Security cases (*i.e.*, cases governed by the statute from which Rev. Proc. 99-21 borrowed its definition) a psychologist's opinion is entitled to great weight. The government offered no evidence that the IRS had any reason that was not arbitrary for adopting a definition of "physician" that excluded psychologists from the category of professionals qualified to support a claimant's financial disability. Thus, the court denied the government's motion to dismiss.<sup>70</sup>

This case is significant because it suggests that, notwithstanding Rev. Proc. 99-21, some courts may require the IRS to consider statements by psychologists when determining a person's financial disability. Accordingly, it could lead the IRS to address longstanding concerns expressed by the National Taxpayer Advocate and others that IRC § 6511(h), as implemented by Rev. Proc. 99-21, is too narrow to protect many taxpayers who are unable to make timely claims because of a physical or mental impairment.<sup>71</sup>

**In *Borenstein v. Commissioner*, the Tax Court held it had no jurisdiction to review an overpayment claim by a non-filer who had obtained a filing extension because the IRS mailed the notice of deficiency at just the wrong time—after the second year following the original due date and before the third year following the extended due date.**<sup>72</sup>

By April 15, 2013, Ms. Borenstein had paid more tax than she owed for 2012, but timely requested a six-month extension to file. Her prepayments were deemed to have been made on the due date of the return (*i.e.*, April 15, 2013, in the case of her prepayments for 2012).<sup>73</sup> Ms. Borenstein did not file a return by the extended due date of October 15, 2013. On June 19, 2015, the IRS sent her a notice of deficiency. She filed her delinquent 2012 return claiming a refund on August 29, 2015, and timely petitioned the Tax Court a few weeks later. The IRS argued the Tax Court lacked jurisdiction with respect to the overpayment.

The Tax Court has jurisdiction to determine if the taxpayer has made an overpayment with respect to a disputed year,<sup>74</sup> but only with respect to amounts paid during the applicable lookback period.<sup>75</sup> The lookback period ends on the date a taxpayer files an administrative claim for refund, unless the taxpayer

70 The court said that "a decision committed by statute to an agency's discretion may be subject to more limited review than the standard established in 5 U.S.C. § 706(2)(A)" and offered the IRS an opportunity to brief that issue. *Estate of Stauffer*, 285 F. Supp. 3d at 483, n. 2 (citations omitted). See 5 U.S.C. § 701(a)(2) ("This chapter applies, according to the provisions thereof, except to the extent that—... (2) "agency action" is committed to agency discretion by law."). The court also discounted the IRS's argument that the psychologist's statement was submitted with the appeal and not with the initial claim. It cited various authorities for the proposition that imperfect claims, including those that lack a doctor's note, can be perfected later.

71 See National Taxpayer Advocate 2013 Annual Report to Congress 302-310 (Legislative Recommendation: *Broaden Relief from Timeframes for Filing a Claim for Refund for Taxpayers with Physical or Mental Impairments*). See also Bruce A. McGovern, *The New Provision for Tolling the Limitations Period for Seeking Tax Refund: Its History, Operation and Policy, and Suggestions for Reform*, 65 Mo. L. Rev. 797, 873 (2000); Keith Fogg & Rachel Zuraw, *Financial Disability for All*, 62 Cath. U. L. Rev. 965 (2013); American Bar Association, Section of Taxation, *Comments on Revenue Procedure 99-21* (Feb. 1, 2018), <https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/020118comments.authcheckdam.pdf>. After this case was decided, the IRS requested comments on Rev. Proc. 99-21, but the request only concerned the burden associated with the paperwork requirements. See IRS, *Notice and request for Comments*, 82 Fed. Reg. 48,314 (Oct. 17, 2017).

72 *Borenstein v. Comm'r*, 149 T.C. No. 10 (2017), *appeal docketed*, No. 17-3900 (2d Cir. Dec. 4, 2017).

73 IRC § 6513(b).

74 IRC § 6512(b)(1).

75 IRC § 6512(b)(3).

did not file one, in which case, the period ends on the date the IRS mails the notice of deficiency.<sup>76</sup> The length of the lookback period also depends on when the taxpayer filed an administrative claim for refund.<sup>77</sup> For claims timely filed within the three-year period provided by IRC § 6511(a) (*i.e.*, within three years of filing the return), the lookback period is three years plus the period of any filing extension(s).<sup>78</sup> For other claims, the lookback period is two years.<sup>79</sup>

In *Lundy*, the Supreme Court held that the two-year lookback period applied to a non-filer because the taxpayer had not filed a return before the IRS mailed the notice of deficiency.<sup>80</sup> Like most non-filers, including the taxpayer in *Lundy*, Ms. Borenstein did not file a return before the IRS mailed the notice of deficiency (*i.e.*, June 19, 2015). Thus, the notice of deficiency would have been too late to trigger jurisdiction for amounts she was deemed to have paid on the due date (*i.e.*, April 15, 2013) under the two-year lookback period.

In response to *Lundy*, however, Congress added a final sentence to IRC § 6512(b)(3), which applies a three-year lookback period to certain non-filers.<sup>81</sup> The sentence states:

... where the date of the mailing of the notice of deficiency is during the third year after the **due date (with extensions)** for filing the return of tax and no return was filed before such date, the applicable [lookback] period under subsections (a) and (b)(2) of section 6511 shall be 3 years. [Emphasis added.]

The IRS argued that this sentence did not give the Tax Court jurisdiction with respect to Ms. Borenstein's claim because October 15, 2013, was Ms. Borenstein's "due date (with extensions)" and the IRS did not mail her a notice of deficiency during the third year thereafter (*i.e.*, on or after October 15, 2015). Thus, Ms. Borenstein's notice of deficiency was mailed during the second year after the "due date (with extensions)," not the third.

Ms. Borenstein and *amici curiae* observed that the IRS's interpretation created an anomalous result—a donut hole in the Tax Court's overpayment jurisdiction as applied to non-filers with valid filing extensions.<sup>82</sup> The Tax Court would have had jurisdiction if the IRS had mailed the notice of deficiency on or between October 15, 2015, and April 15, 2016, but had no jurisdiction in this case because it mailed the notice during the donut hole period (*i.e.*, between April 15, 2015, and October 15, 2015). They argued that this anomalous result could be avoided.

The Tax Court agreed with the IRS, however, rejecting Ms. Borenstein's arguments as inconsistent with the plain language of the statute. It also declined to invoke the "anti absurdity" doctrine. While acknowledging that a plain-language interpretation of the law produced an odd result in certain circumstances, the court concluded that it did not render the amendment "absurd" as a whole.

76 Specifically, IRC § 6512(b)(3)(B) authorizes refunds or credits of amounts paid "within the period which would be applicable under section 6511(b)(2)... if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed)...."

77 To be timely, IRC § 6511(a) generally requires a taxpayer to make an administrative claim for refund within two years of paying the tax or within three years of filing the return, whichever is later.

78 See IRC § 6511(b)(2)(A).

79 See IRC § 6511(b)(2)(B).

80 *Comm'r v. Lundy*, 516 U.S. 235 (1996).

81 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1282(a) and (b), 111 Stat. 1037-38 (1997).

82 *Borenstein v. Comm'r*, 149 T.C. No. 10, at \*5 (2017).

This case is significant because it suggests that Congress did not fully address the problem highlighted by *Lundy* in the case of non-filers who obtain filing extensions. Depending upon when the IRS issues a notice of deficiency, the Tax Court may not have jurisdiction to grant them refunds to which they would otherwise be entitled.<sup>83</sup>

**In *Hulett v. Commissioner*, the Tax Court held that filing a return with the United States Virgin Islands (USVI) triggered the statute of limitations for U.S. Income Tax purposes, even if the taxpayers were not *bona fide* residents of the USVI, because the USVI forwarded parts of their return to the IRS.<sup>84</sup>**

Taxpayers claiming residency in the USVI are required to file returns with and pay tax to the USVI Bureau of Internal Revenue (BIR), but before 2007 it was unclear what, if anything, they had to file with the IRS.<sup>85</sup> Their tax liability, which is determined under a “mirror code” system, is usually the same as it would be if they were residents of the United States. However, those who receive approval from the USVI Economic Development Commission may claim the Economic Development Program (EDP) credit under IRC § 934, which reduces the effective tax rate on certain income.<sup>86</sup>

Ms. Coffey (aka Ms. Hulett) worked in the USVI during 2003 and 2004 and filed joint returns with the BIR, rather than the IRS, because she claimed to be a *bona fide* resident of the USVI. The BIR sent photocopies of the first two pages of the Forms 1040 for the years at issue, along with their W-2s (both U.S. W-2s and VI W-2s) to the IRS pursuant to the Tax Implementation Agreement (TIA). The IRS processed the forms and created a tax transcript for those years, which showed a U.S. tax liability of zero.

The IRS began to audit the 2003 and 2004 returns in August 2005 and in May 2006, respectively, but did not issue a notice of deficiency until 2009. It contended that Ms. Coffey was not a *bona fide* resident of the USVI and was not entitled to the EDP credit. The Coffeys petitioned the Tax Court, arguing the three-year statute of limitations (SOL) on assessment provided by IRC § 6501(a) had expired. The IRS countered that the SOL was open because, for the year in question, it would only begin to run when the Coffeys filed a return with the IRS, not when they filed a return with the BIR. The Coffeys argued that even if they were not *bona fide* USVI residents and were supposed to file with the IRS, the BIR had forwarded their return information to the IRS, thereby triggering the SOL upon receipt by the IRS.

83 For a recommendation to fix this glitch, see Legislative Recommendation: Tax Court Jurisdiction: *Fix the Donut Hole in the Tax Court's Jurisdiction to Determine Overpayments by Taxpayers with Filing Extensions*, *supra*.

84 *Hulett v. Comm'r*, 150 T.C. No. 4 (2018), *motion for reconsideration filed* (Feb. 28, 2018). By way of background, the National Taxpayer Advocate has recommended legislation to provide a fixed statute of limitations to those claiming United States Virgin Islands (USVI) residency and filing with the Bureau of Internal Revenue (BIR). See National Taxpayer Advocate 2009 Annual Report to Congress 391-399 (Legislative Recommendation: *Provide a Fixed Statute of Limitations for U.S. Virgin Islands Taxpayers*). According to the Eleventh Circuit Court of Appeals: “We agree with the assessment made by the National Taxpayer Advocate in a 2009 report to Congress: [The IRS’s statute-of-limitations position] sends the message that the IRS might arbitrarily eliminate the benefit of any SOL by singling out those who take advantage of legitimate tax incentives. Perceptions of arbitrary and unfair tax administration not only undermine the purpose of tax incentives designed to attract business to the USVI, but may also increase controversy and diminish the public’s willingness to comply with the law, potentially reducing federal tax receipts.” *Huff v. Comm'r*, 743 F.3d 790, 799 n.12 (11th Cir. 2014).

85 IRS Form 1040, *Instructions* (2004); IRS Pub. 570, *Tax Guide for Individuals with Income from U.S. Possessions* (2004). Although IRC § 7654(e) required the IRS to issue regulations under IRC § 932, the IRS did not provide specific guidance about the filing requirements until 2007. Notice 2007-19, 2007-1 C.B. 689 divided those claiming to be *bona fide* USVI residents into two categories: those who earned \$75,000 or more and those who did not. Those earning more than \$75,000 had to file with the BIR and send a zero return (*i.e.*, return reporting no gross income) to the IRS office in Pennsylvania, with a statement explaining the taxpayer’s residency. Shortly thereafter, Notice 2007-31, 2007-1 C.B. 971, eliminated the income distinction and provided that all taxpayers claiming *bona fide* USVI residency should file just with the BIR, a position later adopted by regulation. Treas. Reg. § 1.932-1(c)(2)(ii). However, this was the IRS’s position only for tax years ending on or after December 31, 2006.

86 See IRC § 934(b).

To qualify as a return under the *Beard* test, a submission must (1) contain sufficient data to calculate tax liability, (2) purport to be a return, (3) be an honest and reasonable attempt to satisfy the requirements of the tax law, and (4) be executed under penalties of perjury.<sup>87</sup> The IRS argued what it received from the BIR was not a return because it lacked an original signature and also because it did not contain sufficient data to allow the IRS to “verify” the liability, but the Tax Court was not convinced.<sup>88</sup>

The Tax Court observed that for purposes of getting interest on an overpayment, IRC § 6611(g) provides that “a return shall not be treated as filed until it is filed in processible form,” which requires enough information for the IRS to verify the taxpayer’s computations. Thus, IRC § 6611(g) implies that a filing that lacks sufficient information to be “processable” or verifiable can still be a return.<sup>89</sup> Moreover, returns need not be perfect.<sup>90</sup> Those that are fraudulent or missing schedules are still returns for purposes of the SOL.<sup>91</sup> The court explained that the IRS had received enough information to “compute” taxable income (*i.e.*, income, deductions, and credits) without creating special procedures, as evidenced by the tax transcripts it created, even if it had not received all of the information it needed to compute the correct taxable income or to verify it.

As to the other requirements, the Tax Court concluded that the Coffeys’ filing purported to be a return because it was on the Form 1040. The court rejected the IRS’s assertion that the Form 1040 was merely a territorial filing, as the failure to file it would have been prosecuted as a failure to file a Federal Income Tax Return. It also concluded that the filing was a reasonable attempt to satisfy the law, rejecting the IRS’s assertion that the “reasonable attempt” prong of the test was subjective and that a return that reflected all zeros would have been more reasonable than what the IRS received. Further, the subjective intent of the taxpayer is not important because it would be impractical for the IRS to contemplate the taxpayer’s state of mind when processing returns.<sup>92</sup>

Finally, the Tax Court found that the requirement to sign the returns under penalties of perjury was satisfied. Although the IRS objected that the signature was photocopied, the court reasoned that in certain circumstances the IRS accepts returns by fax.<sup>93</sup> Moreover, courts have concluded that even missing signatures can be overlooked in certain circumstances (*e.g.*, where one spouse neglects to sign

87 *Beard v. Comm’r*, 82 T.C. 766 (1984), *aff’d per curiam*, 793 F.2d 139 (6th Cir. 1986).

88 The IRS did not argue that the returns did not start the SOL because they were not “filed” with the IRS.

89 Similarly, the court observed according to the Internal Revenue Manual (IRM), “a return will be valid even though it is missing Form W-2 or Schedule D, but it will not be processable because the calculations are not verifiable.” IRM 25.6.1.6.16(2) (Oct. 1, 2010).

90 *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172, 180 (1934).

91 See *Blount v. Comm’r*, 86 T.C. 383 (1986) (missing Form W-2); *McCaskill v. Comm’r*, 77 T.C. 689 (1981) (missing Schedule C); *Badaracco v. Comm’r*, 464 U.S. 386 (1984) (fraudulent returns).

92 Judge Marvel, writing for the dissent, argues that subjective intent of the taxpayer (or his or her representative) to file a return with the IRS is required to start the statute of limitations (SOL). Professor Camp observes that the majority of the Tax Court took a more functional approach that recognizes that the purpose of IRC § 6501(a) is to provide closure. See Bryan Camp, *Lesson From the Tax Court: Forms Follow Function in Return Filing*, TAXPROF BLOG (Feb. 5, 2018), [http://taxprof.typepad.com/taxprof\\_blog/2018/02/lesson-from-the-tax-court-when-filing-a-return-is-a-matter-of-principle.html](http://taxprof.typepad.com/taxprof_blog/2018/02/lesson-from-the-tax-court-when-filing-a-return-is-a-matter-of-principle.html). He argues that the court’s rationale in *Coffey* is inconsistent with *Allen v. Comm’r*, 128 T.C. 37 (2007) where the Tax Court held that the extended SOL applicable to fraudulent returns applied to a taxpayer’s return, even though a preparer, rather than the taxpayer, committed the fraud. For further discussion of *Allen*, see National Taxpayer Advocate 2007 Annual Report to Congress 562, 565 (*Significant Cases*).

93 See, *e.g.*, Rev. Rul. 68-500, 1968-2 C.B. 575 (fax signatures okay after authorization with original signature); Rev. Proc. 2005-39, 2005-2 C.B. 82 (permitting fax signatures on certain employment tax returns). See also CCA 200518079 (May 6, 2005) (concluding fax signatures are valid on a Form 872, *Consent to Extend the Time to Assess Tax*).

a joint return or where a subsidiary neglects to sign a consolidated return).<sup>94</sup> While the signature requirement helps to authenticate returns, in this case the BIR had already authenticated them.

This case is significant because it shows that the IRS continues to burden taxpayers and waste resources pursuing old cases without sufficient legal authority, even though it does not have clean hands and Congress has reiterated that taxpayers have the right to finality.<sup>95</sup> As the court explained:

[t]he IRS failed to promulgate mandatory regulations under section 932, failed to tell taxpayers that they should file protective zero returns, and failed to send the Coffeys a notice of deficiency within three years of receiving the cover-over documents. And, only a few short years later, the IRS finally did promulgate regulations that adopt precisely the position that the Coffeys took about how to start the statute of limitations. Despite all this, the Commissioner tells us that the Coffeys lose—though one is left to wonder how the current regulation is valid if the Commissioner is correct that filing anything other than a zero return with the IRS would be inadequate under the Code.

Over a decade ago, stakeholders, including stakeholders in Congress, complained to the National Taxpayer Advocate about the IRS's position.<sup>96</sup> TAS warned the IRS that it would end up wasting resources by pursuing old cases based on unconvincing legal theories, as it apparently continues to do.<sup>97</sup> This case highlights the need for Congress to require the IRS to place more emphasis on taxpayer rights.<sup>98</sup> The case also helps to clarify what constitutes a return and when the IRS has received enough information to start the SOL.<sup>99</sup>

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94 See, e.g., *Estate of Campbell v. Comm'r*, 56 T.C. 1 (1971) (spouse); *Gen. Mfg. Corp. v. Comm'r*, 44 T.C. 513 (1965) (subsidiary).

95 IRC § 7803(a)(3)(F). See *Coffey v. Comm'r*, 150 T.C. No. 4, at \*58 (2018).

96 See, e.g., Letter from Ranking Member, House Ways and Means Committee, to National Taxpayer Advocate, *reprinted as, Rangel Requests Meeting With Olson on Tax Treatment of U.S.V.I. Residents*, 2007 TNT 64-15 (Sept. 19, 2006).

97 The IRS apparently prioritized revenue considerations. See Letter from IRS to Ranking Member, Senate Finance Committee, *reprinted as, USVI Proposal Would 'Significantly Affect Examinations,' IRS Says*, 2007 TNT 222-245 (Nov. 9, 2007).

98 See National Taxpayer Advocate Purple Book: *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration 5-6 (Enact the Taxpayer Bill of Rights as a Freestanding Provision in the Internal Revenue Code)* (Dec. 2017). This case is one of many involving USVI SOL issues. See, e.g., *Appleton v. Comm'r*, 140 T.C. 273 (2013).

99 Under the Tax Court's reasoning the SOL began to run when the IRS received two pages of the return from the BIR, however, a taxpayer would not know when the IRS received such information from the BIR. By contrast, Judge Thornton's concurring opinion suggests that the SOL started when the BIR received the returns because the return was a reasonable attempt to satisfy the requirement. More Judges joined this concurring opinion than the opinion of the court.



MLI  
#1**Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)****SUMMARY**

Internal Revenue Code (IRC) § 6662(b)(1) and (2) authorizes the IRS to impose a penalty if a taxpayer's negligence or disregard of rules or regulations causes an underpayment of tax required to be shown on a return, or if an underpayment exceeds a computational threshold called a substantial understatement, respectively. IRC § 6662(b) also authorizes the IRS to impose the accuracy-related penalty on an underpayment of tax in six other circumstances.<sup>1</sup>

**TAXPAYER RIGHTS IMPACTED<sup>2</sup>**

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

**PRESENT LAW**

The amount of an accuracy-related penalty equals 20 percent of the portion of the underpayment attributable to the taxpayer's negligence or disregard of rules or regulations, or to a substantial understatement.<sup>3</sup> An underpayment is the amount by which any tax imposed by the IRC exceeds the excess of:

The sum of (A) the amount shown as the tax by the taxpayer on his return, plus (B) amounts not shown on the return but previously assessed (or collected without assessment), over the amount of rebates made.<sup>4</sup>

In computing the amount of underpayment for accuracy-related penalty purposes, Congress changed the law in 2015 to provide that the excess of refundable credits over the tax is taken into account as a negative amount.<sup>5</sup> Therefore, for returns filed after December 18, 2015, or for returns filed on or before

1 Internal Revenue Code (IRC) § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement under chapter 1 (IRC §§ 1-1400U-3); IRC § 6662(b)(4) authorizes a penalty for any substantial overstatement of pension liabilities; IRC § 6662(b)(5) authorizes a penalty for any substantial estate or gift tax valuation understatement; IRC § 6662(b)(6) authorizes a penalty when the IRS disallows the tax benefits claimed by the taxpayer when the transaction lacks economic substance; IRC § 6662(b)(7) authorizes a penalty for any undisclosed foreign financial asset understatement; and IRC § 6662(b)(8) authorizes a penalty for any inconsistent estate basis. IRC § 6662(b)(8) was added by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, § 2004(c)(1), 129 Stat. 443, 456 (2015). We have chosen not to cover the IRC § 6662(b)(3) - (8) penalties in this report, as these penalties were not litigated nearly as often as IRC § 6662(b)(1) and 6662(b)(2) during the period we reviewed.

2 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).

3 IRC § 6662(b)(1) (negligence/disregard of rules or regulations); IRC § 6662(b)(2) (substantial understatement of income tax).

4 IRC § 6664(a).

5 *Id.* Prior to December 18, 2015, refundable credits could not reduce below zero the amount shown as tax by the taxpayer on a return. See *Rand v. Comm'r*, 141 T.C. 376 (2013). On December 18, 2015, Congress enacted a law that reversed the Tax Court's decision in *Rand* and amended IRC § 6664(a) to be consistent with the rule of IRC § 6211(b)(4). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title II, § 209, 129 Stat. 2242, 3084 (2015).

that date for which the period of limitations on assessment under IRC § 6501 has not expired, a taxpayer can be subject to an IRC § 6662 underpayment penalty based on a refundable credit that reduces tax below zero.

The IRS may assess penalties under IRC § 6662(b)(1) and (2), but the total penalty rate generally cannot exceed 20 percent (*i.e.*, the penalties are not “stackable”).<sup>6</sup> Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith.<sup>7</sup>

### Negligence

The IRS may impose the IRC § 6662(b)(1) negligence penalty if it concludes that a taxpayer’s negligence or disregard of the rules or regulations caused the underpayment. A taxpayer will be subject to the negligence component of the penalty only on the portion of the underpayment attributable to negligence. If a taxpayer wrongly reports multiple sources of income, for example, some errors may be justifiable mistakes, while others might be the result of negligence; the penalty applies only to the latter.

Negligence is defined to include “any failure to make a reasonable attempt to comply with the provisions of this title, and the term ‘disregard’ includes any careless, reckless, or intentional disregard.”<sup>8</sup> Negligence includes a failure to keep adequate books and records or to substantiate items that give rise to the underpayment.<sup>9</sup> Strong indicators of negligence include instances where a taxpayer failed to report income on a tax return that a payor reported on an information return,<sup>10</sup> as defined in IRC § 6724(d)(1),<sup>11</sup> or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.<sup>12</sup> The IRS can also consider various other factors in determining whether the taxpayer’s actions were negligent.<sup>13</sup>

### Substantial Understatement

Generally, an “understatement” is the difference between (1) the correct amount of tax and (2) the tax reported on the return, reduced by any rebate.<sup>14</sup> Understatements are further reduced by the portion attributable to (1) an item for which the taxpayer had substantial authority or (2) any item for which the taxpayer, in the return or an attached statement, adequately disclosed the relevant facts affecting the

6 Treas. Reg. § 1.6662-2(c). The penalty rises to 40 percent if any portion of the underpayment is due to a gross valuation misstatement (IRC § 6662(h)(1)); Treas. Reg. § 1.6662-5(a), a nondisclosed noneconomic substance transaction (IRC § 6662(i)(1)), or an undisclosed foreign financial asset understatement (IRC § 6662(j)(3)).

7 IRC § 6664(c)(1).

8 IRC § 6662(c).

9 Treas. Reg. § 1.6662-3(b)(1).

10 Treas. Reg. § 1.6662-3(b)(1)(i).

11 IRC § 6724(d)(1) defines an information return by cross-referencing various other sections of the IRC that require information returns (e.g., IRC § 6724(d)(1)(A)(ii) cross-references IRC § 6042(a)(1) for reporting of dividend payments).

12 Treas. Reg. § 1.6662-3(b)(1)(ii).

13 These factors include the taxpayer’s history of noncompliance; the taxpayer’s failure to maintain adequate books and records; actions taken by the taxpayer to ensure the tax was correct; and whether the taxpayer had an adequate explanation for underreported income. Internal Revenue Manual (IRM 4.10.6.2.1, *Negligence* (May 14, 1999)). See also IRM 20.1.5.2.2, *Common Features of Accuracy-Related and Civil Fraud Penalties* (Dec. 13, 2016).

14 IRC § 6662(d)(2)(A)(i) - (ii).



item's tax treatment and the taxpayer had a reasonable basis for the tax treatment.<sup>15</sup> For individuals, the understatement of tax is substantial if it exceeds the greater of \$5,000 or ten percent of the tax that must be shown on the return for the taxable year.<sup>16</sup> For corporations (other than S corporations or personal holding companies), an understatement is substantial if it exceeds the lesser of ten percent of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or \$10,000,000.<sup>17</sup>

For example, if the correct amount of tax is \$10,000 and an individual taxpayer reported \$6,000, the substantial underpayment penalty under IRC § 6662(b)(2) would not apply because although the \$4,000 shortfall is more than ten percent of the correct tax, it is less than the fixed \$5,000 threshold. Conversely, if the same individual reported a tax of \$4,000, the substantial understatement penalty would apply because the \$6,000 shortfall is more than \$5,000, which is the greater of the two thresholds.

### Reasonable Cause and Good Faith

The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.<sup>18</sup> A reasonable cause determination considers all the pertinent facts and circumstances.<sup>19</sup> Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.<sup>20</sup> Reliance on a return preparer may constitute reasonable cause and good faith if the reliance was reasonable and the taxpayer acted in good faith.<sup>21</sup> *Neonatology Associates v. Commissioner* establishes the three-part test for reasonable reliance on a tax professional in accuracy-related penalty cases:

- (1) The adviser was a competent professional who had sufficient expertise to justify reliance;
- (2) The taxpayer provided necessary and accurate information to the adviser; and
- (3) The taxpayer actually relied in good faith on the adviser's judgment.<sup>22</sup>

### Reasonable Basis

An understatement of tax may be reduced by any portion of the understatement attributable to an item for which the tax treatment is adequately disclosed and supported by a reasonable basis.<sup>23</sup> This standard is met if the taxpayer's position reasonably relies on one or more authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii).<sup>24</sup> Applicable authority could include information such as sections of the IRC; proposed, temporary, or final regulations; revenue rulings and revenue procedures; tax treaties

15 IRC § 6662(d)(2)(A)(i) - (ii). No reduction is permitted, however, for any item attributable to a tax shelter. See IRC § 6662(d)(2)(C)(i). If a return position is reasonably based on one or more of the authorities set forth in Treas. Reg. § 1.6662-4(d)(3)(iii), the return position will generally satisfy the reasonable basis standard. This may be true even if the return position does not satisfy the substantial authority standard found in Treas. Reg. § 1.6662-4(d)(2). See Treas. Reg. § 1.6662-3(b)(3).

16 IRC § 6662(d)(1)(A)(i) - (ii).

17 IRC § 6662(d)(1)(B)(i) - (ii). S corporations and personal holding companies are subject to the same thresholds as individuals and all other non-C corporation taxpayers, found in IRC § 6662(d)(1)(A)(i) - (ii).

18 IRC § 6664(c)(1).

19 Treas. Reg. § 1.6664-4(b)(1).

20 *Id.*

21 Treas. Reg. § 1.6664-4(b).

22 115 T.C. 43, 99 (2000) (citations omitted), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

23 IRC § 6662(d)(2)(B)(ii)(I), (II).

24 Treas. Reg. § 1.6662-3(b)(3).

and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; and congressional intent as reflected in committee reports.<sup>25</sup>

### Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process<sup>26</sup> and through its Automated Underreporter (AUR) computer system.<sup>27</sup> Before a taxpayer receives a notice of deficiency, he or she generally has an opportunity to engage the IRS on the merits of the penalty.<sup>28</sup> Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC §§ 6211-6213).<sup>29</sup> Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to petition the United States Tax Court to challenge the assessment.<sup>30</sup> Alternatively, taxpayers may seek judicial review through refund litigation.<sup>31</sup> Under certain circumstances, a taxpayer can request an administrative review of IRS collection procedures (and the underlying liability) through a Collection Due Process hearing.<sup>32</sup>

IRC § 6751(b)(1) provides the general rule that no penalties may be assessed “unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher-level official as the Secretary may designate.” However, IRC § 6751(b)(2)(B) provides an exception for penalties calculated automatically “through electronic means.” The IRS interprets this exception as allowing it to use its AUR system to propose

25 Treas. Reg. § 1.6662-4(d)(3)(iii).

26 IRM 4.10.6.2(1), *Recognizing Noncompliance* (May 14, 1999) (“assessment of penalties should be considered throughout the audit”). See also IRM 20.1.5.3, *Examination Penalty Assertion* (Dec. 13, 2016).

27 The Automated Underreporter (AUR) is an automated program that identifies discrepancies between the amounts that taxpayers reported on their returns and what payors reported via Form W-2, Form 1099, and other information returns. IRM 4.19.3.2, *Overview of IMF Automated Underreporter* (Dec. 15, 2017); IRM 4.19.3.17.6, *Accuracy-Related Penalty Due to Negligence or Disregard of Rules or Regulations (Negligence Disregard Penalty)* (May 19, 2017).

28 For example, when the IRS proposes to adjust a taxpayer’s liability, including additions to tax such as the accuracy-related penalty, it typically sends a notice (“30-day letter”) of proposed adjustments to the taxpayer. A taxpayer has 30 days to contest the proposed adjustments to the IRS Office of Appeals, during which time he or she may raise issues related to the deficiency, including any reasonable cause defense to a proposed penalty. If the issue is not resolved after the 30-day letter, the IRS sends a statutory notice of deficiency (“90-day letter”) to the taxpayer. See IRS Pub. 5, *Your Appeal Rights and How to Prepare a Protest if You Don’t Agree* (Jan. 1999); IRS Pub. 3498, *The Examination Process* (Nov. 2004). However, for some taxpayers, the IRS sends a “combo” letter that combines the initial contact letter and the 30-day letter, which confuses taxpayers who do not know whether they should continue working with the examination function, file an appeal, or both. See National Taxpayer Advocate 2011 Annual Report to Congress, vol. 2, 85-86.

29 IRC § 6665(a)(1).

30 IRC § 6213(a). A taxpayer has 150 days instead of 90 to petition the Tax Court if the notice of deficiency is addressed to a taxpayer outside of the United States. See Most Serious Problem: *Statutory Notices of Deficiency: The IRS Fails to Clearly Convey Critical Information in Statutory Notices of Deficiency, Making it Difficult for Taxpayers to Understand and Exercise Their Rights, Thereby Diminishing Customer Service Quality, Eroding Voluntary Compliance, and Impeding Case Resolution*, *supra*.

31 Taxpayers may litigate an accuracy-related penalty by paying the tax liability (including the penalty) in full, filing a timely claim for refund, and then timely instituting a refund suit in the appropriate United States District Court or the Court of Federal Claims. 28 U.S.C. § 1346(a)(1); 28 U.S.C. § 1491; IRC §§ 7422(a); 6532(a)(1); *Flora v. United States*, 362 U.S. 145 (1960) (generally requiring full payment of tax liabilities as a prerequisite for jurisdiction over refund litigation). For exceptions to the *Flora* rule, see Legislative Recommendation: *Fix the Flora Rule: Give Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can*, *supra*.

32 IRC §§ 6320 and 6330 provide for due process hearings in which a taxpayer may raise a variety of issues, including the underlying liability, provided the taxpayer did not actually receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute such liability. IRC §§ 6320(c), 6330(c)(2)(B). See Most Serious Problem: *Collection Due Process Notices: Despite Recent Changes to Collection Due Process Notices, Taxpayers Are Still at Risk for Not Understanding Important Procedures and Deadlines, Thereby Missing Their Right to an Independent Hearing and Tax Court Review*, *supra*.

the substantial understatement and negligence components of the accuracy-related penalty without supervisor review.<sup>33</sup>

### Burden of Proof

In court proceedings involving individual taxpayers, the IRS bears the initial burden of production regarding the accuracy-related penalty.<sup>34</sup> The IRS must first present sufficient evidence to establish that the penalty was warranted.<sup>35</sup> The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.<sup>36</sup> Because the reasonable basis standard is a higher standard to meet than reasonable cause, it is possible that a taxpayer may obtain relief from a penalty assessment by successfully arguing a reasonable cause defense, even if that defense does not satisfy the reasonable basis standard.<sup>37</sup>

## ANALYSIS OF LITIGATED CASES

We identified 120 opinions issued between June 1, 2017, and May 31, 2018, where taxpayers litigated the negligence or disregard of rules or regulations, or the substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 86 cases (72 percent), taxpayers prevailed in full in 29 cases (24 percent), and five cases (four percent) were split decisions. Table 1 in Appendix 3 provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 60 of the 120 cases (50 percent). *Pro se* taxpayers convinced the court to dismiss or reduce the penalty in 22 percent of those 60 cases, which is slightly below the overall success rate for taxpayers challenging these penalties. In some cases, the court found taxpayers liable for the accuracy-related penalty but failed to clarify whether it was for negligence under IRC § 6662(b)(1) or a substantial understatement of tax under IRC § 6662(b)(2), or both. Regardless of the subsection at issue, the analysis of reasonable cause is generally the same. As such, we have combined our analyses of reasonable cause for the negligence and substantial understatement cases.

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- 33 If a taxpayer responds to an AUR-proposed assessment, the IRS first involves its employees at that point to determine whether the penalty is appropriate. If the taxpayer does not respond timely to the notice, the computers automatically convert the proposed penalty to an assessment without managerial review. See National Taxpayer Advocate 2014 Annual Report to Congress 404-410 (Legislative Recommendation: *Managerial Approval: Amend IRC § 6751(b) to Require IRS Employees to Seek Managerial Approval Before Assessing the Accuracy-Related Penalty Attributable to Negligence under IRC § 6662(b)(1)*); National Taxpayer Advocate 2007 Annual Report to Congress 259 (“Although automation has allowed the IRS to more efficiently identify and determine when such underreporting occurs, the IRS’s over-reliance on automated systems rather than personal contact has led to insufficient levels of customer service for taxpayers subject to AUR. It has also resulted in audit reconsideration and tax abatement rates that are significantly higher than those of all other IRS examination programs.”).
- 34 IRC § 7491(c) provides that “the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.”
- 35 *Higbee v. Comm’r*, 116 T.C. 438, 446 (2001); IRC § 7491(c). See *Portillo v. Comm’r*, 932 F.2d 1128 (5th Cir. 1991), *rev’g in part, aff’g in part, remanding* T.C. Memo. 1990-68, which involved an assessment based solely on an information return submitted by a third party and held that the presumption of correctness does not apply to the IRS’s deficiency assessment in a case involving unreported income if the IRS cannot present any evidence supporting the determination.
- 36 IRC § 7491(a). See also Tax Ct. R. 142(a).
- 37 Treas. Reg. § 1.6662-3(b)(3).

### Requirement for Managerial Approval Prior to Assessment of Penalties

In last year's Accuracy-Related Penalty Most Litigated Issue, we reported on two significant decisions regarding the IRC § 6751(b)(1) requirement to have a supervisor approve the penalties in writing prior to the initial determination of assessment. In *Chai v. Commissioner*, the Second Circuit held that the supervisory approval requirement is an element of a penalty claim for which the IRS bears the burden of production, and the court allowed the taxpayer to raise the lack of supervisory approval after trial.<sup>38</sup> Following *Chai*, the United States Tax Court vacated its 2016 decision in *Graev v. Commissioner*, where it had held that it was premature to conclude that the IRS had failed to comply with the supervisory approval requirement during trial because the penalty had not yet been assessed and written approval of the initial determination of the assessment could occur any time before the assessment.<sup>39</sup>

#### *Graev v. Commissioner (Graev III)*<sup>40</sup>

In late 2017, the Tax Court overruled in part its 2016 *Graev* decision and held that it was appropriate in the deficiency proceeding to consider the taxpayers' argument that the IRS failed to comply with the IRC § 6751(b)(1) supervisory approval requirement. The Graevs had claimed a charitable deduction for the donation of a facade easement. A revenue agent disallowed the deduction and proposed penalties. The agent's manager approved a 40 percent gross valuation misstatement penalty under IRC § 6662(h). IRS Counsel subsequently recommended the IRS assert, in the alternative, the 20 percent accuracy-related penalty under IRC § 6662(a). The revenue agent revised the notice of deficiency to include both penalties for the alternative noncash contributions, as recommended, but did not resubmit it for written supervisory approval. In litigation, the IRS conceded the 40 percent penalty, but continued to assert the 20 percent penalty. In the amendment to the answer, the IRS also asserted for the first time IRC § 6662(a) penalties at the 20 percent rate for the cash charitable contribution deduction and carryover deduction.

The Tax Court agreed with *Chai* that compliance with the supervisory approval requirement was part of the IRS's burden of production under IRC § 7491(c).<sup>41</sup> However, the court did not adopt *Chai*'s holding that the burden of proof with respect to the penalties also rests with the IRS.<sup>42</sup> The court found the IRS satisfied the IRC § 6751(b) requirement with respect to the alternative noncash contributions included in the notice of deficiency because the IRS Area Counsel docket attorney's memorandum, recommending the IRS assert the 20 percent penalty in the alternative, was approved in writing by his immediate supervisor, an Associate Area Counsel.<sup>43</sup> As to the cash charitable contribution deduction, which was not raised until the amendment to the answer, the court found the IRS had also met its burden because the amendment to the answer was approved in writing by the supervisor of the attorney who made and filed the amendment.<sup>44</sup>

38 *Chai v. Comm'r*, 851 F.3d 190 (2d Cir. 2017).

39 *Graev v. Comm'r*, 147 T.C. No. 16 (2016), vacated, Docket No. 30638-08 (T.C. Mar. 30, 2017).

40 149 T.C. No. 23 (2017) (hereinafter *Graev III*). This decision is the third in a series of Tax Court decisions related to the Graevs' liability for tax years 2004 and 2005.

41 149 T.C. No. 23.

42 149 T.C. No. 23, 2017 U.S. Tax Ct. LEXIS 58 at \*15 n.20 ("Once the Commissioner's burden of production is met, the taxpayer has the burden of proof with respect to defenses, *Higbee v. Commissioner*, 116 T.C. at 446, except that if the Commissioner pleads a new matter, an increase in deficiency, or an affirmative defense in the answer, the burden of proof is on the Commissioner.").

43 149 T.C. No. 23.

44 *Id.*

The taxpayers argued that, although Chief Counsel attorneys can sometimes make the initial determination of penalties, they never have the authority to make the initial penalty determination if the penalties are included in the notice of deficiency. The court rejected this argument and the argument that an initial determination cannot take the form of advice. The court found nothing in the legislative history that would suggest the person considered to make the initial determination is dependent on whether the penalty is included in the notice of deficiency.<sup>45</sup> Further, the court found that an initial determination under IRC § 6751(b), whether made by an examination employee or Chief Counsel attorney, is advice until it receives supervisory approval and is finalized by the Commissioner or one of his agents.<sup>46</sup>

### *Other Decisions Addressing IRC § 6751(b)*

Of the 120 cases we reviewed this year, there were eight decisions where the court found the taxpayers not liable for the accuracy-related penalty under IRC § 6662(b)(1) or (b)(2) because the IRS did not meet its burden of production with respect to the supervisory approval requirement.<sup>47</sup> In two of these eight cases, the court refused to reopen the record to allow additional evidence of compliance with IRC § 6751(b).<sup>48</sup> In addition to *Graev III*, in ten of the cases reviewed, the court specifically noted that the IRS met its burden of production with respect to the IRC § 6751(b) requirement, including two cases where it chose to reopen the record to allow evidence of compliance.<sup>49</sup> In *Dynamo Holdings Limited Partnership v. Commissioner*, an opinion not included in the 120 cases because it was not a final decision on the merits of IRC § 6662, the taxpayers' motion to dismiss the accuracy-related penalties based on lack of supervisory approval was denied.<sup>50</sup> The court concluded that under IRC § 7491(c), the IRS did not have the burden of production with respect to the penalties because it was a partnership-level proceeding, which is not a proceeding with respect to an individual and by its nature inconsistent with IRC § 7491(c), which relates to liability. However, the court noted that the IRS's not bearing the burden of production does not necessarily mean a motion by the IRS to reopen the record should be denied. A taxpayer may raise the lack of supervisory approval as a defense to the penalties. Then the IRS might want to reopen the record to demonstrate compliance if the issue was properly raised as a defense. However, in *Dynamo Holdings*, the partnership did not raise the lack of supervisory approval until after the record was closed and the case was fully submitted, and did not seek to reopen the record to argue there was no written approval.

*Dynamo Holdings* and the other cases where the court either did or did not allow for the record to be reopened demonstrate the confusion and variability following the aftermath of the *Chai* and *Graev* decisions. In June 2018, the IRS Office of Chief Counsel issued a Notice, explaining how to address IRC § 6751(b) issues in litigation.<sup>51</sup> The Notice advises that if an attorney raises the penalty in an answer or amended answer, the attorney's immediate supervisor must provide written approval. If an IRS employee receives a recommendation from a Chief Counsel attorney that a penalty should be asserted, the Notice states that the attorney should advise the IRS employee to document his or her acceptance of that recommendation and have his or her immediate supervisor approve the acceptance in

45 149 T.C. No. 23.

46 *Id.*

47 See, e.g., *Ford v. Comm'r*, T.C. Memo. 2018-8, *aff'd*, 2018 U.S. App. LEXIS 31221 (6th Cir., Nov. 5, 2018); *Azam v. Comm'r*, T.C. Memo. 2018-72.

48 *Rademacher v. Comm'r*, T.C. Memo. 2018-43; *Azam v. Comm'r*, T.C. Memo. 2018-72.

49 *Fiedziuszko v. Comm'r*, T.C. Memo. 2018-75; *Sarvak v. Comm'r*, T.C. Memo. 2018-68.

50 150 T.C. No. 10 (2018). The taxpayers in these consolidated cases were a corporation and the tax matters partner of a partnership. The IRS sought to impose the accuracy-related penalty only against the tax matters partner.

51 IRS Chief Counsel Notice Section 6751(b), Compliance Issues for Penalties in Litigation, CC-2018-006 (June 6, 2018).

writing. In cases where there is no sufficient evidence to meet the burden of production with respect to the supervisory approval requirement, the Notice advises Counsel attorneys to concede the case.

### Reasonable Cause

#### *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*<sup>52</sup>

The taxpayer, a foreign corporation, bought an interest in a U.S. limited liability company that was a partnership for tax purposes. In 2008, the partnership redeemed the taxpayer's interest and made two liquidating payments to the taxpayer. The taxpayer did not report any gain from the redemption. Although the taxpayer conceded that the gain realized that was attributable to U.S. real property interests was taxable income, the taxpayer challenged the remainder of the gain that was not U.S.-source income and not effectively connected to a U.S. trade or business, and the accuracy-related penalty for the conceded liability.

The court found the taxpayer was not liable for the accuracy-related penalty because the taxpayer established reasonable cause and good faith. The court noted that the foreign corporation had no other involvement in U.S. business, outside the investment in the partnership. The taxpayer's central financial officer did not understand the concept of a partnership for tax purposes. The taxpayer relied on advice from a trusted advisor to hire a tax professional, which the court found was reasonable given what little the taxpayer knew of the U.S. tax system. Although the tax professional did not specialize in international tax or have an LL.M. degree, the court found that as a licensed attorney and certified public accountant, the tax professional met the *Neonatology* test requiring "a competent professional who had sufficient expertise to justify reliance."<sup>53</sup>

#### *Petersen v. Commissioner*<sup>54</sup>

The married taxpayers were shareholders of a closely held S corporation, which formed an employee stock ownership plan (ESOP) and transferred stock and cash to the related ESOP trust. As a matter of first impression, the court held that the entity holding the corporation's stock for the benefit of its ESOP participants was a "trust" under the Code. Also as a matter of first impression, the court held the S corporation and employees taking part in the ESOP were "related persons" under IRC § 267(a), which defers deductions for expenses paid by a taxpayer to a related person until those payments are includable in the person's gross income. In determining the taxpayers met the reasonable cause and good faith exception to the accuracy-related penalty, the court relied solely on the fact that the application of IRC § 267(a) to employers and ESOP participants was a question of first impression. The court noted that it had previously decided not to impose a penalty where it was an issue of first impression and the statutory language was not fully clear.<sup>55</sup> Because the taxpayers made a good-faith effort to assess their tax liabilities properly and acted reasonably and in good faith, the court refused to impose any accuracy-related penalty.

