LR #3 Allocate to the IRS the Burden of Proving it Properly Imposed the Two-Year Ban on Claiming the Earned Income Tax Credit

PROBLEM

Internal Revenue Code (IRC) § 32(k) authorizes the IRS to ban taxpayers from claiming the earned income tax credit (EITC) for two years if the IRS determines they claimed the credit improperly due to reckless or intentional disregard of rules and regulations. Neither section 32 nor its regulations define the terms "reckless or intentional disregard," nor is there any judicial interpretation of the provision. However, the requisite state of mind goes beyond mere negligence.[1] IRS Chief Counsel guidance provides that if the IRS disallowed the EITC because the taxpayer did not respond (or did not respond adequately) to a request for substantiation of claimed EITC, the ban should not be imposed.[2]

The IRS routinely imposes the ban on taxpayers with whom it had no interaction and where there was no occasion to ascertain anything about the taxpayer's state of mind. The IRS often ignores the statutory requirements for imposing the ban, contravenes its own Chief Counsel guidance, and bypasses its own procedural safeguards to impose the ban.[3] A taxpayer may petition the Tax Court for review of the IRS's determination to impose the two-year ban, but the taxpayer may have the burden of proving the IRS imposed the ban improperly.[4]

EXAMPLE

M and F, an unmarried couple, lived together with their two children, ages 8 and 10, for all of 2011. M earned $30,000 in 2011 and F earned $35,000, but they did not share bank accounts and neither parent knew how much the other parent made. In 2012, the couple separated and F moved out of the family home. The children then resided equally with M and F, living alternate weeks with each parent. For tax purposes, the children were the "qualifying children" of both M and F in 2011, but F had the higher adjusted gross income and under the tie-breaker rules was entitled to the dependency deductions and EITC.[5] However, F told M that M could claim tax benefits, so M filed a separate 2011 return on which she claimed dependency deductions and approximately $4,000 of EITC, reducing her tax liability to zero. Unknown to M, F also claimed dependency deductions and EITC with respect to the children on his separate return for 2011.

The IRS audited M's return and disallowed the dependency deductions and EITC. M did not respond to the IRS's requests for documentation or participate in the audit because she inquired and learned that she was not entitled to benefits she claimed. She could not demonstrate that her adjusted gross income

1 See below for a discussion of IRC § 6662 and related regulations that define and distinguish "negligence," from a "reckless disregard" or "intentional disregard."

2 IRS SCA 200245051 (Nov. 8, 2002).

3 Most Serious Problem: *EITC: The IRS Inappropriately Bans Many Taxpayers From Claiming EITC, supra*.

4 Tax Court Rule of Practice and Procedure, 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

5 The applicable "tie breaker" rule of IRC § 152(c)(4)(B)(ii) provides that where more than one parent claims a qualifying child and the parents do not file a joint return together, if the child resides with both parents for the same amount of time during such taxable year, the child is the qualifying child of the parent with the highest adjusted gross income.

exceeded F's. The IRS asserted an accuracy-related penalty under IRC § 6662.[6] The IRS also imposed the two-year ban on M, so M cannot claim EITC in 2013 or 2014, even if her adjusted gross income exceeds F's in those years and she would otherwise be entitled to claim the credit.[7]

The maximum EITC for two qualifying children in 2012 was $5,236, and $5,372 for 2013.[8] If M petitions the Tax Court for review, the IRS will have the burden of showing that M negligently claimed the disallowed tax benefits and is liable for the section 6662 penalty. However, M may have the burden of proving the IRS erred in imposing the two-year ban, which if left in place potentially deprives her of more than $10,000 in tax benefits. She may be in a position of attempting to prove a negative — that her improper claim of EITC was not due to reckless or intentional disregard of rules and regulations.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend IRC § 32(k) to provide that the IRS has the burden of proof as to whether it is appropriate to impose the two-year ban on claiming EITC.

