MOST LITIGATED ISSUES: Introduction

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(XI) 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).[1] 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, 2018, through May 31, 2019, 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.[2] This year's Most Litigated Issues are, in order from most to least cases:

1. Trade or Business Expenses (IRC § 162(a) and related Code sections);
2. Collection Due Process (CDP) hearings (IRC §§ 6320 and 6330);
3. Accuracy-Related Penalty (IRC § 6662(b)(1) and (2));[3]
4. Gross Income (IRC § 61 and related Code sections);
5. Summons Enforcement (IRC §§ 7602(a), 7604(a), and 7609(a));
6. Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax (IRC § 7403);
7. 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);
8. Schedule A Deductions (IRC §§ 211-224);
9. Charitable Contribution Deductions (IRC § 170); and
10. Frivolous Issues Penalty (IRC § 6673 and related appellate-level sanctions).

Overall, the total number of cases identified in the Most Litigated Issues section decreased again this year, from 623 in 2018 to 524 this year, a 16 percent decrease from last year.[4] Seven of the ten categories decreased in number of cases litigated this year. Accuracy-related penalties saw the greatest decrease since last year, dropping from 120 cases to 79 cases we identified this year (a 34 percent decrease). CDP, Liens, and Schedule A cases saw increases, with Schedule A seeing the biggest proportional increase from 23 to 32 cases (39 percent), and the Liens category seeing the biggest increase in cases, from 39 cases in 2018 to 52 cases this year (33 percent increase). Overall, taxpayers prevailed in full or in part in 86 cases (about 16 percent), a slight decrease from 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 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 2018 Annual Report to Congress 426. This decline may be attributed to the general decline in tax litigation in recent years. *See, e.g.*, David McAffee, 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).

TAS analyzed each of the Most Litigated Issues, specifically a summary of findings, taxpayer rights impacted, description of present law, analysis of the litigated cases, and conclusion.[5] Each case is listed in Appendix 5, which categorizes the cases by type of taxpayer (*e.g.*, individual or business).[6] Appendix 5 also provides the citation for each case, indicates whether the taxpayer was represented at trial or argued the case *pro se*, and lists the court's decision.[7]

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 generally used the same reporting period, beginning on June 1, 2018, and ending on May 31, 2019, that we used for the ten Most Litigated Issues; however, we also included one significant case decided outside of the reporting period.

AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

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

- U.S. Tax Court;
- U.S. District Courts;
- U.S. Court of Federal Claims; and
- U.S. Bankruptcy Courts.

With limited exceptions, taxpayers have an automatic right of appeal from the decisions of any of these courts.[8]

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.[9]

The U.S. District Courts and the U.S. Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in full[10] and (2) the taxpayer has filed an

5 *See* Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR that was proposed by the National Taxpayer Advocate and adopted by the IRS are now codified in the IRC. *See* IRC § 7803(a)(3).

6 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.

7 "*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.

8 *See* IRC § 7482, which provides that the U.S. Courts of Appeals (other than the U.S. Court of Appeals for the Federal Circuit) have jurisdiction to review the decisions of the U.S. 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 U.S. District Court are sent to the appropriate U.S. Court of Appeals); 28 U.S.C. § 1295 (appeals from the U.S. Court of Federal Claims are heard in the U.S. Court of Appeals for the Federal Circuit); 28 U.S.C. § 1254 (appeals from the U.S. Courts of Appeals may be reviewed by the U.S. Supreme Court).

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

10 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). *See* National Taxpayer Advocate 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 82-84 (*Repeal Flora: Give Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can*).

administrative claim for refund.[11] The U.S. District Courts, along with the bankruptcy courts in very limited circumstances, provide the only fora in which a taxpayer can receive a jury trial.[12] Bankruptcy courts can adjudicate tax matters that were not adjudicated prior to the initiation of a bankruptcy case.[13]

ANALYSIS OF *PRO SE* LITIGATION

As in previous years, many taxpayers appeared before the courts *pro se*. Figure 2.0.1 shows that taxpayers assisted by a representative achieved better outcomes than *pro se* taxpayers who represented themselves. *Pro se* taxpayers prevailed in full or in part in only 26 cases (five percent), and in five of the ten categories, the only taxpayers that achieved a favorable outcome were represented.

FIGURE 2.0.1, Outcomes for *Pro Se* and Represented Taxpayers

	Pro Se Taxpayers			Represented Taxpayers		
Most Litigated Issue	Total Cases	Taxpayer Prevailed in Full or in Part	Percent	Total Cases	Taxpayer Prevailed in Full or in Part	Percent
Trade or Business Expenses	35	6	17%	47	15	32%
Collection Due Process	25	4	16%	55	2	4%
Accuracy-Related Penalty	37	12	32%	42	15	36%
Gross Income	35	0	0%	37	12	32%
Summons Enforcement	37	0	0%	22	4	18%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	23	0	0%	29	4	14%
Failure to File, Failure to Pay, and Estimated Tax Penalties	19	0	0%	15	2	13%
Schedule A Deductions	16	1	6%	16	2	13%
Charitable Deductions	7	0	0%	10	4	40%
Frivolous Issues	13	3	23%	3	0	0%
Total	**247**	**26**	**11%**	**276**	**60**	**22%**

11 IRC § 7422(a).

12 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).

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

ANALYSIS OF UNPUBLISHED OPINIONS

For the third year, we reviewed Tax Court summary judgments and bench orders, both of which are unpublished.[14] 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.

We identified 63 bench orders and 181 summary judgments[15] by searching the Tax Court orders on its web site.[16] We listed the bench orders and summary judgments in tables, Appendix 5, Tables 11 and 12. 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.[17] The most prevalent issues discussed in the bench orders reviewed were trade or business expense deductions (17 of 63 or about 27 percent), CDP (13 of 63 or about 21 percent), and gross income (11 of 63 or about 17 percent).[18]

Eighty-five percent (991 of 1,172) of summary judgments we reviewed were procedural and did not discuss a substantive tax law issue, leaving 181 substantive decisions. CDP matters dominated this category of unpublished tax court litigation by far, comprising about 70 percent (127 of 181) of the remaining substantial, non-procedural summary judgments. The second largest category was gross income issues which made up about eight percent (15 of 181) of summary judgments.

Overall, the IRS prevailed in about 90 percent of motions for summary judgment (162 of 181) and in about 68 percent of bench orders (43 of 63). About two percent (three of 181) of summary judgment orders and about 25 percent (16 of 63) of bench orders resulted in split decisions. Taxpayers were least successful in bench order outcomes, with about six percent (four of 63) of taxpayers prevailing; whereas 16 of 181 taxpayers prevailed in summary judgments (about nine percent). Taxpayers appeared *pro se* in 46 of the 63 bench orders (73 percent) and were represented by counsel in only 17 of the 63 (about 27 percent). Of the total of 181 summary judgment orders, 126 (70 percent) taxpayers appeared *pro se*.[19]

14 In prior years our review of litigation in federal courts was generally limited to discussing U.S. 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* IRC § 7463(b); Unites States Tax Court Rules of Practice and Procedure, Rule 50(f), (denying precedential status to orders) and Rule 152(c) (denying precedential status to bench opinions).

15 Unlike bench orders, summary judgments are decisions without trial. United States 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 as a Most Litigated Issue.

16 We utilized the orders search tab on the U.S. Tax Court website, applying the reporting period date restriction and key search phrases: "summary judgment" and "7459(b)" and "152(b)." We did not analyze summary judgments and bench orders in other federal courts. There are thousands of documents to be reviewed in other federal courts to determine whether the cases were decided on the merits of a particular litigated issue. *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).

17 Under Tax Court 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* United States Tax Court Rules of Practice and Procedure, Rule 121(d). We included summary judgments entered upon default in situations where the order discussed the merits.

18 Since many of the bench orders involve multiple issues, the percentages do not add up to 100 percent.

19 *See* Appendix 5, Most Litigated Issues Case Tables 11 and 12, *infra*.

MOST LITIGATED ISSUES: 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 federal tax administration.[1] These decisions are summarized below.

In *Altera Corp. v. Commissioner*, the U.S. Court of Appeals for the Ninth Circuit held that Treasury's cost-sharing regulations were both substantively and procedurally valid.[2]

Altera Corp. (Altera), a Delaware corporation, and its foreign subsidiary agreed to share the cost of a research and development project. The agreement originally included both cash and stock compensation paid to project employees, thereby reducing Altera's ability to shift income to its foreign subsidiary by bearing a disproportionate share of the project's costs for compensation. To address income shifting, Internal Revenue Code (IRC) § 482 authorizes the Secretary to (re)allocate income and expenses among related entities "clearly to reflect the income" of the entities.

In 2005, the Tax Court held in *Xilinx* that the government could not use IRC § 482 to require related entities to share stock-based compensation under regulations applicable to tax years 1997-1999.[3] In 2003, the government had updated its regulations to require related entities to share stock-based compensation.[4] Nonetheless, Altera responded to *Xilinx* by modifying its cost-sharing agreement in 2005 to exclude stock-based compensation. Predictably, the IRS audited Altera and increased its U.S. taxable income for 2004-2007 to account for the employees' stock-based compensation, as provided by the new regulation.[5] Altera argued the regulation was invalid under the Administrative Procedure Act[6] and the Tax Court agreed.

By way of background, other regulations provide that the allocation under IRC § 482 "to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer," but they specify several different methods for reaching this so-called "arm's length" result.[7] They explain that "whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances."[8] However, in 1986, Congress added a sentence to IRC § 482, which says the allocation of income in connection with the transfer of intangible property must be "commensurate with the income attributable to the intangible,"[9] diluting the relevance of comparable arm's length transactions in certain circumstances.

1 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2018, and ending on May 31, 2019. For purposes of this section, we generally used the same period. However, we included one case, *Altera Corp. v. Comm'r*, for which an opinion was issued immediately after the end of the reporting period because it is particularly significant. In addition, we have included one case, *J.B. v. United States*, which is discussed as part of a most litigated issue (Summons). We include it here because of its potential impact on IRS procedures unrelated to summons that have been discussed in prior reports (*i.e.*, third party contacts).

2 *Altera Corp. v. Comm'r*, 926 F.3d 1061 (9th Cir. 2019), *rev'g* 145 T.C. 91 (2015) [hereinafter *Altera*]. The Ninth Circuit had previously reversed the Tax Court, but the original reversal was withdrawn because Circuit Court Judge Reinhardt died after oral arguments but before the opinion was issued. *See Altera Corp. v. Comm'r*, 2018-2 U.S.T.C. (CCH) ¶ 50,344 (9th Cir. 2018), *withdrawn by* 898 F.3d 1266 (9th Cir. 2018).

3 *Xilinx Inc. v. Comm'r*, 125 T.C. 37, 57 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010).

4 Treas. Reg. § 1.482-7(d)(1)(i) (as amended by T.D. 9088, 2003-42 I.R.B. 841).

5 Treas. Reg. § 1.482-7A(d)(2).

6 5 U.S.C. §§ 550-596.

7 Treas. Reg. § 1.482-1(b)(1).

8 *Id*.

9 Tax Reform Act of 1986, Pub. L. No. 99-514, Title XII, § 1231(e)(1), 100 Stat. 2085, 2562-2563 (1986).

Nonetheless, the preamble to the disputed regulation proposed in 2002 did not expressly justify the rule — that cost sharing agreements must include stock-based compensation — on the basis that doing so was "commensurate with income."[10] Rather, it emphasized that the rule would produce an arm's length result. In response, stakeholders submitted information showing that unrelated parties did not share the cost of stock-based compensation because its value is speculative, potentially large, and outside of their control.

Instead of explicitly adopting another basis for the rule (*e.g.*, to ensure the allocation was "commensurate with the income"), the preamble to the final regulations reiterated that "stockbased compensation must be taken into account … [to satisfy the] arm's length standard."[11] It continued to assert that parties dealing at arm's length "generally would not distinguish between stock-based compensation and other forms of compensation."[12]

Under the framework established in *Chevron*, if a court determines that a statute is ambiguous, it generally defers to regulations unless they are arbitrary and capricious.[13] Altera argued, and the Tax Court generally agreed, that the disputed regulation was arbitrary and capricious, and therefore, invalid because the government did not explain why it rejected significant comments it received from stakeholders and did not provide a contemporaneous "reasoned explanation" for its final rule as required under *State Farm*.[14]

The U.S. Court of Appeals for the Ninth Circuit reversed. Applying *Chevron*, the Ninth Circuit determined that the statute was ambiguous, and the regulations were not arbitrary and capricious. The court observed that even before the 1986 amendment, an analysis of comparable transactions was not the only way to reach an arm's length result.[15] Congress explained in 1986 that the "commensurate with income" standard was necessary because of "difficulties in determining whether the arm's length transfers between unrelated parties are comparable."[16] Thus, the court concluded the rule was substantively reasonable.

Turning to the procedural requirements, the Ninth Circuit said "Treasury made clear that it was relying on the commensurate with income provision… [and that it would] coordinate the new regulations with the arm's length standard, suggesting that it was attempting to synthesize the potentially disparate

10 Prop. Treas. Reg. § 1.482-7(d)(2), 67 Fed. Reg. 48,997, 49,002 (July 29, 2002).

11 T.D. 9088, 68 Fed. Reg. 51,171, 51,173 (Aug. 26, 2003).

12 *Id*.

13 *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

14 5 U.S.C. § 706(2)(A) (establishing an "arbitrary, capricious, an[d] abuse of discretion" standard of review); 5 U.S.C. § 553(c) (requiring an agency to consider comments and provide a concise statement explaining the basis and purpose for a final rule when promulgating legislative rules); *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983) (requiring rules to be the product of reasoned decisionmaking).

15 Because the court rejected *Altera's* argument that the rule's departure from comparability analysis and its new requirement to include stock-based compensation as a cost was a significant departure from prior policy, it also rejected Altera's argument that a more searching review was required under *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502 (2009).

16 H.R. Rep. No. 99-426, at 425 (1985) (Conf. Rep.).

standards."[17] The court also concluded that Treasury made "clear enough" its decision to abandon comparability analysis by including "citations to legislative history."[18]

Accordingly, the court reasoned that comments documenting a lack of comparable transactions between unrelated parties reinforced Treasury's decision to abandon comparability analysis. When viewed in this light, the comments might not even have been significant enough to require a response, according to the court. Nonetheless, the preamble to the final regulations addressed the comments by distinguishing the situations cited by commentators on the basis that they did not involve the "development of high-profit intangibles."[19] Thus, the regulations satisfied the procedural requirements.

This case is significant because it could stall Treasury's stepped-up efforts to provide taxpayers with reasonably clear advanced notice about significant shifts in policy or practice, to respond to significant comments, and to explain the reasons for those shifts.[20] Such efforts are consistent with a taxpayer's *right to be informed*.[21] This case may also be significant because commenters have suggested that given the amount of money riding on the issue in other cases, Altera is likely to appeal.[22]

In *Good Fortune Shipping v. Commissioner*, the U.S. Court of Appeals for the District of Columbia Circuit held that Treasury regulations were invalid because the explanation provided by the government for the change was unreasonable.[23]

Good Fortune Shipping SA (Good Fortune) was a foreign corporation that earned income by shipping goods to and from the United States. Such income is subject to a special transportation tax under IRC § 887 unless it is exempt. Corporations "organized in a foreign country" that "grants an equivalent exemption to corporations organized in the United States," are exempt from the transportation tax under IRC § 883(a)(1). A foreign corporation is ineligible for the exemption, however, "if 50 percent or more of the value" of its stock "is owned by individuals who are not residents" of a country providing a reciprocal exemption.[24]

Good Fortune was organized in a qualifying country, had issued shares in bearer form (*i.e.*, unregistered shares, which are not held in the owner's name), and had documentation that its bearer shares were indirectly owned by qualifying individuals. Accordingly, it took the position that it qualified for the

17 *Altera*, 926 F.3d at 1081.

18 *Id*. at 1082. For the same reasons, the Ninth Circuit concluded that the government did not violate *Chenery's* bar against post hoc justifications. *Id*. at 1083 (citing *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947)). A forceful dissent characterizes the preamble's citation to legislative history as "cryptic." *Id*. at 1087 (O'Malley, J., dissenting). It also asserts that the majority opinion: "supplies a reasoned basis for the agency's action that the agency itself has not given, … encourages 'executive agencies' penchant for changing their views about the law's meaning almost as often as they change administrations, … and endorses a practice of requiring interested parties to engage in a scavenger hunt to understand an agency's rulemaking proposals." *Id*. at 1087-1088 (Internal citations omitted).

19 T.D. 9088, 68 Fed. Reg. 51,171, 51,173 (Aug. 26, 2003).

20 Andrew Velarde, *Reg Process Could Get Slower and Less Stable, Wilkins Warns*, 2016 TNT 123-7 (June 27, 2016) (discussing the agency's response to the Tax Court decision). The Ninth Circuit arguably lowered the bar for how clearly an agency must identify what it is changing and why. On the other hand, the court may have concluded that the IRS's relatively "cryptic" explanation was only "clear enough" considering the intended audience–international corporations sophisticated enough to have tax sharing agreements. If so, the decision does not alter the requirement for regulations of more general applicability.

21 IRC § 7803(a)(3)(A).

22 Reuven Avi-Yonah, *9th Circ. Got Cost-Sharing Right in Altera v. Commissioner*, 2019 Law360 169-60 (June 18, 2019). Moreover, another taxpayer could mount a successful challenge to these very same regulations before the Tax Court because the Tax Court is not bound by the Ninth Circuit's decision in cases appealable to other circuits. *See Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

23 *Good Fortune Shipping v. Comm'r*, 897 F.3d 256 (D.C. Cir. 2018), *rev'g* 148 T.C. 262 (2017).

24 IRC § 883(c)(1).

exemption on its 2007 return. Because Good Fortune's shares were issued in "bearer" form, however, the IRS took the position based on its regulations (discussed below) that Good Fortune could not substantiate the identity of its shareholders to qualify for the exemption. Good Fortune petitioned the Tax Court, arguing that the regulations were invalid.

Between 1991 and 2003 when the disputed regulations were issued, foreign corporations were allowed to prove qualifying ownership of bearer shares.[25] Notwithstanding objections received during the notice and comment period, the IRS explained that it adopted a new categorical rule in 2003, which excluded bearer shares because of "the difficulty" of reliably tracking "the location of a given owner."[26]

The Tax Court upheld the regulations because it said the statute was ambiguous and the regulations were reasonable, but the U.S. Court of Appeals for the District of Columbia Circuit reversed. It said the regulations rewrote the meaning of "owned" in IRC § 883(c)(1) to require not only valid ownership, but also ownership that is not "difficult" to track. It might have been reasonable for the IRS to do so if it had found that their owners were "impossible" to track, but it did not. Indeed, it had determined between 1991 and 2003 that they could be tracked, and in preamble to regulations it issued under IRC § 883 in 2010, the IRS observed that bearer shares were becoming easier to track over time.[27] Thus, it was unclear why the agency seemed to decide that bearer shares were more difficult to track in 2003 than in 1991.

The court also observed that other forms of ownership make the beneficial owners difficult to track, including the appointment of nominees and trustees. Yet, the 2003 regulations treat ownership through these arrangements as qualifying if the taxpayer submits detailed statements substantiating the beneficial owners. Thus, it was unreasonable for the 2003 regulations to adopt a categorical rule to deny the opportunity to provide similar substantiation of the ownership of bearer shares without explanation.

Finally, the court observed that the IRS allowed corporations to substantiate the ownership of bearer shares when determining if a corporation is closely held.[28] It said that the IRS cannot reasonably treat bearer shares as a form of second-class ownership in some contexts but not in others where the same concerns exist unless it provides a reasonable contemporaneous explanation, which it had not done.

This case is significant to the extent it suggests that regulations are invalid, even if they provide an explanation for the rules being adopted, if that explanation does not seem reasonable. An explanation may be unreasonable if it is not consistent with reasoning or facts expressed or acknowledged by the IRS in other contexts.[29]

25 *Compare* Rev. Proc. 91-12, § 8.02(3), 1991-1 C.B. 473 *with* Treas. Reg. §§ 1.883-4(a), -4(b), -4(c), -4(d) (as amended by T.D. 9087, 2003-40 I.R.B. 781).

26 Notice of Proposed Rulemaking, 67 Fed. Reg. 50,510, 50,518 (Aug. 2, 2002) (re-proposed regulations); T.D. 9087, 68 Fed. Reg. 51,394, 51,399 (Aug. 26, 2003). In 2010, the regulations were amended to allow certain types of bearer shares that could be tracked. T.D. 9502, 75 Fed. Reg. 56,858, 56,860 (Sept. 17, 2010). However, this amendment is not applicable to the period at issue (*i.e.*, 2007).

27 T.D. 9502, 75 Fed. Reg. 56,858, 56,860 (Sept. 17, 2010).

28 *See Good Fortune Shipping*, 897 F.3d at 265 (citing IRC § 884(e)(4)(B) and T.D. 8432, 57 Fed. Reg. 41,644 (Sept. 11, 1992)).

29 For additional discussion of the case's significance, see, *e.g.*, Andrew Velarde, *Another Altera May Be Waiting in the Wings of the D.C. Circuit*, 2018 TNT 131-3 (July 9, 2018).

In *Baldwin v. United States*, the U.S. Court of Appeals for the Ninth Circuit held that a claim for refund was late because the common law mailbox rule was supplanted by Treas. Reg. § 301.7502-1(e)(2)(i).[30]

To claim a refund for 2005, the Baldwins were required to file an amended return by October 15, 2011. They sent the return to the IRS by U.S. mail in June 2011, but the IRS did not receive it or pay a refund. The Baldwins then brought a refund suit in district court. The main issue was whether the refund claim was timely.

Under the longstanding common law "mailbox" rule, if a taxpayer has proof that they timely mailed a document, it is presumed to have been delivered when such a mailing would ordinarily arrive.[31] In 1954, Congress enacted IRC § 7502, which said a document is deemed timely if it is: (1) postmarked on or before the deadline, and (2) *actually delivered*.[32] If the document is never delivered, this statutory mailbox rule does not apply.[33]

Although some circuits have held that the statutory rule displaced the common law rule, others, including the Ninth Circuit, have held the statutory rule provided a safe harbor that supplements the common law rule, rather than displacing it.[34] Because the IRS did not receive the Baldwins' claim, the statutory rule was no help to them. Accordingly, they sought to rely on the common law mailbox rule to establish that their claim for refund was presumptively delivered to the IRS (timely) in June 2011.

The government countered that regulations had eliminated the circuit split and supplanted the common law rule. Specifically, Treas. Reg. § 301.7502-1(e) was amended in 2011 to say:

> Other than direct proof of actual delivery, proof of proper use of registered or certified mail, and proof of proper use of a duly designated [private delivery service] … are the *exclusive means* to establish prima facie evidence of delivery …. *No other evidence of a postmark or of mailing will be prima facie evidence of delivery or raise a presumption that the document was delivered*.[35]

The district court held the regulations invalid. It reasoned that the plain language of IRC § 7502 unambiguously supplemented the common law rule, leaving no gap in the law for the regulations to fill.[36]

30 *Baldwin v. United States*, 921 F.3d 836 (9th Cir. 2019), *reh'g denied*, 2019 U.S. App. LEXIS 18968 (9th Cir. June 25, 2019), *petition for cert. filed*, 2019 WL 4673331 (U.S. Sept. 23, 2019) (No. 19-402).

31 *See, e.g.*, *Detroit Automotive Products Corp. v. Comm'r*, 203 F.2d 785, 785-786 (6th Cir. 1953) (per curiam); *Arkansas Motor Coaches, Ltd. v. Comm'r*, 198 F.2d 189, 191 (8th Cir. 1952).

32 The National Taxpayer Advocate has recommended extending the mailbox rule to cover electronic transmissions. *See* National Taxpayer Advocate 2019 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 22-23 (*Treat Electronically Submitted Tax Payments as Timely if Submitted Before the Applicable Deadline*); 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*).

33 *See Miller v. United States*, 784 F.2d 728, 730 (6th Cir. 1986) (per curiam).

34 *Anderson v. United States*, 966 F.2d 487, 491 (9th Cir. 1992) ("The statute itself does not reflect a clear intent by Congress to displace the common law mailbox rule. Accordingly, we decline to read section 7502 as carving out exclusive exceptions to the old common law physical delivery rule.").

35 T.D. 9543, 76 Fed. Reg. 52,561 (Aug. 23, 2011) (emphasis added).

36 *Baldwin v. United States*, 2:15-cv-06005-RGk-AGR, 2016 WL 11593219 (C.D. Cal. 2016), *rev'd and remanded*, 921 F.3d 836 (9th Cir. 2019).

On appeal, the U.S. Court of Appeals for the Ninth Circuit reversed. It applied the two-step analysis set forth in *Chevron*.[37] It found that although IRC § 7502 applies a presumption of delivery to documents sent by registered mail, electronic filing, certified mail, and private delivery services, it is silent as to whether any presumption of delivery applies to documents sent by regular mail. Thus, IRC § 7502 left a gap for the regulations to fill.

Under *Brand X*, "[a] court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion."[38] In this case, the Ninth Circuit said its prior decision made clear that it was filling a statutory gap. Thus, the Treasury Department was free to fill that gap by adopting its own reasonable interpretation of IRC § 7502.

This case is significant because it confirms that the common law mailbox rule has been superseded in the Ninth Circuit. It is perhaps even more significant because it highlights the increasingly controversial Supreme Court decisions in *Chevron* and *Brand X*, which generally allow reasonable agency regulations to trump judicial interpretations where the statute is silent or ambiguous.[39] Litigators have indicated this case may be the perfect vehicle for the Supreme Court to consider overruling those decisions.[40] If it overrules *Chevron* and *Brand X*, commenters have speculated that the common law mailbox rule could spring back to life in the Ninth Circuit.[41]

In *JB v. United States*, the United States Court of Appeals for the Ninth Circuit held that IRS Publication 1 did not provide the taxpayer with "reasonable notice in advance" of third-party contacts, as required by IRC § 7602(c)(1).[42]

Mr. Baxter is an attorney who accepts appointments from the California Supreme Court to represent indigent defendants. In July 2013, the Baxters received a letter indicating their joint return for 2011 had been selected for an audit as part of the IRS's National Research Program. The letter came with IRS Publication 1, Your Rights as a Taxpayer (Pub 1), which says, in relevant part, that "we sometimes talk with other persons if we need information that you have been unable to provide, or to verify information we have received." Two months later, the IRS requested documents from the Baxters. The Baxters responded by asking the IRS to excuse them from the audit because of Mr. Baxter's poor health and the couples' advanced age. The IRS refused, and in May 2015, the Baxters filed a separate suit to stop the audit based on health concerns.

37 *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

38 *Baldwin*, 921 F.3d at 843 (quoting *National Cable & Telecom. Assoc. v. Brand X Internet Services*, 545 U.S. 967, 982 (2005)).

39 *See, e.g.*, Andrew Velarde, *Can the Humble Mailbox Rule Bring Monumental Changes to Chevron?* 94 Tax Notes Int'l 412 (Apr. 29, 2019) (noting that Justices Thomas, Gorsuch, Kavanaugh, Alito, Breyer, and Chief Justice John Roberts have arguably expressed reservations about an overly broad reading of *Chevron*).

40 *See id.*

41 Carlton Smith, *Ninth Circuit Holds Reg. Validly Overrules Case Law; Disallows Parol Evidence of Timely Mailing*, Procedurally Taxing Blog (Apr. 18, 2019), https://proceduralltaxing.com/ninth-circuit-holds-reg-validly-overrules-case-law-disallows-parol-evidence-of-timely-mailing/.

42 *JB v. United States*, 916 F.3d 1161 (9th Cir. 2019), *aff'g sub nom. Baxter v. United States*, 117 A.F.T.R.2d (RIA) 694 (N.D. Cal. 2016).

In September 2015, the IRS issued a summons to the California Supreme Court (Mr. Baxter's employer) seeking invoices or other documents that resulted in payment to Mr. Baxter for the 2011 calendar year.[43] The Baxters filed a timely petition to quash, arguing that the IRS had not followed the requirement of IRC § 7602(c)(1) to provide "reasonable notice in advance" that third parties may be contacted. The district court agreed that Pub 1 did not provide sufficient notice, reasoning that "the implementing regulations contemplate notice for each contact, not a generic publication's reference that the IRS may talk to third parties throughout the course of an investigation."[44]

The U.S. Court of Appeals for the Ninth Circuit affirmed. It explained that the requirement for "reasonable notice in advance" means the IRS must provide enough specific information that it gives the taxpayer a "meaningful opportunity to volunteer records on his own, so that third-party contacts may be avoided if the taxpayer complies with the IRS's demand."[45] Its holding was based, in large part, on the unambiguous plain language of the statute and the Supreme Court's interpretation of similar notice requirements in other laws.

Just as a taxpayer is given notice of a summons under IRC § 7609 and a meaningful opportunity to file a petition to quash it, the advance notice requirement is supposed to protect the taxpayer's reputation because it "gives the taxpayer a meaningful opportunity to resolve issues and volunteer information before the IRS seeks information from third parties, which would be unnecessary if the relevant information is provided by the taxpayer himself."[46] Pub 1 is so general that without more, it provided no such meaningful opportunity in this case, according to the court.

The court reasoned that the statutory exceptions to the advance notice requirement suggest that Congress intended the pre-contact notice to reference a specific contact or piece of information. IRC § 7602(c)(3) waives the requirement if (a) the taxpayer has authorized the contact; (b) the Commissioner, with good cause, believes the notice may jeopardize the IRS's tax collection efforts or open a third party to reprisal; or (c) there is a pending criminal investigation. These exceptions would be unnecessary if the requirement could always be satisfied with a generic notice such as Pub 1. Only if the notice reveals who the IRS plans to contact or what the IRS plans to request does the taxpayer have enough information to authorize the contact, jeopardize collection efforts, retaliate against the third parties, or interfere with a pending criminal investigation. Thus, the IRS's interpretation of the notice requirement would make the statutory exceptions superfluous.

Next, the court rejected the IRS's argument that the requirement under IRC § 7602(c)(2) to provide the taxpayer with a post-contact report of who it contacted would be superfluous if their names had to be furnished beforehand under IRC § 7602(c)(1). First, the court said that IRC § 7602(c)(1) only requires reasonable notice, and what is reasonable depends on the facts. Reasonable notice may not always require the IRS to provide a list of names in advance. Second, the pre-contact notice requirement applies to

43 The Ninth Circuit remarked that [according to the National Taxpayer Advocate], the Baxters' "experience receiving notice after a third party has been contacted is becoming more common." *JB*, 916 F.3d at 1166 n.6 (9th Cir. 2019) (citing statistics from the National Taxpayer Advocate 2015 Annual Report to Congress 123, 128 (Most Serious Problem: *Third Party Contacts: IRS Third Part Contact Procedures Do Not Follow the Law and May Unnecessarily Damage Taxpayers' Businesses and Reputations*), and the National Taxpayer Advocate Fiscal Year 2018 Objectives Report to Congress 98-101 (Area of Focus: *IRS Third Party Contact (TPC) Notices Should Be More Specific, Actionable, and Effective*).

44 *Baxter v. United States*, 117 A.F.T.R.2d (RIA) 694, 2016 U.S. Dist. LEXIS 15855, at *8 (N.D. Cal. 2016), *aff'd sub nom.*, *JB v. United States*, 916 F.3d 1161 (9th Cir. 2019).

45 *JB*, 916 F.3d at 1173; *J.B.*, 916 F.3d at 1168 (citing S. Rep. No. 105-174, at 77 (1988) and quoting Internal Revenue Manual (IRM) 4.11.57.2(3), Definition of TPC (May 26, 2017), and *Third Party Contacts*, 67 Fed. Reg. 77,419, 77,419-77,420 (Dec. 18, 2002)).

46 *JB*, 916 F.3d at 1168.

those the IRS "may" contact, whereas the post-contact report must list those the IRS did contact (with certain exceptions). Thus, neither requirement is superfluous because they apply to two different groups.