<sup>52</sup> 149 T.C. No. 3 (2017).

<sup>53</sup> 149 T.C. No. 3, 2017 U.S. Tax Ct. LEXIS 36 at \*51 (quoting *Neonatology Assocs., P.A. v. Comm'r*, 115 T.C. at 99).

<sup>54</sup> *Petersen v. Comm'r*, 2017 WL 2558852 (T.C. 2017), appeal docketed, No. 17-9003 (10th Cir., Aug. 8, 2017).

<sup>55</sup> *Id.* at \*26 (citing *Hitchens v. Comm'r*, 103 T.C. 711, 719-720 (1994)). See also *Avrahami v. Comm'r*, 2017 WL 3610601 (T.C. Aug. 21, 2017), another case we reviewed this year, in which the court found reasonable cause and good faith based partly on the fact that the issue involving a captive insurance company was one of first impression.



*McGuire v. Commissioner*<sup>56</sup>

The married taxpayers received the advanced premium tax credit (APTC) under the Affordable Care Act, which was paid directly to their health insurance provider to reduce their insurance premiums. During the tax year, Mrs. McGuire, who was not working at the start of the year, received a job that increased their household income above 400 percent of the federal poverty level, disqualifying them for the APTC. The taxpayers made repeated attempts to notify their health insurance provider of this change in income. However, their health insurance provider did not make any changes to account for this change in income, nor did it update the taxpayers' address after the taxpayers notified them of this change. Thus, the taxpayers did not receive correspondence from the provider or Form 1095-A, *Health Insurance Marketplace Statement*.

When the taxpayers filed their annual return, they did not report the APTC of \$7,092 that was paid to the healthcare provider. First, the court noted that in the notice of deficiency, the IRS made “a boilerplate determination of an accuracy-related penalty” by identifying “four possible causes for the underpayment: negligence, a substantial understatement of income tax, a substantial valuation misstatement, and a transaction lacking economic substance.” The court immediately disregarded the latter two as having no relevance to the facts of this case. Likewise, the court disregarded the negligence penalty, noting that the IRS had the burden of production with respect to penalties but did not provide any evidence as to why the negligence penalty might apply.<sup>57</sup> Finally, the court determined that even though the amount of understatement met the threshold under IRC § 6662(d)(1)(A), the taxpayers were not liable for the accuracy-related penalty due to reasonable cause and good faith. The court stated that not receiving an information return generally is not enough in and of itself to constitute reasonable cause. However, the court noted that it had recently held in *Frias v. Commissioner* that nonreceipt of an information return could contribute to a reasonable cause finding if the taxpayer did not know or have reason to know about receiving the income.<sup>58</sup> The court noted that the taxpayers did not receive the Form 1095-A, and the APTC was paid directly to the health insurance provider. The taxpayers had relied on a third party (the healthcare provider) to properly determine and adjust their eligibility for the APTC. In addition, the taxpayers relied on a certified public accountant to prepare their return.

**Calculation of the Understatement***Galloway v. Commissioner*<sup>59</sup>

The married taxpayers filed a return claiming the American Opportunity Tax Credit (AOC), which was calculated on Form 8863 as \$7,500 (\$2,500 for each of their children). However, due to what appears to be a clerical error, the taxpayers only reported the refundable portion of the credit (\$3,000) on their Form 1040, and omitted the \$4,500 nonrefundable portion. The taxpayers claimed a refund of \$4,303 on their return, but during processing the IRS adjusted their return to account for the nonrefundable portion of the AOC and issued a refund of \$8,803. Subsequently during examination, the IRS disallowed the AOC in full.

56 *McGuire v. Comm'r*, 2017 WL 3730620 (T.C. Aug. 28, 2017).

57 The National Taxpayer Advocate has previously written about how the IRS's assessment of negligence penalties by automatic means without speaking to the taxpayer infringes on taxpayer rights. National Taxpayer Advocate 2014 Annual Report to Congress 404-410 (Legislative Recommendation: *Managerial Approval: Amend IRC § 6751(b) to Require IRS Employees to Seek Managerial Approval Before Assessing the Accuracy-Related Penalty Attributable to Negligence under IRC § 6662(b)(1)*).

58 In *Frias v. Commissioner*, the taxpayer was on maternity leave from her job and did not know or have reason to know that her loan from her retirement plan was treated as a deemed distribution because her employer did not deduct the loan repayment amounts from her paycheck. T.C. Memo. 2017-139.

59 149 T.C. No. 19 (2017).

Mr. Galloway conceded at trial that they were not entitled to any portion of the AOC, and the opinion suggests the AOC had already been claimed for the children in the prior four taxable years, making the children ineligible. However, the taxpayers argued that the IRS did not meet its burden of production with respect to the accuracy-related penalty under IRC § 6662(b)(2) because the understatement should be limited to \$3,000, which was the amount of the refund they sought on their return. The taxpayers posited that had the IRS not issued them the refund, the amount of the deficiency would be under the statutory \$5,000 threshold. The court disagreed, citing the definition of an understatement in IRC § 6662(d)(2)(A), which states that the amount of tax shown on a taxpayer's return is "reduced by any rebate."<sup>60</sup> The court rejected the argument that the taxpayers were being penalized by the IRS's action and noted that for a refund to meet the definition of "rebate," it must be based on a determination that the tax imposed is less than the tax shown on the taxpayer's return. The court considered the tax shown on the return to include the nonrefundable AOC shown on the Form 8863 and considered its omission on the Form 1040, *U.S. Individual Income Tax Return*, to be a clerical error.

The taxpayers argued that the amount of the understatement should nonetheless be reduced to \$3,000 because there was substantial authority for the taxpayers to not claim the nonrefundable portion of the credit. In the alternative, they argued the form used to calculate the credits served as a disclosure, and there was a reasonable basis for the taxpayers not to claim the \$4,500 on the return. The court dismissed these arguments because:

We do not view petitioners as having claimed only a \$3,000 refundable AOC: Their Form 8863 reported a total AOC of \$7,500. Petitioners are not subject to the accuracy-related penalty for their failure to claim a \$4,500 nonrefundable AOC on their Form 1040 but instead for their claim of such a credit on their Form 8863. Because the refundable portion of the AOC is, by definition, 40% of the total AOC to which a taxpayer is entitled, sec. 25A(i)(6), claiming a \$3,000 refundable AOC and no nonrefundable AOC cannot be supported by substantial authority.<sup>61</sup>

Finally, the taxpayers argued reasonable cause and good faith, stating they attempted to follow the instructions of a return preparation program and the error was due to confusion. The court relied heavily on the unambiguous statutory language that states the credit is only available for the first four years of post-secondary education and the clear instructions on Form 8863 to conclude that the taxpayers' confusion was not reasonable based on the circumstances.

This case demonstrates that an understatement can give rise to an accuracy-related penalty where the taxpayer actually entered a larger refund on part of his or her return, but did not claim it, and the IRS adjusted the return. In a footnote, the court notes that in theory, an understatement could arise from a refund that is based on an erroneous third-party information return, but presumably a taxpayer would be able to show reasonable cause and good faith if he or she did nothing to initiate the refund and bore no responsibility for the erroneous third-party reporting.<sup>62</sup>

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60 *Galloway*, 149 T.C. No. 19.

61 *Galloway*, 149 T.C. No. 19, 2017 U.S. Tax Ct. LEXIS 53 at \*20.

62 *Galloway*, 149 T.C. No. 19, 2017 U.S. Tax Ct. LEXIS 53 at \*19 n.4.



## CONCLUSION

The accuracy-related penalty under IRC § 6662(b)(1) and (2) remains the number one most litigated tax issue, continuing a trend from the last five years. The *Graev III* decision should bring more clarity for future cases by establishing that the Tax Court will follow the *Chai* decision with respect to the requirement for the IRS to show compliance with IRC § 6751(b) as part of its burden of production. However, because of the multiple cases that were initiated before *Graev III* and some even before *Chai*, the Tax Court is likely to continue to grapple with under what circumstances it is appropriate to reopen the record to allow the IRS to demonstrate compliance. This year, we saw courts allow it in some circumstances, but not in others. In addition, because the Tax Court declined to adopt *Chai*'s holding that compliance with IRC § 6751(b) is part of the burden of proof, there may be some uncertainty for taxpayers depending on where their cases may be appealed.

The cases of *Petersen v. Commissioner* and *McGuire v. Commissioner* were positive for taxpayers. In *Petersen*, the court suggested that issues of first impression should generally give rise to a reasonable cause finding. Conversely, in *McGuire*, the court held that nonreceipt of an information return does not generally constitute reasonable cause by itself, but that such nonreceipt could contribute to a reasonable cause finding.

The *Galloway* decision shows that the IRS can find an accuracy-related penalty as a result of an adjustment it makes to a return, based on an attached form. The court mentioned in a footnote the possibility of finding an understatement based on a third-party's information return but noted that such a taxpayer could qualify for the reasonable cause exception. Future cases may show how far the IRS can go in terms of basing an accuracy-related penalty on an adjustment it makes to a return.

## MLI #2 Trade or Business Expenses Under IRC § 162 and Related Sections

### SUMMARY

The deductibility of trade or business expenses has long been among the ten Most Litigated Issues (MLIs) since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.<sup>1</sup> We identified 106 cases involving a trade or business expense issue that were litigated in federal courts between June 1, 2017, and May 31, 2018. The courts affirmed the IRS position in 81 of these cases, or about 76 percent, while taxpayers fully prevailed in only six cases, or about six percent of the cases. The remaining 19 cases, or about 18 percent, resulted in split decisions.

### TAXPAYER RIGHTS IMPACTED<sup>2</sup>

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

### PRESENT LAW

Internal Revenue Code (IRC) § 162(a) permits a taxpayer to deduct ordinary and necessary trade or business expenses paid or incurred during the taxable year.<sup>3</sup> These expenses include:

- A reasonable allowance for salaries or other compensation for personal services actually rendered;
- Travel expenses while away from home in the pursuit of a trade or business; and
- Rentals or other payments for use of property in a trade or business.<sup>4</sup>

In addition to the general allowable expenses described above, IRC § 162 addresses deductible and nondeductible expenses incurred in carrying on a trade or business, and provides special rules for health insurance costs of self-employed individuals.<sup>5</sup>

The interaction of IRC § 162 with other Code sections that explicitly limit or disallow deductions can be very complex. For example, the year in which the deduction for trade or business expenses can be

1 See National Taxpayer Advocate 1998-2016 Annual Reports to Congress.

2 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).

3 The taxable year in which a business expense may be deducted depends on whether the taxpayer uses the cash or accrual method of accounting. IRC § 446.

4 IRC § 162(a)(1), (2), and (3).

5 See, e.g., IRC § 162(c), (f), and (l). For example, nondeductible trade or business expenses include illegal bribes, kickbacks, fines, and penalties.

taken and its amount depend on when the cost was paid or incurred, the useful life of an asset on the date of acquisition, and when it was sold or when the business operation is terminated.<sup>6</sup>

Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance over the years. The IRS, the Department of Treasury, Congress, and the courts continue to pose questions and provide legal guidance about whether a taxpayer is entitled to certain trade or business deductions. The litigated cases analyzed for this report illustrate both the ongoing nature of this process and the necessary analysis of facts and circumstances unique to each case. When a taxpayer seeks judicial review of the IRS's determination of a tax liability relating to the deductibility of a particular expense, the courts must often address a series of questions, including, but not limited to, the ones discussed below.

### What Is a Trade or Business Expense Under IRC § 162?

Although “trade or business” is a widely used term in the IRC, neither the Code nor the Treasury Regulations provide a definition.<sup>7</sup> The definition of a “trade or business” comes from common law, where the concepts have been developed and refined by the courts.<sup>8</sup> The Supreme Court has interpreted “trade or business” for purposes of IRC § 162 to mean an activity conducted with “continuity and regularity” and with the primary purpose of earning income or making a profit.<sup>9</sup>

### What Is an Ordinary and Necessary Expense?

IRC § 162(a) requires a trade or business expense to be both “ordinary” and “necessary” in relation to the taxpayer's trade or business to be deductible. In *Welch v. Helvering*, the Supreme Court stated that the words “ordinary” and “necessary” have different meanings, both of which must be satisfied for the taxpayer to benefit from the deduction.<sup>10</sup> The Supreme Court describes an “ordinary” expense as customary or usual and of common or frequent occurrence in the taxpayer's trade or business.<sup>11</sup> The Court describes a “necessary” expense as one that is appropriate and helpful for the development of the business.<sup>12</sup>

Common law also requires that in addition to being ordinary and necessary, the amount of the expense must be reasonable for the expense to be deductible. In *Commissioner v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held “the element of reasonableness is inherent in the phrase ‘ordinary

6 See, e.g., IRC § 165 (deductibility of losses), IRC § 167 (deductibility of depreciation), IRC § 183 (activities not engaged in for profit), and IRC § 1060 (special allocation rules for certain asset acquisitions, including the reporting of business asset sales when closing a business).

7 *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987). “The phrase ‘trade or business’ has been in section 162(a) and that section's predecessors for many years. Indeed, the phrase is common in the Code, for it appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations... The concept thus has a well-known and almost constant presence on our tax-law terrain. Despite this, the Code has never contained a definition of the words “trade or business” for general application, and no regulation has been issued expounding its meaning for all purposes. Neither has a broadly applicable authoritative judicial definition emerged.”

8 Carol Duane Olson, *Toward a Neutral Definition of “Trade or Business” in the Internal Revenue Code*, 54 U. CIN. L. REV. 1199 (1986).

9 *Groetzinger*, 480 U.S. at 35.

10 290 U.S. 111, 115 (1933) (suggesting an examination of “life in all its fullness” will provide an answer to the issue of whether an expense is ordinary and necessary).

11 *Deputy v. du Pont*, 308 U.S. 488, 495 (1940) (internal citations omitted).

12 See *Comm'r v. Heining*, 320 U.S. 467, 471 (1943).

and necessary.’ Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount.<sup>13</sup>

Further, an employee business expense is not ordinary and necessary if the employee is entitled to reimbursement from the employer.<sup>14</sup> The employee has the burden of establishing the amount of the expense and that the expense is not eligible for reimbursement.

### Is the Expense a Currently Deductible Expense or a Capital Expenditure?

A currently deductible expense is an ordinary and necessary expense paid or incurred during the taxable year in the course of carrying on a trade or business.<sup>15</sup> No current deductions are allowed for the cost of acquisition, construction, improvement, or restoration of an asset expected to last more than one year.<sup>16</sup> Instead, those types of expenses are generally considered capital expenditures, which may be subject to depreciation, amortization, or depletion over the useful life of the property.<sup>17</sup>

Whether an expenditure is deductible under IRC § 162(a) or is a capital expenditure under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach to applying principles of capitalization and deductibility.<sup>18</sup>

### When Is an Expense Paid or Incurred During the Taxable Year, and What Proof Is There That the Expense Was Paid?

IRC § 162(a) requires an expense to be “paid or incurred during the taxable year” to be deductible. The IRC also requires taxpayers to maintain books and records that substantiate income, deductions, and credits, including adequate records to substantiate deductions claimed as trade or business expenses.<sup>19</sup> If a taxpayer cannot substantiate the exact amounts of deductions by documentary evidence (*e.g.*, invoice paid, paid bill, or canceled check) but can establish that he or she had some business expenditures, the courts may employ the *Cohan* rule to grant the taxpayer a reasonable amount of deductions.<sup>20</sup>

#### The Cohan Rule

The *Cohan* rule is one of “indulgence” established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.<sup>21</sup> The court held that the taxpayer’s business expense deductions were not adequately substantiated, but stated that “the [Tax Court] should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But

13 176 F.2d 815, 817 (6th Cir. 1949), *cert. denied*, 338 U.S. 949 (1950).

14 *Podems v. Comm’r*, 24 T.C. 21, 22-23 (1955).

15 IRC § 162(a).

16 IRC § 263. See also *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79 (1992).

17 IRC § 167; IRC § 179. Note, the Tax Cuts and Jobs Act increased the maximum deduction under IRC § 179 from \$500,000 to \$1 million and increased the maximum asset-spending phaseout from \$2 million to \$2.5 million. IRC § 179(b)(1), (b)(2).

18 See *PNC Bancorp, Inc. v. Comm’r*, 212 F.3d 822 (3d Cir. 2000); *Norwest Corp. v. Comm’r*, 108 T.C. 265 (1997).

19 IRC § 6001. See also Treas. Reg. §§ 1.6001-1 and 1.446-1(a)(4).

20 See *Cohan v. Comm’r*, 39 F.2d 540 (2d Cir. 1930).

21 *Id.* George M. Cohan was an actor, playwright, and producer who spent large sums travelling and entertaining actors, employees, and critics. Although Cohan did not keep a record of his spending on travel and entertainment, he estimated that he incurred \$55,000 in expenses over several years. The Board of Tax Appeals, now the Tax Court, disallowed these deductions in full based on Cohan’s lack of supporting documentation. Nevertheless, on appeal, the Second Circuit concluded that Cohan’s testimony established that legitimate deductible expenses had been incurred. As a result, the Second Circuit remanded the case back to the Board of Tax Appeals with instructions to estimate the amount of deductible expenses.

to allow nothing at all appears to us inconsistent with saying that something was spent.”<sup>22</sup> In *Estate of Elkins v. Commissioner*, the Fifth Circuit described “the venerable lesson of Judge Learned Hand’s opinion in *Cohan*: In essence, make as close an approximation as you can, but never use a zero.”<sup>23</sup>

The *Cohan* rule cannot be used in situations where IRC § 274(d) applies. IRC § 274(d) provides that unless a taxpayer complies with strict substantiation rules, no deductions are allowable for:

- Travel expenses;
- Gifts; and
- Certain “listed property.”<sup>24</sup>

A taxpayer must substantiate a claimed IRC § 274(d) expense with adequate records or sufficient evidence to establish the amount, time, place, and business purpose.<sup>25</sup> A contemporaneous log is not explicitly required, but a statement not made at or near the time of the expenditure has the same degree of credibility only if the corroborative evidence has “a high degree of probative value.”<sup>26</sup>

### Who Has the Burden of Proof in a Substantiation Case?

Generally, the taxpayer bears the burden of proving that he or she is entitled to the business expense deductions and the IRS’s proposed determination of tax liability is incorrect.<sup>27</sup> IRC § 7491(a) provides that the burden of proof shifts to the IRS when the taxpayer:

- Introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer’s liability;
- Complies with the requirements to substantiate deductions;
- Maintains all records required under the Code; and
- Cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.

## ANALYSIS OF LITIGATED CASES

The deductibility of trade or business expenses has been one of the ten MLIs since the first edition of the National Taxpayer Advocate’s Annual Report to Congress in 1998.<sup>28</sup> This year, we reviewed 106 cases involving trade or business expenses that were litigated in federal courts from June 1, 2017, through May 31, 2018. Table 2 listed in Appendix 3. contains a list of the respective issues in these cases.

22 39 F.2d 540 (2d Cir. 1930) at 544, *aff’g and remanding* 11 B.T.A. 743 (1928).

23 767 F.3d 443, 449 n. 7 (5th Cir. 2014) (citing *Cohan*, 39 F.2d at 543-44), *rev’g* 140 T.C. 86 (2013).

24 “Listed property” means any passenger automobile; any other property used as a means of transportation; any property of a type generally used for purposes of entertainment, recreation, or amusement; any computer or peripheral equipment (except when used exclusively at a regular business establishment and owned or leased by the person operating such establishment); and any other property specified by regulations. IRC § 280F(d)(4)(A) and (B).

25 Treas. Reg. § 1.274-5T(b). Ironically, if George M. Cohan brought his case today before the Tax Court, he would be unable to benefit from application of that rule because of the strict substantiation required by IRC § 274(d).

26 Treas. Reg. § 1.274-5T(c)(1); *Reynolds v. Comm’r*, 296 F.3d 607, 615-16 (7th Cir. 2002) (noting that keeping written records is not the only method to substantiate IRC § 274 expenses but “alternative methods are disfavored”).

27 See *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (citations omitted) and U.S. Tax Court Rules of Practice and Procedure, Rule 142(a).

28 See National Taxpayer Advocate 1998-2016 Annual Reports to Congress.

Figure 3.2.1 categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

**FIGURE 3.2.1, Trade or Business Expense Issues Cases Reviewed<sup>29</sup>**

Issue	Type of Taxpayer	
	Individual	Business
Substantiation of Expenses Under IRC § 162, Including Application of the <i>Cohan</i> Rule	3	44
Substantiation of Expenses Under IRC § 274(d)	9	23
Schedule A Unreimbursed Employee Expenses Requiring Proof Employer Did Not Reimburse Taxpayer Under IRC § 162	14	5
Hobby Losses, Nondeductible Under Either IRC §§ 183 or 162	1	12
Home Office Under IRC § 280A	0	3
Net Operating Losses Under IRC § 172	0	7
Personal Expenditures Disallowed Under IRC § 262	2	1
Capitalization and Cost Recovery Under IRC §§ 263, 263A, 195, 179, and 167	3	9
Illegal Activities Under IRC §§ 280E, 162(c), 162(f), and 162(g)	0	1
Economic Substance Doctrine	1	3
Business Bad Debt Deduction Under IRC § 166	0	10
Not Engaged In a Trade or Business Under IRC § 162	2	10
Interest Deduction Under IRC § 163	0	2

Taxpayers represented themselves (*pro se*) in 60 of the 106 cases (about 57 percent). Taxpayers were represented by counsel in 46 out of the 106 cases (about 43 percent). Of the 106 cases, the taxpayers prevailed in six cases in full, and in 19 cases in part. The IRS won in the remaining 81 cases. None of the *pro se* individual taxpayers prevailed in full.

As in previous years, a number of individual taxpayers claimed deductions for Schedule A unreimbursed employee expenses that were either related to personal rather than business activities or the taxpayer did not meet the burden of showing his or her employer would not reimburse these expenses.<sup>30</sup> Additionally, taxpayers claimed travel, meals, and entertainment expenses, but occasionally failed to meet the heightened substantiation requirements of IRC § 274(d).<sup>31</sup> Many *pro se* litigants were unable to meet substantiation requirements.<sup>32</sup>

29 Multiple issues can appear within one case; therefore these figures will not match the total case count.

30 See, e.g., *Farolan v. Comm'r*, T.C. Summ. Op. 2018-28; *Cates v. Comm'r*, T.C. Memo. 2017-178, *appeal dismissed*, (11th Cir. Apr. 30, 2018); *Beckey v. Comm'r*, T.C. Summ. Op. 2017-80.

31 See *Lewis v. Comm'r*, T.C. Memo. 2017-117; *Fehr v. Comm'r*, T.C. Summ. Op. 2018-26.

32 See *Wooten v. Comm'r*, T.C. Summ. Op. 2017-58.

### Individual Taxpayers

Unsurprisingly, relatively few of this year's IRC § 162 trade or business cases involve individual taxpayers (the term "individual" excludes sole proprietorships). All of these cases were issued as either Tax Court memorandum opinions or summary opinions.<sup>33</sup> Two cases illustrating some of the most commonly arising issues in individual trade or business cases are *Baham v. Commissioner* and *Rademacher v. Commissioner*.<sup>34</sup>

Although Tax Court summary opinions have no precedential value, the Tax Court's decision in *Baham v. Commissioner* provides an instructive scenario in which *pro se* Taxpayers (a husband and wife) sought to deduct, as unreimbursed employee business expenses, costs the wife incurred in relation to various animals she brought into the classroom as a teacher.<sup>35</sup> In order for a teacher to deduct expenses for teaching supplies, the supplies must be directly related to the job and a necessary expense of being a teacher, not just helpful to students and appropriate for use in the classroom.<sup>36</sup>

At various points, Mrs. Baham acquired and cared for two bearded dragons, two African gray parrots, several red-eared sliders, two rabbits, koi, a tortoise, and a rainbow boa that she kept in the classroom during the school year. She then would take them home at the end of each school year to look after them over the summer. The Tax Court determined the related expenses generally were not personal expenditures, as testimony indicated that her children disliked having the animals at home because they were required to clean up after them, and the animals were not given names. Moreover, the animals did assist the teacher in her work, as they reduced tardiness and truancy and helped better engage the attention of students.

Nevertheless, the Tax Court denied Taxpayers' claimed deductions on the grounds that the expenses were not "ordinary and necessary," as required by IRC § 162. "We do not doubt that the classroom animals were pedagogically helpful to students and appropriate for classroom use, but this is not sufficient to cause these expenses to be deductible as ordinary and necessary business expenses." The court based its holding on the premise that, although teachers may, at times, provide equipment for classroom use out of their own funds, they do not do so ordinarily, even though the result might be to enhance their reputations as dedicated teachers or to increase the quality of the education they provide.

As discussed in the Present Law section above, taxpayers must substantiate their trade or business expenditures. Additionally, certain categories of expenses are subject to heightened substantiation requirements under IRC § 274(d). One case considering whether these more stringent standards were met is *Rademacher v. Commissioner*, which examined the expenses of a manager of a used car business.<sup>37</sup> Taxpayer, as part of his duties, incurred expenses for vehicle mileage, travel, meals, and entertainment, which he sought to deduct.

33 Tax Court decisions are categorized into three types: regular decisions, memorandum decisions, and small tax case ("S") decisions. The regular decisions of the Tax Court include cases which have some new or novel point of law, or in which there may not be general agreement, and therefore have the most legal significance. In contrast, memorandum decisions generally involve fact patterns within previously settled legal principles and therefore are not as legally significant. Finally, "S" case decisions (for disputes involving \$50,000 or less where the taxpayer has elected Small Case status) are not appealable and thus have no precedential value. See also IRC § 7463(b); U.S. Tax Court Rules of Practice and Procedure, Rules 170-175.

34 *Baham v. Comm'r*, TC Summ. Op. 2017-85; *Rademacher v. Comm'r*, T.C. Memo 2018-43.

35 *Baham v. Comm'r*, T.C. Summ. Op. 2017-85.

36 *Farias v. Comm'r*, T.C. Memo. 2011-248 (citations omitted).

37 *Rademacher v. Comm'r*, T.C. Memo. 2018-43.



The Tax Court disallowed Taxpayer's meals and entertainment expenses attributable to snacks, coffee, and drinks for potential clients, which he estimated at approximately \$60 per day, but could not document.<sup>38</sup> On the other hand, as part of his duties, Taxpayer was required to attend the same four car auctions every week, to which he drove his personal vehicle. As he was not reimbursed for this mileage and could establish that he drove approximately 38,000 miles per year for the years in question, the Tax Court held that Taxpayer had met his substantiation burden, even under the heightened standards of IRC § 274(d). Accordingly, these deductions were sustained.

### Business Taxpayers

TAS reviewed 86 cases involving business taxpayers. In this context, business taxpayers fully prevailed in six cases (approximately seven percent), partially prevailed in 13 cases (approximately 15 percent), and the IRS was completely successful in the remaining cases (approximately 78 percent).

Of cases in which business taxpayers fully or partially prevailed, 47 percent (9 of 19) involved taxpayers represented by counsel. Alternatively, ten *pro se* business taxpayers partially prevailed, but none fully prevailed. Of cases in which the IRS fully prevailed, approximately 49 percent (33 of 67) involved business taxpayers represented by counsel, while approximately 51 percent (34 of 67) involved *pro se* taxpayers.

As was the case for the individual taxpayers, substantiation of deductible expenses was by far the most prevalent issue. In most such cases, courts denied business taxpayers' deductions for failure to substantiate.<sup>39</sup> However, courts did allow deductions for some expenses when business taxpayers were able to provide sufficient evidence in the form of records, receipts, or logs.<sup>40</sup> Courts occasionally applied the *Cohan* rule where the taxpayer presented sufficient documentation to prove an expense was incurred but had limited documentation of the precise amount.<sup>41</sup> As previously mentioned, however, IRC § 274(d) makes the *Cohan* rule unavailable in certain circumstances in which taxpayers are subject to heightened documentation requirements.

Nevertheless, even where IRC § 274(d) requirements are absent, the courts still demand the production of persuasive evidence before they will apply *Cohan*. For example, in *Brookes v. Commissioner*, a husband and wife carried on a business under the auspices of Brookes Financial, an S corporation.<sup>42</sup> Taxpayer wife operated an art business, while Taxpayer husband conducted a financial services and tax return preparation business.

Among other expenditures, Taxpayers sought to deduct miscellaneous expenses through their S corporation, including legal and professional fees, maintenance costs, office expenses, and storage, telephone, and utility charges. The Tax Court determined Taxpayers provided poorly organized evidence but nonetheless looked at the merits of the case and applied the *Cohan* rule. As explained by

38 Under changes made by the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054, 2124 (2017), deductions for entertainment expenses are no longer allowable for amounts incurred or paid after December 31, 2017. IRC § 274(a)(1). Subject to various limitations, meals remain deductible to the extent that they do not constitute entertainment.

39 See, e.g., *RJ Channels, Inc. v. Comm'r*, T.C. Memo. 2018-27; *Justine v. Comm'r*, T.C. Memo. 2017-198.

40 See, e.g., *Cai v. Comm'r*, T.C. Memo. 2018-52.

41 See, e.g., *Pokawa v. Comm'r*, T.C. Memo. 2017-186.

42 *Brookes v. Comm'r*, T.C. Memo. 2017-146.



the Tax Court, however, Taxpayers' level of substantiation was insufficient even to support an estimate of any deductions:

The Court has sustained respondent's determination with regard to these deductions because petitioners have failed to offer any evidence that certain expenses were in fact paid and because petitioners' lack of receipts, confusing and inconsistent accounting techniques, and vague testimony leave the Court with no reasonable means of differentiating or estimating which of the reported expenses Brookes Financial paid as ordinary and necessary business expenses.

By contrast, the Tax Court was willing to apply *Cohan* to allow some deductions for art supply costs and rental expenditures. The Tax Court began its analysis by determining that Taxpayers did not meet their substantiation burden because of illegible or insufficient receipts for the art supplies and a lack of proof of payment for the rent. Nevertheless, the court applied *Cohan* to allow Taxpayers a portion of their claimed deductions, as the court was persuaded that such payments had been made and the minimum amount could be estimated with reasonable accuracy.

Another issue that is the subject of recurring litigation from year to year involves taxpayers' attempts to deduct losses from activities that may or may not be engaged in for profit. To the extent that an activity is carried on as a trade or business, such losses are fully deductible, but to the extent that the activity in question represents a hobby, expenses are only deductible against income generated by the activity. For example, in *Knowles v. Commissioner*, Taxpayer, in addition to other deductions, claimed losses attributable to Big Dog Farms, which was established for the purpose of breeding, selling, and showing horses.<sup>43</sup>

The Tax Court examined Taxpayer's deductions using the nine factor test of Treas. Reg. § 1.183-2(b).<sup>44</sup> Among other things, the Tax Court determined that Big Dog Farm's losses were perpetual and substantial; that the activity was not carried on in a businesslike manner; that Taxpayer could not substantiate that she had ever hired professionals to assist in operating the horse farm; that Taxpayer demonstrated no reasonable expectation that the farm or its assets would appreciate in value; and that Taxpayer was a medical doctor who had significant income during the tax years at issue, and the losses from Big Dog Farms would generate substantial tax benefits. Based on these factual findings, the Tax Court concluded that Big Dog Farms was not a for-profit activity and generated hobby losses that, under IRC § 183, could only be deducted against income generated by the horse farm.<sup>45</sup>

In cases where the existence of a business is not in controversy, the courts are sometimes called upon to determine whether a given transaction had economic substance and therefore produced an expense deductible under IRC § 162 or related Code sections. For example, in *Rutter v. Commissioner*, Taxpayer operated a medical technology company that did business as a C corporation.<sup>46</sup> Taxpayer, a reknowned

43 *Knowles v. Comm'r*, T.C. Memo. 2017-152.

44 Those factors are: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation.

45 To illustrate the frequency with which this controversy arises with respect to horsebreeding operations, see *Hylton v. Comm'r*, 721 F. App'x 300 (4th Cir. 2018), *aff'g* T.C. Memo. 2016-234, *reh'g* and *reh'g en banc denied*, No. 17-1777 (4th Cir. Aug. 3, 2018), and *McMillan v. Comm'r*, 697 F. App'x 489 (9th Cir. 2017), *aff'g* T.C. Memo. 2013-40, *cert. denied*, 138 S.Ct. 1010 (2018).

46 *Rutter v. Comm'r*, T.C. Memo. 2017-174, *appeal dismissed*, No. 17-73320 (9th Cir. Jan. 30, 2018).

biotechnologist, previously had played a role in sequencing the HIV genome; discovering the Hepatitis C virus; developing a diagnostic test to detect HIV and the Hepatitis B and C viruses; developing the first vaccine for the Hepatitis B virus using recombinant DNA technology; and co-developing a method to clone human insulin genes to produce vaccines that are used throughout the world. His new company, iMetrikus International (iMetrikus) developed technology systems to improve doctor-patient access to clinical data via a device and an application. Taxpayer was not a shareholder of common stock in iMetrikus; he was its driving force and funded the bulk of its operations through cash advances. Ultimately, the company was unable to form the corporate partnerships it had envisioned, incurred millions of dollars of losses, and eventually ceased business operations. As the company's financial situation became increasingly precarious, Taxpayer and the company entered into negotiations regarding the cash he had previously contributed, as part of which they collectively executed a debt forgiveness certificate for \$8.55 million.

Taxpayer sought to deduct this amount under IRC § 166 as a bad debt incurred in the course of a trade or business. The IRS, however, argued that the \$8.55 million was not debt, but instead represented equity that could not yet be deducted. In analyzing the issue, the Tax Court looked to the economic substance of the transfers in question. “The question of whether the advances...are debt or equity depends on the economic substance of the transactions between them and not upon the form of the advances.”<sup>47</sup>

As a guide to analyzing the cash advances, the Tax Court considered a range of nonexclusive factors traditionally distinguishing debt from equity. For example, Taxpayer acted as a capital investor, rather than a creditor; exercised management control over the company; and provided funds under circumstances and terms that no regular creditor would have found acceptable. Based on these criteria, the Tax Court concluded that, in substance, the cash advances represented equity in the company. Accordingly, Taxpayer's IRC § 166 bad debt deduction was disallowed.

A separate element essential to an IRC § 162 deduction is the taxpayer's ability to prove that it was incurred in the year in which the deduction is claimed. This issue arises in another IRC § 166 case, *Hatcher v. Commissioner*.<sup>48</sup> Taxpayer loaned her boyfriend approximately \$400,000 over a period of years to develop a golf-themed cartoon strip entitled, “In the Rough.” Later, after the boyfriend became an ex-boyfriend, she sought repayment in 2010 and received an email saying, “I HAVE NO MONEY.” Shortly thereafter, Taxpayer and her husband sued the ex-boyfriend in an attempt to recover some or all of the amounts loaned. Ultimately, no money was ever recovered and Taxpayer sought to claim a bad debt deduction for the principal interest in 2010.

The Fifth Circuit, however, affirmed the Tax Court's decision that Taxpayer had failed her burden of proving that the debt actually became worthless in 2010. In particular, the Fifth Circuit noted that Taxpayer's attempts to collect the debt via legal proceedings in 2011 and related negotiations in 2012 were inconsistent with the position that the debt was worthless as of 2010. Consequently, even though the debt may have been worthless in a later year and properly deductible in that year, it could not be claimed as an IRC § 166 bad debt deduction related to the conduct of a trade or business in 2010.

Once expenses otherwise deductible under IRC § 162 are established, the question arises regarding whether those expenditures created assets with a useful life of more than one year, such that the

47 Rutter, T.C. Memo. 2017-174 (quoting *Davis v. Comm'r*, 69 T.C. 814, 835 (1978)).

48 *Hatcher v. Comm'r*, 726 F. App'x (5th Cir. 2018), *aff'g* T.C. Memo. 2016-188.

expenditures must be capitalized and depreciated over the useful life of the assets.<sup>49</sup> In *Wells v. Commissioner*, Taxpayer owned and operated a farm in Colorado, which produced grapes for wine and grape juice, and which also leased part of its land to third parties for the grazing of horses and cattle.<sup>50</sup> The farm experienced a number of nature-related setbacks, including drought, a wildfire, flooding, and bears that consumed much of the grape harvest and damaged vines. Taxpayer incurred a variety of resulting costs, including installation of an improved piping system carrying water throughout the farm, replacement of a road, construction of fencing, and rehabilitation of areas damaged by fire. Taxpayer sought to currently deduct under IRC § 162 the full amount of these expenses.

Although allowing some of the claimed deductions, the IRS contended that the bulk of the expenses should be capitalized and recovered over time. The Tax Court generally agreed with the IRS, ruling that these expenditures did not simply restore the property to its prior condition, but extended the useful life of the property for a period in excess of one year. Most of the expenditures were made as part of a long-term plan of improvement and could not be fully deducted in the year incurred. Accordingly, the Tax Court required that the expenditures be capitalized and recovered over time as depreciation deductions.

## CONCLUSION

The existence and amount of allowable business expenses are highly fact-specific and are often open to interpretation. IRC § 162 deductions are based upon a complex interaction of multiple statutes and regulations, as well as case law. This circumstance perpetuates substantial controversy between the IRS and taxpayers regarding the scope and extent of properly claimed business deductions. As a result, courts rendered decisions in over 106 cases involving IRC § 162 related issues between June 1, 2017, and May 31, 2018.

As in prior years, a variety of cases arose regarding the merits of claimed deductions for home office expenses, hobby losses, and business expenses that were held to be personal in nature. Many of these cases involved taxpayers' often-unsuccessful attempts to meet general substantiation requirements or to comply with the heightened substantiation rules of IRC § 274(d). Moreover, a number of taxpayers in this year's litigated cases evidenced difficulty distinguishing between nondeductible personal expenses or hobby losses on the one hand, and deductible business expenses on the other hand.

As recommended by the National Taxpayer Advocate in the past, ongoing efforts to educate taxpayers and their representatives on these subjects are an essential element of tax compliance and would benefit both taxpayers and the IRS.<sup>51</sup> Also, consistent with observed historical patterns, many *pro se* litigants were unable to meet substantiation requirements. This circumstance presents an opportunity for the IRS to conduct better outreach and education on substantiation issues. However, we note that there are only 105 employees dedicated to outreach for small business/self-employed taxpayers, and 17 states have no such employee within their borders.<sup>52</sup>

49 The capitalization analysis occurs under IRC §§ 263 and 263A, while the period over which the capitalized costs will be recovered is generally determined by IRC § 167.

50 *Wells v. Comm'r*, T.C. Memo. 2018-11, *appeal docketed*, No. 18-9007 (10th Cir. Aug. 27, 2018).

51 National Taxpayer Advocate 2016 Annual Report to Congress 388-389.

52 National Taxpayer Advocate Fiscal Year (FY) 2019 Annual Report to Congress 2.

Additionally, many of the cases that are litigated in this area likely could be resolved at the administrative level if the IRS developed and implemented a more robust alternative dispute resolution program.<sup>53</sup> Such a program would facilitate a dialogue between taxpayers and the IRS that would clarify disputed facts and would help taxpayers better understand the applicable law. This process for clarification and education would enable taxpayers and the IRS to administratively resolve an increased number of cases and generally resort to litigation only where there are true disagreements regarding the facts or law essential to a case decision. It would also further taxpayers' rights *to be informed* and *to challenge the IRS's position and be heard*.

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53 National Taxpayer Advocate 2016 Annual Report to Congress 211-219.

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## Summons Enforcement Under IRC §§ 7602, 7604, and 7609

## SUMMARY

Pursuant to Internal Revenue Code (IRC) § 7602, the IRS may examine any books, records, or other data relevant to an investigation of a civil or criminal tax liability.<sup>1</sup> To obtain this information, the IRS may serve a summons directly on the subject of the investigation or any third party who may possess relevant information.<sup>2</sup> If a person summoned under IRC § 7602 neglects or refuses to obey the summons; to produce books, papers, records, or other data; or to give testimony as required by the summons, the IRS may seek enforcement of the summons in a United States District Court.<sup>3</sup>

A person who has a summons served on him or her may contest its legality if the government petitions to enforce it.<sup>4</sup> Thus, summons enforcement cases are different from many other cases described in other Most Litigated Issues because often the government, rather than the taxpayer, initiates the litigation. If the IRS serves a summons on a third party, any person entitled to notice of the summons may challenge its legality by filing a motion to quash or by intervening in any proceeding regarding the summons.<sup>5</sup> Generally, the burden on the taxpayer to establish the illegality of the summons is heavy.<sup>6</sup> When challenging the summons's validity, the taxpayer generally must provide "some credible evidence" supporting an allegation of bad faith or improper purpose.<sup>7</sup> The taxpayer is entitled to a hearing to examine an IRS agent about his or her purpose for issuing a summons only when the taxpayer can point to specific facts or circumstances that plausibly raise an inference of bad faith.<sup>8</sup> Naked allegations of improper purpose are not enough, but because direct evidence of IRS's bad faith "is rarely if ever available," circumstantial evidence can suffice to meet that burden.<sup>9</sup>

TAS identified 85 federal cases decided between June 1, 2017, and May 31, 2018, involving IRS summons enforcement issues. The government was the initiating party in 61 cases, while the taxpayer was the initiating party in 24 cases. Overall, taxpayers fully prevailed in three cases, while four cases were split. The IRS prevailed in the remaining 78 cases.

1 Internal Revenue Code (IRC) § 7602(a)(1); Treas. Reg. § 301.7602-1.

2 IRC § 7602(a).

3 IRC § 7604(b).

4 *U.S. v. Powell*, 379 U.S. 48, 58 (1964).

5 IRC § 7609(b).

6 *U.S. v. LaSalle Nat'l Bank*, 437 U.S. 298, 316 (1978).

7 *U.S. v. Clarke*, 134 S. Ct. 2361, 2367 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S.T.C. (CCH) ¶ 50,732 (S.D. Fla. 2012).

8 *Id.* (stating that "[t]he taxpayer need only make a showing of facts that give rise to a plausible inference of improper motive").

9 *U.S. v. Clarke*, 134 S. Ct. 2361, 2367-68 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S.T.C. (CCH) ¶ 50,732 (S.D. Fla. 2012).

## TAXPAYER RIGHTS IMPACTED<sup>10</sup>

- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

## PRESENT LAW

The IRS has broad authority under IRC § 7602 to issue a summons to examine a taxpayer's books and records or demand testimony under oath.<sup>11</sup> Further, the IRS may obtain information related to an investigation from a third party if, subject to the exceptions of IRC § 7609(c), it provides notice to the taxpayer or other person identified in the summons.<sup>12</sup> In limited circumstances, the IRS can issue a summons even if the name of the taxpayer under investigation is unknown, *i.e.*, a “John Doe” summons.<sup>13</sup> However, the IRS cannot issue a summons after referring the matter to the Department of Justice (DOJ).<sup>14</sup>

If the recipient fails to comply with a summons, the United States may commence an action under IRC § 7604 in the appropriate United States District Court to compel document production or testimony.<sup>15</sup> If the United States files a petition to enforce the summons, the taxpayer may contest the validity of the summons in that proceeding.<sup>16</sup> Also, if the summons is served upon a third party, any person entitled to notice may petition to quash the summons in an appropriate district court, and may intervene in any proceeding regarding the enforceability of the summons.<sup>17</sup>

Generally, a taxpayer or other person named in a third-party summons is entitled to notice.<sup>18</sup> However, the IRS does not have to provide notice in certain situations. For example, the IRS is not required to give notice if the summons is issued to aid in the collection of “an assessment made or judgment rendered against the person with respect to whose liability the summons is issued.”<sup>19</sup> Congress created this exception because it recognized a difference between a summons issued to compute the taxpayer's taxable income and a summons issued after the IRS has assessed tax or obtained a judgment.

10 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).