CURRENT LAW

IRC § 32(k)(1)(B)(ii) disallows EITC claims for two taxable years if there has been a final determination that the taxpayer's claim of credit was due to "reckless or intentional disregard of rules and regulations."[9] There is no statutory, regulatory, or judicial interpretation of section 32(k)(1)(B)(ii), but section 6662(b)(1), which imposes an accuracy-related penalty on certain underpayments due to "negligence or disregard of rules or regulations," contains and defines the same terms, either in the statute or in the related regulations. Section 6662(c) provides that "negligence" includes "any failure to make a reasonable attempt to comply with any provision of this title." The regulations under section 6662 provide that "reckless disregard" means "the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe."[10] "Intentional disregard" exists "if the taxpayer knows of the rule or regulation that is disregarded."[11]

6 We note the dicta in *Rand v. Comm'r*, 141 T.C. No. 12, slip op. at 32 (Nov. 18, 2013), "it appears that Congress intended that the two-year bar be in lieu of any other monetary sanctions." Thus, while it is not clear that the Tax Court would sanction the imposition of the section 6662 penalty in addition to the two-year ban, the IRS is not explicitly prevented by statute from pursuing both.

7 F would also not be entitled to the credit under the tie-breaker rule of IRC § 152(c)(4)(A)(ii). IRC § 152(c)(4)(C), which permits another taxpayer to claim an individual as a qualifying child when the individual's parents may claim him or her but do not, does not apply. F and M's children would therefore not have the benefit of any EITC support.

8 EITC amounts for 2012 and 2013 are *available at* http://www.irs.gov/Individuals/Preview-of-2012-EITC-Income-Limits,-Maximum-Credit–Amounts-and-Tax-Law-Updates.

9 IRC § 32(k)(1)((B)(ii). IRC § 32(k) was enacted as part of the Tax Reform Act of 1997, Pub. L. No. 105-34, § 1085(a)(1), 111 Stat. 788, 956. IRC § 32(k(1)(B)(i) authorizes the IRS to impose a ten-year ban on taxpayers who fraudulently claim EITC, but the IRS imposes the ten-year ban infrequently (13 times, 27 times, and 17 times in 2009, 2010, and 2011 respectively). IRS Compliance Data Warehouse, *Individual Returns Transaction File* (Tax Years 2009, 2010, 2011).

10 Treas. Reg. § 1.6662-3(b)(2).

11 *Id*.

It is Not Clear Whether IRC § 7491 Shifts the Burden of Production to the IRS in Two-Year Ban Cases.

When the IRS audits a taxpayer's return and determines to disallow claimed EITC and impose the two-year ban, it issues a statutory notice of deficiency that includes notice of the IRS's determination to impose the ban.[12] The taxpayer may petition the Tax Court for review of the disallowed EITC as well as the determination to impose the ban.[13] Once in Tax Court, the taxpayer generally bears the burden of proof.[14] This "burden of proof" has two components. First, the taxpayer has the burden of coming forward with evidence (sometimes referred to as the burden of production). Second, the taxpayer must persuade the court that the evidence he or she submitted rises to the requisite level, such as the preponderance standard (sometimes referred to as the burden of persuasion).[15] Recognizing that "a taxpayer should not bear the burden of proving a negative (no unreported income) if the Commissioner can present no substantive evidence to support his deficiency claim," courts held that the burden of proof shifted to the IRS in some unreported income cases.[16] Consistent with this position, IRC § 7491, enacted as part of the IRS Restructuring and Reform Act of 1998, in subsection (b) shifts to the IRS the burden of proof in certain omitted income cases.[17] Additionally, subsection (c) of the statute shifts to the IRS the burden of production (and not the burden of persuasion) in penalty cases.[18] Thus, the IRS has the burden of producing evidence to show it properly imposed the IRC § 6662 accuracy-related penalty.

However, because the two-year ban on claiming EITC may not be a "penalty" for purposes of section 7491(c), it is not clear that the statute allocates to the IRS the burden of producing evidence that it was proper to impose the ban.[19] If section 7491(c) does not shift the burden to the IRS, the taxpayer contesting the ban will be required to produce evidence to prove a negative (that he or she did not claim the credit due to reckless or intentional disregard of rules and regulations), a requirement that is considered

12 The statutory notice of deficiency, authorized by IRC § 6212, informs the taxpayer of the additional amount of tax the IRS believes he or she owes and advises of the right to petition the Tax Court for review of that determination. IRM 4.19.14.6.1(6), (11) (Jan. 1, 2013); IRM 4.13.3.18 (Sept. 30, 2010).

13 *See, e.g., Garcia v. Comm'r*, T.C. Summ. Op. 2013-28 (Apr. 3, 2013) for the facts contained therein; under IRC § 7463(b), the opinion is not precedent for any other case.

