Most Litigated Issues: Introduction

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify the ten tax issues most often litigated in the federal courts, classified by type of taxpayer affected. Through analysis of these issues, the National Taxpayer Advocate will, if appropriate, propose legislative recommendations to mitigate disputes that result in litigation.

The Taxpayer Advocate Service (TAS) utilized commercial legal research databases to identify the ten most litigated issues in federal courts from June 1, 2006, through May 31, 2007.[1] For purposes of this section of the Annual Report to Congress, the term "litigated" means cases in which the court issued an opinion.[2] This year's ten Most Litigated Issues are:

- Collection Due Process hearings (IRC §§ 6320 and 6330);
- Gross income (IRC § 61 and related Code sections);
- Summons enforcement (IRC §§ 7602(a), 7604(a), and 7609(a));
- Civil damages for certain unauthorized collection actions (IRC § 7433);
- Frivolous issues penalty (IRC § 6673 and related appellate-level sanctions);
- Failure to file penalty (IRC § 6651(a)(1)) and estimated tax penalty (IRC § 6654);
- Trade or business expenses (IRC § 162(a) and related Code sections);
- Accuracy-related penalty (IRC § 6662(b)(1) and (2));
- Relief from joint and several liability for spouses (IRC § 6015); and
- Family status issues (IRC §§ 2, 24, 32, and 151).

The ten Most Litigated Issues are substantially similar to those identified in 2006, with one exception.[3] This year, civil damages for certain unauthorized collection actions became a Most Litigated Issue and debuted relatively high on the list, ranking fourth. The emergence of this issue may be an aberration, as many of the meritless complaints were inspired by templates found on the Internet. Further, the entry of this new issue edged out charitable contribution deduction issues under IRC § 170, which made its first appearance in an Annual Report to Congress in 2006.[4] The order of the other nine issues remains substantially similar to the 2006 list.[5]

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 We recognize that 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. Additionally, courts can issue less formal "bench opinions," which are not published or precedential.

3 *See* National Taxpayer Advocate 2006 Annual Report to Congress 553-555.

4 *See Id*. at 631-635.

5 The accuracy-related penalty issue ranked fourth in 2006 with 92 cases. *See* National Taxpayer Advocate 2006 Annual Report to Congress 555. This year, the issue dropped in ranking to eighth with 75 cases.

Once we identified the top ten most litigated issues, TAS analyzed each issue in four sections: summary of findings, description of present law, analysis of the litigated cases, and conclusion. Each case analyzed is listed in Appendix III, where the cases are categorized by type of taxpayer (*i.e.*, individual or business).[6] Appendix III also provides the citation for each case, indicates whether the taxpayer in each case was represented at trial or argued the case *pro se*, and lists the court's decision in each case.[7]

This year, our office expanded the Most Litigated Issues section of this report by adding a new "Significant Cases" discussion before the comprehensive analysis of the ten Most Litigated Issues. This discussion summarizes important judicial decisions not included in the above-listed top ten issues that were deemed significantly relevant to tax administration.[8]

An Overview of How Tax Issues are Litigated

Taxpayers generally have access to four different tribunals in which to initially litigate a tax matter: the United States Tax Court, United States District Courts, the United States Court of Federal Claims, and United States Bankruptcy Courts. With limited exceptions, taxpayers have an automatic right of appeal from decisions of the trial court.[9]

The Tax Court is generally a "prepayment" forum. In other words, taxpayers have access to 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, collection due process, and relief from joint and several liability.[10]

The federal district courts and United States Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,[11] and (2) the taxpayer has filed an administrative claim for refund.[12] The federal district courts are the only forums in which a taxpayer can receive a jury trial. Bankruptcy courts can adjudicate tax matters that were not previously adjudicated before the initiation of a bankruptcy case.[13]

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

7 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 A few of the cases discussed in the "Significant Cases" section of this report were decided outside the June 1, 2006, through May 31, 2007 period used to identify cases for the top ten most litigated issues, but we nonetheless have included them because of their impact on tax administration.

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

10 IRC §§ 6214; 7476-7479; 6330; 6015.

11 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).

12 IRC § 7422(a).

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

Analysis Of *Pro Se* Litigation

As in previous years, our analysis indicates that many taxpayers appeared before the courts *pro se*.[14] Table 3.1-01 lists the most litigated issues for the period June 1, 2006, through May 31, 2007, and identifies the number of cases, broken down by issue, in which taxpayers appeared *pro se*. As illustrated in the table below, the issues with the highest rate of *pro se* taxpayers are family status issues, civil damages for certain unauthorized collection actions, and the frivolous issues penalty.

TABLE 3.1-01, *Pro Se* Cases By Issue

Most Litigated Issue	Total Number of Litigated Cases Reviewed	*Pro Se* Litigation	Percentage of *Pro Se* Cases
Collection Due Process	217	142	65%
Gross Income	112	76	68%
Summons Enforcement	109	78	72%
Civil Damages for Certain Unauthorized Collection	100	94	94%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	87	79	91%
Failure to File and Estimated Tax Penalties	82	64	78%
Trade or Business Expense	77	56	73%
Accuracy-Related Penalty	75	42	56%
Joint and Several Liability	46	25	54%
Family Status Issues	41	39	95%
Total	**946**	**695**	**73%**

Table 3.1-02 demonstrates our belief that overall, taxpayers have a higher chance of prevailing in litigation if they are represented. However, *pro se* taxpayers actually experienced a higher rate of success than represented taxpayers in litigation over collection due process, the frivolous issues penalty, the failure to file and estimated tax penalties, and family status issues. The higher success rate for *pro se* taxpayers litigating these issues is noteworthy and indicates a potential failure in communications between taxpayers and the IRS at the administrative level.

[14] "*Pro Se*" means "for oneself; on one's own behalf; without a lawyer." *Black's Law Dictionary* 1236-37 (8th ed. 2004).

TABLE 3.1-02, Outcomes for *Pro Se* and Represented Taxpayers

	Pro Se Taxpayers			Represented Taxpayers		
Most Litigated Issue	Total Cases	Taxpayer Prevailed in whole or in part	Percent	Total Cases	Taxpayer Prevailed in whole or in part	Percent
Collection Due Process	142	12	8%	75	5	7%
Gross Income	76	5	7%	36	9	25%
Summons Enforcement	78	2	3%	31	4	13%
Civil Damages for Certain Unauthorized Collection	94	3	3%	6	1	17%
Frivolous Issues Penalty	79	10	13%	8	1	13%
Failure to File and Failure to Pay Estimated Income Tax Penalties	64	9	14%	18	1	6%
Trade or Business Expense	56	16	29%	21	9	43%
Accuracy-Related Penalty	42	11	26%	33	17	52%
Joint and Several Liability	25	7	28%	21	7	33%
Family Status Issues	39	5	13%	2	0	0%
Totals	**695**	**80**	**12%**	**251**	**54**	**22%**

Significant Cases

In prior Annual Reports to Congress, we have limited our discussion of cases to those involving one of the ten "most litigated issues."[1] This year, we are including this new "significant cases" section. The purpose of this section is to summarize certain judicial decisions that do not involve one of the ten most litigated issues, but nonetheless highlight important issues relevant to tax administration.[2] These important decisions are summarized below.

In *EC Term of Years Trust v. United States*, the Supreme Court held that Internal Revenue Code (IRC) § 7426(a)(1), which allows for judicial review of wrongful levy actions, provides the exclusive remedy for third parties alleging a wrongful levy.[3]

The IRS levied assets held by a trust because the creators of the trust (husband and wife) had outstanding tax liabilities and the IRS believed the transfer of assets to the trust was to evade taxes. Almost a year later, the trust brought a civil action for wrongful levy under IRC § 7426(a)(1) seeking a refund. The district court dismissed the claim because it was filed after the nine-month statute of limitations applicable to wrongful levy actions under IRC § 7426(a)(1) had expired.[4] After unsuccessfully seeking a refund from the IRS, the trust filed a second refund action under 28 U.S.C. § 1346(a)(1).[5] Since the trust filed the claim within the two-year period applicable to refund actions under 28 U.S.C § 1346(a)(1), it would not have been time barred.[6] The district court dismissed the action, concluding that IRC § 7426 was the exclusive remedy, and the Court of Appeals for the Fifth Circuit affirmed.[7] On appeal, the Supreme Court held that IRC § 7426(a)(1) is the exclusive remedy available to a third party alleging a wrongful levy.[8] It reasoned that permitting third parties to bring refund actions under 28 U.S.C. § 1346(a)(1) would permit them to circumvent the nine-month statute of limitations applicable to wrongful levy actions.

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1 The National Taxpayer Advocate is required to include the ten most litigated issues pursuant to IRC § 7803(c)(2)(B)(ii)(X).

2 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning June 1, 2006, and ending on May 31, 2007. For purposes of this section of the report, we have tried to use the same time period. However, we have included a few cases that were decided after May 31, 2007, because the issues involved in those cases are particularly important.

3 *EC Term of Years Trust v. U.S.*, 127 S.Ct. 1763 (Apr. 30, 2007), *aff'g* 434 F.3d 807 (5th Cir. 2006).

4 IRC § 6532(c) (nine-month statute of limitations); *BSC Term of Years Trust v. U.S.*, 87 A.F.T.R.2d (RIA) 546 (W.D. Tex. 2000).

5 *See* IRC § 6532(a) and IRC § 7422(a) (requiring a taxpayer to file an administrative claim with the IRS and then waiting six months (unless the IRS renders a decision earlier) before instituting a refund suit).

6 *See* IRC § 6532(a)(1) (taxpayer must file suit within two years after the IRS issues a notice of claim disallowance).

7 *EC Term of Years Trust v. U.S.*, 2004 U.S. Dist. LEXIS 30391 (W.D. Tex. 2004), *aff'd*, 434 F.3d 807 (5th Cir. 2006).

8 The decision abrogated *WWSM Investors v. U.S.*, 64 F.3d 456 (9th Cir. 1995).

In *Hinck v. United States*, the Supreme Court held that the Tax Court has exclusive jurisdiction to review interest abatement claims under IRC § 6404(e)(1).[9]

While the IRS was examining the returns of a partnership in which the Hincks (husband and wife) had invested, the couple made an advance remittance toward any personal deficiency that might result from a final adjustment of the partnership's return. They later reached a settlement with the IRS concerning the partnership adjustment that affected their joint return. Shortly thereafter, as a result of the adjustments, the IRS imposed an additional liability against the Hincks for tax and interest and applied the advanced remittance to the liability. The Hincks requested interest abatement under IRC § 6404(e)(1) based on IRS error and delay.[10] The IRS denied the request. The Hincks sought review of the IRS's determination in the U.S. Court of Federal Claims. The Court of Federal Claims granted the government's motion to dismiss and the Court of Appeals for the Federal Circuit affirmed.[11] The Supreme Court held that IRC § 6404(h) vests exclusive jurisdiction to review interest abatement claims under IRC § 6404(e)(1) in the Tax Court.[12] It reasoned, in part, that taxpayers could otherwise circumvent the limiting features of IRC § 6404(h), such as the requirement to bring an action within 180 days of the IRS's determination and the limitation on a taxpayer's net worth.[13]

In *Bakersfield Energy Partners, LP v. Commissioner*, the Tax Court held that an overstatement of basis was not an omission of gross income for purposes of extending the statute of limitations on assessment under IRC § 6501(e).[14]

On October 4, 2005, the IRS determined that Bakersfield Energy, a partnership, had overstated its basis on the sale of an oil and gas property reflected on its 1998 return. The general rule is that the IRS is required to assess tax within three years after a return is filed, but a longer six-year period applies when a taxpayer omits from gross income an amount greater than 25 percent of the gross income stated in the return.[15] In *The Colony, Inc. v. Commissioner*, the Supreme Court held that an overstatement of basis was not an omission of gross income under the predecessor of IRC § 6501 because no income was "left out" of the return.[16] In *Bakersfield Energy*, the IRS attempted to distinguish *Colony* on the basis

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9 *Hinck v. U.S.*, 127 S.Ct. 2011 (May 21, 2007), *aff'g* 446 F.3d 1307 (Fed. Cir. 2006).

10 At that time, IRC § 6404(e) allowed the IRS to abate any assessment of interest on a deficiency when the interest was attributable in whole or in part to any error or delay by an officer or employee of the IRS (acting in his official capacity) in performing a ministerial act.

11 *Hinck v. U.S.*, 64 Fed. Cl. 71 (2005), *aff'd*, 446 F.3d 1307 (Fed. Cir. 2006).

12 The decision abrogated *Beall v. U.S.*, 336 F.3d 419, 430 (5th Cir. 2003) (holding that IRC § 6404(h) grants concurrent rather than exclusive jurisdiction to the Tax Court).

13 Jurisdiction under IRC § 6404(h) is conditioned on bringing an action within 180 days and having a net worth below a certain threshold, whereas jurisdiction over refund actions is conditioned on bringing an action within two years and is not subject to any net worth limitations. *See* IRC § 6532(a).

14 *Bakersfield Energy Partners, LP v. Comm'r*, 128 T.C. 207 (2007), *appeal docketed*, No. 4204-06 (9th Cir. Oct. 24, 2007) (hereinafter, "*Bakersfield Energy*").

15 IRC §§ 6501(a); 6501(e). Even if the IRS can establish the omission, however, the three-year statute of limitations will still apply if the taxpayer can show that the "adequate disclosure" safe harbor applies. IRC § 6501(e)(1)(A)(ii).

16 *The Colony, Inc. v. Comm'r*, 357 U.S. 28 (1958) (hereinafter, "*Colony*"). Although *Colony* was decided on the basis of the predecessor of current IRC § 6501(e), the Court noted that its decision was "in harmony" with the unambiguous language of IRC § 6501, which had recently been enacted. *Id.* at 37.

that *Colony* involved the sale of goods and services (*i.e.*, the sale of residential lots by a taxpayer whose principal business was the development and sale of lots) rather than the sale of business property (*i.e.*, the sale of property reported on Form 4797, Sale of Business Property), and argued that the longer six-year statute of limitations applied.[17] The Tax Court rejected the IRS's reasoning, holding that an overstatement of basis is not an omission of gross income for purposes of the extended limitations period, as the phrase "omits" in IRC § 6501(e) means something left out, not something put in and overstated.

One district court, however, subsequently reached the opposite conclusion.[18] The district court concluded that the phrase "omits from gross income an amount properly includible therein" encompasses not only situations where an item of income is left out, but also situations where the amount of gross income is understated due to an error in calculation. The Court of Federal Claims has also recently both accepted and rejected the IRS's argument that an overstated basis in property used in a trade or business (sometimes called § 1231 property) can extend the statute of limitations.[19] In the more recent *Salman Ranch* decision, the Court of Federal Claims sided with the IRS and declined to follow its prior decision in *Grapevine,* but made no attempt to distinguish it.[20] Instead, the Court of Federal Claims explained that the meaning of the term "omit" must be defined by reference to the meaning of the term "gross income," which depends on the nature of a taxpayer's business and the transaction at issue.[21] The disparity in results among various courts (and even from the same court) may lead to additional litigation on this issue.

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17 The IRS may have developed its position in response to the infamous Son-of-Boss tax shelter. For one press account of the IRS's use of the statute of limitations to battle Son-of-Boss shelter participants, see Sheryl Stratton, *With Six-Year Statute, IRS Pulls Out Assessment Stops for Shelters*, 111 Tax Notes 536 (May 1, 2006). Section 814 of the American Jobs Creation Act of 2004 extends the statute of limitations applicable to undisclosed "listed" tax shelters such as Son-of-Boss, if the taxpayer fails to include specifically enumerated information about the transaction on the return. *See* IRC § 6501(c)(10); Rev. Proc. 2005-26, 2005-1 C.B. 965. As a result, the IRS's recent interpretation of the "adequate disclosure" safe harbor is most relevant to taxpayers who have not invested in listed tax shelters.