11 IRC § 7602(a). See also *LaMura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985) (citing *U.S. v. Bisceglia*, 420 U.S. 141, 145-146 (1975)).

12 IRC § 7602(c). Those entitled to notice of a third-party summons (other than the person summoned) must be given notice of the summons within three days of the day on which the summons is served to the third party but no later than the 23rd day before the day fixed on the summons on which the records will be reviewed. IRC § 7609(a).

13 The court must approve a “John Doe” summons prior to issuance. In order for the court to approve the summons, the United States commences an *ex parte* proceeding. The United States must establish during the proceeding that its investigation relates to an ascertainable class of persons; it has a reasonable basis for the belief that these unknown taxpayers may have failed to comply with the tax laws; and it cannot obtain the information from another readily available source. IRC § 7609(f).

14 IRC § 7602(d). This restriction applies to “any summons, with respect to any person if a [DOJ] referral is in effect with respect to such person.” IRC § 7602(d)(1).

15 IRC § 7604.

16 *U.S. v. Powell*, 379 U.S. 48, 58 (1964).

17 IRC § 7609(b). The petition to quash must be filed not later than the 20th day after the date on which the notice was served. IRC § 7609(b)(2)(A).

18 IRC § 7609(a)(1); Treas. Reg. § 301.7609-1(a)(1). See, e.g., *Cephas v. U.S.*, 112 A.F.T.R.2d (RIA) 6483 (D. Md. 2013).

19 IRC § 7609(c)(2)(D)(i). The exception also applies to the collection of a liability of “any transferee or fiduciary of any person referred to in clause (i).” IRC § 7609(c)(2)(D)(ii).



For example, the IRS does not have to give notice to the taxpayer or person named in the summons if it is attempting to determine whether the taxpayer has an account in a certain bank with sufficient funds to pay an assessed tax because such notice might seriously impede the IRS's ability to collect the tax.<sup>20</sup> Courts have interpreted this "aid in collection" exception to apply only if the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned.<sup>21</sup> Additionally, the IRS is not required to give notice when, in connection with a criminal investigation, an IRS criminal investigator serves a summons on any person who is not the third-party record-keeper.<sup>22</sup>

Whether the taxpayer contests the summons in a motion to quash or in response to the United States' petition to enforce, the legal standard is the same.<sup>23</sup> In *United States v. Powell*, the Supreme Court set forth four threshold requirements (referred to as the *Powell* requirements) that must be satisfied to enforce an IRS summons:

1. The investigation must be conducted for a legitimate purpose;
2. The information sought must be relevant to that purpose;
3. The IRS must not already possess the information; and
4. All required administrative steps must have been taken.<sup>24</sup>

The IRS bears the initial burden of establishing that these requirements have been satisfied.<sup>25</sup> The government meets its burden by providing a sworn affidavit of the IRS agent who issued the summons declaring that each of the *Powell* requirements has been satisfied.<sup>26</sup> The burden then shifts to the person contesting the summons to demonstrate that the IRS did not meet the requirements or that enforcement of the summons would be an abuse of process.<sup>27</sup>

The taxpayer can show that enforcement of the summons would be an abuse of process if he or she can prove that the IRS issued the summons in bad faith.<sup>28</sup> In *United States v. Clarke*, the Supreme Court held that during a summons enforcement proceeding, a taxpayer has a right to conduct an examination of the responsible IRS officials about whether a summons was issued for an improper purpose only when the taxpayer "can point to specific facts or circumstances plausibly raising an inference of bad faith."<sup>29</sup> Blanket claims of improper purpose are not sufficient, but circumstantial evidence can be.<sup>30</sup>

20 H.R. REP. NO. 94-658 AT 310, REPRINTED IN 1976 U.S.C.C.A.N. AT 3206. SEE ALSO S. REP. NO. 94-938, PT. 1, AT 371, REPRINTED IN 1976 U.S.C.C.A.N. AT 3800-01 (containing essentially the same language).

21 *Ip v. U.S.*, 205 F.3d 1168, 1172-1176 (9th Cir. 2000).

22 IRC § 7609(c)(2)(E). A third-party record-keeper is broadly defined and includes banks, consumer reporting agencies, persons extending credit by credit cards, brokers, attorneys, accountants, enrolled agents, and owners or developers of computer source code but only when the summons "seeks the production of the source or the program or the data to which the source relates." IRC § 7603(b)(2).

23 *Kamp v. U.S.*, 112 A.F.T.R.2d (RIA) 6630 (E.D. Cal. 2013).

24 *U.S. v. Powell*, 379 U.S. 48, 57-58 (1964).

25 *Fortney v. U.S.*, 59 F.3d 117, 119-120 (9th Cir. 1995).

26 *U.S. v. Dynavac, Inc.*, 6 F.3d 1407, 1414 (9th Cir. 1993).

27 *Id.*

28 *U.S. v. Powell*, 379 U.S. 48, 58 (1964).

29 *U.S. v. Clarke*, 134 S. Ct. 2361, 2367 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S.T.C. (CCH) ¶ 50,732 (S.D. Fla. 2012).

30 *U.S. v. Clarke*, 134 S. Ct. 2361, 2367-68 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S.T.C. (CCH) ¶ 50,732 (S.D. Fla. 2012).

A taxpayer may also allege that the information requested is protected by a constitutional, statutory, or common-law privilege, such as the:

- Fifth Amendment privilege against self-incrimination;
- Attorney-client privilege;<sup>31</sup>
- Tax practitioner privilege;<sup>32</sup> or
- Work product privilege.<sup>33</sup>

However, these privileges are limited. For example, courts reject blanket assertions of the Fifth Amendment,<sup>34</sup> but note that taxpayers may have valid Fifth Amendment claims regarding specific documents or testimony.<sup>35</sup> However, even if a taxpayer may assert the Fifth Amendment on behalf of him or herself, he or she cannot assert it on behalf of a business entity.<sup>36</sup>

Additionally, taxpayers cannot, on the basis of the Fifth Amendment privilege, withhold self-incriminatory evidence of a testimonial or communicative nature if the summoned documents fall within the “foregone conclusion” exception to the Fifth Amendment. The exception applies if the government establishes its independent knowledge of three elements:

1. The documents’ existence;
2. The documents’ authenticity; and
3. The possession or control of the documents by the person to whom the summons was issued.<sup>37</sup>

The attorney-client privilege protects “tax advice,” but not tax return preparation materials.<sup>38</sup> The “tax shelter” exception limits the tax practitioner privilege and permits discovery of communications between a practitioner and client that promote participation in any tax shelter.<sup>39</sup> Thus, the tax practitioner privilege does not apply to any written communication between a federally authorized tax practitioner and “any person, any director, officer, employee, agent, or representative of the person, or any other person holding a capital or profits interest in the person” which is “in connection with the promotion of the direct or indirect participation of the person in any tax shelter.”<sup>40</sup>

31 The attorney-client privilege provides protection from discovery of information where: (1) legal advice of any kind is sought, (2) from a professional legal advisor in his or her capacity as such, (3) the communication is related to this purpose, (4) made in confidence, (5) by the client, (6) and at the client’s insistence protected, (7) from disclosure by the client or the legal advisor, (8) except where the privilege is waived. *U.S. v. Evans*, 113 F.3d 1457, 1461 (7th Cir. 1997) (citing 8 JOHN HENRY WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW § 2292 (John T. McNaughten rev. 1961)).

32 IRC § 7525 extends the protection of the common law attorney-client privilege to federally authorized tax practitioners in federal tax matters. Criminal tax matters and communications regarding tax shelters are exceptions to the privilege. IRC § 7525(a)(2), (b). The interpretation of the tax practitioner privilege is based on the common law rules of attorney-client privilege. *U.S. v. BDO Seidman, LLP*, 337 F.3d 802, 810-12 (7th Cir. 2003).

33 The work product privilege protects against the discovery of documents and other tangible materials prepared in anticipation of litigation. Fed. R. Civ. P. 26(b)(3); see also *Hickman v. Taylor*, 329 U.S. 495 (1947).

34 See, e.g., *U.S. v. McClintic*, 113 A.F.T.R.2d (RIA) 330 (D. Or. 2013).

35 See, e.g., *U.S. v. Lawrence*, 113 A.F.T.R.2d (RIA) 1933 (S.D. Fla. 2014).

36 *Braswell v. U.S.*, 487 U.S. 99 (1988).

37 *U.S. v. Bright*, 596 F.3d 683, 692 (9th Cir. 2010).

38 *U.S. v. Frederick*, 182 F.3d 496, 500 (7th Cir. 1999).

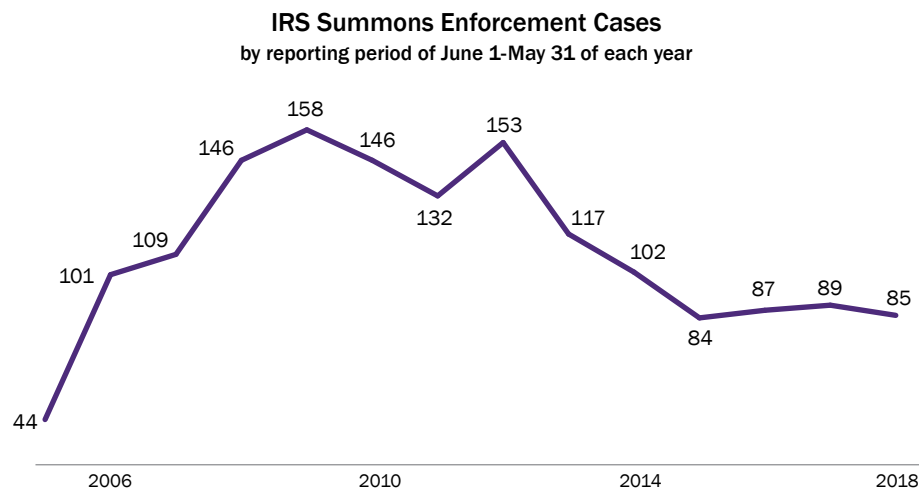
39 IRC § 7525(b). See also *Valero Energy Corp. v. U.S.*, 569 F.3d 626 (7th Cir. 2009).

40 IRC § 7525(b). A tax shelter is defined as “a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.” IRC § 6662(d)(2)(C)(ii).

## ANALYSIS OF LITIGATED CASES

Summons enforcement has been a Most Litigated Issue in the National Taxpayer Advocate's Annual Report to Congress every year since 2005, when TAS identified only 44 cases but predicted the number would rise as the IRS became more aggressive in its enforcement initiatives. The number of cases peaked at 158 for the reporting period ending on May 31, 2009, but had generally declined, except for a one-year increase for the year ending May 31, 2012, as shown in Figure 3.3.1. This year, the number of summons enforcement cases fell slightly, as TAS identified 85 cases for the reporting period ending on May 31, 2018, a decrease from the 89 cases TAS identified during last year's reporting period. A detailed list of these cases appears in Table 3 of Appendix 3.

**FIGURE 3.3.1**



Of the 85 cases TAS reviewed this year, the IRS prevailed in full in 78, a 92 percent success rate, which is one percent less than the 2017 reporting period.<sup>41</sup> Taxpayers had representation in 34 cases (40 percent) and appeared *pro se* (*i.e.*, on their own behalf) in the remaining 51. This is a notable increase in the percentage of represented taxpayers as 28 percent of taxpayers were represented during the 2017 reporting period.<sup>42</sup> This year's percentage of represented taxpayers (40 percent) is a return close to the percentage we observed during the 2016 reporting period, where 44 percent of taxpayers had representation.<sup>43</sup> Sixty-four cases involved individual taxpayers, while the remaining 21 involved business taxpayers, including sole proprietorships.<sup>44</sup> Cases generally involved one of the following themes.

41 See National Taxpayer Advocate 2017 Annual Report to Congress 395.

42 *Id.*

43 See National Taxpayer Advocate 2016 Annual Report to Congress 459.

44 There were cases in which the IRS issued summons for investigations into both the individual taxpayer and his or her business. For the purposes of this Most Litigated Issue, TAS placed these cases into the business taxpayer category.

### Petitions to Enforce and *Powell* Requirements

The United States petitioned to enforce a summons in 61 cases and successfully met its burden under *Powell* in 58 cases.<sup>45</sup> In two cases, taxpayers partially prevailed with *Powell* challenges. An example of a partially successful *Powell* challenge can be found in *United States v. Lui*.<sup>46</sup> In *Lui*, the taxpayer, an individual with interests in foreign entities and bank accounts, was served with summonses on two occasions related to his alleged tax liabilities. In the first summons, the IRS requested testimony from the taxpayer, and in the second summons, the IRS requested testimony and documents concerning the taxpayer's foreign interests. Pursuant to the first summons, the taxpayer refused to testify on privilege grounds. Following the second summons, the taxpayer refused to testify once more, and provided only a portion of the requested documents. The IRS sought a court order to enforce both summonses. Based on the initial petition and accompanying declaration, the court found that the IRS had established a *prima facie* case under *Powell*. Once the government met its initial burden, the burden shifted to the taxpayer. Consequently, the court ordered the taxpayer to show cause as to why he should not be compelled to testify and to produce all the requested documents.

In showing why he should not be compelled to produce all the requested documents, the taxpayer argued that he did not possess, control, or have custody of the requested documents. The IRS had sought a broad range of documents in connection with the taxpayer's foreign holdings and posited that the taxpayer had not provided credible evidence showing that he no longer possessed the documents. In evaluating the parties' claim, the court adopted a sliding scale test from *United States v. Malhas*,<sup>47</sup> *i.e.*, "the more the IRS's evidence suggests the taxpayer possesses the documents at issue, the heavier the taxpayer's burden to successfully demonstrate that he does not." In *Malhas*, the taxpayer had the burden of showing that he was not in possession of documents requested by the IRS. The court found that the taxpayer failed to provide credible evidence, as he relied only on his own affidavits and testimony. In contrast, the IRS provided a plethora of documents and records illustrating the taxpayer's connection with the requested documents. Based upon those facts, the court in *Malhas* found that the taxpayer failed to satisfy his burden.

In contrast to *Malhas*, in the instant case, the court found that the taxpayer had a substantially more compelling position. The taxpayer presented far more than his own affidavit to support his argument of non-possession. The taxpayer showed that he had transferred his interest in the foreign holdings (upon which the document summonses were directed) to the control and custody of his siblings by the date of the summonses. Since the taxpayer transferred the documents, the documents were effectively out of his control. The IRS offered little evidence to the contrary, but pointed out the "suspicious timing" of the transfers. The court noted that suspicious timing alone was insufficient to overcome the plethora of evidence that the taxpayer presented, finding that the taxpayer succeeded in demonstrating that he did not possess documents directly related to the assets he had transferred. However, the court found that the taxpayer had not met the burden of showing that he had no documents related to the transfer of those assets. Accordingly, the court ordered the taxpayer to turn over all records in his possession regarding the transfers, or to submit a declaration under penalty of perjury that no such documents exist.

45 See, e.g., *U.S. v. Cavins*, 121 A.F.T.R.2d (RIA) 2220 (S.D. Ill. 2018); *U.S. v. Elridge*, 121 A.F.T.R.2d (RIA) 1341 (E.D. Ark. 2018); *U.S. v. Morton*, 2017 U.S. App. LEXIS 20409 (6th Cir. 2017), *reh'g denied*, 2017 U.S. App. LEXIS 22757 (6th Cir. 2017), *aff'g* 119 A.F.T.R.2d (RIA) 362 (W.D. Mich. 2016); *U.S. v. Earth, Wind, and Solar, Inc.*, 120 A.F.T.R.2d (RIA) 5328 (E.D. Cal. 2017), *adopting* 119 A.F.T.R.2d (RIA) 2335 (E.D. Cal. 2017); *U.S. v. Pardue*, 120 A.F.T.R.2d (RIA) 5283 (M.D. Fla. 2017), *adopting* 120 A.F.T.R.2d (RIA) 5281 (M.D. Fla. 2017).

46 *U.S. v. Lui*, 120 A.F.T.R.2d (RIA) 5332 (N.D. Cal. 2017).

47 *U.S. v. Malhas*, 116 A.F.T.R.2d (RIA) 6724 (N.D. Ill. 2015).

In showing why he should not be compelled to testify, the taxpayer invoked his Fifth Amendment privilege. A taxpayer may “invoke his Fifth Amendment rights in response to an IRS summons when there are substantial hazards of self-incrimination that are real and appreciable,” but mere blanket assertions of the Fifth Amendment are disallowed. Since the taxpayer asserted his Fifth Amendment privilege to almost every question asked of him during his testimony, the court found that the taxpayer’s invocation of the Fifth Amendment privilege was overbroad and that he should be required to answer at least some additional questions. More specifically, the court ordered the taxpayer to answer the general background questions. However, the court decided not to compel any follow-up questions about the taxpayer’s interests in foreign accounts or his ownership and reporting of foreign entities, except for one question with respect to which *Lui* waived his Fifth Amendment privilege as this topic was included in his declaration to the court. The court also allowed a series of specific follow up questions regarding the taxpayer’s declaration.

Finally the court addressed the taxpayer’s challenge to the IRS’s *prima facie* case and analyzed the *Powell* factors.<sup>48</sup> It concluded that summonses were properly verified following all required administrative steps, were relevant to the taxpayer’s tax liabilities, would lead to discovery of new information, and were not made in bad faith.

Accordingly, the IRS’s petition to enforce summons against the taxpayer was granted in part and denied in part as to the documents he did not possess.

### Petitions to Quash and Lack of Subject Matter Jurisdiction

Taxpayers petitioned to quash an IRS summons to a third party in 25 instances;<sup>49</sup> however, in many of these cases, courts dismissed the petitions for lack of jurisdiction on procedural or notice grounds. For example, an appellate court affirmed a district court’s dismissal of a taxpayer’s petition to quash a summons issued to the taxpayer’s bank because the summons was issued to aid in the collection of a tax and the taxpayer therefore had no recourse under IRC § 7609.<sup>50</sup> In *Rifle Remedies, LLC v. United States*, the taxpayer, a limited liability corporation, sought to quash a summons issued by the IRS to a third party, the Marijuana Enforcement Division of the Colorado Department of Revenue.<sup>51</sup> The IRS was investigating the taxpayer on the basis of IRC § 280E, which prohibits deductions or credits for amounts acquired through the trade or business of trafficking in controlled substances.<sup>52</sup>

The IRS’s burden to enforce the summons “is a slight one because the statute must be read broadly in order to ensure that the enforcement powers of the IRS are not unduly restricted.”<sup>53</sup> After the IRS shows compliance with the *Powell* factors which is usually established by the affidavits of the IRS employees who issued the summons, the burden then shifts to the taxpayer resisting enforcement of the summons. This burden is a heavy one because the taxpayer should show that enforcement would “constitute an

48 *U.S. v. Powell*, 379 U.S. 48, 57-58 (1964).

49 In some instances, the taxpayer made the motion to quash in its answer to the government’s petition to enforce.

50 *Ngo v. U.S.*, 699 F. App’x 617 (9th Cir. 2017), *aff’g* 118 A.F.T.R.2d (RIA) 5453 (N.D. Cal. 2015). Under IRC § 7609(c)(2)(D)(i), the IRS is not required to provide notice to the taxpayer, and the taxpayer therefore has no right to quash the summons if the summons is issued to aid in the collection of the taxpayer’s liability.

51 *Rifle Remedies, LLC v. U.S.*, 120 A.F.T.R.2d 6385 (D. Colo. 2017).

52 See IRC § 280E (prohibiting a deduction or credit for carrying on any trade or business if such trade or business consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act)). For more information about IRS enforcement of IRC § 280E, see Leslie Book, *Court Allows IRS to Proceed With Summons Issued to Taxpayer in the Medical Marijuana Business*, Procedurally Taxing Blog, <http://procedurallytaxing.com/court-allows-irs-to-proceed-with-summons-issued-to-taxpayer-in-the-medical-marijuana-business/> (Apr. 20, 2017).

53 *Rifle Remedies, LLC v. U.S.*, 120 A.F.T.R.2d 6385 (D. Colo. 2017) (internal citations omitted).

abuse of the court's process, or that in issuing the summons the IRS lacked institutional good faith."<sup>54</sup> To meet this burden the taxpayer must factually oppose the IRS's allegations by affidavit and refute the government's *prima facie* *Powell* showing or factually support a proper affirmative defense. Thus, the court started its analysis with an evaluation of the taxpayer's position with respect to the *Powell* requirements.

First, with respect to the legitimate purpose *Powell* requirement, the court found that the IRS's summons was issued to verify the taxpayer's financial records and to determine whether information reported in the taxpayer's tax returns could be substantiated. The taxpayer raised several illegitimate purpose arguments rebutting the IRS's position, but the court rejected all of them. The taxpayer's primary argument was that the IRS was essentially conducting a criminal investigation, as the taxpayer was being investigated for trafficking in a controlled substance. The court rejected this argument (alongside the other illegitimate purpose arguments), noting that the primary purpose of the investigation was to determine whether the taxpayer was entitled to a deduction or credit, and the IRS's inquiry into whether IRC § 280E applies to the taxpayer is not a criminal prosecution.

In respect to the second *Powell* requirement, the taxpayer did not contest that the IRS agent's declaration sufficiently established that the information sought by the summons would be relevant to the purpose of the IRS's investigation.

With respect to the *Powell* requirement that the information sought by the IRS was not already in its possession, the taxpayer argued that the IRS possessed the information it sought to summon. The taxpayer believed that the IRS obtained '.xls files' which contained private taxpayer information. These files were allegedly large enough to contain all the requested information already. The court rejected this argument, concluding that the IRS did not possess the specific information that it has requested in the summons.

With respect to the last *Powell* requirement that the material sought by the IRS be relevant to its investigation and that the IRS follow all necessary administrative steps, the court found that the IRS satisfied its burden through its declaration. The taxpayer did not contest this. Accordingly, the court found that IRS satisfied its burden under *Powell*, and thus the burden shifted to the taxpayer. Construing the taxpayer's arguments challenging the purpose of the IRS' investigation as attempting to satisfy the taxpayer's burden of showing that enforcement of the summons will be an abuse of process or that the IRS lacked institutional good faith, the court rejected those arguments as insufficient. Those arguments were "based upon rank speculation, on a lack of facts, or a combination of both."<sup>55</sup> Accordingly, the Court denied the taxpayer's petition to quash summonses, and granted the IRS's motion to enforce summonses.

### Privileges

As in past years, taxpayers attempted to invoke various privileges, including Fifth Amendment and attorney-client privileges in response to an IRS summons. In one case, the taxpayers successfully invoked the attorney-client privilege for certain requested documents or testimony.<sup>56</sup> In another case,

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54 *Rifle Remedies, LLC v. U.S.*, 120 A.F.T.R.2d 6385 (D. Colo. 2017) (internal citations omitted).

55 *Id.*

56 *See U.S. v. Owensboro Dermatology Associates*, 120 A.F.T.R.2d (RIA) 5119 (W.D. Ky. 2017).



the United States Court of Appeals for the Ninth Circuit vacated and remanded rulings from a district court to review memos *in camera* for privilege concerns.<sup>57</sup>

In *United States v. Servin*, the taxpayer, an attorney, appealed a district court order enforcing two administrative summonses issued by the IRS on the basis of attorney-client privilege.<sup>58</sup> The IRS suspected that the taxpayer owed delinquent taxes and sought to verify the income the taxpayer generated from his law practice. To accomplish this, the IRS requested information concerning the taxpayer's client list, which encompassed the names and addresses of each client. The taxpayer responded to the summons, appearing, but did not disclose the requested information.

In appealing the district court's decision, the taxpayer argued that state attorney-client privilege laws and the duty of confidentiality (drawn from the state rules of professional conduct) prohibited the unconsented disclosure of a client's name and address. The Court of Appeals for the Third Circuit rejected this position on both grounds. First, the Court of Appeals held that federal law concerning attorney-client privilege preempted state law, and that on the federal level, the privilege only shielded against the disclosure of confidential information. Absent rare circumstances, the attorney-client privilege did not shield against disclosing clients' identities. Since the taxpayer did not present any unusual circumstances that would warrant a different approach, the court rejected the argument on privilege grounds. Second, the appellate court rejected the taxpayer's reliance on the state rules of professional conduct. The court reasoned that the duty of confidentiality is extensive under state law, but it is not substantive law because it governs only disciplinary proceedings against attorneys practicing in the state who violate the rules—it does not affect judicial application of the attorney-client privilege. Accordingly, since the taxpayer failed to provide a compelling argument, the Court of Appeals upheld the lower court's decision.

### Civil Contempt

A taxpayer who “neglects or refuses to obey” an IRS summons may be held in civil contempt.<sup>59</sup> In five cases this year, taxpayers were held in civil contempt for failing to comply with a court order enforcing an IRS summons.<sup>60</sup> However, in *United States v. Lui*, discussed earlier, the government's motion for contempt was denied.<sup>61</sup> In another case, *United States v. Ali*, the Court of Appeals for the Fourth Circuit affirmed a district court finding a taxpayer in contempt for failing to produce certain documents subject to an enforcement order.<sup>62</sup> The taxpayer had refused to produce the documents at the contempt stage on grounds of nonpossession and asserted Fifth Amendment privilege.<sup>63</sup> The court rejected the taxpayer's position on the ground that those defenses were to be raised at the enforcement stage, since allowing the taxpayer to rely on these defenses at the contempt stage would lead to a retrial of the original

57 See *U.S. v. Sanmina Co. and Subsidiaries*, 707 F. App'x 865 (9th Cir. 2017), *vacating and remanding* 115 A.F.T.R.2d (RIA) 1882 (N.D. Cal. 2015). We discussed the lower court's decision in our 2015 Annual Report. See National Taxpayer Advocate 2015 Annual Report to Congress 473-474.

58 *U.S. v. Servin*, 721 F. App'x 156 (3d Cir. 2018), *aff'g* 121 A.F.T.R. 2d (RIA) 646 (E.D. Pa. 2017).

59 IRC § 7604(b).

60 See *U.S. v. Briseno*, 121 A.F.T.R.2d (RIA) 1540 (E.D. Cal. 2018); *U.S. v. Ali*, 874 F.3d 825 (4th Cir. 2017), *aff'g* 119 A.F.T.R.2d (RIA) 1145 (D. Md. 2016); *U.S. v. Barela*, 120 A.F.T.R.2d (RIA) 6494 (E.D. Cal. 2017); *U.S. v. Conner*, 120 A.F.T.R.2d (RIA) 6244 (N.D. Tex. 2017), *appeal docketed*, No. 17-11417 (5th Cir., Dec. 1, 2017), *adopting* 120 A.F.T.R.2d (RIA) 6241 (N.D. Tex. 2017); *U.S. v. Posner*, 120 A.F.T.R.2d (RIA) 5812 (S.D. Cal. 2017).

61 *U.S. v. Lui*, 121 A.F.T.R.2d (RIA) 1537 (N.D. Cal. 2018).

62 *U.S. v. Ali*, 874 F.3d 825 (4th Cir. 2017), *aff'g* 119 A.F.T.R.2d (RIA) 1145 (D. Md. 2016).

63 We discussed the *Ali* case in the privilege section of our 2015 Annual Report summons enforcement most litigated issue narrative. See National Taxpayer Advocate 2015 Report to Congress 473.

controversy. The court relied on the Supreme Court in *United States v. Rylander*<sup>64</sup> that if a taxpayer contests a summons, he or she must raise all applicable defenses at the enforcement stage, not for the first time in a contempt proceeding.<sup>65</sup>

The taxpayer's appeal of the district court's contempt order relied on three arguments. First, Ms. Ali contended that because she asserted her Fifth Amendment privilege against self-incrimination during the enforcement proceeding, she could not also assert a defense of nonpossession at that time. The Court of Appeals refused to allow the taxpayer to invoke the Fifth Amendment to satisfy her burden of production at the contempt stage even if she previously asserted that right at the enforcement stage based on *Rylander*. Then the court addressed the taxpayer's second and third arguments. Ms. Ali contended that once she produced some documents in response to an enforcement order, she could not be held in contempt unless the IRS could prove by clear and convincing evidence that she failed to produce all the responsive documents in her possession or control. She also argued that the district court erroneously switched the burden from the IRS to her by requiring her to affirmatively show that she had produced all responsive documents in her possession or control. The Court rejected these arguments. First of all, a summons enforcement order establishes a presumption that the defendant possesses responsive documents. Thus, the IRS did not need to show that the taxpayer had actual possession of other responsive documents that she failed to produce. Instead, the failure to produce documents presumptively within the taxpayer's possession constitutes an actual or constructive violation of the enforcement order. Therefore, it was enough for the IRS to show, by clear and convincing evidence, that the taxpayer's production was presumptively incomplete, *e.g.*, a production of bank records omitting bank statements is presumptively incomplete. The IRS is not required to identify each missing bank statement and need not prove that the taxpayer has access to that specific statement.

After the IRS establishes that the taxpayer violated the enforcement order, the burden shifts to the taxpayer to show that she made reasonable efforts to comply in good faith.

The Court of Appeals agreed with the district court's finding that the taxpayer had not satisfied this burden, concluding that a bare assertion of nonpossession or the production of some responsive documents do not demonstrate all reasonable efforts to comply with the summons enforcement order. Accordingly, the Court of Appeals for the Fourth Circuit found that the district court did not abuse its discretion in finding the taxpayer in contempt.

Overall, contempt proceedings accounted for approximately seven percent of all summons-related cases. Unless the taxpayer complied with the court order, the taxpayer was subject to arrest.<sup>66</sup>

### Virtual Currency and "John Doe" Summons

The IRS has taken the position that virtual currency, such as Bitcoin, is considered property for tax purposes and therefore general tax principles apply to transactions involving such currency.<sup>67</sup> In *United States v. Coinbase, Inc.*, the IRS served a John Doe summons on a virtual currency exchange seeking

64 460 U.S. 752 (1983).

65 The Supreme Court recognized "present inability to comply" as the only exception, *i.e.*, when an inability to comply arises after the enforcement proceeding and exists at the time of the contempt proceeding. 460 U.S. at 756-757.

66 *U.S. v. Briseno*, 121 A.F.T.R.2d (RIA) 1540 (E.D. Cal. 2018); *U.S. v. Barela*, 120 A.F.T.R.2d (RIA) 6494 (E.D. Cal. 2017); *U.S. v. Posner*, 120 A.F.T.R.2d (RIA) 5812 (S.D. Cal. 2017).

67 See IRS Notice 2014-21, 2014-16 I.R.B. 938; IRS Pub. 525, *Taxable and Nontaxable Income 4* (Jan. 2017). In her 2013 Annual Report to Congress, the National Taxpayer Advocate recommended that the IRS issue guidance to assist users of digital currency. See National Taxpayer Advocate 2013 Annual Report to Congress 249-255 (Most Serious Problem: *DIGITAL CURRENCY: The IRS Should Issue Guidance to Assist Users of Digital Currency*).

records regarding nearly all of its customers for a two-year period.<sup>68</sup> After the exchange failed to comply with the summons, the IRS filed a petition to enforce the summons. The court heard oral argument on a motion to quash the summons and a motion to intervene, leading the IRS to narrow the scope of its summons.<sup>69</sup> Whereas the initial summons sought information from nearly all the exchange's users, the narrowed summons sought information regarding accounts "with at least the equivalent of \$20,000 in any one transaction type."<sup>70</sup> The currency exchange refused to comply with the narrowed summons, and subsequently, the court granted a motion by a "John Doe" to intervene and challenge the government's attempt to enforce the summons.<sup>71</sup>

### *The Right to Intervene*

An intervenor must satisfy a four-part test to qualify:

- (1) file a timely motion;
- (2) assert an interest relating to the property or transaction which is the subject of the summons enforcement action;
- (3) be so situated that without intervention the disposition of the action may impair or impede the intervenor's ability to protect that interest; and
- (4) have an interest not adequately represented by other parties.<sup>72</sup>

The party seeking to intervene bears the burden of showing the four elements are met, but the requirements are broadly interpreted in favor of intervention.<sup>73</sup> The IRS did not dispute that John Doe had timely applied to intervene. Thus, the Court turned to the remaining three factors. John Doe did not claim privilege in his Coinbase records, but contended that the broad scope of the summons suggests an abuse of process sufficient to support intervention as of right. The IRS did not explain how it can "legitimately use most of these millions of records on hundreds of thousands of users."<sup>74</sup> It claimed that as long as it submitted a declaration from an IRS agent that it is conducting an investigation to determine the identity and correct tax liabilities of taxpayers who had conducted transactions in virtual currencies, the summons does not involve an abuse of process. The Court refused to adopt the IRS argument stating that under this reasoning "the IRS could request bank records for every United States customer from every bank branch in the United States because it is well known that tax liabilities in general are under reported and such records might turn up tax liabilities."<sup>75</sup> The court noted that the IRS could not cite a single case to support such broad discretion. The IRS also argued that because the summons was issued pursuant to 15 U.S.C. § 7609(f), John Doe did not have a protectable interest, claiming that only the direct subject of the summons may challenge the government's good faith. The Court was unpersuaded commenting that nothing in the John Doe summons procedure adopted by Congress suggests that when the John Doe nonetheless learns of a summons from other means the John Doe has no interest in challenging the enforcement of that summons. The court also rejected the

68 *U.S. v. Coinbase, Inc.*, 120 A.F.T.R.2d (RIA) 5239 (N.D. Cal. 2017). For the related case, see also *U.S. v. Coinbase, Inc.*, 120 A.F.T.R.2d (RIA) 6671 (N.D. Cal. 2017). We discussed the Coinbase "John Doe" summons litigation in our 2017 Annual Report. See National Taxpayer Advocate 2017 Annual Report to Congress 400.

69 See *U.S. v. Coinbase, Inc.*, 120 A.F.T.R. 2d (RIA) 5239 (N.D. Cal. 2017).

70 *U.S. v. Coinbase, Inc.*, 120 A.F.T.R. 2d (RIA) 5239, 5241 (N.D. Cal. 2017).

71 See *U.S. v. Coinbase, Inc.*, 120 A.F.T.R. 2d (RIA) 5239 (N.D. Cal. 2017).

72 See *U.S. v. Oregon*, 839 F.2d 635, 637 (9th Cir. 1988).

73 See *Prete v. Bradbury*, 438 F.3d 949, 954 (9th Cir. 2006).

74 *U.S. v. Coinbase, Inc.*, 120 A.F.T.R. 2d (RIA) 5239, 5243 (N.D. Cal. 2017).

75 *Id.*

IRS's argument that John Doe's intervention would place an undue burden on the IRS's legitimate use of John Doe summons. Finally, the court disagreed with the IRS's assertion that John Doe was merely trying to shield his or her identity. The IRS had consented to its proceeding as a John Doe. John Doe had offered to reveal his or her identity provided the IRS would agree not to then withdraw the summons to moot John Doe's interest in the proceeding, but the IRS had rejected John Doe's offer. The Court determined that John Doe has a protectable interest in this enforcement proceeding. Moving to the next prong, the court concluded that if the IRS would obtain John Doe's personal information and other transaction history at Coinbase, it would impair the intervenor's ability to protect his or her protectable interest in the summons proceeding. Lastly, the court concluded that John Doe's interests were not adequately represented by other parties, distinguishing the intervenor's and Coinbase's interests. Coinbase's financial interest as an entity is that the IRS's investigation does not affect its profits or valuation. The intervenor's personal interest, however, is in the very documents the IRS seeks. As a result, Coinbase and John Doe may have differences as to a proper resolution of the summons enforcement action. For these reasons the court concluded that John Doe has a right to intervene.

### *The Narrowed Summons*

Following the oral argument on the intervention motions, the IRS narrowed the scope of its summons seeking information regarding accounts “with at least the equivalent of \$20,000 in any one transaction type (buy, sell, send, or receive) in any one year during the 2013-2015 period.”<sup>76</sup> According to Coinbase the summons would apply to 8.9 million transactions and 14,355 account holders. Coinbase refused to comply with the Narrowed Summons, opposing the summons enforcement by the IRS along with John Doe.<sup>77</sup> Three *amici* briefs in opposition were filed by the Competitive Enterprise Institute; the Coin Center; and the Digital Currency and Ledger Defense Fund. Because the parties did not dispute that the third and fourth *Powell* factors were satisfied, the court only addressed the first and second *Powell* factors: whether the summons serves a legitimate purpose, and whether it seeks relevant information. With respect to the legitimate purpose *Powell* requirement, the court noted that over a two-year period, the exchange had conducted over 6 billion in transactions and had at least 5.9 million customers. Despite this, in the same period, only 800 to 900 taxpayers a year have electronically filed returns with a property description related to bitcoin. This discrepancy led to the inference that more of the exchange's users are trading virtual currencies than reporting gains on their tax returns. Subsequently, the court found that the revised summons had the legitimate purpose of investigating the “reporting gap between the number of virtual currency users [the exchange] claims to have had during the summons period” and “U.S. bitcoin users reporting gains or losses to the IRS during the summoned years.”<sup>78</sup> Although the respondents raised a number of counterarguments, the court rejected them, emphasizing that the IRS's burden is minimal at this stage in the proceeding.

With respect to the relevance *Powell* requirement, the court agreed that while the requested records would permit the IRS to investigate unreported taxable gains, the IRS's demand for information was too broad. In addition to transaction records and information concerning account holder identity, the IRS sought “account opening records, copies of passports or driver's licenses, all wallet addresses, all public keys for all accounts/wallets/vaults, records of Know-Your-Customer diligence, agreements or instructions granting a third-party access, control, or transaction approval authority, and correspondence between Coinbase and the account holder.”<sup>79</sup> The court found that at this stage in the proceeding, these

76 *U.S. v. Coinbase, Inc.*, 120 A.F.T.R. 2d (RIA) 5239, 5241 (N.D. Cal. 2017).

77 120 A.F.T.R.2d (RIA) 6671 (N.D. Cal. 2017).

78 120 A.F.T.R.2d (RIA) 6671, 6674 (N.D. Cal. 2017).

79 120 A.F.T.R.2d (RIA) 6671, 6676 (N.D. Cal. 2017).

requests sought information that was broader than necessary. The court reasoned that the first question the IRS had to resolve was whether an account holder had a taxable gain. If the account holder did not, then correspondence between the exchange and the account holder was irrelevant. Consequently, the court narrowed the type of documents that the IRS may acquire to documents material to identifying the account holder and any unreported gains. For instance, while the court permitted enforcement of records concerning the taxpayer's ID number, name, date of birth, address, and transaction history, the court found that documents concerning Records of Know-Your-Customer diligence, agreements or instructions granting a third-party access, control, or transaction approval authority, and correspondence between Coinbase and the account holder as unnecessary. Accordingly, the outcome resulted in a split decision, with court granting the IRS's petition to enforce in part.<sup>80</sup>

## CONCLUSION

The IRS may issue a summons to obtain information to determine whether a tax return is correct or if a return should have been filed to ascertain a taxpayer's tax liability or to collect a liability.<sup>81</sup> Accordingly, the IRS may request documents and testimony from taxpayers who have failed to provide that information voluntarily.

Summons enforcement continues to be a significant source of litigation and the number of litigated cases rose slightly from last year. The IRS also continues to be successful in the vast majority of summons enforcement litigation. Taxpayers and third parties rarely succeed in contesting IRS summonses due to the significant burden of proof and strict procedural requirements.

The increase in virtual transactions and gig economy seem to attract legitimate IRS attention,<sup>82</sup> but may also lead to overreaching by the government in its summons' demands for information. We anticipate more summons enforcement activity in this area with IRS seeking information from third-party platforms.

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80 120 A.F.T.R.2d (RIA) 6671 (N.D. Cal. 2017).

81 IRC § 7602(a).

82 See National Taxpayer Advocate 2017 Annual Report to Congress 165-171 (Most Serious Problem: *Participants in the Sharing Economy Lack Adequate Guidance From the IRS*).

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## Gross Income Under IRC § 61 and Related Sections

## SUMMARY

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.<sup>1</sup> For this report, we reviewed 79 cases decided between June 1, 2017, and May 31, 2018. The majority of cases involved taxpayers failing to report items of income, including some specifically mentioned in Internal Revenue Code (IRC) § 61 such as wages,<sup>2</sup> interest,<sup>3</sup> dividends,<sup>4</sup> and pensions.<sup>5</sup>

TAXPAYER RIGHTS IMPACTED<sup>6</sup>

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

## PRESENT LAW

IRC § 61 broadly defines gross income as “all income from whatever source derived.”<sup>7</sup> The U.S. Supreme Court has defined gross income as any accession to wealth.<sup>8</sup> The concept of “gross income” is to be broadly construed, while exclusions from income are to be narrowly construed.<sup>9</sup> However, over time, Congress has carved out numerous exceptions and exclusions from this broad definition of gross income, and has based other elements of tax law on the definition.<sup>10</sup>

The Commissioner may identify particular items of unreported income or reconstruct a taxpayer's gross income using methods such as the bank deposits method.<sup>11</sup> If the Commissioner determines a tax

1 See, e.g., National Taxpayer Advocate 2017 Annual Report to Congress 420-427; National Taxpayer Advocate 2013 Annual Report to Congress 355-361.

2 Internal Revenue Code (IRC) § 61(a)(1). See, e.g., *Fleming v. Comm'r*, T.C. Memo. 2017-120.

3 IRC § 61(a)(4). See, e.g., *Avrahami v. Comm'r*, 149 T.C. No. 7 (2017).

4 IRC § 61(a)(7). See, e.g., *Povolny Group, Inc.*, T.C. Memo. 2018-37.

5 IRC § 61(a)(9). See, e.g., *Azam v. Comm'r*, T.C. Memo. 2018-72.

6 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).

7 IRC § 61(a).

8 *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 431 (1955) (interpreting § 22 of the Internal Revenue Code of 1939, the predecessor to IRC § 61).

9 See *Comm'r v. Schleier*, 515 U.S. 323, 327-328 (citations omitted) (1995); *Taggi v. U.S.*, 35 F.3d 93, 95 (citations omitted) (2d Cir. 1994).

10 See, e.g., IRC §§ 104 (compensation for injuries or sickness); 105 (amounts received under accident and health plans); 108 (income from discharge of indebtedness); 6501 (limits on assessment and collection, determination of “substantial omission” from gross income).

11 IRC § 6001. See, e.g., *DiLeo v. Comm'r*, 96 T.C. 858, 867 (1991).



deficiency, the IRS issues a Statutory Notice of Deficiency.<sup>12</sup> If the taxpayer challenges the deficiency, the Commissioner's notice is entitled to a presumption of correctness; the taxpayer bears the burden of proving that the determination is erroneous or inaccurate.<sup>13</sup>

## ANALYSIS OF LITIGATED CASES

In the 79 opinions involving gross income issued by the federal courts and reviewed for this report, gross income issues most often fell into two categories: (1) what is included in gross income under IRC § 61, and (2) what can be excluded under other statutory provisions. A detailed list of the cases appears in Table 4 of Appendix 3.

In 37 cases (about 47 percent), taxpayers were represented, while the rest were *pro se* (without counsel). Nine of the 37 cases where taxpayers had representation (about 24 percent) prevailed in full or in part in their cases, whereas *pro se* taxpayers prevailed in full or in part in seven cases (about 17 percent). Overall, taxpayers prevailed in full or in part in 16 of 79 cases (about 20 percent).

Drawing on the full list in Table 4 of Appendix 3, we have chosen to discuss cases involving damage awards, income treatment under U.S. tax treaties, and a case of first impression involving the treatment of an excess state tax credit.

### Damage Awards

Taxation of damage awards continues to generate litigation. This year, taxpayers in at least seven cases (about eight percent of those reviewed) challenged the inclusion of damage awards in their gross income, but no taxpayers prevailed in these cases.<sup>14</sup>

IRC § 104(a)(2) specifies that damage awards and settlement proceeds<sup>15</sup> are taxable as gross income unless the award was received “on account of personal physical injuries or physical sickness.”<sup>16</sup> Congress added the “physical injuries or physical sickness” requirement in 1996;<sup>17</sup> until then, the word “physical” did not appear in the statute. The legislative history of the 1996 amendments to IRC § 104(a)(2) provides that “[i]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness...[but] emotional distress is not considered a physical injury or physical sickness.”<sup>18</sup> Thus, damage awards for emotional distress are not considered as received on account of physical injury or physical sickness, even if the emotional distress results in “insomnia, headaches, [or] stomach disorders.”<sup>19</sup>

12 IRC § 6212. See also Internal Revenue Manual (IRM) 4.8.9.2, *Notice of Deficiency Definition* (Aug. 11, 2016).

13 See IRC § 7491(a) (burden shifts only where the taxpayer produces credible evidence contradicting the Commissioner's determination and satisfies other requirements). See also *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (citations omitted).