The IRS also argued that the subsection title for IRC § 7602(c)(1) (*i.e.*, "General Notice") and the subsection title for IRC § 7602(c)(2) (*i.e.*, "Notice of Specific Contacts") lend support to its argument that the statute was at least ambiguous about whether the pre-contact notice could be "general." The court cited cases holding that titles cannot limit the plain meaning of a statutory text, reasoning that titles cannot create ambiguity where, as in this case, the statutory language is clear.[47] It also cited legislative history suggesting that both the pre- and post-contact notices were intended to protect the taxpayer's reputation, and to do so they had to be specific enough to be meaningful (*i.e.*, actionable).[48]

In addition, the IRS argued that when the Conference Committee clarified that "in general," the IRS could provide advance notice to the taxpayer "as part of an existing IRS notice provided to taxpayers," it meant that the IRS could include a general notice in Pub 1. The court explained that Congress knew how to refer to Pub 1 when it wanted to — it referenced Pub 1 by name three times in the same legislation — but did not reference it by name in connection with the pre-contact notice requirement. The court also observed that immediately after enactment, the IRS itself did not believe that a single general notice like Pub 1 was sufficient to comply with the statutory requirement, as discussed in the National Taxpayer Advocate's report.[49] Moreover, even the agency's regulations support an interpretation of "reasonable notice" that requires meaningful notice to the taxpayer.[50]

Next, the court addressed the IRS's argument that every court to have considered the issue has held that Pub 1 satisfied the pre-contact notice requirement. It pointed out that other courts have recognized that IRC § 7602(c)(1) requires a context-dependent inquiry, and in some contexts the Pub 1 might be sufficient. In this case, it was particularly troubled by the fact that (1) the IRS had reason to know that the billing records at issue might have been subject to attorney-client privilege, (2) the taxpayers would have been able to provide the pertinent records if the IRS had given them a meaningful opportunity, and (3) the Pub 1 was "divorced from any specific request for documents."[51]

Although the Ninth Circuit acknowledged that a context-dependent inquiry might be difficult to administer, it said this concern was a matter for Congress. Nonetheless, it was "doubtful that Publication 1 alone will ever suffice to provide reasonable notice in advance to the taxpayer, as the statute requires."[52]

The National Taxpayer Advocate previously recommended changes to the IRS's pre-contact procedures that would give taxpayers a meaningful opportunity to provide information and avoid contacts that could damage their reputations.[53] This case is significant because it suggests that IRS procedures did

47 *JB*, 916 F.3d at 1169 (citing for example, *Oregon Public Utility Comm'n v. ICC*, 979 F.2d 778, 780 (9th Cir. 1992)).

48 *JB*, 916 F.3d at 1170 (citations omitted).

49 *Id*. at 1170-1171 (citing National Taxpayer Advocate 2015 Annual Report to Congress 123, 127 n.23 (Most Serious Problem: *Third Party Contacts: IRS Third Part Contact Procedures Do Not Follow the Law and May Unnecessarily Damage Taxpayers' Businesses and Reputations*)).

50 Treas. Reg. § 301.7602-2 ("the pre-contact notice may be given either orally or in writing").

51 *JB*, 916 F.3d at 1169.

52 *Id*. at 1172 n.15. The Tenth Circuit appears to disagree. *See High Desert Relief, Inc. v. United States*, 917 F.3d 1193 (10th Cir. 2019) (assuming without deciding, after JB, that Pub. 1 did provide sufficient notice under section 7602(c)(1)).

53 *See* National Taxpayer Advocate 2015 Annual Report to Congress 123-142 (Most Serious Problem: *Third Party Contacts: IRS Third Party Contact Procedures Do Not Follow the Law and May Unnecessarily Damage Taxpayers' Businesses and Reputations*); National Taxpayer Advocate Fiscal Year 2018 Objectives Report to Congress 98-101 (Area of Focus: *IRS Third Party Contact (TPC) Notices Should Be More Specific, Actionable, and Effective*).

not always comply with the requirement to provide reasonable notice in advance.[54] Subsequently enacted legislation now requires the IRS to issue a notice when it actually intends to make a third-party contact and to specify approximately when the contact(s) will be made.[55] However, it removed the requirement to provide reasonable notice in advance.[56] Nonetheless, the case remains significant because of its analysis of what constitutes reasonable notice could apply in other contexts.[57]

In *Haynes v. United States*, the U.S. Court of Appeals for the Fifth Circuit held that when an e-filed return was timely submitted by a preparer and rejected by the IRS without notice, a taxpayer had reasonable cause to avoid a negligence penalty if the preparer was not negligent (*i.e.*, the preparer had reasonable cause).[58]

On October 17, 2011, Mr. Dunbar, the Hayneses' accountant, electronically transmitted their 2010 income tax return to the Lacerte Software Corporation for filing with the IRS. The same day, he notified Mr. Haynes that the return had been timely filed. Although Mr. Dunbar did not receive a rejection notice from the IRS, the IRS had rejected the return because Mrs. Haynes's Social Security number (SSN) erroneously appeared on the line designated for an employment identification number. Neither Mr. Dunbar nor the Hayneses took further action to confirm that the IRS had received the return or acknowledged its acceptance for processing. Additionally, although the Hayneses' return reflected an unpaid balance due of more than $40,000, they made no tax payment prior to August

54 For the IRS's initial response to the National Taxpayer Advocate's concerns, see National Taxpayer Advocate Fiscal Year 2017 Objectives Report to Congress 72-79 (*Review of the 2016 Filing Season*). For further analysis of this case, see, *e.g.*, Leslie Book, *Ninth Circuit Rejects IRS's Approach to Notifying Taxpayers of Third Party Contacts*, Procedurally Taxing Blog (Mar. 4, 2019), http://proceduralltaxing.com/ninth-circuit-rejects-irss-approach-to-notifying-taxpayers-of-third-party-contacts/. The IRS appears to be planning to defend its prior practice. See IRM 5.17.6.7, Third-Party Contact Requirements of IRC § 7602(c) (Aug. 1, 2019) ("If challenged, the IRS intends to defend third-party contacts that its employees previously made (before the effective date of section 1206 of the Taxpayer First Act of 2019), in accordance with then-existing instructions ...).

55 Taxpayer First Act, Pub. L. No. 116-25, § 1206, 133 Stat. 981 (2019) (codified at IRC § 7602(c)(1)) (requiring a third party contact to occur only "during a period (not greater than 1 year) which is specified in a notice which — (A) informs the taxpayer that contacts with persons other than the taxpayer are intended to be made during such period, and (B) except as otherwise provided by the Secretary, is provided to the taxpayer not later than 45 days before the beginning of such period.").

56 Due, in part, to the fact that the notice is no longer required to be "reasonable," the IRS does not believe it is required to include the information it needs on the TPC notice. *See, e.g.*, IRS, Interim Guidance on Third-Party Contact Notification Procedures, SBSE-04-0719-0034 (July 26, 2019). For a legislative recommendation to require the IRS to inform the taxpayer of what information it needs, see National Taxpayer Advocate 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 101-102 *(Require the IRS to Specify the Information It Needs in Third Party Contact Notices)*.

57 For example, we wonder whether the Ninth Circuit's analysis of the requirement to provide "reasonable notice" before making third party contacts under IRC § 7602(c)(1) provides any insight about how a court might interpret the requirement for agencies to provide reasonable notice of the basis for rule changes in the preamble to proposed regulations that apply to individuals and small businesses. As noted in the discussion of *Altera* (above), the Ninth Circuit found the requirement for the IRS to provide a "reasonable" explanation for a rule was satisfied by a reference to legislative history that the dissent called "cryptic." Although the court was applying a different statute, *Altera* and *JB* could be reconciled on the basis that to be "reasonable" the IRS needs to provide more specific information to individuals under audit, than it must provide to experts representing international businesses.

58 *Haynes v. United States*, 760 F. App'x 324 (5th Cir. 2019) (unpublished, per curiam), *vacat'g and remand'g* 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017). The Hayneses subsequently requested a rehearing, urging the court to decide if the taxpayers could have reasonable cause even if the preparer was negligent. *Appellants' Petition for Panel Rehearing, Haynes v. United States*, 123 A.F.T.R.2d (RIA) 570 (5th Cir. 2019) (No. 3:16-CV-112) (Feb. 25, 2019). For a legislative recommendation addressing these issues, see National Taxpayer Advocate 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 57-59 *(Extend Reasonable Cause Abatement of the Failure-to-File Penalty to Taxpayers Who Rely on Return Preparers to E-File Their Returns)*.

2012.[59] After the IRS assessed a late fling penalty, they paid the penalty and requested a refund on the basis that their failure to timely file did not result from "willful neglect," and was due to "reasonable cause" under IRC § 6651(a)(1).[60] The IRS denied their claim, and they timely filed a refund suit in district court.

In *Boyle*, the Supreme Court explained in 1985 that reasonable cause may exist for failure to file when a taxpayer relies on the erroneous advice of counsel concerning a substantive question of law (*e.g.*, whether a liability exists or a return is required), but generally not when a taxpayer relies on an agent to file.[61] The Court reasoned that no expertise is required to know that returns have fixed filing deadlines. The Hayneses argued before the District Court:

> (1) that *Boyle* only applies to paper-filed returns; (2) that the act of e-filing a tax return itself is a form of substantive legal advice; (3) that a defective return transmitted to and rejected by the IRS is nonetheless a timely-filed return; (4) that the alleged failure of the Lacerte software to provide notification of the IRS's rejection of the tax return amounts to circumstances beyond Plaintiffs' control and establishes reasonable cause; and (5) that reliance on Plaintiffs' experienced, educated, and prominent accountant constitutes 'reasonable cause.'[62]

Unpersuaded, the District Court granted the government's motion for summary judgment based on the bright line rule expressed in *Boyle*. On appeal the U.S. Court of Appeals for the Fifth Circuit did not decide whether to extend *Boyle* to e-filed returns.[63] It explained that in *Boyle* the preparer was negligent in missing the deadline and his negligence was imputed to the taxpayer, whereas the negligence of Mr. Dunbar had not been established in this case. Thus, even if the logic of *Boyle* were extended to e-filing, the government was not entitled to summary judgment because it was not clear, as a factual matter, whether Mr. Dunbar was negligent or if his actions met the reasonable cause standard (*i.e.*, whether ordinary business care and prudence would demand that he personally contact the IRS to ensure acceptance). Accordingly, the Fifth Circuit vacated and remanded the decision.

59 A fact finder might view a couple who did not take the time to ensure they had timely paid their liabilities as less likely to have exercised reasonable care to ensure they filed timely.

60 *See also* Treas. Reg. § 301.6651-1(a) ([a penalty applies] "unless the failure to file the return within the prescribed time is shown to … be due to reasonable cause and not to willful neglect"); Treas. Reg. § 301.6651-1(c)(1) ("If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause.").

61 *United States v. Boyle*, 469 U.S. 241, 250-52 (1985).

62 *Haynes v. United States*, 2017 U.S. Dist. LEXIS 106252, at *10 (W.D. Tex. June 15, 2017).

63 Amici argued that the bright line rule of *Boyle* should not apply to e-filed returns. *See* Brief of Amicus Curiae, American College of Tax Counsel, In Support of Appellants and Reversal, *Haynes v. United States*, 123 A.F.T.R.2d (RIA) 570 (5th Cir. 2019) (No. 17-50816) (Nov. 27, 2017). They point out that if the return had been mailed on the same date, it would have been timely filed under the mailbox rule (*i.e.*, IRC § 7502). Applying *Boyle* unfairly discriminates against e-filers who are forced to depend on third parties to determine if the IRS has accepted their returns, according to the brief. As noted above, the National Taxpayer Advocate has recommended legislation to extend the mailbox rule to electronic submissions. *See, e.g.*, National Taxpayer Advocate, 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 14-15 (*Treat Electronically Submitted Tax Payments and Documents as Timely If Submitted Before the Applicable Deadline*); National Taxpayer Advocate 2019 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 22-23 (*Treat Electronically Submitted Tax Payments as Timely if Submitted Before the Applicable Deadline*).

This case is significant because its analysis is likely to shape whether and how the late filing penalty will apply to e-filed returns that are timely transmitted to the IRS but not timely accepted.[64] We can expect taxpayers to continue to argue that they have reasonable cause for late e-filing on the basis that: (1) the preparer was not negligent (*e.g.*, because the IRS did not timely alert him or her to an error), and (2) the taxpayer can reasonably rely on a preparer's confirmation that an e-filed return was timely filed because the bright line rule established in *Boyle* does not apply to e-filing deadlines.[65]

In *BASR Partnership v. United States*, the U.S. Court of Appeals for the Federal Circuit awarded attorney fees to a partnership with no assets after the government rejected a qualified offer of $1 to settle.[66]

The Pettinati family formed the BASR partnership to shelter the gain from the sale of their printing business in 1999. It was not until 2010 that the IRS issued a Final Partnership Administrative Adjustment (FPAA), proposing to disallow the purported tax benefits from the sale under procedures established by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").[67] Mr. Pettinati, BASR's tax matters partner, filed suit in the U.S. Court of Federal Claims, challenging the FPAA as untimely. While the case was pending, BASR, which had no assets, made a "qualified offer" to settle for $1.[68] The government rejected the offer.

The Court of Federal Claims held that BASR's limitations period had expired.[69] BASR then moved for an award of litigation costs under IRC § 7430, which the Court of Federal Claims granted, and the U.S. Court of Appeals for the Federal Circuit affirmed.

A "party" to a court proceeding meeting the net worth requirements of 28 U.S.C. § 2412(d)(2)(B) can be awarded litigation costs under IRC § 7430(c)(1) if he or she is the "prevailing party" and the tax liability pursuant to the judgment is equal to or less than the taxpayer's "qualified offer" to settle with respect to the tax "at issue" in the proceeding.

The government argued that BASR was not eligible because: (1) the BASR partnership could not be a "party" because only partners are parties in TEFRA litigation, (2) the amount of tax liability was not "at issue" because BASR had none — tax liability is determined at the partner level, (3) BASR did not incur any litigation costs — the costs were incurred by the Pettinati family, (4) the Pettinati family was the real-party-in-interest, but they did not meet the net worth requirement, and (5) the trial court abused its

64 For helpful commentary, see, *e.g.*, Leslie Book, *Update on Haynes v US: Fifth Circuit Remands and Punts on Whether Boyle Applies in E-Filing Cases*, Procedurally Taxing Blog (Feb. 12, 2019), http://proceduralltaxing.com/update-on-haynes-v-us-fifth-circuit-remands-and-punts-on-whether-boyle-applies-in-e-filing-cases/; Leslie Book, *Delinquency Penalties: Boyle in the Age of E-Filing*, Procedurally Taxing Blog (Nov. 30, 2017), http://proceduralltaxing.com/delinquency-penalties-boyle-in-the-age-of-e-filing/ ("If there is no timely notification and little way for the taxpayer to independently check whether the return was rejected, it seems unfair to apply *Boyle* in these circumstances"); Andrew Velarde, *Circuit Court Punts on Application of Boyle to E-Filing*, 2019 TNT 5-35 (Feb. 4, 2019).

65 Similar arguments were recently rejected on the basis that even if a taxpayer uses a preparer he is free to file by mail. *See Intress v. United States*, 2019 U.S. Dist. LEXIS 130504 (M.D. Tenn. 2019).

66 *BASR Partnership v. United States*, 915 F.3d 771 (2019), *aff'g* 130 Fed. Cl. 286 (2017).

67 IRC § 6221 *et seq*.

68 In certain circumstances, a taxpayer may recover reasonable litigation costs if their liability turns out to be less than or equal to a "qualified offer" they made to settle the dispute with the government. *See generally* IRC § 7430; Treas. Reg. § 301.7430-1 *et. seq*.

69 *BASR Partnership v. United States*, 113 Fed. Cl. 181 (2013), *aff'd*, 795 F.3d. 1338 (Fed. Cir. 2015). We discussed this case in the 2014 report. *See* National Taxpayer Advocate 2014 Annual Report to Congress 427, 437 (Most Litigated Issues: *Significant Cases*).

discretion in awarding costs because BASR's settlement offer of $1 was not a good faith effort to settle. The Federal Circuit rejected these arguments.

This case is significant because it confirms that partnerships can obtain litigation costs under IRC § 7430 if they — and not necessarily their partners — meet the requirements in 28 U.S.C. § 2412. More importantly, it rejected the government's suggestion that it would be an abuse of discretion to award litigation costs when a qualified offer is too low.[70] Low-income taxpayers who have had their refunds frozen and believe they will prevail often submit $1 offers, hoping a qualified offer will prompt the government to resolve their cases more quickly. Time is of the essence because they often need the refunds to meet their basic living expenses.

In *Montrois v. United States*, the U.S. Court of Appeals for the District of Columbia Circuit held the IRS had authority to impose a fee to issue and renew Preparer Tax Identification Numbers (PTINs) because PTINs provide a specific benefit to preparers by protecting the confidentiality of their SSNs.[71]

A group of tax return preparers filed suit arguing that the IRS lacks authority under the Independent Offices Appropriations Act of 1952 (IOAA) to charge for obtaining and renewing PTINs. Under the IOAA, agencies may only establish a fee "for a service or thing of value provided by the agency."[72] The IOAA only permits agencies to charge for special benefits that are voluntarily requested and not shared by the general public.[73]

Before 2010, anyone could prepare and file a tax return for someone else. Preparers were required to enter their SSN or a PTIN on the returns they prepared.[74] In 2010, the government began to regulate return preparers, issuing regulations requiring that preparers have a PTIN (not just an SSN), which would only be issued to those who paid a user fee.[75] The regulation noted that the requirement would benefit preparers by helping to "maintain the confidentiality of [their] SSNs."[76] The IRS issued another regulation to establish a fee for the initial PTIN registration and for each annual renewal.[77]

In 2014, the U.S. Court of Appeals for the District of Columbia Circuit held in *Loving* that the Treasury Department lacked authority to regulate the conduct of registered tax return preparers.[78] Following *Loving*, the only remaining parts of the regulatory scheme were the requirements to obtain and use PTINs and to pay PTIN fees. The preparers filed suit challenging the fee.[79]

70 Two low income taxpayer clinics submitted an amicus brief because of the importance of this issue to low-income taxpayers. *See* Brief for the Harvard Federal Tax Clinic and the Philip C. Cook Low-Income Taxpayer Clinic of Georgia State University as Amici Curiae in Support of the Appellees, *BASR Partnership v. United States*, 123 A.F.T.R.2d (RIA) 691 (2019) (No. 17-1925) (Nov. 2, 2017); Ted Afield, *Nominal Qualified Offers and TEFRA*, Procedurally Taxing Blog (Feb. 25, 2019), http://proceduralltaxing.com/nominal-qualified-offers-and-tefra/; *Tax Clinic Amicus Brief Argument Supported*, Georgia State Law Clinical Programs Blog (Feb. 8, 2019), https://georgiastatelawclinicalprograms.blog/2019/02/08/tax-clinic-amicus-brief-argument-supported/.

71 *Montrois v. United States*, 916 F.3d 1056 (D.C. Cir. 2019), *petition for cert. filed* (May. 24, 2019) (No. 18-1493).

72 31 U.S.C. § 9701(b).

73 *See Nat'l Cable Television Assn. v. United States*, 415 U.S. 336 (1974).

74 *Furnishing Identifying Number of Income Tax Return Preparer*, T.D. 8835, 64 Fed. Reg. 43,910 (Aug. 12, 1999).

75 *Furnishing Identifying Number of Tax Return Preparer*, T.D. 9501, 75 Fed. Reg. 60,309, 60,315 (Sept. 30, 2010).

76 *Id*. at 60,309.

77 *User Fees Relating to Enrollment and Preparer Tax Identification Numbers*, T.D. 9503, 75 Fed. Reg. 60,316 (Sept. 30, 2010).

78 *Loving v. Comm'r*, 742 F.3d 1013 (D.C. Cir. 2014), *aff'g* 920 F. Supp. 2d 108 (D.D.C. 2013).

79 While the case was pending before the district court, the IRS reduced the amount of the PTIN fee from $50 to $33 (not including a vendor fee) to reflect the fact that fee proceeds were no longer needed to cover the regulation of preparers. *Preparer Tax Identification Number (PTIN) User Fee Update*, T.D. 9781, 81 Fed. Reg. 52,766 (Aug. 10, 2016).

The district court ruled in favor of the preparers, issued an injunction barring the IRS from charging the PTIN fee, and ordered the IRS to refund previously collected fees.[80] It reasoned that if every member of the public could obtain a PTIN, as they could after *Loving*, the IRS was not providing a special benefit that was not available to the general public. Moreover, the regulations did not indicate that SSNs were being inadvertently disclosed or find that their confidentiality was at risk.

The District of Columbia Circuit vacated the district court. It concluded that the protection of the confidentiality of tax return preparers' SSNs was a special benefit. Although the preamble to the regulations did not discuss the confidentiality concern when the agency adopted the fee,[81] the concern runs throughout the regulatory history of the requirement, including the legislative history of Congress's authorization for the IRS to mandate the use of PTINs. In addition, H&R Block and others had submitted comments in support of mandatory PTINs because the requirement would "protect the confidentiality of SSNs."[82] In summary, the IRS could rely on the special benefit of confidentiality even though this benefit was not articulated in the user fee regulations because the benefit was articulated in related regulations, comments, and legislative history pertaining to the requirement to use a PTIN.

This case is significant because it clarifies that the IRS is authorized to charge preparers for PTINs under the IOAA, even though the use of PTINs is mandated by the IRS.[83]

In *Gaylor v. Mnuchin*, the U.S. Court of Appeals for the Seventh Circuit held the federal parsonage housing tax exemption is constitutional because it is neutral towards religion (*i.e.*, it does not violate the Free Exercise or the Establishment clauses of the U.S. Constitution).[84]

Under the longstanding "convenience of the employer" doctrine (later incorporated into IRC § 119(a)(2)) housing provided to employees for the convenience of their employer (*e.g.*, for sailors aboard ships) was not income, but in 1921, the Treasury Department said that housing provided to ministers was income.[85] Congress responded by enacting IRC § 107, which provides that a "minister of the gospel" may exclude housing provided in-kind (under IRC § 107(1)) or in the form of a housing allowance (under IRC § 107(2)).

Seeking to challenge constitutionality of IRC § 107, the Freedom from Religion Foundation (FFRF) paid a housing allowance to employees and former employees, none of whom were ministers. The employees filed amended tax returns claiming refunds for their housing allowances under IRC § 107(2). After six months, the FFRF and its employees filed suit in district court as permitted by IRC § 6532(a)(1). The district court permitted several pastors and their religious organizations to intervene to defend IRC § 107(2).

80 *Steele v. United States*, 260 F.Supp.3d 52 (D.D.C. 2017), *vacated and remanded by Montrois v. United States*, 916 F.3d 1056 (D.C. Cir. 2019). For a discussion of *Steele*, see, *e.g.*, National Taxpayer Advocate 2017 Annual Report to Congress 351, 364-366 (Most Litigated Issues: *Significant Cases*).

81 *Id.* (citing *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947)). The IRS had discussed the benefit in connection with regulations imposing the requirement to use a PTIN (cited above).

82 *Montrois v. United States*, 916 F.3d 1056, 1066 (D.C. Cir. 2019).

83 For concerns about user fees, see, *e.g.*, National Taxpayer Advocate 2015 Annual Report to Congress 14-22 (Most Serious Problem: *IRS User Fees: The IRS May Adopt User Fees to Fill Funding Gaps Without Fully Considering Taxpayer Burden and the Impact on Voluntary Compliance*); National Taxpayer Advocate Memo to Associate Chief Counsel (Procedure and Administration), *Comments on User Fees for Offers in Compromise* (Nov. 28, 2016), https://www.regulations.gov/document?D=IRS-2016-0038-0003.

84 *Gaylor v. Mnuchin*, 919 F.3d 420 (7th Cir. 2019).

85 O.D. 862, 4 C.B. 85 (1921).

Both parties filed for summary judgment. The District Court for the Western District of Wisconsin held the statute violates the Establishment Clause of the First Amendment,[86] but the U.S. Court of Appeals for the Seventh Circuit reversed.[87]

To determine if IRC § 107(2) violates the Establishment Clause, the Seventh Circuit applied the *Lemon* test and the historical significance test.[88] Under the *Lemon* test, the statute must: (1) have a secular legislative purpose; (2) have a principal or primary effect that neither advances nor inhibits religion; and (3) not foster excessive government entanglement with religion.

First, the Seventh Circuit deferred to the government's sincere articulation of three secular purposes: to eliminate discrimination against ministers, to eliminate discrimination between ministers (*i.e.*, between those who receive in-kind housing and those that do not), and to avoid excessive entanglement with religion. It reasoned that IRC § 107(2) is simply one of many *per se* rules that provide a tax exemption to employees with work-related housing requirements.[89] The ease of administration represented by a categorical exclusion is a secular purpose. While the exclusion applicable to ministers is overbroad, it is no more overbroad than the other categorical exclusions, according to the court. Although the IRS must still determine whether a taxpayer qualifies as a "minister," the court found that this inquiry is less intrusive than an inquiry into how a religious organization uses its facilities. Thus, IRC § 107(2) has a secular purpose to avoid entanglement, which satisfies both the first and third prongs of the *Lemon* test.[90]

Moving to the second prong of the *Lemon* test, the court rejected FFRF's argument that the tax exemption for ministers under IRC § 107(2) has the principal effect of advancing religion by subsidizing it. After acknowledging the economic equivalence of a tax exemption and a subsidy, the court said that a tax exemption is not the same as a subsidy for purposes of this test.[91]

Turning to the historical purpose test, the court said that for over two centuries, states have implemented church property tax exemptions. While the provision at issue was an income tax provision, the income tax was not constitutional before 1913 and Congress excluded parsonages within a few years of income

86 *Gaylor v. Mnuchin*, 278 F. Supp. 3d 1081, 1104 (W.D. Wis. 2017).

87 *Gaylor*, 919 F.3d at 420.

88 *Lemon v. Kurtzman*, 403 U.S. 602 (1971) (the *Lemon* test); *Town of Greece v. Galloway*, 572 U.S. 562 (2014) (the historical significance test).

89 For example, IRC § 132 and § 162 exclude housing provided to an employee away on business for less than a year; IRC § 134 excludes housing provided to current or former members of the military; IRC § 911 excludes housing above a certain level provided to citizens or residents living abroad; IRC § 912 excludes housing provided to civilian officers and employees of the U.S. government living abroad. These categorical exemptions allow a wide range of employees to receive tax-exempt housing without needing to prove it was provided for the convenience of the employer under IRC § 119(a)(2).

90 Critics have observed that defining "minister of the gospel" is a "really hard and invasive question." *See, e.g.*, Amy Lee Rosen, *Clergy Tax Exemption Problematic Despite 7th Circ. Ruling*, 2019 Law360 78-138 (Mar. 19, 2019) (quoting Samuel D. Brunson, a professor at Loyola University Chicago School of Law). Moreover, several tax professors, including Brunson, signed an amicus brief to the Seventh Circuit arguing the clergy housing tax exemption should be quashed because it entangles church and state and subsidizes religion. Amicus Curiae Brief of Tax Law Professors in Support of Appellees, *Gaylor v. Mnuchin*, 919 F.3d 420 (2019) (No. 18-1277), 2018 WL 3311509.

91 Amici observed that "[T]reating targeted exemptions differently from direct spending would permit Congress to subvert the First Amendment by offering refundable tax credits to churches, exempting all ministerial income from tax, or exempting all religious people from the income tax." Amicus Curiae Brief of Tax Law Professors in Support of Appellees, at 13, *Gaylor v. Mnuchin*, 919 F.3d 420 (2019) (No. 18-1277), 2018 WL 3311509. For further analysis of the constitutionality of tax exemptions, see Edward A. Zelinsky, *Winn and the Inadvisability of Constitutionalizing Tax Expenditure Analysis*, 121 Yale L.J. Online 25 (2011).

becoming taxable; and a few decades later it excluded cash housing allowances as well.[92] Thus, it held IRC § 107(2) does not violate the Free Exercise Clause or the Establishment Clause.

This case is significant because over 200,000 congregations provide a housing allowance to their ministers.[93] Because it raises controversial constitutional issues, however, we might expect further litigation in this area.[94]

In *Wagner v. United States*, the U.S. District Court for the Eastern District of Washington held that the two-year period for filing a refund claim under IRC § 6532(a) was subject to equitable tolling due to confusing correspondence from the IRS.[95]

The Wagners timely filed their 2012 federal income tax return, claiming a refund of $1,364,363. They asked for $500,000 to be refunded and for the remainder ($864,363) to be applied to their tax liability for 2013. In November 2014, the IRS sent a letter, which indicated it was allowing only $839,999 of the claim and disallowing the remainder ($524,364). On December 5, 2014, the Wagners appealed.

The IRS did not respond until May 2016, when it sent another letter, this time stating it "allowed only $0.00 of the claim," apparently disallowing the $839,999 of the claim for the first time. Because there was an outstanding and unexplained credit of $523,686 on the account, the IRS took only $335,871 (rather than the entire $859,357 then owed for 2012 – the original $839,999 plus interest and penalties) from the Wagners' 2014 refund and applied it to their 2012 tax liability.[96]

On March 1, 2018, the Wagners filed suit seeking a refund of $839,999. The government moved to dismiss, arguing that the portion of the claim that was not offset against the credit from tax year 2014 (*i.e.*, $523,686) was time barred.[97] It reasoned that the two-year period provided by IRC § 6532(a) to bring suit commenced when the IRS sent its first letter in November 2014, and ended in November 2016.

The court denied the government's motion, holding that the filing was timely for two reasons. First, it reasoned that the two-year period for filing suit did not commence until May 2016, when the IRS issued the second letter, which was the first time it informed the taxpayer of its decision to disallow the $839,999 claim. Therefore, the March 1, 2018, filing was within the two-year period.

In the alternative, if the two-year period commenced in November 2014, the court said the period was tolled and the filing deadline was extended because of "equitable considerations" generated by the IRS's confusing correspondence, "including the fact that Plaintiffs were informed that $839,999 of the

92 Amici observe that without a property tax exemption, the state might lien or levy on church property if the tax went unpaid, whereas if a housing allowance were subject to the income tax, no similar entanglement would ensue. Amicus Curiae Brief of Tax Law Professors in Support of Appellees, at *17, *Gaylor v. Mnuchin*, 919 F.3d 420 (2019) (No. 18-1277), 2018 WL 3311509.

93 *Gaylor*, 919 F.3d at 424 n.3.

94 See Amy Lee Rosen, *Clergy Tax Exemption Problematic Despite 7th Circ. Ruling*, 2019 Law360 78-138 (Mar. 19, 2019); Amicus Curiae Brief of Tax Law Professors in Support of Appellees, *Gaylor v. Mnuchin*, 919 F.3d 420 (2019) (No. 18-1277), 2018 WL 3311509. Moreover, the *Lemon* test was subsequently questioned by the Supreme Court. *See Am. Legion v. Am. Humanist Ass'n*, 139 S. Ct. 2067 (2019).

95 *Wagner v. United States*, 353 F. Supp. 3d 1062 (E.D. Wash. 2018).

96 The decision does not indicate when the IRS offset the 2014 refund against the 2012 liability. The IRS presumably applied the refund to 2012 (rather than 2013, as requested) because it arose in 2012 and the IRS did not believe there was an overpayment in 2012.

97 The court did not address the question of whether it lacked jurisdiction because the Wagners had not fully paid the liability. *See Flora v. United States*, 362 U.S. 145 (1960). For a proposal to repeal or limit this rule, see National Taxpayer Advocate 2018 Annual Report to Congress (Legislative Recommendation: *Fix The* Flora *Rule: Give Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can*).

requested refund claim was not going to be allowed less than 6 months before the statute of limitations expired..."[98]

Because equitable tolling does not apply to jurisdictional deadlines, the court examined whether the filing deadline was jurisdictional. Filing deadlines are non-jurisdictional unless Congress makes them jurisdictional through a "clear statement."[99] "Congress must do something special, beyond setting an exception-free deadline, to tag a statute of limitations as jurisdictional and so prohibit a court from tolling it," according to the Supreme Court.[100]

The District Court reasoned that the distance between the waiver of sovereign immunity, which is found in 28 U.S.C. § 1346(a)(1), and the filing deadline, which is found in IRC § 6532(a) under a subtitle labeled "Procedure and Administration," is a strong indication that the deadline is procedural and not jurisdictional. The deadline does not explicitly limit the court's power and is not cast in jurisdictional terms. Moreover, it reasoned that the recovery of amounts wrongfully withheld is akin to the common law tort of conversion, and the grant of jurisdiction does not in any way limit the court's usual equitable powers.

This case is significant because it suggests for the first time that the period for filing a refund claim under IRC § 6532(a) is subject to equitable tolling.[101] Equitable tolling is consistent with the taxpayer's *rights to appeal an IRS decision in an independent forum* and *to a fair and just tax system*.