18 *See Brandon Ridge Partners v. U.S.*, 100 A.F.T.R.2d (RIA) 5347 (M.D. Fla. 2007) (holding a six-year statute of limitations applied to a return reporting a partnership's overstatement of basis attributable to a tax shelter).

19 *Compare Salman Ranch, Ltd. v. U.S.*, 2007 WL 3378145 (Fed. Cl. Nov. 9, 2007) (holding that an overstated basis did extend the limitations period), *with Grapevine Imps, Ltd. v. U.S.*, 100 A.F.T.R.2d (RIA) 5228 (Fed. Cl. 2007) (holding that an overstated basis *did not* extend the limitations period).

20 *Salman Ranch, Ltd. v. U.S.*, 2007 WL 3378145, at *24-*27 (Fed. Cl. Nov. 9, 2007).

21 *Salman Ranch, Ltd. v. U.S.*, 2007 WL 3378145, at *37 (Fed. Cl. Nov. 9, 2007). The court's analysis may suggest that when a person sells inventory in the ordinary course of his or her trade or business, "gross income" means "receipts" (not receipts minus basis), but when a person sells property used in a trade or business (*i.e.*, § 1231 property), "gross income" means "gain" (*i.e.*, receipts minus basis). Under this analysis, the mere understatement of basis on the sale of inventory in the ordinary course of a trade or business would not extend the limitations period, but an understatement of basis on the sale of § 1231 property could.

In *Wachovia Bank v. United States*, the Eleventh Circuit Court of Appeals held that the three-year statute of limitations on claims for refund applied rather than the six-year statute of limitations applicable to general claims against the government, even though the claimant was not required to pay taxes or file a return.[22]

Wachovia, as trustee for a tax-exempt trust, mistakenly filed income tax returns for, and continued to pay taxes out of, the trust for the 1991 through 2001 tax years. On May 7, 2003, after realizing its mistake, Wachovia filed amended returns requesting a refund on behalf of the trust for the 1997 and 1998 tax years. The IRS denied the refund claims on the basis that the applicable three-year limitations period had expired.[23] Wachovia contended that the statute of limitations covering tax refund claims (IRC § 6511(a)) did not apply to its claims because it was never required to file a tax return for the trust. Wachovia's position was that only the general six-year statute of limitations set forth in 28 U.S.C. § 2401(a), applied to its refund claim. The district court found merit in Wachovia's position, and concluded the three-year limitations period in IRC § 6511 applies only to taxpayers who are required to file tax returns. On appeal, the Court of Appeals for the Eleventh Circuit held the three-year statute of limitations applied to the claim for refund, even though the trust was not required to pay taxes or file a return.

In *Allen v. Commissioner*, the Tax Court held that the extended statute of limitations applicable to fraudulent returns applied to a taxpayer's return, even though a preparer, rather than the taxpayer, committed the fraud.[24]

Allen, a truck driver, provided his Form W-2 and other tax-related records to a preparer, who timely filed Allen's returns for 1999 and 2000. The preparer was later convicted of willfully aiding and assisting in the preparation of false or fraudulent income tax returns for other taxpayers. In March 2005, more than three years after the preparer filed Allen's 1999 and 2000 returns, the IRS issued a notice of deficiency disallowing various deductions claimed on those returns. As noted above, the IRS is generally required to assess tax within three years after a return is filed.[25] It may assess additional tax at any time, however, "in the case of a false or fraudulent return with the intent to evade tax."[26] The IRS agreed that Allen had no intent to evade tax and did not assert the fraud penalty against him. The IRS argued, however, that the statute of limitations on assessing the tax had not expired because Allen's preparer had the requisite intent. The Tax Court agreed with the IRS, noting that it is every taxpayer's obligation to review his or her own return for items that are obviously false or incorrect. Otherwise, a taxpayer could receive the benefit of a fraudulent return by hiding behind the preparer.

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22 *Wachovia Bank v. U.S.*, 455 F.3d 1261 (11th Cir. 2006), *rev'g* 95 A.F.T.R.2d (RIA) 1939 (M.D. Fla. 2005).

23 IRC § 6511(a).

24 *Allen v. Comm'r*, 128 T.C. 37 (2007).

25 IRC § 6501(a).

26 IRC § 6501(c)(1).

In *G-5 Investment Partnership v. Commissioner,* the Tax Court held the IRS could issue Notices of Final Partnership Administrative Adjustments (FPAAs) for closed partnership years so that it could make assessments on partners' returns in open years.[27]

As noted above, the IRS is generally required to assess tax within three years after a return is filed.[28] However, the IRS generally has a *minimum* of three years from the time a partnership return is filed to assess a tax attributable to partnership items (or affected items).[29] G-5 filed its partnership return for tax year 2000 on October 4, 2001. The IRS issued a Final Partnership Administrative Adjustment (FPAA) to G-5 for tax year 2000 on April 12, 2006, more than three years after the filing date of both the partnership's year 2000 tax return and the partners' individual returns for 2000 and 2001, but before the expiration of three years from the dates the partners filed their individual returns for 2002-2004. The FPAA denied partnership losses in 2000. G-5's partners reported their distributive shares of partnership losses for 2000 as capital loss carryovers on their individual returns for 2002-2004. G-5 argued the IRS could not assess a tax liability for the 2002-2004 taxable years where the underlying partnership item adjustments related to transactions that were completed and reported on G-5's partnership return in 2000, a year closed to assessment. The Tax Court held the FPAA was not barred by any period of limitations and that the adjustments shown on the FPAA could be used to assess taxes attributable to partnership items for the partners' 2002-2004 tax years, including the loss carryforwards, as those tax years were not barred by any period of limitations.

In *Estate of Roski v. Commissioner*, the Tax Court ruled the IRS abused its discretion by requiring all estates making an IRC § 6166 election (*i.e.*, an election to pay estate tax on certain closely held businesses in installments) to post a surety bond or grant the IRS a lien in lieu of bond.[30]

Generally, the executor of an estate may make an IRC § 6166 election to pay the estate taxes attributable to a closely held business in installments over 15 years if the value of the decedent's interest in a closely held business exceeds 35 percent of the adjusted gross estate.[31] The IRS may require security from estates making the election.[32] In lieu of furnishing security in the form of a bond, an estate may elect to grant the IRS a special lien.[33] IRS policy provides that it will deny any IRC § 6166 election by an estate that fails

27 *G-5 Investment Partnership v. Comm'r*, 128 T.C. 186 (2007). For a similar analysis and conclusion, see *Kligfeld Holdings v. Comm'r*, 128 T.C. 192 (2007) and *Grapevine Imps, Ltd. v. U.S.*, 71 Fed. Cl. 324 (2006).

28 IRC § 6501(a).

29 IRC § 6229(a).

30 *Estate of Roski v. Comm'r*, 128 T.C. 113 (2007). The Tax Court also held that it had jurisdiction pursuant to IRC § 7479 to review the IRS's exercise of discretion.

31 IRC § 6166.

32 IRC § 6166(k)(1); IRC § 6165.

33 IRC § 6166(k)(2); IRC § 6324A.

to provide a bond or a special lien.[34] Pursuant to this policy, the IRS denied the Estate of Roski's IRC § 6166 election because it failed to post a bond or elect to grant a special lien. The Tax Court determined the IRS could not require security in all cases. Rather, the IRS must exercise its discretion by making a case-by-case determination of whether security is necessary to assure payment of the tax.

In *Tax Analysts v. IRS*, the District Court for the District of Columbia clarified the type of written advice from the Office of Chief Counsel to National Office Program Managers that the IRS is required to disclose upon request.[35]

On October 2, 1996, Tax Analysts filed a Freedom of Information Act suit seeking, among other things, disclosure of Technical Assistance (TA) Memoranda from the IRS Office of Chief Counsel to National Office Program Managers. The District Court for the District of Columbia ordered the IRS to release five TAs.[36] The IRS appealed the order with respect to three of the five. In 2002, the D.C. Circuit affirmed that the three TAs must be disclosed and provided general guidance about the type of TAs that must be disclosed.[37] The IRS then identified 242 TAs "of the type that must be disclosed per the decision of the Court of Appeals." The parties ultimately agreed on the disposition of all but 34 TAs dating from 1993 and 1994. These TAs were submitted to the district court in July 2003 for an *in camera* inspection. After the National Taxpayer Advocate's discussion of IRS transparency in her 2006 Annual Report to Congress, the district court completed its inspection in early 2007 and ordered the IRS to disclose eight of the 34 memos (with some redaction).[38]

In separate litigation also styled *Tax Analysts v. IRS*, the Court of Appeals for the District of Columbia Circuit affirmed the district court's decision that written advice prepared by IRS attorneys may not be withheld from the public on the basis that it was prepared in less than two hours. [39]

The IRS generally must release Chief Counsel Advice to the public.[40] Chief Counsel Advice is defined as certain written advice prepared by any national office "component" of the Office of Chief Counsel which is "issued" to certain IRS employees. Tax Analysts requested documents that the IRS Office of Chief Counsel withheld from public disclosure pursuant to the IRS's policy of withholding written advice that "can be rendered in less than two

34 IRM 4.25.1.4.9(1) (Dec. 31, 2002).

35 *Tax Analysts v. IRS*, 483 F. Supp. 2d 8 (D. D.C. 2007).

36 *Id. at* 1 (D.C. Cir. 2001).

37 *Tax Analysts v. IRS*, 294 F. 3d 71 (D.C. Cir. 2002).

38 *Tax Analysts v. IRS*, 483 F. Supp. 2d 8 (D. D.C. 2007); National Taxpayer Advocate 2006 Annual Report to Congress 10-30 (Most Serious Problem: Transparency of the IRS). *See also* National Taxpayer Advocate's Fiscal Year 2008 Objectives Report to Congress xxi-xxvii (June 30, 2007) (Update on Transparency of the IRS).

39 *Tax Analysts v. IRS*, 495 F.3d 676 (D.C. Cir. 2007), *aff'g* 416 F. Supp. 2d 119 (D. D.C. 2006). For prior discussion of related issues, see National Taxpayer Advocate 2006 Annual Report to Congress 10-30 (Most Serious Problem, *Transparency of the IRS*) and National Taxpayer Advocate Fiscal Year 2008 Objectives Report to Congress xxi-xxvii (June 30, 2007) (Update on Transparency of the IRS) .

40 IRC § 6110.

hours," or that "can be prepared in less than two hours." Before the district court, the IRS argued primarily that informal written advice was not subject to disclosure because it was not "issued."[41] On appeal, the IRS argued primarily that informal advice of individual lawyers provided without supervisory review could not be considered advice of a "component," interpreting a component as an institutional entity.[42] The Court of Appeals for the District of Columbia Circuit found these arguments unpersuasive and held that written advice could not be withheld on the basis that it was informal advice prepared in less than two hours.

In *Mayo Foundation for Medical Education and Research v. United States*, the District Court for the District of Minnesota held the Mayo Clinic's medical residents' stipends were exempt from Federal Insurance Contributions Act (FICA) taxes and that the IRS's regulations were invalid.[43]

FICA taxes must generally be paid on all wages.[44] However, payments for service performed by certain students in the employ of a "school, college, or university" are not subject to FICA taxes.[45] In a related case decided in 2003, the court rejected the IRS's argument that the Mayo clinic was not a "school, college, or university" within the meaning of the FICA statute because education was not its "primary purpose" and awarded a refund of FICA taxes withheld and paid on Mayo's medical residents' stipends.[46] In 2004, the IRS amended the FICA regulations, in part to make clear that an institution would not be considered a "school, college, or university" unless education was its "primary purpose."[47] Mayo brought a new refund action for the FICA taxes on stipends paid to medical residents during a quarter that was impacted by the amended regulations, challenging the IRS's assertion that it was ineligible for the FICA exclusion under the new regulations. The district court granted Mayo's motion for summary judgment and held the IRS's regulations to be invalid on the basis that the plain meaning of "school, college, or university," as set forth in the statute, was not ambiguous.[48]

41 *Tax Analysts v. IRS*, 416 F. Supp. 2d 119 (D. D.C. 2006).

42 *Tax Analysts v. IRS*, 495 F. 3d 676 (D.C. Cir. 2007).

43 *Mayo Found. for Med. Educ. and Research v. U.S.*, 503 F. Supp. 2d 1164 (D. Minn. 2007), *appeal docketed*, No. 07-3242 (8th Cir. Sept. 28, 2007).

44 *See* IRC § 3101 *et. seq.*

45 IRC § 3121(b)(10).

46 *United States v. Mayo Found. for Med. Educ. and Research*, 282 F. Supp. 2d 997 (D. Minn. 2003).

47 Treas. Reg. § 31.3121(b)(10)-2(c); T.D. 9167, 69 Fed. Reg. 76,404 (Dec. 21, 2004).

48 *Mayo Found. for Med. Educ. and Research v. U.S.*, 503 F. Supp. 2d 1164 (D. Minn. 2007), *appeal docketed*, No. 07-3242 (8th Cir. Sept. 28, 2007).

Most Litigated Issues

MLI #1

Appeals from Collection Due Process (CDP) Hearings Under Internal Revenue Code Sections 6320 and 6330

Summary

Collection Due Process (CDP) hearings were created by the IRS Restructuring and Reform Act of 1998 (RRA 98).[1] CDP hearings provide taxpayers with an independent review by the Office of Appeals of the IRS's decision to file a lien or its proposal to undertake a levy action. In other words, a CDP hearing gives taxpayers an opportunity for a meaningful hearing in front of an independent appeals officer *before* the IRS deprives them of property. At the CDP hearing, the taxpayer has the statutory right to raise any relevant issues related to the unpaid tax, the lien or the proposed levy, including the appropriateness of collection action, collection alternatives, spousal defenses, and under certain circumstances, the underlying tax liability.[2]

Taxpayers have the right to judicial review of Appeals' determination provided that they timely request the CDP hearing and timely petition the court.[3] Generally, collection action is stayed during the CDP hearing process and any judicial review that may follow.[4]

Since 2003, Collection Due Process has been the tax issue most frequently litigated in the federal courts and analyzed for the National Taxpayer Advocate's Annual Report to Congress. This year continues the trend, with the courts issuing at least 217 opinions during the review period of June 1, 2006, through May 31, 2007.[5] Some critics have argued that the CDP process stalls the IRS collection process and allows taxpayers to raise frivolous arguments. However, the National Taxpayer Advocate remains convinced that the CDP process serves an important function by providing taxpayers with a forum to raise legitimate issues prior to the IRS depriving them of property. The opinions reviewed this year support this view. Many of the reviewed decisions provided useful guidance on substantive issues, while others appropriately imposed or warned taxpayers about the possibility of sanctions being imposed in the future.

1 IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3401, 112 Stat. 685 (1998).

2 IRC §§ 6320(c); 6330(c).

3 IRC §§ 6320(a)(3)(B); 6330(a)(3)(B). These provisions set forth the time requirements for requesting a CDP hearing. IRC §§ 6320(c); 6330(d). These provisions set forth the time requirements for obtaining judicial review of Appeals' determination.

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 during judicial review upon a showing of "good cause," if the underlying tax liability is not at issue.