14 See, e.g., *Bell v. U.S.*, 290 F. Supp. 3d 166 (D. Conn. 2017).

15 See Treas. Reg. § 1.104-1(c) (damages, for purposes of IRC § 104(a)(2), means amounts received (other than workers' compensation) “through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution”).

16 IRC § 104(a)(2).

17 Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (1996).

18 H.R. REP. NO. 104-586, at 143-44 (1996) (Conf. Rep.).

19 H.R. REP. NO. 104-737, at 301 (1996) (Conf. Rep.). Note, however, that IRC § 104(a)(2) excludes from income damages, up to the cost of medical treatment for which a deduction under IRC § 213 was allowed for any prior taxable year, for mental or emotional distress causing physical injury.

To justify exclusion from income under IRC § 104, the taxpayer must show settlement proceeds are in lieu of damages for physical injury or sickness.<sup>20</sup> In *Bell v. U.S.*, the taxpayers (husband and wife) sought a refund of taxes withheld from a settlement payment received by Dr. Bell.<sup>21</sup> The taxpayers attempted to assert that the settlement was payment for a physical injury and thus should be exempt from taxation. The court first looked to the payor's intention to determine the nature of the settlement payment. In this case, the supplemental agreement signed by Dr. Bell and his employer specified release with regard to any claim arising from his employment and termination of employment, not tort-type rights. Second, the court considered whether the damages sought were for physical injuries or physical sickness under IRC § 104(a)(2).<sup>22</sup> While Dr. Bell argued that he intended to bring claims related to the intentional infliction of emotional distress and the negligent infliction of emotional distress, which are both torts under Connecticut state law, and thus the release also covered these, giving rise to tort-type claims, the court disagreed. Further, the court found that even if Dr. Bell had released these tort-type claims, damages for emotional distress are not physical injuries or sickness under IRC § 104(a)(2). Thus, the court held that the payment from the settlement contract is considered wages, and therefore the taxpayers were not entitled to a refund of taxes withheld from the settlement proceeds.<sup>23</sup>

As illustrated by continuing litigation of the characterization of settlement damages, the question of when damage awards can be excluded from gross income continues to confuse taxpayers. The National Taxpayer Advocate notes that taxpayers continue to disagree with the IRS's and courts' interpretation that mental illness equates to emotional distress, as opposed to physical sickness or injury.<sup>24</sup> In the same way that a physical injury or sickness may have mental or emotional side effects, many mental illnesses manifest themselves as physical symptoms. For instance, many people who have severe depression experience the following physical symptoms: stomachaches, indigestion, constant headaches, tightness in the chest, difficulty breathing, and fatigue.<sup>25</sup> Physical symptoms occur in other mental disorders, such as Post-Traumatic Stress Disorder (PTSD), which affects people who have experienced a traumatic event, such as mugging, rape, torture, being kidnapped or held captive, child abuse, car accidents, train wrecks, plane crashes, bombings, natural or human-caused disasters, or military combat.<sup>26</sup> Current research shows the experience of trauma can cause neurochemical changes in the brain that create a vulnerability to hypertension and atherosclerotic heart disease, abnormalities in thyroid and other hormone functions, and increased susceptibility to infections and immunologic disorders that are associated with PTSD.<sup>27</sup> The interpretation that mental illness equates to emotional distress seems particularly outdated when

20 See, e.g., *Green v. Comm'r*, 507 F.3d 857 (5th Cir. 2007), *aff'g* T.C. Memo. 2005-250.

21 290 F. Supp. 3d 166 (D. Conn. 2017).

22 See also *Abrahamsen v. U.S.*, 228 F.3d 1360, 1363 (Fed. Cir. 2000).

23 “Whether a specific settlement agreement falls into one of the exceptions for taxable wages under [the Federal Insurance Contributions Act] calls for the same standard as whether a settlement agreement is excluded from gross income.” *Bell*, 290 F. Supp. 3d at 170 (citation omitted).

24 See, e.g., *Collins v. Comm'r*, T.C. Summ. Op. 2017-74; *Devine v. Comm'r*, T.C. Memo. 2017-111.

25 National Institute of Mental Health, *Signs and Symptoms of Depression*, <https://www.nimh.nih.gov/health/topics/depression/index.shtml> (last visited Aug. 30, 2018).

26 National Institute of Mental Health, *Post-Traumatic Stress Disorder*, <http://www.nimh.nih.gov/health/topics/post-traumatic-stress-disorder-ptsd/index.shtml> (last visited Aug. 30, 2018).

27 See U.S. Department of Veterans Affairs, *National Center for PTSD*, <http://www.ptsd.va.gov/professional/co-occurring/ptsd-physical-health.asp> (last visited Aug. 30, 2018).

considering the medical advancements in understanding the physical cause and symptoms of mental illness.<sup>28</sup>

### Income Under Tax Treaties

Taxpayers in at least six cases argued that various items of income were excludable under a variety of tax accords, conventions or treaties.<sup>29</sup> Only one taxpayer prevailed in part in this series of cases.<sup>30</sup> Each case required the courts to interpret the terms of the treaty, convention or accord in relation to the item of income the taxpayer was attempting to exclude.

In *Guo v. Commissioner*, the Tax Court considered, in a matter of first impression, the taxpayer's contention that his unemployment compensation is exempt from income tax under the Convention with Respect to Taxes on Income and Capital between Canada and the United States.<sup>31</sup> In this case, the taxpayer was a Canadian citizen who worked in the U.S. as a post-doctoral fellow. When her employment concluded, she returned to Canada and applied to the state of Ohio for unemployment compensation.

The taxpayer received unemployment compensation from Ohio during 2012 and Ohio issued her a 1099-G, *Certain Government Payments*, reflecting no federal income tax withheld. She timely filed her 1040NR-EZ, *U.S. Income Tax Return for certain Nonresident Aliens with No Dependents*, and took the position that her unemployment compensation was excludable under the treaty. The Commissioner and the taxpayer agreed that she received the unemployment compensation, that it was an item of gross income, and it was "effectively connected" to the conduct of the taxpayer in relation to a U.S. trade or business.<sup>32</sup> However, the Commissioner and the taxpayer disagreed over the exclusion of the income under the treaty.

The court looked first to the written language of the treaty and noted that neither the treaty nor its protocols specify how unemployment compensation should be treated. The taxpayer argued that under article XV of the treaty, unemployment compensation falls into the category of "salaries, wages, and other similar remuneration."<sup>33</sup> The court found that unemployment compensation is neither salary nor wages, and remuneration is not defined in the treaty. It next turned to the IRC for a definition of remuneration, where it is also not defined; however, the court found the location of the term within the IRC and its context to provide guidance and found it closely associated with wages paid for services.<sup>34</sup> Thus, the court found that unemployment compensation is not remuneration as it is not wages or

28 National Taxpayer Advocate 2009 Annual Report to Congress 351-56 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*). The National Taxpayer Advocate recommended that Congress amend IRC §104(a)(2) to exclude from gross income payments received as settlement for mental anguish, emotional distress, and pain and suffering. Such change was recommended because mental anguish, emotional distress, and pain and suffering can be caused by a physical condition in the body and can cause physical symptoms. Over the past few years, doctors and researchers have made significant advances in identifying changes that occur in the brain when a person is plagued with mental illness.

29 See, e.g., *Ye v. Comm'r*, T.C. Memo. 2017-216.

30 See *Kiselev v. Comm'r*, T.C. Summ. Op. 2018-2.

31 *Guo v. Comm'r*, 149 T.C. No. 14 (2017), *appeal dismissed*, 2018 WL 3216499 (D.C. Cir., May 11, 2018).

32 *Id.*

33 *Id.*

34 Two places in the IRC that mention remuneration are IRC § 3401 (definitions for withholding income tax from wages) and IRC § 3121 (definitions for withholding federal insurance contributions act taxes from wages).

benefits paid by an employer to an employee but “other income” under article XXII of the treaty,<sup>35</sup> which is not excludable from U.S. taxation.

### Refundable State Tax Credits

The Court of Federal Claims decided a case of first impression regarding the characterization and taxability of targeted New York State tax credits.<sup>36</sup> New York State offers state income tax credits to businesses or individuals who meet the requirements of the tax credit program. The purpose of the program is to rehabilitate targeted areas of New York. The program applies a percentage of the cost of the project against a corporation’s franchise tax or an individual’s income tax liability and any amount in excess of that owed can be deferred to another tax year or credited as an overpayment. New York does not tax any part of the credit. In *Ginsburg v. Commissioner*, the taxpayers (a husband and wife) received an excess credit of nearly \$2 million from New York State, which they did not include as income on their tax return.<sup>37</sup> The IRS conducted an audit and asserted a tax deficiency. Mr. and Mrs. Ginsburg then paid the deficiency and brought a refund suit. They argued that the excess credit was not income, as it was a classic recovery of capital. Alternatively, they argued the excess credit is excludable from gross income as a nontaxable contribution to capital. The Commissioner asserted the excess credit is a cash subsidy and not excludable from gross income.<sup>38</sup> Both parties moved for summary judgment.

Similar to the case of *Maines v. Commissioner*, which we discussed in a previous report, the court in *Ginsburg* found that while New York treated the credit as a nontaxable refund, federal law ultimately controls how state-created interests are taxed under the federal income tax.<sup>39</sup>

The court found that the excess credit was nothing more than a cash transfer to the taxpayers, and on its face was income, unless an exclusion from income could be applied. The court next considered the theories of capital recovery and nontaxable contribution to capital advanced by the taxpayers. The court determined that the recovery of capital doctrine is limited to the sale of goods, which is not applicable in the instant matter.<sup>40</sup> The court also rejected the taxpayers’ contention that the excess credit was a contribution to capital by New York State and thus not taxable. The court noted that the transfer was not made for an interest in the taxpayers’ partnership and the taxpayers freely chose to participate in the program. As a result, the excess credit was income to the taxpayers and did not qualify for any exception or exclusion from gross income.<sup>41</sup>

35 Article XXII of the treaty was captioned “Other Income” and served as a catchall provision to cover items of income not dealt with elsewhere in the treaty. It expressly provided that the U.S. could tax items of income arising in the U.S.

36 *Ginsburg v. U.S.*, 136 Fed. Cl. 1 (2018), *appeal docketed*, No. 18-1788 (Fed. Cir., Mar. 30, 2018).

37 136 Fed. Cl. 1 (2018), *appeal docketed*, No. 18-1788 (Fed. Cir., Mar. 30, 2018).

38 *Ginsburg v. Comm’r*, 136 Fed. Cl. 1 (2018), *appeal docketed*, No. 18-1788 (Fed. Cir., Mar. 30, 2018).

39 *Maines v. Comm’r*, 144 T.C. 123 (2015). See National Taxpayer Advocate 2015 Annual Report to Congress 479-80.

40 As the District Court for the Eastern District of New York explained in the case of *In re Tax Refund Litigation*, 766 F. Supp. 1248 (E.D.N.Y. 1991), “There can be no return of capital until, as in the case of a manufacturer or merchandiser, that asset is sold or exchanged by the lessor.” In *Ginsburg v. Commissioner*, the taxpayer retained all ownership of the property in question, therefore, there could be no return of capital since the taxpayer had not divested of the asset for which he claimed to be recovering capital.

41 *Ginsburg v. Commissioner*, 136 Fed. Cl. 1 (2018), *appeal docketed*, No. 18-1788 (Fed. Cir., Mar. 30, 2018).

## CONCLUSION

Taxpayers litigate many of the same gross income issues every year due to the complex nature of what constitutes gross income. As the definition is very broad and the courts broadly interpret accession to wealth as gross income, most cases were decided in favor of the IRS and exclusions from gross income continued to be narrowly interpreted.

Overall, litigation of items of gross income decreased this year, from 85 cases in the 2017 reporting cycle to 79 cases this year.<sup>42</sup> The number of cases involving the tax treatment of settlements and awards held steady in this reporting cycle at seven; thus, it clearly remains a perennial area of confusion for taxpayers. The National Taxpayer Advocate has previously recommended a legislative change that would clarify the tax treatment of court awards and settlements by permitting taxpayers to exclude any payments received as a settlement or judgment for mental anguish, emotional distress, or pain and suffering.<sup>43</sup>

One new area appeared in the issues reviewed this year and presented the Tax Court with an issue of first impression involving the treatment of income under various tax treaties. Previous reporting cycles did not identify cases in this area.<sup>44</sup> Taxpayers litigated this issue with only minor success this year, prevailing in part in only one case.

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42 National Taxpayer Advocate 2017 Annual Report to Congress 420-427.

43 National Taxpayer Advocate Annual 2009 Report to Congress 351-356 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*).

44 See, e.g., National Taxpayer Advocate 2017 Annual Report to Congress 544-546 (Appendix 3).

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## Appeals From Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330

## SUMMARY

The IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>1</sup> created Collection Due Process (CDP) hearings to provide taxpayers with an independent review by the IRS Office of Appeals (Appeals) of the decision to file a Notice of Federal Tax Lien (NFTL) or the IRS's proposal to undertake a levy action. In other words, a CDP hearing is an opportunity for a taxpayer to have a meaningful hearing prior to the IRS's first levy or immediately after its first NFTL filing to enforce a tax liability. At the hearing, the taxpayer has the right to raise any relevant issues related to the unpaid tax, the lien, or the proposed levy, including the appropriateness of the collection action, collection alternatives, spousal defenses, and, under certain circumstances, the underlying tax liability.<sup>2</sup>

Once Appeals issues a determination, a taxpayer has the right to judicial review of the determination if the taxpayer timely requests a CDP hearing and timely petitions the United States Tax Court.<sup>3</sup> Generally, the IRS suspends levy actions during a levy hearing and any judicial review that may follow.<sup>4</sup>

Only a small fraction of taxpayers exercise their right to an administrative hearing, and far fewer taxpayers petition the Tax Court to review their case. Between 2004 and 2018, only 1.43 percent of the taxpayers who received a CDP notice requested an administrative hearing (*i.e.*, 390,041 out of 27,264,457) and only 0.08 percent filed a petition in Tax Court (*i.e.*, 22,012 out of 27,264,457).

Yet CDP has been one of the federal tax issues most frequently litigated in the federal courts since 2001. Our review of litigated issues found 74 opinions on CDP cases during the review period of June 1, 2017, through May 31, 2018, which is a decrease of about 13 percent since last year's report.<sup>5</sup> Taxpayers prevailed in full in five of these cases (about seven percent) and, in part, in four others (over five percent). The 12 percent success rate for the taxpayers is higher than last year. Of the nine opinions where taxpayers prevailed in whole or in part, four taxpayers appeared without a representative authorized to advocate to the court on their behalf (*pro se*),<sup>6</sup> and five were represented by an attorney or other court-approved professional.

The cases discussed below demonstrate that CDP hearings serve a vital role by providing a venue for taxpayers to raise legitimate issues before the IRS deprives the taxpayer of property. Many of these decisions shed light on substantive and procedural issues.

- 1 IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, § 3401, 112 Stat. 685, 746 (1998).
- 2 Internal Revenue Code (IRC) §§ 6320(c) (lien) and 6330(c)(2) (levy). IRC § 6320(c) generally requires Appeals to follow the levy hearing procedures under IRC § 6330 for the conduct of the lien hearing, the review requirements, and the balancing test.
- 3 IRC § 6330(d) (setting forth the time requirements for obtaining judicial review of Appeals' determination); IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B) (setting forth the time requirements for requesting a Collection Due Process (CDP) hearing for lien and levy matters, respectively).
- 4 IRC § 6330(e)(1) provides that generally, levy actions are suspended during the CDP process (along with a corresponding suspension in the running of the limitations period for collecting the tax). However, IRC § 6330(e)(2) allows the IRS to resume levy actions upon a determination by the Tax Court of "good cause," if the underlying tax liability is not at issue.
- 5 For a list of all cases reviewed, see Table 5 in Appendix 3, *infra*.
- 6 *Pro se* means "[f]or oneself; on one's own behalf; without a lawyer." *Pro Se*, BLACK'S LAW DICTIONARY (10th ed. 2014).



CDP hearings provide taxpayers with a way to exercise several rights articulated in the Taxpayer Bill of Rights, which was adopted by the IRS in 2014 and was subsequently incorporated in the Internal Revenue Code (IRC) in response to the National Taxpayer Advocate's recommendations.<sup>7</sup> For example, by providing an opportunity for a taxpayer to challenge the underlying liability and raise alternatives to the collection action, the CDP hearing empowers the taxpayer *to challenge the IRS's position and be heard*. If the taxpayer disagrees with Appeals' determination, he or she may file a petition in Tax Court, an exercise of the taxpayer's *right to appeal an IRS decision in an independent forum*. Lastly, since the Appeals Officer (AO) must consider whether the IRS's proposed collection action balances the overall need for efficient collection of taxes with the legitimate concern that the IRS's collection actions are no more intrusive than necessary, the CDP hearing protects a taxpayer's *right to privacy* while also ensuring the taxpayer's *right to a fair and just tax system*.

### TAXPAYER RIGHTS IMPACTED<sup>8</sup>

- *The Right to Be Informed*
- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

### PRESENT LAW

Current law provides taxpayers an opportunity for independent review of an NFTL filed by the IRS or of a proposed levy action.<sup>9</sup> As discussed above, CDP rights ensure taxpayers receive adequate notice of IRS collection activity and an opportunity for a meaningful hearing before the IRS deprives the taxpayer of property.<sup>10</sup> The hearing allows taxpayers to raise issues related to collection of the liability, including:

- The appropriateness of collection actions;<sup>11</sup>
- Collection alternatives such as an installment agreement (IA), offer in compromise (OIC), posting a bond, or substitution of other assets;<sup>12</sup>
- Appropriate spousal defenses;<sup>13</sup>

7 See Taxpayer Bill of Rights (TBOR), <http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights>, IRC § 7803(a)(3).

8 See TBOR, <http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights>. The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).

9 IRC §§ 6320 and 6330.

10 Prior to RRA 98, the U.S. Supreme Court had held that a post-deprivation hearing was sufficient to satisfy due process concerns in the tax collection arena. See *U.S. v. Nat'l Bank of Commerce*, 472 U.S. 713, 726-731 (1985); *Phillips v. Comm'r*, 283 U.S. 589, 595-601 (1931).

11 IRC § 6330(c)(2)(A)(ii).

12 IRC § 6330(c)(2)(A)(iii).

13 IRC § 6330(c)(2)(A)(i).

- The existence or amount of the underlying tax liability, but only if the taxpayer did not receive a statutory notice of deficiency or have another opportunity to dispute the liability;<sup>14</sup> and
- Any other relevant issue relating to the unpaid tax, the NFTL, or the proposed levy.<sup>15</sup>

A taxpayer cannot raise an issue considered at a prior administrative or judicial hearing if the taxpayer participated meaningfully in that hearing or proceeding.<sup>16</sup>

## PROCEDURAL COLLECTION DUE PROCESS REQUIREMENTS

The IRS must provide a CDP notice to the taxpayer indicating the particular tax and tax period after filing the first NFTL and generally before its first intended levy is issued.<sup>17</sup> The IRS must provide the notice not more than five business days after the day of filing the NFTL, or at least 30 days before the day of the proposed levy.<sup>18</sup>

If the IRS files a lien, the CDP lien notice must inform the taxpayer of the right to request a CDP hearing within a 30-day period, which begins on the day after the end of the five business day period after the filing of the NFTL.<sup>19</sup> In the case of a proposed levy, the CDP levy notice must inform the taxpayer of the right to request a hearing within the 30-day period beginning on the day after the date of the CDP notice.<sup>20</sup>

## REQUESTING A CDP HEARING

Under both lien and levy procedures, the taxpayer must return a signed and dated written request for a CDP hearing within the applicable period.<sup>21</sup> The Code and regulations require taxpayers to provide their reasons for requesting a hearing.<sup>22</sup> Failure to provide the basis may result in denial of a face-to-face hearing.<sup>23</sup> Taxpayers who fail to timely request a CDP hearing will be afforded an “equivalent hearing,”

14 IRC § 6330(c)(2)(B).

15 IRC § 6330(c)(2)(A); Treas. Reg. §§ 301.6320-1(e) and 301.6330-1(e).

16 IRC § 6330(c)(4).

17 IRC § 6330(f) permits the IRS to levy without first giving a taxpayer a CDP notice in the following situations: the collection of tax is in jeopardy, a levy was served on a state to collect a state tax refund, the levy is a disqualified employment tax levy, or the levy was served on a federal contractor. A disqualified employment tax levy is any levy to collect employment taxes for any taxable period if the person subject to the levy (or any predecessor thereof) requested a CDP hearing with respect to unpaid employment taxes arising in the most recent two-year period before the beginning of the taxable period with respect to which the levy is served. IRC § 6330(h)(1). A federal contractor levy is any levy if the person whose property is subject to the levy (or any predecessor thereof) is a federal contractor. IRC § 6330(h)(2). Under IRC § 6330(f), the IRS must still provide the opportunity for a CDP hearing “within a reasonable period of time after the levy.”

18 IRC §§ 6320(a)(2) or 6330(a)(2). The CDP notice can be provided to the taxpayer in person, left at the taxpayer’s dwelling or usual place of business, or sent by certified or registered mail (return receipt requested, for the CDP levy notice) to the taxpayer’s last known address.

19 IRC § 6320(a)(3)(B); Treas. Reg. § 301.6320-1(b)(1).

20 IRC § 6330(a)(3)(B); Treas. Reg. § 301.6330-1(b)(1).

21 IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B); Treas. Reg. §§ 301.6320-1(c)(2), Question and Answer (Q&A) (C1)(ii) and 301.6330-1(c)(2), Q&A (C1)(ii).

22 Treas. Reg. §§ 301.6320-1(c)(2), Q&A (C1)(ii) and 301.6330-1(c)(2), Q&A (C1)(ii).

23 IRC §§ 6320(b)(1) and 6330(b)(1); Treas. Reg. §§ 301.6320-1(c)(2), Q&A (C1); 301.6330-1(c)(2), Q&A (C1); 301.6320-1(d)(2), Q&A (D8); and 301.6330-1(d)(2), Q&A (D8). The regulations require the IRS to provide the taxpayer an opportunity to “cure” any defect in a timely filed hearing request, including providing a reason for the hearing. Form 12153 includes space for the taxpayer to identify collection alternatives that he or she wants Appeals to consider, as well as examples of common reasons for requesting a hearing. See IRS Form 12153, *Requests for Collection Due Process or Equivalent Hearing* (Dec. 2013); Internal Revenue Manual (IRM) 8.6.1.4.1, *Conference Practice* (Oct. 1, 2016).

which is similar to a CDP hearing but lacks judicial review.<sup>24</sup> Taxpayers must request an equivalent hearing within the one-year period beginning the day after the five-business-day period following the filing of the NFTL, or in levy cases, within the one-year period beginning the day after the date of the CDP notice.<sup>25</sup>

The IRS generally is required to suspend the levy action throughout a CDP hearing involving a notice of intent to levy. However, the requirement to suspend a levy action is inapplicable in certain circumstances where the IRS is not required to provide a CDP hearing prior to the levy and is only required to provide the CDP hearing within a reasonable time after the levy.<sup>26</sup> These circumstances occur when the IRS determines that:

- The collection of tax is in jeopardy;
- The collection resulted from a levy on a state tax refund;
- The IRS has served a disqualified employment tax levy; or
- The IRS has served a federal contractor levy.<sup>27</sup>

The IRS also is required to suspend levy action throughout any judicial review of Appeals' determination, unless the IRS obtains an order from the court permitting levy action because the underlying tax liability is not at issue, and the IRS can demonstrate good cause to resume collection activity.<sup>28</sup>

## HOW A CDP HEARING IS CONDUCTED

CDP hearings are informal. When a taxpayer requests a hearing with respect to both a lien and a proposed levy, Appeals will attempt to conduct one hearing.<sup>29</sup> A taxpayer can request that the hearing be in person; however, courts have ruled that a CDP hearing need not be face-to-face but can take place by telephone or correspondence,<sup>30</sup> and Appeals will typically conduct the hearing by telephone

24 Treas. Reg. §§ 301.6320-1(i)(2), Q&A (I6) and 301.6330-1(i)(2), Q&A (I6); *Business Integration Servs., Inc. v. Comm'r*, T.C. Memo. 2012-342 at 6-7; *Moorhouse v. Comm'r*, 116 T.C. 263 (2001). A taxpayer can request an Equivalent Hearing by checking a box on Form 12153, *Requests for Collection Due Process or Equivalent Hearing*, by making a written request, or by confirming that he or she wants the untimely CDP hearing request to be treated as an Equivalent Hearing when notified by Collection of an untimely CDP hearing request. IRM 5.19.8.4.3, *Equivalent Hearing (EH) Requests and Timeliness of EH Requests* (Nov. 1, 2007).

25 Treas. Reg. §§ 301.6320-1(i)(2), Q&A (I7) and 301.6330-1(i)(2), Q&A (I7).

26 See, e.g., *Dorn v. Comm'r*, 119 T.C. 356 (2002); *Zapara v. Comm'r*, 124 T.C. 223 (2005); *Bibby v. Comm'r*, T.C. Memo. 2013-281.

27 IRC § 6330(e)(1) provides the general rule for suspending collection activity. IRC § 6330(f) provides that if collection of the tax is deemed in jeopardy, the collection resulted from a levy on a state tax refund, or the IRS served a disqualified employment tax levy or a federal contractor levy, IRC § 6330 does not apply, except to provide the opportunity for a CDP hearing within a reasonable time after the levy. See *Clark v. Comm'r*, 125 T.C. 108, 110 (2005) (citing *Dorn v. Comm'r*, 119 T.C. 356 (2002)).

28 IRC § 6330(e)(1) and (e)(2).

29 IRC § 6320(b)(4).

30 *Katz v. Comm'r*, 115 T.C. 329, 337-38 (2000) (finding that telephone conversations between the taxpayer and the Appeals Officer (AO) constituted a hearing as provided in IRC § 6320(b)). Treas. Reg. §§ 301.6320-1(d)(2), Q&A (D)(6), Q&A (D)(8) and 301.6330-1(d)(2), Q&A (D)(6), Q&A (D)(8).

unless the taxpayer requests a face-to-face conference.<sup>31</sup> The CDP regulations state that taxpayers who provide non-frivolous reasons for opposing the IRS collection action will generally be offered but not guaranteed face-to-face conferences.<sup>32</sup> Taxpayers making frivolous arguments are not entitled to face-to-face conferences.<sup>33</sup> A taxpayer will not be granted a face-to-face conference concerning a collection alternative, such as an IA or OIC, unless other taxpayers would be eligible for the alternative under similar circumstances.<sup>34</sup> For example, the IRS will not grant a face-to-face conference to a taxpayer who proposes an OIC as the only issue to be addressed but failed to file all required returns and is therefore ineligible for an offer. Appeals may, however, at its discretion, grant a face-to-face conference to explain the eligibility requirements for a collection alternative.<sup>35</sup>

The CDP hearing is to be held by an impartial officer from Appeals, who is barred from engaging in *ex parte*<sup>36</sup> communications with IRS employees about the substance of the case and who has had “no prior involvement.”<sup>37</sup> In addition to addressing the issues raised by the taxpayer, the AO must verify that the IRS has met the requirements of all applicable laws and administrative procedures.<sup>38</sup> An integral component of the CDP analysis is the balancing test, which requires the IRS AO to determine whether the proposed collection action balances the need for efficient collection of taxes with the legitimate concern of the taxpayer that any collection action be “no more intrusive than necessary.”<sup>39</sup> The balancing test is central to a CDP hearing because it instills a notion of fairness into the process from the perspective of the taxpayer.<sup>40</sup>

31 Under the recently adopted IRM 8.6.1.4.1, *Conference Practice* (Oct. 1, 2016), the default rule became telephone conferences, with in-person conferences only being available in cases meeting certain criteria and where the Appeals Team Manager approved. Appeals recently announced that it would issue guidance to employees “informing them that Appeals will return to allowing taxpayers to have in-person Appeals conferences in field cases.” However, the policy change is limited to field offices, which leaves the low income taxpayer and much of the middle class without access to in-person conferences.

32 Treas. Reg. §§ 301.6320-1(d)(2), Q&A (D)(7) and 301.6330-1(d)(2), Q&A (D)(7).

33 Treas. Reg. §§ 301.6320-1(d)(2), Q&A (D)(8) and 301.6330-1(d)(2), Q&A (D)(8).

34 *Id.*

35 *Id.*

36 *Ex parte* means “done or made at the instance and for the benefit of one party only, and without notice to, or argument by, anyone having an adverse interest.” *Ex parte*, BLACK’S LAW DICTIONARY (10th ed. 2014).

37 IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1), and 6330(b)(3). See also Rev. Proc. 2012-18, 2012-1 C.B. 455. See, e.g., *Industrial Investors v. Comm’r*, T.C. Memo. 2007-93; *Moore v. Comm’r*, T.C. Memo. 2006-171, *action on dec.*, 2007-2 (Feb. 27, 2007); *Cox v. Comm’r*, 514 F.3d 1119, 1124-28 (10th Cir. 2008), *action on dec.*, 2009-1 (June 1, 2009), 2009-22 I.R.B.1.

38 IRC § 6330(c)(1); *Hoyle v. Comm’r*, 131 T.C. 197 (2008); *Talbot v. Comm’r*, T.C. Memo. 2016-191 (2016).

39 IRC § 6330(c)(3)(C); IRM 8.22.4.2.2, *Summary of CDP Process* (Sept. 25, 2014). See also H.R. REP. No. 105-599, at 263 (1998). For simplicity, we use the term “proposed collection action” referring to both the actions taken and proposed. IRC § 6330 requires the IRS to notify the taxpayer of the right to request a CDP hearing not less than 30 days before issuing the first levy to collect a tax. Pursuant to IRC § 6320, the taxpayer is notified of the right to request a CDP hearing within five business days after the first Notice of Federal Tax Lien (NFTL) for a tax period that is filed. Thus, Treasury Regulations under IRC § 6320 require a Hearing Officer to consider “[w]hether the continued existence of the filed [NFTL] represents a balance between the need for the efficient collection of taxes and the legitimate concern of the taxpayer that any collection action be no more intrusive than necessary.” See Treas. Reg. § 301.6320-1(e)(3), Q&A (E)(1)(vi). Similarly, a levy action can be taken before a hearing in the following situations: collection of the tax was in jeopardy; levy on a state to collect a federal tax liability from a state tax refund; disqualified employment tax levies; or a federal contractor levy. See IRC § 6330(f); IRM 8.22.4.2.2, *Summary of CDP Process* (Sept. 25, 2014).

40 See National Taxpayer Advocate 2014 Annual Report to Congress 185-196 (Most Serious Problem: *Collection Due Process: The IRS Needs Specific Procedures for Performing the Collection Due Process Balancing Test to Enhance Taxpayer Protections*). See also Nina E. Olson, *Taking the Bull by Its Horns: Some Thoughts on Constitutional Due Process in Tax Collection*, 2010 Erwin N. Griswold Lecture Before the American College of Tax Counsel, 63 TAX LAW. 227 (2010).

Special rules apply to the IRS's handling of hearing requests that raise frivolous issues. IRC § 6330(g) provides that the IRS may disregard any portion of a hearing request based on a position the IRS has identified as frivolous or that reflects a desire to delay or impede the administration of tax laws.<sup>41</sup> Similarly, IRC § 6330(c)(4)(B) provides that a taxpayer cannot raise an issue if it is based on a position identified as frivolous or reflects a desire to delay or impede tax administration.

IRC § 6702(b) allows the IRS to impose a penalty for a specified frivolous submission, including a frivolous CDP hearing request.<sup>42</sup> A request is subject to a penalty if any part of it “(i) is based on a position which the Secretary has identified as frivolous ... or (ii) reflects a desire to delay or impede the administration of Federal tax laws.”<sup>43</sup> A taxpayer can timely petition the Tax Court to review an Appeals decision if Appeals determined that a request for an administrative hearing was based entirely on a frivolous position under IRC § 6702(b)(2)(A) and issued a notice stating that Appeals will disregard the request.<sup>44</sup> An Appeals letter disregarding a CDP hearing request is a determination that confers jurisdiction under IRC § 6330(d)(1), because it authorizes the IRS to proceed with the disputed collection action.<sup>45</sup> The IRS Office of Chief Counsel disagreed with the Tax Court precedent in *Thornberry* and is maintaining the position that the Tax Court lacks jurisdiction to review a petition resulting from the denial of a frivolous hearing request under IRC § 6330(g).<sup>46</sup>

In *Ryskamp v. Commissioner*, the D.C. Circuit upheld the Tax Court's precedent in *Thornberry* that the IRS's disregard of a taxpayer's CDP hearing request as frivolous under IRC § 6330(g) is subject to judicial review, and affirmed the Tax Court's holding that the IRS abused its discretion in rejecting a taxpayer's request for a hearing by sending boilerplate rejection letters that do not articulate the grounds of the frivolousness determination.<sup>47</sup> While the IRS Office of Chief Counsel disagrees with *Ryskamp* on both issues, Counsel has modified its litigating guidelines as follows:

- Counsel will no longer contest the Tax Court's threshold jurisdiction to evaluate whether a CDP hearing was properly denied under IRC § 6330(g);
- Counsel will request a remand to Appeals where a hearing was improperly denied;
- Where a hearing was properly denied, instead of filing a motion to remand so Appeals can more fully explain the reasons for rejecting the taxpayer's arguments as frivolous, Counsel will file an appropriate motion with the Court to resolve the case through a dismissal or summary judgment; and

41 IRC § 6330(g). IRC § 6330(g) is effective for submissions made and issues raised after the date on which the IRS first prescribed a list of frivolous positions. Notice 2007-30, 2007-1 C.B. 833, which was published on or about April 2, 2007, provided the first published list of frivolous positions. Notice 2010-33, 2010-17 C.B. 609, contains the current list.

42 The frivolous submission penalty applies to the following submissions: CDP hearing requests under IRC §§ 6320 and 6330, offer in compromise (OIC) under IRC § 7122, installment agreements (IAs) under IRC § 6159, and applications for a Taxpayer Assistance Order under IRC § 7811.

43 IRC § 6702(b)(2)(A). Before asserting the penalty, the IRS must notify the taxpayer that it has determined that the taxpayer filed a frivolous hearing request. The taxpayer has 30 days to withdraw the submission to avoid the penalty. IRC § 6702(b)(3).

44 See *Thornberry v. Comm'r*, 136 T.C. 356, 367 (2011). The D.C. Appeals Court upheld *Thornberry* in *Ryskamp v. Comm'r*, 797 F.3d 1142 (D.C. Cir. 2015) *cert. denied*, 136 S. Ct. 834 (2016). See also National Taxpayer Advocate 2015 Annual Report to Congress 489 (Most Litigated Issue: *Appeals from Collection Due Process Hearings Under IRC §§ 6320 and 6330*).

45 *Thornberry v. Comm'r*, 136 T.C. 356, 364 (2011).

46 See IRS Chief Counsel Notice CC-2016-008, *Disregarding Frivolous CDP Hearing Requests Under Section 6330(g)* (Apr. 4, 2016).

47 *Ryskamp v. Comm'r*, 797 F.3d 1142 (D.C. Cir. 2015), *cert. denied*, 136 S. Ct. 834 (2016).

- Counsel will also consider filing a motion to permit levy so that the Service can immediately levy after the Tax Court's order.<sup>48</sup>

## JUDICIAL REVIEW OF AN IRS DETERMINATION AFTER A CDP HEARING

Within 30 days of Appeals' determination, the taxpayer may petition the Tax Court for judicial review.<sup>49</sup> In several recent court cases,<sup>50</sup> taxpayers filed their petitions one day late because they miscalculated the time period for filing their Tax Court petitions. The Tax Court found it lacked jurisdiction to review the IRS's determination, and several courts of appeal affirmed.<sup>51</sup> The court will only consider issues, including challenges to the underlying liability, that were properly raised during the CDP hearing.<sup>52</sup> An issue is not properly raised if the taxpayer fails to request that Appeals consider the issue, or if the taxpayer fails to present any evidence regarding consideration of that issue after being given a reasonable opportunity.<sup>53</sup> The Tax Court, however, may remand a case back to Appeals for more fact finding when the taxpayer's factual circumstances have materially changed between the hearing date and the trial.<sup>54</sup> When the case is remanded to Appeals, the Tax Court retains jurisdiction.<sup>55</sup> The resulting hearing on remand provides the parties with an opportunity to complete the initial hearing while preserving the taxpayer's right to return to Court and receive judicial review of the ultimate administrative determination.<sup>56</sup>

The standard of review the court will apply depends on the nature of the issue it is reviewing. Where the validity of the underlying tax liability is properly at issue in the hearing, the court will review the amount of the tax liability on a *de novo*<sup>57</sup> basis, and the scope of its review extends to evidence

48 IRS Chief Counsel Notice CC-2016-008, *Disregarding Frivolous CDP Hearing Requests Under Section 6330(g)* (Apr. 4, 2016). In the 2014 Annual Report to Congress, the National Taxpayer Advocate expressed concerns about the Office of Appeals not giving proper attention to the CDP balancing test, especially to legitimate concerns of taxpayers regarding the intrusiveness of the proposed collection action, and often using *pro forma* statements that the balancing test has been conducted. See National Taxpayer Advocate 2014 Annual Report to Congress 185-196 (Most Serious Problem: *Collection Due Process: The IRS Needs Specific Procedures for Performing the Collection Due Process Balancing Test to Enhance Taxpayer Protections*).

49 IRC § 6330(d)(1).

50 See, e.g., *Duggan v. Comm'r*, Order of Dismissal for Lack of Jurisdiction, Tax Ct. No. 4100-15L (2015) (dismissing for lack of jurisdiction where petition was filed "31 days after the mailing of the notices of determination."); *Pottgen v. Comm'r*, Order of Dismissal for Lack of Jurisdiction, Tax Ct. No. 1410-15L (2016) (dismissing for lack of jurisdiction where petition was received by Tax Court one day late); *Integrated Event Management, Inc. v. Comm'r*, Order of Dismissal for Lack of Jurisdiction, Tax Ct. No. 27674-16SL (2017) (dismissing for lack of jurisdiction where petition was filed one day late, disagreeing with taxpayer's calculation putting the day of the letter as day zero rather than as day one); *Protter v. Comm'r*, Order of Dismissal for Lack of Jurisdiction, Tax Ct. No. 22975-15SL (2017) (dismissing for lack of jurisdiction where petition was mailed 31 days after the date on the notice of determination, disagreeing with Taxpayer's construction of the operative language effectively putting the day of the letter as day zero).

51 See, e.g., *Cunningham v. Comm'r*, 716 F. App'x 182 (4th Cir. 2018), *aff'g* No. 16-014090 (T.C. Dec. 7, 2016); *Duggan v. Comm'r*, 879 F.3d 1029 (9th Cir. 2018), *aff'g* No. 15-4100 (T.C. June 26, 2015).

52 *Giamelli v. Comm'r*, 129 T.C. 107 (2007).

53 Treas. Reg. §§ 301.6320-1(f)(2), Q&A (F)(3); 301.6330-1(f)(2), Q&A (F)(3).

54 *Churchill v. Comm'r*, T.C. Memo. 2011-182; see also IRS Chief Counsel Notice CC-2013-002, *Remands to Appeals in CDP Cases When There Is a Post-Determination Change in Circumstances* (Nov. 30, 2012), which provides Counsel attorneys with instructions on when a remand based on changed circumstances might be appropriate; *but see Kehoe v. Comm'r*, T.C. Memo. 2013-63 (taxpayer's eligibility to make withdrawals from his IRA without the threat of penalty does not amount to a material change in circumstances such that remand would be appropriate).

55 See, e.g., *Pomeroy v. Comm'r*, T.C. Memo. 2013-26 at 20; Bob Kamman, *For IRS Appeals Office, An Epidemic of Remands*, PROCEDURALLY TAXING (Oct. 9, 2018), <http://procedurallytaxing.com/for-irs-appeals-office-an-epidemic-of-remands/>.

56 *Wadleigh v. Comm'r*, 134 T.C. 280, 299 (2010).

57 *De novo* means "anew." *De Novo*, BLACK'S LAW DICTIONARY (10th ed. 2014).



introduced at the trial that was not a part of the administrative record.<sup>58</sup> Where the Tax Court is reviewing the appropriateness of the collection action or subsidiary factual and legal findings, the Court will review these determinations under an abuse of discretion standard.<sup>59</sup>

### Court Review of Facts Outside the Administrative Record

When the review is for abuse of discretion, it is the position of the Tax Court that the scope of its review extends beyond the administrative record to include evidence adduced at trial, although in nonliability CDP cases appealable to the U.S. Courts of Appeals for the First, Eighth, and Ninth Circuits, the scope of review is limited to the administrative record.<sup>60</sup> However, in cases appealable to the other U.S. Courts of Appeals, which have yet to address that precise issue in a precedential opinion, the court may consider new evidence not contained in the administrative record.<sup>61</sup>

### Opportunity to Contest an Underlying Liability

The regulations distinguish between liabilities that are subject to deficiency procedures and those that are not. For liabilities subject to deficiency procedures, an opportunity for a post-examination conference with the IRS Office of Appeals does not bar the taxpayer (in appropriate circumstances) from contesting his or her liability in a later CDP proceeding.<sup>62</sup> On the other hand, where a liability is not subject to deficiency procedures, “[a]n opportunity to dispute the underlying liability includes a prior opportunity for a conference with Appeals that was offered either before or after the assessment of the liability.”<sup>63</sup> For example, an IRC § 6707A penalty<sup>64</sup> is an assessable penalty not subject to deficiency procedures.

In March 2017, in *Bitter v. Commissioner*,<sup>65</sup> the Tax Court further reiterated that a taxpayer is entitled to challenge his underlying liability for a § 6707A penalty only if the taxpayer did not have a prior opportunity to dispute it. A “prior opportunity” was found to include a prior opportunity for a conference with Appeals. The *Bitter* determination was a culmination of similar developments in circuit court decisions on the same issue, including the Fourth Circuit decision *James v. Commissioner*,<sup>66</sup> the Tenth Circuit decision in *Keller Tank Serv. II v. Commissioner*,<sup>67</sup> and the Seventh Circuit decision in *Our Country Home Enterprises, Inc. v. Commissioner*.<sup>68</sup>

58 The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing Appeals’ CDP determinations. H.R. REP. NO. 105-599, at 266. See also IRS Chief Counsel Notice CC-2014-002, *Proper Standard of Review for Collection Due Process Determinations* (May 5, 2014).

59 See, e.g., *Murphy v. Comm’r*, 469 F.3d 27 (1st Cir. 2006); *Dalton v. Comm’r*, 682 F.3d 149 (1st Cir. 2012).

60 See *Keller v. Comm’r*, 568 F.3d 710, 718 (9th Cir. 2009), *aff’g* in part as to this issue T.C. Memo. 2006-166; *Murphy v. Comm’r*, 469 F.3d 27; *Robinette v. Comm’r*, 439 F.3d 455 (8th Cir. 2006), *rev’g* 123 T.C. 85 (2004).

61 See IRC § 7482(b)(1)(G)(i), *Rozday v. Comm’r*, 703 F. App’x. 138, 139 (3d Cir. 2017); *Tuka v. Comm’r*, 324 F. App’x 193, 195 n.2 (3d Cir. 2009); *Emery Celli Cuti Brinckerhoff & Abady, P.C. v. Comm’r*, T.C. Memo. 2018-55; and *Robinette v. Comm’r*, 123 T.C. at 103.

62 See Treas. Reg. §§ 301.6320-1(e)(3), Q&A-E2 and 301.6330-1(e)(3), Q&A-E2. Cf. IRC § 6330(c)(2)(B) (receiving the statutory notice of deficiency precludes the taxpayer from contesting the underlying liability).

63 See Treas. Reg. §§ 301.6320-1(e)(3), Q&A-E2 and 301.6330-1(e)(3), Q&A-E2.

64 IRC § 6707A provides a monetary penalty for the failure to include a reportable transaction required to be disclosed under IRC § 6011.

65 *Bitter v. Comm’r*, T.C. Memo. 2017-46.