98 *Wagner*, 353 F. Supp.3d at 1069.

99 *United States v. Wong*, 135 S. Ct. 1625 (2015) (citation omitted) (finding the filing deadlines for Federal Court Claims Act suits in 28 U.S.C. § 2401(b) non-jurisdictional and subject to equitable tolling). *See also Volpicelli v United States*, 777 F.3d 1042 (9th Cir. 2015) (holding the filing deadline in IRC § 6532(c) to bring suit to recover a wrongful levy in district court was non-jurisdictional and subject to equitable tolling).

100 *Wong*, 135 S. Ct. at 1632.

101 *See, e.g., Hessler v. United States*, 2016 U.S. Dist. LEXIS 1210, at *12 n.5 (E.D. Cal. 2016) ("Whether equitable tolling applies to section 6532(a)(1) remains an open question"); *Drake v. United States*, 2011 U.S. Dist. LEXIS 22563 *6 (D. Ariz. 2011) ("We find no authority to apply equitable tolling to this statute and decline to do so when plaintiff does not expressly raise it"). *But see Smith v. United States*, Dkt No. 1:19-cv-271 (W.D. Mich. 2019) (concluding the filing deadlines under IRC §§ 7422(a) and 6432(a)(1) are jurisdictional in the Sixth Circuit). For further discussion of the Wagner case and advocacy on this issue, see Carlton Smith, *District Court Equitably Tolls 2-Year Deadline to File Refund Suit*, Procedurally Taxing Blog (Nov. 28, 2018), http://proceduralltaxing.com/district-court-equitably-tolls-2-year-deadline-to-file-refund-suit/. The National Taxpayer Advocate has recommended extending equitable doctrines, such as equitable tolling, to periods prescribed by the IRC. *See* National Taxpayer Advocate 2017 Annual Report to Congress 283 (Legislative Recommendation: *Equitable Doctrines: Make the Time Limits for Bringing Tax Litigation Subject to the Judicial Doctrines of Forfeiture, Waiver, Estoppel, and Equitable Tolling, and Clarify That Dismissal of an Untimely Petition Filed in Response to a Statutory Notice of Deficiency Is Not a Decision on the Merits of a Case*).

MLI #1 Trade or Business Expenses Under IRC § 162 and Related Sections

SUMMARY

The deductibility of trade or business expenses has perpetually been among the ten Most Litigated Issues (MLIs) since the first National Taxpayer Advocate's Annual Report to Congress in 1998.[1] We identified 82 cases involving a trade or business expense issue that were litigated in federal courts between June 1, 2018, and May 31, 2019. The courts affirmed the IRS position in 61 of these cases, or about 74 percent, while taxpayers fully prevailed in only two cases, or about two percent of the cases. The remaining 19 cases, or about 23 percent, resulted in split decisions.

TAXPAYER RIGHTS IMPACTED[2]

- *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.[3] 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.[4]

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.[5]

The interaction of IRC § 162 with other Code sections that explicitly limit or disallow deductions can be complex. For example, the year in which the deduction for trade or business expenses can be taken and its amount depend on when the cost was paid or incurred, the useful life of an asset on the date of

1 See National Taxpayer Advocate 1998-2018 Annual Reports to Congress.

2 See Taxpayer Bill of Rights (TBOR), 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.

acquisition, and when it was sold or when the business operation is terminated.[6] Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance over the years. 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.[7] The definition of a "trade or business" comes from common law, where the concepts have been developed and refined by the courts.[8] 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.[9]

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.[10] The Supreme Court describes an "ordinary" expense as customary or usual and of common or frequent occurrence in the taxpayer's trade or business.[11] The Court describes a "necessary" expense as one that is appropriate and helpful for the development of the business.[12] Further, an employee business expense is not ordinary and necessary if the employee is entitled to reimbursement from the employer.[13] 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.[14]

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.[15]

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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).

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 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.

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

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

13 *Podems v. Comm'r*, 24 T.C. 21, 22-23 (1955). As unreimbursed employee business expenses are miscellaneous itemized deductions under IRC § 67, they will not be available to taxpayers for the 2018-2025 tax years under IRC § 67(g). The employee has the burden of establishing the amount of the expense and that the expense is not eligible for reimbursement.

14 In *Comm'r v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held "the element of reasonableness is inherent in the phrase 'ordinary 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." 176 F.2d 815, 817 (6th Cir. 1949), *cert. denied*, 338 U.S. 949 (1950).

15 IRC § 162(a). IRC § 263. No current deduction is allowed for the cost of acquisition, construction, improvement, or restoration of an asset expected to last more than one year. *See also INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992). 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. 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).

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.[16] 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.[17]

When Can an Approximation of Business Expenses Be Used?

The *Cohan* rule is one of "indulgence" established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.[18] 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 to allow nothing at all appears to us inconsistent with saying that something was spent."[19] 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."[20]

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 (including meals and lodging while away from home);
- Gifts; and
- Certain "listed property."[21]

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.[22]

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

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

18 *Id.*

19 39 F.2d 540 (2d Cir. 1930) at 544, *aff'g and remanding* 11 B.T.A. 743 (1928).

20 767 F.3d 443, 449 n. 7 (5th Cir. 2014) (citing *Cohan*, 39 F.2d at 543-44), *rev'g* 140 T.C. 86 (2013).

21 "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).

22 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). 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." Treas. Reg. § 1.274-5T(c)(1); *Reynolds v. Comm'r*, 296 F.3d 607, 615-616 (7th Cir. 2002) (noting that keeping written records is not the only method to substantiate IRC § 274 expenses but "alternative methods are disfavored").

ANALYSIS OF LITIGATED CASES

This year, we reviewed 82 cases involving trade or business expenses that were litigated in federal courts from June 1, 2018, through May 31, 2019. The table 1 listed in Appendix 5 contains a list of the respective issues in these cases. Figure 2.1.1 categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

FIGURE 2.1.1, Trade or Business Expense Issues Cases Reviewed[23]

Issue	Type of Taxpayer	
	Individual	Business
Substantiation of Expenses Under IRC § 162, Including Application of the *Cohan* Rule	10	34
Substantiation of Expenses under IRC § 274(d)	8	18
Schedule A Unreimbursed Employee Expenses Requiring Proof Employer Did Not Reimburse Taxpayer Under IRC § 162	8	7
Hobby Losses, Nondeductible Under Either IRC §§ 183 or 162	0	9
Home Office Under IRC § 280A	4	5
Net Operating Losses Under IRC § 172	0	6
Personal Expenditures Disallowed Under IRC § 262	2	2
Capitalization and Cost Recovery Under IRC §§ 263, 263A, 195, 179, and 167	0	10
Illegal Activities Under IRC §§ 280E, 162(c), 162(f), and 162(g)	0	6
Economic Substance Doctrine	0	2
Business Bad Debt Deduction Under IRC § 166	0	4
Not Engaged In a Trade or Business Under IRC § 162	0	2
Interest Deduction Under IRC § 163	0	1

Taxpayers represented themselves (*pro se*) in 35 of the 82 cases (about 43 percent). Taxpayers were represented by counsel in 47 out of the 82 cases (about 57 percent). Of the 82 cases, the taxpayers prevailed in two cases in full, and in 19 cases in part. The IRS won in the remaining 61 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.[24] Additionally, taxpayers claimed travel, meals, and entertainment expenses, but occasionally failed to meet the heightened substantiation requirements of IRC § 274(d).[25] Many *pro se* litigants were unable to meet substantiation requirements.[26]

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

24 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.

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

26 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 but one of these cases were issued as either Tax Court memorandum opinions or summary opinions.[27]

The sole individual case decided by a Court of Appeals was *Liljeberg v. Commissioner*, in which the Court of Appeals for the D.C. Circuit affirmed an earlier decision by the U.S. Tax Court.[28] *Liljeberg* involved the question of whether three nonresident foreign students enrolled in the State Department's Exchange Visitor Program could deduct Schedule A unreimbursed employee business expenses for travel, meal, and entertainment costs. The students, who were from Finland, Russia, and Ireland, entered the U.S. on nonimmigrant "J visas," which permitted them to work part-time jobs while studying as full-time students for up to four consecutive months. The students argued that they could deduct their travel, meal, and entertainment expenses under IRC § 162(a)(2), which allows taxpayers to deduct business expenses incurred while "away from home" for business reasons.[29]

The D.C. Circuit, however, ruled that the students were not away from home on business in the manner contemplated by IRC § 162(a)(2). Such was the case because the students came to work in the U.S. voluntarily and were not required by their employers to retain an abode in their home countries. The fact that this home country residency requirement was established by the visa process, as opposed to the employers themselves, was insufficient in the eyes of the D.C. Circuit. As a result, the Court of Appeals affirmed the Tax Court and denied deductions for unreimbursed employee business expenses not incurred in the pursuit of a trade or business.

Another case illustrating some of the most commonly arising issues in the individual trade or business context is *Sutherland v. Commissioner*.[30] There, a taxpayer sought to deduct a variety of job search expenses. The court allowed deductions related to the creation and mailing of a "value proposition deck," because it was used to seek employment. On the other hand, deductions incurred for meals, entertainment, and transportation costs during the job search were disallowed because Taxpayer did not meet the heightened contemporaneous documentation standards of IRC § 274(d). Likewise, Taxpayer could not establish that computer supplies had been used solely for business purposes.

Taxpayer's spouse, a manager for a furniture company, also attempted to deduct meals and entertainment expenditures as unreimbursed employee business expenses. He claimed deductions for meals purchased while out of town on business and for costs incurred in taking his employees out for meals and entertainment for team building and recognition. However, these deductions were disallowed because, among other reasons, he never requested reimbursement and because he did not seek authorization from his superiors for the recognition-related expenses.

27 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.

28 *Liljeberg v. Comm'r*, 907 F.3d 623 (D.C. Cir. 2018), *aff'g* 148 T.C. 83 (2017).

29 *See Barone v. Comm'r*, 85 T.C. 462, 465 (1985) (citations omitted), which states that for an expense to qualify under section 162(a)(2) it must (1) be ordinary and necessary, (2) have been incurred while the taxpayer was "away from home", and (3) have been incurred in the pursuit of a trade or business. The second element of whether the taxpayers were "away from home" was in dispute in *Liljeberg*.

30 *Sutherland v. Comm'r*, T.C. Memo. 2018-186.

Business Taxpayers

TAS reviewed 69 cases involving business taxpayers. Business taxpayers prevailed fully in two cases (approximately three percent), partially prevailed in 16 cases (approximately 23 percent), and the IRS was completely successful in the remaining cases (approximately 74 percent). Of cases in which business taxpayers fully or partially prevailed, 67 percent (12 of 18) involved taxpayers represented by counsel. Alternatively, six *pro se* business taxpayers partially prevailed, but none fully prevailed. Of cases in which the IRS fully prevailed, approximately 61 percent (31 of 51) involved business taxpayers represented by counsel, while approximately 39 percent (20 of 51) involved *pro se* taxpayers.

One of the more commonly litigated issues from year to year is whether an activity is carried on as a business for profit or whether it simply represents a hobby. This distinction is significant because losses attributable to a hobby can only be deducted to the extent of income generated by the activity, while business losses have no such limitation.[31]

The analysis employed to distinguish between business and hobby activities is well illustrated by *Ford v. Commissioner*. The case focused on a music venue called Bell Cove that enjoyed substantial success when operated by Taxpayer, a former country music singer, and her husband, a producer and record label owner.[32] The venue closed upon the husband's death, but was reopened by Taxpayer several years later as she attempted to restore Bell Cove to its former glory. Among other things, Taxpayer engaged musicians to perform on weekends and hosted various events, including parties and weddings. Despite Taxpayers' efforts, however, Bell Cove was consistently unprofitable, losing approximately $420,000 between 2008 and 2014. She was able to continue operating the venue by drawing on trust funds at her disposal.

In affirming the prior Tax Court decision, the Sixth Circuit analyzed the nine-factor test for distinguishing for-profit activities from hobbies, set forth in the regulations under IRC § 183.[33] Based on these factors, the Sixth Circuit determined that Taxpayer did not have the requisite intent to make a profit in her operation of Bell Cove. Among other things, the Sixth Circuit noted that Bell Cove was not operated in the manner of a traditional business, as Taxpayer made no effort either to minimize expenses or to undertake improvements and innovations that would increase revenue. Further, the activity generated ongoing losses that showed no realistic likelihood of being offset by annual profits or appreciation in the property. These circumstances, when combined with the substantial personal pleasure derived by Taxpayer from running Bell Cove and her ability to defray losses with her personal income, caused the Sixth Circuit to conclude that Bell Cove and its operations represented a hobby, rather than a business. Accordingly, Taxpayer was unable to deduct Bell Cove's losses against her income from other sources.

On the other hand, in *Potter v. Commissioner*, Taxpayer found a way of circumventing the loss limitations of IRC § 183.[34] Taxpayer, an independent contractor who sold soil on commission, operated his business through a C corporation, of which he was the sole shareholder and only employee. When the third-party company for whom Taxpayer sold soil was purchased, Taxpayer, via his corporation, received substantial termination pay and discontinued all sales activities. Having significant leisure time, he took up cowboy mounted shooting, in which participants, wearing old western or military garb, engage in riding and shooting competitions for prize money.

31 IRC § 183(b)(2).

32 *Ford v. Comm'r*, 751 F. App'x. 843 (6th Cir. 2018) *aff'g* T.C. Memo. 2018-8.

33 Treas. Reg. § 1.183-2(b).

34 *Potter v. Comm'r*, T.C. Memo. 2018-153.

In furtherance of this activity, Taxpayer purchased a truck, trailer, and tractor for over $150,000. These expenditures were capitalized and depreciated by Taxpayer's corporation. At first, the deductions were disallowed by the IRS on the grounds that Taxpayer was involved in a hobby, rather than a for-profit activity. However, IRC § 183, by its very terms, does not apply to C corporations. Thus, when the Tax Court determined that Taxpayer was pursuing his cowboy mounted shooting through the corporation, rather than in his individual capacity, this ruling led to the presumptive conclusion that Taxpayer was involved in a trade or business, expenses from which could be deducted even if they exceeded income from the associated activity.

Where a trade or business is being carried on, compensation is one of the few deductible expenses specifically identified by IRC § 162.[35] Occasionally, controversy arises regarding whether payments made by the business are in fact deductible compensation, or instead represent some other sort of nondeductible transfer. Just such an issue was presented in the case of *Little Mountain Corp v. Commissioner*.[36]

Taxpayer (Little Mountain Corp) purchased a precious metals business from Franklin Sanders, who then set up a sole proprietorship, Always Frank Consulting, and purportedly began performing consulting services for Taxpayer.[37] According to Taxpayer, it paid him approximately $900,000 of consulting fees, which Taxpayer deducted on its 2011 return. However, Taxpayer did not issue Sanders a Form 1099, and he reported no compensation of any sort during that year. The IRS disallowed Taxpayer's deduction on the grounds that Taxpayer failed to prove that the payments in question were deductible compensation.

The Tax Court sustained this determination and, upon review, the Ninth Circuit affirmed the lower court's decision. In particular, the Ninth Circuit was concerned that the payments were provided in the form of checks made out to "cash," which ultimately were endorsed by individuals unassociated with Franklin Sanders or his consulting business. Likewise, an ill-kept ledger and generic invoices, when combined with the lack of any Forms 1099 and Sanders's nonreporting, failed to clarify the nature of the payments. As a result, the Ninth Circuit held that Taxpayer had fallen short of the level of proof necessary to establish that the cash transfers in question represented deductible compensation.

An increasing number of cases also present scenarios in which otherwise allowable expenses are barred from deductibility because of a specific statutory exclusion. The most common of these prohibitions arises with respect to illegal expenses under IRC § 280E in the context of marijuana dispensaries. *Patients Mut. Assistance Collective Corp. v. Commissioner* provides an excellent discussion of the legal issues surrounding the controversy.[38] The case involved a corporate taxpayer that operated a medical marijuana dispensary, legally organized under California law. Taxpayer incurred a variety of expenses, including employee compensation, that it sought to deduct. Despite conceding that these expenditures were directly related to Taxpayer's trade or business, the IRS disallowed these deductions under IRC § 280E, which specifies, "No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances." In upholding the IRS's disallowance of the deductions, the Tax Court explained that IRC § 280E had been passed by

35 IRC § 162(a)(1).

36 *Little Mtn. Corp. v. Comm'r*, 736 F. App'x 691 (9th Cir. 2018), *aff'g* T.C. Memo. 2016-147.

37 Taxpayer was owned by relatives of Franklin Sanders and, according to the Tax Court, "The record strongly suggests that the corporation is Mr. Sanders' alter ego." *Little Mtn. Corp. v. Comm'r, T.C. Memo.* 2016-147.

38 *Patients Mut. Assistance Collective Corp. v. Comm'r*, 151 T.C. No. 11 (2018).

Congress as a direct response to a prior decision that "allowed a cocaine dealer to deduct the ordinary and necessary expenses of his illicit trade."[39]

Taxpayer also provided a variety of other non-marijuana services and products, including yoga, tai chi, hypnotherapy, acupuncture, and t-shirts. The IRS disallowed all expenses related to these lines of business as well. In sustaining the IRS disallowances, the Tax Court premised its conclusion on a broad reading of IRC § 280E, holding that it prohibits deductions from all activities within a trade or business, even if only part of the trade or business actually involves the direct sale of marijuana.[40]

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 82 cases involving IRC § 162 related issues between June 1, 2018, and May 31, 2019.

As in prior years, a variety of cases arose regarding the merits of claimed deductions for legal fees, costs associated with marijuana dispensaries, and business expenses that were held to be personal in nature. Many 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.

39 *Edmonson v. Comm'r*, T.C. Memo. 1981-623.

40 In a separate case dedicated to the consideration of whether Taxpayer should be liable for accuracy-related penalties under IRC § 6662(a), the Tax Court determined that these penalties were inapplicable because of the lack of clear authority in this area.

MLI #2 Appeals From Collection Due Process Hearings Under IRC §§ 6320 and 6330

SUMMARY

A Collection Due Process (CDP) hearing is an opportunity for a taxpayer to have an independent and meaningful review by the IRS Office of Appeals (Appeals) prior to the IRS's first levy or immediately after its first Notice of Federal Tax Lien (NFTL) filing to enforce a tax liability.[1] 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.[2]

Once Appeals issues a determination, a taxpayer has the right to judicial review of that determination if the taxpayer timely requests a CDP hearing and timely petitions the U.S. Tax Court.[3] Generally, the IRS suspends levy actions during a levy hearing and any subsequent judicial review of the Appeals determination that follows the hearing.[4]

CDP has been one of the federal tax issues most frequently litigated in the federal courts since 2001; however, only a small fraction of eligible taxpayers exercise their right to an administrative hearing, and far fewer taxpayers petition the Tax Court to review their case. Between 2003 and 2019, only 1.44 percent of the taxpayers who received a CDP notice requested an administrative hearing (*i.e.*, 426,484 out of 29,614,768) and only 0.08 percent filed a petition in Tax Court (*i.e.*, 24,690 out of 30,726,471).

Our review of litigated issues found 80 opinions on CDP cases during the review period of June 1, 2018, through May 31, 2019, which is an increase of about eight percent since last year's report.[5] Taxpayers prevailed in full in four of these cases (five percent) and, in part, in two others (about three percent). The eight percent success rate for the taxpayers is lower than last year. Of the six 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*),[6] and two were represented by an attorney or other court-approved professional. 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

1 IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, § 3401, 112 Stat. 685, 746 (1998). Prior to RRA 98, the U.S. Supreme Court had held that a post-deprivation hearing satisfied due process concerns in the tax collection arena. *See United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 726-31 (1985); *Phillips v. Comm'r*, 283 U.S. 589, 595-601 (1931).

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 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 2 in Appendix 5, Most Litigated Issues Case Tables, *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).

suggest.[7] The IRS prevailed fully in 74 cases (about 93 percent) of the opinions, an increase from the 88 percent success rate last year.[8]

TAXPAYER RIGHTS IMPACTED[9]

- *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 when the IRS proposes a levy action or after it files an NFTL.[10] 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.[11] The hearing allows taxpayers to raise issues related to collection of the liability, including:

- The appropriateness of collection actions;[12]
- Collection alternatives such as an installment agreement (IA), offer in compromise (OIC), a bond posting, or substitution of other assets;[13]
- Appropriate spousal defenses;[14]
- A challenge of 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;[15] and
- Any other relevant issue relating to the unpaid tax, the NFTL, or the proposed levy.[16]

A taxpayer cannot raise an issue already raised and considered at a prior administrative or judicial hearing if the taxpayer participated meaningfully in that hearing or proceeding.[17]

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

8 National Taxpayer Advocate 2018 Annual Report to Congress 488-508 (Most Litigated Issue: *Appeals from Collection Due Process Hearings Under IRC §§ 6320 and 6330)*.

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

10 IRC §§ 6320 and 6330.

11 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.

12 IRC § 6330(c)(2)(A)(ii).

13 IRC § 6330(c)(2)(A)(iii).

14 IRC § 6330(c)(2)(A)(i).

15 IRC § 6330(c)(2)(B).

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

17 IRC § 6330(c)(4).

Procedural Collection Due Process Requirements

The IRS must provide a CDP notice to the taxpayer indicating the specific tax and tax period after filing the first NFTL and generally before the first intended levy is issued.[18] 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.[19]

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.[20] 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.[21]

Requesting a Collection Due Process Hearing

Under both lien and levy procedures, the taxpayer must return a signed and dated written request for a CDP hearing, including the reasons for requesting a hearing, within the applicable period.[22] Taxpayers who fail to timely request a CDP hearing will be afforded an "equivalent hearing" that is similar to a CDP hearing, but there is no judicial review of an adverse determination.[23] 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.[24]

How a Collection Due Process 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.[25] A taxpayer can request that the hearing be in-person; however, courts have ruled that a CDP hearing need not be in-person but can take place

18 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."

19 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.

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

21 *Id*.

22 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). 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, Request for Collection Due Process or Equivalent Hearing (Dec. 2013); Internal Revenue Manual (IRM) 8.6.1.5.1, Conference Practice (Sept. 25, 2019).

23 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, 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).

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

25 IRC § 6320(b)(4).

by telephone or correspondence,[26] and Appeals will typically conduct the hearing by telephone unless the taxpayer requests an in-person conference and provides non-frivolous reasons for opposing the IRS collection action.[27]

The CDP hearing is to be held by an impartial officer from Appeals who has had "no prior involvement" and who is barred from engaging in *ex parte*[28] communications with IRS employees about the substance of the case.[29] In addition to addressing the issues raised by the taxpayer, the Appeals Officer (AO) must verify that the IRS has met the requirements of all applicable laws and administrative procedures.[30] 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."[31] 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.[32]

Judicial Review of an IRS Determination After a Collection Due Process Hearing

Within 30 days of Appeals' determination, the taxpayer may petition the Tax Court for judicial review;[33] however, if the petition is filed even one day late, the Tax Court will not have jurisdiction to review the IRS's determination.[34] The court will only consider issues, including challenges to the

26 *Katz v. Comm'r*, 115 T.C. 329, 337-38 (2000) (finding that telephone conversations between the taxpayer and the 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).

27 Under IRM 8.6.1.4.1, Conference Practice (Oct. 1, 2016), the default rule is to hold conferences by telephone, and to offer virtual conferences as an alternative to in-person conferences. Appeals may be able to accommodate a taxpayer's request for an in-person hearing in a field office, however Appeals campus locations cannot accommodate in-person conferences. *See* IRS, Interim Guidance on Appeals Conference Procedures, AP-08-1017-0017 (Oct. 13, 2017). A taxpayer will not be granted an in-person conference concerning a collection alternative, such as an IA or OIC, unless other taxpayers would be eligible for the alternative under similar circumstances. For example, the IRS will not grant an in-person 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. *See* Treas. Reg. §§ 301.6320-1(d)(2), Q&A (D)(8) and 301.6330-1(d)(2), Q&A (D)(8).

28 Rev. Proc. 2012-18, 2012-1 C.B. 455 § 2.01 defines *ex parte* communication as "a communication that takes place between any Appeals employee (*e.g.*, Appeals Officers, Settlement Officers, Appeals Team Case Leaders, Appeals Tax Computation Specialists) and employees of other IRS functions, without the taxpayer/representative being given an opportunity to participate in the communication. The term includes all forms of communication, oral or written. Written communications include those that are manually or electronically generated."

29 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.

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

31 IRC § 6330(c)(3)(C); IRM 8.22.4.2.2, Summary of CDP Process (Aug. 9, 2017). *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. 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).

32 *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).

33 IRC § 6330(d)(1).

34 *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).

underlying liability, that were properly raised during the CDP hearing.[35] 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.[36] 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.[37] When the case is remanded to Appeals, the Tax Court retains jurisdiction.[38] 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.[39]

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*[40] basis, and the scope of its review extends to evidence introduced at the trial that was not a part of the administrative record.[41] 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.[42]

Special rules apply to the IRS's handling of hearing requests that raise frivolous issues. Internal Revenue Code (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.[43] 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.[44] A request is subject to a penalty if any part of it "(i) is based on a position that the Secretary has identified as frivolous … or (ii) reflects a desire to delay or impede the administration of Federal tax laws."[45] 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

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

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

37 *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).

38 *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 Blog (Oct. 9, 2018), http://proceduralltaxing.com/for-irs-appeals-office-an-epidemic-of-remands/.

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

40 Under a *de novo* standard of review, the Tax Court will consider all relevant evidence introduced at trial. *Jordan v. Comm'r*, 134 T.C. 1, 8 (2010).

41 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).

42 *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).

43 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 provided the first published list of frivolous positions. Notice 2010-33, 2010-17 C.B. 609, contains the current list.

44 The frivolous submission penalty applies to the following submissions: CDP hearing requests under IRC §§ 6320 and 6330, OIC under IRC § 7122, IAs under IRC § 6159, and applications for a Taxpayer Assistance Order under IRC § 7811.

45 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).

frivolous position under IRC § 6702(b)(2)(A) and issued a notice stating that Appeals will disregard the request.[46] If IRS Counsel's review reveals that a CDP hearing was properly denied under IRC § 6330(g), Counsel will file an appropriate motion with the Court to resolve the case through a dismissal or summary judgment. If the Tax Court determines that a hearing was improperly denied, IRS Counsel will request a remand to Appeals. Counsel will also consider filing a motion to permit levy so that the Service can immediately levy after the Tax Court's order.[47]

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.[48] However, in cases appealable to the other U.S. Courts of Appeals that have yet to address that precise issue in a precedential opinion, the court may consider new evidence not contained in the administrative record.[49]

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.[50] 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."[51] For example, an IRC § 6707A penalty[52] is an assessable penalty not subject to deficiency procedures.[53]

46 *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 481, 489 (Most Litigated Issue: *Appeals from Collection Due Process Hearings Under IRC §§ 6320 and 6330*).

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

48 *See Kasper v. Comm'r*, 150 T.C. No. 2 at 19 n.13 (2018); *see also 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).

49 *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.

50 *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).

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

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

53 The Tax Court 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. *See Bitter v. Comm'r*, T.C. Memo. 2017-46. The *Bitter* determination was a culmination of similar developments in circuit court decisions on the same issue. *See Iames v. Comm'r*, 850 F.3d 160 (4th Cir. 2017); *Keller Tank Serv. II, Inc. v. Comm'r*, 854 F.3d 1178 (10th Cir. 2017); *Our Country Home Enterprises, Inc. v. Comm'r*, 855 F.3d 773 (7th Cir. 2017).

Appellate Venue From Decisions of the Tax Court

Under the rule established in *Golsen v. Commissioner*,[54] 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. 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).[55]

ANALYSIS OF LITIGATED CASES

We identified and reviewed 80 CDP court opinions, an increase of about eight percent from the 74 published opinions in last year's report. During 12 out of the last 16 years, the number of requests for IRS CDP hearings has risen and fallen consistent with the number of CDP notices the IRS mails to taxpayers each year. The number of petitions for judicial review in the Tax Court has followed a similar trend during ten out of the last 16 years. This year, the number of petitions decreased by five percent while the IRS issued 11 percent more notices than it did last year. Notably, only a small fraction of taxpayers exercise their right to request an administrative hearing or petition for judicial review. Fewer than one in 50 taxpayers who received a CDP notice requested an administrative hearing, and fewer than one in 800 filed a petition in Tax Court. This could be an indication that taxpayers aren't reading CDP notices or that they don't understand how to respond to them or exercise their rights as taxpayers. Figure 2.2.1 depicts these trends.

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

55 According to the ruling in *Byers v. Comm'r*, the correct venue for appeals from the Tax Court in cases filed before December 18, 2015 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. *Byers*, 740 F. 3d 668 (D.C. Cir. 2014). In 2015, Congress amended IRC § 7482 to overturn *Byers*. Pub. L. No. 114-113, Div. Q, Title IV, § 423(a), (b) (2015). The National Taxpayer Advocate recommended this precise legislative change. See 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*). 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*).

FIGURE 2.2.1

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

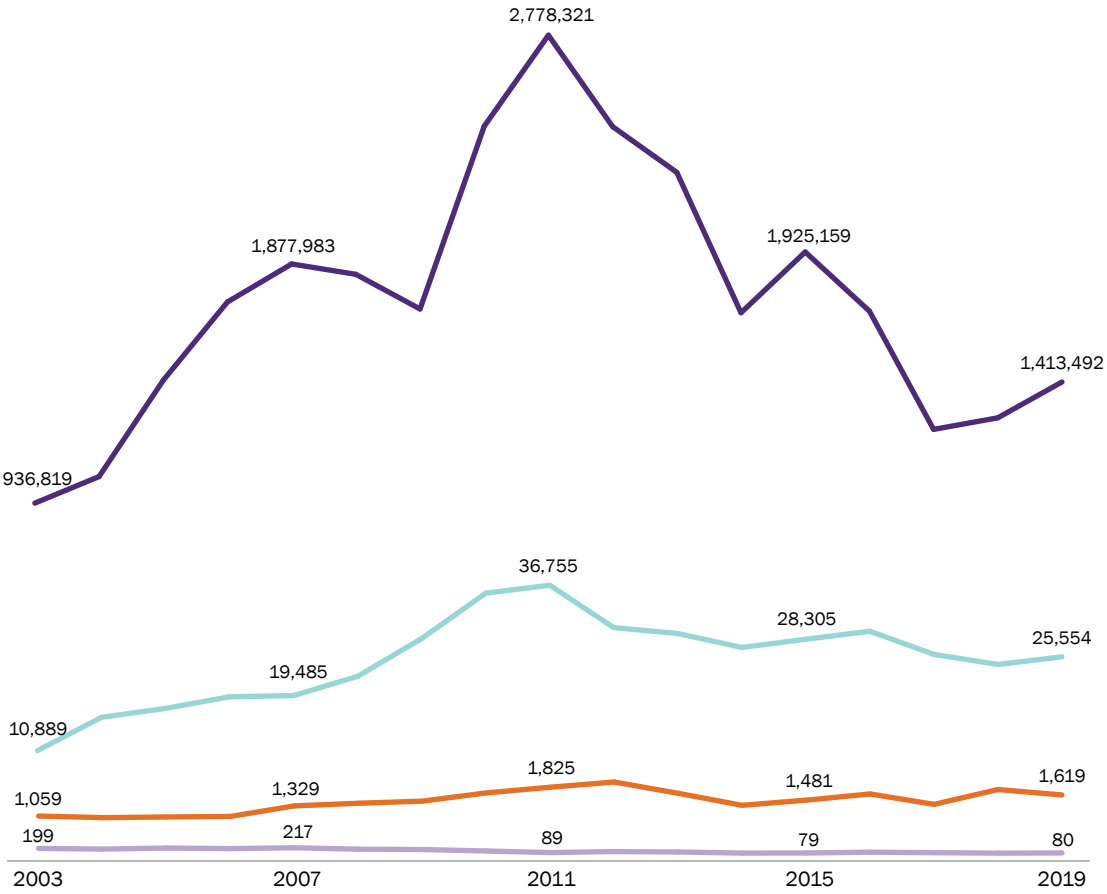
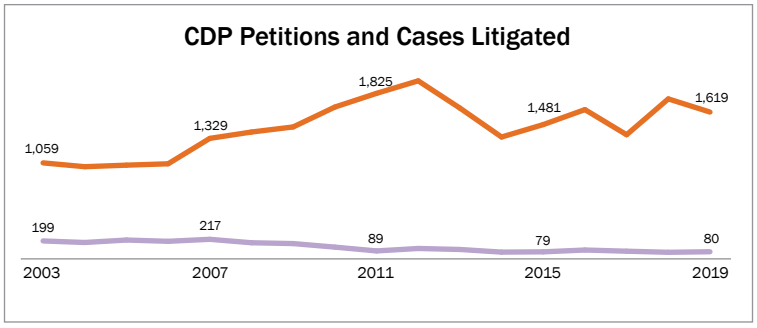


Figure is not to exact scale



The 80 opinions identified this year do not reflect the full number of CDP cases because the court does not issue an opinion in all cases.[56] Some are resolved through settlements, and in other cases, taxpayers do not pursue litigation after filing a petition with the court.[57] The Tax Court also disposes of some cases by issuing unpublished orders.[58] Table 2 in Appendix 5 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.