5 For a list of all of the cases reviewed, see Appendix 3, Table 1, *infra*.

Present Law

Current law provides taxpayers an opportunity for independent review of a Notice of Federal Tax Lien (NFTL) filed by the IRS[6] or a proposed levy action.[7] The purpose of CDP rights is to give taxpayers adequate notice of IRS collection activity and a meaningful hearing *before* the IRS deprives them of property.[8] The hearing allows taxpayers an opportunity to raise issues relating to the collection of the subject tax, including:

- Appropriateness of collection actions;[9]
- Collection alternatives such as an installment agreement, offer in compromise, posting a bond or substitution of other assets;[10]
- Appropriate spousal defenses;[11]
- The existence or amount of the tax, but only if the taxpayer did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the tax liability;[12] and
- Any other relevant issue relating to the unpaid tax, the lien or the proposed levy.[13]

A taxpayer may not reintroduce an issue that was raised and considered at a prior administrative or judicial hearing if the individual participated meaningfully in the prior hearing or proceeding.[14]

Procedural Collection Due Process Requirements

Procedurally, the IRS must provide notice to the taxpayer of the lien filing and its intent to levy. The IRS must provide the NFTL to the taxpayer not more than five business days after the day of filing the notice of the lien.[15] The IRS must provide the Notice of Intent to Levy to taxpayers at least 30 days before the day of the levy.[16] Further, the IRS must notify the taxpayer of his or her right to a CDP hearing after the filing of the NFTL and before any levy action can take place. In the case of a lien, the CDP hearing notice must be provided to the taxpayer not more than five business days after the filing of the NFTL, and must inform the taxpayer of his or her rights to request a CDP hearing within the 30-day period that

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6 IRC § 6320.

7 IRC § 6330.

8 Prior to the enactment of RRA 98, the U.S. Supreme Court had held that a post-deprivation hearing was sufficient to satisfy due process concerns in the tax collection arena. *See Phillips v. Comm'r*, 283 U.S. 589, 595-601 (1931).

9 IRC §§ 6330(c)(2)(A)(ii); 6320(c).

10 IRC §§ 6330(c)(2)(A)(iii); 6320(c).

11 IRC §§ 6330(c)(2)(A)(i); 6320(c).

12 IRC §§ 6330(c)(2)(B); 6320(c).

13 IRC §§ 6330(c)(2)(A); 6320(c).

14 IRC §§ 6330(c)(4); 6320(c).

15 IRC § 6320(a)(2). The NFTL can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail to the taxpayer's last known address.

16 IRC §§ 6331(d)(2). The Notice of Intent to Levy can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail to the taxpayer's last known address.

begins on the expiration of the fifth business day after the filing of the NFTL.[17] In the case of a levy, the CDP hearing notice must be provided to the taxpayer no fewer than 30 days before the first levy and must inform the taxpayer of his or her right to request a hearing within 30 days from the date the notice is sent.[18]

Requesting a Collection Due Process Hearing

Under both lien and levy procedures, the taxpayer must return a signed, written request for a CDP hearing within the applicable period for requesting a hearing.[19] Taxpayers who request a CDP hearing after this time period (generally 30 days from the date of the notice) will receive an "equivalent hearing," which is similar to a CDP hearing but with no judicial review.[20] Regulations that took effect in November 2006 require taxpayers to provide in writing the reasons for the CDP hearing (preferably using Form 12153, Request for a Collection Due Process or Equivalent Hearing), and the failure to provide the basis for the hearing may result in a denial of a face-to-face hearing.[21] The regulations also provide that untimely requests are no longer automatically treated as requests for an equivalent hearing and eliminate the availability of equivalent hearings if the taxpayer does not request a hearing within a certain time. The time period for requesting an equivalent hearing after the filing of an NFTL is one year from the end of the five-business-day period following the filing of the notice,[22] while the period for requesting an equivalent hearing prior to levy is one year from the date the IRS issued the CDP notice.[23]

Conduct of a Collection Due Process Hearing

The IRS will suspend collection action throughout the CDP hearing process unless it determines the collection of tax is in jeopardy, the collection resulted from a levy on a state tax refund, or the IRS has served a disqualified employment tax levy.[24] Collection activity is also suspended throughout any judicial review of Appeals' determination, unless the

17 IRC §§ 6320(a)(2), (a)(3)(B).

18 IRC §§ 6330(a)(2), (a)(3)(B). The CDP hearing notice can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or can be sent by certified or registered mail (return receipt requested) to the taxpayer's last known address.

19 IRC §§ 6330(a)(3)(B); 6320(a)(3)(B); Treas. Reg. §§ 301.6320-1(c); 301.6330-1(c).

20 Treas. Reg. §§ 301.6320-1(i); 301.6330-1(i).

21 Treas. Reg. §§ 301.6320-1(c)(2) Q&A-D8; 301.6330-1(c)(2) Q&A-C1; 301.6330-1(d)(2) Q&A-D8. The regulations require the IRS to provide the taxpayer an opportunity to "cure" any defect in a timely filed hearing request, including providing a reason for the hearing. In conjunction with issuing regulations, the IRS revised Form 12153 to include space for the taxpayer to identify collection alternatives that he or she wants Appeals to consider. The current form also includes a description of common alternatives so taxpayers can apply them to the specific facts of their cases. *See* Form IRS 12153, *Request for Collection Due Process or Equivalent Hearing* (Nov. 2006). Additionally, § § 6320(b)(1) and 6330(b)(1) were recently amended to require taxpayers to include, in writing, in their CDP hearing request the grounds for requesting the hearing.

22 Treas. Reg. § 301.6320-1(i)(2) Q&A-17.

23 *Id.*

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

underlying tax liability is not at issue and the IRS can demonstrate to the court good cause to resume collection activity.[25]

CDP hearings are informal. When a taxpayer requests CDP hearings with respect to both a lien and a proposed levy, the IRS Appeals office will attempt to conduct one hearing.[26] The Office of Appeals presumptively establishes telephonic CDP hearings, so it is incumbent on the taxpayer to request a face-to-face hearing.[27] Courts have determined that, depending on the circumstances, a CDP hearing need not be face-to-face with the Appeals office, but can take place by telephone[28] or by an exchange of correspondence. The new CDP regulations clarify when the IRS will grant a face-to-face hearing and state that taxpayers who provide non-frivolous reasons for opposing the IRS collection action will ordinarily be offered a face-to-face conference, however there is no guarantee.[29] Taxpayers making only frivolous arguments or only requesting collection alternatives for which they cannot qualify will not be entitled to a face-to-face conference.[30]

The CDP hearing is to be held by an impartial officer from the Appeals function of the IRS, who is barred from engaging in *ex parte* communication with IRS personnel regarding the substance of the case.[31] In addition to the issues described above which the taxpayer is permitted to address in the CDP hearing, the Appeals officer must obtain verification that the requirements of all applicable laws and administrative procedures have been satisfied for the IRS to proceed with collection activity.[32] In making its determination, Appeals must weigh the issues raised by the taxpayer and determine whether the proposed collection action balances the need for efficient collection of taxes with the legitimate concern of the taxpayer that any collection be no more intrusive than necessary.[33]

On December 6, 2006, Congress passed the Tax Relief and Health Care Act of 2006 (TRHCA).[34] Section 407 of the TRHCA significantly changed the CDP process by creating IRC § 6330(g), which provides that the IRS may disregard any portion of a hearing request that is based on a position identified as frivolous by the IRS or reflects a desire to delay or

25 IRC §§ 6330(e)(1), (e)(2).

26 IRC § 6320(b)(4).

27 Appeals Letter 3855 schedules a conference call, but provides information on the availability of a face-to-face conference. *See also* Treas. Reg. §§ 301.6320-1(d)(2) Q&A-D6, D8; 301-6330-1(d)(2) Q&A-D6, D8.

28 *Katz v. Comm'r*, 115 T.C. 329, 337-38 (2000) (finding that telephone conversations between the taxpayer and the Appeal officer constituted a hearing as provided in § 6320(b)). *See, e.g., Simien v. IRS*, 99 A.F.T.R.2d (RIA) 495 (W.D. La. 2007); *Industrial Investors v. Comm'r*, T.C. Memo. 2007-93.

29 Treas. Reg. §§ 301.6320-1(d)(2) Q&A-D7; 301.6330-1(d)(2) Q&A-D7.

30 Treas. Reg. §§ 301.6320-1(d)(2) Q&A-D8; 301.6330-1(d)(2) Q&A-D8.

31 IRC §§ 6320(b)(1); 6320(b)(3); 6330(b)(1); 6330(b)(3). *See also* Rev. Proc. 2000-43, 2000-2 C.B. 404. *See, e.g., Industrial Investors v. Comm'r*, T.C. Memo. 2007-93; *Moore v. Comm'r*, T.C. Memo 2006-93, *action on dec.*, 2007-2 (Feb. 27, 2007).

32 IRC §§ 6330(c)(1); 6320(c).

33 IRC §§ 6330(c)(3)(C); 6320(c).

34 Pub. L. No. 109-432, 120 Stat. 2922 (2006). The provisions set forth in § 407 are effective for submissions made and issues raised after the date on which the IRS first prescribed a list of frivolous positions. Notice 2007-30, 2007-14 I.R.B. 883 (Apr. 2, 2007), provides the first published list of frivolous positions.

impede the administration of federal tax laws.[35] Section 407 also amended IRC § 6702 to create a new frivolous submission penalty that applies to frivolous CDP hearing requests.[36] A CDP hearing request is subject to the penalty, if any portion of the request "(i) is based on a position which the Secretary has identified as frivolous…or (ii) reflects a desire to delay or impede the administration of the Federal tax laws."[37]

Section 407 also amended IRC §§ 6320(b)(1) and 6330(b)(1) to require taxpayers to include, in writing, in their CDP hearing requests the grounds for requesting the hearing.[38] IRC § 6330(c)(4) was amended to provide that an "issue may not be raised at a hearing" if the issue is based on a position identified as frivolous by the IRS or reflects a desire to delay or impede the administration of federal tax laws.[39] These provisions were passed to assist the IRS in combating the problems associated with the submission of frivolous documents.[40]

On May 25, 2007, Congress again changed the CDP laws by passing § 8243(a) of the Small Business and Work Opportunity Tax Act of 2007.[41] Section 8243(a) provided for modification of the CDP procedures for employment tax liabilities by amending IRC § 6330(f) to permit a levy to collect employment taxes without first giving a taxpayer a pre-levy CDP notice if the levy is a "disqualified employment tax levy."[42]

Judicial Review of Collection Due Process Determination

Within 30 days of the Appeals determination, the taxpayer may petition the United States Tax Court for judicial review of Appeals' determination.[43] Where the validity of the tax liability is properly at issue in the CDP hearing, the court will review the amount of the tax liability on a de novo basis.[44] Where the appropriateness of the collection action is at issue, the court will review the IRS's administrative determination for abuse of discretion.[45]

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35 IRC § 6330(g).

36 The frivolous submission penalty applies to the following submissions: a CDP hearing request, an offer-in-compromise, installment agreement request and application for a taxpayer assistance order.

37 IRC § 6702(b)(2)(a). Before assertion of the penalty, the IRS must notify the taxpayer that it has determined that the taxpayer filed a frivolous hearing request. The taxpayer then has 30 days to withdraw the submission in order to avoid assertion of the penalty. IRC § 6702(b)(3).

38 IRC §§ 6320(b)(1); 6330(b)(1).

39 IRC § 6330(c)(4).

40 S. Rep. No. 109-336, at 49 (2006).

41 Pub. L. No. 110-28, §8243(a), (b), 121 Stat. 112, 200 (2007).

42 Pub. L. No. 110-28, §8243(a), (b), 121 Stat. 112, 200 (2007). This amendment is effective for such levies served on or after September 22, 2007. A disqualified employment tax levy is "any levy in connection with the collection of employment taxes for any taxable period if the person subject to the levy (or any predecessor thereof) requested a hearing under this section with respect to the 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).

43 IRC §§ 6330(d)(1); 6320(c). Prior to October 17, 2006, the taxpayer could also petition the district court if the Tax Court did not have jurisdiction over the underlying tax liability.

44 The legislative history of RRA 98 address the standard of review courts should apply in reviewing the IRS's administrative CDP determinations. H.R. Rep. No. 105-99, at 266 (Conf. Rep.). The term *de novo* means anew. *Black's Law Dictionary*, 447 (7th ed. 1999).

45 *See, e.g., Murphy v. Comm'r*, 469 F.3d 27 (1st Cir. 2006).

Analysis of Litigated Cases

Collection Due Process was the most litigated tax issue in the federal court system between June 1, 2006, and May 31, 2007. We reviewed 217 CDP court opinions were reviewed, which represents an 11 percent increase from the 195 cases in last year's analysis. Moreover, the 217 decided cases do not reflect the full measure of CDP litigation because not all CDP cases result in court opinions. Some cases are resolved through pre-litigation settlements while other taxpayers do not pursue litigation after filing a petition with the court, resulting in dismissal of the action prior to the court issuing an opinion. Other cases are disposed of by unpublished order. Table 1 in Appendix III provides a detailed list of the 217 CDP opinions reviewed, including specific information about the issue(s) considered, the types of taxpayers involved, and the outcomes of the cases.

Litigation Success Rate

Taxpayers prevailed in ten of the 217 cased reviewed (or approximately five percent), and prevailed in part in an additional seven cases.[46] Of those cases in which the courts found for the taxpayer, the taxpayers appeared *pro se* in six cases[47] and were represented in the remaining four.[48] It is interesting to note that during the review period, there was one case in which the court did not find for either the taxpayer or the IRS.[49]

Table 3.1.1 below compares litigation success rates in CDP cases for the 2003 through 2007 Annual Reports to Congress.[50]

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46 *Kozikowski v. Comm'r*, 98 A.F.T.R.2d (RIA) 7333 (E.D. Mich 2006), *appeal docketed*, No. 07-2000 (6th Cir. Aug. 16, 2007); *Calafati v. Comm'r*, 127 T.C. 219 (2006); *Clough v. Comm'r*, T.C. Memo 2007-106; *Wright v. Comm'r*, T.C. Memo 2006-273, *appeal docketed*, No. 07-1462 (2nd Cir. Mar. 30, 2007); *Maxfield v. Comm'r*, T.C. Summ. Op. 2007-79; *Freme v. Comm'r*, T.C. Summ. Op. 2007-70; *Karnaze v. Comm'r*, T.C. Summ. Op. 2007-18.

47 *R&A Insurance Services, Inc. v. Comm'r*, 99 A.F.T.R.2d (RIA) 1630 (E.D. Mich. 2007); *Simien v. IRS*, 99 A.F.T.R.2d (RIA) 495 (W.D. La. 2007); *Steiner v. IRS*, 98 A.F.T.R.2d (RIA) 6233 (N.D. Ohio 2006); *Clarke v. Comm'r*, T.C. Summ. Op. 2007-52; *Buffano v. Comm'r*, T.C. Memo 2007-32; *Harris v. Comm'r*, T.C. Memo 2006-186.

48 *Burt, Inc. v. IRS*, 98 A.F.T.R.2d (RIA) 6929 (N.D. Ind. 2006); *Industrial Investors v. Comm'r*, T.C. Memo 2007-32; *Mathia v. Comm'r*, T.C. Memo 2007-4; *Moore v. Comm'r*, T.C. Memo 2006-171, *action on dec.*, 2007-2 (Feb. 27, 2007).

49 *See Schwartz v. Comm'r*, 128 T.C. 6 (2007). For a full discussion of *Schwartz*, see *infra.*

50 *See* National Taxpayer Advocate 2006 Annual Report to Congress 561, Table 3.1.1(Most Litigates Issue: *Appeals from Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330*) for 2003, 2004, 2005, and 2006 statistics.