66 See *James v. Comm’r*, 850 F.3d 160 (4th Cir. 2017).

67 See *Keller Tank Serv. II, Inc. v. Comm’r*, 854 F.3d 1178 (10th Cir. 2017).

68 See *Our Country Home Enterprises, Inc. v. Comm’r*, 855 F.3d 773 (7th Cir. 2017).



## APPELLATE VENUE FROM DECISIONS OF THE TAX COURT

IRC § 7482(b)(1)(G) specifies that CDP cases are appealable to the circuit of the taxpayer's legal residence (if the taxpayer is an individual) or the taxpayer's principal place of business, office, or agency (if the taxpayer is not an individual). This provision applies only to cases filed after December 18, 2015, but it should not be construed to create any inference regarding cases filed before that date.<sup>69</sup>

For cases filed before December 18, 2015, the correct venue for appeals from the Tax Court generally was the D.C. Circuit Court unless one of the rules specified in IRC § 7482(b)(1) or exceptions specified in IRC § 7482(b)(2) or (b)(3) applied. For instance, IRC § 7482(b)(1)(A) provides that in cases where a taxpayer other than a corporation seeks redetermination of a tax liability, venue for review by the United States Court of Appeals lies with the Court of Appeals for the circuit based upon the taxpayer's legal residence.<sup>70</sup> Pursuant to IRC § 7482(b)(2), the taxpayer and the IRS may stipulate the venue for an appeal in writing. In *Byers v. Commissioner*, the D.C. Circuit held that it would not transfer cases in non-liability CDP cases unless both parties stipulate to the transfer.<sup>71</sup> However, the Court acknowledged that in some CDP cases involving both challenges to the tax liability and collection issues, the venue presumably would be in the appropriate regional circuit.<sup>72</sup>

It has been the longstanding practice of taxpayers and the IRS to appeal CDP, innocent spouse, and interest abatement cases to the circuit of the taxpayer's legal residence, principal place of business, or principal office or agency. The Tax Court has also followed this approach. Under the rule established in *Golsen v. Commissioner*,<sup>73</sup> the Tax Court follows the precedent of the circuit court to which the parties have the right to appeal regardless of whether the taxpayer's tax liability was at issue. In 2014, to address the uncertainty and confusion among taxpayers and practitioners caused by the *Byers* decision, the National Taxpayer Advocate recommended that Congress amend IRC § 7482 to provide that the proper

69 Pub. L. No. 114-113, Div. Q, Title IV, § 423(a), (b) (2015). See also IRS Chief Counsel Notice CC-2016-006, *Path [Protecting Americans from Tax Hikes] Act Legislative Amendments: Appellate Venue for CDP and Innocent Spouse Cases, Tax Court Jurisdiction and S-Case Status for Interest Abatement Cases, and Applicability of Federal Rules of Evidence the Tax Court* (Feb. 1, 2016). For cases filed before that date, the guidance in IRS Chief Counsel Notice CC-2015-006, *Venue for Appeals from Decisions of the Tax Court* (June 30, 2015) applies.

70 IRC § 7482(b)(1) also provides that the proper venue lies with the Court of Appeals for the circuit in which the taxpayer is located: in the case of a corporation seeking redetermination of tax liability, the principal place of business or principal office or agency of the corporation, or if it has no principal place of business or principal office or agency in any judicial circuit, then the office to which was made the return of the tax in respect of which the liability arises; in the case of a person seeking a declaratory decision under IRC § 7476, the principal place of business or principal office or agency of the employer; in the case of an organization seeking a declaratory decision under IRC § 7428, the principal office or agency of the organization; in the case of a petition under IRC §§ 6226, 6228(a), 6247, or 6252 (for partnership taxable years beginning on or before Dec. 31, 2017), or in the case of a petition under IRC § 6234 (for partnership taxable years beginning after Dec. 31, 2017), the principal place of business of the partnership; in the case of a taxpayer under section IRC § 6234(c) (for partnership taxable years beginning on or before Dec. 31, 2017), (i) the legal residence of the taxpayer if the taxpayer is not a corporation, and (ii) the place or office applicable under subparagraph (B) if the taxpayer is a corporation; in the case of a petition under IRC § 6015(e) (for partnership taxable years beginning after Dec. 31, 2017), the legal residence of the taxpayer; or in the case of a petition under IRC §§ 6320 or 6330 (for partnership taxable years beginning after Dec. 31, 2017), (i) the legal residence of the taxpayer if the taxpayer is an individual, and (ii) the principal place of business or principal office or agency if the taxpayer is an entity other than an individual.

71 740 F.3d 668 (D.C. Cir. 2014). For a more detailed discussion of the *Byers* case see National Taxpayer Advocate 2014 Annual Report to Congress 477-494 (Most Litigated Issue: *Appeals from Collection Due Process Hearings Under IRC §§ 6320 and 6330*).

72 740 F.3d at 676. The Court noted that it had "no occasion to decide ... whether a taxpayer who is seeking review of a CDP decision on a collection method may file in a court of appeals other than the D.C. Circuit if the parties have not stipulated to venue in another circuit." *Id.* at 677.

73 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

venue to seek review of a Tax Court decision in all collection due process cases lies with the federal court of appeals for the circuit in which the taxpayer resides.<sup>74</sup> Congress made this precise legislative change in 2015.<sup>75</sup>

## ANALYSIS OF PUBLISHED OPINIONS

We identified and reviewed 74 CDP court opinions, a decrease of about 13 percent from the 85 published opinions in last year's report. From 2003 to 2010, the average number of published opinions was approximately 185. Since 2011, the average number of published opinions has dropped by about half, to 90. We analyzed potential factors that could have affected CDP litigation. First, we looked at the number of CDP notices the IRS issued to taxpayers, either in relation to an NFTL or a levy. The number of CDP notices increased from 2003, peaking in 2012 at just over 2,778,000, and then began to decrease. By 2018, the number of notices had decreased by 47 percent from 2012. Second, we determined the number of CDP hearing requests has generally followed the same trend.<sup>76</sup> In 2011, the number of CDP hearing requests peaked at 36,755, up from 10,889 requests in 2003. However, between 2011 and 2018, the number of hearing requests has declined by 34 percent. Finally, the number of Tax Court petitions also grew from 2003 to 2012, peaking at 1,963, and then started falling in 2012. From 2012 to 2018, petitions dropped by about ten percent. These trends are depicted in Figure 3.5.1, Collection Due Process (CDP) Notices, Hearing Requests, Petitions, and Litigation.

74 National Taxpayer Advocate 2014 Annual Report to Congress 387-391 (Legislative Recommendation: *Appellate Venue in Non-Liability CDP Cases: Amend IRC § 7482 to Provide That the Proper Venue to Seek Review of a Tax Court Decision in All Collection Due Process Cases Lies with the Federal Court of Appeals for the Circuit in Which the Taxpayer Resides*).

75 See Protecting Americans from Tax Hikes (PATH) Act of 2015, Pub. L. No. 114-113, Div. Q, Title IV, § 423(b).

76 IRC §§ 6320 and 6330 provide a taxpayer the right to a hearing if a request is made within a 30-day period.

**FIGURE 3.5.1**

**Collection Due Process (CDP) Notices, Hearing Requests, Petitions, and Litigation**

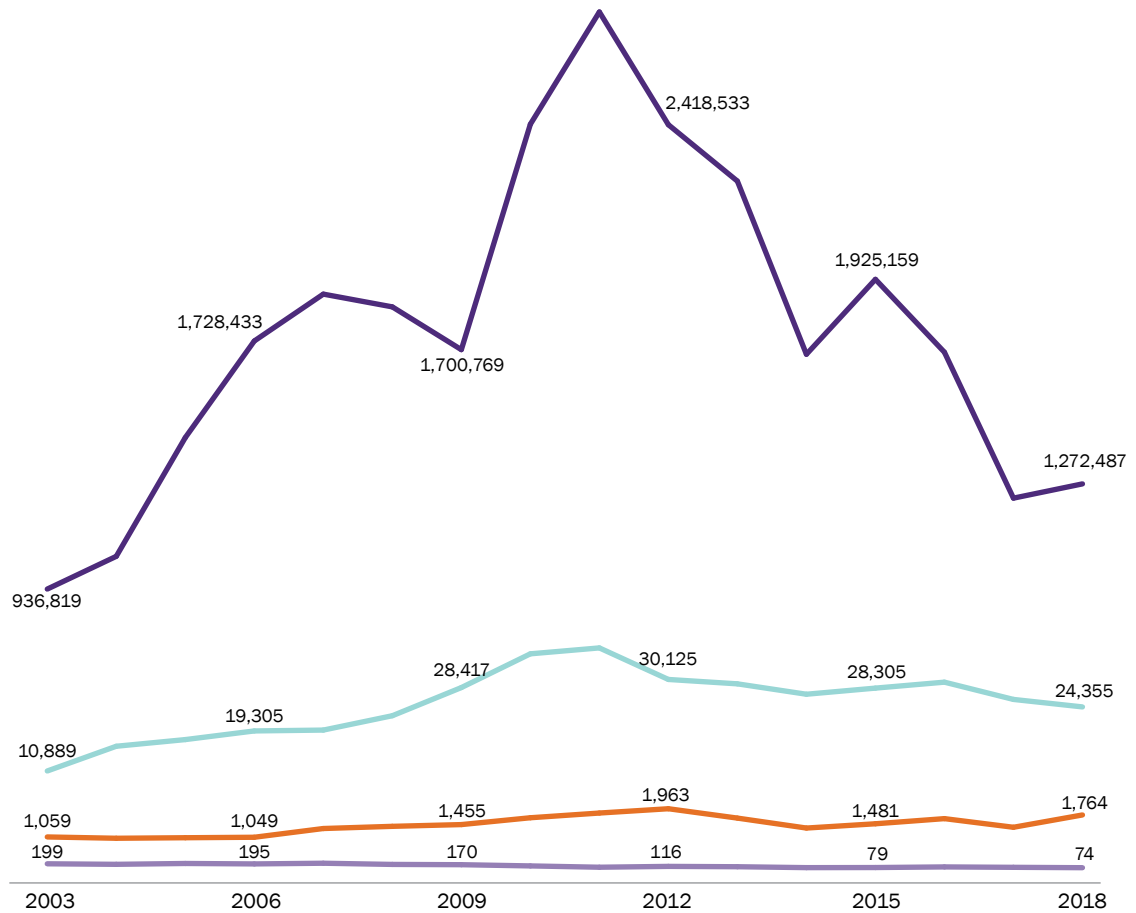
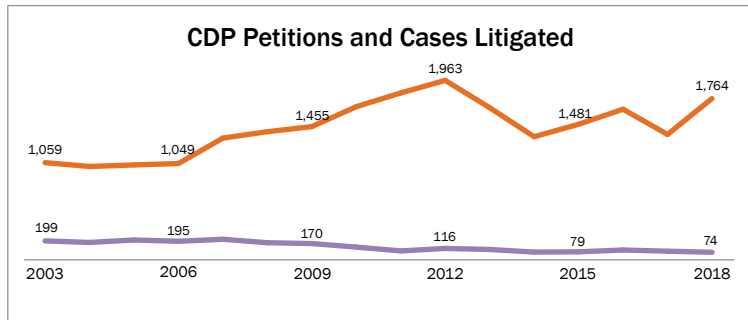


Chart is not to exact scale

- CDP Notices Mailed
- CDP Hearing Requests
- CDP Petitions
- CDP Cases Litigated



The decline in notices, hearing requests, and petitions may be attributed, in part, to a series of operational changes in fiscal years (FYs) 2011 and 2012 that led to fewer NFTL filings during the past few years and a higher number of accepted OICs than in 2011 and 2012.<sup>77</sup> These factors likely had a positive impact on many taxpayers and revenue collection. Fewer NFTL filings directly impacts the number of CDP notices issued to taxpayers, which in turn influence the number of CDP hearing requests and subsequent petitions to review IRS CDP determinations in Tax Court.

We acknowledge that there may be some additional reasons for the general decline in the number of litigated CDP cases. The IRS has experienced significant budget and staff reductions since 2010, which likely had an impact on enforced collection action. Any decline in litigated cases in the years after 2010 may also be due to taxpayers litigating many issues of first impression in the years immediately following the enactment of IRC §§ 6320 and 6330, which have been resolved by the courts.

The 74 opinions identified this year do not reflect the full number of CDP cases because the court does not issue an opinion in all cases.<sup>78</sup> Some are resolved through settlements, and in other cases, taxpayers do not pursue litigation after filing a petition with the court.<sup>79</sup> The Tax Court also disposes of some cases by issuing unpublished orders.<sup>80</sup> Table 5 in Appendix 3 provides a detailed list of the published CDP opinions, including specific information about the issues, the types of taxpayers involved, and the outcomes of the cases.

## LITIGATION SUCCESS RATE

Taxpayers prevailed in full in five of the 74 opinions issued during the year ending May 31, 2018 (about seven percent). Taxpayers prevailed in part in four other cases (over five percent). Of the nine published opinions in which the courts found for the taxpayer, in whole or in part, the taxpayers appeared *pro se* in four cases and were represented in five cases. Cognizant of the distinct disadvantage that *pro se* litigants face, federal courts routinely read their submissions liberally and interpret them to raise the strongest arguments that they suggest.<sup>81</sup> The IRS prevailed fully in 65 cases (about 88 percent) of the published

77 For instance, in fiscal year (FY) 2017, the IRS filed about 57 percent fewer NFTLs than in FY 2011, including a corresponding 62 percent reduction in liens filed by the Automated Collection System (ACS). In FY 2011, the IRS filed 1,042,230 liens. See IRS, Collection Activity Report 5000-23 (Oct. 11, 2011). In FY 2017, the IRS filed 446,378 liens. See IRS, Collection Activity Report 5000-25 (Oct. 4, 2017). We also note that the IRS has accepted 29 percent more OICs than during FY 2011, and that the actual number of accepted offers has almost doubled when compared to FY 2010, with FY 2017 having an acceptance rate of 38.1 percent. See IRS, Collection Activity Report 5000-108 (Oct. 5, 2010); IRS, Collection Activity Report 5000-108 (Oct. 5, 2011); IRS, Collection Activity Report 5000-108 (Oct. 2, 2017).

78 See U.S. Tax Court, Orders Search, <https://www.ustaxcourt.gov/InternetOrders/OrdersSearch.aspx>.

79 Prior to Oct. 17, 2006, the taxpayer could also petition the federal district court if the Tax Court did not have jurisdiction over the underlying tax liability (e.g., if the matter involved an employment tax liability).

80 The statistics analyzing the number of litigated cases excludes Tax Court summary judgments and bench orders, which are unpublished, however Appendix 3, Tables 11 and 12 of the Most Litigated Issues section lists the summary judgments and bench orders. Each division or memorandum opinion goes through a legislatively mandated pre-issuance review by the Chief Judge. IRC §§ 7459(b); 7460(a). While division opinions are precedential, orders are not, being issued “in the exercise of discretion” by a single judge. See 7463(b); Rule 50(f), Tax Court Rules of Practice and Procedure (denying precedential status to orders) and 152(c) (denying precedential status to bench opinions). See also *Introduction: Most Litigated Issues*, *supra*.

81 See *Haines v. Kerner*, 404 U.S. 519, 520 (1972); *Burgos v. Hopkins*, 14 F.3d 787, 790 (2d Cir. 1994); *Buczek v. U.S.*, No. 15-CV-273S, 2018 U.S. Dist. LEXIS 77471, at \*3 (W.D.N.Y. May 8, 2018).

opinions, a decrease from the 92 percent success rate last year.<sup>82</sup> The 12 percent success rate<sup>83</sup> among taxpayers is higher than last year.

## Issues Litigated

### *Cunningham v. Commissioner*

In *Cunningham v. Commissioner*,<sup>84</sup> the taxpayer sought Court of Appeals review of the Tax Court’s dismissal of her petition for review of an IRS CDP determination. The Tax Court concluded that it lacked the necessary jurisdiction to review Ms. Cunningham’s petition, which she filed one day after the 30-day deadline set forth in IRC § 6330(d)(1).

The IRS issued Cunningham a final notice of intent to levy in October 2015 for unpaid income tax she allegedly owed from 2010, 2011, 2013, and 2014.<sup>85</sup> After receiving the notice, Cunningham exercised her right to a CDP hearing before the IRS Office of Appeals.<sup>86</sup> Following the hearing, the IRS sent Cunningham a letter dated May 16, 2016, advising her of its decision. The letter explained the IRS’s determination that the levy notice was properly issued and that the proposed levy was appropriate and no more intrusive than necessary.<sup>87</sup> It also advised Cunningham that if she wished to dispute the determination, she “must file a petition with the United States Tax Court within a 30-day period beginning the day after the date of this letter.” Finally, it cautioned that “[t]he law limits the time for filing your petition to the 30-day period mentioned above. The courts cannot consider your case if you file late.”

On June 16, 2016—31 days after the date of the determination letter—Cunningham mailed a petition to the Tax Court seeking to challenge the IRS’s decision. The IRS moved to dismiss for lack of jurisdiction, and the Tax Court granted the motion since she filed it after the statutory deadline.<sup>88</sup> Cunningham appealed.

In her appeal, Cunningham claimed the letter was misleading and tricked her and other taxpayers into filing late as equitable grounds for why the filing deadline should have been tolled.

The Court of Appeals applied reasoning from a recent Supreme Court decision analyzing a statutorily prescribed deadline for appealing the determination of a government agency to consider whether the 30-day deadline to file a petition with the Tax Court for review of a CDP determination was jurisdictional, distinguishing jurisdictional time limits from claim processing rules.<sup>89</sup> There is a

82 National Taxpayer Advocate 2015 Annual Report to Congress 489 (Most Litigated Issue: *Appeals from Collection Due Process Hearings Under IRC § 6320 and 6330*).

83 The success rate includes decisions for the taxpayer as well as split decisions.

84 *Cunningham v. Comm’r*, 716 F. App’x 182 (4th Cir. 2018), *aff’g* No. 16-014090 (T.C. Dec. 7, 2016).

85 IRC § 6330(a).

86 IRC § 6330(a), (b).

87 IRC § 6330(a), (b), and (c)(3).

88 IRC § 6330(d)(1).

89 716 F. App’x at 183-184. While acknowledging that noncompliance with a jurisdictional time limit can never be excused, the Court of Appeals noted that “mandatory claim-processing rules” are “less stern,” and “may be waived or forfeited.” See *Cunningham*, 716 F. App’x at 184 (citing *Hamer v. Neighborhood Housing Servs. of Chicago*, 138 S. Ct. 13, 17 (2017) (“A provision governing the time to appeal in a civil action qualifies as jurisdictional only if Congress sets the time.”)).

rebuttable presumption that equitable tolling is available to litigants, even in cases where the government is a party.<sup>90</sup>

The Court of Appeals concluded that “even if” the 30-day period specified in the statute to file a petition for Tax Court review of a CDP hearing was subject to equitable tolling, the specific circumstances of Cunningham’s appeal “must warrant the application of equitable tolling in this particular case.”<sup>91</sup> Federal courts employ equitable tolling sparingly, and only in those rare instances where—due to circumstances external to the party’s own conduct—it would be unconscionable to enforce the limitation period against the party and gross injustice would result, when a litigant can establish:

- That he or she has been pursuing his or her rights diligently, and
- That some extraordinary circumstance stood in his or her way and prevented timely filing.<sup>92</sup>

Cunningham did not show that she had been pursuing her rights diligently and that extraordinary circumstances external to her own conduct prevented her from timely filing her appeal. The court noted that Cunningham’s miscalculation of the filing deadline may well have been an innocent mistake—she either misread (or misunderstood) the IRS’s notice, or else simply miscounted the number of days—but posited that granting equitable tolling on those grounds alone would erode the authority of the filing deadline to mere advisory status.

The court stated that the IRS’s letter notifying Cunningham of the filing deadline stated that she had a 30-day period beginning the day after the date of the letter to file an appeal, which was not misleading and could only be construed to require counting the day after the date of the letter as day one. The court went on to say Cunningham’s interpretation of the letter as requiring her to count the day after the date of the letter as day zero was contrary to U.S. Tax Court Rules of Practice and Procedure, Rule 25(a), the plain language of the letter, and common sense. For these reasons, the Court of Appeals for the Fourth Circuit affirmed the Tax Court’s dismissal of Cunningham’s petition, as the facts did not warrant equitable tolling of the petition filing deadline.

### *Duggan v. Commissioner*

The Court of Appeals for the Ninth Circuit in *Duggan v. Commissioner*<sup>93</sup> analyzed whether the 30-day period to file a Tax Court petition was jurisdictional and whether an untimely petition strips the Tax Court of jurisdiction to hear the case. In a manner similar to Ms. Cunningham, Mr. Duggan erroneously calculated the deadline for mailing a petition for review to the Tax Court, mistakenly counting the first day after the date of the IRS determination letter as day zero and mailing his petition 31 days after the date of the IRS determination.

90 *Irwin v. Dep’t of Veterans Affairs*, 498 U.S. 89, 95-96, 111 S. Ct. 453, 112 L. Ed. 2d 435 (1990). The court noted that it is uncertain whether the presumption applies at all outside the context of Article III courts. See *Sebelius v. Auburn Regional Med. Ctr.*, 568 U.S. 145, 158-159, (2013) (“We have never applied the *Irwin* presumption to an agency’s internal appeal deadline....”).

91 716 F. App’x at 183-184. While acknowledging that noncompliance with a jurisdictional time limit can never be excused, the Court of Appeals noted that “mandatory claim-processing rules” are “less stern,” and “may be waived or forfeited.” See *Cunningham*, 716 F. App’x at 184 (citing *Hamer v. Neighborhood Housing Servs. of Chicago*, 138 S. Ct. 13, 17 (2017) (internal quotation marks omitted)).

92 *Menominee Indian Tribe of Wis. v. U.S.*, 136 S. Ct. 750, 755 (2016), and *Whiteside v. U.S.*, 775 F.3d 180, 184 (4th Cir. 2014) (*en banc*).

93 *Duggan*, 879 F.3d 1029 (9th Cir. 2018), *aff’g* T.C. No. 15-4100 (T.C. June 26, 2015).

The IRS moved the Tax Court to dismiss the petition for lack of jurisdiction. Mr. Duggan, proceeding *pro se*, opposed the IRS's motion, arguing that the IRS's notices were "incomplete, misleading, or ambiguous," and that his attempts to comply with the filing deadline were reasonable. The Tax Court granted the IRS's motion and dismissed Duggan's petition on jurisdictional grounds. Duggan moved for reconsideration, contending, among other things, that he should not be faulted for his reasonable interpretation of the filing deadline. The Tax Court denied Duggan's motion to reconsider, and Duggan timely appealed his case to the Court of Appeals for the Ninth Circuit.

Unlike the Fourth Circuit in *Cunningham*, the Court of Appeals for the Ninth Circuit first analyzed whether the 30-day deadline to file a CDP petition in Tax Court was jurisdictional before considering equitable tolling, "because a party's failure to satisfy a deadline that is jurisdictional places the case beyond the powers of the court."<sup>94</sup> If the 30-day period is jurisdictional, the court concluded that it would not have authority to entertain "such a suit even if the timeliness objection were waived by the other party, or if a compelling argument for equitable tolling could otherwise be made."<sup>95</sup> After reviewing cases holding that the IRC § 6015(e)(1)(A) 90-day deadline to file an innocent spouse petition in the Tax Court is jurisdictional, the court applied similar reasoning to IRC § 6330(d)(1).<sup>96</sup>

An amicus brief filed in the case discussing the import of recent Supreme Court decisions on the jurisdiction of IRC § 6330(d)(1)<sup>97</sup> cited a prior version of § 6330(d)(1) that allowed a person who brought an appeal in an incorrect court 30 days to refile in the correct court as evidence of Congressional intent that the filing deadline was not jurisdictional. The court disagreed, stating that the plain language of the current version of IRC § 6330(d)(1) confers jurisdiction on the Tax Court only if a CDP petition is filed in that court within 30 days of the IRS's determination, and noting that "[t]he starting point in discerning congressional intent ... is the existing statutory text and not predecessor statutes."<sup>98</sup> Addressing the amicus brief arguments, the court pointed out that Congress might have intended the 30-day deadline to file an appeal in the Tax Court to be non-jurisdictional while including a clause explicitly granting a second 30-day deadline for misdirected appeals out of an abundance of caution or to sweep in cases not comprehended by the doctrine of equitable tolling. Alternatively, the court speculated that Congress might have intended the second 30-day deadline to act as an exception that mitigates the harshness of an otherwise jurisdictional rule. Regardless, the court concluded that "such speculation must yield to the text of the statute."<sup>99</sup>

Accordingly, the court held that because the text of IRC § 6330(d)(1) conditions the Tax Court's jurisdiction on the timely filing of a petition for review, the 30-day deadline in IRC § 6330(d)(1) is jurisdictional. Duggan's failure to meet this deadline divested the Tax Court of the power to hear his case and foreclosed any argument for equitable tolling.

94 *Duggan*, 879 F.3d 1029, 1031 (citing *U.S. v. Kwai Fun Wong*, 135 S. Ct. 1625, 1631 (2015)).

95 *Duggan*, 879 F.3d 1029, 1031.

96 Several courts of appeal have held that the 90-day deadline in § 6015(e)(1)(A) is a jurisdictional requirement and the Tax Court lacks jurisdiction to hear untimely petitions for innocent spouse relief, regardless of whether equitable considerations supporting the extension of the prescribed time period exist. See *Matuszak v. Comm'r*, 862 F.3d 192 (2d Cir. 2017); *Rubel v. Comm'r*, 856 F.3d 301 (3d Cir. 2017), *aff'g* No. 16-9183 (T.C. July 11, 2016); *Calvo v. Comm'r*, 117 A.F.T.R.2d (RIA) 2246 (D.C. Cir. 2016). See also National Taxpayer Advocate 2017 Annual Report to Congress 462-72; 299-306. See also *Maier v. Comm'r*, 360 F.3d 361 (2d Cir. 2004).

97 *Duggan*, 879 F.3d at 1034, n. 2. The court granted leave to file an amicus brief "discussing the import of recent Supreme Court decisions on the jurisdictionality of § 6330(d)(1)" to another taxpayer, because the decision in this case could potentially have affected the outcome of her appeal.

98 *Duggan*, 879 F.3d at 1034 (citing *Lamie v. U.S.*, 540 U.S. 526, 534, (2004)) (internal citations omitted).

99 *Duggan*, 879 F.3d 1029, 1034 (citing *United Food & Commercial Workers Union Local 751 v. Brown Grp., Inc.*, 517 U.S. 544, 550 (1996)) (internal quotations omitted).



### *McCree v. Commissioner*

In *McCree v. Commissioner*,<sup>100</sup> the IRS Integrity & Verification Operation (IVO) screened the taxpayer's timely filed 2010 return for possible fraudulent inflated withholdings, after she reported a zero taxable amount on an IRA distribution, claiming a refund of more than \$8,000.<sup>101</sup> She reported the distribution as a rollover, but failed to deposit the distribution in a qualified account. IVO determined that the withholdings reported on her tax return were correct, but it did not evaluate or determine whether she had reported her income correctly. IVO sent Ms. McCree Letter 4464C, *Questionable Refund 3rd Party Notification*, informing her that her refund was being held for review and verification, and that she was "not required to do anything at this time" and that if she did not receive her refund within 45 days, she could call the telephone number provided. She received her refund 39 days later.

Sixteen months later, the IRS mailed her a statutory notice of deficiency determining a deficiency in her 2010 federal income tax of \$5,637 and an accuracy-related penalty under IRC § 6662(a) of \$1,127.40; however, Ms. McCree did not receive the notice.

Ms. McCree made several attempts to contest the liability, but IRS incorrectly told her she could not, because she had already had an opportunity to contest the underlying liability. Before the initial CDP hearing, Ms. McCree submitted documents that supported reducing her underlying liability and eliminating the accuracy-related penalty. During the CDP hearing, Appeals abated some of the tax liability and the entire accuracy-related penalty based on the documentation she provided, despite erroneously informing Ms. McCree that she would be unable to contest the 2010 tax liability.

Ms. McCree, who represented herself at all stages of the controversy, claimed Letter 4464C was an audit letter, and she was improperly audited twice.<sup>102</sup> She argued that IRS should not be able to issue a refund after reviewing a return and later audit that return and determine a deficiency.

The issuance of a refund to the taxpayer after acceptance of the taxpayer's return and verification of withholding did not preclude the IRS from subsequently determining a deficiency in the taxpayer's income tax and seeking to recover the refund. A letter from the IRS informing the taxpayer that the refund was being withheld to verify withholdings did not constitute an unnecessary examination since the letter did not request documents or information and was only a limited informational contact by the IRS. The Court noted that the IRS IVO does not conduct audits of taxpayers' tax returns but does screen tax returns to detect false wages or withholding.

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100 T.C. Memo. 2017-145.

101 For concerns about the IRS's fraud detection and wage verification programs, see National Taxpayer Advocate 2016 Annual Report to Congress 151-160 (Most Serious Problem: *Fraud Detection: The IRS's Failure to Establish Goals to Reduce High False Positive Rates for Its Fraud Detection Programs Increases Taxpayer Burden and Compromises Taxpayer Rights*) and National Taxpayer Advocate 2017 Annual Report to Congress 219-226 (Most Serious Problem: *Fraud Detection: The IRS Has Made Improvements to Its Fraud Detection Systems, But a Significant Number of Legitimate Taxpayers Are Still Being Improperly Selected by These Systems, Resulting in Refund Delays*).

102 See National Taxpayer Advocate 2017 Annual Report to Congress 49-63 (Most Serious Problem: *Audit Rates: The IRS Is Conducting Significant Types and Amounts of Compliance Activities That It Does Not Deem to Be Traditional Audits, Thereby Underreporting the Extent of Its Compliance Activity and Return on Investment, and Circumventing Taxpayer Protections*) and Nina Olson, "Real" vs. "Unreal" Audits and Why This Distinction Matters, NTA BLOG (July 6, 2018), <https://taxpayeradvocate.irs.gov/news/nta-blog-real-vs-unreal-audits-and-why-this-distinction-matters>.

Research of records in IRS possession to verify withholdings does not constitute an examination in violation of IRC § 7605(b).<sup>103</sup> Letter 4464C was not an indication of an audit or an examination, but one of the “narrow, limited contacts or communications between the Service and a taxpayer that do not involve the Service inspecting the taxpayer’s books of account.”<sup>104</sup>

Because Ms. McCree properly challenged her underlying liability, the proper standard of review for the court with respect to this issue is *de novo*.<sup>105</sup> Since Ms. McCree made the necessary showing that there was a genuine issue of material fact for trial, the court awarded her a partial victory and agreed that she could contest her underlying liability at a future trial setting.

### *Seminole Nursing Home, Inc. v. Commissioner*

In *Seminole Nursing Home, Inc. v. Commissioner*,<sup>106</sup> the corporate taxpayer did not contest the underlying tax liability, but contended that the business would suffer economic hardship if the proposed levy were sustained. At the CDP hearing, the corporate taxpayer proposed a monthly payment that would allow it to stay current on its federal tax deposit payments as a collection alternative, and argued that it was less intrusive than enforced levy action. The IRS Settlement Officer (SO) rejected the installment agreement because the taxpayer was not in compliance with its federal employment tax deposit obligations. Rejecting a collection alternative because of noncompliance with estimated tax payment requirements does not violate the proper balancing requirement, but noncompliance is not the only factor involved in the balancing requirement. The taxpayer claimed the SO either did not conduct the required CDP balancing test<sup>107</sup> or did not explain her reason for concluding that its requirements were met.

The Tax Court noted that economic hardship relief is only available to individual taxpayers,<sup>108</sup> pursuant to Treas. Reg. § 301.6343-1(b)(4)(i).<sup>109</sup> The court held the SO was not required to consider the taxpayer’s economic hardship argument in the light of IRC § 6343(a)(1)(D) and thus, it was not an abuse of discretion. Although a corporation may not claim economic hardship as a defense,

103 See Rev. Proc. 2005-32, § 4.03; see also *Grossman v. Comm’r*, 74 T.C. 1147, 1156 (1980) (holding that mere examination of a taxpayer’s income tax return and accompanying schedules does not constitute a second inspection of that taxpayer’s books within the meaning of section 7605(b)); *Rice v. Comm’r*, T.C. Memo. 1994-204.

104 See Rev. Proc. 2005-32, § 4.03.

105 See *Giamelli v. Comm’r*, 129 T.C. at 111.

106 *Seminole Nursing Home, Inc. v. Comm’r*, T.C. Memo. 2017-102.

107 See National Taxpayer Advocate 2014 Annual Report to Congress 185-196 (Most Serious Problem: *Collection Due Process: The IRS Needs Specific Procedures for Performing the Collection Due Process Balancing Test to Enhance Taxpayer Protections*); see also Nina E. Olson, *Taking the Bull by Its Horns: Some Thoughts on Constitutional Due Process in Tax Collection*, 2010 Erwin N. Griswold Lecture Before the American College of Tax Counsel, 63 TAX LAW. 227 (2010).

108 See National Taxpayer Advocate 2017 Annual Report to Congress, Purple Book 34 (*Authorize the IRS to Release Levies That Cause Economic Hardship for Business Taxpayers*).

109 See *Lindsay Manor Nursing Home, Inc. v. Comm’r*, 148 T.C. 9 (2017). The court found that the discretion provided to the Secretary by IRC § 6343(a) and the existence of other avenues for nonindividuals in similar circumstances to obtain the relief (e.g., such as offers in compromise based on doubt as to collectability or public policy considerations) intended by Congress indicate that the limiting of “economic hardship” to individuals by Treas. Reg. § 301.6343-1(b)(4)(i) is not inconsistent with the provisions of IRC § 6343(a). Moreover, the regulations note that applying an economic hardship standard to nonindividuals would not necessarily promote effective tax administration because it might result in the Government’s determining whether and when to forgo the collection of taxes to support a nonviable business; but see National Taxpayer Advocate 2011 Annual Report to Congress 537-543 (Legislative Recommendation: *Amend IRC § 6343(a) to Permit the IRS to Release Levies on Business Taxpayers that Impose Economic Hardship*); and Protecting Taxpayers Act, S. 3278, 115th Cong. § 303 (2018).

the balancing test should consider a taxpayer's specific economic realities and the consequences of a proposed collection action.<sup>110</sup>

Prior to the CDP hearing, the taxpayer submitted a Form 433-B, *Collection Information Statement for Businesses*, showing that its monthly income exceeded its monthly expenses, and it had adequate net monthly income for monthly payments. However, the SO made a substantial mathematical error, reflected both in her case activity report and on the Form 433-B. The error made it appear that the taxpayer's monthly expenses far exceed its income. This factual error, while harmless to the SO's denial of the taxpayer's proposed installment agreement request, was consistently repeated.<sup>111</sup>

The Court remands a CDP case to the IRS Appeals Office when the Court determines that a further hearing would be "helpful," "necessary," or "productive."<sup>112</sup> The additional hearing is not intended as a new hearing or a "do over" for a taxpayer whose missteps during the CDP process resulted in its collection alternative's being rejected, but rather a supplement to the taxpayer's original hearing.<sup>113</sup>

Because the SO repeated her error and because there was nothing in the record reflecting a correction of that error, the Court found that the balancing test under IRC § 6330(c)(3)(C) could have been affected, and remanded the case back to Appeals for the limited purpose of reconsidering the balancing analysis in the light of the corrected facts and circumstances.

## CONCLUSION

CDP hearings provide instrumental protections for taxpayers to meaningfully address the appropriateness of IRS collection actions. Given the important safeguard that CDP hearings offer taxpayers, it is unsurprising that CDP remains one of the most frequently litigated issues. The U.S. Tax Court has jurisdiction over appeals from CDP hearings only if the taxpayer files a timely petition. If a taxpayer misses the deadline, the Tax Court does not have jurisdiction to review the IRS's determination and the taxpayers are deprived of their *rights to be informed, to appeal the IRS's decision in an independent forum, and to a fair and just tax system*.

Current law does not require the IRS to provide the date by which a taxpayer must file his or her CDP petition in the U.S. Tax Court, only the date of the determination that is subject to judicial review. Several recent court cases demonstrate that taxpayers misinterpret the calculation of the last day to file a request for a CDP hearing or to file a CDP or innocent spouse petition with the Tax Court. Thus, the *Cunningham* and *Duggan* decisions discussed herein illustrate the importance of complying with the filing deadlines for taxpayers to avail themselves of judicial review and exercise their *right to appeal an IRS decision in an independent forum*.<sup>114</sup> The *Cunningham* opinion reviewed the concept of equitable tolling, which is only available if the taxpayer shows diligent pursuit of rights and that timely filing

110 The Tax Court found in *Lindsay Manor Nursing Home, Inc. v. Comm'r*, 148 T.C. 9 (2017) that the § 6330(c)(3)(C) balancing test must consider a taxpayer's specific economic realities and the consequences of a proposed collection action.

111 *Cf. Sulphur Manor, Inc. v. Comm'r*, T.C. Memo. 2017-95, at 11 n.7 (finding harmless a poorly worded sentence in the Settlement Officer's (SO's) case activity report where the SO's notes elsewhere reflected proper calculation).

112 *Seminole Nursing Home, Inc. v. Comm'r*, T.C. Memo. 2017-102 (citing *Kelby v. Comm'r*, 130 T.C. 79, 86 n.4 (2008); *Lunsford v. Comm'r*, 117 T.C. 183, 189 (2001); *Churchill v. Comm'r*, T.C. Memo. 2011-182).

113 *Seminole Nursing Home, Inc. v. Comm'r*, T.C. Memo. 2017-102 (citing *Takeh v. Comm'r*, T.C. Memo. 2015-103, at 13; *Kelby v. Comm'r*, 130 T.C. at 86).

114 *Cunningham v. Comm'r*, 716 F. App'x 182 (4th Cir. 2018), *aff'g* No. 16-014090 (T.C. Dec. 7, 2016) and *Duggan v. Comm'r*, 879 F.3d 1029 (9th Cir. 2018), *aff'g* No. 15-4100 (T.C. June 26, 2015).

of an appeal was prevented by some extraordinary circumstance. A taxpayer's innocent misreading or misunderstanding of the filing deadline falls short of that standard.

In the CDP context, the burden is on taxpayers, and not the IRS, to keep track of when the 30-day appeal filing period begins, namely, the requirement in IRC § 6330(d)(1) that the taxpayer petition the Tax Court within 30 days of the date of an IRS notice. As stated above, the consequence of not filing of a timely petition is dire. If a taxpayer misses the deadline, the Tax Court does not have jurisdiction to review the IRS's determination.<sup>115</sup> Unsophisticated taxpayers are more likely to misinterpret the current language in the IRS notice of determination that states: "If you want to dispute this determination in court, you must file a petition with the United States Tax Court within 30 days from the date of this letter,"<sup>116</sup> while a close reading of the applicable regulations reveals that "the taxpayer may appeal such determinations made by Appeals within the 30-day period commencing the day after the date of the Notice of Determination."<sup>117</sup> To strengthen CDP rights of taxpayers, the National Taxpayer Advocate proposed a legislative recommendation to require the IRS calculate and provide the last date for filing an appeal on all CDP notices of determination to make them consistent with the requirements for statutory notices of deficiency under IRC § 6213(a).<sup>118</sup> The proposed legislative change would also deem requests timely filed for a CDP hearing and petitions to the Tax Court to review CDP and innocent spouse determinations as long as they are filed<sup>119</sup> by the "last date" listed in the IRS notice.<sup>120</sup>

*McCree v. Commissioner* shows that taxpayers contacted by the IRS after being flagged by an IVO filter<sup>121</sup> can be very confused about whether the wage verification process is an audit. The National Taxpayer Advocate has previously written about the similarities between "real" vs "unreal" audits.<sup>122</sup> The IRS considers taxpayer compliance contacts through programs and procedures such as identity and

115 If the taxpayer does not request a hearing within the 30-day period, the taxpayer may still be entitled to an equivalent hearing with Appeals but will not have any appeal rights allowing the taxpayer to file for judicial review of the equivalency hearing determination. Treas. Reg. §§ 301.6320-1(i); 301.6330-1(i).

116 IRS, Letter 3193, *Notice of Determination: Concerning Collection Action(s) Under Section 6320 or 6330 of The Internal Revenue Code* (July 2018).

117 See Treas. Reg. § 301.6320-1(f)(1) and 301.6330-1(f)(1); see also Most Serious Problem: *Collection Due Process Notices: Despite Recent Changes to Collection Due Process Notices, Taxpayers Are Still at Risk for Not Understanding Important Procedures and Deadlines, Thereby Missing Their Right to an Independent Hearing and Tax Court Review*, *supra*.

118 National Taxpayer Advocate 2017 Annual Report to Congress 299-306 (Legislative Recommendation: *Collection Due Process and Innocent Spouse Notices: Amend IRC §§ 6320, 6330, and 6015 to Require That IRS Notices Sent to Taxpayers Include a Specific Date by Which Taxpayers Must File Their Tax Court Petitions, and Provide That a Petition Filed by Such Specified Date Will Be Treated As Timely*).

119 The "statutory mailbox rule" in IRC § 7502 provides that if a time-sensitive document or payment arrives late but is postmarked on or before the due date, the postmark date is treated as the date the document or payment was filed with the IRS. Further, IRC § 7502(c) provides that registered or certified mail, or methods deemed substantially equivalent by the Secretary of Treasury, is *prima facie* evidence of delivery. The rule applies to documents and payments sent through the U.S. Postal Service, designated private delivery services, and electronic return transmitters. IRC § 7502(e). See National Taxpayer Advocate 2017 Annual Report to Congress 278 (Legislative Recommendation: *Electronic Mailbox Rule: Revise the Mailbox Rule to Include All Time-Sensitive Documents and Payments Electronically Transmitted to the IRS*).

120 Under this legislative recommendation taxpayers are allowed the later of the date on the notice or the last statutory date, which provides an additional protection if the IRS miscalculates the date on the notice.

121 See National Taxpayer Advocate 2016 Annual Report to Congress 151-160 (Most Serious Problem: *Fraud Detection: The IRS's Failure to Establish Goals to Reduce High False Positive Rates for Its Fraud Detection Programs Increases Taxpayer Burden and Compromises Taxpayer Rights*) and National Taxpayer Advocate FY 2019 Objectives Report to Congress 160-166 (Most Serious Problem: *Fraud Detection: The IRS Has Made Improvements to Its Fraud Detection Systems, But a Significant Number of Legitimate Taxpayers Are Still Being Improperly Selected by These Systems, Resulting in Refund Delays*).

122 See National Taxpayer Advocate 2017 Annual Report to Congress 49-63 (Most Serious Problem: *Audit Rates: The IRS Is Conducting Significant Types and Amounts of Compliance Activities That It Does Not Deem to Be Traditional Audits, Thereby Underreporting the Extent of Its Compliance Activity and Return on Investment, and Circumventing Taxpayer Protections*) and Nina Olson, "Real" vs. "Unreal" Audits and Why This Distinction Matters, NTA BLOG (July 6, 2018), <https://taxpayeradvocate.irs.gov/news/nta-blog-real-vs-unreal-audits-and-why-this-distinction-matters>.

wage verification are not “real” audits. Yet to taxpayers, the experience of receiving compliance contacts may feel like a “real” examination. This distinction between “real” and “unreal” audits has real-world consequences impacting taxpayer rights, including *the right to challenge the IRS’s position and be heard, the right to appeal an IRS decision in an independent forum, the right to finality, and the right to a fair and just tax system*. In *McCree*, the Tax Court reaffirmed the taxpayer’s *right to challenge the IRS’s position and be heard*, ruling that a taxpayer’s petition for review of a CDP determination should not lose in summary judgment, provided the taxpayer makes the necessary showing that there was a genuine issue of material fact for trial, and should be given an opportunity to contest the underlying liability, if the taxpayer had no prior opportunity to do so.

Finally, *Seminole Nursing Home, Inc. v. Commissioner* raises two important issues extensively discussed in prior reports to Congress. First, the case reemphasizes the importance of the CDP balancing test, whether the taxpayer is an individual or a business. It appears that even several years since the Tax Court decision in *Budish v. Commissioner*,<sup>123</sup> the IRS Office of Appeals continues to issue *pro forma* statements and boilerplate language (without proper analysis), in place of a proper balancing test, thereby violating the taxpayers’ *right to privacy*, which states that taxpayers have the right to expect that an IRS enforcement action will comply with the law and be no more intrusive than necessary. Appeals did not properly weigh the legitimate concerns of the taxpayer regarding the intrusiveness of the proposed collection action against the government’s interest in collecting the tax debt. By remanding the case back to Appeals the court reaffirmed the importance of a full balancing test analysis.<sup>124</sup> Educating IRS officers that conduct hearings and encouraging them to fully explain to the taxpayer and make a record of which factors they considered could go a long way in reducing future litigation.<sup>125</sup> By not giving proper attention to the balancing test, the IRS is missing opportunities to improve compliance, enhance taxpayer trust and confidence, and relieve undue burden on taxpayers.