Kearse v. Commissioner

In *Kearse v. Commissioner*,[59] the taxpayer sought review, pursuant to IRC §§ 6320(c) and 6330(d)(1), of the IRS's determination to uphold an NFTL filing. Mr. Kearse is a retired professional athlete who played in the National Football League from 1999 to 2010. His liability stems from an IRS determination rejecting a $1,359,000 deduction he claimed on his Form 1040, U.S. Individual Income Tax Return, in 2010 for a "business bad debt expense."[60] On May 11, 2012, the IRS issued a notice of deficiency to the Kearse's last known address. The taxpayer contended that the IRS failed to properly mail the notice of deficiency. Both parties stipulated that the IRS could not provide United States Postal Service (USPS) Form 3877 to prove the notice was properly mailed.

On November 4, 2012, the IRS filed an NFTL for the 2010 tax liability and sent Kearse a Letter 3172, Notice of Federal Tax Lien and Filing and Your Right to a Hearing.[61] In response, Kearse timely submitted a CDP hearing request, Form 12153, Request for a Collection Due Process or Equivalent Hearing, and an OIC request, Form 656-L, Offer in Compromise (Doubt as to Liability). In his OIC request, he offered to pay $1 and attached a document disputing the proper mailing of the notice. At the CDP hearing, Kearse's authorized representative raised his underlying tax liability and alleged that the notice of deficiency was not properly mailed. The AO sent Kearse a Notice of Determination stating that the requirements of applicable law or administrative procedures had been met and the actions taken were appropriate under the circumstances and sustained the NFTL. Kearse timely filed a petition with the Tax Court for review of the notice of determination.

The Tax Court held that the AO failed to accurately verify that a properly mailed notice preceded the taxpayer's assessment as mandated by IRC § 6330(c).[62] If the defaulted notice of deficiency is the basis for the assessment, an AO must verify that the notice of deficiency was properly mailed to the taxpayer before the assessment.[63] The court rejected the AO's reliance on the IRS's Integrated Data Retrieval

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

57 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).

58 The statistics analyzing the number of litigated cases exclude Tax Court summary judgments and bench orders, which are unpublished; however, Appendix 5, Tables 11 and 12 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* IRC § 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*.

59 T.C. Memo. 2019-53.

60 During the CDP process and in Tax Court the taxpayer asserted that he had not suffered a business bad debt loss but rather a theft loss of $1,679,500.

61 IRC § 6320.

62 IRC § 6320(c).

63 IRM 8.22.5.4.2, Legal and Administrative (L & A) Procedure Review (Mar. 29, 2012); 8.22.5.4.2.1.1, Statutory Notice of Deficiency (SNOD) (Nov. 8, 2013).

System to verify that the notice was issued per the IRS guidance.[64] When a taxpayer claims a notice was not properly mailed, the AO must review a copy of the notice of deficiency and the USPS Form 3877 or the equivalent IRS certified mail list bearing a USPS date stamp or the initials of a postal employee.[65] The AO acknowledged that she did not secure and review either of these documents before the notice of determination was issued.[66] The court concluded that the AO failed to verify that all procedural requirements were met before sustaining the NFTL and thus abused her discretion.

Gregory v. Commissioner[67]

In *Gregory v. Commissioner*, the taxpayer also challenged the validity of the assessment during the CDP hearing, but the IRS did not make a stipulation as to proof of the mailing, and the Tax Court upheld the IRS AO's determination.[68] The IRS mailed the NFTL to the taxpayer on January 28, 2014, and the taxpayer requested a CDP hearing one month later. IRS Appeals issued a notice of determination sustaining the NFTL in December 2015. The taxpayer's argument challenging the validity of the assessment was four-fold.

First, the taxpayer claimed the IRS did not create a notice of deficiency because the administrative file did not contain a copy of the actual notice that was mailed. The Court rejected the claim holding that even if the reprint does not qualify as a duplicate, it can still serve as evidence that the IRS prepared a notice of deficiency.[69]

Second, regarding the taxpayer's challenge as to the mailing of the notice, the Court agreed that the IRS had provided a certified mail list it maintains that associates a certified mail number with the notice and thus provides evidence that the notice was not only created but also mailed.[70] The taxpayer also objected to the IRS's use of a certified mail list in place of USPS Form 3877, but the Tax Court held that it was equivalent evidence of proper mailing of a notice of deficiency for his 2009 taxable year because Gregory did not identify any information missing from the IRS's certified mail list that would be included on a USPS Form 3877.

Third, the taxpayer challenged the validity of the assessment claiming the reprint lacked some of the elements described in Internal Revenue Manual (IRM) 4.8.9.2. However, the Tax Court noted that it is immaterial that the IRM defines the term "notice of deficiency" to consist of elements beyond those required by case law. Specifically, a notice of deficiency is adequate if it notifies the taxpayer of the Commissioner's intent to assess a deficiency and gives him the opportunity to petition the Tax Court for redetermination.

64 IRC § 6330(c)(1); IRM 8.22.5.4.2.1.1 (Nov. 8, 2013).

65 IRM 8.22.5.4.2.1.1(6) (Nov. 8, 2013).

66 It should be noted that the IRS was eventually able to produce USPS Form 3877, verifying that the notice of deficiency was properly mailed to Kearse. However, both parties had previously stipulated that the IRS could not produce the document. Stipulations are treated as conclusive admissions, which the Court will not allow a party to alter or contradict, unless in extraordinary circumstances. The IRS also did not challenge or ask to be released from the stipulation, so the Court maintained the stipulation. *Kearse v. Comm'r*, T.C. Memo. 2019-53 (citing *Winter v. Comm'r*, T.C. Memo. 2010-287, at 10).

67 *Gregory v. Comm'r*, T.C. Memo. 2018-192, *appeal dismissed*, 2019 WL 4184071 (9th Cir. June 21, 2019).

68 *Id*.

69 Because the information shown on the reprint was included in the IRS's database, the Court could infer that it was created in accordance with customary practice.

70 By the time of the taxpayer's CDP hearing in March 2015, however, that certified mail number could not have been used to track a notice of deficiency mailed on November 13, 2012, because the Postal Service stores tracking information on items sent by certified mail for no more than two years.

Lastly, the taxpayer challenged the validity of the assessment as lacking the signature of an authorized individual. The notice was signed by a technical services territory manager in the Small Business/Self-Employed (SB/SE) division of the IRS. The Tax Court followed the ruling in *Muncy v. Commissioner*[71] that accepted Delegation Order 4-8, IRM 1.2.43.9 (Sept. 4, 2012), as documentation that SB/SE technical services territory managers have authority to issue notices of deficiency.

Ultimately, having rejected each of the taxpayer's challenges to the validity of the assessment the Tax Court concluded that the AO properly sustained the NFTL.

Loveland v. Commissioner[72]

In *Loveland v. Commissioner*, a married couple stopped paying their taxes after suffering a series of health issues and losing their home to foreclosure during a recession.[73] In 2015, the IRS issued a notice of intent to levy for their outstanding tax liabilities for taxable years 2011-2014 in an amount over $60,000. During negotiations with a revenue officer, the taxpayers discussed an OIC based on doubt as to collectibility with "special circumstances." The IRS rejected the OIC stating that based on the financial information provided, the taxpayers could pay the full amount, and that their "special circumstances" did not warrant accepting the OIC.

The taxpayers tried to borrow money to make a large payment to bring their liability below $50,000, qualifying them for a streamlined installment agreement processing. However, on the same day the taxpayers submitted their loan application, the IRS filed an NFTL. As a result, the taxpayers were unable to obtain a loan. The taxpayers timely requested a CDP hearing with the IRS Office of Appeals, asking for release of the lien and claiming that it derailed a mortgage refinance and caused economic hardship. The IRS AO sent the taxpayers a letter scheduling their hearing and informing them of the necessary documents to submit for a collection alternative to be considered. In response, the taxpayers sent a letter containing several documents, including Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals, and requested the AO revisit the OIC, consider an installment agreement, and consider their economic hardship and exceptional circumstances.

During the hearing, the AO rejected the taxpayers' proposed installment agreement and did not consider the taxpayers' financial information. The AO sent a notice of determination to the taxpayers and refused to release the lien, stating incorrectly that the couple had not provided the necessary financial documents.

The taxpayers filed a petition in the Tax Court for review of the decision to sustain the lien. They contended that the determination caused economic hardship and violated their due process rights, and that the AO did not genuinely consider their special circumstances. They provided the financial information that they had previously submitted and cited to regulations that allowed the IRS to present alternatives for taxpayers whose disabilities limit their ability to pay.

The Tax Court held that meeting with a revenue officer did not constitute a previous administrative proceeding under IRC § 6330(c)(4)(A)(i) and Treas. Reg. § 301.63201(e)(1) because the taxpayers only negotiated with the IRS revenue officer and did not have a CDP hearing regarding her rejection of their OIC. Thus, they could request consideration of the same OIC in a subsequent CDP hearing on the same

71 T.C. Memo. 2017-83.

72 *Loveland v. Comm'r*, 151 T.C. 78 (2018).

73 Mr. Loveland is a retired boilermaker, and Mrs. Loveland is a retired teacher.

tax liabilities for the same tax periods. The court held that the AO's refusal to consider the proposed OIC, failure to consider a proposed installment agreement on a false premise that taxpayers did not provide any financial information, and failure to consider taxpayers' claim of economic hardship was an abuse of discretion. The court remanded the case to Appeals for further consideration.

Romano-Murphy v. Commissioner

In *Romano-Murphy v. Commissioner*, the IRS sent the Chief Operating Officer of a nurse-staffing company, Ms. Romano-Murphy, a Letter 1153, Trust Fund Penalty Recovery Letter, to propose a trust fund recovery penalty (TFRP) under IRC § 6672(a) for the failure to pay employment taxes withheld from employees' wages of Nurses PRN, LLC.[74] Ms. Romano-Murphy filed a timely protest of the proposed assessment and requested "a conference to discuss the supporting documents contained with her formal written protest." The IRS did not make a final administrative determination regarding her protest and instead assessed the TFRP and proceeded with collection actions such as issuing a notice of proposed levy and filing of an NFTL. The taxpayer timely requested a CDP hearing with the IRS Office of Appeals. At the hearing she challenged her liability for the penalty. The Office of Appeals determined that she was liable for the penalty and sustained the proposed levy and the filing of the notice of lien.

The Tax Court determined that the IRS was not required to make a final administrative determination regarding her protest before assessing the TFRP and upheld Appeals' determination.[75] The taxpayer appealed the Tax Court's decision to the U.S. Court of Appeals for the Eleventh Circuit arguing the IRS failed to provide her with a pre-assessment determination following her response to Letter 1153.[76] The IRS argued that IRC § 6672(b)(3) does not confer a right to a pre-assessment hearing or a pre-assessment final administrative determination; instead, it extends the period for the IRS to assess the penalty.[77] The Eleventh Circuit held that the IRS improperly assessed the penalty because IRC § 6672(b)(3)(B) and Treasury regulations required the IRS to make a final administrative determination before assessing the penalty, and that requirement was one of the "requirements of applicable law or administrative procedure," compliance with which had to be verified under IRC § 6330(c)(1).[78] The Eleventh Circuit remanded the case back to the Tax Court to determine what corrective action should be taken to remedy the IRS's violation of this requirement.[79]

On remand, the Tax Court held that the TFRP assessment was invalid and that the Office of Appeals abused its discretion in upholding the proposed levy and the filing of the NFTL to collect the assessment without first making a final decision on the protest.[80] The Tax Court also determined that its holding was consistent with general principles of law regarding harmless error.[81] The timing of the

74 2019 U.S. Tax Ct. LEXIS 17 (May 21, 2019).

75 T.C. Memo. 2012-330.

76 *Romano-Murphy v. Comm'r*, 816 F.3d 707 (11th Cir. 2016), *rev'g and remanding* T.C. Memo. 2012-330.

77 *See* IRC § 6672(b)(3)(B).

78 The Court of appeals states that even assuming IRC § 6672 were ambiguous, Treasury regulations require the IRS Office of Appeals to make a pre-assessment determination of § 6672 liability when a timely protest is filed. *See* Treas. Reg. §§ 301.7430-3(d), Ex. (5) and (7); 301.6320-1(e)(4), Ex. (3). This is also consistent with § 601.106(a)(1)(iv), Statement of Procedural Rules, which provides that the taxpayer may appeal certain penalties to the Office of Appeals after assessment. However, the TFRP is not such a penalty "because the taxpayer has the opportunity to appeal this penalty prior to assessment." *Id*.

79 *Romano-Murphy v. Comm'r*, 816 F.3d at 714.

80 2019 U.S. Tax Ct. LEXIS 17.

81 *Id*.

assessment determines when collection can legally begin and end, so the Court did not need to consider whether the taxpayer was specifically harmed by the timing error.

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 cases discussed this year were important for a variety of reasons.

These cases affirmed important rights for taxpayers, including the *rights to be informed*, *to challenge the IRS's position and be heard*, and *to appeal an IRS decision in an independent forum*.[82] A key to ensuring that these rights are protected is the IRS's communication with the taxpayer.[83] This year, the courts reemphasized the importance of IRS AOs verifying that the requirements of applicable law or administrative procedure are met before issuing determinations as required under IRC § 6330(c)(1). The IRS satisfying procedural requirements in the CDP process goes a long way to protect the taxpayer *rights to be informed*, *to appeal the IRS's decision in an independent forum*, and *to a fair and just tax system*.[84] Court decisions in *Kearse* and *Romano-Murphy* showed that courts would not tolerate AOs failing to verify that the IRS met all applicable legal and administrative procedure requirements when sustaining IRS collection actions. Although the burden is on the IRS during the court proceeding to produce documents that verify it followed procedural requirements, taxpayers should 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. The taxpayer may be at a disadvantage in this situation because the IRS is the party with the records in its custody. For example, in *Gregory*, the Tax Court did not find an abuse of discretion in the IRS AO sustaining the NFTL when the IRS's administrative record showed that the IRS met all procedural requirements for the assessment. For the reasons stated above, it is possible that this will be an issue of litigation in the future.

In a full Tax Court opinion in *Loveland*, the court reinforced the taxpayers' *rights to challenge the IRS's position and be heard* and *to fair and just tax system* by raising alternatives to the collection action during the CDP hearing. The court sent a clear message to the IRS that it is an abuse of discretion to neglect to consider all of the issues raised by a taxpayer and the appropriate financial information the taxpayers provided. A thorough and meaningful verification that all procedural requirements are met may reduce litigation and improve voluntary compliance.

82 On July 2, 2019, Congress passed the Taxpayer First Act. It codifies the independence of the Office of Appeals within the IRS. It will also give certain taxpayers the ability to access administrative case files referred to the Independent Appeals. S. 1, 116 Cong. H.R. 1957 (2019).

83 See National Taxpayer Advocate 2018 Annual Report to Congress 212-222 (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*).

84 See *Kearse v. Comm'r*, T.C. Memo. 2019-53; *Romano-Murphy v. Comm'r*, 2019 U.S. Tax Ct. LEXIS 17 (May 21, 2019).

MLI #3 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.[1] We identified 79 opinions issued between June 1, 2018, and May 31, 2019, where taxpayers litigated the negligence or substantial understatement components of the accuracy-related penalty, which is a notable decrease over recent years.

TAXPAYER RIGHTS IMPACTED[2]

- *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.[3] 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 or her return, plus (B) amounts not shown on the return but previously assessed (or collected without assessment), over the amount of rebates made.[4] For this computation, 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.[5] Therefore, for

1 IRC § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement under chapter 1 (IRC §§ 1-1400Z-2); 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. 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 IRC § 6664(a). 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).

returns filed after December 18, 2015, or returns filed on or before 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").[6] 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.[7]

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. The negligence component of the penalty applies only to the portion of the underpayment attributable to negligence. 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."[8] Negligence includes a failure to keep adequate books and records or to substantiate items that give rise to the underpayment.[9] Strong indicators include instances where a taxpayer failed to report income on a tax return that a payor reported on an information return,[10] as defined in IRC § 6724(d)(1),[11] or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.[12] The IRS can also consider various other factors in determining negligence.[13]

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.[14] An understatement of tax may be reduced by any portion of the understatement attributable to an item for which there is either (1) substantial authority for the tax treatment of the item or (2) the tax treatment is adequately disclosed and supported by a reasonable basis.[15] This substantial authority 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).[16]

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 20.1.5.3.2, Common Features of Accuracy-Related and Civil Fraud Penalties (Apr. 22, 2019).

14 IRC § 6662(d)(2)(A)(i) - (ii).

15 IRC § 6662(d)(2)(B)(i) - (ii).

16 Treas. Reg. § 1.6662-3(b)(3). Applicable authority could include information such as sections of the IRC; proposed, temporary, or final regulations; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; and congressional intent as reflected in committee reports. Treas. Reg. § 1.6662-4(d)(3)(iii).

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.[17] 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.[18]

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.[19] A reasonable cause determination considers all the pertinent facts and circumstances.[20] Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.[21] Reliance on a return preparer may constitute reasonable cause and good faith if the reliance was reasonable and the taxpayer acted in good faith.[22] *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.[23]

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process[24] and through its Automated Underreporter (AUR) computer system.[25] 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.[26] Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC §§ 6211-6213).[27] 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 U.S. Tax Court to challenge the

17 IRC § 6662(d)(1)(A)(i) - (ii). Note, however, that in the case of a taxpayer who claims a deduction allowed under IRC § 199A, the understatement of income tax is substantial if it exceeds the greater of five percent of the tax required to be shown on the return or $5,000.

18 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).

19 IRC § 6664(c)(1).

20 Treas. Reg. § 1.6664-4(b)(1).

21 *Id*.

22 Treas. Reg. § 1.6664-4(b).

23 115 T.C. 43, 99 (2000) (citations omitted), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

24 IRM 4.10.6.2(1), Recognizing Noncompliance (May 14, 1999) ("assessment of penalties should be considered throughout the audit"). See also IRM 20.1.5.4, Examination Penalty Assertion (Apr. 22, 2019).

25 The 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 4.19.3.18.6, Accuracy-Related Penalty Due to Negligence or Disregard of Rules or Regulations (Negligence Disregard Penalty) (May 19, 2017).

26 For example, when the IRS proposes to adjust a taxpayer's liability, it typically sends a notice ("30-day letter"), which gives the taxpayer 30 days to contest the proposed adjustments to the Office of Appeals and raise issues related to the deficiency, including any reasonable cause defense to a proposed penalty. If not resolved after the 30-day letter, the IRS sends a statutory notice of deficiency ("90-day letter"). *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).

27 IRC § 6665(a)(1).

assessment.[28] Alternatively, taxpayers may seek judicial review through refund litigation.[29] Under certain circumstances, a taxpayer can request an administrative review of IRS collection procedures (and the underlying liability) through a Collection Due Process (CDP) hearing.[30]

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 the substantial understatement and negligence components of the accuracy-related penalty without supervisor review.[31]

Burden of Proof

In court proceedings involving individual taxpayers, the IRS bears the initial burden of production regarding the accuracy-related penalty.[32] The IRS must first present sufficient evidence to establish that the penalty was warranted.[33] The burden of proof then shifts to the taxpayer to establish a penalty exception, such as reasonable cause.[34]

28 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.

29 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).

30 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).

31 If the taxpayer does not respond timely to an AUR notice proposing an assessment, the computers automatically convert the proposed penalty to an assessment without managerial review. IRM 4.19.3.21.1.4, Accuracy-Related Penalties (Sept. 30, 2018).

32 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."

33 *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.

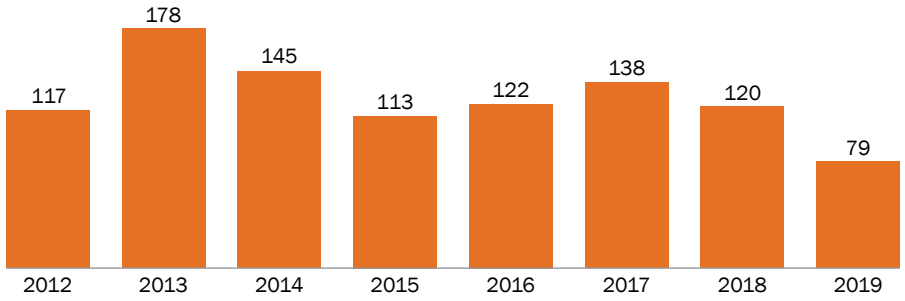
34 IRC § 7491(a). *See also* Tax Ct. R. 142(a).

ANALYSIS OF LITIGATED CASES

We identified 79 opinions issued between June 1, 2018, and May 31, 2019, where taxpayers litigated the negligence or substantial understatement components of the accuracy-related penalty. This is the lowest number of accuracy-related penalty cases in the last eight years, as shown in Figure 2.3.1.

FIGURE 2.3.1

Accuracy-Related Penalty Cases Under IRC § 6662(b)(1) and (2) Decided During One-Year Periods Ending May 31 for 2012-2019



The IRS prevailed in full in 52 cases (66 percent), taxpayers prevailed in full in 25 cases (32 percent), and two cases (three percent) were split decisions. Table 3 in Appendix 5 provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 37 of the 79 cases (47 percent). *Pro se* taxpayers convinced the court to dismiss or reduce the penalties in 32 percent of these 37 cases, which is the same as the overall success rate for all 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.

Requirement for Managerial Approval Prior to Assessment of Penalties

In several past reports, we reported on 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.[35] Of the 27 decisions we reviewed this year where taxpayers prevailed in full or in part, 19 were due to the IRS's failure to obtain written supervisory approval prior to the initial determination of assessment. This is a significant increase over last year, where only eight out of 34 decisions where taxpayers prevailed in full or in part were due to the IRS's lack of compliance with the IRC § 6751(b) supervisory approval requirement. Additionally, we noted many opinions this year that verified compliance with the supervisory approval requirement — courts verified compliance in 32 of the 54 cases where the

35 *See Chai v. Comm'r*, 851 F.3d 190 (2d Cir. 2017); *Graev v. Comm'r*, 147 T.C. 460 (2016), *vacated*, Docket No. 30638-08 (T.C. Mar. 30, 2017). 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. *Graev III*, 149 T.C. 485 (2017) (This decision was the third in a series of Tax Court decisions related to the Graevs' liability for tax years 2004 and 2005).

IRS prevailed in whole or in part. The courts also discussed the supervisory approval requirement in an additional nine cases.[36]

We reviewed a number of memorandum decisions that teased out some of the intricacies of the IRC § 6751(b) requirement.[37] Two decisions highlighted timing issues. In one case, the court refused to accept an undated written supervisory approval,[38] and in another case the IRS did not prevail when it tried to satisfy IRC § 6751(b) by reasserting the accuracy-related penalties in an amended answer and then securing supervisory approval for the amendments.[39] In two cases, the taxpayer sought to question the IRS about the supervisory approval. In *Raifman v. Commissioner*, in response to the IRS's motion to reopen the record to demonstrate supervisory approval, the taxpayers requested the opportunity to cross examine the revenue agent and his supervisor.[40] However, the court did not allow it, noting that the penalty approval form itself would indicate compliance with IRC § 6751(b). In *Archer v. Commissioner*, the IRS's motion to reopen the record to demonstrate IRC § 6751(b) compliance was accompanied by a declaration of the examiner, and the court permitted the taxpayer to serve on the IRS interrogatories comprised of single, definite questions directed towards the examiner's declaration.[41]

In some cases, the Tax Court took a strict stance with the supervisory approval requirement. In one case, the Tax Court disallowed the accuracy-related penalty because the statutory notice of deficiency only listed the IRC § 6662(b)(2) penalty based on substantial understatement, but the supervisory approval was for the negligence component of the penalty under IRC § 6662(b)(1).[42]

Although no CDP hearing cases were included in our count of reviewed decisions because none decided the accuracy-related penalty based on the merits, we did note CDP opinions are increasingly referencing the IRC § 6751(b) requirement. In two of these CDP cases, the IRS conceded the penalty based on the settlement officer's failure to verify that the supervisory approval requirement had been met, even though the taxpayer could not challenge the liability in either of these cases.[43]

Discussed in detail below, all four of the full Tax Court decisions issued during our reporting period include analyses of the IRS's compliance with IRC § 6751(b).

Palmolive Building Investors, LLC v. Commissioner[44]

The taxpayer filed a Form 1065, U.S. Return of Partnership Income, claiming a $33 million deduction for the charitable contribution of a façade easement. The IRS disallowed the deduction and asserted

36 In some of these cases, analysis of whether the IRS met its burden was unnecessary because the taxpayer established reasonable cause. In others, there was simply no analysis of how the IRS met the requirement.

37 Generally, the Tax Court issues memorandum opinions in cases that do not involve a novel legal issue. These opinions can be cited as legal authority and appealed. United States Tax Court, Taxpayer Information: After Trial, https://www.ustaxcourt.gov/taxpayer_info_after.htm (last visited Aug. 12, 2019).

38 *Shuman v. Comm'r*, T.C. Memo. 2018-135, *aff'd*, 774 F. App'x 813 (4th Cir. Aug. 15, 2019).

39 *Endeavor Partners Fund, LLC v. Comm'r*, T.C. Memo. 2018-96, *appeal docketed*, Nos. 18-1275, 18-1276, 18-1277, 18-1278 (D.C. Cir. Oct. 3, 2019).

40 *Raifman v. Comm'r*, T.C. Memo. 2018-101.

41 *Archer v. Comm'r*, T.C. Memo. 2018-111, *appeal docketed*, Nos. 19-70304, 19-70305 (9th Cir. Feb. 4, 2019). In this case, the court found that the taxpayer submitted interrogatories outside the scope of what was permitted and thus squandered the opportunity to provide a valid objection to the IRS's motion to reopen the record.

42 *Estate of Ronning v. Comm'r*, T.C. Memo. 2019-38.

43 *Ansley v. Comm'r*, T.C. Memo. 2019-46; *Ransom v. Comm'r*, T.C. Memo. 2018-211. Taxpayers can only raise the underlying liability at a collection due process hearing if taxpayer did not receive a statutory notice of deficiency for the liability or did not otherwise have an opportunity to dispute the liability. IRC § 6330(c)(2)(B).

44 152 T.C. No. 4 (2019).

multiple penalties under IRC § 6662. The Tax Court previously granted the IRS's motion for summary judgement with respect to the deduction,[45] and the taxpayer and the IRS subsequently filed competing motions, asking the court to address whether the IRS obtained supervisory approval for the penalties, required under IRC § 6751(b).

During the examination, the examiner initially asserted two penalties related to the disallowed deduction — a 40 percent gross valuation misstatement penalty under IRC § 6662(h) and a 20 percent accuracy-related penalty for negligence under IRC § 6662(b)(1). The examiner's supervisor signed the Form 5701, Notice of Proposed Adjustment, which included only the IRC § 6662(h) penalty, but was accompanied by two Forms 866A, Explanation of Items, which included both penalties. Following an Appeals conference, the Appeals Officer proposed issuing a final partnership administrative adjustment (FPAA) by issuing a Form 5402-c, Appeals Transmittal and Case Memo. Attached to the appeals case memo was a Form 866A, Explanation of Items, which included the initial two penalties proposed by the examiner, and penalties for substantial understatement of tax under IRC § 6662(b)(2) and substantial valuation misstatement under IRC § 6662(b)(3). Subsequently, the IRS issued the FPAA to the taxpayer disallowing the deduction and determining all four penalties.

The court held that the initial determinations of the penalties were those by the examiner when he issued the Form 5701, which was approved in writing by his supervisor, and by the Appeals Officer when he issued the Form 5402-c, which was also approved in writing by his supervisor. The court was not persuaded by the taxpayer's observance that the examiner only asserted and received supervisory approval for two of the penalties because it held there is no requirement under IRC § 6751(b) for all the penalties to be asserted and approved at the same time. The taxpayer also argued that the penalty determinations were invalid because the IRS failed to comply with the IRM instruction for the penalty approval to be documented in the examination work papers. The court noted that the IRM is not binding and held that using a form other than what is prescribed by administrative rules does not preclude a finding of compliance with IRC § 6751(b) and the statute does not require approval on any particular form. Thus, the court granted the IRS's motion for summary judgement.

Alternative Health Care Advocates v. Commissioner[46]

The Tax Court held the taxpayer, a C corporation operating a medical dispensary, was not entitled to business expense deductions because its sole trade or business was trafficking in a controlled substance. The Tax Court also held that the C corporation had substantially understated its income tax and did not establish reasonable cause. The court rejected the taxpayer's arguments that it would be unfair to impose the accuracy-related penalty given the unsettled case law and confusion over IRC § 280E at the time the returns were filed. The court drew a clear distinction between the present case and the only relevant case involving medical marijuana during the years at issue, where the facts allowed the court to allocate expenses between the taxpayer's businesses. The court stated that the only directly relevant authority was directly against the taxpayer's tax treatment.[47] In a footnote, the court explained that because IRC § 7491(c) does not apply to corporations, the IRS did not have the burden of production with respect to the accuracy-related penalty and since the taxpayer did not raise IRC § 6751(b), it was unnecessary to reopen the record for the IRS to demonstrate compliance with the supervisory approval requirement.[48]

45 *Palmolive Bldg. Inv'rs, LLC v. Comm'r*, 149 T.C. 380 (2017).

46 151 T.C. 225 (2018).

47 *Alt. Health Care Advocates*, 151 T.C. at 247.

48 *Id*. at 246 n.15.

Walquist v. Commissioner[49]

In this case, the IRS examined the taxpayers via correspondence and issued a 30-day letter to them via its Correspondence Examination Automated Support (CEAS) software program, which processes a case with little to no examiner involvement unless the taxpayer responds. The software automatically calculated a substantial understatement penalty under IRC § 6662(b)(2), which was included in the 30-day letter. When the taxpayers failed to respond to the 30-day letter, the CEAS software generated a statutory notice of deficiency (SNOD), which included the IRC § 6662(b)(2) penalty. The penalty was not reviewed by an employee prior to the issuance of the SNOD. The court held that because the penalty was determined mathematically by a computer software program with no involvement by a human IRS employee, the penalty was "automatically calculated through electronic means." The court explained how it would be difficult for the IRS demonstrate compliance with IRC § 6751(b)(1) for a penalty calculated by a computer program because there would be no individual making the determination; if the computer itself were the individual, then the question would arise as to who the immediate supervisor of the computer program was. Thus, the court held the IRS had met its burden with respect to the accuracy-related penalty.