TABLE 3.1.1, Success Rates in CDP Cases

Court Decision	2003 Percentage	2004 Percentage	2005 Percentage	2006 Percentage	2007 Percentage[51]
Decided for IRS	96%	95%	89%	90%	92%
Decided for Taxpayer	1%	4%	8%	8%	5%
Split Decision[52]	3%	1%	3%	2%	3%
Neither[53]	N/A	N/A	N/A	N/A	Less than 1%[54]

Issues Litigated

The cases discussed below are those which the National Taxpayer Advocate believes are significant or noteworthy. The outcomes of these cases can provide important information to Congress, the IRS, and taxpayers about the rules and operation of CDP hearings. Equally important, all of the cases reviewed during this time period offer the chance to examine the CDP process and look for opportunities for improvement, both in its application and execution.

Procedural Rulings

Schwartz v. Commissioner

In *Schwartz v. Commissioner*,[55] *pro se* married taxpayers filed a petition under the small tax case procedures[56] to review a Notice of Determination concerning a Notice of Intent to Levy for tax years 1997 through 2003. The total unpaid balance due for the tax years at issue was over $150,000; however, the unpaid tax for any single year during the period did not exceed $50,000. IRC § 7463(a) allows S case procedures to be used for certain types of cases, including taxes imposed by subtitle A of the Code (income taxes) where the amount at issue for any one taxable year does not exceed $50,000.[57]

In *Schwartz*, the court *sua sponte* raised the question of whether the small case designation was appropriate. Both the taxpayer and the IRS agreed it was appropriate to proceed under S case procedures because the unpaid tax for any single year at issue did not exceed $50,000. The IRS argued that although IRC § 7463(f) suggests that S case procedures

Most Litigated Issues

51 Numbers have been rounded to nearest percentage.

52 A "split" decision refers to a case with multiple issues where both the IRS and the taxpayer prevail on one or more substantive issues.

53 A "neither" decision refers to a case in which the court's decision was not in favor of either party.

54 Only one case falls into this category; thus, it is less than one percent of the total of cases reviewed during the period. *See Schwartz v. Comm'r*, 128 T.C. 6 (2007).

55 128 T.C. 6 (2007).

56 Small tax cases, often referred to as "S" cases, as discussed in IRC § 7463, are limited to certain types of cases involving $50,000 or less. S cases are typically less formal in nature than a regular Tax Court case and as a result, often result in speedier disposition of the case. S case decisions are not appealable.

57 Prior to December 21, 2000, there was no statutory authority for using S case procedures for IRC § 6330 collection cases. The Community Renewal Tax Relief Act of 2000 added IRC § 7463(f), which allows for the use of S case procedures for appeals under IRC § 6330(d)(1)(a) to the Tax Court where the unpaid tax does not exceed $50,000. Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 313(b)(1), 114 Stat. 2763A-642 (adding IRC § 7463(f)).

should be based on the entire unpaid balance of tax, IRC § 7463(f) also provides that "proceedings may be conducted under this section (in the same manner as a case described in subsection (a))."[58] Under IRC § 7463(a), the dollar limitation is applied on a per-year basis; thus, the IRS argued the same rule should apply to cases under IRC § 7463(f). The Tax Court disagreed, holding that the $50,000 limitation in IRC § 7463(f)(2) applies to the total amount of the unpaid tax, not to the amount per year.[59] The court reasoned that unlike IRC § 7463(a)'s explicit references to per-year dollars at issue, IRC § 7463(f)(2)'s limitation for CDP cases was clearly expressed in terms of the total amount of tax at issue in the case.[60] Because the taxpayers' total unpaid tax exceeded the $50,000 limitation in IRC § 7463(f)(2), the court determined that the small case designation should be removed and the case should be remanded and conducted according to the regular IRC § 6330 procedures.[61]

Haag v. United States

In *Haag v. United States*,[62] married taxpayers brought an action challenging the IRS's filing of tax liens, claiming they never received their CDP hearing notices. The First Circuit held that in the absence of contrary evidence, the government's affidavit and deposition testimony were sufficient to establish that notification letters were sent to the taxpayers in a timely manner.[63] Also, computerized IRS records containing receipts signed by the husband supported the contention that the letters at issue were in fact received at the taxpayers' house.[64] The court *sua sponte* raised the issue of whether the proceedings were barred by an automatic stay when one of the taxpayers filed bankruptcy while the appeal was pending.[65] The court noted that § 362(a)(1) of the Bankruptcy Code bars only actions "against the debtor" and that it did not apply in this case because the suit was brought by the taxpayers themselves.[66]

Lewis v. Commissioner

In *Lewis v. Commissioner*,[67] the taxpayer was assessed additions to tax under IRC §§ 6651(a)(1) and (2).[68] The taxpayer requested that Appeals abate the additions to tax, and after a

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58 *Schwartz v. Comm'r*, 128 T.C. 6, 11 (2007).

59 128 T.C. 12. In *Leahy v. Comm'r*, 129 T.C. No. 8 (2007), a case that came out after the period covered in the report, the Tax Court further explained that the total amount of unpaid tax includes all interest and penalties that have accrued as of the petition date.

60 128 T.C. 6 at 9-11.

61 128 T.C. 6 at 13. The IRS Office of Chief Counsel now agrees with the holding in *Schwartz* and advises field attorneys to verify that all CDP cases with a small tax case designation meet the dollar amount limitations as established in *Schwartz.*

62 485 F.3d 1 (1st Cir. 2007).

63 485 F.3d at 3.

64 Although the Haags argued that the government failed to show that the letters were actually placed into the envelopes sent to them, the government's deposition testimony of an employee describing the ordinary IRS procedures, and absent any affirmative evidence to the contrary, was sufficient to establish that the envelopes were not empty in this case. 485 F.3d at 3.

65 485 F.3d at 4.

66 *Id.* In its discussion, the court noted that some courts have held that an action brought by a debtor should be recharacterized as a continuation of an administrative proceeding against the debtor and therefore the automatic stay would apply. *Id.* (*citing Delpit v. Comm'r*, 18 F.3d 768 (9th Cir. 1994)).

67 128 T.C. 48 (2007).

68 The additions to tax were due to a late filed return and late payment. 128 T.C. 48 at 49.

review by Appeals, the request was denied.[69] The taxpayer then received a Notice of Intent to Levy and notice of his CDP rights.[70] The taxpayer requested a CDP hearing, and during the hearing process the settlement officer determined that the taxpayer had already had an opportunity to contest the liability when the issue was considered by Appeals, and therefore, the taxpayer could not contest the liability during the CDP hearing. The taxpayer appealed the determination. The Tax Court held that if the taxpayer has an *actual* conference with Appeals prior to the start of a collection action, that conference constitutes a prior opportunity to dispute the tax, regardless of whether the taxpayer can seek judicial review.[71] The court noted that the Code and applicable legislative history do not define what is meant by have an "opportunity to dispute" a tax liability, but held that the intent is to have an IRS Appeals process that is meaningful for taxpayers, not just by offering prior litigation opportunities, but also prior administrative proceedings. [72]

Andre v. Commissioner

In *Andre v. Commissioner*,[73] the IRS filed NFTLs against the taxpayers for the years 1996 through 2000, and provided them with a notice of their right to a hearing. The taxpayers then submitted a CDP hearing request for tax years 1990 through 2000 and subsequently received a Notice of Intent to Levy for tax years 1990 through 1994. The IRS also issued a Notice of Determination, after which the taxpayers petitioned the Tax Court seeking review for tax years 1990 through 2000. The court dismissed the years 1990-1994 from the petition, holding that the taxpayers were not entitled to a CDP hearing for those years because their request was premature and was not fixed by the IRS's later issuance of a Notice of Determination that mentioned the earlier tax periods.[74] IRC § 6330(a)(3)(B) only gives taxpayers the right to request a CDP hearing during the 30-day period before the first levy action by the IRS.[75]

Appeals Impartiality

IRC §§ 6320(b)(3) and 6330(b)(3) require CDP hearings to be conducted by an "impartial" Appeals officer or employee – one "who has had no prior involvement with respect to the unpaid tax" before the first CDP lien or levy hearing. As noted in previous annual reports, the National Taxpayer Advocate is concerned about a lack of independence of the IRS Office of Appeals from the IRS compliance function, which can impair Appeals' ability to

69 The taxpayer did not have the right to appeal this determination in court.

70 The taxpayer submitted a Form 12153 requesting a CDP hearing and on the form, requested an abatement of the late filing and late payment additions to tax. 128 T.C. 48 at 49.

71 128 T.C. 48 at 60-61. The Tax Court's holding upheld Treas. Reg. § 301.6330-1(e)(3), Q&A-E2 which states that a pre-CDP IRS Appeals conference constituted prior opportunity to contest liabilities within the meaning of IRC § 6330(c)(2)(B). 128 T.C. 48 at 62. The Tax Court did not rule on whether a taxpayer, who is offered the opportunity to dispute a liability with Appeals but declines the offer, can dispute the liability during a subsequent CDP hearing.

72 128 T.C. 48 at 55.

73 127 T.C. 68 (2006).

74 127 T.C. 68.

75 IRC § 6320(a)(3)(B) outlines the timeframe for requesting a CDP hearing relative to a NFTL.

act impartially.[76] The following two cases illuminate the problems that may arise when Appeals' employees engage in prohibited *ex parte* communications which can compromise their independence.

Industrial Investors v. Commissioner

In *Industrial Investors v. Commissioner*,[77] the IRS sent the taxpayer a Notice of Intent to Levy, and the taxpayer requested a CDP hearing. When the revenue officer who had worked the case in Collection transferred the case to Appeals, she included a cover letter describing in some detail why she felt the levy should be sustained. The Tax Court found the revenue officer's cover letter was an impermissible *ex parte* communication prohibited by IRC § 6330 and Rev. Proc. 2000-43, 2000-2 C.B. 404.[78] IRC § 6330(b)(3) provides that hearings will be conducted by an impartial IRS employee. *Ex parte* communication – those communications between Appeals and the IRS where the taxpayer does not have a "reasonable opportunity to participate"[79] – are prohibited where the communication would appear to compromise the independence of the Appeals officer.[80]

Moore v. Commissioner

In *Moore v. Commissioner*,[81] the taxpayer submitted an offer in compromise during a CDP hearing.[82] When considering the offer, the Appeals officer had a number of communications with an offer specialist assigned to work on the petitioner's offer and two revenue officers previously involved in attempting to collect the petitioner's outstanding liability for the years at issue.[83] The communications involved concerns about transfers of the taxpayer's assets, recommendations to the Appeals officer on how to proceed with investigating, and a recommendation to reject the offer. The Appeals officer subsequently issued a Notice of Determination and rejected the taxpayer's offer.[84]

The Tax Court held that the communications between the Appeals officer and the offer specialist and the revenue officers were substantive in nature and constituted prohibited *ex parte* communications.[85] Despite the government's claim that the taxpayer was not

76 For a discussion of the National Taxpayer Advocate's concerns with the independence of Appeals, see National Taxpayer Advocate 2006 Annual Report to Congress 266 (Most Serious Problem, *Concerns with the IRS Office of Appeals*); National Taxpayer Advocate 2005 Annual Report to Congress 136 (Most Serious Problem: *Appeals Campus Centralization*); National Taxpayer Advocate 2004 Annual Report to Congress 264 (Most Serious Problem, *Independence of the Office of Appeals*).

77 T.C. Memo. 2007-93.

78 *Id.*

79 Rev. Proc. 2000-4, 2000-2 C.B. 404, § 3.

80 T.C. Memo. 2007-93 at 9 (discussing Rev. Proc. 2000-4).

81 T.C. Memo. 2006-171, *action on dec.*, 2007-2 (February 27, 2007).

82 Offers in compromise are provided for in IRC § 7122 and allow the IRS to compromise the taxpayer's liability based on doubt as to liability, doubt as to collectibility, and effective tax administration. Treas. Reg. § 301.7122 -1(b).

83 The communications occurred over the phone and via email, without petitioner's participation. T.C. Memo 2006-171 at 5.

84 T.C. Memo 2006-171 at 5-6. Attached to the Notice of Determination was a statement from the Appeals officer that taxpayer's offer was not in the best interest of the Government, in part due to "alleged nominee transfers of taxpayer's real property." T.C. Memo 2006-171 at 6.

85 T.C. Memo. 2006-171 at 11.

harmed because the taxpayer later learned from the Appeals officer the content of the *ex parte* communications, the court held that subsequently informing the taxpayer about the communications does not allow the Appeals officer to avoid the prohibition on *ex parte* communications.[86]

The Administrative Record

Murphy v. Commissioner

In *Murphy v. Commissioner*,[87] the petitioner submitted an offer in compromise during his CDP hearing, which the IRS rejected. In the subsequent Tax Court trial, the petitioner and the appeals officer both testified regarding the offer. The IRS sought to exclude the testimony on the grounds that the court's review should be limited to the administrative record.[88] In *Murphy*, the U.S. Court of Appeals for the First Circuit held that judicial review of Tax Court CDP determinations should be limited to a review of the administrative record, with limited exceptions. In *Olsen v. United States*,[89] the court had previously held that based on general administrative law principles, judicial review in CDP district court cases should be limited to the administrative record and that those principles apply equally to judicial review in CDP Tax Court cases.[90] The court adopted its previous reasoning in *Olsen*, concluding that in the review of Tax Court cases, judicial review should be limited to the administrative record.[91] Because the Tax Court is reviewing the case for abuse of discretion, judicial review would normally be limited to the information that was before the IRS when it was making its determination.

Audio Recording of Hearings

In *Calafati v. Commissioner*,[92] the Tax Court held that a taxpayer is not entitled under IRC § 7521 to audio record a IRC § 6330 hearing held by phone. The Tax Court concluded a CDP hearing conducted by telephone was not an "in-person interview" within the meaning of IRC § 7521 and thus, the IRS was not required to allow a taxpayer to make an audio recording of the CDP hearing. In *Simien v. IRS*,[93] the U.S. District Court for the Western District of Louisiana took a different view, holding that a taxpayer is entitled to record

86 T.C. Memo. 2006-171 at 12.

87 469 F.3d 27 (1st Cir. 2006).

88 The Tax Court rejected this argument but instead excluded the testimony on the grounds that it was not relevant and upheld the IRS's determination to proceed with the proposed levy. The Tax Court found that the appeals officer did not abuse her discretion by rejecting the petitioner's offer or by prematurely terminating the CDP hearing. 469 F.3d at 32-33.

89 414 F.3d 144 (1st Cir. 2005). For a discussion of *Olsen*, *see* National Taxpayer Advocate 2006 Annual Report to Congress 565-66 (Most Litigated Issue: *Appeals from Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330).*

90 414 F.3d 144 at 150 - 51.

91 469 F.3d 27 at 31. The court did note some limited exceptions not applicable here. For example, evidence outside of the administrative record may be allowable where there is a failure to explain the administrative action so as to frustrate effective judicial review. 469 F.3d 27 at 31.

92 127 T.C. 219 (2006).