The *Seminole* case also raised another important issue—the inability of a business taxpayer to claim economic hardship as a defense to an IRS collection action. IRC § 6343(a)(1)(D) requires the IRS to release a levy if “the Secretary has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer.” However, defining economic hardship as the inability to pay reasonable basic living expenses means that only individuals (including sole proprietorship entities) can experience economic hardship.<sup>126</sup> As a result, it is more difficult for businesses to settle their tax debts with collection alternatives (rather than enforced collection). In essence, an otherwise viable business facing economic hardship may be forced to choose between terminating or laying off employees, and failing to meet its tax obligations. To mitigate these concerns, the National Taxpayer Advocate proposed a legislative change to amend IRC § 6343 to authorize the IRS to release a levy if it determines that the levy is creating an economic hardship due to the financial condition of the taxpayer’s viable trade

123 T.C. Memo. 2014-239.

124 IRC § 6330(c)(3)(C); IRM 8.22.4.2.2 (Sept. 25, 2014). See also H.R. REP. No. 105-599, at 263 (1998) (Conf. Rep.). For simplicity, we use the term “proposed collection action” referring to both the actions taken and proposed. IRC § 6330 requires the IRS to notify the taxpayer of the right to request a CDP hearing not less than 30 days before issuing the first levy to collect a tax. Pursuant to IRC § 6320 the taxpayer is notified of the right to request a CDP hearing within five business days after the first Notice of Federal Tax Lien (NFTL) for a tax period is filed. Thus, Treasury Regulations under IRC § 6320 require a Hearing Office to consider “whether the continued existence of the filed [NFTL] represents a balance between the need for the efficient collection of taxes and the legitimate concern of the taxpayer that any collection action be no more intrusive than necessary.” See Treas. Reg. § 301.6320-1(e)(3), A-E1(vi).

125 See National Taxpayer Advocate 2014 Annual Report to Congress 185-196 (Most Serious Problem: *Collection Due Process: The IRS Needs Specific Procedures for Performing the Collection Due Process Balancing Test to Enhance Taxpayer Protections*). See also Nina E. Olson, *Taking the Bull by Its Horns: Some Thoughts on Constitutional Due Process in Tax Collection*, 2010 Erwin N. Griswold Lecture Before the American College of Tax Counsel, 63 TAX LAW. 227 (2010).

126 Treas. Reg. § 301.6343-1(b)(4).

or business, and to require the IRS, in making the determination to release a levy against a business on economic hardship grounds, to consider the economic viability of the business, the nature and extent of the hardship (including whether the taxpayer exercised ordinary business care and prudence), and the potential harm to individuals if the business is liquidated.<sup>127</sup> These factors are already considered in bankruptcy proceedings, and address the IRS's concerns about advantaging non-viable businesses.<sup>128</sup>

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127 National Taxpayer Advocate 2017 Annual Report to Congress, Purple Book 34 (*Authorize the IRS to Release Levies That Cause Economic Hardship for Business Taxpayers*). See also Protecting Taxpayers Act, S. 3278, 115th Cong. § 303 (2018); Small Business Taxpayer Bill of Rights Act of 2018, S. 2689, 115th Cong. § 16 (2018); H.R. 4368, 112th Cong. § 1 (2012); Taxpayer Rights Act of 2015, H.R. 4128 114th Cong. § 304 (2015) and S. 2333, 114th Cong. § 304 (2015).

128 The United States Supreme Court has limited the application of the Trust Fund Recovery Penalty to help financially troubled companies maintain “minimum working capital .... to maintain operations and avoid liquidation of the business.” See *Slodov v. U.S.*, 436 U.S. 238 (1978) (holding that the individual's conduct was not willful when he used after-acquired funds for operating expenses of the business) and *In re Rossiter*, 167 B.R. 919 (C.D. Cal. 1994) (applying *Slodov* analysis).



MLI  
#6**Failure to File Penalty Under IRC § 6651(a)(1), Failure to Pay an Amount Shown As Tax on Return Under IRC § 6651(a)(2), and Failure to Pay Estimated Tax Penalty Under IRC § 6654****SUMMARY**

We reviewed 47 decisions issued by federal courts from June 1, 2017, to May 31, 2018, regarding additions to tax for:

- i. Failure to file a tax return by the due date under Internal Revenue Code (IRC) § 6651(a)(1);
- ii. Failure to pay an amount shown on a tax return under IRC § 6651(a)(2);
- iii. Failure to pay installments of the estimated tax under IRC § 6654; or
- iv. Some combination of the three.<sup>1</sup>

The phrase “addition to tax” is commonly referred to as a penalty, so we will refer to these additions to tax as the failure to file penalty, the failure to pay penalty, and the estimated tax penalty. Twelve cases involved the imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties; 35 cases involved the failure to file or failure to pay penalties without the estimated tax penalty; and there were no cases involving the estimated tax penalty as the only issue.

A taxpayer can avoid the failure to file and failure to pay penalties by demonstrating the failure is due to reasonable cause and not willful neglect.<sup>2</sup> The estimated tax penalty is imposed unless the taxpayer falls within one of the statutory exceptions.<sup>3</sup> Taxpayers were unable to avoid a penalty in 41 of the 47 cases.

**TAXPAYER RIGHTS IMPACTED<sup>4</sup>**

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

**PRESENT LAW**

Under IRC § 6651(a)(1), a taxpayer who fails to file a return on or before the due date (including extensions of time for filing) will be subject to a penalty of five percent of the tax due (minus any credit the taxpayer is entitled to receive and payments made by the due date) for each month or partial month the return is late. This penalty will accrue up to a maximum of 25 percent, unless the failure is due to

1 Internal Revenue Code (IRC) § 6651(a)(3) imposes an addition to tax if the tax required to be shown on a return, but which is not shown, is not paid within 21 calendar days from the date of notice and demand for payment. Because we only identified two cases involving this penalty, we did not include it in our analysis.

2 IRC § 6651(a)(1), (a)(2).

3 IRC § 6654(e).

4 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).



reasonable cause and not willful neglect.<sup>5</sup> For the taxpayer to avoid the penalty by showing there was a reasonable cause, the taxpayer must have exercised ordinary business care and prudence.<sup>6</sup> The failure to file penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.<sup>7</sup>

When an income tax return is filed more than 60 days after the due date (including extensions), the penalty shall not be less than the lesser of two amounts—100 percent of the tax required to be shown on the return that the taxpayer did not pay on time, or a specific dollar amount, which is adjusted annually due to inflation.<sup>8</sup> The specific dollar amounts are as follows:

- \$215 for returns due on or after 1/1/2019;
- \$210 for returns due on or after 1/1/2018;
- \$205 for returns due between 1/1/2016 and 12/31/2017;
- \$135 for returns due between 1/1/2009 and 12/31/2015; and
- \$100 for returns due before 1/1/2009.

The failure to pay penalty, IRC § 6651(a)(2), applies to a taxpayer who fails to pay an amount shown or required to be shown as tax on the return. The penalty accrues at a rate of half a percent (0.5 percent) per month on the unpaid balance for as long as it remains unpaid, up to a maximum of 25 percent of the amount due.<sup>9</sup> When the IRS imposes both the failure to file and failure to pay penalties for the same month, it reduces the failure to file penalty by the amount of the failure to pay penalty (0.5 percent for each month).<sup>10</sup> The taxpayer can avoid the penalty by establishing the failure was due to reasonable cause; in other words, the taxpayer must have exercised ordinary business care and prudence but nonetheless was unable to pay by the due date, or that paying on the due date would have caused undue hardship.<sup>11</sup> The failure to pay penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.<sup>12</sup>

Courts will consider “all the facts and circumstances of the taxpayer’s financial situation” to determine whether the taxpayer exercised ordinary business care and prudence.<sup>13</sup> In addition, “consideration will be given to the nature of the tax which the taxpayer has failed to pay.”<sup>14</sup>

5 IRC § 6651(a)(1), (b)(1). The penalty increases to 15 percent per month up to a maximum of 75 percent if the failure to file is fraudulent. IRC § 6651(f).

6 Treas. Reg. § 301.6651-1(c)(1).

7 IRC § 6651(a)(1).

8 IRC § 6651(a). The IRS typically announces various inflation adjustments by publishing a revenue procedure. See, e.g., Rev. Proc. 2018-18, 2018-10 I.R.B. 392.

9 IRC § 6651(a)(2). Note that if the taxpayer timely files the tax return (including extensions) but an installment agreement is in place, the penalty will continue accruing at the lower rate of 0.25 percent rather than 0.5 percent of the tax shown. IRC § 6651(h).

10 IRC § 6651(c)(1). When both the failure to file and failure to pay penalties are accruing simultaneously, the failure to file will max out at 22.5 percent and the failure to pay will max out at 2.5 percent, thereby abiding by the 25 percent maximum limitation.

11 Treas. Reg. § 301.6651-1(c)(1). Even when a taxpayer shows undue hardship, the regulations require proof of the exercise of ordinary business care and prudence.

12 IRC § 6651(a)(2).

13 Treas. Reg. § 301.6651-1(c)(1). See, e.g., *East Wind Indus. v. U.S.*, 196 F.3d 499, 507 (3d Cir. 1999).

14 Treas. Reg. § 301.6651-1(c)(2).

IRC § 6654 imposes a penalty on any underpayment of estimated tax by an individual or by certain estates or trusts.<sup>15</sup> The law requires four installments per tax year, each generally 25 percent of the required annual payment.<sup>16</sup> The required annual payment is generally the lesser of 90 percent of the tax shown on the return for the current tax year or 100 percent of the tax for the previous tax year.<sup>17</sup>

The amount of the penalty is determined by applying:

- The underpayment rate established under IRC § 6621;
- To the amount of the underpayment;
- For the period of the underpayment.<sup>18</sup>

The amount of the underpayment is the excess of the required payment over the amount paid by the due date. To avoid the penalty, the taxpayer has the burden of proving that one of the following exceptions applies:

- The tax due (after taking into account any federal income tax withheld) is less than \$1,000;<sup>19</sup>
- The preceding tax year was a full 12 months, the taxpayer had no liability for the preceding tax year, and the taxpayer was a U.S. citizen or resident throughout the preceding tax year;<sup>20</sup>
- The IRS determines that because of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;<sup>21</sup> or
- The taxpayer retired after reaching age 62, or became disabled, in the tax year for which estimated payments were required, or in the tax year preceding that year, and the underpayment was due to reasonable cause and not willful neglect.<sup>22</sup>

In any court proceeding, the IRS has the burden of producing sufficient evidence that it imposed the failure to file, failure to pay, or estimated tax penalties appropriately.<sup>23</sup>

## ANALYSIS OF LITIGATED CASES

We analyzed 47 opinions issued between June 1, 2017, and May 31, 2018, where the failure to file penalty, failure to pay penalty, or estimated tax penalty was in dispute. All but eight of these cases were either litigated in the United States Tax Court, or an appeal of a Tax Court decision. A detailed list appears in Table 6 in Appendix 3. Twenty-eight cases involved individual taxpayers and 19 involved businesses (including individuals engaged in self-employment or partnerships).

15 IRC § 6654(a), (l).

16 IRC § 6654(c)(1), (d)(1)(A).

17 IRC § 6654(d)(1)(B). If the adjusted gross income shown on the return of the individual for the preceding taxable exceeds \$150,000, the required annual payment increases to an amount 110 percent of the tax shown on the return of the individual for the preceding tax year (if preceding tax year was 2002 or after). IRC § 6654(d)(1)(C)(i).

18 IRC § 6654(a).

19 IRC § 6654(e)(1).

20 IRC § 6654(e)(2).

21 IRC § 6654(e)(3)(A).

22 IRC § 6654(e)(3)(B).

23 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001) (applying IRC § 7491(c)). An exception to this rule relieves the IRS of this burden where the taxpayer's petition fails to state a claim for relief from the penalty (and therefore is deemed to concede the penalty). *Funk v. Comm'r*, 123 T.C. 213, 218 (2004).

Of the 19 cases in which taxpayers appeared *pro se* (without counsel), the outcomes generally favored the IRS. In one case, the court granted partial relief to the taxpayer, and in one case, the court granted full relief to the taxpayer. The IRS prevailed in full in the remaining 17 cases. Taxpayers represented by counsel fared slightly better; of the 27 cases in which taxpayers had representation, taxpayers prevailed in full in four cases and were denied relief in the remaining 23 cases.

### Failure to File Penalty

In 41 out of the 46 cases reviewed where the failure to file penalty was at issue, the taxpayers could not prove that the failures to file were due to reasonable cause.<sup>24</sup> Taxpayers provided reasons such as physical injury or mental illness, reliance on an agent, and electronic filing errors as a basis for reasonable cause. Circumstances suggesting reasonable cause are typically outside the taxpayer's control.<sup>25</sup>

#### *Physical Injury or Mental Illness Defense*

A physical injury or mental illness may provide a basis for a taxpayer to establish reasonable cause for not filing, if the condition affected the taxpayer to such a degree that he or she could not file a tax return on time. When determining whether the condition establishes reasonable cause, the court analyzes how the taxpayer conducted his or her business affairs during the illness.

In *Rogers v. Commissioner*, the Tax Court found that married taxpayers had established reasonable cause for their failure to file their 2009 tax return based on illness.<sup>26</sup> The taxpayers testified that Mr. Rogers was hospitalized for an extended period in 2009 to treat his alcoholism, during which time there was no means of communication between Mr. and Mrs. Rogers.<sup>27</sup> After his release, Mr. Rogers continued to deal with his illness. Mrs. Rogers was preoccupied caring for her husband and taking on substantial additional responsibilities in their businesses.<sup>28</sup> The court also noted that the taxpayers timely filed their income tax returns in prior years under extension, and would have done so for 2009 if they had requested an extension for that year.<sup>29</sup> Mrs. Rogers experienced her own health problems with stress, anxiety, and depression in connection with her husband's illness and subsequent care. Acknowledging that "[i]llness or incapacity of a taxpayer or a member of his immediate family may be reasonable cause for late filing," the court found the taxpayers were not liable for the failure to file penalty.<sup>30</sup>

In contrast, a vague reference to illness does not establish reasonable cause. The taxpayers in *Barrett v. Commissioner* were unable to establish reasonable cause for filing their 2012 and 2014 tax returns late.<sup>31</sup> Although Mr. Barrett referred vaguely to illness as an excuse for not filing the 2014 return before the

24 Taxpayers avoided the failure to file penalty by successfully proving reasonable cause in four cases.

25 *McMahan v. Comm'r*, 114 F.3d 366, 369 (2d Cir. 1997) (citation omitted), *aff'g* T.C. Memo. 1995-547.

26 *Rogers v. Comm'r*, T.C. Memo. 2018-53.

27 *Id.* Mr. Rogers is a tax attorney and a CPA with over 40 years of experience. He has a *juris* doctor degree (J.D.) from Harvard University and a master of business administration degree (M.B.A.) from the University of Chicago. He was a partner at various law firms from January 1998 to May 2008, when he formed Rogers & Associates as a sole proprietorship. Mrs. Rogers has a bachelor's degree in chemistry, a master's degree in biochemistry, an M.B.A., a doctorate in educational administration, and a J.D. Before retiring in 2005, she worked as a high school chemistry and computer science teacher and an associate principal for over 20 years. She was licensed as a real estate broker in 1967 and an attorney in 1991. Since 2009, she represented clients in property tax appeals.

28 *Id.*

29 *Id.*

30 *Id.*

31 *Barrett v. Comm'r*, T.C. Memo. 2017-195.

IRS sent them a notice of deficiency, he did not offer any excuse for the late filing of the 2012 return.<sup>32</sup> The Tax Court found the taxpayers failed to establish reasonable cause for either of the late filings.<sup>33</sup>

### *Reliance on Agent Defense*

When a taxpayer relies on an agent to fulfill a known filing requirement, it does not relieve the taxpayer of the responsibility.<sup>34</sup> Taxpayers have a non-delegable duty to file a tax return on time.<sup>35</sup> In order for reliance on an agent to rise to the standard of reasonable cause for failing to fulfill the filing requirement, the taxpayer must make full disclosure of all relevant facts to the tax professional that he relies upon.<sup>36</sup> In other words, merely hiring a tax professional (*e.g.*, accountant, lawyer, or Enrolled Agent) to handle tax return filing is not enough to establish that the taxpayer used ordinary business care and prudence if there are facts that indicate otherwise.

In *Mazzei v. Commissioner*, the taxpayers entered into complex transactions marketed by the Western Growers Association, a trade association for farmers.<sup>37</sup> The transactions were designed to reduce taxes by routing funds from the Mazzeis' family business through foreign sales corporations and then into Roth Individual Retirement Accounts (IRAs) designed for this purpose.<sup>38</sup> Before entering into these transactions, the taxpayers presented the transaction paperwork to their personal accountant, Mr. Bedke, who approved their participation in the transaction.<sup>39</sup> Mr. Bedke had prepared the Mazzeis' tax returns for several years, had no connection with the Western Growers Association, and no expectation of profits from the taxpayers' transactions.<sup>40</sup> The Mazzeis did not, however, file Forms 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, to report the transactions for each of the years at issue.

The Tax Court held that the taxpayers established reasonable cause for their failure to timely file the returns and failure to pay the amounts shown on those returns. The Tax Court applied the following three-part test from *Neonatology Associates, P.A. v. Commissioner*:<sup>41</sup>

Reliance on professional advice is reasonable and thus warrants reasonable cause abatement if:

- i. The advisor was a competent professional with sufficient expertise to justify reliance;
- ii. The taxpayer provided necessary and accurate information to the adviser; and
- iii. The taxpayer actually relied on the adviser's judgment in good faith.

The court found Mr. Bedke, a tax partner at an accounting firm where he had practiced for 29 years, was a competent professional with sufficient expertise to justify the Mazzeis' reliance. The Mazzeis

32 *Barrett v. Comm'r*, T.C. Memo. 2017-195.

33 *Id.*

34 The Supreme Court held in *U.S. v. Boyle* that reasonable cause may exist when a taxpayer relies on the erroneous advice of counsel concerning a question of law. To escape liability for the failure to file penalty, the taxpayer bears the heavy burden of proving both (1) that the failure did not result from 'willful neglect,' and (2) that the failure was 'due to reasonable cause.' 469 U.S. 241, 245, 250 (1985).

35 *U.S. v. Boyle*, 469 U.S. 241 (1985). The Court noted that "[i]t requires no special training or effort to ascertain a deadline and make sure that it is met." *Id.* at 252.

36 *Id.*

37 *Mazzei v. Comm'r*, 150 T.C. No. 7 (2018), *appeal docketed*, No. 18-72451 (9th Cir., Sept. 5, 2018).

38 *Id.*

39 *Id.*

40 *Id.*

41 *Neonatology Assocs., P.A. v. Comm'r*, 115 T.C. 43, 99 (2000); *aff'd*, 299 F.3d 221 (3d Cir. 2002).

had provided all the necessary transaction documents to Mr. Bedke.<sup>42</sup> Additionally, Mr. Bedke did not promote, participate in structuring, or profit from the transactions at issue.<sup>43</sup> Accordingly, the court found that the taxpayers reasonably relied on their accountant and therefore, were not liable for the failure to file and failure to pay penalties.<sup>44</sup>

### *Electronic Filing Errors Defense*

In several cases, taxpayers argued they had reasonable cause for failure to file their tax returns due to alleged malfunctions in their tax return electronic filing software. The courts uniformly rejected this defense.<sup>45</sup>

In *Spottiswood v. United States*, married taxpayers attempted to file their joint income tax return electronically using TurboTax software.<sup>46</sup> The IRS rejected taxpayers' return because the social security number and last name of a dependent on the return did not match the IRS's records.<sup>47</sup> TurboTax informed the taxpayers of the electronic filing rejection on or about the same day that they filed the return. However, the taxpayers did not check the email account associated with their TurboTax account, nor did they use the "check e-file status" TurboTax screen to confirm the IRS had accepted their return until many months later.<sup>48</sup> As a result, the court held that the taxpayers failed to establish reasonable cause for failing to file a return.<sup>49</sup>

Circumstances suggesting reasonable cause are typically outside the taxpayer's control.<sup>50</sup> In *Haynes v. United States*, taxpayers argued that the failure of the tax software to notify them when the IRS rejected their return was a circumstance beyond their control.<sup>51</sup> The court rejected this argument, holding that "an alleged software failure does not rise to the level of the Supreme Court's definition of a circumstance beyond Plaintiffs' control—disability, infirmity, objective incapacity—in *Boyle*."<sup>52</sup> Furthermore, the court noted that taxpayers had the option of filing their tax return on paper, electronically, or through any number of tax return preparers.<sup>53</sup> The court was careful in distinguishing cases in which reasonable cause may exist when taxpayers rely on erroneous advice of counsel on a question of law.<sup>54</sup> Accordingly, while it may have been reasonable for the taxpayers to retain an expert accountant to electronically file their return, their decision to do so does not rise to reasonable cause for the abatement of late-filing penalties. This case had generated much interest in the tax practitioner community.<sup>55</sup> On appeal, the Fifth Circuit vacated the judgment and remanded the case back to the district court, holding that it was

42 *Mazzei v. Comm'r*, 150 T.C. No. 7 (2018), *appeal docketed*, No. 18-72451 (9th Cir., Sept. 5, 2018).

43 *Id.*

44 *Id.*

45 See, e.g., *Spottiswood v. U.S.*, 121 A.F.T.R.2d (RIA) 1595 (N.D. Cal. 2018), *appeal docketed*, No. 18-16103 (9th Cir. June 14, 2018); *Haynes v. U.S.*, 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017), *vacated and remanded*, No. 17-50816 (5th Cir. Jan. 29, 2019).

46 *Spottiswood v. U.S.*, 121 A.F.T.R.2d (RIA) 1595 (N.D. Cal. 2018), *appeal docketed*, No. 18-16103 (9th Cir. June 14, 2018).

47 *Id.*

48 *Id.*

49 *Id.*

50 *McMahan v. Comm'r*, 114 F.3d 366, 369 (2d Cir. 1997) (citation omitted), *aff'g* T.C. Memo. 1995-547.

51 *Haynes v. U.S.*, 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017), *vacated and remanded*, No. 17-50816 (5th Cir. Jan. 29, 2019).

52 *Haynes v. U.S.*, 119 A.F.T.R.2d (RIA) 2202, 2017 U.S. Dist. LEXIS 106252, at \*27-28 (W.D. Tex. 2017) (citing *U.S. v. Boyle*, 469 U.S. 241, 250 (1985)), *vacated and remanded*, No. 17-50816 (5th Cir. Jan. 29, 2019).

53 *Haynes v. U.S.*, 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017), *vacated and remanded*, No. 17-50816 (5th Cir. Jan. 29, 2019).

54 *Id.*

55 See <http://procedurallytaxing.com/delinquency-penalties-boyle-in-the-age-of-e-filing/> (last visited Sept. 4, 2018). The American College of Tax Counsel has filed an *amicus brief* in support of the taxpayers.

not yet necessary to consider whether an exception to the Boyle standard should be created for taxpayers who e-file.<sup>56</sup>

### Failure to Pay an Amount Shown Penalty

The failure to pay penalty is based on the amount shown on the tax return. If the taxpayer did not file a tax return, the IRS can only assess the IRC § 6651(a)(2) penalty if it has introduced a Substitute for Return (SFR) that satisfies the requirements of IRC § 6020(b). During litigation involving an SFR, if the IRS cannot produce the SFR, it fails to meet its burden of production under IRC § 7491 and the taxpayer can avoid a failure to pay penalty.<sup>57</sup>

As with the failure to file penalty, raising a reasonable cause defense to the failure to pay penalty requires that the taxpayer show that she exercised ordinary business care and prudence in the payment of her tax liabilities, but nevertheless was either unable to timely pay the tax or would suffer undue hardship if the payment was made on time.<sup>58</sup> Unsurprisingly, taxpayers often use medical illness or reliance on an agent as the basis for establishing reasonable cause to avoid the failure to pay penalty under IRC § 6651(a)(2), as they do for the failure to file penalty under IRC § 6651(a)(1).

In *Dykstra v. Commissioner*, the taxpayer filed her 2005 return late.<sup>59</sup> The taxpayer testified she became overwhelmed by work and had retained her longtime accountant, who did not prioritize her return.<sup>60</sup> When faced with the stress of the 2007 financial crisis, particularly given her job in real estate, the taxpayer said her delinquent tax returns started accumulating.<sup>61</sup> The taxpayer ultimately hired a new accountant and filed all of her overdue returns; however, the court did not excuse her failure to file her returns and pay the additions to tax.<sup>62</sup> The Tax Court acknowledged the difficult time the taxpayer endured, but held that her explanation did not demonstrate that she exercised ordinary care and prudence in meeting her obligations.<sup>63</sup> As a result, the court sustained the IRS's determinations as to the additions to tax.<sup>64</sup>

In contrast, the taxpayer in *Emery Celli Cuti Brinckerhoff & Abady, P.C. v. Commissioner*, a law firm, established reasonable cause for its failure to file an employment tax return and failure to pay an amount shown.<sup>65</sup> The law firm, Emery, Celli, Brinckerhoff & Abady, LLP (Emery LLP), paid wages to its employees during the first quarter of 1999 and made employment tax deposits for each of them.<sup>66</sup> However, the law firm's payroll service provider that made the employment tax deposits deposited them erroneously under Emery LLP's employer identification number (EIN).<sup>67</sup> The Tax Court held that the

56 *Haynes v. U.S.*, vacated and remanded, No. 17-50816 (5th Cir. Jan. 29, 2019).

57 See *Wheeler v. Comm'r*, 127 T.C. 200, 210 (2006), *aff'd*, 521 F.3d 1289 (10th Cir. 2008).

58 See Treas. Reg. § 301.6651-1(c)(1).

59 *Dykstra v. Comm'r*, T.C. Memo. 2017-156.

60 *Id.*

61 *Id.*

62 *Id.*

63 *Id.*

64 *Dykstra v. Comm'r*, T.C. Memo. 2017-156.

65 *Emery Celli Cuti Brinckerhoff & Abady, P.C. v. Comm'r*, T.C. Memo. 2018-55.

66 *Id.*

67 *Id.*

company nevertheless exercised ordinary business care and prudence.<sup>68</sup> The paramount factor was a timely filed return and timely deposited employment taxes, albeit under an incorrect EIN.<sup>69</sup>

### Estimated Tax Penalty

Courts routinely found taxpayers liable for the IRC § 6654 estimated tax penalty when the IRS proved the taxpayer:

- i. Had a tax liability;
- ii. Had no withholding credits;
- iii. Made no estimated tax payments for that year; and
- iv. Offered no evidence to refute the IRS.

The IRS has the burden under IRC § 7491(c) to produce evidence that IRC § 6654(d)(1)(B) requires an annual payment from the taxpayer.

The estimated tax penalty is calculated with reference to four required installment payments of the taxpayer's estimated tax liability.<sup>70</sup> Each required installment is equal to 25 percent of the taxpayer's "required annual payment."<sup>71</sup> The required annual payment equals the lesser of: (i) 90 percent of the tax shown on the individual's return for that year (or, if no return is filed, 90 percent of the individual's tax for such year); or (ii) if the individual filed a valid return for the immediately preceding tax year, 100 percent of the tax shown on that return (this can increase to 110 percent based on adjusted gross income).<sup>72</sup> The IRS has the burden to produce evidence that IRC § 6654(d)(1)(B) requires an annual payment from the taxpayer.<sup>73</sup> If a taxpayer did not pay enough tax throughout the year, either through withholding or by making estimated tax payments, the IRS will assess a penalty for underpayment of estimated tax.<sup>74</sup>

In *Plato v. Commissioner*, the Tax Court held that the IRS did not meet its burden of showing the taxpayer had an annual required payment.<sup>75</sup> Mr. Plato, the taxpayer, had recently separated from his wife and filed a married filing separately return for the first time during the tax year. If taxpayers, like Mr. Plato, who filed a married filing jointly return for the prior year, file married filing separately returns, the regulations provide a special rule for calculating their required annual payments.<sup>76</sup> Under

68 *Emery Celli Cuti Brinckerhoff & Abady, P.C. v. Comm'r*, T.C. Memo. 2018-55.

69 *Id.*

70 IRC § 6654(c)-(d).

71 IRC § 6654(d)(1)(A).

72 IRC § 6654(d)(1)(B). There are special rules on calculating the required annual payment for taxpayers who filed a married filing jointly return for the prior tax year but are filing married filing separately for the current year, and for taxpayers whose adjusted gross income exceed a certain amount. For instance, if a taxpayer's AGI for 2017 was more than \$150,000 (\$75,000 if the taxpayer's filing status for 2018 is married filing a separate return), the taxpayer must substitute 110 percent for 100 percent. See IRC § 6654(d)(1)(C) and Treas. Reg. § 1.6654-2(e).

73 IRC § 7491(c).

74 The law allows the IRS to waive the penalty if: (1) a taxpayer did not make a required payment because of a casualty event, disaster, or other unusual circumstance and it would be inequitable to impose the penalty, or (2) a taxpayer retired (after reaching age 62) or became disabled during the tax year or in the preceding tax year for which you should have made estimated payments, and the underpayment was due to reasonable cause and not willful neglect. IRC § 6654(e)(3).

75 *Plato v. Comm'r*, T.C. Memo. 2018-7.

76 Treas. Reg. § 1.6654-2(e).



Treasury Regulation § 1.6654-2(e), the taxpayers' prior year tax liabilities are the taxes the spouses would be liable for, if they each filed a married filing separately return for that year.<sup>77</sup>

However, the community property law where Mr. Plato and his wife resided, required that any withholding payments had to be allocated when married spouses chose to file separately. Yet the IRS did not provide evidence of allocation of the adjusted gross income and tax per the return for the prior year between Mr. Plato and his wife. Consequently, although the Tax Court could calculate 90 percent of the taxpayer's tax in the current year under clause (i) of the penalty calculation, it was unable to calculate the number equal to 100 percent of the tax shown on the taxpayer's prior year return under clause (ii). The IRS had the burden to prove the amount of a required annual payment, and failed to carry its burden of production. Thus, the Tax Court did not sustain the estimated tax penalty.<sup>78</sup>

## CONCLUSION

Taxpayers prevailed in full in only five of 47 (nearly 11 percent) of the failure to file, failure to pay, and estimated tax penalty cases analyzed in this report. One taxpayer prevailed in part (two percent), meaning the IRS won nearly 87 percent of the cases. The number of cases, in which failure to file, failure to pay, and estimated tax penalties were at issue, decreased by almost 23 percent from last year, and the portion of cases where the taxpayer received at least some form of relief decreased from 20 percent to 13 percent. This decline may be attributed to the general decline in tax litigation in recent years.<sup>79</sup>

It is critical that IRS employees thoroughly analyze all facts and circumstances of a case when assessing reasonable cause claims rather than solely relying on the Reasonable Cause Assistant (RCA) software,<sup>80</sup> which is designed to help IRS employees make fair and consistent abatement determinations.<sup>81</sup> The RCA program allows IRS employees to override the results in certain circumstances, but employees must understand the definition of reasonable cause to apply the override.<sup>82</sup> Thus, a close review by an employee is essential to ensure that the failure to file penalty or the failure to pay penalty is imposed appropriately. Additionally, it is imperative that taxpayers verify the IRS has accepted their electronically filed return. Although electronic filing instead of mailing has some benefits, to include receiving a refund much quicker, the IRS can reject an electronically-filed return for a wide range of reasons. In those cases, taxpayers will need to figure out the error and try filing again.

<sup>77</sup> Treas. Reg. § 1.6654-2(e)(1)-(2), Example (1).

<sup>78</sup> *Plato v. Comm'r*, T.C. Memo. 2018-7.

<sup>79</sup> David McAfee, *Tax Court: Tax Court Caseload Drops as Enforcement Lags: Former Chief Judge 142 DTR 8* (July 24, 2018). Former Chief Judge L. Paige Marvel noted that the Tax Court's inventory is dropping, due in part to lax enforcement. This trend could correlate with the fewer litigated lien cases in the U.S. District Courts. See also Most Litigated Issue: *Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403*, *infra*.

<sup>80</sup> The Reasonable Cause Assistant (RCA) can only consider failure to file or failure to pay penalties for certain individual tax returns.

<sup>81</sup> National Taxpayer Advocate 2010 Annual Report to Congress 198 (Most Serious Problem: *The IRS's Over-Reliance on Its "Reasonable Cause Assistant" Leads to Inaccurate Penalty Abatement Determinations*). See also IRS, *Reasonable Cause Assistant (RCA) Usability Test Final Report Summary 4* (May 28, 2010). The test showed that employees using the RCA determined penalty abatement requests correctly in only 45 percent of the cases. An even more disturbing finding was that all of the employees in the study believed they were making correct legal determinations based on reasonable cause.

<sup>82</sup> Internal Revenue Manual 20.1.1.3.6.10(3) (Nov. 25, 2011) ("[F]air and consistent application of penalties requires employees to make a final penalty relief determination consistent with the RCA conclusion ... [U]nderstanding that the individual facts and circumstances vary for each case and that there may be unique facts and circumstances in certain cases that RCA cannot consider, an 'override (abort)' function is available in RCA.")

As previously recommended by the National Taxpayer Advocate, Congress should amend IRC § 6404 to authorize the Secretary of the Treasury to grant a one-time abatement of the failure to file penalty (IRC § 6651(a)(1)) and failure to pay penalty (IRC § 6651(a)(2)) for first-time filers and taxpayers who have a consistent history of compliance, where no countervailing factors are present.<sup>83</sup> Finally, taxpayers are encouraged to review their W-4 forms and make any adjustments if they have too little withheld from their paychecks. In a July 2018 report, the Government Accountability Office estimated that 21 percent—or 30 million taxpayers—will be under withheld and need to make up the difference when they file their 2018 tax return.<sup>84</sup> In response, the IRS will not apply estimated tax penalties to underpayments of tax as a result of the Tax Cuts and Jobs Act (TCJA). The National Taxpayer Advocate applauds these efforts by the IRS, but has noted there is no information on how the IRS will determine that an underpayment is pursuant to the TCJA nor how it will otherwise apply the policy. In sum, to promote voluntary compliance and to uphold a taxpayer's *right to a fair and just tax system* and the *right to pay no more than the correct amount of tax*, the facts of taxpayers' individual cases must be carefully considered.

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83 National Taxpayer Advocate 2001 Annual Report to Congress 188.

84 See Government Accountability Office (GAO), GAO-18-548, *Federal Tax Withholding: Treasury and IRS Should Document the Roles and Responsibilities for Updating Annual Withholding Tables* (July 2018), <https://www.gao.gov/assets/700/693582.pdf>.

MLI  
#7**Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403****SUMMARY**

Internal Revenue Code (IRC) § 7403 authorizes the United States to file a civil action in U.S. District Court against a taxpayer who has refused or neglected to pay any tax, to enforce a federal tax lien, or to subject any of the delinquent taxpayer's property and rights to property to the payment of tax. Unlike cases in other Most Litigated Issues, lien enforcement cases are always initiated by the government through the Department of Justice rather than the taxpayer. We identified 39 opinions issued between June 1, 2017, and May 31, 2018, that involved civil actions to enforce liens under IRC § 7403. The IRS prevailed in 37 of these cases, one case was remanded for additional proceedings, and one case resulted in a split decision. The 39 cases identified for this reporting period represent a 35 percent decrease from the previous year.

**TAXPAYER RIGHT(S) IMPACTED<sup>1</sup>**

- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Finality*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

**PRESENT LAW**

If a taxpayer is delinquent in satisfying a federal tax liability, IRC § 7403 authorizes the United States to initiate a civil action in the appropriate United States District Court to enforce its federal tax lien over the liability or to subject any of the delinquent taxpayer's property, right, title, or interest in property to the payment of that liability.<sup>2</sup> When the United States files a complaint in district court to enforce a lien under IRC § 7403, it is required to name all parties having liens on, or otherwise claiming interest in the relevant property, as parties to the action.<sup>3</sup> The law of the state where the property is located determines the nature of a taxpayer's legal interest in the property.<sup>4</sup> However, once it is determined that the taxpayer has an interest under state law in the property, federal law controls whether the property is exempt from attachment of the lien.<sup>5</sup>

IRC § 7403(c) directs the court to “finally determine the merits of all claims to and liens upon the property,” and if the United States proves a claim or interest, the court may order an officer of the court to sell the property and distribute the proceeds in accordance with the court's findings with respect to the interests of the parties, including the United States' claim for the delinquent tax liability.<sup>6</sup>

1 See Taxpayer Bill of Rights (TBOR), <https://taxpayeradvocate.irs.gov/taxpayer-rights>. The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).

2 IRC § 7403(a); Treas. Reg. § 301.7403-1(a).

3 IRC § 7403(b).

4 *U.S. v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985).

5 *U.S. v. Rodgers*, 461 U.S. 677, 683 (1983).

6 IRC § 7403(c).

Ordering the sale of a taxpayer's property is a powerful collection tool and directly affects any parties who have an interest in the property subject to sale. Based on the Supreme Court case *United States v. Rodgers*, however, the court is not required to authorize a forced sale and may exercise limited equitable discretion. Under *Rodgers*, when a forced sale involves the interests of a third party who does not have a federal tax debt, the court should consider the following four factors when determining whether the property should be sold:

1. The extent to which the government's financial interests would be prejudiced if they were relegated to a forced sale of the partial interest of the delinquent taxpayer;
2. Whether the innocent third party with a separate interest in the property, in the normal course of events, has a legally recognized expectation that the property would not be subject to a forced sale by the delinquent taxpayer or taxpayer's creditors;
3. The likely prejudice to the third party in personal dislocation costs and inadequate compensation; and
4. The relative character and value of the non-liable and liable interests held in the property.<sup>7</sup>

In cases where the United States holds a first priority lien, it may offer bids at the sale of the foreclosed property up to an amount equal to the amount of the lien, plus selling expenses.<sup>8</sup> If a foreclosure action is initiated by another creditor, IRC § 7403(c) authorizes the United States to intervene in the action to assert any interests from a lien on the property subject to such action.<sup>9</sup>

If the case was initiated in a state court, the United States may remove the case to a U.S. District Court.<sup>10</sup> However, if the foreclosure action is adjudicated under state court proceedings, federal tax liens that are junior to other creditors may be effectively removed, even if the United States is not a party to the proceeding.<sup>11</sup> While the action is pending, the court may appoint a receiver empowered in equity to preserve and operate the property prior to the sale, upon the government's certification that it is in the public interest.<sup>12</sup>

The IRS must make the initial referral of a case to the Department of Justice (DOJ) and request the DOJ to file the foreclosure suit.<sup>13</sup> The Internal Revenue Manual (IRM) provides procedures with respect to what actions the IRS must take before requesting that the DOJ commence a foreclosure proceeding.<sup>14</sup> With respect to a recommendation to foreclose on a taxpayer's principal residence, there

<sup>7</sup> *Rodgers*, 461 U.S. at 709-11.

<sup>8</sup> IRC § 7403(c).

<sup>9</sup> However, if the application of the United States to intervene is denied, the adjudication will have no effect upon the federal tax lien on the property. IRC § 7424. Under 28 U.S.C. § 2410, the United States may be named a party in any civil action or suit in any district court, or in any state court having jurisdiction of the subject matter.

<sup>10</sup> 28 U.S.C. § 1444.

<sup>11</sup> *U.S. v. Brosnan*, 363 U.S. 237 (1960).

<sup>12</sup> IRC §§ 7403(d) and 7402(a).

<sup>13</sup> IRC § 7401. The IRS prepares a suit recommendation package, and then the IRS Office of Chief Counsel reviews it, and if it agrees sends a letter to the Department of Justice (DOJ) asking the DOJ to commence the litigation. Chief Counsel Directives Manual, 34.6.1.1.1, *Steps Prior to Litigation* (Oct. 7, 2015).

<sup>14</sup> Internal Revenue Manual (IRM) 5.17.4.8, *Foreclosure of Federal Tax Lien* (Aug. 1, 2010).

are special procedures that the IRS must follow before initiating a referral to DOJ.<sup>15</sup> The IRM instructs the IRS to refer a case to DOJ to pursue a suit to foreclose only when there are no other reasonable administrative remedies and the foreclosure would not create or exasperate hardship issues for the taxpayer.<sup>16</sup> Under IRM procedures, the IRS is required to take the following actions and describe the results in a suit recommendation narrative that accompanies the referral:

- Attempt to personally contact the taxpayer and inform them that a suit to foreclose the tax lien on the principal residence is the next planned action;
- Attempt to identify the occupants of the principal residence;
- Attempt to discuss administrative remedies with the taxpayer such as an offer in compromise (including Effective Tax Administration offer or an offer with consideration of special circumstances), when appropriate;
- Advise the taxpayer about TAS, provide Form 911, *Request for Taxpayer Advocate Assistance (and Application for Taxpayer Assistance Order)*, and explain its provisions;<sup>17</sup> and
- Include a summary statement in the case history, along with the information on the taxpayer and the occupants of the principal residence, including children.<sup>18</sup>

## ANALYSIS OF LITIGATED CASES

We reviewed 39 opinions issued between June 1, 2017, and May 31, 2018, that involved civil actions to enforce federal tax liens. Table 7 in Appendix 3 contains a detailed list of those cases. Of the 39 cases, taxpayers appeared *pro se* (without counsel) in 26 cases, and were represented in the remaining 13 cases. The IRS prevailed in all cases brought against taxpayers proceeding *pro se*.

### Foreclosure of Tax Liens Where Non-Liable Taxpayer Had Interest in Property

In *United States v. Wilhite*, the government filed suit to collect long-outstanding restitution obligations by foreclosing on a company owned and controlled in part by the taxpayer.<sup>19</sup> The taxpayer's restitution obligations stemmed from years of unpaid tax from fraudulent transfers, creating an enforceable federal

15 IRM 5.17.4.8.2.5, *Lien Foreclosure on a Principal Residence* (Jan. 8, 2016). In 2012, TAS issued an Advocacy Proposal to the IRS recommending that the IRS consider the negative impact on the taxpayer of a suit to foreclose on a principal residence prior to forwarding the case to the DOJ. TAS, *Memorandum for Director, Collection Policy* (Aug. 20, 2012). The National Taxpayer Advocate followed this advocacy proposal with a legislative recommendation that Congress amend IRC § 7403 to require that the IRS, before recommending that DOJ file a suit to foreclose, first determine whether the taxpayer's other property or rights to property, if sold, are insufficient to pay the amount due, and that the foreclosure and sale of the residence will not create an economic hardship due to the financial condition of the taxpayer. National Taxpayer Advocate 2012 Annual Report to Congress 537-43 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*). Following this recommendation, TAS worked closely with the IRS to develop an Internal Guidance Memorandum (IGM), which was incorporated into IRM 5.17.4.8.2.5 on March 30, 2015, to address the issues raised by the National Taxpayer Advocate. Prior to the release of the IGM in 2013, the IRM provisions relating to referring cases under IRC § 6334(e)(1) required the IRS to consider who is living in the residence in determining whether referral to DOJ was appropriate but the procedures under IRC § 7403 did not.

16 IRM 5.17.4.8.2.5, *Lien Foreclosure on a Principal Residence* (Jan. 8, 2016); See Most Serious Problem: *Economic Hardship: The IRS Does Not Proactively Use Internal Data to Identify Taxpayers at Risk of Economic Hardship Throughout the Collection Process*, *supra*.

17 If the taxpayer indicates that the planned foreclosure of the principal residence would create a hardship, the Revenue Officer (RO) will assist the taxpayer with the preparation of Form 911 and forward the form to the local TAS office if the RO cannot or will not provide the requested relief.

18 IRM 5.17.4.8.2.5, *Lien Foreclosure on a Principal Residence* (Jan. 8, 2016).

19 *U.S. v. Wilhite*, 2018 U.S. Dist. LEXIS 42318 (D. Colo., Mar. 14, 2018), *appeal docketed*, No. 18-1090 (10th Cir., Mar. 15, 2018).

tax lien which attached to the taxpayer's property, including his ownership interest in the company.<sup>20</sup> The taxpayer and his wife, a non-liable third party, jointly owned the company with an equitable interest of 73.9 percent and 26.1 percent, respectively.<sup>21</sup>

Having found the federal tax lien valid and that it attached to the taxpayer's equitable interest in the company, the court analyzed the *Rodgers* factors described above to determine the appropriateness of a forced sale of the company in its entirety, rather than a sale of just the portion owned by the taxpayer.