Clay v. Commissioner[50]

The taxpayers, members of a Native American tribe, challenged the IRS's determination of unreported income from tribal casino revenue and related penalties. Although the Tax Court found the members were liable for the unreported income, it found the taxpayers not liable for the accuracy-related penalty due to the IRS's failure to obtain supervisory approval. The trial was held before the Tax Court issued its third *Graev* ruling, so the court accepted the IRS's motion to reopen the record to demonstrate compliance, as well as motions by the taxpayers to conduct additional discovery around the new documents. The taxpayers argued the IRS did not meet its burden because the supervisory approval did not occur before the IRS sent the taxpayers written notice of the proposed penalties in the form of the revenue agent report, which contained the first suggestion of the penaltes. The court agreed that the revenue agent report transmitted with the 30-day letter constituted the initial determination of the penalties. The court cited the *Palmolive* decision discussed above, stating "when those proposed adjustments are communicated to the taxpayer formally as part of a communication that advises the taxpayer that penalties will be proposed and giving the taxpayer the right to appeal them with Appeals (via a 30-day letter), the issue of penalties is officially on the table."[51]

Reasonable Cause

Losantiville Country Club v. Commissioner[52]

The taxpayer, a private country club operating as an IRC § 501(c)(7) tax exempt organization, deducted expenses for nonmember events from its investment income. The IRS disallowed these deductions because it stated that the club did not intend to profit from its nonmember sales, meaning it could not deduct these losses under IRC § 162. The IRS also asserted accuracy-related penalties for negligence. The Tax Court ruled in favor of the IRS on both issues, finding that the taxpayer did not prepare the returns in good faith and did not have reasonable cause.[53] The Court of Appeals for the Sixth Circuit likewise ruled that the taxpayer did not have reasonable cause and could not demonstrate reasonable

49 152 T.C. No. 3 (2019).
50 152 T.C. No. 13 (2019).
51 *Clay*, 152 T.C. No. 13, 2019 U.S. Tax Ct. LEXIS 14, at *40 (T.C. Apr. 24, 2019).
52 906 F.3d 468 (6th Cir. 2018), *aff'g* T.C. Memo. 2017-158.
53 *Losantiville Country Club v. Comm'r*, T.C. Memo. 2017-158.

reliance on the advice of a tax professional.[54] The taxpayer did not submit any opinion letters or correspondence from its accountants explaining their advice, and the evidence shows that the taxpayer itself communicated its own opinions about its tax obligations to its accountants. The taxpayer argued that because it was advocating for a novel application of existing law, it met the reasonable cause exception. The court rejected this argument, noting that the tax treatment had to be buttressed by substantial authority to meet reasonable cause and the taxpayer did not provide any evidence supporting its arguments for underpayment.[55]

CONCLUSION

This year marked a significant decrease in cases deciding the accuracy-related penalty under IRC § 6662(b)(1) and (2). Despite this decrease in overall cases, more courts are grappling with the issue of whether the IRS obtained the required supervisory approval for the accuracy-related penalty. Notably, the majority of cases where taxpayers prevailed this year were due to the IRS's failure to meet the supervisory approval provision. Based on the decisions this year, it appears that the timing of the supervisory approval is something that will continue to be contested. The following administrative recommendations to update the IRM and further specify when the approval must occur could mitigate future litigation.

RECOMMENDATIONS TO MITIGATE DISPUTES

The National Taxpayer Advocate recommends that Congress:

- Amend IRC § 6751(b)(2)(B) to clarify that written managerial approval is required prior to the assessment of the accuracy-related penalty imposed on the portion of an underpayment attributable to negligence or disregard of rules or regulations under IRC § 6662(b)(1) and consider clarifying which penalties or facts-and-circumstances result in penalties "automatically calculated through electronic means" that are exempt from the managerial-approval requirement.[56]

The National Taxpayer Advocate recommends that the IRS:

- Issue regulations clarifying that written supervisory approval required under IRC § 6751(b) must occur prior to the first time the IRS formally communicates the proposed penalties to the taxpayer in writing.
- Update the IRM to require written supervisory approval not just "prior to the issuance of the Statutory Notice of Deficiency (SNOD)"[57] but instead "prior to the first time the penalties are communicated to the taxpayer formally as part of a written communication that advises the taxpayer the penalties will be proposed."[58]

54 *Losantiville Country Club*, 906 F.3d at 476, *aff'g* T.C. Memo. 2017-158.

55 *Id*.

56 National Taxpayer Advocate 2020 Purple Book: *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration*, 62-63 (*Clarify the Parameters for Written Managerial Approval Required for Penalty Assessments under IRC § 6751(B)*). *See also* National Taxpayer Advocate 2014 Annual Report to Congress 404 (Legislative Recommendation: *Managerial Approval: Amend § 6751(b) to Require IRS Employees to Seek Managerial Approval Before Assessing the Accuracy-Related Penalty Attributable to Negligence under IRC § 6662(b)(1)*).

57 IRM 20.1.5.2.3, Supervisory Approval of Penalties - IRC 6751 Procedural Requirements (Apr. 22, 2019).

58 This language is based on the Tax Court's holding in *Clay v. Comm'r*, 152 T.C. No. 13 (2019).

MLI #4 Gross Income Under IRC § 61 and Related Sections

SUMMARY

When preparing tax returns, taxpayers must complete the 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.[1] For this report, we reviewed 72 cases decided between June 1, 2018, and May 31, 2019. 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,[2] interest,[3] dividends,[4] and pensions.[5]

TAXPAYER RIGHTS IMPACTED[6]

- *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."[7] The U.S. Supreme Court has defined gross income as any accession to wealth.[8] The concept of "gross income" is to be broadly construed, while exclusions from income are to be narrowly construed.[9] 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.[10]

1 *See, e.g.*, National Taxpayer Advocate 2017 Annual Report to Congress 420 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*); National Taxpayer Advocate 2013 Annual Report to Congress 355 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*).

2 IRC § 61(a)(1). *See, e.g.*, *Canzoni v. Comm'r*, T.C. Memo. 2018-130.

3 IRC § 61(a)(4). *See, e.g.*, *Allen v. United States*, 331 F. Supp. 3d 852 (E.D. Wis. 2018).

4 IRC § 61(a)(7). *See, e.g.*, *Smith v. Comm'r*, 151 T.C. 41 (2018).

5 IRC § 61(a)(9). *See, e.g.*, *Castaneda v. Comm'r*, T.C. Memo. 2018-173, *appeal docketed*, No. 19-71793 (9th Cir. July 17, 2019).

6 *See* IRS, Taxpayer Bill of Rights (TBOR), http://www.irs.gov/Taxpayer-Bill-of-Rights. The rights contained in the TBOR are 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. United States*, 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).

If the Commissioner determines a tax deficiency, the IRS issues a statutory notice of deficiency.[11] If the taxpayer challenges the deficiency, the Commissioner's notice is entitled to a presumption of correctness; the taxpayer generally bears the burden of proving that the determination is erroneous or inaccurate.[12]

ANALYSIS OF LITIGATED CASES

In the 72 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 5.

In 37 cases (51 percent), taxpayers were represented, while the rest were *pro se* (without counsel). In 12 of the 37 cases where taxpayers had representation (about 32 percent), they prevailed in full or in part in their cases, whereas *pro se* taxpayers did not prevail in full or in part in any cases identified during this review period.

Drawing on the full list in Table 4 of Appendix 5, we have chosen to discuss discharge of indebtedness and a case involving the tax treatment of a *qui tam* award.[13]

Discharge of Indebtedness

We reviewed six cases in which taxpayers challenged the IRS's determination that a discharge of indebtedness was taxable income. Taxpayers prevailed in part in one case.[14] Generally, a taxpayer must include income from discharge of indebtedness when calculating gross income,[15] but in certain circumstances cancellation of indebtedness income may be excluded. IRC § 108(a) provides that a taxpayer may exclude, subject to limitations, income from the discharge of indebtedness if the discharge occurs in a title 11 bankruptcy case, when the taxpayer is insolvent, or if the indebtedness is qualified farm indebtedness (for a taxpayer other than a C corporation), qualified real property business indebtedness debt, qualified principal residence indebtedness discharged before January 1, 2018, or subject to an arrangement that is entered into and evidenced in writing before January 1, 2018.[16] The creditor may issue a Form 1099-C, Cancellation of Debt, to the taxpayer for canceled debts of $600 or more.[17] If a creditor has discharged a debt the taxpayer owes, the taxpayer must include the discharged amount in gross income, even if it is less than $600 or a Form 1099-C is not received, unless one of the exceptions in IRC § 108(a) applies. The issuance of a Form 1099-C is not dispositive of whether or when the debt is actually discharged.[18] A debt is deemed to have been discharged for purposes of information

11 IRC § 6212. *See also* Internal Revenue Manual 4.8.9.2, Notice of Deficiency Definition (Aug. 11, 2016). The Commissioner may identify particular items of unreported income or reconstruct a taxpayer's gross income using indirect methods such as the bank deposits method. IRC § 6001. *See, e.g., DiLeo v. Comm'r*, 96 T.C. 858, 867 (1991).

12 *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).

13 *Qui tam pro domino rege quam pro se ipso in hac parte sequitur*: "who as well for the king as for himself sues in this matter." *A qui tam* action is brought under a statute that allows a private individual to sue for a penalty where, if successful, the government or other public institution will receive a portion of the penalty and the individual will share in the recovery. Black's Law Dictionary (11th ed. 2019).

14 *See Bui v. Comm'r*, T.C. Memo. 2019-54.

15 IRC § 61(a)(11).

16 IRC § 108(a)(1)(A)-(E).

17 IRS, Instructions for Form 1099-A and 1099-C Acquisition or Abandonment of Secured Property and Cancellation of Debt, https://www.irs.gov/pub/irs-pdf/i1099ac.pdf (Oct. 3, 2018).

18 *Kleber v. Comm'r*, T.C. Memo. 2011-233 (citation omitted).

reporting, and a Form 1099-C is required, if and only if, an "identifiable event" has occurred.[19] Form 1099-C may be required even if the discharged amount is not taxable to the debtor.[20] Generally, the burden of proof is on the taxpayer to show that any of the exceptions in IRC § 108(a) apply.[21] However, if a Form 1099-C serves as the basis for the determination of a deficiency, IRC § 6201(d) may apply to shift the burden of production to the IRS. IRC § 6201(d) provides that in any court proceeding, if a taxpayer asserts a reasonable dispute with respect to the income reported on an information return and the taxpayer has fully cooperated with the IRS, then the IRS has the burden of producing reasonable and probative information in addition to the information return.

In one case we reviewed, the taxpayer prevailed in part under the qualified principal residence exclusion in IRC § 108(a)(1)(E) and in part under the insolvency exception in IRC § 108(a)(1)(B). In the case of *Bui v. Commissioner*, the taxpayer excluded over $350,000 of discharged indebtedness from her gross on her tax year 2011 tax return, indicating that the discharged debt was qualified principal residence indebtedness under IRC § 108(a)(1)(E).[22] At trial, the taxpayer further asserted the discharged indebtedness should be excluded under IRC § 108(a)(1)(B) due to insolvency. The court determined that only $12,000 of the discharged indebtedness was qualified principal residence indebtedness; however, the taxpayer was limited to excluding $5,299 by operation of IRC § 108(h)(4), which allows a taxpayer to exclude only the amount that exceeds the portion of the debt discharged that is not qualified principal residence debt. The taxpayer's original loan was $250,000, of which $12,000 was determined to be qualified principal residence debt. The total discharged debt was $243,299, and subtracting the $238,000 of nonqualified debt allowed the taxpayer to exclude $5,299.

At trial, the Commissioner conceded that at the time of the discharge of indebtedness, the taxpayer was insolvent by the amount of $42,852.[23] While the taxpayer asserted the Commissioner was incorrect in this calculation, the taxpayer had already agreed to the calculation prior to trial and thus the court found the taxpayer could exclude $42,852 from gross income under the insolvency exclusion.

Qui Tam Award

During this review cycle, we identified one case that addressed the tax treatment of a *qui tam* award.[24] A *qui tam* action is brought under a statute by a private individual on behalf of the government and if the claim succeeds, the individual keeps a portion of the recovery while the rest goes to the government or other public institution. In the case of *Barnes v. United States*, Mrs. Barnes filed a *qui tam* action under the False Claims Act[25] and then reached a settlement agreement with the United States and the defendants for over $20 million, of which she received over $3.5 million.[26]

19 *See* Treas. Reg. § 1.6050P-1(a)(1). Note that the IRS has issued final regulations which eliminate the 36-month testing period for information returns required to be filed, and payee statements required to be furnished, after December 31, 2016. 81 Fed. Reg. 78908 (Nov. 10, 2016). *See also* National Taxpayer Advocate 2010 Annual Report to Congress 383-386 (Legislative Recommendation: *Remove the 36-Month "Testing Period" That May Trigger Cancellation of Debt Reporting*).

20 Treas. Reg. § 1.6050P-1(a)(3).

21 U.S. Tax Court Rules of Practice and Procedure, Rule 142(a).

22 T.C. Memo. 2019-54.

23 *Bui v. Comm'r*, T.C. Memo. 2019-54. Under IRC § 108(a)(2)(C), the insolvency exclusion applies only when the taxpayer elects the insolvency exclusion to apply in lieu of the qualified principal residence indebtedness exclusion. In this case, the taxpayer did not elect to do so but had three different loans discharged. The exclusion was applied to one of the loans.

24 *Barnes v. United States*, 353 F. Supp. 3d 582 (N.D. Tex. 2019).

25 31 U.S.C. § 3730(b) (2010).

26 353 F. Supp. 3d 582 (N.D. Tex. 2019).

Mr. and Mrs. Barnes reported the settlement amount on their joint income tax return and paid tax on it. They then filed a refund claim on the basis that settlement proceeds from a *qui tam* action are not taxable. After the IRS disallowed the claim in part, they filed a refund suit under the theory that the award Mrs. Barnes received for her *qui tam* action was not taxable income and further argued that if the court found the award to be taxable income, that it should be taxed as a capital gain rather than ordinary income.[27] The court agreed with the government's argument that a *qui tam* award is rightly classified as a bounty or fee rewarding the individual who initiated the *qui tam* action for assisting the government in making and successfully litigating the claim. A bounty or fee is not excluded under IRC § 61 and is thus includable in gross income. Further, the court disagreed with the taxpayer's contention that the *qui tam* award, if taxable, should be taxable as capital gains and found for the government that the award is taxable is ordinary income. The taxpayers argued that the award should be a capital gain based on the accretion of value over the three years between the filing of the claim and the settlement of the action. The court concurred with the reasoning of other courts that a *qui tam* award is more analogous to a contingency fee arrangement or a future payment for services rendered than a capital gain.[28]

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 (about 83 percent) were decided in favor of the IRS and exclusions from gross income continued to be narrowly interpreted. However, taxpayers in this review cycle raised a less prevalent issue about the tax treatment of *qui tam* awards, and litigation in areas such as retirement plan distributions and settlement proceeds were not as prevalent either.[29]

Overall, litigation of gross income issues decreased this year, from 79 cases in the 2018 reporting cycle to 72 cases this year, about a nine percent decrease.[30] Of note this year, no *pro se* taxpayers prevailed in full or in part in any cases identified for this review cycle, while the number of represented taxpayers increased from 47 percent to about 51 percent this year and had a higher success rate of 32 percent compared to 24 percent in the 2018 review cycle.[31]

27 353 F. Supp. 3d 582 (N.D. Tex. 2019).

28 *See, e.g.*, *Patrick v. Comm'r*, 799 F. 3d 885 (7th Cir. 2015) *aff'g* 142 T.C. 124 (2014).

29 We identified only four cases involving settlement income in this review period compared to seven cases in the 2018 review period and four cases involving retirement plan distributions compared to 18 in the 2017 review period. *See* National Taxpayer Advocate 2018 Annual Report to Congress 481, 487 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*); National Taxpayer Advocate 2017 Annual Report to Congress 420, 423 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*).

30 National Taxpayer Advocate 2018 Annual Report to Congress 481, 487 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*).

31 *Id.*

MLI #5 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.[1] 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.[2] 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 U.S. District Court.[3]

TAS identified 60 federal cases decided between June 1, 2018, and May 31, 2019, involving IRS summons enforcement issues. The government was the initiating party in 35 cases, while the taxpayer was the initiating party in 25 cases. Overall, taxpayers fully prevailed in two cases, while two cases were split. The IRS prevailed in the remaining 56 cases.

TAXPAYER RIGHTS IMPACTED[4]

- *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.[5] 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.[6] 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.[7] Under the recent changes in the law, the IRS must narrowly tailor the information sought in a John Doe summons and give taxpayers 45 days advance notice if it intends to contact third

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

2 IRC § 7602(a).

3 IRC § 7604(b). 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.

4 See Taxpayer Bill of Rights (TBOR), 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 § 7602(a). See also *LaMura v. United States*, 765 F.2d 974, 979 (11th Cir. 1985) (citing *United States v. Bisceglia*, 420 U.S. 141, 145-46 (1975)).

6 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).

7 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 narrowly tailor the summons and 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 source. IRC § 7609(f).

parties during a specified period.[8] The new law also limits access of tax return information to non-IRS employees except for expert assistance and prohibits non-IRS employees from questioning witnesses under oath in summons hearings.[9] The IRS cannot issue a summons after referring the matter to the Department of Justice (DOJ).[10]

If the recipient fails to comply with a summons, the United States may commence an action under IRC § 7604 in the appropriate U.S. District Court to compel document production or testimony.[11] If the United States files a petition to enforce the summons, the taxpayer may contest the validity of the summons in that proceeding.[12] 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.[13]

Generally, a taxpayer or other person named in a third-party summons is entitled to notice.[14] 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 a liability or judgment[15] or if it is attempting to determine assets owned by the taxpayer to pay an assessed tax because such notice might seriously impede the IRS's ability to collect the tax.[16] 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.[17]

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.[18] In *United States v. Powell*, the Supreme Court set

8 Taxpayer First Act (TFA), Pub. L. No. 116-25, §§ 1204 and 1206, 133 Stat. 981 (2019). (Adding new subsection (f) to IRC § 7609 and amending section 7602(c)(1)). *See also United States v. Coinbase*, 120 A. F.T.R.2d (RIA) 5239 (N.D. Cal. 2017); National Taxpayer Advocate 2018 Annual Report to Congress 469 (Most Litigated Issue: *Summons Enforcement Under IRC §§ 7602, 7604, and 7609*).

9 TFA, Pub. L. No. 116-25, §1208, 133 Stat. 981 (2019). (Adding new subsection (f) to IRC § 7602). *See also* National Taxpayer Advocate 2015 Annual Report to Congress 467 (Most Litigated Issue: *Summons Enforcement Under IRC §§ 7602, 7604, and 7609*); National Taxpayer Advocate 2016 Annual Report to Congress 455 (Most Litigated Issue: *Summons Enforcement Under IRC §§ 7602, 7604, and 7609*).

10 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).

11 IRC § 7604.

12 *United States v. Powell*, 379 U.S. 48, 58 (1964).

13 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).

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

15 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). 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.

16 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). The "aid in collection" exception applies only if the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned. *Ip v. United States*, 205 F.3d 1168, 1172-76 (9th Cir. 2000).

17 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).

18 *Kamp v. United States*, 112 A.F.T.R.2d (RIA) 6630 (E.D. Cal. 2013).

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.[19]

The IRS bears the initial burden of establishing that these requirements have been satisfied.[20] 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.[21] 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.[22] Generally, the burden on the taxpayer to establish the illegality of the summons is heavy.[23]

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.[24] 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."[25] Blanket claims of improper purpose are not sufficient, but circumstantial evidence can be.[26]

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;[27]
- Tax practitioner privilege;[28] or

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

20 *Fortney v. United States*, 59 F.3d 117, 119-20 (9th Cir. 1995).

21 *United States v. Dynavac, Inc.*, 6 F.3d 1407, 1414 (9th Cir. 1993).

22 *Id.*

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

24 *United States v. Powell*, 379 U.S. 48, 58 (1964).

25 *United States v. Clarke*, 134 S. Ct. 2361, 2367 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S. Tax Cas. (CCH) ¶ 50,732 (S.D. Fla. 2012).

26 *Id.*

27 The attorney-client privilege provides protection from discovery of information where: (1) legal advice 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. *United States 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)). The attorney-client privilege protects "tax advice," but not tax return preparation materials. *United States v. Frederick*, 182 F.3d 496, 500 (7th Cir. 1999).

28 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). *Valero Energy Corp. v. United States*, 569 F.3d 626 (7th Cir. 2009). The interpretation of the tax practitioner privilege is based on the common law rules of attorney-client privilege. *United States v. BDO Seidman, LLP*, 337 F.3d 802, 810-12 (7th Cir. 2003).

- Work product privilege.[29]

However, these privileges are limited. For example, courts reject blanket assertions of the Fifth Amendment,[30] but note that taxpayers may have valid Fifth Amendment claims regarding specific documents or testimony.[31]

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 has gradually declined each year, except for a one-year spike to 153 cases for the year ending May 31, 2012. By the year ending May 31, 2015, the number of cases fell to 84 and generally plateaued until a decline again this year. For the period ending May 31, 2019, TAS identified 60 cases, a 29 percent decrease from the 85 cases identified during last year's reporting period. A detailed list of these cases appears in Table 5 of Appendix 5.

Of the 60 cases TAS reviewed this year, the IRS prevailed in full in 56, a 93 percent success rate, which is one percent greater than the 2018 reporting period.[32] Taxpayers had representation in 22 cases (37 percent) and appeared *pro se* (*i.e.*, on their own behalf) in 37 cases.[33] This is the second consecutive year of a notable increase in the percentage of represented taxpayers as only 28 percent of taxpayers were represented during the 2017 reporting period, but is still a decline from the percentage we observed in the 2016 reporting period, where 44 percent of taxpayers had presentation.[34] Forty-five cases involved individual taxpayers, while the remaining 15 involved business taxpayers, including sole proprietorships.[35] Cases generally involved one of the following themes:

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

30 *See, e.g.*, *United States v. McClintic*, 113 A.F.T.R.2d (RIA) 330 (D. Or. 2013).

31 *See, e.g.*, *United States v. Lawrence*, 113 A.F.T.R.2d (RIA) 1933 (S.D. Fla. 2014). Individual taxpayers may claim the Fifth Amendment right against self-incrimination, but not on behalf of a business entity. *Braswell v. United States*, 487 U.S. 99 (1988). Additionally, taxpayers cannot withhold self-incriminatory evidence if the summoned documents fall within the "foregone conclusion" exception, which applies if the government establishes its independent knowledge of the document's existence, the document's authenticity, and the possession or control of the documents by the person to whom the summons was issued. *United States v. Bright*, 596 F.3d 683, 692 (9th Cir. 2010).

32 *See* National Taxpayer Advocate 2018 Annual Report to Congress 473 (Most Litigated Issue: *Summons Enforcement Under IRC §§ 7602, 7604, and 7609*).

33 One case was an *ex parte* proceeding to issue the John Doe Summons to unknown taxpayers.

34 *See* National Taxpayer Advocate 2017 Annual Report to Congress 390, 395 (Most Litigated Issue: *Summons Enforcement Under IRC §§ 7602, 7604, and 7609*); National Taxpayer Advocate 2016 Annual Report to Congress 455, 459 (Most Litigated Issue: *Summons Enforcement Under IRC §§ 7602, 7604, and 7609*).

35 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 30 cases and successfully met its burden under *Powell* in all cases.[36] In cases where taxpayers contested the summons, they generally argued that the IRS did not satisfy one or more of the *Powell* requirements, but these arguments were not successful. Taxpayers did not meet with much success because the government's burden of proving that the *Powell* requirements have been met is "slight or nominal."[37] Then, the burden shifts to the taxpayer to show that enforcement of the summons would be an abuse of the court's process, and that burden is heavy.[38]

Petitions to Quash and Lack of Subject Matter Jurisdiction

Taxpayers petitioned to quash an IRS summons to a third party in 25 instances.[39] In six of these cases, courts dismissed the petitions for lack of jurisdiction on procedural or notice grounds.[40] One taxpayer was successful in quashing a summons after proving the IRS failed to follow all of the required administrative steps in issuing the summons. In *JB v. United States,* [41] the U.S. Court of Appeals for the Ninth Circuit affirmed the district court's finding that the IRS failed to give reasonable advance notice to the taxpayer before making a third-party contact, and therefore failed to satisfy the fourth element of the *Powell* requirements. The significant cases portion of this report provides a discussion of the case.[42]

Although the Ninth Circuit in *JB* did not prescribe what would constitute reasonable advance notice in each case, it suggested, based on the legislative history of IRC § 7602(c), Treasury Regulations, and the exceptions to the advance notice requirement in IRC § 7602(c)(1), that the IRS provide taxpayers with a meaningful advance notice and opportunity to respond. Although the Taxpayer First Act (TFA) eliminated the requirement for notice to be "reasonable," it now requires that when the IRS has intent to contact third parties, notice be sent to the taxpayer at least 45 days before third-party contacts are made and specify the period (not to exceed one year) during which the IRS will make contacts.[43] The IRS began implementing the TFA on August 15, 2019, but its revised notices to taxpayers do not include the information the IRS is seeking to obtain or verify from third parties.[44] Although the Ninth Circuit in *JB* contemplated that the notice would occur either simultaneously with or after an information request to allow the taxpayer to provide the information without need for the IRS to contact the third

36 *See, e.g., United States v. Boyd*, 123 A.F.T.R.2d (RIA) 302 (W.D. Ky. 2018); *United States v. Brammer*, 122 A.F.T.R.2d (RIA) 6258 (S.D. Cal. 2018); *United States v. Castanhiero*, 122 A.F.T.R.2d (RIA) 6956 (M.D. Fla. 2018); *United States v. Fleishman*, 2018 WL 6303687 (M.D. Fla. 2018). As mentioned above, the government initiated summons litigation in 30 cases during the current reporting period. The government petitioned to enforce summons litigation in 29 cases. In one case, *In the Matter of the Tax and Liabilities of John Does*, 122 A.F.T.R.2d (RIA) 6306 (W.D. Tex. 2018), the government filed an *ex parte* petition with the court for leave to serve a "John Doe" summons.

37 *Mazurek v. United States*, 271 F.3d 226, 230 (5th Cir. 2001).

38 *United States v. Kris*, 658 F.2d 526 (7th Cir. 1981).

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

40 *See, e.g., Floyd v. United States*, 2018 WL 7199738 (E.D. Mo. 2018), *appeal dismissed*, 2019 WL 3731373 (8th Cir. Apr. 2, 2019); *Floyd v. United States*, 122 A.F.T.R.2d (RIA) 6894 (W.D. Tex. 2018), *appeal dismissed*, 2019 WL 3574245 (5th Cir. Apr. 9, 2019); *Floyd v. United States*, 123 A.F.T.R.2d (RIA) 1642 (D. Del. 2019), *appeal dismissed*, No. 19-02627 (3d Cir. Aug. 15, 2019); *Floyd v. United States*, 2019 WL 386385 (W.D. Mo. 2019), *appeal dismissed*, No. 19-01253 (8th Cir. Mar. 28, 2019); *Pelletier v. United States*, 123 A.F.T.R.2d (RIA) 1102 (S.D. Cal. 2019); *Speidell v. United States*, 123 A.F.T.R.2d (RIA) 1704 (D. Colo. 2019), *appeal docketed*, No. 19-01214 (10th Cir. June 18, 2019).

41 *JB v. United States*, 916 F.3d 1161 (9th Cir. 2019), *aff'g* 117 A.F.T.R.2d (RIA) 694 (N.D. Cal. 2016).

42 *See* Most Litigated Issues: *Significant Cases, supra.*

43 TFA, Pub. L. No. 116-25, § 1206, 133 Stat. 981 (2019).

44 IRS, Interim Guidance Memorandum (IGM) SBSE-04-0719-0034, Interim Guidance on Third-Party Contact Notification Procedures (July 26, 2019). Despite the holding in *JB*, if challenged in a case existing before TFA became effective, the IRS will defend its prior practice of satisfying the advance notice requirement as provided in the Internal Revenue Manual (IRM). *See* IRM 5.17.6.7, Third-Party Contact Requirements of IRC § 7602(c) (Aug. 1, 2019).

party, the IRS's new procedures seem to assume the TFA has eliminated any such requirement. Because there is no clear indication that Congress intended to remove the requirement by allowing the IRS to provide a boilerplate notice in advance that deprives taxpayers of any meaningful opportunity to respond, taxpayers may challenge its new procedures, particularly in the Ninth Circuit. Accordingly, we recommend the IRS include the information it is seeking to obtain from third parties in every taxpayer pre-contact notice. This practice might reduce litigation and would be consistent with the taxpayer's *rights to privacy* and *confidentiality*.

Finally, during this reporting period, four businesses involved in the marijuana industry unsuccessfully petitioned to quash summonses issued to a third parties.[45] In each case, the IRS was investigating the taxpayer on the basis of IRC § 280E, which prohibits deductions or credits for expenses paid or incurred in the trade or business of trafficking in controlled substances. Although the courts found that the IRS made a *prima facie* showing that the *Powell* requirements were met, the taxpayers generally argued that the IRS lacked good faith in issuing the summonses because they believed the IRS was instead issuing the summons to place them in criminal jeopardy. Each court, including the Tenth Circuit Court of Appeals, rejected the taxpayers' arguments finding that there was no basis to conclude the IRS was acting in bad faith or harassing the taxpayers.[46]

The 2018 summons enforcement narrative discussed at length the *Rifle Remedies, LLC* case,[47] and this year summons suits related to the marijuana industry increased fourfold. As more states legalize or decriminalize the sale of marijuana and the industry grows, IRS examinations will also likely increase to ensure compliance with IRC § 280E. Thus, we anticipate that litigation in this area will continue to grow, despite the fact courts continue to find that the IRS is not acting in bad faith in issuing summonses to these taxpayers or third parties. To avoid litigation in this area, the IRS could try to educate this industry on the special compliance rules that apply.

Privileges

As in past years, taxpayers attempted to invoke various privileges, including the Fifth Amendment and attorney-client privileges in response to an IRS summons.[48] Taxpayers were partially successful in invoking privileges in two cases. In the *Durham* case, the court enforced the summons in part, concluding that the taxpayer properly invoked his Fifth Amendment right against self-incrimination with respect to some of the information requested by the IRS.[49] In the *Baldwin* case, the court found that the documentation requested by the IRS was subject to the attorney-client privilege and granted in part the taxpayer's motion to quash a third-party summons.[50] However, in *U.S. v. Sanmina Co. and Subsidiaries,* which was on remand from the Ninth Circuit Court of Appeals, the taxpayer was not successful in

45 *Green Sol., LLC v. United States*, 123 A.F.T.R.2d (RIA) 1711 (D. Colo. 2019), *appeal docketed*, No. 19-01214 (10th Cir. June 18, 2019); *High Desert Relief, Inc. v. United States*, 917 F.3d 1170 (10th Cir. 2019); *Medicinal Wellness Center, LLC v. United States*, 123 A.F.T.R.2d (RIA) 1714 (D. Colo. 2019), *appeal docketed*, No. 19-01217 (10th Cir. June 19, 2019); *Medicinal Wellness Center, LLC v. United States*, 123 A.F.T.R.2d (RIA) 1699 (D. Colo. 2019), *appeal docketed*, No. 19-01218 (10th Cir. June 18, 2019); *Standing Akimbo, LLC v. United States*, 2018 WL 6791071 (D. Colo. 2018), *appeal docketed*, No. 19-01049 (10th Cir. Feb. 8, 2019), *adopting* 2018 WL 6791104 (D. Colo. Oct. 6, 2018).

46 *See, e.g., High Desert Relief, Inc. v. United States*, 917 F.3d 1170 (10th Cir. 2019); *Green Sol., LLC v. United States*, 123 A.F.T.R.2d (RIA) 1711 (D. Colo. 2019), *appeal docketed*, No. 19-01214 (10th Cir. June 18, 2019).

47 *Rifle Remedies, LLC v. United States*, 120 A.F.T.R.2d (RIA) 6385 (D. Colo. 2017).

48 *See Belcik v. United States*, 123 A.F.T.R.2d (RIA) 5702 (N.D. Ala. 2018).

49 *See United States v. Durham*, 122 A.F.T.R.2d (RIA) 5100 (E.D. Mo. 2018).

50 *See Baldwin v. United States*, 2018 WL 4372553 (C.D. Cal. 2018).

invoking privileges. Although the district court determined that two documents were indeed privileged under the attorney work-product and attorney-client privilege, both grounds had been waived.[51]

Civil Contempt

A person who "neglects or refuses to obey" an IRS summons may be held in civil contempt.[52] In four cases this year, taxpayers were held in civil contempt for failing to comply with a court order enforcing an IRS summons.[53] 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.[54]

International Treaty Obligations

Courts denied three taxpayers' motions to quash third-party summonses and granted the government's motion to enforce a summons in one other case based on the government's compliance with international agreements.[55] Taxpayers generally argued that the IRS summonses were not issued for a legitimate purpose as the foreign countries were requesting the information in bad faith. The courts applied the *Powell* requirements, citing Supreme Court precedent that as long as the IRS itself acts in good faith and complies with the applicable statutes, it is entitled to enforcement of its summons.[56]

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.[57] 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. 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. However, we anticipate that the TFA's change to the requirements for John Doe summonses and advance notice before making third-party contacts should reduce summons litigation.