93 2007-1 U.S.T.C. (CCH) ¶ 50,352 (W. D. La. 2007).

a telephonic CDP hearing.[94] The court in *Simien* reasoned that the term "in-person" is subject to many meanings, and nothing in the legislative history of IRC § 7521(a) precludes including telephone hearings in the definition.[95] Additionally, a telephone CDP hearing is intended to be a valid substitute for a face-to-face CDP hearing, and therefore there is "no practical difference between a face-to-face hearing and a telephone hearing."[96] Thus, there is a disparity between the Tax Court and one district court on the issue of recording telephone CDP hearings. Although IRC § 6330(d)(1) was amended to give the Tax Court sole jurisdiction over judicial review of a CDP Notice of Determination, the Tax Court's position raises the stakes for Appeals' statement that it will grant face-to-face hearings on request.[97].

Imposition of Sanctions

One notable issue emerging from the review of CDP decisions during the time period is the extent to which the courts imposed sanctions on taxpayers for frivolous positions. IRC § 6673(a)(1) authorizes the Tax Court to impose sanctions when it appears that proceedings have been instituted primarily for delay.[98] An analysis of the court decisions we reviewed demonstrates that courts are trying to deter the filing of frivolous CDP hearing requests by imposing sanctions under IRC § 6673 or by warning taxpayers of the possible imposition of sanctions in the future. Of the 217 cases decided during the review period, the courts imposed sanctions in 22 cases — or over ten percent. In one case, the Tax Court imposed a sanction of over $6,000 even though the taxpayer prevailed in part in the case.[99] The courts discussed, but did not impose, sanctions in six other cases. In an additional case, the Seventh Circuit increased the amount of a sanction against a taxpayer to reflect the cost of defending frivolous appeals.[100]

Pro Se Analysis

One hundred and forty two (or 65 percent) of the 217 cases litigated were brought before the courts by the taxpayer *pro se*, or without benefit of counsel. This is a decrease from the 73 percent in the previous year and 79 percent in 2005.[101] Table 3.1.2 shows the breakdown of *pro se* and represented taxpayer cases and the decisions rendered by the court, indicating that approximately eight percent of *pro se* taxpayers received some relief on judicial review while approximately seven percent of represented taxpayers received full or partial relief from their CDP appeals.

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94 *Id.*

95 *Id.*

96 *Id.* The court also noted that discretion to grant a face-to-face hearing lies with the IRS.

97 In addition, there is still the chance that someone could appeal the Tax Court's decision in *Simien*.

98 For a more detailed discussion of § 6673, *see* Most Litigated Issue, *IRC § 6673, Frivolous Issues Penalty and Related Appellate Level Sanctions* Under Internal Revenue Code Section 6673, *infra.*

99 *Clough v. Comm'r*, T.C. Memo 2007-106.

100 *Szopa v. U.S.*, 460 F.3d 884 (7th Cir. 2006).

101 National Taxpayer Advocate 2006 Annual Report to Congress 573. One reason for the increase in represented taxpayers as compared with the previous year is the volume of Hoyt cases discussed previously.

TABLE 3.1.2, *Pro Se* and Represented Taxpayer Cases and Decisions

Court Decisions	Taxpayer *Pro Se*		Represented	
	Volume	Percentage of Total	Volume	Percentage of Total
Decided for IRS	129	91%	70	93%
Decided for Taxpayer	6	4%	4	5%
Split Decisions	6	4%	1	1%
Neither	1	Less than 1%	N/A	
Totals:	**142**		**75**	

One interesting note is that the percentage of taxpayers represented in CDP cases has increased from 27 to 35 percent from the same time period last year. One reason for the increase in represented taxpayers over last year is the 17 Hoyt partnership cases decided by the courts during this time period, which all stem from a series of cattle and sheep breeding partnerships. A number of taxpayers who were assessed additional tax, penalties, and interest as a result of their investment in the Hoyt partnerships submitted offers in compromise to resolve their outstanding tax liabilities. All of the Hoyt cases except one were brought by represented taxpayers. The high volume of Hoyt cases during the review period may have had an influence on the lower percentage of CDP cases brought by *pro se* taxpayers. The National Taxpayer Advocate is interested to see whether the trend towards an increased percentage of represented taxpayers in CDP hearings will continue in the future.

Conclusion

CDP hearings continue to provide a critical means for taxpayers to challenge IRS attempts to deprive them of property. Given the important protection that CDP hearings offer, it should be of little surprise that CDP remains the most frequently litigated tax issue in the federal courts – a trend that is not likely to change anytime soon. The cases reviewed illustrate the need for both taxpayers and the IRS to comply with the basic CDP requirements – timely filing of a hearing request, the need for an impartial Appeals Officer, and the role of the administrative record. The cases also addressed the unsettled issue of the right to record a telephone CDP hearing – an issue that the courts are apt to face in the future.

Because of the important role of CDP hearings in protecting taxpayer rights, taxpayers and their representatives will likely continue to pursue their CDP rights in court. However, the courts have evidenced a decreasing tolerance for taxpayers making frivolous claims designed to stall the collection process. The new legislation designed to deter taxpayers from making frivolous arguments during the CDP process, along with the courts' new trend of imposing sanctions, may in the future reduce the number of reported decisions discussing only frivolous arguments. On the other hand, the new legislative requirement for stating specific grounds in a request for hearing may prevent *pro se* taxpayers from raising substantive issues simply because they are not versed in IRS procedures. The National Taxpayer Advocate will continue to monitor how this new legislation plays out and its effect, if any, on the CDP process.

MLI #2

Gross Income Under Internal Revenue Code Section 61 and Related Sections

Summary

When preparing tax returns, taxpayers must make the crucial calculation of gross income for the taxable year in order to determine the tax that must be paid. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.[1] Common issues in the 112 cases decided between June 1, 2006, and May 31, 2007 and reviewed for this report include:

- Damage awards;
- Discharge of indebtedness income; and
- Disability and Social Security benefits.

Present Law

Internal Revenue Code (IRC) § 61 broadly defines gross income as "all income from whatever source derived."[2] The U.S. Supreme Court has broadly defined gross income as any accession to wealth.[3] However, over time, Congress has carved out numerous exceptions and exclusions to this definition.[4]

Analysis Of Litigated Cases

We analyzed 112 opinions issued by the federal courts between June 1, 2006, and May 31, 2007, which involved gross income.[5] Gross income issues most often fall into two categories: what is included in gross income under IRC § 61 and what can be excluded from gross income under other statutory provisions. A detailed list of all cases is presented in Table 2 of Appendix III. In 36 cases (32 percent), taxpayers were represented by attorneys, while the rest were *pro se*, without representation. Nine of the 36 represented taxpayers (25 percent) prevailed in full or in part of their cases, while overall, taxpayers prevailed in full or in part in only 14 of the 112 cases (13 percent).

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1 *See, e.g.*, National Taxpayer Advocate 2006 Annual Report to Congress 575-581.

2 IRC § 61(a).

3 *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).

4 *See, e.g.*, IRC §§ 104, 105, and 108.

5 We reviewed federal cases involving IRC § 61 where the issue was whether the taxpayer had an item of unreported income or whether the taxpayer was entitled to exclude the item from gross income.

The vast majority of the cases we reviewed this year involved taxpayers failing to report items of income. Some items that taxpayers failed to report but are specifically mentioned in IRC § 61 are wages and tips,[6] gross income from business,[7] and interest.[8]

In the context of items that can be excluded from gross income, the following issues were commonly raised in the cases we analyzed:

Damage Awards

Taxpayers continue to litigate the issue of taxation of damage awards. Taxpayers challenged the IRS's determination that their awards should be included in gross income on the basis that they should be excluded in full or in part because of having been received "on account of personal physical injuries or physical sickness."[9] Under IRC § 104(a)(2), any award other than punitive damages is excludible from gross income if the award is compensation for damages resulting from a physical injury or sickness.[10] It makes no difference whether the award is received by suit or settlement agreement, or whether the award is paid as a lump sum or in periodic payments, because all such awards are excludible unless they represent punitive damages. At least seven taxpayers presented this argument to the courts in the cases analyzed.[11]

Congress amended IRC § 104(a)(2) in 1996, to clarify the conditions under which a damage award may be excluded from income, making an award excludible only if the damages are received on account of personal physical injury or physical sickness.[12] Prior to 1996, the word "physical" did not appear in the statute. The change in law was effective for amounts received after the enactment on August 20, 1996,[13] but not effective for amounts received under a written, binding agreement, court decree, or mediation award in effect (or issued) on or before September 13, 1995.[14]

During our review, we identified one case that addressed whether the taxability of the award was governed by the pre-August 1996 version of IRC § 104(a)(2).[15] In *Polone v. Commissioner*, the taxpayer filed suit against his former employer, alleging defamation. Polone entered a settlement agreement for damages on May 3, 1996, in which his $4 million settlement was paid in four installments of $1 million each on May 3, 1996,

6 IRC § 61(a)(1). *See, e.g.*, *Belmont v. Comm'r*, T.C. Memo. 2007-68.

7 IRC § 61(a)(2). *See, e.g.*, *Irving v. Comm'r*, T.C. Memo. 2006-169.

8 IRC § 61(a)(4). *See, e.g.*, *Adams v. Comm'r*, T.C. Memo. 2006-114.

9 IRC § 104(a)(2).

10 IRC § 104(a)(2).

11 *See, e.g.*, *Connolly v. Comm'r*, T.C. Memo. 2007-98, *appeal docketed*, No. 07-3237 (2d Cir. July 27, 2007).

12 Pub. L. No. 104-188, § 1605(a).

13 Pub. L. No. 104-188, § 1605(d)(1).

14 Pub. L. No. 104-188, § 1604(d)(2).

15 *Polone v. Comm'r*, 479 F.3d 1019 (9th Cir. 2007) *aff'g* T.C. Memo. 2003-339, *withdrawn and reh'g en banc denied*, 2007 U.S. App. LEXIS 23802 (9th Cir. Oct. 11, 2007), *superseded by* 2007 U.S. App. LEXIS 23804 (9th Cir. Oct. 11, 2007).

November 11, 1996, May 5, 1997, and November 11, 1998.[16] Polone argued the entire settlement should be governed under the pre-August 1996 version of IRC § 104(a)(2) and thus should be excluded from his gross income, as damages due to defamation were excludible under the law that existed at the time he executed his settlement agreement.[17] The court found the plain language of the amended statute applies to damages received after August 20, 1996 from settlement agreements entered into after September 13, 1995.[18] Polone's settlement agreement was executed after September 13, 1995, and three of his installment payments were received after the effective date of August 20, 1996; therefore, three of his four installment payments were not excludible from gross income.

The legislative history to the 1996 amendment to IRC § 104(a)(2) provides that

> [i]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness… [but] emotional distress is not considered a physical injury or physical sickness.[19]

Although the legislative history is quite clear, the relationship between mind and body and the biological and neurological basis of mental problems, is not always as clear. In the 2006 Annual Report to Congress, we analyzed the decision of the United States Court of Appeals for the District of Columbia Circuit in *Murphy v. IRS*, and alluded to its potential impact on future litigation of IRC § 104(a)(2) claims, as that decision suggested a connection between physical injury and emotional distress.[20] The taxpayer sued the New York National Guard for employment discrimination and entered into a settlement agreement allocating $45,000 of her award to "emotional distress and mental anguish" and the remaining $25,000, to "injury to professional reputation."[21] She and her husband filed a joint return in which they reported the entire $70,000 award as gross income and subsequently filed a claim for a refund, which the IRS denied. The taxpayer then initiated a refund suit in the United States District Court for the District of Columbia.[22] The district court found for the government on all counts and the taxpayers appealed the decision. While the Court of Appeals agreed the award was not for physical injuries or physical sickness under IRC § 104(a)(2), the court also determined that IRC § 104(a)(2) was "unconstitutional insofar as it permits the taxation of an award of damages for mental distress and loss of reputation" as "damages received solely in compensation for a personal injury are not income within the meaning of that

16 *Polone v. Comm'r*, 479 F.3d 1019 (9th Cir. 2007) *aff'g* T.C. Memo. 2003-339, *withdrawn and reh'g en banc denied*, 2007 U.S. App. LEXIS 23802 (9th Cir. Oct. 11, 2007), *superseded by* 2007 U.S. App. LEXIS 23804 (9th Cir. Oct. 11, 2007).

17 *Id.*

18 *Id.*

19 H.R. Rep. No. 104-586, at 143-44 (1996).

20 National Taxpayer Advocate 2006 Annual Report to Congress 577-78; *Murphy v. IRS*, 460 F.3d 79 (D.C. Cir. 2006) *rev'g* 362 F.Supp. 2d 206 (D. D.C. 2005), *vacated*, 2007-1 U.S.T.C. (CCH) ¶ 50,228 (D.C. Cir. 2006), *case reheard*, 493 F.3d 170 (D.C. Cir. 2007), *aff'g* 362 F.Supp.2d 206 (D. D.C. 2005), *reh'g en banc denied*, 2007 U.S. App. LEXIS 22173 (D.C. Cir. Sept. 14, 2007).

21 *Murphy v. IRS*, 460 F.3d at 81.

22 *See Murphy v. IRS*, 362 F.Supp.2d 206 (D.D.C. 2005).

term in the Sixteenth Amendment."[23] Consequently, the taxpayers did not have income from the settlement award.

Following substantial adverse commentary,[24] the Court of Appeals vacated its decision *sua sponte*[25] and reheard the case on April 23, 2007. In its second decision, the Court of Appeals reasoned that when Congress amended IRC § 104(a)(2) in 1996 to tax compensatory damages that were not received on account of physical injury or sickness, it implicitly expanded the definition of income under IRC § 61 to include such damages.[26] This time, the court sidestepped the issue of whether compensation awards are "income" under the Constitution. Instead, it held that the tax on compensatory damages was an excise tax on an involuntary conversion transaction (*i.e.*, Murphy had to surrender part of her mental health and reputation in return for monetary damages), and as such was not subject to the constitutional requirements for a tax on "income."[27] Thus, although the definition of income under IRC § 61 may be broader than the definition of income under the Constitution, IRC § 61 is nonetheless constitutional. Consequently, Murphy's entire settlement award of $70,000, $45,000 of which was allocated to "emotional distress and mental anguish" and $25,000 of which was allocated to "injury to professional reputation," was not excludible from gross income.[28]

Discharge of Indebtedness

In seven cases, taxpayers argued that the IRS mistakenly determined they had received discharge of indebtedness income from the cancellation of a debt,[29] but only one taxpayer prevailed.[30] Under current law, discharge of indebtedness income generally must be included in gross income.[31] A taxpayer is permitted to exclude discharge of indebtedness income where the taxpayer was insolvent at the time of the discharge.[32] In the Tax Court, the burden of proving insolvency generally rests with the taxpayer.[33] In *Miller v. Commissioner,* the Tax Court found that while the taxpayers (a husband and wife) did have

23 *Murphy v. IRS*, 460 F.3d at 92. The Sixteenth Amendment provides: The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

24 *See, e.g.*, Allen Kenney, *Murphy A Boon for Protesters, Critics Say*, 112 Tax Notes 832 (Sept. 4, 2006); Robert W. Wood, *Tax-Free Damages: Murphy's Law Opens Floodgates*, 112 Tax Notes 850 (Sept. 4, 2006).

25 "*Sua sponte*" is a term that means without prompting or suggestion. Thus, without any request from either of the parties, the Court of Appeals decided to rehear the case.

26 *Murphy v. IRS*, 460 F.3d 79, 179-80 (D.C. Cir. 2006) *rev'g* 362 F.Supp. 2d 206 (D. D.C. 2005), *vacated*, 2007-1 U.S.T.C. (CCH) ¶ 50,228 (D.C. Cir. 2006), *case reheard*, 493 F.3d 170 (D.C. Cir. 2007), *aff'g* 362 F.Supp.2d 206 (D. D.C. 2005), *reh'g en banc denied*, 2007 U.S. App. LEXIS 22173 (D.C. Cir. Sept. 14, 2007).