With respect to the first *Rodgers* factor, the court concluded that the partial sale of the company would prejudice the government's financial interest because no potential buyer would be likely to pay fair market value for a majority interest in the taxpayer's family-owned company, especially when one of the family members would remain heavily involved in the business.<sup>22</sup> Furthermore, the court noted that selling the taxpayer's interest at discounted price or not selling it at all would impede the government's right to collect on the taxpayer's outstanding restitution obligations.<sup>23</sup> Thus, the court found this factor weighed in favor of a sale of the company in its entirety.

With respect to the second *Rodgers* factor, the non-liable party's legally recognized expectation that the property would not be subject to a forced sale, the court determined that any belief held by the wife that the property would not be subject to a forced sale was unfounded. The court reasoned that the taxpayer's wife had knowledge of the taxpayer's outstanding tax liability from the point when the government publicly recorded the lien in 2001.<sup>24</sup> The court also noted that the taxpayer's wife was involved in activities to hinder and defraud the government from collecting the outstanding liability by starting the company and hiding the taxpayer's involvement in the company.<sup>25</sup> With such knowledge and involvement, the court concluded that the taxpayer's wife failed to present any legally cognizable expectation that her ownership interest would be protected from the sale.<sup>26</sup> Therefore, this factor also weighed in favor of a sale.

In addressing the third *Rodgers* factor, the likely prejudice to the third party in personal dislocation costs and inadequate compensation, the court recognized that the taxpayer's wife may suffer some prejudice. However, the court concluded that government's right to force the sale and collect the taxpayer's outstanding debt outweighed the minimal burden the wife would experience. Even if a sale would affect the wife's monthly income, she would be given the opportunity to make a bid at the foreclosure sale to protect her interests, or in the alternative, be adequately compensated after the sale in proportion to her interest in the company.<sup>27</sup> Thus, this factor still weighed in favor of a sale.

Finally, with respect to the fourth *Rodgers* factor, the relative character and value of the liable and non-liable party's possessory interest in the subject property, the court noted that the taxpayer was the true

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20 Taxpayer's restitution obligation imposed under the *Mandatory Victim's Restitution Act (MVRA)* created a federal lien. See 18 U.S.C. §§ 3663A; 3613. In this case, the government's action to enforce its lien is "in every real sense a proceeding in court to collect a tax." *Willhite*, 2018 U.S. Dist. LEXIS 42318, at \*3. The court previously found that under Colorado law, the taxpayer had a 73.9 percent ownership interest in the company, which was subject to the federal tax lien.

21 *Id.* at \*2.

22 *Id.* at \*9-10.

23 *Id.* at \*10.

24 *Id.* at \*10-11.

25 *Id.* at \*11.

26 *Id.*

27 *Willhite*, 2018 U.S. Dist. LEXIS 42318, at \*11-12. The court determined that government holds a first priority lien superior to other creditors.



beneficial owner, despite his wife's minority interest, because he controlled and operated the company.<sup>28</sup> Considering all the factors presented in this case, the court held that a forced sale of the entire company was appropriate.<sup>29</sup>

### Preservation of Federal Tax Lien Against Subsequent Purchasers of Property

If a person who owes a federal tax liability fails to pay after the IRS sends notice and demand for payment, then a lien arises in favor of the government upon all property or rights to property, whether real or personal, belonging to that person.<sup>30</sup> The Supreme Court has broadly interpreted this provision to apply to every interest the taxpayer may have in real property.<sup>31</sup> A federal tax lien arises automatically at the time an assessment is made, and continues until the assessed tax liability is satisfied or becomes unenforceable by reason of lapse of time.<sup>32</sup> In most cases, the “transfer of property subsequent to the attachment of the lien does not affect the lien,” which remains attached to the property regardless of ownership.<sup>33</sup> However, a lien will not be enforced against a subsequent purchaser of property if the purchaser acquires an interest without notice.<sup>34</sup> Notice includes “constructive notice,” which is determined by asking whether a reasonable and diligent inspection of the relevant local index would reveal the existence of the lien.<sup>35</sup>

In *United States v. Z Investment Properties, LLC*, the government sought to satisfy the federal tax liabilities owed by a taxpayer by enforcing a federal tax lien against a parcel of real property (hereinafter “the Property”) at that point owned by a third party.<sup>36</sup> Carroll Raines, the taxpayer, initially owned the Property with his wife, becoming the sole owner upon her death. In 2007, the IRS notified the taxpayer it had made an assessment against him for unpaid federal income taxes, penalties, and interest. In August 2010, the taxpayer's liabilities remained unpaid and the IRS filed a notice of federal tax lien in the county where the taxpayer owned the Property, which indicated that federal tax liens attached to all property and rights to property belonging to the taxpayer, including the Property. The notice filed by the IRS incorrectly spelled the taxpayer's first name, listing it as “Carrol” V. Raines instead of “Carroll” V. Raines.<sup>37</sup>

The taxpayer died intestate in 2009, and his son recorded an Affidavit of Heirship over the Property in November 2010. That month, all six of the taxpayer's heirs conveyed their interests in the Property through a quitclaim deed of trust to a land trust, one of the third-party defendants in this case. A search of the taxpayer's exact first and last name on the local recorder's electronic database would not have revealed the federal tax liens, but did display potential aliases, including “C V Raines” and “Carol

28 *Willhite*, 2018 U.S. Dist. LEXIS 42318, at \*12.

29 The court also granted the government's request under IRC § 7403(d) for a receiver noting that the government had made a prima facie showing that a substantial tax liability exists and that the government's collection efforts may be jeopardized if a receiver is not appointed. *Id.* at \*15.

30 IRC § 6321.

31 *U.S. v. Nat'l Bank of Commerce*, 472 U.S. 713, 719-20 (1985).

32 IRC § 6322. The lien remains in effect until the limitations period for collection of the tax expires, which is generally 10 years from the assessment date. See IRC § 6502.

33 *U.S. v. Bess*, 357 U.S. 51, 57 (1958).

34 IRC § 6323(a), (h)(6).

35 See *In re Sparring Tool & Mfg. Co.*, 412 F.3d 653, 656 (6th Cir. 2005) (internal quotation marks omitted); see also *Tony Thornton Auction Serv., Inc. v. U.S.*, 791 F.2d 635, 639 (8th Cir. 1986)

36 *U.S. v. Z Investment Properties, LLC.*, 121 A.F.T.R.2d (RIA) 1317 (N.D. Ill. 2018), *appeal docketed*, No. 18-1915 (7th Cir. Apr. 26, 2018).

37 *Z Investment Properties, LLC.*, 121 A.F.T.R.2d (RIA) at \*1.

Raines.”<sup>38</sup> A search for all last names beginning with “Raines” and first names beginning with “C” also would have revealed the existence of the liens, as would a “Sounds Like” search using the taxpayer’s first and last names.<sup>39</sup>

The court held that the minor misspelling in the notice of federal tax lien did not bar the enforcement of the lien. To find otherwise, the court stated, would impose a requirement that tax liens identify a taxpayer with absolute precision, which would unduly burden the government’s tax collection ability.<sup>40</sup> The court emphasized the availability of multiple, easily-executed and low-cost search options available on the local recorder’s website raised the standard for what constitutes a “reasonable” search.<sup>41</sup> The court also noted that the exact search of the taxpayer’s name revealed the alias, “Carol” V. Raines, actually used on the Notice of Federal Tax Liens. In such circumstances, the court held that “a reasonable search demands that the searcher act upon the notice of aliases provided by that initial search, for example by using one of the other, flexible search functions” available on the local reporter.<sup>42</sup> The court found the lien valid and enforceable. Finally, the court allowed the government to enforce the federal tax lien against the Property and sell the Property free and clear of all rights, titles, claims, and interests of the parties. This case shows the power of a lien as a collection tool and highlights the importance for taxpayers to exercise caution when transferring title to real property.

### Foreclosure of Tax Liens Against Property Held by a Taxpayer’s Nominee or Alter Ego

The number of opinions that involved foreclosure of federal tax liens against property titled in the name of a taxpayer’s nominee or alter ego showed an increase over last year, with 23 cases in 2018, compared to 15 in 2017. A nominee is one “who holds bare legal title to property for the benefit of another.”<sup>43</sup> Courts typically look at the following factors to assess whether an entity, trust, or a third party is a nominee of a taxpayer:

- The nominee paid no or inadequate consideration;
- The property was placed in the name of the nominee in anticipation of the tax debt or litigation while the transferor retained control;
- There is a close relationship between the transferor and the nominee;
- The parties to the transfer failed to record the conveyance;
- The transferor retained possession (or control); and
- The transferor continues to enjoy the benefits of property.<sup>44</sup>

Courts have also noted that the government is not required to prove the existence of each factor, and that no single factor is determinative.<sup>45</sup> Of the nominee factors, the courts routinely attach greater weight and importance to the taxpayer’s control of the assets.<sup>46</sup>

38 *Z Investment Properties, LLC.*, 121 A.F.T.R.2d (RIA) at \*2.

39 *Id.*

40 *Id.* at \*6.

41 *Id.*

42 *Id.*

43 Nominee, BLACK’S LAW DICTIONARY (10th ed. 2014). See also *U.S. v. Beeman*, 108 A.F.T.R.2d (RIA) 5074 (W.D. Penn. 2011).

44 See, e.g., *U.S. v. Balice*, 120 A.F.T.R.2d (RIA) 5444 (D. N.J. 2017), appeal docketed, No. 18-2528 (3d Cir. July 11, 2018). See also *U.S. v. Kraus*, 121 A.F.T.R.2d (RIA) 1323 (W.D. Wash. 2018), appeal docketed, No. 18-35516 (9th Cir. June 18, 2018).

45 *Dalton v. C.I.R.*, 682 F.3d 149, 158 (1st Cir. 2012).

46 *Shades Ridge Holding Co. v. U.S.*, 888 F.2d 725, 728; *U.S. v. Novotny*, 88 A.F.T.R.2d (RIA) 7194, at \*2 (D. Colo. 2001).

In *United States v. Wade*, the government filed suit to collect a taxpayer's outstanding federal tax liabilities for tax years 1993 through 2004 by foreclosing tax liens against taxpayer's interest in 19 real properties.<sup>47</sup> Taxpayer transferred his ownership interests in some of those properties to sham entities and trusts after he was convicted for tax evasion. In 2004, he transferred all other ownership interests to his wife by a way of gift.<sup>48</sup> In its motion for summary judgment, the government argued that the purported gift the taxpayer made to his wife was invalid and that the entities and trusts with ownership interests in the subject properties were mere nominees of the taxpayer.

The taxpayer had an outstanding tax liability and a valid tax assessment against him for tax years 1982 to 1984; however no formal tax assessment had been made for tax years 1993 to 2004 at the time of the alleged gift.<sup>49</sup> The taxpayer argued that the lien was invalid because the IRS had not made a formal tax assessment for the subject years, and he had made a proper gift of all his interests to his wife. However, even though there was no formal tax assessment, the court noted the taxpayer nevertheless still owed millions of dollars in unpaid federal income tax, making the government his creditor. Furthermore, the court noted that the taxpayer's transfer of his assets as a "gift" to his wife occurred after this liability had accrued, indicating the transfer was an intentional action to hinder, delay and defraud the United States.<sup>50</sup> Thus, the court found that the taxpayer had an outstanding tax liability for the tax years at issue and set aside the alleged gift to his wife as a fraudulent transfer under state law.

With respect to all the properties held by other alleged third-party entities and business trusts, the court applied the nominee factors mentioned above to determine whether the current legal titleholders were nominees of the delinquent taxpayer. First, the court noted that the taxpayer conceded that he transferred his interests in all properties to various entities and business trusts for inadequate consideration.<sup>51</sup> Second, the taxpayer transferred the properties after incurring an outstanding tax liability and intentionally and continuously failing to report his true taxable income.<sup>52</sup> The court stated that the taxpayer should have known that he could incur additional federal tax liability. Therefore, the first two factors clearly weighed in favor of government.

The court did not fully analyze the existence of the close relationship and the failure to record the conveyance, the third and fourth factors to determine nominee status. Instead, the court put greater focus on the fifth and sixth factors — the taxpayer's continued control and enjoyment of the benefits of the subject property. The court emphasized that the taxpayer clearly retained control of the property after the transfers because he continued to exercise the dominion over the properties and even continued operating an apartment rental business on them.<sup>53</sup> Moreover, the taxpayer continued to benefit from the property. He maintained a 50 percent ownership interest in the subject properties, as the partnership income distributions were still directed to the taxpayer. Based on all these factors, the court found that the legal title holders of the 19 properties were merely taxpayer's nominees, and thus, the government's liens validly attached to the subject properties.<sup>54</sup> The court granted the government's motion for summary judgment to enforce the tax lien against all 19 of the subject properties.

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47 *U.S. v. Wade*, 120 A.F.T.R.2d (RIA) 6004 (D. Utah 2017), *appeal docketed*, No. 18-4140 (10th Cir., Sept. 28, 2018).

48 *Id.* at \*6.

49 *Id.* at \*9-10.

50 *Id.* at \*13-14.

51 *Id.* at \*21.

52 *Id.* at \*22-23.

53 *Id.* at \*23.

54 *Id.*

In another nominee case, *Arlin Geophysical v. United States*, the Circuit Court of Appeals for the Tenth Circuit held that a federal tax lien could not be enforced against a property allegedly held by the taxpayer's nominee because the taxpayer and third party were not provided a meaningful opportunity to defend against the government's position.<sup>55</sup> The appellate court found the district court erred in basing its determination of the third party's nominee status on findings from a related dispute to which the taxpayer and third party were nonparties.<sup>56</sup> Thus, the appellate court vacated the judgment and the order of sale and remanded the case for further proceedings.<sup>57</sup>

## CONCLUSION

Lien enforcement cases continue to be a consistent source of litigation between the government and taxpayers. After peaking at 278 cases in 2012, the number of IRS lien enforcement cases received by the Department of Justice decreased to 215 in fiscal year (FY) 2013 and remained fairly constant in the years following.<sup>58</sup> In recent years, the number of cases received has fluctuated greatly, as the number of lien cases received increased by about five percent to 223 cases in FY 2017. However, in FY 2018, the number of cases received decreased to just 200, over a 10 percent decrease.<sup>59</sup> The 200 cases received is the lowest amount since FY 2011 and could explain why fewer lien cases were litigated during our reporting period. This trend is shown in Figure 3.7.1.<sup>60</sup>

55 *Arlin Geophysical v. U.S.*, 696 F. App'x 362 (10th Cir. 2017), *vacating and remanding* No. 2:08-cv-00414-DN (D. Utah Sept. 17, 2015). The court acknowledged that "[t]he fundamental requirement of due process is the opportunity to be heard 'at a meaningful time and in a meaningful manner.'" *Arlin*, 696 F. App'x 362, 368 (citing *Mathews v. Eldridge*, 424 U.S. 319, 333 (1976)). See also Nina E. Olson, 2010 Erwin N. Griswold Lecture Before the American College of Tax Counsel, *Taking the Bull by Its Horns: Some Thoughts on Constitutional Due Process in Tax Collection*, 63 *Tax Law* 227 (Spring 2010).

56 *Arlin Geophysical v. U.S.*, 696 F. App'x 362, 371.

57 *Id.* In this case, the taxpayer's subject property was sold at a judicial execution sale on May 24, 2017. While this case primarily involves the interests of the third party, we have chosen to include and highlight this case because it highlights how the rights of a taxpayer are frequently tied to the rights of a third party in nominee cases. On remand, the lower court granted the government's Motion for Summary Judgment, finding that the "undisputed material facts demonstrate that Fujilyte held title to the Properties as Worthen's nominee" and that "the United States is entitled to the funds on deposit in the court registry." *Arlin Geophysical & Laura Olson v. U.S.*, 2018 WL 4621748 (D. Utah 2018).

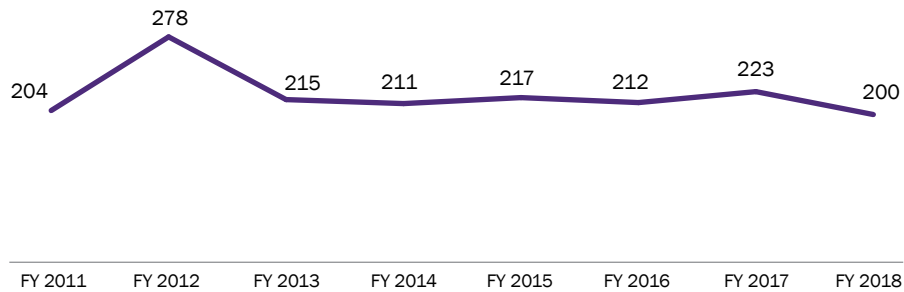
58 National Taxpayer Advocate 2016 Annual Report to Congress 496 (FY 2010 to FY 2016).

59 DOJ Tax Division, *Suits to Foreclose Tax Lien – Summary by Fiscal Year of Case Receipt* (Oct. 2018).

60 *Id.*

FIGURE 3.7.1

## Liens Cases Referred to U.S. Department of Justice



The reduction in cases received by the DOJ could be attributable in part to the IRS’s 2016 decision to refer fewer suits to foreclose tax liens on taxpayers undergoing a hardship or in situations where there are reasonable alternatives.<sup>61</sup> The National Taxpayer Advocate continues to urge Congress to adopt her 2012 recommendation to codify the approach used in the IRM so it cannot be reversed administratively.<sup>62</sup> In addition, the National Taxpayer Advocate recommends revising IRS guidance to instruct employees to more thoroughly consider the negative impact of foreclosing a principal residence.<sup>63</sup> The National Taxpayer Advocate suggests the use of an algorithm to better identify economic hardship cases early in the case selection process, which will help the IRS work with those taxpayers to find collection alternatives other than lien enforcement and foreclosure.<sup>64</sup>

Nominee cases represented 56 percent (23 out of 39) of lien cases seen in this reporting period. To address taxpayer burden and enhance the taxpayer *rights to privacy, to a fair and just tax system, and to appeal the IRS’s decision in an independent forum*, the National Taxpayer Advocate has also recommended that Congress amend IRC §§ 6320 and 6330 to extend Collection Due Process rights to “affected third parties,” known as nominees, alter egos, and transferees, who hold legal title to property subject to IRS collection actions.<sup>65</sup>

61 See IRM 5.17.4.8.2.5, *Lien Foreclosure on a Principal Residence* (Jan. 8, 2016).

62 National Taxpayer Advocate 2012 Annual Report to Congress 537-543 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*).

63 See National Taxpayer Advocate 2012 Annual Report to Congress 544-552 (Legislative Recommendation: *Amend IRC §§ 6320 and 6330 to Provide Collection Due Process Rights to Third Parties (Known as Nominees, Alter Egos, and Transferees) Holding Legal Title to Property Subject to IRS Collection Actions*).

64 See Most Serious Problem: *Economic Hardship: The IRS Does Not Proactively Use Internal Data to Identify Taxpayers at Risk of Economic Hardship Throughout the Collection Process*, *supra*.

65 National Taxpayer Advocate 2012 Annual Report to Congress 544-552 (Legislative Recommendation: *Amend IRC §§ 6320 and 6330 to Provide Collection Due Process Rights to Third Parties (Known as Nominees, Alter Egos, and Transferees) Holding Legal Title to Property Subject to IRS Collection Actions*).

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## Charitable Contribution Deductions Under IRC § 170

## SUMMARY

Subject to certain limitations, taxpayers can take deductions from their adjusted gross incomes (AGIs) for contributions of cash or other property to or for the use of charitable organizations.<sup>1</sup> To take a charitable deduction, taxpayers must contribute to a qualifying organization<sup>2</sup> and substantiate contributions of \$250 or more.<sup>3</sup> Litigation generally occurred in this reporting cycle in the following three areas:

- Substantiation of the charitable contribution;
- Valuation of the charitable contribution; and
- Requirements for a qualified conservation easement.

TAS identified and reviewed 29 cases decided between June 1, 2017, and May 31, 2018, with charitable deductions as a contested issue. The IRS prevailed in 24 cases, taxpayers prevailed in four cases, and the remaining case resulted in a split decision. Taxpayers represented themselves (appearing *pro se*) in 10 of the 29 cases (34 percent), and the IRS prevailed fully in all 10 cases.

TAXPAYER RIGHTS IMPACTED<sup>4</sup>

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

## PRESENT LAW

Charitable contributions made within the taxable year are generally deductible by taxpayers, but in the case of individual taxpayers, a taxpayer must itemize deductions from income on his or her income tax return in order to deduct the contribution.<sup>5</sup> Transfers to charitable organizations are deductible only if they are contributions or gifts,<sup>6</sup> not payments for goods or services.<sup>7</sup> A contribution or gift will be allowed as a deduction under Internal Revenue Code (IRC) § 170 only if it is made “to” or “for the use of” a qualifying organization.<sup>8</sup>

1 Internal Revenue Code (IRC) § 170.

2 To claim a charitable contribution deduction, a taxpayer must establish that he or she made a gift to a qualified entity organized and operated exclusively for an exempt purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual. IRC § 170(c)(2).

3 IRC § 170(f)(8)(A).

4 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).

5 IRC §§ 63(d) and (e), 161, and 170(a).

6 The Supreme Court of the United States has defined “gift” as a transfer proceeding from a “detached and disinterested generosity.” *Comm’r v. Duberstein*, 363 U.S. 278, 285 (1960).

7 See also Treas. Reg. § 1.170A-1(g) (no deduction for contribution of services).

8 IRC § 170(c).



For individuals, charitable contribution deductions are generally limited to 60 percent of the taxpayer's contribution base (AGI computed without regard to any net operating loss carryback to the taxable year under IRC § 172).<sup>9</sup> However, subject to certain limitations, individual taxpayers can carry forward unused charitable contributions in excess of the 60 percent contribution base for up to five years.<sup>10</sup> Corporate charitable deductions are generally limited to ten percent of the taxpayer's taxable income and are also available for carryforward for up to five years, subject to limitation.<sup>11</sup> Taxpayers cannot deduct services that they offer to charitable organizations; however, incidental expenditures incurred while serving a charitable organization and not reimbursed, may constitute a deductible contribution.<sup>12</sup>

### Substantiation

For cash contributions, taxpayers must maintain receipts from the charitable organization, copies of cancelled checks, or other reliable records showing the name of the organization, the date, and the amount contributed.<sup>13</sup> Deductions for single charitable contributions of \$250 or more are disallowed in the absence of a contemporaneous written acknowledgement from the charitable organization.<sup>14</sup>

The donor is generally required to obtain the contemporaneous written acknowledgment no later than the date he or she files the return for the year in which the contribution is made, and it must include:

- The name of the organization;
- The amount of cash contribution;
- A description (but not the value) of non-cash contribution;
- A statement that no goods or services were provided by the organization in return for the contribution, if that was the case;
- A description and good faith estimate of the value of goods or services, if any, that an organization provided in return for the contribution; and
- A statement that goods or services, if any, that an organization provided in return for the contribution consisted entirely of intangible religious benefits, if that was the case.<sup>15</sup>

For each contribution of property other than money, taxpayers generally must maintain a receipt showing the name of the recipient, the date and location of the contribution, and a description of the property.<sup>16</sup> When taxpayers contribute property other than money, the amount of the allowable deduction is the fair market value of the property at the time of the contribution.<sup>17</sup> This general rule

9 This new 60 percent limitation was part of tax reform legislation that went into effect on January 1, 2018 and is an increase from the 50 percent prior limit. See Pub. L. No. 115-97, § 11023, 131 Stat. 2054, 2074-2075 (Dec. 22, 2017). In addition, the new legislation repealed the donee reporting provision contained in IRC § 170(f)(8)(D). See Pub. L. No. 115-97, § 13705, 131 Stat. 2054, 2169 (Dec. 22, 2017). We discussed a case involving this provision in our 2017 Annual Report. See National Taxpayer Advocate 2017 Annual Report to Congress 447-449 (discussing *15 West 17th Street LLC v. Comm'r*, 147 T.C. No. 19 (2016)).

10 IRC § 170(d)(1).

11 IRC § 170(b)(2) and (d)(2).

12 Treas. Reg. § 1.170A-1(g). Meal expenditures in conjunction with offering services to qualifying organizations are not deductible unless the expenditures are away from the taxpayer's home. *Id.* Likewise, travel expenses associated with contributions are not deductible if there is a significant element of personal pleasure involved with the travel. IRC § 170(j).

13 Treas. Reg. § 1.170A-13(a)(1).

14 IRC § 170(f)(8). See also Treas. Reg. § 1.170A-13(f).

15 IRS Pub. 1771, *Charitable Contributions Substantiation and Disclosure Requirements* (Rev. 3-2016).

16 Treas. Reg. §§ 1.170A-13(b)(1)(i) to (iii).

17 Treas. Reg. § 1.170A-1(c)(1).

is subject to certain exceptions that in some cases limit the deduction to the taxpayer's cost basis in the property.<sup>18</sup> For claimed contributions exceeding \$5,000, the taxpayer must obtain a qualified appraisal prepared by a qualified appraiser.<sup>19</sup>

## ANALYSIS OF LITIGATED CASES

TAS reviewed 29 decisions entered between June 1, 2017, and May 31, 2018, involving charitable contribution deductions claimed by taxpayers. Table 8 in Appendix 3 contains a detailed list of those cases. Of the 29 cases, the most common issues were: substantiation (or lack thereof) of the claimed contribution (18 cases), valuation of the property contributed (four cases), and contribution of an easement (nine cases).<sup>20</sup>

### Substantiation

Eighteen cases involved the substantiation of deductions for charitable contributions. When determining whether a claimed charitable contribution deduction is adequately substantiated, courts tend to follow a strict interpretation of IRC § 170. As noted earlier, deductions for single charitable contributions of \$250 or more are disallowed in the absence of a contemporaneous written acknowledgement from the charitable organization.<sup>21</sup>

In *RERI Holdings I, LLC v. Commissioner*, the taxpayer, a limited liability company, purchased the remainder interest of a property in Hawthorne, California in March 2002 for \$2,950,000.<sup>22</sup> In August 2003, the taxpayer assigned the remainder interest to the University of Michigan, a tax-exempt organization. On its 2003 Form 1065, *U.S. Return of Partnership Income*, the taxpayer claimed a charitable contribution deduction of \$33,019,000. The taxpayer attached a required Form 8283, *Noncash Charitable Contributions*, to its return that provided the date and manner of acquisition of the contributed remainder interest but, critical to this case, left blank the space for the "Donor's cost or other adjusted basis." The IRS initially reduced, then subsequently disallowed, the claimed charitable contribution deduction and asserted valuation misstatement penalties. The taxpayer challenged this disallowance and penalty assertion in Tax Court.

In addressing whether the taxpayer had properly substantiated its contribution of the remainder interest in the property and was entitled to claim a charitable contribution deduction, the court discussed the Deficit Reduction Act of 1984 (DEFRA).<sup>23</sup> The court noted that this legislation directed the Treasury Secretary to prescribe regulations under IRC § 170 that would require donors to meet stricter substantiation requirements to support claimed charitable contribution deductions. The court examined

18 Treas. Reg. § 1.170A-1(c)(1). Note that the deduction is reduced for certain contributions of ordinary income and capital gain property. See IRC § 170(e).

19 IRC § 170(f)(11)(C). "Qualified appraisal" and "qualified appraiser" are defined in IRC §§ 170(f)(11)(E)(i) and (ii), respectively. On July 27, 2018, after the close of our reporting period, the IRS released lengthy final regulations relating to IRC § 170. See T.D. 9836, 83 Fed. Reg. 36417-01 (July 30, 2018). These regulations provide guidance on cash, check, or other monetary gift substantiation requirements; noncash substantiation requirements; and new requirements for qualified appraisals and qualified appraisers. For example, the regulations provide that an email from a donee organization to a donor can qualify as a written communication and be used to substantiate a monetary contribution. However, a blank pledge card provided by a donee organization but filled out by a donor is insufficient substantiation.

20 Cases addressing more than one described issue are counted for each issue. For example, cases addressing the valuation of easements are counted once as a valuation issue case and again as a conservation easement issue case. As a result, the breakdown of case issues above will not add up to the total number of cases reviewed by TAS.

21 IRC § 170(f)(8). See also Treas. Reg. § 1.170A-13(f).

22 *RERI Holdings I, LLC v. Comm'r*, 149 T.C. No. 1 (2017), appeal docketed, No. 17-1266 (D.C. Cir. Dec. 18, 2017).

23 Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 155(a)(1) and (2), 98 Stat. 494, 691 (1984).

the legislative history of DEFRA and stated that in enacting the legislation, Congress intended that the new substantiation requirements would alert the IRS to potential overvaluations of contributed property, thereby deterring taxpayers from claiming excessive charitable contribution deductions, which was a concern of Congress.

The court then noted that in response to Congress' directive in DEFRA, Treasury amended Treas. Reg. § 1.170A-13 to add new paragraph (c), which provided new substantiation requirements that apply to donors who contribute property worth more than \$5,000. To meet these requirements, donors must obtain a qualified appraisal of the contributed property, attach a "fully completed" appraisal summary to the return on which the deduction is first claimed, and maintain records containing specified information. The appraisal summary must provide the adjusted cost or other basis of the donated property. Under the regulations, a taxpayer that does not meet these requirements is denied a deduction for the contribution.

The court next discussed the doctrine of substantial compliance, which may allow a taxpayer to claim a charitable contribution deduction even if it fails to strictly comply with all reporting requirements. The court discussed two cases with different results and then applied them to this case. The court previously held in *Bond v. Commissioner* that the reporting requirements of Treas. Reg. § 1.170A-13 are "directory and not mandatory," meaning that a taxpayer who fails to strictly comply with reporting requirements may still be allowed to claim a charitable contribution deduction provided the taxpayer substantially complies.<sup>24</sup> In *Bond*, the taxpayers attached to their return an appraisal summary on Form 8283 that included all required information except for the appraiser's qualifications. However, the taxpayers provided this missing information around the time that the IRS began the audit of their return. The court in *Bond* stated that a denial of the deduction would be an unnecessary sanction and therefore allowed the deduction based on the substantial compliance doctrine.

The court then contrasted *Bond* with its holding in *Hewitt v. Commissioner*.<sup>25</sup> In *Hewitt*, the taxpayers donated non-publicly traded stock but did not obtain a qualified appraisal or attach an appraisal summary to their return. The IRS disallowed the taxpayers claimed charitable contribution deduction even though it did not dispute that the amount the taxpayers deducted was equal to the stock's value. The court in *Hewitt* upheld the IRS's disallowance of the deduction and rejected the taxpayers' substantial compliance argument, finding that the statutory language required an appraisal and the need for the IRS to be provided with appropriate information to be aware of potential overvaluations, thereby distinguishing this case from *Bond*. The court also mentioned the case of *Smith v. Commissioner*, where it articulated a standard for substantial compliance based on the *Bond* and *Hewitt* cases.<sup>26</sup> In *Smith*, the court noted that in determining whether there was substantial compliance, the court would consider whether the donor provided sufficient information for the IRS to evaluate the contribution, in accordance with congressional intent.

Turning to the case at hand, the court noted that the taxpayer's Form 8283, *Noncash Charitable Contributions*, appraisal summary showed that it had purchased the remainder interest in the property but left blank the space for "Donor's cost or other adjusted basis." Therefore, the taxpayer did not meet the requirements of the regulations.<sup>27</sup> The court then addressed whether the taxpayer should be allowed to claim the charitable contribution deduction based on the doctrine of substantial compliance.

24 *Bond v. Comm'r*, 100 T.C. 32, 40-41 (1993).

25 *Hewitt v. Comm'r*, 109 T.C. 258 (1997), *aff'd without published opinion*, 166 F.3d 332 (4th Cir. 1998).

26 *Smith v. Comm'r*, T.C. Memo. 2007-368, *aff'd*, 364 F. App'x 317 (9th Cir. 2009).

27 See Treas. Reg. § 1.170A-13(c)(4)(ii)(E).

The court noted that the taxpayer's omission of its basis in the remainder interest on the Form 8283 prevented the appraisal summary from accomplishing its intended purpose. The court reiterated that Congress had directed Treasury to adopt stricter substantiation requirements for charitable contributions to alert the IRS to potential overvaluations of contributed property, thereby deterring taxpayers from claiming excessive deductions. The court stated that the taxpayer had purchased the remainder interest in March 2002 for around \$3 million and claimed a charitable contribution deduction of approximately \$33 million for its assignment of the remainder interest in August 2003, a mere 17 months later. Had the taxpayer properly reported its cost basis on the Form 8283, the significant disparity between the purchase price of the property and its claimed fair market value would have alerted the IRS to a potential overvaluation of the property. Therefore, because the taxpayer failed to provide sufficient information on its Form 8283 for the IRS to evaluate its contribution, the court found that the taxpayer had not substantially complied with the substantiation requirements and was not entitled to any deduction.<sup>28</sup>

### Value of the Property Contributed

In *Gardner v. Commissioner*, the taxpayer, an avid big-game hunter, owned a vast collection of 'trophies' from his hunting expeditions.<sup>29</sup> The taxpayer sought to downsize his collection and, on the advice of a fellow hunter, decided to donate various unwanted specimens to the Dallas Ecological Foundation, a tax-exempt organization. Following the recommendation of the fellow hunter, the taxpayer contacted an appraisal expert, who agreed to appraise 177 specimens that the taxpayer wished to donate.

The appraisal expert prepared a report and used a replacement cost method to determine the fair market value of the items. Specifically, the appraiser estimated the cost to replace each item by calculating the expected out-of-pocket expenses for traveling to a hunting site, spending time on a safari, killing the animal, removing, preserving, and shipping the body, and taxidermy costs. The appraiser, who was aware that the taxpayer intended on claiming a charitable contribution deduction for the donation of the items, appraised the taxpayer's 177 specimens at \$1,425,900. Relying on this valuation, the taxpayer reported a charitable contribution of \$1,425,900 on his 2006 tax return. Due to charitable contribution deduction limits, the taxpayer only claimed a charitable contribution deduction of \$129,459 in 2006, but carried forward the excess contribution into the following tax years, deducting \$429,313 in 2007 and another \$783,509 in 2008.<sup>30</sup> The IRS examined the taxpayer's 2006-2008 returns and determined that the value of the 177 specimens was only \$163,045. The IRS therefore asserted deficiencies of \$137,647 and \$274,228 for 2007 and 2008, respectively.

The court first noted that under the regulations, the amount of the charitable contribution allowed as a deduction is generally equal to the fair market value of the property at the time the contribution is made.<sup>31</sup> The court also mentioned that the IRS and taxpayer agreed that the taxpayer had fulfilled all necessary procedural requirements, including obtaining a qualified appraisal. The court pointed out that the only dispute in this case was the fair market value of the 177 donated items and that the burden of proving it was on the taxpayer.

The court then discussed the valuation methodologies of the parties and noted their fundamental disagreement in this regard. The IRS took the position that fair market value is determined by

28 *RERI Holdings I, LLC v. Comm'r*, 149 T.C. No. 1 (2017) appeal docketed, No. 17-1266 (D.C. Cir. Dec. 18, 2017).

29 *Gardner v. Comm'r*, T.C. Memo. 2017-165.

30 See IRC § 170(b)(1)(C).

31 See Treas. Reg. § 1.170A-1(c)(1).

considering market prices for comparable items while the taxpayer insisted that, because of their unique nature, the specimens had no real comparables in the open market and valuation was appropriate using a replacement cost methodology.

The court noted that an important factor in the dispute between the IRS and the taxpayer was whether the specimens were more appropriately classified as “collectibles,” whose value depends on who shot the animal, where it was shot, and previous ownership, or “commodities,” which can be valued on the open market. The court stated that it had “no difficulty” concluding that the specimens were commodities and the IRS’s valuation based on the market price was appropriate. The court noted that the taxpayer did not call his appraiser as a witness or seek to enter his report into evidence. The court stated that the donated specimens were no longer available for inspection and that the expert witnesses on both sides had therefore relied on the appraisal report, which overrated many specimens, provided limited information about them, and did not explain why the appraiser had adopted a replacement cost approach.

The court then discussed the testimony of experts on both sides. It noted that the IRS’s expert was a certified taxidermy appraiser, who had conducted appraisals for museums, state and local governments, and the IRS. The expert’s testimony, which the court found “credible and convincing,” characterized the specimens as consisting primarily of “remnants and scraps” of a trophy collection. The expert valued the contributed specimens by consulting market data from brick and mortar auction houses, online auction sites, and websites specializing in hunting specimens. The expert assigned each specimen a price on the assumption that each specimen was in “excellent” condition, then reduced the appraised value by each observed defect from photographs in the appraisal report. Ultimately, the IRS’s expert valued the 177 contributed specimens at \$41,140 in excellent condition and, after viewing the appraisal photographs of the items that showed defects in many items, he reduced his appraisal to \$34,240.

Next, the court discussed the testimony of the taxpayer’s three experts. It noted that two of these experts did not put a dollar figure on the 177 specimens but rather sought to defend the replacement cost methodology. The court found their testimony, which essentially claimed that the market approach asserted by the IRS could not capture the true fair market value of the specimens because they were museum-quality pieces uniquely valuable for research, to be without any factual support and therefore “wholly unreliable.” The court pointed out various issues with their qualifications, lack of professional experience appraising taxidermy, improper assumptions, and overreliance on the original flawed appraisal report. The taxpayer’s third expert claimed that the 177 specimens had a replacement cost value of \$2,544,300, which was \$1,128,400 more than the replacement cost that the taxpayer had claimed as a charitable contribution on his tax return. This expert arrived at this figure by assuming that each of the 177 specimens would be obtained on a separate trip, crated and shipped back individually, and incur taxidermy and mounting expenses. The court noted that this expert conceded that multiple animals could be hunted in one trip and the taxpayer had in fact done so.

The court, which had adjudicated valuation disputes over charitable contributions of hunting specimens in the past, stated that it generally relied on a comparable sales method of valuation where an active market existed, and that the replacement cost method of valuation was proper only in the case of unique property with a limited market and no evidence of comparable sales. The court was persuaded by the testimony of the IRS’s expert that the specimens were mostly “remnants, leftovers, and scraps” and that the taxpayer was essentially discarding unwanted items. The court found the testimony of the taxpayer’s experts that all the specimens were of excellent quality to be unpersuasive, and noted that their assertions lacked a factual basis and were contradicted by the photographs contained in the initial

appraisal report. Therefore, the court found that the specimens were commodities, not collectibles, and that the market price for similar items, rather than replacement cost, should determine fair market value. The court stated that the IRS's expert had credibly determined that the fair market value of the specimens, depending on their condition, was between \$34,240 and \$41,140. The court held that the taxpayer had not carried his burden of proving that the fair market value of the specimens exceeded the \$163,045 value allowed by the IRS and therefore sustained the IRS's determination to disallow the taxpayer's charitable contribution deduction in excess of this amount.<sup>32</sup>

### Qualified Conservation Contribution

For a gift to constitute a qualified contribution under IRC § 170, the donor must possess a transferrable interest in the property and intend to irrevocably relinquish all rights, title, and interest to the property without any expectation of some benefit in return.<sup>33</sup> Taxpayers generally are not permitted to deduct gifts of property consisting of less than the taxpayer's entire interest in that property.<sup>34</sup> Nevertheless, taxpayers may deduct the value of a contribution of a partial interest in property that constitutes a "qualified conservation contribution,"<sup>35</sup> also known as a conservation easement. A contribution will constitute a qualified conservation contribution only if it is of a "qualified real property interest" made to a "qualified organization" and "exclusively for conservation purposes."<sup>36</sup> All three conditions must be satisfied for the donation to be deemed a "qualified conservation contribution." For the current reporting period, we identified nine charitable contribution deduction cases involving conservation easements, an increase from the five cases we identified in the 2017 reporting period.<sup>37</sup>

In *BC Ranch II, L.P. v. Commissioner*, the taxpayers, two limited partnerships, BCR I and BCR II, appealed to the United States Court of Appeals for the Fifth Circuit a Tax Court decision upholding the IRS's disallowance of their charitable contribution deductions for conservation easements grants.<sup>38</sup> In 2003 BCR I had purchased a 3,744-acre piece of land (the "ranch") and, in 2005, conveyed approximately 1,866 acres to BCR II. In 2003, the developers of the ranch approached the North American Land Trust ("NALT"), an IRC § 501(c)(3) organization, to determine if the ranch could qualify for a tax-deductible conservation easement. NALT advised the taxpayers that the land would qualify as a conservation easement, with one benefit of the easement being the protection of the nesting areas and habitat of the gold-cheeked warbler, which was listed as an endangered species.

Prior to donating the conservation easement, the taxpayers assembled extensive documentation from NALT's visits to the ranch site, including photographs, property maps, details of site visit by an NALT biologist, and maps of the gold-cheeked warbler habitat. The taxpayers also hired an environmental consultant to advise as to how the property should be developed to ensure compliance with the Endangered Species Act. The consultant completed a report that included detailed aerial photographs and topographic maps that had habitat surveys of the gold-cheeked warbler's probable nesting areas.

After the taxpayers and NALT assembled two binders of "baseline documents" detailing the conservation easements, the taxpayers, BCR I and BCR II, donated conservation easements to NALT in

32 *Gardner v. Comm'r*, T.C. Memo. 2017-165.

33 IRC § 170(f)(3).

34 *Id.*

35 IRC §§ 170(b)(1)(E) and (f)(3)(B)(iii).

36 IRC § 170(h)(1)(A)-(C).

37 See National Taxpayer Advocate 2017 Annual Report to Congress 447.

38 *BC Ranch II, L.P. v. Comm'r*, 867 F.3d 547 (5th Cir. 2017), *vacating and remanding* T.C. Memo. 2015-130.



2005 and 2007, respectively. Both easements were substantially similar and provided for the protection and preservation of the environment and its natural inhabitants, including the gold-cheeked warbler and other birds and animals. The easements granted perpetual rights to NALT over the conservation areas while reserving certain narrow rights to the taxpayers that could not impact the conservation purpose of the easements. The easements could only be amended with the NALT's consent and only to modify the boundaries of "homesite parcels," which were areas of land where limited partners could build homes on select five-acre sites. These modifications were allowed so long as they did not increase the homesite parcels above five acres. NALT regularly monitored the conservation area and found it to be in good condition and in compliance with the terms of the easements.

The taxpayers each claimed charitable contribution deductions of approximately \$8,000,000 for conservation easements they had donated to NALT in 2005 and 2007. The IRS disallowed these deductions and asserted that the taxpayers were liable for gross valuation misstatement penalties. The taxpayers petitioned the Tax Court, which held that the IRS had properly disallowed the charitable contribution deductions, as the conservation easements were not given in perpetuity. The taxpayer appealed to the United States Court of Appeals for the Fifth Circuit.

After reviewing the basic law governing conservation easements and noting that a conservation easement restriction must be made in perpetuity to qualify for a charitable contribution deduction, the court discussed the perpetuity requirement. The court discussed the basic terms of the easement, including the homesite modification provision. As mentioned above, this provision allowed the taxpayers, with NALT's consent, to amend the property covered by the easements but only for the limited purpose of modifying the boundaries of the five-acre homesite parcels and without increasing these parcels above five acres. The court stated that these modifications were only permitted if in NALT's reasonable judgment they did not interfere with any of the conservation purposes.

The Tax Court had agreed with the IRS that the homesite boundary modification provision violated the perpetuity requirement contained in IRC § 170(h)(2)(C). Relying on *Belk v. Commissioner*, the Tax Court held that an easement is not qualified real property granted in perpetuity if the boundaries of the property subject to the easement may be modified.<sup>39</sup> The Court of Appeals for the Fifth Circuit found that the Tax Court's reliance on the *Belk* case was misplaced and distinguished it. It noted that the easements in this case were significantly different than the one in *Belk*. For example, the easements in this case allowed only the homesite parcels boundaries to be changed and only within the tracts subject to the easement and without increasing the size of the homesite parcels. Unlike in *Belk*, where entire tracts of land could be swapped in and out of the easement, the exterior boundaries and total acreage of the easements in this case could not be changed. Any homesite parcel boundary adjustments would require NALT's consent and remain within the easements. The court noted that such adjustments might be necessary to account for new nesting sites for the warblers and would not provide any financial benefit to the easement donors.