51 *United States v. Sanmina Co. and Subsidiaries*, 122 A.F.T.R.2d (RIA) 6232 (N.D. Cal. 2018), *appeal docketed*, No. 18-17036 (9th Cir., Oct. 19, 2018), 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 the 2015 and 2018 Annual Reports. See National Taxpayer Advocate 2018 Annual Report to Congress 469, 476-477 (Most Litigated Issue: *Summons Enforcement Under IRC §§ 7602, 7604, and 7609*); National Taxpayer Advocate 2015 Annual Report to Congress 467, 473-474 (Most Litigated Issue: *Summons Enforcement Under IRC §§ 7602, 7604, and 7609*).

52 IRC § 7604(b).

53 *See United States v. Edwards*, 122 A.F.T.R.2d (RIA) 7035 (W.D. Tenn. 2018); *United States v. Gonzalez*, 122 A.F.T.R.2d (RIA) 5352 (M.D. Fla. 2018); *United States v. Heist*, 123 A.F.T.R.2d (RIA) 1493 (W.D. Wis. 2019), *appeal dismissed*, 2019 WL 4464233 (7th Cir. May 2, 2019); *United States v. Higgins*, 122 A.F.T.R.2d (RIA) 5705 (D. Ariz. 2018).

54 *See United States v. Edwards*, 122 A.F.T.R.2d (RIA) 7035 (W.D. Tenn. 2018); *United States v. Gonzalez*, 122 A.F.T.R.2d (RIA) 5352 (M.D. Fla. 2018); *United States v. Heist*, 123 A.F.T.R.2d (RIA) 1493 (W.D. Wis. 2019), *appeal dismissed*, 2019 WL 4464233 (7th Cir. May 2, 2019).

55 *See GA2.com SP. ZO. O. (LTD) v. United States*, 123 A.F.T.R.2d (RIA) 5759 (D. Del. 2018); *Verges v. United States*, 121 A.F.T.R. 2d (RIA) 2287 (S.D. Fla. 2018); *Vistadis, LLC v. United States*, 123 A.F.T.R.2d (RIA) 1353 (E.D. Pa. 2019); *United States v. Thielemann*, 123 A.F.T.R.2d (RIA) 665 (S.D. Cal. 2019).

56 *Vistadis, LLC v. United States*, 123 A.F.T.R.2d (RIA) 1353 (E.D. Pa. 2019) (citing *United States v. Stuart*, 409 U.S. 353 (1989)).

57 IRC § 7602(a).

RECOMMENDATIONS TO MITIGATE DISPUTES

The National Taxpayer Advocate recommends that Congress:

- Amend IRC § 7602(c)(1) to clarify that the IRS must tell the taxpayer what information it needs (or needs to verify) and to give the taxpayer a reasonable opportunity to provide the information (or verification of it) before contacting a third party, unless doing so would be pointless or an exception applies.

The National Taxpayer Advocate recommends that the IRS:

- Revise its letters and internal guidance to inform the taxpayer of what information it needs (or needs to verify) and to give the taxpayer a reasonable opportunity to provide the information (or verification of it) before contacting the third parties.
- Educate industries involved in the sale of controlled substances about the prohibition on claiming any deduction or credit under IRC § 280E.

MLI #6 Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403

SUMMARY

The United States may file a civil action in U.S. District Court under Internal Revenue Code (IRC) § 7403 to enforce its federal tax lien by subjecting any of the delinquent taxpayer's property, right, title, or interest in property to the payment of the taxpayer's liability. Unlike cases in other Most Litigated Issues, lien enforcement cases are always initiated by the government through the Department of Justice (DOJ) rather than the taxpayer. If the United States succeeds in proving the lien is valid and may be enforced, the court will typically issue an order of sale that (1) authorizes the United States to foreclose on the taxpayer's subject property and (2) describes how the proceeds of sale should be distributed.

During our reporting period from June 1, 2018, to May 31, 2019, we identified 52 opinions that involved civil actions to enforce liens under IRC § 7403. The IRS prevailed in 48 of these cases, taxpayers prevailed in two cases, and two cases resulted in split decisions in which the IRS and taxpayers or a third party prevailed in part. The 52 cases identified for this reporting period represent a 33 percent increase from the 39 cases reported last year.

TAXPAYER RIGHTS IMPACTED[1]

- *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

A federal tax lien (FTL) arises when the IRS assesses a tax liability, sends the taxpayer notice and demand for payment, and the taxpayer does not fully pay the debt within ten days of the notice and demand.[2] An FTL is effective as of the date of assessment and attaches to all of the taxpayer's property and rights to property, whether real or personal, including those acquired by the taxpayer after that date.[3] This lien continues against the taxpayer's property until the liability either has been fully paid or is legally unenforceable.[4] Section 7403 authorizes the United States to enforce a federal tax lien over the taxpayer's liability or to subject any of the delinquent taxpayer's property, right, title, or interest in property to the payment of that liability by initiating a civil action in the appropriate U.S. District Court.[5]

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

2 IRC §§ 6321 and 6322. IRC § 6201 authorizes the IRS to assess all taxes owed. IRC § 6303 provides that within 60 days of the assessment the IRS must provide notice and demand for payment to any taxpayer liable for an unpaid tax.

3 *See* IRC § 6321; Internal Revenue Manual (IRM) 5.12.1.1.1, Federal Tax Liens, Background (July 11, 2018).

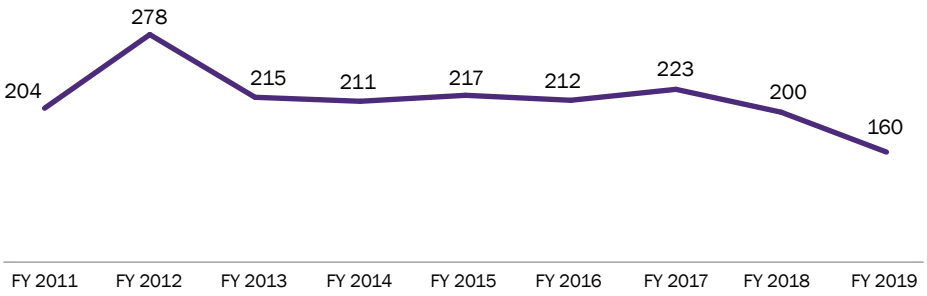
4 IRC § 6322.

5 IRC § 7403(a); Treas. Reg. § 301.7403-1(a).

To bring an enforcement suit, the IRS must refer a case to the DOJ and request it to file the foreclosure suit.[6] In fiscal year (FY) 2019, the IRS referred 160 cases to the DOJ. Figure 1 shows the trend in the number of lien enforcement cases referred to the DOJ since FY 2011, which has been mostly steady with a small downward trend in the last two fiscal years.

FIGURE 2.6.1

Liens Cases Referred to U.S. Department of Justice



The Internal Revenue Manual (IRM) provides the factors the IRS should consider when determining whether to initiate an enforcement suit, including the feasibility of administrative collection devices, the statute of limitations, and the economic value of lien foreclosure.[7] With respect to a recommendation to foreclose on a taxpayer's principal residence, the IRM instructs the IRS to refer a case to DOJ to file suit to foreclose only when there are no other reasonable administrative remedies and the foreclosure would not create or exacerbate hardship issues for the taxpayer or result in the inability of the taxpayer to secure future housing.[8]

Once the DOJ receives the referral, it can initiate suit to enforce the lien under IRC § 7403 by filing a complaint in the appropriate district court.[9] The DOJ is required to name all parties having liens on or otherwise claiming interest in the relevant property as parties to the action.[10] The law of the state where the property is located determines the nature of a taxpayer's legal interest in the property.[11] However, once it is determined that the taxpayer has an interest under state law in the property, federal law

6 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 DOJ asking the DOJ to commence the litigation. Chief Counsel Directives Manual 34.6.1.1.1, Steps Prior to Litigation (Oct. 7, 2015).

7 IRM 5.17.4.8, Foreclosure of Federal Tax Lien (May 23, 2019).

8 IRM 5.17.4.8.2.5, Lien Foreclosure on a Principal Residence (May 23, 2019). The requirement to include an analysis of ability to secure future housing is an update from previous versions of the IRM. This provision is a step towards meeting the National Taxpayer Advocate's recommendation that the IRS instruct employees to more thoroughly consider the negative impact of foreclosing a principal residence. *See* National Taxpayer Advocate 2012 Annual Report to Congress 537 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*).

9 The United States may also intervene in foreclosure actions initiated by other creditors to assert any lien on the property that is the subject of such action. If the lien enforcement claim arises as a counterclaim or interpleader action in a case that originated in a state court, the United States may remove the case to a U.S. District Court. 28 U.S.C. § 1444. 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. *See United States v. Brosnan*, 363 U.S. 237 (1960).

10 IRC § 7403(b).

11 *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985).

determines the respective priorities of the federal tax lien and competing liens or, alternatively, whether the property is exempt from attachment of the lien.[12]

Section 7403(c) directs the court to "finally determine the merits of all claims to and liens upon the property." 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.

ANALYSIS OF LITIGATED CASES

We reviewed 52 opinions during our reporting period that involved civil actions to enforce federal tax liens. Table 6 in Appendix 5 contains a detailed list of those cases. Of the 52 cases, ten resulted in default judgment against the taxpayer. Taxpayers appeared *pro se* (without counsel) in 23 cases, while 19 of the cases involved taxpayers with representation. The IRS prevailed in all cases brought against *pro se* taxpayers. This section will highlight key issues in the cases we identified, including the enforcement of tax liens where a non-liable taxpayer has an interest in the subject property; the enforcement of a lien against property held by third parties; and the government's ability to enforce its lien during the existence of an installment agreement.

Foreclosure of Tax Liens Where a Non-Liable Taxpayer Had Interest in Property

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*,[13] 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.[14]

The *Rodgers* analysis balances the right of the United States to receive the highest return possible by selling the property in its entirety while also ensuring third parties receive just compensation through judicial valuation and distribution. Following the forced sale, any proceeds are distributed in accordance with the relative interests of the parties, with the United States receiving the proceeds of sale proportional to only the interest of the delinquent taxpayer.

The courts addressed the *Rodgers* factors in four cases during this reporting period. For example, in the case of *United States v. Jackson*, the defendant taxpayer and his wife contested the government's proposed sale of a property, arguing that the proposed sale and distribution would unduly diminish the taxpayer's wife's interest in the subject properties because her portion would be reduced after payments were made

12 *United States v. Rodgers*, 461 U.S. 677, 683 (1983).
13 *United States v. Rodgers*, 461 U.S. 677 (1983).
14 *Id.* at 709-711.

to Property Appraisal and Liquidation Specialists (PALS).[15] The court evaluated the appropriateness of sale using the *Rodgers* factors. First, the court found that the United States would be prejudiced if it were relegated to selling only the taxpayer's interest rather than the properties in their entirety, as this would diminish the value the government could expect to receive in a sale. Second, the wife lacked any expectation the properties would not be sold because she had participated in the fraudulent transfer of the properties, acting to frustrate the government's collection efforts and tilting the balance against her for this factor.[16] Third, the wife would not receive inadequate consideration for her share of the property, and she cited no legal authority to show that the administrative costs of sale should be borne by the government. The court relied on "the Government's paramount interest in prompt and certain collection of delinquent taxes" to conclude that the net proceeds from the sale of the properties should be distributed to PALS first.[17] Finally, the court held that the government would recover "more than 'a fraction of the value of the propert[ies]'" in a forced sale.[18] Thus, all factors weighed in favor of sale of the properties and distribution of the sale proceeds.

Foreclosure of Tax Liens Against Property Held by Third Parties

During this reporting period, we identified 18 cases in which the United States sought to enforce its federal tax lien against property that it claimed was nominally held by a third party. The IRM identifies the following legal theories under which a third party can be held liable for the tax liability of another: fiduciary liability, successor liability, transferee liability, and nominee or alter ego.[19] Although the "nominee" and "alter ego" doctrines frequently overlap, the nominee analysis typically focuses on the taxpayer's use and control of the property, while the alter ego analysis focuses on the nature of taxpayer's relationship to the entity with legal title to the property.[20] Nominee and alter ego situations also share common elements with fraudulent transfers but do not require transfer of legal title or that the taxpayer be insolvent for the lien to attach.[21] A tax lien attaches to property held by a third party such as the taxpayer's nominee or alter ego.[22]

In *Shaw v. United States*, the district court evaluated a delinquent taxpayer's transfer of property to a business trust under the nominee, alter ego, and fraudulent transfer theories, and found that each showed the transfer should be set aside and the tax lien enforced against the property.[23] First, in its nominee analysis, the court found that the taxpayer was the source of the funds used to purchase the property initially, and he transferred the property to the trust for no consideration. After the transfer, he continued to use the property without paying rent, and he paid for its maintenance out of an account containing solely his funds. In addition, the court emphasized that the taxpayer transferred the property to the trust in anticipation of evading his liabilities, as he explicitly stated the role of the trustee was to "protect

15 123 A.F.T.R.2d (RIA) 594 (W.D. Mo. 2019). The taxpayer and wife also objected to distribution to the county, another lien holder with priority. However, the court found that the wife was liable for outstanding property tax payments owed to the county, justifying the county's priority position in proceed distribution.

16 The taxpayer and his wife had attempted to transfer the subject properties to various trusts after the taxpayer's debts had arisen, but they conceded that those transfers were invalid during the course of litigation. 123 A.F.T.R.2d (RIA) 594 at *3.

17 123 A.F.T.R.2d (RIA) 594 at *3.

18 123 A.F.T.R.2d (RIA) 594 at *3, *citing United States v. Bierbrauer*, 936 F.2d 373, 375 (8th Cir. 1991).

19 IRM 5.17.14.1, Third Party Liability Overview (Jan. 24, 2012).

20 Alter egos typically relate to sham business entities controlled by or indistinct from the taxpayer, while a nominee is generally a third-party individual who holds legal title to property of a taxpayer while the taxpayer enjoys full use and benefit of that property. *See* IRM 5.17.2.5.7.1, Alter Ego (Mar. 19, 2018); IRM 5.17.2.5.7.2, Nominee (Mar. 19, 2018).

21 IRM 5.17.14.6, Nominee and Alter Ego Doctrines (Jan. 24, 2012). *See Holman v. United States*, 505 F.3d 1060, 1064-65 (10th Cir. 2007) (nominee lien against property purchased by nominee with money from the taxpayer is permissible).

22 *See, e.g., Fourth Inv., L.P. v. United States*, 720 F.3d 1058, 1066 (9th Cir. 2013).

23 122 A.F.T.R.2d (RIA) 6151 (D. Nev. 2018).

the trust from any third party or government agencies."[24] These factors indicated that the taxpayer still maintained use and control of the property, and thus the tax lien could be enforced against it.

Second, in its alter ego analysis, the court found that the taxpayer "showed no respect for the 'separate identity' of the corporation," as the trust did not keep records, issue quarterly reports, or even maintain a bank account separate from the taxpayer.[25] The court found the United States would suffer injustice if it treated the trust as a separate entity, as the taxpayer impoverished himself by transferring all his property to it. There was also fraudulent intent, as the transfer occurred just as the taxpayer was accruing significant tax liabilities, and the transfer was made for the purpose of protecting his assets. These factors showed the trust was a sham entity and supported the court's finding of alter ego liability.[26]

Third, the court found that taxpayer's transfer of the property was both constructively and actually fraudulent under Nevada law.[27] The court highlighted that the transfer occurred after the taxpayer reasonably should have believed he would incur debts beyond his ability to pay. Thus, the nominee, alter ego, and fraudulent transfer analyses all showed that the tax lien attached to the property, and the United States could enforce it by sale.[28]

In another case, *United States v. Orr*, the district court assessed the nominee doctrine in the context of married taxpayers.[29] The United States attempted to enforce a tax lien against a property held by a delinquent taxpayer's wife, asserting that she was his nominee. However, each had provided part of the cost for purchase of the property, weighing against nominee status. Importantly, the court noted the purchase occurred two years before the IRS assessed the tax against the taxpayer, indicating it was not in anticipation of litigation.[30] The court placed less weight on several factors that typically indicate a nominee situation because of the taxpayer's marital relationship. Although the taxpayer had a close relationship with his wife, and he possessed and enjoyed the benefits of the property, the court would "not hold it against a married couple to live together."[31] Thus, the court found that the wife was not the taxpayer's nominee. However, because the wife purchased the property with commingled funds, some of which were traceable to the taxpayer, the court found the taxpayer did have a partial interest in the property. The United States was allowed to foreclose on the property but was required to compensate the wife for her interest.

Lien Enforcement During Existence of an Installment Agreement

The existence of an installment agreement prohibits the IRS from continuing certain types of collection actions against taxpayers. For example, IRC § 6331(k) prevents the IRS from undertaking a levy against a taxpayer while installment agreement is pending or in effect. In *State Auto Prop. Cas. Ins. Co. v. Burnett*, the district court considered whether the existence of an installment agreement barred

24 *Id* at *8.

25 122 A.F.T.R.2d (RIA) 6151 (D. Nev. 2018) at *9-10.

26 The court addressed the question of whether federal or state standards should be used in the nominee analysis, and determined that the alter ego inquiry "goes not to the ownership of property (a question of state law), but rather to the question of who is liable for a tax," which should be evaluated under federal law. 122 A.F.T.R.2d (RIA) 6151 (D. Nev. 2018) at *9. However, even if state law applied, the court found the trust was the taxpayer's nominee as well.

27 Property rights are determined under state law. *See United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985).

28 Any one of these three findings would be sufficient for the lien to attached to the property and be enforced.

29 336 F. Supp. 3d 732 (W.D. Tex. 2018).

30 The court would not speculate that the couple had schemed for the taxpayer to fail to pay his income taxes that far in advance.

31 336 F. Supp. 3d 732, 760 (W.D. Tex. 2018).

the United States from enforcing its tax lien against interpleaded insurance funds.[32] The court found, "There is nothing in the IRS Code suggesting that the limitations found in the statue governing levies (§ 6331) are applicable to the statute governing liens (§ 6321)."[33] Thus, in light of the statute's plain language, as well as similar interpretations by other courts, the court held that despite the existence of an installment agreement, the United States was entitled to enforce its lien against the interpleaded insurance funds.[34]

CONCLUSION

Lien enforcement cases continue to be a frequent source of litigation and often implicate the rights of taxpayers and third parties. In particular, the National Taxpayer Advocate is concerned with the following aspects of the lien enforcement process.

First, seizure of a taxpayer's principal residence may have potentially devastating impact on the taxpayer and his or her family, especially if the taxpayer is at risk of economic hardship. As discussed in the 2018 Annual Report to Congress, the IRS is inadequately using internally available data to identify taxpayers at risk of economic hardship, which could be used to shield taxpayers from referral to the DOJ.[35] Foreclosing on a taxpayer's home when he or she is experiencing economic hardship jeopardizes the taxpayer's *right to a fair and just tax system*. While the May 2019 revisions to the IRM instruct the IRS to provide additional details in the referral including whether the action proposed would result in an inability to secure future housing or otherwise lead to an economic hardship, these provisions are simply instructions that can be modified or rescinded at any time. Furthermore, taxpayers may generally not use IRM violations as the basis for challenging IRS actions in court, leaving them little opportunity for relief at the stage of lien enforcement.[36]

Second, Collection Due Process (CDP) notice and hearing procedures described in IRC §§ 6320 and 6330 are not extended to third parties that may have an interest in property subject to lien enforcement. This deprives affected third parties, such as alleged nominees or alter egos, of the *right to challenge the IRS's position and be heard* prior to a lien enforcement suit. Allowing affected third parties the opportunity to raise defenses and propose collection alternatives in a CDP hearing could help reduce litigation by resolving these issues earlier in the process.[37]

32 122 A.F.T.R.2d (RIA) 5407 (N.D. Miss. 2018). IRC § 6331(k)(3) prevents the IRS from referring a case to the Department of Justice "for the commencement of a proceeding in court against a person named in an installment agreement … if levy to collect the liability is prohibited under paragraph (a)(1)," but it does not prevent the United States from filing a counterclaim or defend the United States in an action under § 2410 in which the taxpayer's liability for a tax that is the subject of an installment agreement may be established.

33 122 A.F.T.R.2d (RIA) 5407 (N.D. Miss. 2018) at *3.

34 *See, e.g., Am. Tr. v. Am. Cmty. Mut. Ins. Co.*, 142 F.3d 920, 923-24 (6th Cir. 1998) ("The United States Courts of Appeals that have considered the relationship between administrative levies and tax liens have recognized that a tax lien under § 6321 can attach to property that would be exempt from a § 6331 administrative levy."); *United States v. Cazzell*, 2016 U.S. Dist. LEXIS 168875, at *3 (W.D. Mo. Aug. 10, 2016) ("[W]hile the Government is precluded from using an administrative levy while an installment agreement is pending, the Government is not precluded from seeking judicial enforcement of their tax lien.").

35 *See* National Taxpayer Advocate 2018 Annual Report to Congress 228 (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*).

36 National Taxpayer Advocate 2020 Purple Book: *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 46-47 *(Provide Taxpayer Protections Before the IRS Recommends the Filing of a Lien Foreclosure Suit on a Principal Residence*).

37 National Taxpayer Advocate 2020 Purple Book: *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 48 *(Provide Collection Due Process Rights to Third Parties Holding Legal Title to Property Subject to IRS Collection Actions*).

Third, allowing the United States to seize funds through a lien enforcement proceeding while the taxpayer has a pending or existing installment agreement infringes on the taxpayer's *rights to finality* and *a fair and just tax system*. When a taxpayer enters into an installment agreement, the agreement constitutes a defined plan by which a taxpayer will address his or her liability and allows the taxpayer to create a budget for other expenses. If taxpayers continue to face the possibility that the IRS can intervene to enforce a lien against their property interests even after they enter a payment plan, they could be discouraged from entering into installment agreements. Allowing lien enforcement actions to continue is also incongruous with IRC § 6331, which prevents levies while offers in compromise or installment agreements are pending or in effect.

RECOMMENDATIONS TO MITIGATE DISPUTES

The National Taxpayer Advocate recommends that Congress:

1. Amend IRC § 7403 to codify current IRM administrative protections, including that an IRS employee must receive executive-level written approval to proceed with a lien foreclosure suit referral.[38]
2. Amend IRC § 7403 to preclude IRS employees from requesting that the DOJ file a civil action in U.S. District Court seeking to enforce a tax lien and foreclose on a taxpayer's principal residence except where the employee has determined that (1) the taxpayer's other property or rights to property, if sold, would be insufficient to pay the amount due, including the expenses of the proceedings, and (2) the foreclosure and sale of the residence would not create an economic hardship due to the financial condition of the taxpayer.[39]
3. Amend IRC §§ 6320 and 6330 to extend CDP rights to "affected third parties" who hold legal title to property subject to IRS collection actions.[40]

38 National Taxpayer Advocate 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 46-47 *(Provide Taxpayer Protections Before the IRS Recommends the Filing of a Lien Foreclosure Suit on a Principal Residence)*.

39 *Id.*

40 National Taxpayer Advocate 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 48 *(Provide Collection Due Process Rights to Third Parties Holding Legal Title to Property Subject to IRS Collection Actions)*.

MLI #7 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 34 decisions issued by federal courts from June 1, 2018, to May 31, 2019, regarding additions to tax for:

1) Failure to file a tax return by the due date under Internal Revenue Code (IRC) § 6651(a)(1);
2) Failure to pay an amount shown as tax on a tax return under IRC § 6651(a)(2);
3) Failure to pay installments of the estimated tax under IRC § 6654; or
4) Some combination of the three.

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. Three cases involved the successful imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties; 30 cases involved the failure to file and/or failure to pay penalties without the estimated tax penalty; however, the estimated tax penalty was not the sole issue in any of the cases.

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.[1] The estimated tax penalty is imposed unless the taxpayer falls within one of the statutory exceptions.[2] Taxpayers were unable to avoid a penalty in just two of the 34 cases.

TAXPAYER RIGHTS IMPACTED[3]

- *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 reasonable cause and not willful neglect.[4] For the taxpayer to avoid the penalty by showing there was a

1 IRC § 6651(a)(1), (a)(2).

2 IRC § 6654(e).

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

4 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). 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.

reasonable cause, the taxpayer must have exercised ordinary business care and prudence.[5] The failure to file penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.[6]

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.[7] 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.[8] 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.[9] The failure to pay penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.[10]

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.[11] In addition, "consideration will be given to the nature of the tax which the taxpayer has failed to pay."[12]

IRC § 6654 imposes a penalty on any underpayment of estimated tax by an individual or by certain estates or trusts.[13] The law requires four installments per tax year, each generally 25 percent of the required annual payment.[14] 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.[15] The IRS lowered to 80 percent the threshold required for certain taxpayers to qualify for estimated tax penalty relief if their federal income tax withholding and estimated tax payments fell short of their total tax liability in tax year 2018.[16]

5 Treas. Reg. § 301.6651-1(c)(1).

6 IRC § 6651(a)(1).

7 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). 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.

8 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.

9 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.

10 IRC § 6651(a)(2).

11 Treas. Reg. § 301.6651-1(c)(1). *See, e.g., East Wind Indus., Inc. v. United States*, 196 F.3d 499, 507 (3d Cir. 1999).

12 Treas. Reg. § 301.6651-1(c)(2).

13 IRC § 6654(a), (l).

14 IRC § 6654(c)(1), (d)(1)(A).

15 IRC § 6654(d)(1)(B). If the adjusted gross income shown on the return of the individual for the preceding taxable year exceeds $150,000, the required annual payment increases to 110 percent of the tax shown on the return of the individual for the preceding tax year (if the preceding tax year was 2002 or after). IRC § 6654(d)(1)(C)(i).

16 Notice 2019-11, 2019-05 I.R.B. 430, *modified and superseded by* Notice 2019-25, 2019-15 I.R.B. 942. Notice 2019-25 updated procedures for requesting the waiver of the addition to tax and provided procedures for requesting a refund of penalties paid for TY 2018. On August 14, 2019, the IRS announced it would automatically waive the estimated tax penalty for the more than 400,000 eligible taxpayers who already filed their 2018 federal income tax returns but did not claim the waiver. IR-2019-144.

The amount of the penalty is dependent upon the particular facts of the underpayment.[17] 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;[18]
- 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;[19]
- It is determined that because of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;[20] 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.[21]

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.[22]

ANALYSIS OF LITIGATED CASES

We analyzed 34 opinions issued between June 1, 2018, and May 31, 2019, where the failure to file penalty, failure to pay penalty, or estimated tax penalty was in dispute. Twenty-eight of these cases were either litigated in the U.S. Tax Court, or an appeal of a Tax Court decision. A detailed list appears in Table 7 in Appendix 5. Twenty-four cases involved individual taxpayers and ten involved businesses (including individuals engaged in self-employment or partnerships).

Of the 19 cases in which taxpayers appeared *pro se* (without counsel), the outcomes always favored the IRS. Taxpayers were represented in the only two cases in which the court ruled in their favor.

Failure to File Penalty

In 30 out of the 32 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.[23] Taxpayers provided reasons such as physical injury or mental illness and reliance on an agent as a basis for reasonable cause. Circumstances suggesting reasonable cause are typically outside the taxpayer's control.[24]

Physical Injury/Mental Illness or Pending Litigation as 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

17 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. The amount of the underpayment is the excess of the required payment over the amount paid by the due date.

18 IRC § 6654(e)(1).

19 IRC § 6654(e)(2).

20 IRC § 6654(e)(3)(A).

21 IRC § 6654(e)(3)(B).

22 IRC § 7491(c). *See also 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).

23 A taxpayer avoided the failure to file penalty by successfully proving reasonable cause in just one case.

24 *McMahan v. Comm'r*, 114 F.3d 366, 369 (2d Cir. 1997) (citation omitted), *aff'g* T.C. Memo. 1995–547.

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 *Namakian v. Commissioner,* the court held the taxpayer did not establish reasonable cause for failure to file his 2011, 2012, and 2013 tax returns.[25] The taxpayer argued that his financial decline beginning in 2007, along with the death of his mother-in-law in 2011, and his father-in-law in 2014, invoked stress-induced anxiety and depression, which caused insomnia and an inability to retain focus. The taxpayer stated that these stress-induced health problems rendered him unable to file his returns.[26] The court sympathized with the taxpayer's circumstances, but did not believe these setbacks constituted reasonable cause, as the taxpayer was still able to generate significant income during these time periods, showing that he was capable of managing his business affairs.

The taxpayer also argued that his failure to file was due to awaiting a pending outcome on litigation regarding his 2007 and 2008 returns that he believed would affect the filing of these later years. The court pointed out that a stipulated decision on his 2008 matter was entered on August 27, 2013, several months prior to the due date for his 2013 return; thus, this explanation for his late filing of his 2013 return was unconvincing. The court further pointed out, in regard to the 2011 and 2012 returns, that the reasonable and prudent course of action would have been to file timely using the best information available, disclosing that a dispute existed regarding how he should be treated regarding his stock sales, (*i.e.,* investor or trader).

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 for ensuring timely filing.[27] Taxpayers have a non-delegable duty to file a tax return on time.[28] 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 or she relies upon.[29] 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 *Burbach v. Commissioner*, the IRS imposed failure to file penalties on the taxpayer (Mr. Burbach) and the taxpayer's business (Burbach Aquatics Inc. or BAI, Inc.).[30] Both Mr. Burbach and BAI argued that their failure to file was due to their reliance on their tax professional and advice given by this professional. However, the court held that both Mr. Burbach's and BAI's reliance was unreasonable.

In regards to BAI, Inc.'s corporate tax returns, Mr. Burbach relied on his tax professional's statement that corporations have six years to file their returns. The court stated that it did not find credible

25 *Namakian v. Comm'r*, T.C. Memo. 2018-200.

26 *Id*.

27 The Supreme Court held in *United States 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).

28 *United States 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." *Boyle*, 469 U.S. at 252.

29 *Boyle*, 469 U.S. at 241.

30 *Burbach v. Comm'r*, T.C. Memo. 2019-17.

Burbach's statement that he relied on this advice, because he had timely filed his own business and personal returns for decades, and described Burbach as a sophisticated businessman.[31]

Regarding Mr. Burbach's individual tax returns, the court also rejected his reasonable cause defense for many of the same reasons stated above (*i.e.,* Mr. Burbach was a sophisticated businessman), concluding that it was unwilling to excuse his late filing because he relied on advice that he knew, or should have known, was inaccurate.

In *Estate of Sanders v. Commissioner*, the taxpayer disputed a failure to file penalty under IRC § 6651(a)(1) for 2002, arguing that he was not required to file a return with the IRS because he was a *bona fide* resident of the U.S. Virgin Islands (USVI) for that year. Further, the taxpayer stated that even if he was not a *bona fide* USVI resident, and thus was required to file a return with the IRS, the penalty should be abated under reasonable cause because he reasonably relied on professional advice.[32]

In regards to the *bona fide* resident argument, the court determined, after considering 11 factors that fell into one of four broad categories,[33] that the taxpayer was a non-*bona fide* USVI resident for 2002,[34] meaning the taxpayer was required to file two income tax returns — one with the IRS and another with the Virgin Islands Bureau of Internal Revenue (VIBIR).[35] The taxpayer filed a return with the VIBIR for 2002, but did not file a return with the IRS for that year. However, the court held that the taxpayer's failure to file was due to reasonable cause and not willful neglect, because he had relied on advice from his attorney that he was a *bona fide* resident of the USVI, and thus did not need to file a return with the IRS.[36]

Failure to Pay an Amount Shown Penalty

As with the failure to file penalty, raising a reasonable cause defense to the failure to pay penalty requires that the taxpayer show that he or she exercised ordinary business care and prudence in the payment of his or 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.[37] 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 *Deaton Oil Company v. United States*, the taxpayer, Deaton Oil Co., LLC, was assessed a failure to pay penalty under IRC § 6651(a)(2) for 2010 through 2013 for failure to pay its employment taxes.[38] In 2015, the taxpayer paid the penalties and interest on the unpaid employment taxes, and subsequently

31 The court was unable to verify whether Mr. Burbach's tax return preparer was actually an enrolled agent. See *Burbach v. Comm'r*, T.C. Memo. 2019-17.

32 *Estate of Sanders v. Comm'r*, T.C. Memo. 2018-104.

33 The four categories are: intent; physical presence; social, family, and professional relationships; and the taxpayer's own representation.