27 *Id.*

28 *Murphy v. IRS*, 460 F.3d at 81.

29 *See, e.g., Rendall v. Comm'r*, T.C. Memo. 2006-174, *appeal docketed*, No. 06-9007 (10th Cir. Nov. 22, 2006).

30 *Miller v. Comm'r*, T.C. Memo. 2006-125.

31 IRC § 61(a)(12).

32 IRC § 108(a)(1)(B).

33 U.S. Tax Court Rules of Practice and Procedure, Rule 142(a); *Traci v. Comm'r*, T.C. Memo. 1992-708.

discharge of indebtedness income, they were insolvent at the time they received it.[34] The taxpayers in *Miller* were able to provide financial statements to the court showing their liabilities just prior to the discharge of indebtedness greatly exceeded their assets, by more than the amount of the discharge of indebtedness income.[35] Consequently, the taxpayers were entitled to exclude the entire amount of the discharge of indebtedness income from their gross income.

There is much potential for litigation in the discharge of indebtedness area; with the collapse of the subprime housing market and the corresponding rise in home foreclosures, taxpayers may face huge tax bills as the cancellation or forgiveness of a home loan is includible in gross income, absent an exception such as insolvency,[36] or other action on the part of Congress.[37] These issues, and the National Taxpayer Advocate's recommendations for mitigating them, are discussed in detail elsewhere in this report.[38]

Social Security and Disability Benefits

Taxpayers often litigate the characterization of Social Security and other types of disability benefits because portions of these benefits may be excludable from gross income. In *Bell v. Commissioner,* the taxpayer argued that disability payments he received were excludible under IRC § 105,[39] which provides that amounts received from a disability plan and attributable to employee contributions are excludible from gross income.[40] The Court of Appeals for the Ninth Circuit found that the taxpayer had contributed only to his health insurance plan, while his employer had maintained the disability plan in question; thus the payments the taxpayer received from the disability plan were included in gross income.[41]

Income Earned in Antarctica

At least one taxpayer argued that income he earned in Antarctica should be excluded from gross income under IRC § 911.[42] IRC § 911 permits a qualified taxpayer to elect to exclude foreign earned income, within statutory limits, earned while residing in a foreign country.[43] For purposes of IRC § 911, only territory under the sovereignty of a foreign nation is considered a "foreign country."[44] In *Arnett v. Commissioner,* the taxpayer argued that Antarctica is a foreign country and he was entitled to exclude the income he earned while working

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34 *Miller v. Comm'r*, T.C. Memo. 2006-125.

35 *Miller v. Comm'r*, T.C. Memo. 2006-125.

36 *See* IRC § 108(a).

37 Mortgage Forgiveness Debt Relief Act, Pub. L. No. 110-142, § 2 (2007).

38 *See* Most Serious Problem, *Tax Consequences of Cancellation of Debt Income, supra.*

39 *Bell v. Comm'r*, 229 Fed. Appx. 464 (9th Cir. 2007) *aff'g* T.C. Docket No. 017910-04.

40 IRC § 105.

41 *Bell v. Comm'r*, 229 Fed. Appx. 464 (9th Cir. 2007) *aff'g* T.C. Docket No. 017910-04.

42 *Arnett v. Comm'r*, 473 F.3d 790 (7th Cir. 2007) *aff'g* 126 T.C. 89 (2006).

43 IRC § 911.

44 Treas. Reg. § 1.911-2(h).

there.[45] The Court of Appeals for the Seventh Circuit upheld the decision of the Tax Court that Antarctica is not a foreign country as the United States recognizes no nation's sovereignty over Antarctica; consequently, it is not a foreign country.[46] We mention this case because it mirrors the facts of a multitude of cases decided since May 31, 2007.[47]

Conclusion

Gross income remains a perennial area of confusion and contention between taxpayers and the IRS. The complex nature of what may and may not be excluded from gross income lends itself to a less than clear standard for taxpayers, especially in areas such as disability benefits, where the characterization of the benefits may not be easily apparent. The treatment of awards and settlements also provides an area ripe for litigation, as demonstrated by *Murphy v. IRS*. Although the award in *Murphy* was characterized as an award for injuries that were not received on account of physical injuries or physical sickness, the Court of Appeals for the D.C. Circuit did acknowledge that the taxpayer had suffered physical symptoms as a result of the emotional distress caused by her treatment at the hands of her employer.[48] This area of the law may evolve to permit exclusions of awards for the physical problems caused by emotional distress. It is possible that litigation over discharge of indebtedness income will increase as a result of the subprime mortgage crisis. While Congress has provided relief to most taxpayers facing foreclosure for tax years 2007-2009, litigation may still lie ahead for taxpayers who lost their homes in 2006, and the interest rates on many subprime mortgages are due to reset after 2009 when the relief provision expires.

45 *Arnett v. Comm'r*, 473 F.3d 790 (7th Cir. 2007) *aff'g* 126 T.C. 89 (2006).

46 *Arnett v. Comm'r*, 473 F.3d 790 (7th Cir. 2007) *aff'g* 126 T.C. 89 (2006).

47 *See, e.g., Barber v. Comm'r*, T.C. Memo. 2007-338; *Swanson v. Comm'r*, T.C. Memo. 2007-337.

48 *Murphy v. IRS*, 493 F.3d 170, 176 (D.C. Cir. 2007), *aff'g* 362 F.Supp.2d 206 (D. D.C. 2005), *reh'g en banc denied*, 2007 U.S. App. LEXIS 22173 (D.C. Cir. Sept. 14, 2007).

MLI #3

Summons Enforcement Under Internal Revenue Code Sections 7602, 7604, and 7609

Summary

We reviewed 109 federal court opinions on issues related to IRS summons enforcement during the 12 months from June 1, 2006, through May 31, 2007.[1] The IRS has the authority to summon the production of books, records, other data, or testimony from witnesses when investigating a civil or criminal tax liability.[2] The IRS can obtain the information from the subject of the investigation by serving a summons directly on that person.[3] The IRS can also obtain the information from a third-party recordkeeper who is holding records relating to the person who is the subject of the investigation. The IRS must serve the summons upon the recordkeeper and notify the person identified in the summons of the summons.[4]

A person who has a summons served upon him or her may contest the legality of the summons if the government brings a proceeding to enforce the summons and may raise appropriate defenses at that time.[5] Once a summons is served upon a third-party record-keeper, the person identified in the summons can challenge the legality of the summons by filing a motion to quash it or intervening in a proceeding.[6] Generally, the burden on the IRS to establish the validity of the summons is minimal and the burden on the taxpayer to establish the illegality of the summons is formidable.[7] The taxpayer or the third-party recordkeeper prevailed in only four of the 109 cases we reviewed.

Present Law

The IRS has broad authority under IRC § 7602 to issue a summons to examine a taxpayer's books and records or direct testimony under oath.[8] The IRS can enforce a summons under IRC § 7604 by bringing suit in the appropriate United States District Court. Further, the IRS has the authority to obtain information related to an investigation from a third-party recordkeeper pursuant to IRC § 7609, provided that notice is given to those identified in the

1 A summons is a document compelling the person to appear at a specified time to answer claims; give testimony; or produce certain books, papers, or other data. *Albachten v. Corbett*, 156 F. Supp. 863 (S.D. Cal. 1957).

2 IRC § 7602; Treas. Reg. § 301.7602-1.

3 IRC §§ 7602(a); 7603(a).

4 IRC §§ 7603(b); 7609(a).

5 IRC § 7609; *see e.g., U.S. v. Davis*, 636 F.2d 1028, 1034 (5th Cir. 1981).

6 IRC § 7609(a) requires that anyone identified in a third-party summons (other than the person summoned) must be given notice of the summons. IRC § 7609(b) provides that those persons who are entitled to notice can intervene in a proceeding regarding the summons and can initiate a proceeding to quash the summons.

7 *Arrington v. U.S.*, 99 A.F.T.R.2d (RIA) 1322 (E.D. Cal. 2007), *adopted by*, 99 A.F.T.R.2d (RIA) 2999 (E.D.Cal. 2007), *Benoit v. U.S.*, 98 A.F.T.R.2d (RIA) 6328 (S.D. Cal. 2006), *appeal docketed,* No. 06-56457 (9th Cir. Oct. 23, 2006).

8 *LaMura v. U.S.*, 765 F.2d 974, 979, *citing U.S. v. Bisceglia*, 420 U.S. 141, 145 -146 (1975).

summons so they have the opportunity to contest it. A summons can be contested on the grounds that the IRS has failed to satisfy the threshold requirements for issuing a summons as set forth by the Supreme Court in *United States v. Powell*:

- The investigation must be conducted for a legitimate purpose;
- The information sought must be relevant to that purpose;
- The IRS must not already possess the information; and
- All required administrative steps must have been taken.[9]

The IRS initially has the burden in a summons enforcement proceeding to show that the *Powell* requirements are satisfied. Then, the burden shifts to the person attempting to quash the summons to demonstrate that the IRS did not meet the *Powell* requirements or that enforcement of the summons would be an abuse of process.[10] As noted above, the IRS's burden in satisfying the *Powell* requirements is minimal, while the taxpayer's burden, demonstrating that one of the factors has not been satisfied, is heavy.[11]

Other limitations on the issuance of a summons include the restriction against issuing a summons *after* the IRS has referred the matter to the Department of Justice (DOJ) for possible criminal prosecution.[12] Nor can the IRS obtain information protected by a statutory or common law privilege, such as:

- Attorney-client privilege;[13]
- Work product privilege;[14] or
- Tax practitioner privilege.[15]

However, there are also limitations to these privileges; for example, they extend to "tax advice" but not to tax return preparation materials.[16] Further, the identities of clients are not generally considered privileged information except in rare cases where so much of the actual confidential communication has been disclosed that merely identifying the client

Most Litigated Issues

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

10 *La Mura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985).

11 The IRS burden can generally be satisfied by presenting the sworn affidavit of the agent who issued the summons attesting to the necessary facts. *La Mura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985).

12 IRC § 7602(d).

13 The attorney-client privilege generally provides protection from discovery of information where:
(1) legal advice of any kind is sought, (2) from a professional legal advisor in his or her capacity as such, (3) the communication is related to this purpose, (4) made in confidence, (5) by the client, (6) and at the client's insistence protected, (7) from disclosure by the client or the legal advisor, (8) except where the privilege is waived. *United States v. Evans*, 113 F.3d 1457, 1461 (7th Cir. 1997), (*citing* John Henry Wigmore, Evidence in Trials at Common Law § 2292 (John T. McNaughten rev. 1961)).

14 The work product doctrine protects against the discovery of documents and other tangible things prepared in anticipation of litigation. Fed. R. Civ. P. 26(b)(3).

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

16 *United States v. Frederick*, 182 F.3d 496, 500-01 (7th Cir. 1999).

would effectively disclose that communication.[17] Another limitation is the so-called "crime-fraud" exception, which permits discovery of communications between an attorney and client that are in furtherance or perpetration of a fraud.[18]

When serving a summons on a third-party recordkeeper,[19] the IRS is required to give notice of the summons to the taxpayer and any person identified in the summons so that they can contest the summons.[20] The IRS must provide notice to the person within three days of the day on which the summons is served to the recordkeeper, but no later than the 23rd day before the day fixed on the summons on which the records will be reviewed.[21] Persons entitled to notice under IRC § 7609(a)(2) may bring a proceeding to quash a summons by filing a petition in the appropriate United States District Court within 20 days after notice of the summons is served.[22] Persons entitled to notice may also intervene in any proceeding to enforce the summons.[23]

Several exceptions apply to the IRC § 7609 notice procedures. Generally, the IRS is not required to give notice to persons identified in a summons when its purpose is to aid collection. A summons in aid of collection is issued in connection with the collection of an assessment or judgment against the person with respect to whose liability the summons is issued, or a transferee or fiduciary of the liable person.[24] However, the courts have interpreted the "aid of collection" exception to apply only where the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned.[25] In addition, summonses issued by the IRS in connection with a criminal investigation are also generally exempt from IRC § 7609 notice procedures if the summoned third party is not a third-party recordkeeper.[26]

Analysis of Litigated Cases

Summons enforcement has appeared as a topic in the National Taxpayer Advocate's Annual Report to Congress as a Most Litigated Issue since 2005. In the 2005 Report, we reviewed only 44 cases but predicted the number would rise as the IRS became more aggressive in

17 *United States v. Blackman*, 72 F.3d 1418, 1424 (9th Cir. 1995).

18 *United States v. Zolin*, 491 U.S. 554 (1989).

19 A third-party recordkeeper 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 data to which the source relates." IRC § 7603(b)(2).

20 IRC § 7609(a); *see also Ip v. U.S.*, 205 F.3d 1168,1172 (9th Cir. 2000) (stating "The purpose of the notice provision is to allow people to assert defenses, such as attorney-client privilege or relevancy objections, that would be unavailable to them in the absence of notice").

21 IRC § 7609(a)(1).

22 IRC § 7609(b)(2)(A).

23 IRC § 7609(b)(1).

24 IRC § 7609(c)(2)(D). Proposed regulations were published on July 21, 2006, which further explain this provision. In particular, the guidance explains that the IRS must give notice of a third-party summons issued in aid of collection if it seeks collection of an unassessed tax. Prop. Treas. Reg. § 301.7609-2, 71 Fed. Reg. 41,377 (July 21, 2006).

25 *Ip v. U.S.*, 205 F.3d 1168,1172-76 (9th Cir. 2000).

26 IRC § 7609(c)(2)(E).

its enforcement initiatives. Our prediction was accurate, as the volume of cases grew to 101 cases in 2006 and 109 this year. A detailed listing of this year's cases can be found in Table 3 in Appendix lll.

In 102 cases the court ruled fully in favor of the IRS, in four cases the taxpayer or the third party prevailed, and three cases resulted in split decisions. Attorneys represented taxpayers in 31 cases, while 78 cases involved taxpayers who were *pro se (i.e.,* without counsel). Arguments raised by litigants against the IRS summons generally fell into the following categories:

- **Powell Requirements:** As discussed previously, the burden for the IRS to satisfy the *Powell* requirements is minimal while the taxpayer's burden to dispute the requirements is significant. Generally, taxpayers were unable to show the court that the IRS had abused the process or acted without good faith.[27] Taxpayers often claimed the IRS already possessed the summonsed documents, but this argument was generally defeated once the agent who issued the summons provided an affidavit to the contrary.[28] Further, many taxpayers argued the IRS requested documents that were not relevant to the investigation. This argument was generally unsuccessful as well.[29]
- **Notice:** Taxpayers raised the issue of insufficient notice in several cases in an attempt to invalidate summonses.[30] Generally, the IRS is not required to give notice of a summons in aid of collection provided the taxpayer who is the subject of the investigation has a legally significant interest in the account or other property for which records are sought.[31] Additionally, because entitlement to notice confers standing to challenge a summons issued to a third-party recordkeeper under IRC § 7609(b), the IRS also raised entitlement to notice as a means to argue that litigants did not have standing to contest the summonses.[32]
- **Criminal Referral:** Taxpayers raised IRC § 7602(d) to invalidate summonses where taxpayers perceived an impending referral to the DOJ for criminal prosecution. The IRS is prohibited from issuing a summons or starting enforcement proceedings if the IRS has sent the case to DOJ.[33] Generally, courts accept the testimony of the IRS agent who issued the summons concerning whether the IRS has made a criminal referral to the DOJ unless the taxpayer can provide direct evidence to the contrary.[34] Enforcement

27 *See, e.g., Arrington v. U.S.*, 99 A.F.T.R.2d (RIA) *1322* (E.D. Cal. 2007) *adopted by*, 99 A.F.T.R.2d (RIA) 2999 (E.D.Cal. 2007); *Benoit v. U.S.*, 98 A.F.T.R.2d (RIA) 6328 (S.D. Cal. 2006), *appeal docketed*, No. 06-56457 (9th Cir. Oct. 23, 2006).