14 Tax Court Rule of Practice and Procedure, 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

15 Bittker and Lokken, *Tax Court Trial Practice* (Revised), par. 115.4.2, Thomson Reuters Tax and Accounting (2013).

16 *See, e.g., Gatlin v. Comm'r*, 754 F.2d 921, 923 (11th Cir.1985) and cases cited therein.

17 IRC § 7491(b) provides "In the case of an individual taxpayer, the Secretary shall have the burden of proof in any court proceeding with respect to any item of income which was reconstructed by the Secretary solely through the use of statistical information on unrelated taxpayers." IRC § 6201(d) contains a similar provision: "In any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return filed with the Secretary under subpart B or C of part III of subchapter A of chapter 61 by a third party and the taxpayer has fully cooperated with the Secretary (including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer as reasonably requested by the Secretary), the Secretary shall have the burden of producing reasonable and probative information concerning such deficiency in addition to such information return." IRC § 7491(a) also shifts the burden of proof to the IRS if, in a court proceeding, the taxpayer "introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B." However, in order for this provision to apply, IRC § 7491(a)(2)(A) requires that the taxpayer "complied with the requirements under this title to substantiate any item," which may not be possible where EITC was properly disallowed (although the ban was improperly imposed).

18 Pub. L. No. 105-206 § 3001, adding IRC § 7491. Subsection (c) provides "[n]otwithstanding any other provision of this title, 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." Allocating the burden of production to the IRS means "the Commissioner must come forward with sufficient evidence indicating that it is appropriate to impose the relevant penalty." The burden of persuasion remains with the taxpayer, however, so that "once the Commissioner meets his burden of production, the taxpayer must come forward with evidence sufficient to persuade a Court that the Commissioner's determination is incorrect." *Higbee v. Comm'r*, 116 T.C. 438 at 446, 447 (2001).

19 As noted, IRC § 7491(c) shifts the burden for any "penalty, addition to tax, or additional amount imposed by this title" (i.e., Title 26). IRC § 32 is found in Title 26, in Subtitle A, Chapter 1. Title 26, Subtitle F, Chapter 68 is captioned "Additions to the Tax, Additional Amounts, and Assessable Penalties." *See also Rand v. Comm'r*, 141 T.C. No. 12, slip op. at 31-32 (Nov. 18, 2013), noting "[t]o the extent an erroneously claimed credit reduces a tax liability, it may be subject to an accuracy-related penalty under section 6662; to the extent that credit generates a refund, it may be subject to a penalty under section 6676" and "it appears that Congress intended that the two-year bar be in lieu of any other monetary sanctions."

unfair in certain unreported income cases.[20] Even if section 7491(c) does apply to two-year bans, the statute does not shift the burden of persuasion to the IRS, but only the burden of production. The IRS would have the burden of producing evidence to show it properly imposed the ban, but the taxpayer would bear the burden of persuading a court that the IRS's determination was incorrect. If the evidence on both sides were equal, the IRS would win.

Other Code Provisions and Tax Court Rules Shift the Burden of Proof to the IRS in Cases that May Be Analogous to Two-Year Ban Cases.

IRC § 7491 is not the only Code section that shifts the burden of proof to the IRS. For example, a taxpayer is generally entitled to innocent spouse relief under IRC § 6015(c) unless he or she had actual knowledge of an erroneous item allocable to the other spouse that gave rise to an understatement of tax on a joint return.[21] The IRS has the burden of proof with respect to such knowledge.[22] Another example is IRC § 7430, which provides for the award of reasonable costs for an administrative or court proceeding under certain circumstances when the taxpayer is the prevailing party. The taxpayer is not a "prevailing party" within the meaning of the statute if "the United States establishes that the position of the United States in the proceeding was substantially justified," and the government has the burden of proof to show its position was substantially justified.[23] Still other Code sections shift the burden of proof to the IRS with respect to various issues relating to a taxpayer's state of mind or the reasonableness of a position.[24] The Tax Court's Rules of Practice and Procedure reflect several statutory burden allocations in addition to containing other burden-shifting provisions not mandated by statute.[25]

REASONS FOR CHANGE

The two-year ban authorized by IRC § 32 is unique in its temporal reach. A taxpayer who is subject to the ban but otherwise eligible for EITC is foreclosed from claiming it for two years following an audit in which EITC was disallowed. For this vulnerable population of low-income taxpayers, inappropriately being deprived of the credit for two years is a serious burden that may be difficult to relieve. These taxpayers

20 IRC §§ 7491(c), 6201(d).

21 IRC § 6015(c) provides "allocation" relief for understatements of tax for spouses who request relief when they are divorced, separated, widowed, or not living together, by allocating the liability between the spouses. IRC § 6015(c)(3)(C) provides that relief is not available where the spouse requesting relief had actual knowledge of the item that gave rise to the deficiency.