34 "The single filing requirement of section 932(c)(2) applies only if a taxpayer 'is a bona fide resident of the Virgin Islands'. Sec. 932(c)(1)(A). The term 'bona fide resident of the Virgin Islands' was not defined by the Code until 2004. The Secretary did not promulgate final regulations for determining whether a taxpayer is a bona fide resident of the USVI until 2006. As a result, a taxpayer attempting to determine whether he or she was a bona fide resident of the USVI for tax years 2002-03 would not find the answer in either the Code or the regulations." *Estate of Sanders v. Comm'r*, T.C. Memo. 2018-104, 2018 Tax Ct. Memo LEXIS at *36-37 (July 15, 2018).

35 Under IRC § 932, non-bona fide residents of the US Virgin Islands who derive income from the USVI, must file two income tax returns: one with the IRS, and another with the VIBIR.

36 *Estate of Sanders v. Comm'r*, T.C. Memo. 2018-104.

37 See Treas. Reg. § 301.6651–1(c)(1).

38 *Deaton Oil Company v. United States*, 904 F.3d 634 (8th Cir. 2018), *aff'g* 119 A.F.T.R.2d (RIA) 1945 (W.D. Ark. 2017).

filed Form 843, Claim for Refund and Request for Abatement, seeking a refund of penalties and interest. The IRS refunded most of the penalties and interest assessed for 2013, but denied the claims for 2010, 2011, and 2012. Shortly thereafter, the taxpayer filed a refund suit in federal district court, which was dismissed for failure to state a claim.[39] The taxpayer appealed this decision.

The taxpayer argued that the paid IRC § 6651(a)(2) penalties should be refunded because the failure to pay was due to reasonable cause. Specifically, the taxpayer's operations manager failed to pay the taxes, which were part of his official responsibilities. Further, Deaton's operations manager did not inform Deaton's owner of these missed filing deadlines, withheld IRS notices from him, and even began settlement negotiations with the IRS without the express consent of Deaton's owner. Additionally, the taxpayer argued that it reasonably relied on its outside Certified Public Accountant's (CPA) assurances that tax returns were filed, and taxes paid timely.

The Court of Appeals for the Eighth Circuit determined that the failure of the operations manager (an agent of Deaton) to fulfill his obligations to Deaton (the principal) by filing tax returns and making payments on behalf of Deaton does not establish reasonable cause for Deaton's failure to comply with its tax obligations, because that failure did not render Deaton disabled with regard to its tax obligations. Further, the court concluded that disability is not established because the operations manager was subject to Deaton's control, regardless of whether or not Deaton sufficiently exercised that control. Therefore, the actions of the operations manager do not establish reasonable cause.

Additionally, the court held that the taxpayer's reliance on its outside CPA to confirm with its operations manager that all filings and payments had been timely made was not a basis for relief. The taxpayer's outside CPA merely asked the operations manager if such filings and payments had been completed and then relayed to the taxpayer that the necessary filings and payments had been made, even though the CPA did not request documentation to verify these actions. The court stated the CPA was not offering tax advice on which the taxpayer could rely, but was merely stating whether or not the tax obligations had been met.[40] Thus, the Court of Appeals determined that the taxpayer did not establish reasonable cause, and consequently was not entitled to relief, thereby affirming the district court's decision to dismiss the taxpayer's case.[41]

Estimated Tax Penalty

In court proceedings involving individuals, the IRS has the burden to produce evidence that IRC § 6654(d)(1)(B) requires an annual payment from the taxpayer.[42] 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.

In all four cases where an IRC § 6654 penalty was imposed, the IRS was able to show that the taxpayer had a required annual payment.[43] In none of these cases did the taxpayer present any evidence to show that he or she qualified for any of the statutory exemptions to the penalty. Thus, the penalty was imposed in all four cases.

39 *Deaton Oil Company v. United States*, 119 A.F.T.R.2d (RIA) 1945 (W.D. Ark. 2017).
40 *Deaton Oil Company v. United States*, 904 F.3d at 638.
41 *Deaton Oil Company v. United States*, 904 F.3d at 642.
42 IRC § 7491(c).
43 *Namakian v. Comm'r*, T.C. Memo. 2018-200; *Wells v. Comm'r*, T.C. Memo. 2018-188; *De Sylva v. Comm'r*, T.C. Memo. 2018-165.

CONCLUSION

Only two taxpayers prevailed in full out of the 34 (about six percent) of the failure to file, failure to pay, and estimated tax penalty cases analyzed in this report. The number of cases in which failure to file, failure to pay, or estimated tax penalties were at issue decreased by almost 28 percent from last year, and the portion of cases where the taxpayer received at least some form of relief decreased from 13 percent to six percent. This decline may be attributed to the general decline in tax litigation in recent years.[44]

44 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* National Taxpayer Advocate 2019 Annual Report to Congress (Most Litigated Issue: *Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403*), *supra*.

MLI #8 Itemized Deductions Reported on Schedule A (Form 1040)

SUMMARY

For the past two years, itemized deductions reported on Schedule A of IRS Form 1040 have been among the ten Most Litigated Issues. We identified 32 cases involving itemized deductions that were litigated in federal courts between June 1, 2018, and May 31, 2019.[1] The courts affirmed the IRS position in 29 of these cases, or about 91 percent, while taxpayers fully prevailed in one case, or about three percent of the cases. The remaining two cases, or about six percent, resulted in split decisions.

TAXPAYER RIGHTS IMPACTED[2]

- *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

Itemized Deductions Prior to the Tax Cuts and Jobs Act[3]

In order to calculate taxable income, individual taxpayers can deduct from gross income (or adjusted gross income (AGI)), a standard deduction based on filing status[4] or may instead elect to itemize deductions.[5] Common itemized deductions include personal expenses such as interest payments (including interest and points on mortgages secured by a principal or secondary residence);[6] state 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 1998-2019 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*, *infra*.

2 *See* Taxpayer Bill of Rights (TBOR), 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 Pub. L. No. 115-97, 131 Stat. 2054 (2017). TAS has a website, available in both English and Spanish, to educate individual taxpayers about items that were changed and not changed as a result of the Tax Cuts and Jobs Act (TCJA). For a detailed list of these changes, see TAS, *Tax Changes by Topic*, https://taxchanges.us/ (last visited Aug. 19, 2019).

4 IRC § 63. Married taxpayers must generally both elect the standard deduction or to itemize deductions, regardless of whether they file joint or separate returns. IRC § 63(c)(6)(A).

5 Itemized deductions are specified "personal" and "other" expenses allowed as deductions from AGI in calculating taxable income. See IRC § 62 for the calculation of AGI. Eligible taxpayers may claim itemized deductions by filing a Schedule A (Form 1040), Itemized Deductions, with their tax returns.

6 IRC § 163.

local income, sales,[7] and property taxes;[8] charitable contributions;[9] casualty and theft losses;[10] and medical and dental expenses exceeding a certain threshold of the taxpayer's AGI.[11]

Prior to the Tax Cuts and Jobs Act (TCJA) (tax years before 2018), itemized deductions also included miscellaneous deductions, such as tax advice and preparation fees, appraisal fees for purposes of charitable contributions or casualty losses, work-related expenses, and moving expenses.[12] Pre-TCJA, taxpayers with an AGI over a certain threshold amount are limited as to the total itemized deductions they can claim.[13] For taxpayers with an AGI over the threshold, allowable itemized deductions are reduced by three percent of the AGI above the applicable threshold to a maximum reduction of 80 percent of the total allowable deductions for the year.[14]

Changes Made Under the Tax Cuts and Jobs Act and Subsequent Regulation[15]

The TCJA eliminated or restricted many itemized deductions in 2018 and increased the standard deduction.[16] For tax year (TY) 2017, there were 143.1 million Forms 1040 filed through the last full processing cycle in fiscal year (FY) 2018, and 43.3 million taxpayers claimed itemized deductions (about 30.2 percent).[17] For TY 2018, there were 144.0 million Forms 1040 filed through the last full processing cycle of FY 2019, and 15.2 million taxpayers claimed itemized deductions (about 10.6 percent).[18] This represents a nearly 65 percent decrease, or about 28 million fewer taxpayers claiming itemized deductions in TY 2018.[19]

7 IRC § 164.

8 *Id*.

9 IRC § 170. Charitable contributions are discussed in a separate Most Litigated Issue, *Charitable Contribution Deductions Under IRC § 170*, *infra*.

10 IRC § 165(e) and (h).

11 IRC § 213. Other deductible expenses include certain payments related to the production or collection of income, such as property management expenses (under IRC § 212), investment interest expenses (under § 163(d)), and gambling losses (under IRC § 165(d)).

12 Work-related expenses include 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. *See* IRC § 67(b).

13 IRC § 68(a).

14 IRC § 68(a). 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. IRC § 68(c).

15 Pub. L. No. 115-97, 131 Stat. 2054 (2017).

16 The Joint Committee on Taxation staff estimated the number of taxpayers who itemize would tumble from about 46.5 million in 2017 to about 18 million in 2018. Joint Comm. on Taxation, *Tables Related to the Federal Tax System as in Effect 2017 Through 2026* (JCX-32-18) (Apr. 23, 2018).

17 Individual Returns Transaction File on the IRS Compliance Data Warehouse (CDW) (through cycle 39 of 2018).

18 Individual Returns Transaction File on the IRS CDW (through cycle 39 of 2019).

19 Individual Returns Transaction File on the IRS CDW (comparing tax returns filed between January 1 and October 1 in both TYs 2017 and 2018).

The TCJA made the following changes to itemized deductions:[20]

1. *Standard deduction*. For TYs 2018-2025, the TCJA roughly doubles the standard deduction amounts from $6,350 to $12,000 for single individuals, $18,000 for heads of household up from $9,350, and $24,000 for joint filers up from $12,700.[21]
2. *Medical expense deduction*. Under prior law, most taxpayers whose unreimbursed medical expenses exceeded ten percent of their AGI could deduct that excess.[22] Under the TCJA, all taxpayers may deduct unreimbursed medical expenses that exceed 7.5 percent of his or her AGI in TYs 2017 and 2018.[23] This change was made retroactive to January 1, 2017.[24] Beginning in TY 2019, all taxpayers will only be able to deduct medical expenses if they exceed ten percent of their AGI.[25]
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 TYs 2018-2025.[26] Prior to the TCJA changes, there was no limitation on the amount of state and local taxes a taxpayer could take as an itemized deduction. This aspect of the TCJA has faced significant opposition and motivated numerous states to develop workarounds to circumvent the limitation, including the creation of charities that residents can donate to in exchange for state and local tax credits.[27] The Department of Treasury and the IRS have promulgated regulations that address these workarounds, requiring taxpayers, under certain circumstances, to reduce their claimed charitable contribution deductions by the amount of any state or local tax credits they receive in return for said contributions.[28] We anticipate litigation in this area in coming years.[29]
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 TYs 2018-2025.[30] However, the limit remains at $1 million ($500,000 in

20 Pub. L. No. 115-97, 131 Stat. 2054 (2017).

21 Pub. L. No. 115-97, § 11021, 131 Stat. 2054, 2072 (2017) (adding IRC § 63(c)(7)). These amounts are adjusted for inflation. IRC § 63(c)(7)(B). 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).

22 IRC § 213(a). 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. IRC § 213(f)(1).

23 Pub. L. No. 115-97, § 11027, 131 Stat. 2054, 2077 (2017); IRC § 213(a), (f).

24 *Id*.

25 *Id*.

26 Pub. L. No. 115-97, § 11042, 131 Stat. 2054, 2085 (2017); IRC § 164(b)(6).

27 For a discussion of the various state workarounds, see Cynthia M. Pedersen, *States' Workarounds to the State and Local Tax Deduction Limitation*, The Tax Adviser (Aug. 1, 2018), https://www.thetaxadviser.com/issues/2018/aug/workarounds-state-local-tax-deduction-limitation.htm.

28 Treas. Reg. § 1.170A-1(h)(3) (as amended in August 2019) (addressing the federal income tax treatment of contributions by reducing federal deductions by the amount of any state or local tax credit that a taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer).

29 The states of New York, Connecticut, Maryland, and New Jersey (and the Village of Scarsdale, New York) have challenged the validity of Treas. Reg. § 1.170A-1(h)(3), arguing, *inter alia*, that it interferes with the states' ability to invest in their citizens and infrastructure, and with the states' sovereign authority to determine their own taxation and fiscal policies. *See, e.g.*, *New Jersey v. Mnuchin*, No. 19-06642 (S.D.N.Y. July 17, 2019). U.S. District Judge J. Paul Oetken dismissed this case, but it may be appealed. *See* Toby Eckert, *Judge Throws Out States' Challenge to Tax Deduction Cap*, Politico (Sept. 30, 2019), https://www.politico.com/news/2019/09/30/judge-dismisses-state-local-tax-deduction-cap-lawsuit-012686.

30 Pub. L. No. 115-97, § 11043, 131 Stat. 2054, 2086 (2017); IRC § 163(h)(3)(F).

the case of married taxpayers filing separate tax returns) for mortgage debt incurred on or before December 15, 2017.[31]

The TCJA also eliminates the deduction for interest on home equity debt for TYs 2018-2025.[32] 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.[33]

5. *Casualty and theft loss deductions.* The TCJA provides that, for TYs 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.[34] The loss must still exceed $100 per casualty and the total net loss must exceed ten percent of the taxpayer's AGI.[35]
6. *Miscellaneous itemized deductions.* For TYs 2018-2025, the deduction for miscellaneous expenses subject to the two percent of the AGI floor, such as certain professional fees, investment expenses, and unreimbursed employee business expenses, has been suspended under the TCJA.[36]
7. *Charitable contribution deductions.*[37] For TYs 2018-2025, the limit on the deduction for cash donations to public charities is increased from 50 to 60 percent of AGI.[38] However, charitable deductions for payments made in exchange for college athletic event seating rights are eliminated.[39]
8. *Tax return preparation fees.* Prior to the TCJA tax return preparation fees were deductible subject to a two percent of AGI limitation. TCJA suspended the deduction of these fees for TYs 2018-2025.[40]

ANALYSIS OF LITIGATED CASES

For the third time since the National Taxpayer Advocate's Annual Report to Congress in 2000, itemized deductions reported on Schedule A of IRS Form 1040 were among the ten Most Litigated Issues. This year, we analyzed 32 cases between June 1, 2018, to May 31, 2019, in which itemized deductions were in dispute. All but two of these cases were litigated in the U.S. Tax Court. A detailed list appears in Table 8 in Appendix 5. Of the 16 cases in which taxpayers appeared *pro se* (without counsel), the IRS prevailed in 15. Notably, the only case where the taxpayer prevailed was a case where the taxpayer appeared *pro se*, as none of the represented taxpayers prevailed. The highest portion of this year's 32 cases involved taxpayers claiming deductions for casualty and theft losses,[41] mortgage and equity interests,[42] and

31 IRC § 163(h)(3)(F)(i)(III).
32 *Id*.
33 IRC § 163(h)(3)(A)(i) and (B). *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.
34 Pub. L. No. 115-97, § 11044, 131 Stat. 2054, 2087 (2017); IRC § 165(h)(5).
35 IRC § 165(c)(3), (h)(1) and (2).
36 IRC § 67(g); Pub. L. No. 115-97, § 11045, 131 Stat. 2054, 2088 (2017).
37 *See also* Most Litigated Issue: *Charitable Contribution Deductions Under IRC § 170*, *infra*.
38 IRC § 170(b)(1)(G); Pub. L. No. 115-97, § 11023, 131 Stat. 2054, 2074 (2017).
39 IRC § 170(l); Pub. L. No. 115-97, § 13704, 131 Stat. 2054, 2169 (2017).
40 *See* IRC §§ 67(a), 212(3); Pub. L. No. 115-97, § 11045, 131 Stat. 2054, 2088 (2017).
41 IRC § 165.
42 IRC § 163.

deductions for state and local taxes paid.[43] Figure 2.8.1 categorizes the main issues raised by taxpayers in the 32 cases we identified.

FIGURE 2.8.1, Itemized Deduction Issues[44]

Itemized Deduction	Number of Cases	Percentage of Cases
Casualty/Theft Loss	12	37.5
Mortgage Interest	10	31
State and Local Taxes Paid Deductions	7	22
Medical and Dental Expenses	3	9
Tax Preparation Fees	2	6.3
Gambling	4	12.5
Other	1	3

Casualty and Theft Loss Deduction

In *Mancini v. Commissioner*, the taxpayer claimed a casualty loss as a result of gambling and investment losses allegedly caused by his altered mental state resulting from a medication he was prescribed.[45] In 2004, Mr. Mancini was diagnosed with Parkinson's disease and was prescribed Pramipexole to treat his symptoms. After allegedly experiencing an altered mental state induced by the medication, the taxpayer began gambling excessively and selling investment properties at irrationally low prices in part to pay off his gambling debts. Mr. Mancini did not keep logs of his gambling activities; however, he did report gambling losses to the extent of gambling profits in TYs 2008-2010 and presented documents from several casinos. The taxpayer argued that his gambling losses should not be subject to the normal limits on such losses, because they were in fact "other casualty" losses resulting from his "sudden, unexpected and unusual" reaction to a prescription drug."[46] The taxpayer argued that his obsessive gambling caused by Pramipexole fell within the definition of an "other casualty" because it emerged suddenly and was unexpected by both the taxpayer and his doctor.[47] However, the Tax Court disagreed, stating that "a casualty loss is deductible only if the taxpayers property suffered physical damage." [48] The Tax Court also found that Mr. Mancini failed to substantiate his claims.[49] Thus, the taxpayer's casualty loss deductions were disallowed.

Mancini reaffirms longstanding precedent related to the requirement for physical damage in order to claim a casualty loss deduction and for the "sudden" nature of "other casualty losses." [50] The case also made clear that to qualify as an "other casualty loss," the loss must be "sudden, unexpected, or unusual"

43 IRC § 164.

44 Several cases we identified had more than one of the issues listed in Figure 2.8.1.

45 *Mancini v. Comm'r*, T.C. Memo. 2019-16, *appeal docketed*, No. 19-72438 (9th Cir. Sept. 25, 2019).

46 *Id.*

47 The Tax Court noted, "other casualty" is a loss arising from something "sudden, unexpected, or unusual" as opposed to something resulting from a "progressive deterioration [due to] a steadily operating cause," even if the damage "was not discovered until it was complete." *Id. See also* IRC §165(a)-(c)(3); Treas. Reg. §§ 1.165-1(d)(1), 1.165-7(a)(1).

48 *Mancini*, T.C. Memo. 2019-16, at 8, *appeal docketed*, No. 19-72438 (9th Cir. Sept. 25, 2019) (citing *Kamanski v. Comm'r*, 477 F. 2d 452 (9th Cir. 1973), *aff'g* T.C. Memo. 1970-352).

49 *Mancini*, T.C. Memo. 2019-16, *appeal docketed*, No. 19-72438 (9th Cir. Sept. 25, 2019).

50 *Mancini*, T.C. Memo. 2019-16, at 7-8 (citations omitted), *appeal docketed*, No. 19-72438 (9th Cir. Sept. 25, 2019).

rather than the result of "progressive deterioration."[51] In preparing for a casualty loss deduction dispute, a taxpayer should pay special attention to documenting the value and the nature of the loss, as well as the timing of the loss's cause.

Mortgage Interest

In *Milkovich v. United States*, the taxpayers claimed they were entitled to a tax refund of $18,817 for 2011, and the government motioned to have the lawsuit dismissed for failure to state a claim, which the district court granted.[52] The taxpayers, Mr. and Mrs. Milkovich, purchased a personal residence in February 2005 with a monthly mortgage payment of approximately $3,700. However, they stopped making payments in February 2009 and filed Chapter 7 bankruptcy. The property was sold in a short sale in July 2011. At the time of the sale, unpaid interest in the amount of $114,688 had accrued on the mortgage. The mortgage holder, Citi Mortgage, received just over $522,000 from the sale and allocated this amount to satisfy the $114,688 in accrued unpaid interest first. The taxpayers deducted $144,688 in mortgage interest from their 2011 taxes, which they claimed should have resulted in a $18,817 tax refund. The court found the parties' dispute centered on the statutory interpretation of the meaning of the term "indebtedness" under Internal Revenue Code (IRC) § 163. Specifically, the court looked at whether the Milkoviches were entitled to deduct mortgage interest paid on the property after it was discharged through bankruptcy and where the outstanding mortgage amount exceeded the fair market value of the property. The court found that while interest deductions are generally allowable, there is an exception when the nonrecourse liability (here, the mortgage) exceeds a reasonable estimate of the fair market value of the indebted property. In such a case, an interest deduction is not allowed. The court found that because the fair market value of the short sale was far below the outstanding mortgage debt, it was not reasonable to expect the taxpayers to satisfy the mortgage debt themselves. For this reason, the court found that the taxpayers' transaction lacked "economic substance."[53] Given the recent legislative changes, we expect to see more litigation in this area.

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.[54] Taxpayers were unable to or had difficulty substantiating their itemized deduction claims in 20 of the 32 cases we identified, or nearly 63 percent of the cases.

One such case was *Sutherland v. Commissioner*,[55] in which the Tax Court found that the taxpayers had not met their burden in substantiating claimed transportation costs associated with seeking medical attention. Mr. and Mrs. Sutherland provided no mileage logs to substantiate the claimed mileage. Instead, they provided only a total mileage amount that corresponded to each medical expense without substantiating where the trip originated, what vehicle was used, or other evidence to substantiate the reported expenses. Thus, the Tax Court disallowed the deduction.

51 *Mancini*, T.C. Memo. 2019-16, at 7-8 (citations omitted), *appeal docketed*, No. 19-72438 (9th Cir. Sept. 25, 2019).

52 *Milkovich v. United States*, 2019 WL 2161665 (W.D. Wash. May 17, 2019).

53 *Id.*, at *3.

54 IRC § 6001; *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Cohan v. Comm'r*, 39 F.2d 540, 543-44 (2d Cir. 1930); Temp. Treas. Reg. § 1.274-5T(b). For detailed recordkeeping guidance for taxpayers, see also IRS, Burden of Proof, https://www.irs.gov/businesses/small-businesses-self-employed/burden-of-proof (last visited July 29, 2019) (describing the requirement to substantiate certain elements of expenses in order to shift the burden of proof according to IRC § 7491) and IRS Publication 583, Starting a Business and Keeping Records (Jan. 2015).

55 *Sutherland v. Comm'r*, T.C. Memo. 2018-186.

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.[56]

In *Castaneda v. Commissioner*, though the taxpayers failed to appear for trial, the Tax Court nonetheless determined that Mr. and Mrs. Castaneda were not entitled to deduct $295,871 of gambling losses.[57] The court found that the taxpayers failed to keep records of their gambling winnings or use players' cards, which would have provided reliable casino records. As a result, the court had no basis to allow those deductions.

In *Kurdziel v. Commissioner*, the Tax Court held that a former fighter pilot, who is the only person in the United States who owns and is licensed to fly a Fairey Firefly, could not deduct losses he incurred in restoring the World War II fighter and anti-submarine aircraft.[58] Among other expenses, the Tax Court disallowed the taxpayer's claimed home mortgage interest, real estate taxes, and tax return preparation fees. While the Commissioner merely argued that the taxpayer had failed to substantiate these deductions without providing more, Mr. Kurdziel also did not add anything more to the record. The Court stated, "[w]hen there's nothing in the record, defeat comes for the party with the burden of proof," finding for the Commissioner on those disputed amounts.[59]

In *Simpson v. Commissioner*,[60] the only case during this reporting period where a taxpayer prevailed on the merits of an issue covered by this Most Litigated Issue, the Tax Court held that Mr. and Mrs. Simpson were entitled to an additional deduction for state and local income taxes for TY 2013 after introducing into evidence an additional payment of $895.96 that was applied to their 2011 California income tax. Under IRC § 164(a)(3), state and local income taxes are allowed as a deduction for the taxable year within which they are paid or accrued. Mr. and Mrs. Simpson had made a direct contribution to the California State Disability Insurance, which the Tax Court has held constitutes a valid income tax payment deductible under IRC § 164(a)(3).

CONCLUSION

In TY 2015, the IRS Statistics of Income data showed that 29.6 percent of individual return filers chose to itemize their deductions.[61] As we anticipated and noted in the 2018 Annual Report to Congress, the number of itemizers significantly decreased, by about 65 percent beginning in TY 2018 because of the tax changes brought about by the TCJA.[62]

A reduction in the number of itemizers may eventually lead to a decrease in litigation in the coming years, especially as it relates to non-disaster related personal casualty or theft losses and miscellaneous deductions. However, litigation related to remaining itemized deductions, such as medical and dental

56 IRC § 165(d).

57 *Castaneda v. Comm'r*, T.C. Memo. 2018-173.

58 *Kurdziel v. Comm'r*, T.C. Memo. 2019-20.

59 *Id.*, at *13 (citing IRC § 7491(a)).

60 *Simpson v. Comm'r*, T.C. Summ. Op. 2019-9.

61 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.

62 For TY 2017, there were 43.2 million taxpayers who claimed itemized deductions (about 30.2 percent). For TY 2018, there were 15.2 million taxpayers who claimed itemized deductions (about 10.6 percent). Individual Returns Transaction File on the IRS CDW (comparing tax returns filed between January 1 and October 1 in both TYs 2017 and 2018).

expenses or state and local taxes, may increase. Taxpayers should also be careful to maintain detailed records related to any deductions they claim. This will assist taxpayers in verifying deductions with the IRS before disputes result in litigation. The IRS must continue to increase awareness and to clarify these deductibility changes, including recordkeeping requirements, which will protect taxpayers' *rights to be informed* and *to pay no more than the correct amount of tax*. By doing so, the IRS will encourage taxpayers to comply with their tax obligations and minimize the risk of litigation.

RECOMMENDATION TO MITIGATE DISPUTES

The National Taxpayer Advocate recommends that the IRS:

- Develop a Tax Forum presentation and communication strategy to better educate return preparers and practitioners about itemized deductions, including recordkeeping requirements.

MLI #9 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.[1] To take a charitable deduction, taxpayers must contribute to a qualifying organization.[2] Taxpayers must also comply with certain substantiation requirements when making a contribution of $250 or more.[3] 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 contribution.

We identified and reviewed 17 cases decided between June 1, 2018, and May 31, 2019, with charitable deductions as a contested issue. The IRS prevailed in 13 cases, and four cases resulted in split decisions. Taxpayers represented themselves (appearing *pro se*) in seven of the 17 cases (41 percent). The IRS prevailed in all seven *pro se* cases. The deduction of conservation easement contributions is an emerging issue during this reporting period as the IRS is focused on curtailing abuse in this area by designating syndicated conservation easements as a listed transaction.[4] We expect to see continued litigation on this issue in the future. Taxpayers must pay close attention to the elements of donating a qualified conservation easement in the absence of safe harbors or other guidance from the IRS on how they may construct a conservation easement deed that satisfies the strict statutory requirements.

TAXPAYER RIGHTS IMPACTED[5]

- *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.[6] Transfers to qualifying organizations are deductible only if

1 Internal Revenue Code (IRC) § 170.

2 IRC § 170(c).

3 IRC § 170(f)(8).

4 See IRS Notice 2017-10, 2017-4 I.R.B. 544, Syndicated Conservation Easement Transactions; IRS, IR-2019-47, Abusive Tax Shelters, Trusts, Conservation Easements Make IRS' 2019 "Dirty Dozen" List of Tax Scams to Avoid (Mar. 19, 2019).

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

6 IRC §§ 63(d) & (e), 161, and 170(a).

they are contributions or gifts,[7] not payments or other consideration in exchange for goods or services.[8] 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.[9] 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.[10]

Under prior law, individual taxpayers' charitable contribution deductions were generally limited to 50 percent of the taxpayer's contribution base (AGI computed without regard to any net operating loss carryback to the taxable year under IRC § 172).[11] The Tax Cuts and Jobs Act (TCJA) increased the limitation to 60 percent for cash donations in tax years (TYs) 2018 through 2025.[12] Subject to certain limitations, individual taxpayers can carry forward unused charitable contributions in excess of these limitations for up to five years.[13]

For corporate taxpayers, 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 limitations.[14]

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.[15] Deductions for single charitable contributions of $250 or more are disallowed in the absence of a contemporaneous written acknowledgement from the charitable organization.[16] The taxpayer 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.[17] The contemporaneous written acknowledgement must include:

- The name of the organization;
- The amount of the cash contribution;
- A description (but not the value) of the noncash 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

7 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).

8 Treas. Reg. § 1.170A-1(h).

9 IRC § 170(c).

10 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).

11 IRC § 170(b)(1)(A).

12 IRC § 170(b)(1)(G); Tax Cuts and Jobs Act, Pub. L. 115-97, § 11023, 131 Stat. 2054 (2017) ¶ 230.

13 IRC § 170(b)(1)(G)(i) & (d)(1).

14 IRC § 170(b)(2) & (d)(2).

15 Treas. Reg. § 1.170A-13(a)(1).

16 IRC § 170(f)(8); Treas. Reg. § 1.170A-13(f).

17 Treas. Reg. § 1.170A-13(f)(3).

- 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.[18]

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.[19] Generally, 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.[20] For contributions of property that result in a taxpayer claiming a deduction in excess of $5,000, the taxpayer must obtain a qualified appraisal prepared by a qualified appraiser.[21]

Valuation

The amount of a charitable contribution that is noncash property is the fair market value of the property at the time of its contribution.[22] The fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[23] This is generally true even when the donation is for a partial interest in property, such as a conservation easement.[24] The value of a conservation easement is "the fair market value of the perpetual conservation restriction at the time of the contribution."[25]

Qualified Conservation Contributions

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.[26] Taxpayers generally are not permitted to deduct gifts of property consisting of less than the taxpayer's entire interest in that property.[27] Nevertheless, taxpayers may deduct the value of a contribution of a partial interest in property that constitutes a "qualified conservation contribution,"[28] 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," "exclusively for conservation purposes."[29] All three conditions must be satisfied for the donation to be deemed a "qualified conservation contribution."[30]

18 IRC § 170(f)(8)(B); Treas. Reg. § 1.170A-13(f)(2); IRS Pub. 1771, Charitable Contributions Substantiation and Disclosure Requirements (Rev. Mar. 2016).

19 Treas. Reg. §§ 1.170A-13(b)(1)(i) to (iii).

20 Treas. Reg. § 1.170A-1(c)(1). This general rule is subject to certain exceptions that in some cases limit the deduction to the taxpayer's cost basis in the property, or otherwise reduced for certain contributions of ordinary income and capital gain property. *See* IRC § 170(e).

21 IRC § 170(f)(11)(C); Treas. Reg. § 1.170A-13(c). "Qualified appraisal" and "qualified appraiser" are defined in IRC § 170(f)(11)(E)(i) and (ii), respectively. Further, taxpayers must attach that qualified appraisal to their Federal income tax returns when claiming a deduction of more than $500,000. IRC § 170(f)(11)(D).

22 Treas. Reg. § 1.170A-1(c)(1).

23 Treas. Reg. § 1.170A-1(c)(2). The calculation of the fair market value is generally determined by a number of factors outlined in the regulations. *See* Treas. Reg. § 1.170A-14(h).

24 *Browning v. Comm'r*, 109 T.C. 303, 311-314 (1997) (citing Treas. Reg. § 1.170A-7(c)).

25 Treas. Reg. §§ 1.170A-7(c) & 1.170A-14(h)(3).

26 IRC § 170(f)(3); *Goldstein v. Comm'r*, 89 T.C 535, 541-542 (1987).

27 IRC § 170(f)(3).

28 IRC § 170 (f)(3)(B)(i), (h).

29 IRC § 170(h)(1).

30 *Id.*

Recent Development: Payments Resulting in State or Local Tax Benefits

The TCJA capped the state and local tax deduction that taxpayers could take at $10,000, for TYs 2018 through 2025.[31] This aspect of the TCJA resulted in numerous states developing workarounds to circumvent the limitation, including the creation of charities which residents can donate to in exchange for state and local tax credits.[32]

The Department of Treasury and the IRS promulgated regulations that address these workarounds, and require taxpayers, under certain circumstances, to reduce their charitable contribution deductions by the amount of any state or local tax credits they receive or expect to receive in return.[33] The reasoning in the new regulation is that if a taxpayer expects to receive a state or local tax credit in exchange for a payment or property transfer considered in IRC § 170(c), that credit is generally a *quid pro quo*, and will reduce the taxpayer's deduction by the amount of the credit.[34] These regulations apply to contributions made after August 27, 2018.[35]

There are a few exceptions to the general rule established by the new regulation. If the state or local tax credits received or expected by the taxpayer amount to 15 percent or less of the taxpayer's payment or the fair market value of their property contribution, the taxpayer may claim the deduction without reducing the federal charitable contribution deduction under IRC § 170.[36]

If the taxpayer receives or expects to receive state or local tax deductions, the taxpayer will not be required to reduce his or her federal charitable contribution deduction, so long as the state and local deductions do not exceed the value of the taxpayer's charitable contribution.[37] Because the regulations became effective after our reporting period ended, we did not review any cases involving the new regulations, though we anticipate that we may see cases involving them in the coming years.