28 *Abell v. Sothen*, 214 Fed. Appx. 743 (10th Cir. 2007), *Martin v. U.S.*, 2006 WL 2621637 (E.D.Cal. 2006): *Gudenau v. U.S.*, A.F.T.R.2d (RIA) 6746 (D. Haw. 2006), *adopted by*, 98 A.F.T.R.2d (RIA) 6745 (D. Haw. 2006), *appeal docketed*, No. 07-15787 (9th Cir. Feb. 5, 2007).

29 *See, e.g., Martin v. U.S.*, 2006 WL 2621637 (E.D.Cal. 2006); *Ledford v. U.S.*, 98 A.F.T.R.2d (RIA) 6624 (D. S.C. 2006), *adopted by*, 98 A.F.T.R.2d (RIA) 6628 (D. S.C. 2006),*Wheeler v. U.S.*, 459 F.Supp.2d 399 (W.D.Pa. 2006).

30 *See, e.g.,Grant v. IRS*, 98 A.F.T.R.2d (RIA) 8196 (D. Ariz. 2006); *LeBeau v. C.I.R.*, 99 A.F.T.R.2d (RIA) 2166 (S.D. Cal. 2007).

31 *Grant v. IRS*, 98 A.F.T.R.2d (RIA) 8196 (D. Ariz. 2006); *LeBeau v. C.I.R.*, 99 A.F.T.R.2d (RIA) 2166 (S.D. Cal. 2007).

32 *Id.*

33 *Stoffels v. Hegarty*, 99 A.F.T.R.2d (RIA) 2088 (D.Colo. 2007), *appeal docketed*, No. 07-1225 (10th Cir. June 1, 2007). *United States v. Taylor*, 99 A.F.T.R.2d (RIA) 1598 (D.Ariz. 2007).

34 *Id.*

of the summons may continue even if the IRS refers the matter to the DOJ during the pendency of the summons enforcement proceeding, as the validity of the summons is determined on the day the enforcement petition is filed.[35]

- **Constitutional Argument:** Taxpayers also argued that their constitutional rights were violated as defense to the enforcement of summonses.[36] For example, a taxpayer claimed the summonses were too broad and thus in violation of the Fourth Amendment's restrictions against unreasonable searches and seizures.[37] Taxpayers also raised Fifth Amendment objections to the IRS summons. Generally, the Fifth Amendment privilege is inapplicable where the summons seeks only nontestimonial data that would not harm the taxpayer.[38] Moreover, corporations do not enjoy a Fifth Amendment privilege, even if the corporation is a one-person operation.[39]
- **Privilege:** Generally, taxpayers were unsuccessful in arguing privilege as a bar to disclosure of the summoned information.[40] For example, in *Reiserer v. United States*,[41] the taxpayer objected to the summons, asserting that his client's identities and fee information were protected from disclosure by the attorney-client privilege. The U. S. Court of Appeals for the Ninth Circuit disagreed, holding that the attorney-client privilege cannot protect bank records from a third party summons because client identity and fee information are not protected.

  However, in *United States v. Roxworthy*,[42] the taxpayer was successful in arguing that the documents sought were protected from disclosure under the work product doctrine. The Court of Appeals for the Sixth Circuit held that the corporation's internal memoranda concerning the corporation's tax treatment of certain transactions were protected by the work product doctrine because the documents were created in anticipation of litigation. The memoranda maintained the work product protection, even though the memoranda were in part prepared to assist the corporation in avoiding underpayment penalties.[43]

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35 *United States v. Taylor*, 99 A.F.T.R.2d (RIA) 1598 (D.Ariz. 2007).

36 *See, e.g., United States v. Arizechi*, 2006 WL 1722591 (D. N.J. 2006); *United States v. Moeshlin*, 99 A.F.T.R.2d (RIA) 2440 (M.D. Fla. 2007), *adopted by*, 99 A.F.T.R.2d (RIA) 2424 (M.D. Fla. 2007). The First Amendment protections of freedom of speech and assembly may be a defense to a summons. Although no cases during the reporting period discussed this issue, Chief Counsel Notice 2006-22, which was published on September 21, 2006, addresses this issue. Notice CC- 2006-22 (Sept. 21, 2006).

37 *United States v. Burkholder*, 2006 WL 2850555 (W.D. Mo. 2006).

38 *See, e.g., U.S. v. Moeshlin*, 99 A.F.T.R.2d (RIA) 2440 (M.D. Fla. 2007), *adopted by*, 99 A.F.T.R.2d (RIA) 2424 (M.D. Fla. 2007).

39 *United States v. Arizechi*, 2006 WL 1722591 (D. N.J. 2006).

40 *See, e.g., Reiserer v. U.S.*, 479 F.3d 1160 (9th Cir. 2007), aff'g *Estate of Reiserer v. U.S.*, 229 F.R.D. 172 (W.D. Wash. 2005).

41 *Reiserer v. U.S.*, 479 F.3d 1160 (9th Cir. 2007), aff'g *Estate of Reiserer v. U.S.*, 229 F.R.D. 172 (W.D. Wash. 2005).

42 *United States v. Roxworthy*, 457 F.3d 590, (6th Cir. 2006), *action on dec.*, 2007-4 (Oct. 1, 2007).

43 *Id. See also, United States v. Textron*, 507 F. Supp.2d 138 (D. R.I 2007), *appeal docketed*, No. 07-2631 (1st Cir. Oct. 31, 2007). Although this case was decided after the reporting period, it illustrates another example of a court quashing a summons with respect to documents protected by the work-product doctrine. In *Textron*, the IRS in the course of its examination summonsed the production of the taxpayer's accrual work papers. The district court held that the work papers were protected by the work product doctrine as the documents were prepared in anticipation of litigation.

- **Timeliness of Taxpayer's Petition or Notice and the Doctrine of Equitable Tolling:** Courts dismissed taxpayers' petitions to quash the summonses where the taxpayer either failed to file the petition in a timely manner[44] or failed to notify the IRS of the petition in accordance with IRC § 7609(b)(2).[45] Courts also refused to apply the doctrine of equitable tolling to extend the statutory deadlines under IRC § 7609.[46]

Conclusion

The IRS may issue a summons to obtain information needed to determine the correctness of a tax return, determine if a return should have been filed, determine a taxpayer's tax liability, or collect a liability.[47] For these purposes, the IRS may summons documentation from taxpayers who have failed to voluntarily provide that information to the IRS. Taxpayers continue to raise arguments regarding IRS summonses but are rarely successful; thereby evidencing the significant burden placed on the taxpayer when attempting to override the summons. It appears that as the IRS continues its aggressive enforcement policy, the IRS will continue to rely heavily on the summons enforcement tool, and we expect the courts will continue to see increased numbers of cases.

44 *See, e.g., Edwards v. IRS*, 98 A.F.T.R.2d (RIA) 8106 (W. D. N.C. 2006); *Glen v. U.S.*, 98 A.F.T.R.2d (RIA) 6494 (D. Colo. 2006).

45 *Serban v. Chynoweth*, 99 A.F.T.R.2d (RIA) 2182 (E.D. Cal. 2006), *adopted by*, 99 A.F.T.R.2d (RIA) 2181 (E.D. Cal. 2007); *Soloman Family Trust v. Chynoweth*, 2006 WL 2724277 (E.D. Cal 2006).

46 *Gudenau v. U.S.*, 98 A.F.T.R.2d (RIA) 6746 (D. Haw. 2006), *adopted by*, 98 A.F.T.R.2d (RIA) 6745 (D. Haw. 2006), *appeal docketed*, No. 17-15187 (9th Cir. Feb. 5, 2007). The court was uncertain if doctrine of equitable tolling could be applied to IRC § 7609. *Joling v. U.S.*, 99 A.F.T.R.2d (RIA) 598 (E.D. Wash. 2007). The court held that the doctrine of equitable tolling applies to IRC § 7609 but was not applicable under the facts of this case.

47 IRC § 7602(a).

MLI #4

Civil Damages for Certain Unauthorized Collection Actions Under Internal Revenue Code Section 7433

Summary

This is the first year that damages for unauthorized collection actions under IRC § 7433 have appeared in the National Taxpayer Advocate's Annual Report to Congress as a Most Litigated Issue. Internal Revenue Code (IRC) § 7433 establishes jurisdiction for United States District Courts (and, in certain circumstances, bankruptcy courts), to hear cases for damages sustained in connection with the wrongful collection of any federal tax because an IRS employee recklessly or intentionally, or by reason of negligence, disregarded any provision of the IRC, any IRS regulations, or certain provisions of the Bankruptcy Code.

We identified 100 opinions that involved a claim for damages for unauthorized collection action under IRC § 7433 and were issued between June 1, 2006, and May 31, 2007. The courts affirmed the IRS position in almost all of the cases. Taxpayers did not win a single case. However, in four cases, taxpayers prevailed on at least one issue.

Present Law

IRC § 7433 allows a taxpayer to seek monetary damages in a U.S. District Court in connection with the collection of federal tax if an IRS employee recklessly or intentionally, or by reason of negligence, disregarded any provision of the Code or any IRS regulations.[1] An action under IRC § 7433 is the taxpayer's exclusive remedy for recovering damages for wrongful collection resulting from the IRS employee's reckless, intentional, or negligent[2] disregard of such provisions and regulations.[3] A taxpayer may bring a suit under IRC § 7433 if the IRS does not follow the rules for proper communication with the taxpayer in connection with the collection of tax in violation of the Fair Debt Collection Practices Act.[4] A taxpayer may also bring suit under IRC § 7433 in connection with the failure to follow the statutory requirements for sale of seized property under IRC § 6335.[5]

1 IRC § 7433.

2 Taxpayers may bring damage actions for negligent disregard of the Code or regulations that occurred after July 22, 1998. The prior version of IRC § 7433 did not provide a remedy for negligent actions by IRS employees. *See* IRC § 7433(a), prior to amendment by the IRS Restructuring and Reform Act of 1998, Pub. L. No.105-206, § 3102(a)(1)(A) (July 22, 1998).

3 IRC§§ 7433(a), (e)(2). In certain circumstances, a taxpayer can also obtain a damage award for the IRS's failure to release a lien. *See* IRC § 7432.

4 IRC § 6304(c).

5 IRC § 6335(e)(4).

A taxpayer may bring an action under IRC § 7433 in a bankruptcy court for pecuniary damages if the IRS willfully violates the automatic stay[6] or discharge[7] provisions of the Bankruptcy Code and any applicable regulations.[8] Notwithstanding § 105 of the Bankruptcy Code, an IRC § 7433 damage action is the exclusive remedy for pecuniary damages resulting from such violations.[9]

A taxpayer may recover the actual, direct economic damages sustained as a proximate result of intentional, reckless, or negligent actions of the IRS employee and costs of the action. Economic damages are capped at $100,000 for negligent actions and $1,000,000 for reckless or intentional actions, plus the costs of the action.[10] However, the amount of damages awarded to a taxpayer will be reduced by the amount that reasonably could have been mitigated.[11]

The statute of limitations for bringing a suit for damages under IRC § 7433 is two years after the right of action accrues,[12] and the taxpayer must first exhaust administrative remedies.[13] Treasury regulations provide that administrative remedies are considered exhausted on the earlier of the date the IRS renders a decision on a properly filed administrative claim for actual, direct economic damages or if the IRS has not acted on the claim, then six months from the date the claim is filed.[14] However, the regulations provide an exception if a taxpayer files an administrative claim in the last six months before the two-year limitations period expires. In such cases, a taxpayer may file the suit at any time from the date when the administrative claim is properly filed and before the limitations period expires.[15]

The regulations establish comprehensive procedures for filing an administrative claim.[16] Such claims must be filed with the IRS Area Director, Attn: Compliance Technical Support Manager, of the area in which the taxpayer resides[17] and must include the following information:[18]

6 *See* 11 U.S.C. § 362.

7 *See* 11 U.S.C. § 524.

8 *See* IRC § 7433(e)(1); Treas. Reg. § 301.7433-2.

9 *See* IRC § 7433(e)(2)(A); Treas. Reg. § 301.7433-2(a)(2); 11 U.S.C. § 105.

10 *See* IRC § 7433(b); Treas. Reg. §§ 301.7433-1; 301.7433-2.

11 *See* IRC § 7433(d)(2).

12 IRC § 7433(d)(3); Treas. Reg. §§ 301.7433-1(g); 301.7433-2(g). The regulations provide that a right of action accrues at the time when the taxpayer has had a reasonable opportunity to discover all essential elements of a possible cause of action. *See* Treas. Reg. §§ 301.7433-1(g)(2); 301.7433-2(g)(2).

13 *See* IRC § 7433(d)(1); Treas. Reg. §§ 301.7433-1(d); 301.7433-2(d) (actions for the violation of the bankruptcy rules).

14 *See* Treas. Reg. §§ 301.7433-1(d)(i), (ii); 301.7433-2(d)(i), (ii).

15 *See* Treas. Reg. §§ 301.7433-1(d)(2); 301.7433-2(d)(2).

16 *See* Treas. Reg. §§ 301.7433-1(e); 301.7433-2(e).

17 *See* Treas. Reg. §§ 301.7433-1(e)(1); 301.7433-2(e)(1) (in actions for violation of bankruptcy rules the administrative claim must be filed with the Chief, Local Insolvency Unit, for the judicial district in which the taxpayer filed the underlying bankruptcy case giving rise to the alleged violation).

18 *See* Treas. Reg. §§ 301.7433-1(e)(2); 301.7433-2(e)(2) (in actions for violation of bankruptcy rules the administrative claim must also include the location of the bankruptcy court in which the underlying bankruptcy case was filed and the case number of the case in which the violation occurred).

- The taxpayer's name, taxpayer identification number, current address, current home and work telephone numbers, and any convenient times to be contacted;
- The detailed grounds for the claim for damages, including copies of all substantiating documentation and correspondence with the IRS;
- A description of the taxpayer's damage-related injuries associated with the claim, including copies of all available substantiating documentation and evidence;
- The amount of the damages, including any reasonably foreseeable future damages related to the claim; and
- The taxpayer's signature or the signature of the duly authorized representative.[19]

Analysis Of Litigated Cases

We reviewed 100 cases involving damages for unauthorized collection actions that were litigated between June 1, 2006, and May 31, 2007. Table 4 in Appendix 3 contains a detailed listing of those cases.

Although most taxpayers litigating damages for wrongful collection activity represented themselves (*pro se*), representation did not affect the outcome in cases litigated under IRC § 7433.[20] Taxpayers with representation received partial relief in one case, and *pro se* taxpayers received partial relief in three cases.

