

#46 REPEAL FLORA: GIVE TAXPAYERS WHO CANNOT PAY THE SAME ACCESS TO JUDICIAL REVIEW AS THOSE WHO CAN

Present Law

Internal Revenue Code (IRC) § 6212 requires the IRS to issue a “notice of deficiency” before assessing certain liabilities. When the IRS issues a notice of deficiency, IRC § 6213 authorizes the taxpayer to petition the U.S. Tax Court within 90 days (or 150 days if the notice is addressed to a person outside the U.S.) to review the IRS determination.

IRC §§ 6201 and 6671(a) authorize the IRS to assess other liabilities, including so-called “assessable” penalties (*e.g.*, penalties codified in IRC §§ 6671-6725), without first issuing a notice of deficiency. Assessable penalties are not computed by reference to a tax deficiency. For example, penalties under IRC §§ 6721 and 6707 for failure to file various information returns are assessable penalties. A taxpayer generally may not obtain judicial review of assessable penalties in the Tax Court.

A taxpayer may sue in a U.S. District Court or the U.S. Court of Federal Claims under 28 U.S.C. § 1346(a)(1) to recover “any sum” that the taxpayer believes has been erroneously assessed or collected. In *Flora v. United States*, 362 U.S. 145 (1960), however, the U.S. Supreme Court held that, with limited exceptions, a taxpayer must have “fully paid” the assessment (called the “full payment rule”) before suing in these courts. In contrast, IRC § 7422(j) provides that the U.S. District Courts and the U.S. Court of Federal Claims “shall not fail to have jurisdiction” to determine the “estate tax liability of such estate (or for any refund with respect thereto) solely because the full amount of such liability has not been paid by reason of an election under section 6166” to pay the liability in installments.

Under IRC § 7422(a) the taxpayer must make a timely administrative claim for refund before filing suit. Assuming the claim is timely, IRC § 6511(b)(2) generally limits a taxpayer’s recovery to amounts paid within two years (or, in some cases, within three years plus any extension of time to file) before the date of the claim.¹⁷²

Under IRC §§ 6330 and 6320, the Tax Court may review an assessed liability if the IRS issues levies or liens to collect an assessment and the taxpayer requests a Collection Due Process (CDP) hearing. However, IRC §§ 6330(c)(2)(B), 6320(c), and Treas. Reg. §§ 301.6320-1(e)(3)A-E2 and 301.6330-1(e)(3)A-E2, provide that the Tax Court may do so only if the taxpayer did not receive a notice of deficiency and did not have an opportunity to raise the dispute in an administrative appeal. In practice, the IRS generally provides an opportunity for an administrative appeal.

Under 11 U.S.C. § 505(a)(1), a bankruptcy court “may” review a tax dispute, but it generally will not do so unless resolution of the dispute would benefit the taxpayer’s other creditors.

Under IRC § 7803(a)(3), the Commissioner is required to ensure that IRS employees act in accord with certain rights (known as the “Taxpayer Bill of Rights”), including the *right to appeal an IRS decision in an independent forum*.

¹⁷² To be timely, IRC § 6511(a) generally requires that an administrative claim must be filed within the later of (i) three years from the date the original return was filed or (ii) two years from the date the tax was paid. If the claim is filed within the three-year period, then IRC § 6511(b)(2)(A) provides that the taxpayer can only recover amounts paid within three years, plus any extension of time to file, before the date of the claim. Otherwise, IRC § 6511(b)(2)(B) provides that the taxpayer can only recover amounts paid within two years before the date of the claim.

Reasons for Change

Consistent with the Taxpayer Bill of Rights, all taxpayers should have an opportunity to obtain judicial review of adverse IRS determinations. Moreover, taxpayers who cannot pay what the IRS says they owe in order to challenge an adverse determination should have the same opportunities as wealthier taxpayers who can pay.

Under current law, there are circumstances in which taxpayers do not have a right to judicial review. Significantly, assessable penalties are not subject to judicial review unless the taxpayer is wealthy enough to fully pay.

Even taxpayers who fully pay may lose the opportunity to recover a portion of their payments if they pay in installments. Payments made more than two years before a taxpayer fully pays and files a refund claim generally cannot be recovered. Thus, a taxpayer who is not affluent enough to pay his or her alleged debt within two years will lose the right to request a refund of the early payments, even if he or she eventually pays in full and the court agrees with him or her on the merits of the refund claim.

Even when the IRS sends a notice of deficiency to low-income taxpayers, they may not have a realistic opportunity for judicial review. A TAS study found that when the IRS sent an audit notice to those claiming the Earned Income Tax Credit (EITC), a refundable tax credit for the working poor, almost 40 percent did not understand what the IRS was questioning, and only about half of the respondents felt that they knew what they needed to do. Thus, many are also unlikely to understand whether and how to timely petition the Tax Court.

Although the Supreme Court once feared that giving the relatively few wealthy persons who were subject to tax the option to litigate rather than pay could threaten the solvency of the government, the U.S. tax base is much broader today, and as a result, whether judicial review occurs before or after payment in individual cases is not nearly as important to the government as it once was. Moreover, since the *Flora* case was decided in 1960, the problems created by the full payment rule have grown. In 1960, there were only four assessable penalties. Today, there are more than 50. Thus, the IRS's authority to assess penalties that cannot be reviewed has increased. In addition, the EITC was not enacted until 1975. It brought the working poor into the tax system by giving them tax benefits. Thus, the full payment rule increasingly erodes the *right to appeal an IRS decision in an independent forum* for tens of millions who were not a part of the tax system in 1960.

The National Taxpayer Advocate recommends that Congress provide all taxpayers with a realistic opportunity to obtain judicial review of adverse IRS determinations without regard to their ability to pay.

Recommendations¹⁷³

While a simple solution might be to repeal the full payment rule, Congress should also consider one or more of the following options:¹⁷⁴

- Amend 28 U.S.C. § 1346(a)(1) to clarify that the full payment rule only applies in cases where the taxpayer has received a notice of deficiency.
- Treat a taxpayer as having fully paid a disputed amount for purposes of the full payment rule when the taxpayer has paid some of it (including by refund offset) and either (a) the IRS has classified the

173 For more detail, see National Taxpayer Advocate 2018 Annual Report to Congress 364 (Legislative Recommendation: *Fix the Flora Rule: Give Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can*).

174 The doctrines of *res judicata* and *collateral estoppel* should help ensure the IRS does not re-litigate the same issues with respect to unpaid liabilities. See, e.g., CCDM 34.5.1.1.2.2.4 (Aug. 11, 2004).

account as currently not collectible due to economic hardship or (b) the taxpayer has entered into an agreement to pay the liability in installments.¹⁷⁵

- Authorize the U.S. Tax Court to review liabilities where the taxpayer has not received a deficiency notice (*e.g.*, assessable penalties) in a manner that parallels the deficiency process. Alternatively, expand the Tax Court's jurisdiction to review these liabilities in connection with CDP appeals, even if the taxpayer has had an opportunity for an *administrative* appeal.

¹⁷⁵ As noted above, a similar rule applies to estates that elect to pay in installments. See IRC § 7422(j).