22 Treas. Reg. 1.6015-3(c)(2)(i) provides, "If, under section 6015(c)(3)(C), the Secretary demonstrates that, at the time the return was signed, the requesting spouse had actual knowledge of an erroneous item that is allocable to the nonrequesting spouse, the election to allocate the deficiency attributable to that item is invalid, and the requesting spouse remains liable for the portion of the deficiency attributable to that item. The Service, having both the burden of production and the burden of persuasion, must establish, by a preponderance of the evidence, that the requesting spouse had actual knowledge of the erroneous item in order to invalidate the election."

23 IRC § 7430(c)(4)(B)(i); *Center for Family Medicine v. U.S.*, 614 F.3d 937 (8th Cir. 2010). *See* H.R. Rep. 104-506 sec. 701(b) Burden of Proof on United States, accompanying Pub. L. No. 104-168, Taxpayer Bill of Rights 2, adding IRC § 7430(c). *See also* Joint Committee Print, Joint Committee on Taxation JCX -7-96, *Description of Amendment in the Nature of a Substitute to H.R. 2337 'Taxpayer Bill of Rights 2' Scheduled for Markup by the House Committee on Ways and Means on March 21,1996* (Mar. 20, 1996) explaining "The proposal would provide that, once a taxpayer substantially prevails over the IRS in a tax dispute, the IRS has the burden of proof to establish that it was substantially justified in maintaining its position against the taxpayer. This would switch the current procedure, which places the burden of proof on the taxpayer to establish that the IRS was not substantially justified in maintaining its position. Therefore, the successful taxpayer would receive an award of attorney's fees unless the IRS satisfies its burden of proof."

24 *See, e.g.*, I.R.C. § 7454(a) (providing "[i]n any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary."); IRC.§ 7429(g)(1)(in a judicial proceeding the IRS has the burden of proof as to whether certain levies, jeopardy assessments, or termination assessments were reasonable).

25 *See, e.g.*, Tax Court Rule of Practice and Procedure 142(b) (allocating to the IRS the burden of proof as to fraud and requiring a "clear and convincing" level of evidence); Rule 142(d) (allocating to the IRS the burden of proof as to transferee liability); Rule 232(e) (allocating to the IRS the burden of proof as set forth in IRC § 7430, including IRC § 7430(c)(4)(B). For circumstances in which the Tax Court places the burden of proof on the IRS other than in situations covered by statute, see Rule 142(a) (allocating the burden of proof to the IRS as to new matters not included in a notice of deficiency, increases in the asserted deficiency, and affirmative defenses).

may be intimidated and fearful of protesting the IRS's treatment of them. They may not understand they have been wronged when the IRS imposes the ban without following the statutory requirements, and consequently they may not seek assistance they need, such as from Low Income Taxpayer Clinics. The disallowance of the EITC in the audit year may also trigger other penalties, but the amount of foregone EITC in the later two years may far exceed those other penalties. Yet while it is clear that the IRS has the burden of production with respect to penalties, it is not clear whether the IRS has any burden of proof as to the two-year ban.

Actual experience with the two-year ban has demonstrated that the IRS imposes it inappropriately. Routinely and automatically, the IRS imposes the ban in cases where it has not interacted with the taxpayer and therefore no basis on which it could "determine," as the statute requires, that the taxpayer acted with "reckless or intentional disregard of rules and regulations." Clarifying that the IRS has the burden of proof in two-year ban cases is a logical remedial step.

EXPLANATION OF PROVISION

The proposal would amend IRC § 32(k) to clarify that the IRS has the burden of proof when proposing to impose the two-year ban on claiming EITC. Consequently, the IRS would be required to produce evidence of the taxpayer's reckless or intentional disregard of rules and regulations and persuade the court that imposition of the ban would be appropriate.