ANALYSIS OF LITIGATED CASES

TAS reviewed 17 decisions entered between June 1, 2018, and May 31, 2019, involving charitable contribution deductions claimed by taxpayers. Table 9 in Appendix 5 contains a detailed list of those cases. Of the 17 cases, the most common issues were: substantiation (or lack thereof) of the claimed contribution (ten cases), valuation of the property contributed (six cases), and contribution of an easement (seven cases).[38]

31 *See* IRC § 164(b)(6)(B); Tax Cuts and Jobs Act, Pub. L. 115-97, §11042, 131 Stat. 2054 (2017) ¶ 215.

32 For a discussion of the various state workarounds, see Cynthia M. Pedersen, *States' Workarounds to the State and Local Tax Deduction Limitation*, The Tax Adviser (Aug. 1, 2018), https://www.thetaxadviser.com/issues/2018/aug/workarounds-state-local-tax-deduction-limitation.html.

33 Treas. Reg. § 1.170A-1(h)(3) *as amended by* 84 Fed. Reg. 27,513 (June 13, 2019) (effective Aug. 12, 2019). The IRS also issued Notice 2019-12 to provide a safe harbor for itemizing taxpayers to be able to add some payments that are or will be disallowed under the new regulation to their state and local tax deductions (up to the $10,000 limit for single and married filing jointly taxpayers; $5,000 if married filing separately). IRS, Notice 2019-12: Guidance Providing a Safe Harbor Under Section 164 for Certain Individuals Who Make a Payment to or for the Use of an Entity Described in Section 170(c) in Return for a State or Local Tax Credit (June 11, 2019).

34 84 Fed. Reg. 27,513 (June 13, 2019), https://www.federalregister.gov/documents/2019/06/13/2019-12418/contributions-in-exchange-for-state-or-local-tax-credits (providing an explanation of the new rules).

35 Treas. Reg. § 1.170A-1(h)(3)(viii). Regulations were effective on August 12, 2019.

36 Treas. Reg. § 1.170A-1(h)(3)(vi).

37 Treas. Reg. § 1.170A-1(h)(3)(ii).

38 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.

Substantiation

Ten 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.[39]

Blau, LLC v. Commissioner

Blau, LLC v. Commissioner involved the issue of whether the taxpayer, RERI Holdings I, LLC (RERI), substantiated its noncash charitable contribution.[40] RERI claimed a charitable contribution deduction of approximately $33 million for its donation of a noncash asset, a future interest in a piece of commercial property, to the University of Michigan.[41] This valuation was based on an appraisal, which RERI attached to its Form 8283, Noncash Charitable Contributions.[42] However, on the Form 8283, RERI did not fill in the space for "Donor's cost or adjusted basis," or explain why it omitted the basis.[43]

Generally, IRC § 170 allows taxpayers to claim deductions for donations to charitable organizations, but "only if verified under regulations prescribed by the [IRS]."[44] To fulfill this requirement, as well as the direction from Congress[45] to make stricter the verification requirements for noncash donations, the Department of Treasury and the IRS promulgated Treas. Reg. § 1.170A-13(c). This regulation requires taxpayers that donate certain noncash property to:

> (A) "[o]btain a qualified appraisal"; (B) "[a]ttach a fully completed appraisal summary ... to the tax return"; and (C) "[m]aintain records" containing specified information. Paragraph (c)(3) defines a "qualified appraisal" and paragraph (c)(4) details the necessary elements of an "appraisal summary," one of which is "[t]he cost or other basis of the property." The taxpayer must provide the appraisal summary on IRS Form 8283.[46]

If these requirements are not met, the deduction is generally not allowed. However, there is an exception for reasonable cause if a taxpayer cannot provide information in the appraisal summary on the manner of acquisition and the basis of the contributed property.[47]

On review, the U.S. Court of Appeals for the D.C. Circuit had to decide whether RERI substantially complied with the substantiation regulations, and thus whether it was entitled to its claimed charitable contribution deduction.

At the trial level, the Tax Court held that RERI was not entitled to a charitable contribution deduction because RERI had failed to "substantially comply" with the requirements of the substantiation regulations by failing to disclose its basis in the donated property.[48]

39 IRC § 170(f)(8); Treas. Reg. § 1.170A-13(f).
40 *Blau v. Comm'r*, 924 F.3d 1261 (D.C. Cir. 2019), *aff'g* 149 T.C. 1 (2017).
41 *Id.* at 1265.
42 *Id.* at 1267.
43 *Id.*
44 IRC § 170(a)(1).
45 Deficit Reduction Act of 1984, Pub. L. No. 983-69, § 155(a)(1), 98 Stat. 494,691.
46 *Blau*, 924 F.3d at 1268 (quoting Treas. Reg. § 1.170A-13(c)).
47 Treas. Reg. § 1.170A-13(c)(4)(iv)(C)(1).
48 *RERI Holdings I, LLC v. Comm'r*, 149 T.C. 1, 15 (2017).

The U.S. Court of Appeals for the D.C. Circuit reviewed this issue *de novo*, as it had not previously decided whether substantial compliance was enough to satisfy the substantiation regulation.[49] On appeal, the IRS argued that the test should be stricter than the test applied by the Tax Court, citing substantial compliance standards used by the Fourth, Fifth, and Seventh Circuits, and proposing that anything short of full compliance could be excused only if "(1) [the taxpayer] had a good excuse for failing to comply with the regulation and (2) the regulation's requirement is unimportant, unclear, or confusingly stated in the regulations or statute."[50]

The Court assumed, but did not decide, that substantial compliance with the regulations would suffice, but determined that RERI's failure to disclose its basis in the donated property meant that it did not substantially comply with Treas. Reg. § 1.170A-13.[51] RERI argued that the Tax Court's ruling conflicted with its prior holding in *Dunlap v. Commissioner*,[52] where the court had excused the petitioner's failure to provide their basis on Form 8283 because providing the basis was not necessary to substantially comply.[53] However, the Tax Court distinguished its non-precedential memorandum opinion in *Dunlap*, which did not consider whether the taxpayers fulfilled the substantiation requirements, and where there was no significant difference in the basis and the claimed deduction.[54] Regardless of whether substantial compliance with the regulations is sufficient, the Court of Appeals agreed with the Tax Court that RERI "fell short of the substantiation requirements by omitting its basis in the donated property"[55] and affirmed the Tax Court judgement. Thus, the taxpayer's charitable contribution deduction was disallowed.[56]

Value of the Property Contributed

Value of the property contribution (valuation) made up six of the 17 cases that TAS reviewed. Three of the six valuation cases arose from the donation of conservation easements.

Pine Mountain Preserve, LLLP v. Commissioner

In *Pine Mountain Preserve, LLLP v. Commissioner*,[57] the Tax Court entered a decision for the IRS on two of three conservation easements at issue. The Tax Court determined the fair market value of the third easement in a separate memorandum opinion filed concurrently, for which the court allowed a charitable contribution deduction.[58] The valuation of the third easement, a conservation easement from 2007, involved the IRS's and the taxpayer's experts computing the valuation using different methodology and reasoning. We will analyze this separate opinion in greater detail.

49 *Blau*, 924 F.3d at 1269.

50 *Id.* at 1269 (citing *Volvo Trucks of N. Am., Inc. v. United States*, 367 F.3d 204, 210 (4th Cir. 2004); *McAlpine v. Comm'r*, 968 F.2d 459, 462 (5th Cir. 1992); *Prussner v. United States*, 896 F.2d 218, 224 (7th Cir. 1990)).

51 *Blau*, 924 F.3d at 1269.

52 103 T.C.M. (CCH) 1689 (2012).

53 *Blau*, 924 F.3d at 1270.

54 *Id.* at 1270-1271 (citing *Dunaway v. Comm'r*, 124 T.C. 80, 87 (2005) for the proposition that the Tax Court is not bound by its non-precedential memorandum opinions).

55 *Id.*

56 *Id.* at 1280.

57 *Pine Mountain Pres., LLLP v. Comm'r*, 151 T.C. 247 (2018), *appeal docketed*, Nos. 19-11795 and 19-12173 (11th Cir. May 8, 2019, and June 5, 2019).

58 *Pine Mountain Pres., LLLP v. Comm'r*, T.C. Memo. 2018-214, *appeal docketed*, Nos. 19-11795 and 19-12173 (11th Cir. May 8, 2019, and June 5, 2019).

The value of a charitable contribution of noncash property is the fair market value of the property at the time of its contribution.[59] The fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[60] Treas. Reg. § 1.170A-14(h)(3) provides the rules for determining the fair market value of a charitable qualified conservation contribution.[61] In its separate memorandum opinion the court broke down those rules into five salient points:

1. The value of the easement is the fair market value at the time it is contributed.
2. To determine the fair market value, look to see if there is a substantial record of comparable sales of similar easements to the donated one. If so, base the valuation on those sales prices.
3. If no record of comparable easements exists, the general rule is that the fair market value of the conservation contribution equals the difference in the value of the encumbered property before granting the easement minus the fair market value of the property after granting the easement.
4. If the easement is only on a portion of the taxpayer's land, its value is calculated by ascertaining the difference between the fair market value of the taxpayer's contiguous property minus the fair market value of the same after the easement is granted.
5. Further, if the donation of the easement increased the value of other property owned by the donor or a related person, the deduction for the conservation easement is reduced by the amount of the increase in the value of the other property (even if the property is not contiguous).[62]

Both the taxpayer, and the IRS had their own experts testify as to the valuation of the conservation easement, and argued that the other expert's method of valuation did not comply with the Treasury Regulation § 1.170A-14(h)(3).[63] The court went through the regulation sentence by sentence and compared the regulation to each expert's method of calculation to evaluate how the easement should be valued.[64]

To determine the fair market value at the time the easement was contributed, the court first looked at the second sentence of the regulation to determine if there were comparable sales that could guide the valuation of the easement at issue in the case. The IRS expert valued the easement based on other sales of easements he thought were comparable to the 2007 easement. However, Pine Mountain Preserve argued that the easements the IRS expert used had little development potential, while the 2007 easement could be developed in the future. It is standard to price a property at its "highest and best" use, so the valuation depended on whether it was reasonably probable that the donated land would be developed. The court examined the relevant facts — "the access from the property to highways, the likelihood that one of the municipalities would approve a real-estate subdivision, and the changing state of the real-estate market" — and reasoned that the Pine Mountain property did have development potential.[65] Because there was development potential, the court determined that "the Pine Mountain property could have been sold to a third-party buyer and the buyer would have paid a relatively high price that corresponded

59 Treas. Reg. § 1.170A-1(c)(1).
60 Treas. Reg. § 1.170A-1(c)(2).
61 Treas. Reg. § 1.170A-14(h)(3).
62 *Pine Mountain Preserve, LLLP*, T.C. Memo. 2018-214 at *4–5 (citing Treas. Reg. § 1.170A-14(h)(3)(i)).
63 *Id.* at *6–16.
64 *Id.* at *16–28.
65 *Id*. at *6.

to the development potential of the property."[66] Therefore, "the second sentence of the regulation does not compel the use of the comparable sales method as employed by [the IRS expert]."[67]

The court next examined how the Pine Mountain Preserve's expert calculated the value of the easement based on the third sentence of the regulation, the general rule that the value equals the fair market value before less the fair market value after. This is the general rule, but the court noted that the easement was only for a portion of Pine Mountain Preserve's contiguous property, governed by the fourth sentence of the regulation. The court reasoned that the expert's opinion did not account for the beneficial effects of the easement on the unencumbered parts of the donor's property. Thus, it was not in compliance with the fourth sentence of the regulation, to consider the fair market value of the whole property both before and after the grant of an easement to a portion of the donor's property. Because the court found that the expert's method was not in compliance with the fourth sentence of the regulation, it did not consider whether the expert's method was also contrary to the fifth sentence.

The court found neither experts' methods complied with the regulation.[68] The court concluded that it could weigh the testimony of each expert to determine how to come to the correct valuation, and that it "[was] not bound by the opinion of any expert witness."[69] The court noted: "(1) how both experts' opinions have aspects that are useful to the determination of the easement's value, (2) the nature of the errors made by each expert, and (3) how weighting the two experts' opinions tends to correct the errors in their respective approaches."[70] Considering these factors, the court believed that the errors present in the two experts' values balanced comparably (equally overestimated by Pine Mountain's expert and underestimated by the IRS's expert).[71] Therefore, the court reasoned that combining the two valuations could correct for each expert's errors. Thus, the court added together fifty percent of each expert's valuation to calculate the allowable charitable deduction.[72]

The IRS and the taxpayer have filed cross-appeals with regard to the Court's decisions in this case.

Qualified Conservation Contribution

The question of whether a donation constituted a qualified conservation contribution arose as an issue in seven of the cases reviewed by TAS. This is also a threshold issue in the two cases discussed above. If the taxpayer fails to establish that the easement is a qualified conservation contribution then the Court will never need to answer questions about valuation and substantial compliance. All of the conservation contribution cases involved business taxpayers (Corporations, Partnerships, Trusts, and Sole Proprietorships: Schedules C, E, F). The Court of Appeals for the Fifth Circuit also decided a conservation easement case during our reporting period. That case is discussed below.

PBBM-Rose Hill, Ltd. v. Commissioner

In *PBBM-Rose Hill, Ltd. v. Commissioner*,[73] the taxpayer, PBBM-Rose Hill, Ltd. (PBBM), appealed the Tax Court's decision that PBBM's contribution of a conservation easement to a land trust did

66 *Pine Mountain Preserve, LLLP*, T.C. Memo. 2018-214 at *6.
67 *Id.* at *7 (citing Treas. Reg. § 1.170A-14(h)(3)(i)).
68 *Id.* at *28-30 (citing Treas. Reg. § 1.170A-14(h)(3)(i)).
69 *Id.* at *28-29.
70 *Id.* at *29-30.
71 *Id.* *31-36.
72 *Id.* at *36.
73 *PBBM-Rose Hill, Ltd. v. Comm'r*, 900 F.3d 193 (5th Cir. 2019), *aff'g* No. 26096-14 (T.C. Jan. 9, 2017).

not constitute a qualified conservation contribution and therefore it disallowed PBBM's charitable contribution deduction and sustained a penalty for overvaluing the easement.

In general, a charitable contribution deduction may be permitted when a taxpayer's donation of an easement constitutes the donation of a qualified conservation contribution.[74] To qualify as a qualified conservation contribution, the easement donation must be (1) of a qualified real property interest, (2) to a qualified organization, and (3) made exclusively for conservation purposes.[75]

The main issue in this case was whether the easement donated by PBBM was made exclusively for conservation purposes.[76] The statute outlines specific easement purposes that constitute a conservation purpose.[77] Each specific purpose has a different requirement for how much public access must be granted.[78] The statute also states that in order for an easement to qualify as having been made "exclusively" for such a conservation purpose, the conservation purpose must be protected in perpetuity.[79]

The Department of Treasury and the IRS issued the "extinguishment regulation"[80] to require that a donated easement's conservation purpose is "protected in perpetuity" in the event that the property underlying the donated easement changes in such a way that it is impossible or impractical for the continued use of the donated property for the conservation purposes.[81] Of particular importance in this case is the part of that regulation that explains that

> [A]t the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right ... with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time.... [T]hat ***proportionate value*** of the donee's property rights shall remain constant.... [When the unexpected change occurs, the donee] must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction.[82]

On the question of whether the donated easement was meant to serve a conservation purpose, there was no substantive dispute; the easement ostensibly served the purpose of preserving "land areas for outdoor

74 IRC § 170(f)(3)(B)(iii) & (h).

75 IRC § 170(h)(1).

76 IRC § 170(h)(4), (5).

77 These purposes are:

"(i) the preservation of land areas for outdoor recreation by, or the education of, the general public,

(ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,

(iii) the preservation of open space (including farmland and forest land) where such preservation is—(I) for the scenic enjoyment of the general public, or (II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or

(iv) the preservation of an historically important land area or a certified historic structure." IRC § 170(h)(4).

78 Treas. Reg. § 1.170A-14(d)(2)(ii), (d)(3)(iii), (d)(4)(ii)(B) & (d)(4)(iii)(C).

79 IRC § 170(h)(5).

80 Treas. Reg. § 1.170A-14(g)(6). The court explains that the purpose of the extinguishment regulation is: The purpose of this regulation is "(1) to prevent a taxpayer (or his successor) 'from reaping a windfall if the property is destroyed or condemned' such that the easement cannot remain in place and (2) to assure that the donee can use its portion of any proceeds to advance the conservation purpose elsewhere." *PBBM-Rose Hill, Ltd.*, 900 F.3d at 205.

81 *PBBM-Rose Hill, Ltd.*, 900 F.3d at 205.

82 *Id.* (quoting Treas. Reg. § 1.170A-14(g)(6)(ii)) (emphasis added).

recreation by … the general public."[83] The issue on appeal for the U.S. Court of Appeals for the Fifth Circuit, rather, was whether the conservation easement had sufficiently preserved that land for use by the general public, as the applicable regulations require that land underlying a conservation contribution must be available "for the substantial and regular use of the general public."[84]

At the trial level, the Tax Court held that the conservation easement did not adequately protect public access to the land. It noted that the deed required the donated property to be open for use by the general public, but also that there was not a right of public access. Furthering the Tax Court's conclusion was the fact that after the creation of the easement the land underlying the easement was operated as an 18-hole golf course and a park. Access to the property was controlled by a gatehouse. Upon entry, visitors would be given a pass that would limit their access to certain areas; they could go to the golf course or restaurant, but not the park.[85]

The Court of Appeals analyzed the regulations regarding conservation easements which "indicate that public access should generally be determined by examining the language of the deed."[86] Additionally, the regulations suggest that whether a conservation easement qualifies should be determined at the time of the donation, not what the subsequent owner does with the property.[87]

The court construed the deed as a whole and gave the specific language in the deed more weight than the general language.[88] PBBM included the statutory conservation purposes for IRC § 170(h)(4)(i)-(iii) in its easement deed.[89] The deed stated that "[t]he Property is and shall continue to be and remain open for substantial and regular use by the general public for outdoor recreation."[90] Additionally, it included language that prohibited charging fees that would defeat this public use or "result in the operation of the Property as a private membership club."[91] The court reasoned that this language in the deed was enough to obligate the owner of the property to operate it in such a way that provided access to the public for substantial and regular recreational use, as the regulation required.[92] The court further explained that the general terms in the deed, which did not grant a right of public access, and retained the right for the owner to put up no-trespassing signs, did not override the specific language that did grant certain public access.[93] Lastly, the court decided that these provisions in the deed referred to "[t]he Property" in its entirety. For that reason, the IRS's argument "that the deed allows the owner to prevent the public from accessing certain areas of the land fails."[94] Therefore, the easement's language fulfilled the public-access requirement for the conservation purpose of outdoor recreation for the general public.[95]

83 *PBBM-Rose Hill, Ltd.*, 900 F.3d at 205. at 201.

84 *Id*. at 205. at 201-202 (citing Treas. Reg. § 1.170A-14(d)(2)(ii)).

85 *Id*. at 202.

86 The Court explained that there is an exception to this general rule when the donor knew or should have known at the time of the donation that the access in actuality would be significantly less than the access under the terms of the deed. Here, however, the court held PBBM failed to meet this exception. *PBBM-Rose Hill, Ltd.,* 900 F.3d at 202-203 (distinguishing Treas. Reg. § 1.170A-14(d)(4)(ii)(B) and (5)(iv)(C)).

87 *PBBM-Rose Hill, Ltd.*, 900 F.3d at 202 (citing Treas. Reg. § 1.170A-14(g)(6)(ii) &(h)(3)).

88 *Id*. at 204-205.

89 *Id*. at 203-204.

90 *Id*. at 204.

91 *Id*.

92 *Id*.

93 *PBBM-Rose Hill, Ltd.,* F.3d at 204.

94 *Id.* at 205.

95 *Id*.

However, for the easement to be considered exclusively for conservation purposes, it must also protect that conservation purpose in perpetuity. This brings us to the extinguishment regulation, and the term "proportionate value," which was of particular importance in this case. The Court of Appeals for the Fifth Circuit interpreted "proportionate value" to be "a fraction equal to the value of the conservation easement at the time of the gift, divided by the value of the property as a whole at that time."[96] In this case, the easement deed's extinguishment provision provided that the donee would be provided a portion of the proceeds of a sale or conversion of the donated property based on the fair market value at the time of the deed or proceeds after the expenses of the sale and the "amount attributable to improvements constructed upon the Conservation Area … are deducted."[97]

The Tax Court determined that the terms of PBBM's conservation easement failed to comply with the extinguishment regulation because "the donee would not receive the amount required by the extinguishment regulation in some circumstances."[98] The regulation does not include language that any amount may be subtracted from the portion of the proceeds owed to the donee.[99] The conservation easement deed contained language that allows the value of improvements to be subtracted out of the total proceeds from a future sale before the donee receives its portion.[100] On appeal, the IRS argued that the extinguishment provision could not include factors like the value of improvements that could potentially reduce the donee's proceeds below the minimum required by the regulation.[101] The Fifth Circuit agreed that the plain language of the regulation stated that the donee "must be entitled to a portion of the proceeds at least equal to that proportionate value," and included nothing about the subtraction of other amounts to that.[102] In fact, the regulation demands that the donee must receive at least the proportionate value of the proceeds.[103] Because the taxpayer's conservation easement deed allowed for a subtraction of the value of improvements from the proceeds, which could reduce the total donee proceeds below the proportionate value, the court held that the conservation easement violated the requirement set forth in the extinguishment regulation.[104]

Thus, the Court of Appeals for the Fifth Circuit held that PBBM's easement did not constitute a qualified conservation contribution, as its failed to comply with the statute's "exclusively for conservation purposes" requirement and with the terms of the related extinguishment regulation.[105] For that reason, the court held that the taxpayer was not entitled to a charitable contribution deduction.[106]

96 *PBBM-Rose Hill, Ltd.,* F.3d at 207.

97 *Id*.

98 *Id*.

99 *See* Treas. Reg. § 1.170A-14(g)(6).

100 *PBBM-Rose Hill, Ltd*., 900 F.3d at 207-08.

101 *Id*. at 207.

102 *Id*. (quoting Treas. Reg. § 1.170A-14(g)(6)(ii)).

103 *Id*. at 207-08 (citing Treas. Reg. § 1.170A-14(g)(6)(ii)).

104 *Id*. at 208-09.

105 *Id*. at 209.

106 *PBBM-Rose Hill, Ltd.*, 900 F.3d at 209. The Fifth Circuit additionally decided on the issues of the valuation of the conservation easement and if PBBM was liable for the accuracy-related penalty, finding for the IRS on both issues. *Id*. at 213-215.

CONCLUSION

IRC § 170 and the accompanying Treasury Regulations provide detailed requirements with which taxpayers must strictly comply. The rules and regulations surrounding charitable contributions are complex. The IRS is focused on curtailing abuse in this area by designating syndicated conservation easements as a listed transaction[107] and abusive conservation easements as one of the top tax scams to avoid in 2019.[108] Thus, we anticipate that litigation will likely continue to increase and we will continue to see this topic as a most litigated issue. Taxpayers must carefully follow all aspects of the relevant laws and regulations when attempting to claim a charitable contribution deduction. Particularly, taxpayers must pay attention to the strict requirements for substantiation of a charitable contribution and to the elements of donating a qualified conservation easement.

RECOMMENDATION TO MITIGATE DISPUTES

The National Taxpayer Advocate recommends that the IRS:

- Develop and publish guidance to provide safe harbors and/or sample easement provisions to provide taxpayers with examples of how they may construct a conservation easement deed that satisfies the statutory requirements and prevent unnecessary litigation.

107 *See* IRS Notice 2017-10, 2017-4 I.R.B. 544, Syndicated Conservation Easement Transactions (these transactions deal with promoter companies obtaining inflated appraisals for real property and constructing conservation easement transactions that purport to give investors the opportunity to obtain charitable contribution deductions in amounts that significantly exceed the amount invested).

108 IRS, IR-2019-47, Abusive Tax Shelters, Trusts, Conservation Easements Make IRS' 2019 "Dirty Dozen" List of Tax Scams to Avoid (Mar. 19, 2019).

MLI #10 Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions

SUMMARY

From June 1, 2018, through May 31, 2019, the federal courts issued decisions in at least 16 cases involving the Internal Revenue Code (IRC) § 6673 "frivolous issues" penalty, with one case involving an analogous penalty at the appellate level. Appellate level penalties are imposed for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal.[1] 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.[2] Nonetheless, we included these cases in our analysis to illustrate what conduct will and will not be tolerated by the courts.

TAXPAYER RIGHT IMPACTED[3]

- *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.[4] The maximum penalty is $25,000.[5] In some cases, the IRS requests that the Tax Court impose the penalty;[6] in other cases, the Tax Court exercises its discretion, *sua sponte*,[7] to consider whether the penalty is appropriate.

1 The Tax Court generally imposes the penalty under 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), 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., Belanger v. Comm'r*, T.C. Memo. 2019-1, *aff'd*, 2019 WL 4316498 (5th Cir. Sept. 11, 2019) (The Tax Court concluded that the taxpayer's positions were "unquestionably frivolous" but recognized it was his first appearance before the court and therefore gave just a warning).

3 *See* Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the Internal Revenue Code. *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). We did not identify any cases under this authority during this review cycle. 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. We identified one case under 28 U.S.C. § 1927, *Lopez v. IRS*, 2018 U.S. Dist. LEXIS 179364 (D. Conn. Aug. 27, 2018), where the District Court sanctioned the taxpayer's counsel $2,500 for vexatiously multiplying the proceedings and introducing frivolous issues, however, we do not discuss it here (nor is it in the case table) as this behavior is attributable to the representative and not indicative of issues taxpayers are litigating.

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 (CCDM). *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., Walquist v. Comm'r*, 2019 WL 962901 (T.C. Feb. 25, 2019).

Taxpayers who institute actions under IRC § 7433[8] 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.[9] In addition, IRC § 7482(c)(4),[10] § 1912 of Title 28 of the U.S. Code,[11] and Rule 38 of the Federal Rules of Appellate Procedure[12] (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 nontax cases, this report focuses primarily on the IRC § 6673 penalty.

In our report last year, we took special note of the decision in *Williams v. Commissioner*, even though it fell outside of last year's reporting cycle, as it involved the novel issue of whether IRC § 6751(b)(1) constrained the ability of the Tax Court to impose a penalty under IRC § 6673(a)(1).[13] 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.[14] Section 6673(a)(1) gives the authority to impose the penalty in a Tax Court proceeding 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 IRC § 6751(b)(1) and § 6673(a)(1) to determine whether the two sections can coexist or whether IRC § 6751(b)(1) supersedes IRC § 6673(a)(1). The Tax Court found that the legislative intent behind IRC § 6751(a)(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 IRC § 6673(a)(1) was to dissuade taxpayers from wasting judicial resources. Because the Tax Court is not mentioned in IRC § 6751(b)(1) or its legislative history, the Tax Court held that IRC § 6751(b)(1) does not apply when it imposes a penalty pursuant to IRC § 6673(a)(1). Thus, when an IRS Office of Chief Counsel attorney requests the Tax Court impose a penalty under IRC § 6673(a)(1), the decision to request the penalty does not require personal written supervisory approval.

ANALYSIS OF LITIGATED CASES

We analyzed 16 opinions issued between June 1, 2018, and May 31, 2019, in which courts addressed the IRC § 6673 penalty. Twelve of these opinions were issued by the Tax Court and four were issued by U.S. Courts of Appeals in cases brought by taxpayers seeking review of the Tax Court's imposition of the penalty. The Courts of Appeals sustained the Tax Court's position in all four cases. One decision issued

8 IRC § 7433(a) allows a taxpayer a civil cause of action against the United States if an IRS officer or employee intentionally or recklessly, or by reason of negligence, disregards any IRC provision or regulation promulgated under Title 26 of the United States Code 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.

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. 1 (2018). *See* National Taxpayer Advocate 2018 Annual Report to Congress 547-550.

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.

by the Fifth Circuit Court of Appeals addressed both an analogous appellate level penalty and reviewed the Tax Court's imposition of the IRC § 6673 penalty.[15]

In five cases, the Tax Court imposed penalties under IRC § 6673, with the amounts ranging from $1,000 to $12,500. 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.[16] Thirteen taxpayers appeared *pro se* (represented themselves) while three were represented. 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.[17]

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):

- **Taxpayers are not taxpayers, are exempt from the income tax, are not required to file a return, or wages are not income:** Taxpayers in at least nine cases presented arguments that they are not taxpayers, they are exempt from tax for various reasons, or that wage income is not taxable.[18] In one case, a taxpayer argued that only federal employees must pay income tax, and the court imposed a penalty of $1,000.[19]
- **The Tax Court should garnish the Secretary of Treasury's Salary:** In an argument the Tax Court deemed "novel (but equally frivolous)," the taxpayers (married filing jointly) argued the court should garnish the salary of the Secretary of the Treasury in an amount equal to the taxpayers' unpaid taxes.[20] The taxpayers in this case further argued that U.S. currency is not lawful money and they have no obligation to file a return.

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. *Lange v. Comm'r*, 748 F. App'x. 635 (5th Cir. 2019) *aff'g* No.11492-17 (T.C. Apr. 27, 2018), *petition for cert. filed*, No. 19-366 (U.S. Sept. 19, 2019) (affirming § 6673 penalty of $2,500 and imposing an additional $8,000 penalty). For purposes of the total number of cases reviewed for this report, we counted this case once. We reviewed a total of 16 cases for this reporting cycle.

16 *See, e.g.*, *Burnett v. Comm'r*, T.C. Memo. 2018-204. In declining to impose a penalty, the Tax Court noted that the taxpayer had not previously made frivolous claims before the Tax Court. Interestingly, the taxpayer had a second case decided on the same day in which he made similar arguments, and the Tax Court again declined to impose the penalty. *Burnett v. Comm'r*, T.C. Memo. 2018-205, *aff'd*, 2019 WL 4233804 (4th Cir. Sept. 6, 2019).

17 *See, e.g.*, *Williams v. Comm'r*, 2018 WL 3301501 (T.C. July 3, 2018) (*citing Crain v. Comm'r*, 737 F.2d 1417, 1417-18 (5th Cir. 1984)).

18 *See, e.g.*, *MacDonald v. Comm'r*, T.C. Memo. 2018-138.

19 *Weiler v. IRS*, 2019 WL 2346915 (N.D. Ohio May 31, 2019), *appeal docketed*, No. 19-3729 (6th Cir. Aug. 1, 2019).

20 *See Walquist v. Comm'r*, 2019 WL 962901 (T.C. Feb. 25, 2019).

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.[21] Taxpayers avoided the IRC § 6673 penalty in only three cases we identified where the IRS requested it and often warned the taxpayers in these cases 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,*[22] and in all but one case, the court either imposed the penalty or cautioned the taxpayer that similar future behavior will result in a penalty.[23]

As indicated by the accompanying Case Table 10 in Appendix 5, 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.[24] Moreover, if the taxpayer has previously been sanctioned, the Tax Court may impose a higher penalty, but not necessarily anything close to the maximum.[25]

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, 2018, and May 31, 2019, continuing a trend of upholding all penalties in cases we have analyzed since June 1, 2005.

21 *See, e.g.*, National Taxpayer Advocate 2016 Annual Report to Congress 503-506 (Most Litigated Issue: *Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions*) .

22 *See, e.g.*, *Venable v. Comm'r*, T.C. Memo. 2018-144 (court raised the issue *sua sponte* and warned the taxpayer not to assert similar arguments in the future).

23 The only case where this did not occur was in *Hartmann v. Comm'r*, T.C. Memo. 2018-154, *aff'd*, 2019 WL 4447378 (3d Cir. Sept. 17, 2019).

24 *See, e.g.*, *Burnett v. Comm'r*, T.C. Memo. 2018-204.

25 *See, e.g.*, *Wesley v. Comm'r*, T.C. Memo. 2019-18 (court imposed $10,000 penalty after imposing $7,500 and $2,500 in earlier cases).