After distinguishing the easements from the one in *Belk*, the court stated that they were more akin to ones in two conservation façade easements cases. In those cases, two courts of appeals held that conservation easements are perpetual even though trusts could consent to the partial lifting of restrictions to allow repairs and changes to the façades of buildings.<sup>40</sup> The Fifth Circuit noted that the courts in those cases had applied "common sense reasoning" to allow for the modification of an

39 *Belk v. Comm'r*, 774 F.3d 221 (4th Cir. 2014), *aff'g* 140 T.C. 1 (2013). We discussed the *Belk* case in our 2015 Annual Report. See National Taxpayer Advocate 2015 Annual Report to Congress 517-518.

40 See *Comm'r v. Simmons*, 646 F.3d 6 (D.C. Cir. 2011); *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012).

easement to promote the underlying conservation interests and that this rationale applied in this case too. The court also noted that the perpetuity of the easement was ensured by the fact that NALT had “virtually unrestricted discretion” to withhold consent to any modifications.

The court finished its discussion of the perpetuity requirement by making two final points. First, it noted that the conservation easement provision under IRC § 170(h) was enacted at the urging of conservation activists, by an overwhelming majority of Congress, and with the goal of conserving thousands of acres of property. Therefore, the usual strict construction of statutory loopholes did not apply to conservation easements. When applying an ordinary standard of statutory construction, the court stated it was satisfied that its perpetuity analysis was correct. Also, the court attached to its opinion a copy of the conservation easement plan and stated that it provided visual confirmation that the homesite adjustment provision would not violate the perpetuity requirement.

The court then turned to the baseline documentation requirement issue. Under the regulations, if a donor of a conservation easement retains rights to property that may impair the conservation interests, the donor must make available to the donee, prior to the time the donation is made, documentation sufficient to establish the condition of the property at the time of the contribution.<sup>41</sup> The regulations provide various examples of proper baseline documents including different types of maps, land use history, and aerial and on-site photographs. The court emphasized that the regulations use the term “may include” rather than “shall include” to indicate that this list is flexible and not rigid.

The Tax Court had held that the taxpayers had failed to meet the baseline documentation requirement of the regulations and characterized the documentation provided by the taxpayers as “unreliable, incomplete, and insufficient” to accurately depict the condition of the property subject to the easements. In reaching this conclusion, the Tax Court determined that some of the documentation was untimely and inaccurate. The Court of Appeals for the Fifth Circuit criticized the Tax Court for its rigid approach and for failing to consider several items in the record that would have sufficiently established the condition of the property prior to the donation, including photographs, reports, and site plans. The Court of Appeals also stated that the timing of these items was appropriate and showed “a great deal of collaboration” between the donor and donee prior to the donation. In sum, the Fifth Circuit found that the taxpayers had provided “more than sufficient” documentation to NALT establishing the condition of the property prior to the donation of the conservation easement and therefore met the baseline documentation requirement.

Therefore, the Court of Appeals for the Fifth Circuit vacated the Tax Court’s holding with respect to the perpetuity and baseline documentation requirements. The court remanded the case to the Tax Court to consider other grounds asserted by the IRS to disqualify the easements that had not been previously addressed by the Tax Court.<sup>42</sup>

<sup>41</sup> See Treas. Reg. § 1.170A-14(g)(5)(i).

<sup>42</sup> *BC Ranch II, L.P. v. Comm’r*, 867 F.3d 547, 556 (5th Cir. 2017), *vacating and remanding* T.C. Memo. 2015-130.

## CONCLUSION

IRC § 170 and the accompanying Treasury Regulations provide detailed requirements with which taxpayers must strictly comply. The statutory and regulatory requirements to qualify for a deduction become more stringent as deductions increase in size and taxpayers should be mindful of the newly-released final regulations under IRC § 170.<sup>43</sup> Like last year, most of the charitable contribution cases we reviewed this year addressed issues regarding substantiation of contributions, while several cases discussed the value of the contributed property and the complex rules governing the donation of a conservation easement.

Under the new tax reform legislation, taxpayers may now deduct up to 60 percent of their contribution base through qualifying charitable contributions.<sup>44</sup> However, due to the increase in the standard deduction, fewer taxpayers are likely to itemize their deductions, leading to a potentially significant reduction in charitable giving and less litigated cases in this area.

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43 See T.D. 9836, 83 Fed. Reg. 36417-01 (July 30, 2018). Some parts of these final regulations do not go into effect until after July 30, 2018 and may lead to more litigation in future years when they become effective.

44 This bill was introduced as the Tax Cuts and Jobs Act but was passed under a different title. See Pub. L. No 115-97, § 11023, 131 Stat. 2054, 2074-2075 (2017).

## MLI #9 Itemized Deductions Reported on Schedule A (Form 1040)

### SUMMARY

For the first time since the National Taxpayer Advocate's Annual Report to Congress in 2002, itemized deductions reported on Schedule A of IRS Form 1040 are among the ten Most Litigated Issues.

We identified 23 cases involving itemized deductions that were litigated in federal courts between June 1, 2017, and May 31, 2018.<sup>1</sup> The courts affirmed the IRS position in 16 of these cases, or about 70 percent, while taxpayers fully prevailed in four cases, or about 17 percent of the cases. The remaining three cases, or about 13 percent, resulted in split decisions.

### TAXPAYER RIGHT(S) IMPACTED<sup>2</sup>

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

### PRESENT LAW

Individual taxpayers can deduct from taxable income a standard deduction, based on filing status, or may instead elect to itemize deductions.<sup>3</sup> Itemized deductions are specified “personal” and “other” expenses allowed as deductions from Adjusted Gross Income (AGI) arriving at taxable income.<sup>4</sup> Eligible taxpayers may claim itemized deductions by filing a Schedule A (Form 1040), *Itemized Deductions*, with their tax returns. Common personal expenses include: interest payments, such as mortgage interest and points on principal and secondary residences,<sup>5</sup> state and local income or sales taxes, property taxes,<sup>6</sup> medical and dental expenses exceeding a certain threshold of the AGI,<sup>7</sup> charitable contributions,<sup>8</sup> and

1 We excluded cases involving unreimbursed employee expenses and charitable deductions as they are discussed elsewhere in the National Taxpayer Advocate's Annual Report to Congress. See National Taxpayer Advocate 1998-2017 Annual Reports to Congress. Unreimbursed employee expenses are discussed in detail in Most Litigated Issue: *Trade or Business Expenses Under IRC § 162 and Related Sections*, *supra*. Cases involving charitable deductions are discussed in detail in Most Litigated Issue: *Charitable Contribution Deductions Under IRC § 170*, *supra*.

2 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).

3 IRC § 63. Married taxpayers must generally both elect the standard deduction or itemize deductions, regardless of whether they file joint or separate returns.

4 See IRC § 62 for the calculation of adjusted gross income (AGI).

5 IRC § 163.

6 IRC § 164.

7 Under the Tax Cuts and Jobs Act (TCJA), any taxpayer may deduct unreimbursed medical expenses that exceed 7.5 percent of their AGI in tax years 2017 and 2018. Pub. L. No. 115-97, § 11027, 131 Stat. 2054, 2077 (2017); IRC § 213(f).

8 IRC § 170. Charitable contributions are discussed in a separate Most Litigated Issue: *Charitable Contribution Deductions Under IRC § 170*, *supra*.

casualty and theft losses.<sup>9</sup> Other deductible expenses include certain payments related to the production or collection of income, such as property management expenses,<sup>10</sup> investment interest expenses,<sup>11</sup> and gambling losses.<sup>12</sup> For tax years prior to 2018, itemized deductions also included miscellaneous deductions, such as tax advice and preparation fees, appraisal fees for purposes of charitable contributions or casualty losses, job search and moving expenses, subscriptions to professional journals, home office expenses, union or professional dues, and unreimbursed work-related travel expenses or employee expenses reimbursed under a nonaccountable plan.<sup>13</sup>

For tax years before 2018, taxpayers with AGI over a certain threshold amount are limited as to the total itemized deductions they can claim.<sup>14</sup> For taxpayers with AGI over the threshold, allowable itemized deductions are reduced by three percent of AGI above the applicable threshold to a maximum reduction of 80 percent of the total allowable deductions for the tax year. These limitations apply to charitable donations, the home mortgage interest deduction, state and local tax deductions, and miscellaneous itemized deductions, but do not apply to medical expenses, investment interest expenses, gambling losses, and certain theft and casualty losses.<sup>15</sup>

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9 IRC §§ 165(e) and 165(h).

10 IRC § 212.

11 IRC § 163(d).

12 IRC § 165(d).

13 Miscellaneous itemized deductions refers to deductions other than: (1) the deduction under IRC § 163 (relating to interest); (2) the deduction under IRC § 164 (relating to taxes); (3) the deduction under IRC § 165(a) for casualty or theft losses described in paragraph (2) or (3) of IRC § 165(c) or for losses described in IRC § 165(d); (4) the deductions under IRC § 170 (relating to charitable, etc., contributions and gifts) and IRC § 642(c) (relating to the deduction for amounts paid or permanently set aside for a charitable purpose); (5) the deduction under IRC § 213 (relating to medical, dental, etc., expenses); (6) any deduction allowable for impairment-related work expenses; (7) the deduction under IRC § 691(c) (relating to the deduction for estate tax in case of income in respect of the decedent); (8) any deduction allowable in connection with personal property used in a short sale; (9) the deduction under IRC § 1341 (relating to computation of tax where taxpayer restores a substantial amount held under claim of right); (10) the deduction under IRC § 72(b)(3) (relating to the deduction where annuity payments cease before investment recovered); (11) the deduction under IRC § 171 (relating to the deduction for amortizable bond premium); and (12) the deduction under IRC § 216 (relating to deductions in connection with cooperative housing corporations). See IRC § 67(b).

14 The TCJA suspended the overall limit on itemized deductions based on AGI for tax years 2018 through 2025. Prior to the TCJA, taxpayers' ability to claim itemized deductions was limited if their AGI exceeded certain thresholds based on filing status. For example, for Tax Year 2017, the threshold is \$313,800 for married taxpayers filing jointly or a qualifying widow(er) (\$261,500 for a taxpayer filing single). See Pub. L. No. 115-97, § 11046, 131 Stat. 2054, 2088 (2017); Rev. Proc. 2016-55, 2016-45 I.R.B. 707.

15 IRC § 68(c).

## Changes Made Under the Tax Reform Legislation<sup>16</sup>

The Tax Cuts and Jobs Act (TCJA) eliminated or restricted many itemized deductions beginning in 2018, and increased the standard deduction. Overall, 61 percent fewer taxpayers are expected to claim itemized deductions in 2018.<sup>17</sup> The TCJA made the following changes to itemized deductions:<sup>18</sup>

### 1. *Standard deduction*

For tax years 2018–2025, the TCJA roughly doubles the standard deduction amounts to \$12,000 for single individuals, \$18,000 for heads of household, and \$24,000 for joint filers.<sup>19</sup> These amounts are adjusted for inflation.<sup>20</sup>

### 2. *Medical expense deduction*

Under prior law, taxpayers whose unreimbursed medical expenses exceeded ten percent of their AGI could deduct that excess. For tax years 2013–2016, a taxpayer could deduct the excess over 7.5 percent of AGI if the taxpayer or his or her spouse had attained age 65 before the close of the taxable year. Under the TCJA, any taxpayer may deduct unreimbursed medical expenses that exceed 7.5 percent of his or her AGI in tax years 2017 and 2018.<sup>21</sup> This change was made retroactive to January 1, 2017.<sup>22</sup>

### 3. *State and local taxes*

The TCJA limits the aggregate amount of the itemized deduction taxpayers can claim for state and local income, sales, real estate, or personal property taxes to \$10,000 per year (\$5,000 in the case of a married individual filing a separate return) for tax years 2018–2025.<sup>23</sup> Prior to the TCJA law, there was no limitation on the amount of state and local taxes a taxpayer could take as an itemized deduction.

### 4. *Mortgage and home equity interest deduction*

For mortgages entered into after December 15, 2017, the TCJA generally allows a taxpayer to deduct interest only up to \$750,000 on mortgage debt used to buy, build, or improve a principal home (\$375,000 in the case of married taxpayers filing separate returns) for tax years 2018 through 2025.<sup>24</sup> However, the limit remains at \$1 million (\$500,000 in the case of married taxpayers filing separate tax returns) for mortgage debt incurred on or before December 15, 2017.

16 Pub. L. No. 115-97, 131 Stat. 2054 (2017). TAS has created a website, available in both English and Spanish, to educate individual taxpayers about items that were changed and not changed as a result of TCJA. For a detailed list of these changes, see TAS, *Tax Changes by Topic*, <https://taxchanges.us/> (last visited Sept. 9, 2018).

17 The Joint Committee on Taxation staff estimates the number of taxpayers who itemize will tumble from about 46.5 million in 2017 to about 18 million in 2018. J. Comm. on Tax'n, *Tables Related to the Federal Tax System as in Effect 2017 through 2026* (JCX-32-18) (Apr. 23, 2018).

18 Pub. L. No. 115-97, 131 Stat. 2054 (2017).

19 *Id.*

20 The TCJA employed a new Consumer Price Index. Specifically, the new index differs from the previous Consumer Price Index by attempting to account for the ability of individuals to alter their consumption patterns in response to relative price changes. See Pub. L. No. 115-97, § 11002, 131 Stat. 2054, 2059 (2017).

21 Pub. L. No. 115-97, § 11027, 131 Stat. 2054, 2077 (2017); IRC § 213(f).

22 *Id.*

23 Pub. L. No. 115-97, § 11042, 131 Stat. 2054, 2085 (2017); IRC § 164.

24 *Id.*; IRC § 163(h)(3).



The TCJA also eliminates the deduction for interest on home equity debt for tax years 2018-2025. However, home equity debt interest might still be deductible if the funds are used for a purpose where interest otherwise may be deductible, such as for home improvement, investment, or business purposes.<sup>25</sup>

#### 5. *Casualty and theft loss deductions*

The TCJA provides that, for tax years 2018-2025, taxpayers may not deduct any personal casualty or theft losses not compensated by insurance or otherwise, unless the casualty loss is attributable to a federally declared disaster.<sup>26</sup> The loss must still exceed \$100 per casualty and the total net loss must exceed ten percent of the taxpayer's AGI.<sup>27</sup>

#### 6. *Miscellaneous itemized deductions*

For tax years 2018-2025, the deduction for miscellaneous expenses subject to the two percent of AGI floor, such as certain professional fees, investment expenses, and unreimbursed employee business expenses, has been suspended under the TCJA.<sup>28</sup>

#### 7. *Charitable contribution deductions*<sup>29</sup>

For tax years 2018-2025, the limit on the deduction for cash donations to public charities is increased from 50 to 60 percent of AGI.<sup>30</sup> However, charitable deductions for payments made in exchange for college athletic event seating rights are eliminated.<sup>31</sup>

## ANALYSIS OF LITIGATED CASES

For the first time since the National Taxpayer Advocate's Annual Report to Congress in 2002, itemized deductions reported on Schedule A of IRS Form 1040 were among the ten Most Litigated Issues. This year, we analyzed 23 cases between June 1, 2017, to May 31, 2018, in which itemized deductions were in dispute. All but five of these cases were either litigated in the United States Tax Court or in a United States Court of Appeals on appeal of a Tax Court decision. A detailed list appears in Table 9 in Appendix 3.

Of the 15 cases in which taxpayers appeared *pro se* (without counsel), the IRS prevailed in nine. The taxpayer prevailed in three cases, while the other three cases resulted in a split decision. Taxpayers represented by counsel fared worse; of the eight cases in which taxpayers had representation, taxpayers prevailed in only one case and were denied relief in seven cases. Most of this year's 23 cases involved taxpayers claiming deductions for casualty and theft losses,<sup>32</sup> tax preparation fees or expenses associated

25 Pub. L. No. 115-97, § 11043, 131 Stat. 2054, 2086 (2017). See also IR 2018-32, *Interest on Home Equity Loans Often Still Deductible Under New Law*, (Feb. 21, 2018), <https://www.irs.gov/newsroom/interest-on-home-equity-loans-often-still-deductible-under-new-law> (last visited Nov. 26, 2018).

26 Pub. L. No. 115-97, § 11044, 131 Stat. 2054, 2087 (2017); IRC § 165(h).

27 IRC § 165(c)(3) & (h).

28 Pub. L. No. 115-97, § 11045, 131 Stat. 2054, 2088 (2017).

29 See also Most Litigated Issue: *Charitable Contribution Deductions Under IRC § 170*, *supra*.

30 Pub. L. No. 115-97, § 11023, 131 Stat. 2054, 2074 (2017).

31 *Id.*

32 IRC § 165.

with the production of income,<sup>33</sup> and medical care.<sup>34</sup> The Figure 3.9.1 categorizes the main issues raised by taxpayers in the 23 cases we identified:

**FIGURE 3.9.1, Itemized Deduction Issues<sup>35</sup>**

Itemized Deduction	Number of Cases	Percentage of Cases
Casualty/Theft Loss	7	30
Miscellaneous Subject to 2% Limit (i.e., Tax Preparation Fees or Production of Income)	6	26
Medical and Dental Expenses	3	13
Interest	3	13
Miscellaneous Not Subject to the 2% Limit (i.e., Gambling)	3	13
Property Taxes	3	13

A common factor in many cases was the court's finding, in nine (39 percent) of the cases, that taxpayers failed to substantiate the itemized deductions claimed.<sup>36</sup>

Although the cases originated because of varied circumstances, the overwhelming majority began as examination cases.<sup>37</sup> Of the 23 cases we reviewed this year, seven began as field exam cases;<sup>38</sup> six began as correspondence exam cases;<sup>39</sup> and five began as office exam cases.<sup>40</sup>

### Medical or Dental Expense Deduction

A taxpayer may deduct the cost of medical care for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the human body.<sup>41</sup> Medical expenses are only deductible to the extent they exceed a statutorily determined percentage of the

33 Treas. Reg. § 1.67-1T; IRC § 212.

34 IRC § 213.

35 The aggregate percentages may not equal 100 percent because of rounding. Additionally, several cases we identified had more than one of the issues listed in Figure 3.9.1.

36 See, e.g., *Fiedziuszko v. Comm'r*, T.C. Memo. 2018-75 (Court disallowed medical and dental expense deduction under IRC § 213 because taxpayers failed to substantiate expenses paid for physician-ordered treatment).

37 TAS analysis of litigated cases indicated that 18 originated as a result of the Small Business Self-Employed Division examination, six – as a result of correspondence examination, five – as a result of an office audit, and seven – as a result of field examination. From the remaining cases, two resulted from an Automated Under Reporter (AUR) program assessment, one – from Automated Substitute for Return (ASFR) under IRC § 6020(b), one case resulted from a contested liability in a Collection Due Process proceeding, and the last case originated from a taxpayer refund claim suit filed in the U.S. Court of Federal Claims. TAS data pull from AIMS, Sept. 2, 2018. The AUR Program verifies a discrepancy between the taxpayer's tax return and an information return, or between a tax return and information otherwise in the IRS's possession. See IRM 4.19.3 (Aug. 31, 2018); Rev. Prov. 2005-32, 2005-23 I.R.B. 1206. The ASFR program allows the IRS to assess tax by obtaining delinquent returns or creating assessments based on reported income. See IRM 5.18.1 (Dec. 31, 2017); IRC § 6020(b). See also *Pryde v. U.S.*, 120 A.F.T.R.2d (RIA) 6843 (Fed. Cl. 2017); *Dykstra v. Comm'r*, T.C. Memo. 2017-156.

38 See also Most Serious Problem: *Field Examination: The IRS's Field Examination Program Burdens Taxpayers and Yields High No-Change Rates, Which Waste IRS Resources and May Discourage Voluntary Compliance*, *supra*.

39 See also Most Serious Problem: *The IRS's Correspondence Examination Procedures Burden Taxpayers and are Not Effective in Educating the Taxpayer and Promoting Future Voluntary Compliance*, *supra*.

40 See also Most Serious Problem: *Office Examination: The IRS Does Not Know Whether Its Office Examination Program Increases Voluntary Compliance or Educates the Audited Taxpayers About How to Comply in the Future*, *supra*.

41 IRC § 213(d)(1).

taxpayer's AGI. For example, a taxpayer who elects to itemize deductions for tax years 2017 and 2018 may deduct medical expenses to the extent his or her medical expenses exceed 7.5 percent of the AGI, regardless of age. For tax years after 2018, the floor will return to ten percent. Medical expenses are also only deductible if they are for the taxpayer, the taxpayer's spouse, or the taxpayer's dependent.

In *Morrissey v. United States*, a homosexual male taxpayer claimed a medical expense deduction for costs associated with the *in vitro* fertilization process.<sup>42</sup> Although the taxpayer conceded that he was medically fertile, he argued the costs were necessary because it is not physiologically possible for two men to reproduce. Most of the taxpayer's expenses were incurred to identify, compensate, and provide medical care for the women who served as an egg donor and gestational surrogate. The court disallowed the medical expense deduction, reasoning that the expenses related to the egg donor and gestational surrogate were not incurred for the purpose of affecting any function of the taxpayer's own body, and the egg donor and gestational surrogate were not the taxpayer's spouse or the taxpayer's dependent.<sup>43</sup> In coming to its conclusion, the United States Court of Appeals for the Eleventh Circuit relied on existing Tax Court precedent that has consistently rejected efforts by male taxpayers to deduct *in vitro* fertilization-related expenses paid to cover the medical care of unrelated female egg donors and gestational surrogates.<sup>44</sup>

### Casualty and Theft Loss Deduction

A taxpayer whose personal property is lost or damaged due to fire, storm, shipwreck, or other casualty, or from theft, may be entitled to an itemized deduction for the amount of the loss that is not reimbursed by insurance or otherwise.<sup>45</sup> The taxpayer may claim a casualty or theft loss deduction only if the loss amount exceeds \$100 and the amount of the net loss exceeds ten percent of the taxpayer's adjusted gross income.<sup>46</sup>

In *Kohn v. Commissioner*, married taxpayers claimed a casualty loss for alleged damage to their docks during a flood.<sup>47</sup> From April through October 1993, St. Charles County, the area where the taxpayers' docks were located, became a federally declared disaster area under the Disaster Relief and Emergency Assistance Act.<sup>48</sup> The taxpayers purchased the docks in February 1993, before the flood, and sold the docks in October 1993 for \$2,600 less than the purchase price. In calculating the amount of the casualty loss deduction, the Tax Court employed the fair market value calculation approach; the fair market value of the property immediately before the casualty less the fair market value of the property immediately after the casualty.<sup>49</sup> Because the resulting \$2,600 was less than ten percent of the taxpayers' adjusted gross income, the court disallowed the casualty loss deduction.

42 *Morrissey v. United States*, 871 F.3d 1260 (11th Cir. 2017).

43 *Id.* at 1267-1268.

44 See, e.g., *Magdalin v. Comm'r*, T.C. Memo. 2008-293, *aff'd*, 2009 WL 5557509 (1st Cir. 2009).

45 IRC §§ 165(a), 165(c)(3).

46 IRC § 165(h).

47 *Kohn v. Comm'r*, T.C. Memo. 2017-159.

48 Taxpayers elected to claim the casualty deduction for the year preceding the year of the flood. Under IRC § 165(i), any losses attributable to a federally declared disaster may be considered for the taxable year immediately preceding the taxable year in which the disaster occurred.

49 The amount of the deduction is the lesser of: (i) the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty; or (ii) the amount of the property's adjusted basis. Treas. Reg. § 1.165-7(b). See also *Helvering v. Owens*, 305 U.S. 468 (1939).

A deduction can include a loss based on theft that was not compensated for by insurance or otherwise.<sup>50</sup> A theft for purposes of the deduction includes any criminal appropriation of another's property to the use of the taker, including larceny, embezzlement, and robbery. The taxpayer bears the burden of proving both the occurrence of a theft and the amount of the loss.

*In re Nora* involved a homeowner who failed to make payments on her mortgage.<sup>51</sup> The mortgage company was successful in obtaining a judgment against the taxpayer, and the residence was sold at foreclosure.<sup>52</sup> The taxpayer was evicted sometime between August and November 2011, although the actual date of eviction could not be established. When the taxpayer arrived at her residence in November, she discovered the locks had been changed and her personal property had been removed and placed in storage. The taxpayer testified she made no attempts to retrieve the property, which included boxes of records, held in storage by the Sheriff's Department or at the storage company. In her 2012 tax return, the taxpayer claimed a casualty loss by theft, a Ponzi Scheme loss, and casualty loss of client files pursuant to IRC § 165.<sup>53</sup> However, she provided no documentary evidence to support deductions for the estimated 20 boxes of client records that had been destroyed or removed from her residence.

The Court found that the taxpayer failed to provide credible evidence to establish what was destroyed and its value in order to meet her burden to rebut the presumption of validity of the proof of claim.<sup>54</sup> Moreover, the court noted that the destroyed records were connected with her trade or business and the deduction for loss of property that arises from a casualty or theft applies only to property not connected with a trade or business.<sup>55</sup> Furthermore, the court noted that when property is taken under a lawful authorization, a taxpayer is not entitled to a theft loss deduction.<sup>56</sup> The United States Tax Court has specifically found that the value of personal property that is lost or damaged during a lawful eviction after foreclosure cannot be the basis of a casualty or loss-theft deduction.<sup>57</sup> Finally, the court noted that her claim for the theft of the business records as a business loss under IRC § 165(c)(1) was meritless.<sup>58</sup>

### Substantiation of Itemized Deductions

Taxpayers are required to substantiate expenses underlying each claimed deduction by maintaining records sufficient to establish the amount of the deduction and to enable the Commissioner to determine the correct tax liability.<sup>59</sup> Taxpayers were unable to substantiate their claimed itemized deduction in nine of the 23 cases we identified, or 39 percent of the cases.

In *Knowles v. Commissioner*, the Tax Court sustained the IRS's disallowance of a taxpayer's claimed deduction for real property taxes paid.<sup>60</sup> Although the taxpayer produced printouts from a county

50 IRC § 165(c)(3).

51 *In re Nora*, 581 B.R. 870 (D. Minn. 2018), *appeal dismissed*, 2018 WI 4520881 (D. Minn. 2018), *appeal docketed*, No. 18-3095 (8th Cir. Oct. 1, 2018).

52 *Id.*

53 The taxpayer is an attorney, who had stored client records in her basement. *Id.* at 873.

54 *Id.* at 879-80.

55 *Id.* at 880. See also IRC §165(c)3).

56 *Id.* at 880-81.

57 *Washington v. Commissioner*, T.C. Memo. 1990-386, *aff'd*, 930 F.2d 919 (6th Cir. 1991) (finding that when taxpayers were evicted pursuant to a court order there was no theft because the mortgage holder "proceeded under a lawful authorization or a least the color of legal authority," and had no criminal intent").

58 *In re Nora* at 882.

59 IRC § 6001; *Higbee v. Comm'r*, 116 T.C. 438 (2001).

60 *Knowles v. Comm'r*, T.C. Memo. 2017-152.

website showing property taxes due, she provided no evidence that she paid those taxes. In general, a taxpayer can substantiate itemized deductions with documentary evidence such as receipts, cancelled checks, bills, or account statements.<sup>61</sup>

Substantiation is also important for the gambling loss deduction. A taxpayer who is not in the trade or business of gambling can deduct gambling losses as an itemized deduction, but only to the extent of gambling winnings.<sup>62</sup>

In *Boneparte v. Commissioner*, the Tax Court found that a taxpayer was not in the trade or business of gambling.<sup>63</sup> The court cited the following factors in its analysis: the taxpayer did not keep any records other than the win/loss statements provided by casinos, which generally provided only the aggregate amount won or lost during the year; he gambled only in his spare time while holding a full-time job; he had a history of gambling losses and did not earn even sporadic profits; and his gambling involved elements of personal pleasure and recreation. The Tax Court then used the taxpayer's casino win/loss statements to reconstruct his taxable gambling income. Since his gain was \$18,000, the taxpayer was allowed an itemized deduction of \$18,000.

Certain deductions are subject to stricter substantiation requirements. For example, a taxpayer claiming the medical expense deduction must be able to produce the name and address of each person to whom expenses for medical care were paid and the date of each payment.<sup>64</sup> The IRS may also request a statement or itemized invoice from the payee showing what kind of treatment was provided and to whom.<sup>65</sup>

In *Fiedziuszko v. Commissioner*, the Tax Court held that married taxpayers failed to substantiate the cost of their physician-ordered weight loss program.<sup>66</sup> At trial, Mr. Fiedziuszko prepared a statement with a list of dates and amounts they paid for the weight-loss program. The taxpayers also provided to the IRS a printout from the website of their healthcare provider, Palo Alto Medical Foundation, containing information about its weight-loss services. The Tax Court held that the Fiedziuszkos did not adequately substantiate their medical expenses because they failed to provide an itemized statement from the payee, Palo Alto Medical Foundation, with corroborating documentation of the claimed medical payments as required under the medical expense deduction regulations.<sup>67</sup>

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61 See *Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930); Treas. Reg. § 1.274-5T(b). See also IRS, Burden of Proof, <https://www.irs.gov/businesses/small-businesses-self-employed/burden-of-proof> (last visited Sept. 9, 2018) (describing the requirement to substantiate certain elements of expenses in order to shift the burden of proof according to IRC § 7491); see also IRS Publication 583, *Starting a Business and Keeping Records* (January 2015), for detailed recordkeeping guidance for taxpayers.

62 IRC § 165(d).

63 *Boneparte v. Comm'r*, T.C. Memo. 2017-193, *appeal docketed*, No. 18-2264 (3d Cir. June 8, 2018).

64 Treas. Reg. § 1.213-1(h).

65 *Id.*

66 *Fiedziuszko v. Comm'r*, T.C. Memo. 2018-75. The IRS considers obesity a disease for purposes of the medical expense deduction. See also Rev. Rul. 2002-19.

67 See Treas. Reg. § 1.213-1(h).

## CONCLUSION

The IRS Statistics of Income data show that 29.6 percent of individual return filers chose to itemize their deductions in tax year 2015.<sup>68</sup> We anticipate this number will decrease beginning in tax year 2018 because recent tax law changes increased the standard deduction and placed limitations on or entirely repealed many itemized deductions.

In the nine cases we reviewed this year in which taxpayers were unable to provide the necessary documentation to support their deductions, the courts identified the lack of documentation and preparation as the reason they ruled against the taxpayers.

The IRS should continue improving its means of communicating with and educating taxpayers about deductibility issues, including recordkeeping requirements. Proactive education and outreach will also promote taxpayers' *rights to be informed* and *to challenge the IRS's position and be heard*. By doing so, the IRS will encourage taxpayers to comply with their tax obligations and minimize the risk of litigation.

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68 IRS, *SOI Tax Stats—Individual Income Tax Returns Publication 1304*, “Table 1.2: All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items” (June 21, 2018), <https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-returns-publication-1304-complete-report>.

## MLI #10 Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions

### SUMMARY

From June 1, 2017, through May 31, 2018, the federal courts issued decisions in at least 19 cases involving the Internal Revenue Code (IRC) § 6673 “frivolous issues” penalty, and in at least three cases involving analogous penalties at the appellate level. These penalties are imposed for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal.<sup>1</sup> In many of the cases we reviewed, taxpayers escaped liability for the penalty but were warned they could face sanctions for similar conduct in the future.<sup>2</sup> Nonetheless, we included these cases in our analysis to illustrate what conduct will and will not be tolerated by the courts.

### TAXPAYER RIGHT IMPACTED<sup>3</sup>

- *The Right to Appeal an IRS Decision in an Independent Forum*

### PRESENT LAW

The U.S. Tax Court is authorized to impose a penalty against a taxpayer if the taxpayer institutes or maintains a proceeding primarily for delay, takes a frivolous position in a proceeding, or unreasonably fails to pursue available administrative remedies.<sup>4</sup> The maximum penalty is \$25,000.<sup>5</sup> In some cases, the IRS requests that the Tax Court impose the penalty;<sup>6</sup> in other cases, the Tax Court exercises its discretion, *sua sponte*,<sup>7</sup> to consider whether the penalty is appropriate.

1 The Tax Court generally imposes the penalty under Internal Revenue Code (IRC) § 6673(a)(1). Other courts may impose the penalty under IRC § 6673(b)(1). U.S. Courts of Appeals are authorized to impose sanctions under IRC § 7482(c)(4), 28 U.S.C. § 1927, or Rule 38 of the Federal Rules of Appellate Procedure, although some appellate-level penalties may be imposed under other authorities.

2 See, e.g., *Fleming v. Comm’r*, T.C. Memo. 2017-120.

3 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).

4 IRC § 6673(a)(1)(A), (B), and (C). Likewise, the Tax Court is also authorized to impose a penalty against any person admitted to practice before the Tax Court for unreasonably and vexatiously multiplying the proceedings in any case. See IRC § 6673(a)(2). However, although we identified one case under this authority, we do not discuss it here as it is outside the scope of this most litigated issue. See *MacPherson v. Comm’r*, 702 Fed. App’x 621 (9th Cir. 2017), *aff’g* *May v. Comm’r*, T.C. Memo. 2016-43.

5 IRC § 6673(a)(1).

6 The standards for the IRS’s decision to seek sanctions under IRC § 6673(a)(1) are found in the Chief Counsel Directives Manual. See CCDM 35.10.2 (Aug. 11, 2004). For sanctions of any attorney or other person authorized to practice before the Tax Court, under IRC § 6673(a)(2), all requests for sanctions are reviewed by the designated agency sanctions officer (currently the Associate Chief Counsel (Procedure & Administration)). This review ensures uniformity on a national basis. See, e.g., CCDM 35.10.2.2.3 (Aug. 11, 2004).

7 “*Sua sponte*” means without prompting or suggestion; on its own motion. BLACK’S LAW DICTIONARY (10th ed. 2014). Thus, for conduct that it finds particularly offensive, the Tax Court can choose to impose a penalty under IRC § 6673 even if the IRS has not requested the penalty. See, e.g., *Williams v. Comm’r*, T.C. Memo. 2018-50, *appeal docketed*, No. 18-60536 (5th Cir. Aug. 1, 2018).



Taxpayers who institute actions under IRC § 7433<sup>8</sup> for certain unauthorized collection actions can be subject to a maximum penalty of \$10,000 if the court determines the taxpayer's position in the proceedings is frivolous or groundless.<sup>9</sup> In addition, IRC § 7482(c)(4),<sup>10</sup> §§ 1912 and 1927 of Title 28 of the U.S. Code,<sup>11</sup> and Rule 38 of the Federal Rules of Appellate Procedure<sup>12</sup> (among other laws and rules of procedure) authorize federal courts to impose penalties against taxpayers or their representatives for raising frivolous arguments or using litigation tactics primarily to delay the collection process. Because the sources of authority for imposing appellate-level sanctions are numerous and some of these sanctions may be imposed in non-tax cases, this report focuses primarily on the IRC § 6673 penalty.

Although outside of our reporting period, we note the recent Tax Court decision in the case of *Williams v. Commissioner*.<sup>13</sup> In *Williams*, the Tax Court considered whether IRC § 6751(b)(1) constrained the ability of the Tax Court to impose a penalty under IRC § 6673(a)(1). Section 6751(b)(1) generally prohibits the imposition of a penalty unless the penalty is approved, in writing, by the supervisor of the employee imposing the penalty or other higher level designee of the Secretary of Treasury.<sup>14</sup> Section 6673(a)(1) gives the authority to impose the penalty solely to the Tax Court, and permits the Tax Court to impose it either at the request of the Commissioner or *sua sponte* (of its own accord). The Tax Court looked to the legislative history of § 6751(b)(1) and § 6673(a)(1) to determine whether the two sections can coexist or whether § 6751(b)(1) supersedes § 6673(a)(1). The Tax Court found that the legislative intent behind § 6751(b)(1) was to prevent the IRS from using the threat of a penalty as a bargaining chip when negotiating with taxpayers, whereas the intent of § 6673(a)(1) was to dissuade taxpayers from wasting judicial resources. Because the Tax Court is not mentioned in § 6751(b)(1) or its legislative history, the Tax Court held that § 6751(b)(1) does not apply when it imposes a penalty pursuant to § 6673(a)(1).

## ANALYSIS OF LITIGATED CASES

We analyzed 19 opinions issued between June 1, 2017, and May 31, 2018, in which courts addressed the IRC § 6673 penalty. Eleven of these opinions were issued by the Tax Court and eight were issued by U.S. Courts of Appeals in cases brought by taxpayers seeking review of the Tax Court's imposition of the

8 IRC § 7433(a) allows a taxpayer a civil cause of action against the United States if an IRS employee intentionally or recklessly, or by reason of negligence, disregards any IRC provision or Treasury regulation in connection with collecting the taxpayer's federal tax liability.

9 IRC § 6673(b)(1).

10 IRC § 7482(c)(4) provides that the United States Courts of Appeals and the Supreme Court have the authority to impose a penalty in any case where the Tax Court's decision is affirmed and the appeal was instituted or maintained primarily for delay or the taxpayer's position in the appeal was frivolous or groundless.

11 28 U.S.C. § 1912 provides that when the Supreme Court or a United States Court of Appeals affirms a judgment, the court has the discretion to award to the prevailing party just damages for the delay, and single or double costs. 28 U.S.C. § 1927 authorizes federal courts to sanction an attorney or any other person admitted to practice before any court of the United States or any territory thereof for unreasonably and vexatiously multiplying proceedings; such person may be required to personally pay the excess costs, expenses, and attorneys' fees reasonably incurred because of his or her conduct.

12 Federal Rule of Appellate Procedure 38 provides that if a United States Court of Appeals determines an appeal is frivolous, the court may award damages and single or double costs to the appellee.

13 151 T.C. No. 1 (2018). This case will appear in the 2019 Most Litigated Issues section if Frivolous Issues is again a top ten issue, as the Tax Court imposed a penalty under § 6673(a)(1) for making frivolous arguments.

14 IRC § 6751(b)(2) provides an exception for additions to tax imposed under §§ 6651, 6654, or 6655. Or any other penalty automatically calculated through electronic means.

penalty. The Courts of Appeals sustained the Tax Court's position in all eight cases. Three decisions were issued by other courts on analogous penalties.<sup>15</sup>

In five cases, the Tax Court imposed penalties under IRC § 6673, with the amounts ranging from \$1,000 to \$10,000. In three cases, taxpayers prevailed when the IRS asked the court to impose a penalty. In most of these cases, the court warned the taxpayers not to bring similar arguments in the future.<sup>16</sup> All taxpayers appeared *pro se* (represented themselves) before the Tax Court, while one taxpayer was represented at the appellate level.<sup>17</sup> The taxpayers presented a wide variety of arguments that the courts have generally rejected on numerous occasions. Upon encountering these arguments, the courts almost invariably cited the language set forth in *Crain v. Commissioner*:

We perceive no need to refute these arguments with somber reasoning and copious citation of precedent; to do so might suggest that these arguments have some colorable merit. The constitutionality of our income tax system — including the role played within that system by the Internal Revenue Service and the Tax Court — has long been established.<sup>18</sup>

In the cases we reviewed, taxpayers raised the following issues that the courts deemed frivolous. Consequently, the taxpayers were subject to a penalty under IRC § 6673(a)(1) or other appellate level sanctions (or, in some cases, the court warned that such arguments were frivolous and could lead to a penalty in the future if the taxpayers maintained the same positions):

- **Taxes and procedures to collect taxes are unconstitutional:** We identified two cases this year where taxpayers made arguments that taxes or how they are collected are unconstitutional.<sup>19</sup> The taxpayer in *Schneider v. Commissioner* advanced common arguments regarding the constitutionality of the income tax and procedures to collect it, including that the income tax is an unconstitutional direct tax. The Court of Appeals for the Eighth Circuit affirmed the Tax Court's imposition of the IRC § 6673 penalty, and also imposed appellate level sanctions. In *Gardner v. Commissioner*, the taxpayer argued that the courts and the Commissioner of the IRS conspired to deny her First Amendment rights to free speech and freedom of religion.<sup>20</sup> In imposing a penalty of \$10,000, the Tax Court warned the taxpayer that if she continued to engage in similar tactics in the future, she would face a much larger penalty.
- **Taxpayers are not United States persons, they are exempt from the income tax, or wages are not income:** Taxpayers in at least five cases presented arguments that they are not United States persons subject to tax, they are exempt from tax for various reasons, or that wage income

15 We identified one decision in which the Court of Appeals addressed both the Tax Court's imposition of the IRC § 6673 penalty and an analogous appellate level penalty. *Schneider v. Comm'r*, 697 F. App'x 474 (8th Cir. 2017) (affirming a § 6673 penalty of \$2,500 and imposing an additional \$5,000 penalty). For purposes of the total number of cases reviewed for this report, we counted this case once. We reviewed a total of 21 cases for this reporting cycle.

16 See, e.g., *Lorusso v. Comm'r*, T.C. Memo. 2018-3. In declining to impose a penalty, the Tax Court noted that although the taxpayer had a history of litigation, the Tax Court had declined to warn the taxpayer in the past.

17 *Best v. Comm'r*, 702 F. App'x 615 (9th Cir. 2017), *aff'g* T.C. Memo. 2014-72, *reh'g, en banc, denied*, 2018 U.S. App. LEXIS 3452 (9th Cir., Feb. 14, 2018), *cert. denied*, 138 S. Ct. 2691 (June 25, 2018).

18 *Crain v. Comm'r*, 737 F.2d 1417, 1417-18 (5th Cir. 1984). See, e.g., *Jagos v. Comm'r*, T.C. Memo. 2017-202.

19 See *Schneider v. Comm'r*, 697 F. App'x 474 (8th Cir. 2017), *aff'g* No. 017566-14 (T.C. Sept. 1, 2016) and No. 029122-14 (T.C. Aug. 24, 2016), *cert. and reh'g denied*, 138 S. Ct. 1708 (2018); *Gardner v. Comm'r*, T.C. Memo. 2017-107.

20 See *Gardner v. Comm'r*, T.C. Memo. 2017-107. The taxpayers in this case were tax shelter promoters and the taxpayer wife argued that she could not receive income because she had taken a vow of poverty.

is not taxable.<sup>21</sup> In *Jagos v. Commissioner*, a taxpayer argued that only federal employees must pay income tax.<sup>22</sup> The court imposed a penalty of \$1,500.

## CONCLUSION

Taxpayers in the cases analyzed this year presented the same arguments raised and repeated year after year, which the courts routinely and universally reject.<sup>23</sup> Taxpayers avoided the IRC § 6673 penalty in only three cases where the IRS requested it. In these cases, the courts often warned the taxpayers not to bring similar arguments in the future, demonstrating the willingness of the courts to penalize taxpayers when they offer frivolous arguments or institute a case merely for delay. Where the IRS has not requested the penalty, the court may nonetheless raise the issue *sua sponte*, and in all cases identified either imposed the penalty or cautioned the taxpayer that similar future behavior will result in a penalty.<sup>24</sup>

As indicated in Appendix 3, Table 10, the penalty amount varies, regardless of the type of frivolous argument being raised. The Tax Court has indicated, however, that it can be lenient when it is the taxpayer's first court appearance.<sup>25</sup> Moreover, if the taxpayer has previously been sanctioned, the Tax Court may impose a higher penalty, but not necessarily close to the maximum.<sup>26</sup>

Finally, the U.S. Courts of Appeals have shown their willingness to uphold the penalties imposed by the Tax Court without fail in the cases analyzed for the period between June 1, 2017, and May 31, 2018, continuing a trend of upholding all penalties in cases we have analyzed since June 1, 2005.

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21 See, e.g., *Blair v. Comm'r*, T.C. Memo. 2017-153.

22 See *Jagos v. Comm'r*, T.C. Memo. 2017-202, *reh'g denied*, No. 18-1087 (6th Cir., Oct. 9, 2018).

23 See, e.g., National Taxpayer Advocate 2016 Annual Report to Congress 503-506.

24 See, e.g., *Zentmyer v. Comm'r*, T.C. Memo. 2017-197, *appeal docketed*, No. 18-72116 (9th Cir. July 26, 2018) (court raised the issue *sua sponte* and warned the taxpayer not to assert similar arguments in the future).

25 See, e.g., *Hawkbey v. Comm'r*, T.C. Memo. 2017-199.

26 See, e.g., *Fleming v. Comm'r*, T.C. Memo. 2017-155 (court imposed \$5,000 penalty after imposing \$1,500 in an earlier case).