Court Decisions

Exhaustion of administrative remedies was the most prevalent issue, and was litigated in 83 cases. In every case the issue was raised, the government prevailed.[21] As the court stated in *McReynolds v. United States*, more than 70 cases were filed in the U.S. District Court for the District of Columbia by *pro se* taxpayers alleging violation of IRC § 7433, and many of these cases were dismissed for failure to exhaust administrative remedies.[22] Taxpayers' filings in this series of cases were "virtually indistinguishable," presumably coordinated, "or aided and abetted, by templates found on the Internet."[23]

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19 A duly authorized representative is an attorney, certified public accountant, or an enrolled preparer, permitted to represent the taxpayer before the IRS in good standing, and who has a written power of attorney executed by the taxpayer. *See* Treas. Reg. §§ 301.7433-1(e)(2)(v); 301.7433-2(e)(3); Treas. Cir. 230 § 10.3 (Sep. 26, 2007) (for the definition of enrolled preparers).

20 Only six of 100 taxpayers were represented by counsel. Of those six cases, the IRS prevailed in five, and only one resulted in a split decision.

21 In four cases, decisions for the government were affirmed on appeal.

22 *See McReynolds v. U.S.*, 99 A.F.T.R.2d (RIA) 1135, fn. 1 (D.D.C. 2007); *see also Cain v. U.S.*, 98 A.F.T.R.2d (RIA) 5289 (D.D.C. 2006); *Gross v. U.S.*, 98 A.F.T.R.2d (RIA) 6900 (D.D.C. 2006); *Lindsey v. U.S.*, 448 F. Supp. 2d 37 (D.D.C. 2006), *dismissed with prejudice*, 100 A.F.T.R.2d (RIA) 5220 (D.D.C. 2007); *Stephens v. U.S.*, 437 F. Supp. 2d 106 (D.D.C. 2006).

23 *McReynolds v. U.S.*, 99 A.F.T.R.2d (RIA) 1135, fn. 1 (D.D.C. 2007); *see also Gross v. U.S.*, 98 A.F.T.R.2d (RIA) 6900 (D.D.C. 2006).

For example, in *Lindsey v. United States*,[24] a typical case in this series,[25] a married couple filed a *pro se* complaint alleging the IRS's violation of numerous provisions of the Code. The complaint failed to allege facts pertaining specifically to the taxpayers in this case; instead, it restated boilerplate factual statements and arguments required to satisfy pertinent IRC provisions relied upon by the taxpayers.[26] Although the taxpayers technically failed to properly serve the government, the court was reluctant to dismiss the *pro se* action for insufficient service of process. Rather, the court dismissed the case on the merits after the taxpayers conceded that they did not exhaust administrative remedies as required by law.[27] Since the taxpayers' complaint, as in 17 other cases,[28] appeared to challenge the validity of the regulations requiring exhaustion of administrative remedies, the court granted limited leave to amend the complaint solely to include a facial challenge as to the validity of the regulations. The taxpayers, however, failed to amend the complaint in a timely manner, so the court dismissed the case with prejudice.[29]

In *Tenpenny v. United States*,[30] the court found that the statute of limitations for filing the action was equitably tolled[31] with respect to her claims against the United States[32] due to the fact that the court erred in dismissing the taxpayer's earlier damage action. In 2003, when the IRS seized the taxpayer's assets, the taxpayer filed a *pro se* action for damages for unauthorized collection activities, which was subsequently dismissed for failure to exhaust administrative remedies while an administrative claim was still pending. After the IRS denied the claim, the taxpayer filed the same suit again within the two-year period. The court found that the suit was untimely but that the statute of limitations was equitably tolled and the case could proceed because the court's prior order improperly dismissing the case was misleading. The order implied that the taxpayer's administrative claim needed to be resolved before she could file suit.

Two cases involved actions for bankruptcy law violations. One case involved the predominate issue in these cases – exhaustion of administrative remedies. In *Shearin v. United*

24 448 F. Supp. 2d 37 (D.D.C. 2006).

25 As of December 1, 2007, *Lindsey* was cited in at least 60 similar cases.

26 Taxpayers cited 17 distinct provisions of the IRC that were allegedly violated by the IRS. *See Lindsey*, 448 F. Supp. 2d at 43.

27 *See* IRC § 7433(d); Treas. Reg. § 301.7433-1.

28 Taxpayers challenged the validity of the regulation requiring exhaustion of remedies in 17 of 100 cases. The government prevailed in all 17 cases.

29 *See Lindsey v. U.S.*, 100 A.F.T.R.2d (RIA) 5220 (D.D.C. 2007).

30 490 F. Supp. 2d 852 (D. Ohio 2007).

31 The Supreme Court spelled out the principle of equitable tolling in 1871. *See Union Mut. Ins. Co. v. Wilkinson, 80 U.S. 222, 223 (1871)* ("The principle is that where one party has by his representations or his conduct induced the other party to a transaction to give him an advantage which it would be against equity and good conscience for him to assert, he would not in a court of justice be permitted to avail himself of that advantage [...] where the technical advantage thus obtained is set up and relied on to defeat the ends of justice or establish a dishonest claim.").

32 The court did not toll the statute of limitations with respect to the individual IRS employees who were not named in the original complaint. The court also could have dismissed taxpayer's claims against the individual IRS employees because they are improper parties to the suit. The only proper party in a IRC § 7433 action is the United States. *See* IRC § 7433(a); *see also Major v. IRS*, 201 Fed. Appx. 564, 566 (9th Cir. 2006), *cert. denied*, 127 S. Ct. 2115 (2007) ("The district court properly dismissed [taxpayer's] claims against individual IRS agents for actions taken to collect taxes because Congress has established a comprehensive statutory scheme for seeking redress in federal tax matters.") (citations omitted).

States,[33] the United States Court of Appeals for the Third Circuit affirmed the lower court's holding that it lacked jurisdiction over the taxpayer's damage action stemming from the IRS's alleged violations of the bankruptcy discharge and automatic stay procedures because the taxpayer had failed to exhaust her administrative remedies.

In *G.B. "Boots Smith" Corporation v. United States*,[34] a corporate taxpayer filed a damage action under IRC § 7433 in district court alleging that the IRS violated the automatic stay. The district court dismissed the case without prejudice because the proper forum for commencing a suit for damages arising out of an alleged breach of the automatic stay provisions is the bankruptcy court, not the district court.[35]

In *Gessert v. United States*,[36] the taxpayers, a corporation and corporate principal, maintained that their damage claims were timely even though they did not commence their suit within the statutorily prescribed two-year limitations period as a result of alleged misrepresentations by an IRS revenue officer regarding voluntary tax payments. The taxpayers discovered alleged wrongful collection activity only after the government handed over the requested transcripts. The court rejected the government's argument that the taxpayers could not challenge the alleged wrongful collection activities when it made voluntary payments, because the taxpayers made the payments in response to government activities. The court further concluded the statute of limitations for filing does not begin to run until the taxpayer discovers alleged wrongful collection activity, and allowed the corporate taxpayer to amend its complaint accordingly. However, the court dismissed the corporate officer's individual claims because he lacked standing since the alleged wrongful collection activities were not directed at him.

Conclusion

This is the first year that the issue of damages for unauthorized collection actions under IRC § 7433 has appeared in the National Taxpayer Advocate's Annual Report to Congress as a Most Litigated Issue. The proliferation of these cases is due in large part to the filing of the series of complaints discussed previously, which were apparently inspired by templates found on the Internet. Although the cases discussed herein were dismissed primarily on procedural grounds, it is unclear whether taxpayers will continue to file these complaints in such high numbers. The fact that courts have universally rejected the arguments contained in these complaints may curtail the filing of these complaints in the future. In response to continued filings, the courts may attempt to reduce the number of these frivolous filings by imposing sanctions and costs against the taxpayer in appropriate cases.[37]

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[33] 193 Fed. Appx. 135 (3rd Cir. 2006), *aff'g* 95 A.F.T.R.2d (RIA) 1440 (D. Del. 2005), *summary judgment denied*, 93 A.F.T.R.2d (RIA) 731 (D. Del. 2004).

[34] 98 A.F.T.R.2d (RIA) 6772 (S.D. Miss. 2006).

[35] *G.B. "Boots Smith" Corp. v. U.S.*, 98 A.F.T.R.2d (RIA) 6772 (S.D .Miss. 2006); *see also* IRC § 7433(e)(1); Treas. Reg. § 301.7333-2.

[36] 99 A.F.T.R.2d (RIA) 1968 (E.D. Wis. 2007), *reconsideration denied*, 100 A.F.T.R.2d (RIA) 5514 (E.D. Wis. 2007).

[37] A federal district court may award a penalty up to $10,000 payable to the United States if the court establishes that the taxpayer has instituted and maintained an action against the United States for unauthorized collection activities based on a frivolous or groundless position. IRC § 6673(b)(1). The IRS may assess the penalty awarded by the court and, upon notice and demand, may collect it in the same manner as a tax. *See* IRC § 6673(b)(2); *see also* Most Litigated Issue: *IRC § 6673, Frivolous Issues Penalty and Related Appellate-Level Sanctions, infra.*

MLI #5

Frivolous Issues Penalty And Related Appellate-Level Sanctions Under Internal Revenue Code Section 6673

Summary

During the 12 months between June 1, 2006, and May 31, 2007, the federal court system issued decisions in at least 70 cases involving the Internal Revenue Code (IRC) § 6673 penalty and at least 17 cases involving an analogous penalty at the appellate level.[1] These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, or unreasonably failing to pursue administrative remedies.[2] In 16 of the 70 cases involving IRC § 6673, the United States Tax Court decided not to impose the penalty but warned taxpayers they could face sanctions in the future for similar conduct.[3] Similarly, we identified one case at the appellate level where the government did not request nor did the court impose a sanction under IRC § 7482(c)(4) or any other authority, but the court did warn the taxpayer that similar conduct will result in a sanction.[4] Nonetheless, we include these cases in our analysis to help illustrate what conduct will and will not be tolerated by the courts.

Present Law

The 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.[5] The maximum penalty is $25,000.[6] In some cases, the IRS requests that the Tax Court impose the penalty; in other cases, the court may exercise its discretion, *sua sponte*,[7] to impose the penalty.

1 In four cases, the U.S. Courts of Appeals both affirmed the imposition of the IRC § 6673 penalty and addressed the issue of an additional sanction against the taxpayer for filing a frivolous appeal. Thus, the total number of cases we have identified involving frivolous claims is 83.

2 The Tax Court generally imposes the penalty under IRC § 6673(a)(1). U.S. Courts of Appeals generally impose sanctions under IRC § 7482(c)(4), 28 U.S.C. § 1927, or Rule 38 of the Federal Rules of Appellate Procedure, although some appellate-level penalties may be imposed under other authorities.

3 *See, e.g., Bowman v. Comm'r*, T.C. Memo. 2007-114, *appeal docketed*, No. 07-2789 (8th Cir. Jul. 25, 2007).

4 *Allen v. Comm'r*, 204 Fed. Appx. 564 (7th Cir. 2006).

5 IRC § 6673(a)(1)(A), (B), (C).

6 IRC § 6673(a)(1).

7 *"Sua sponte"* is a term that means without prompting or suggestion. Thus, for conduct that the Tax Court finds particularly offensive, the Tax Court can choose to impose a penalty under IRC § 6673 even if the IRS has not requested that the penalty be imposed. *See, e.g., Avery v. Comm'r*, T.C. Memo. 2007-60 (The Tax Court imposed a penalty of $5,000 because the taxpayer unreasonably prolonged the proceeding by filing with the Tax Court repetitious, groundless, and frivolous documents alleging that no section of the Internal Revenue Code makes him liable and that the deficiency was an excise tax).

Taxpayers who institute an action pursuant to IRC § 7433[8] in a U. S. District Court for damages against the United States could 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] § 1927 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 attorneys for raising frivolous arguments or using litigation tactics primarily to delay the collection process. Because the sources of authority for imposing appellate-level sanctions are numerous and some of these sanctions may be imposed in non-tax cases, this report focuses primarily on the IRC § 6673 penalty. However, Table 5 in Appendix lll lists 17 cases we identified in which U.S. Courts of Appeals considered sanctions under other authorities.

Analysis of Litigated Cases

We analyzed 70 opinions issued between June 1, 2006, and May 31, 2007, which addressed the IRC § 6673 penalty. Fifty-seven of these opinions were issued by the Tax Court and 13 were issued by U.S. Courts of Appeals on appeals brought by taxpayers who sought review of the Tax Court's imposition of the penalty. Notably, the Courts of Appeals sustained the Tax Court's imposition of the penalty in all 13 cases it decided (a detailed listing of all cases is presented in Table 5 in Appendix lll). In 41 cases, the Tax Court imposed a penalty under IRC § 6673, with the amount ranging from $1,000 to $25,000. We identified only four cases that involved business taxpayers (which includes a taxpayer filing a Form 1040 with a Schedule C, E, or F). Eight taxpayers were represented by attorneys; all other taxpayers appeared *pro se*. The taxpayer prevailed in only six of the 47 cases where the IRS sought imposition of the IRC § 6673 penalty and only one of those taxpayers had representation. Thus, for those 47 cases, the IRS was successful in obtaining the IRC § 6673 penalty about 87 percent of the time.

The taxpayers in these cases presented a wide variety of arguments that the courts generally have rejected on numerous occasions. Upon encountering these arguments, the courts almost invariably cited the language set forth in *Crain v. Commissioner*:

8 IRC § 7433(a) allows taxpayers a cause of action against the IRS, as follows:
If, in connection with any collection of Federal tax with respect to a taxpayer, any officer or employee of the Internal Revenue Service recklessly or intentionally, or by reason of negligence, disregards any provision of this title, or any regulation promulgated under this title, such taxpayer may bring a civil action for damages against the United States in a district court of the United States. Except as provided in section 7432, such civil action shall be the exclusive remedy for recovering damages resulting from such actions.

9 IRC § 6673(b)(1).

10 IRC § 7482(c)(4) provides that the United States Courts of Appeals and the United States 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.§ 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.

12 Rule 38 of the Federal Rules of Appellate Procedure provides that if a United States Court of Appeals determines an appeal is frivolous, the court may award damages and single or double costs of the appellee.

> 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.[13]

Among the cases we reviewed, taxpayers raised the following arguments that the Tax Court has deemed frivolous and consequently were subject to a penalty under IRC § 6673(a)(1) (or, in some cases, were warned that such arguments were frivolous and could lead to a penalty in the future if the taxpayers maintained the same frivolous positions):

- **Income earned is not taxable income:** Taxpayers in at least nine cases argued that they had no taxable income. In *Leggett v. Commissioner*, the taxpayer argued at trial and in documents submitted to the Tax Court that he "does not and has not engaged in an activity that produces 'TAXABLE INCOME', but only an exchange of intellectual and physical property for an agreed upon perceived value in the only medium of exchange of the day *i.e.* FRN's [sic] [Federal Reserve Notes]."[14] The same taxpayer made an identical argument in a second Tax Court case later that year.[15]
- **No statute imposes liability for tax:** Several taxpayers argued that no law exists that permits the collection of an income tax.[16]
- **Payment of income tax is voluntary:** Taxpayers raised this argument, presumably a corollary to the argument that the payment of tax is not required by law, in at least two cases.[17] Additionally, several taxpayers argued that their deficiencies were not valid because they were not personally notified by the Secretary of Treasury of the requirement to file a tax return.[18]
- **Private sector wages are not subject to the income tax:** At least three taxpayers argued that only wages earned while employed by the government are subject to the income tax.[19]
- **Native American citizens are not subject to the income tax:** In *George v. Commissioner*, the taxpayer argued that Native Americans are exempt from the income tax by Executive Order. The Tax Court warned the taxpayer that making similar arguments in the future would result in an IRC § 6673 penalty.[20] Similarly, the taxpayer in *Allen v. Commissioner* presented the argument that income he received from the

13 *Crain v. Comm'r*, 737 F. 2d 1417, 1417-18 (5th Cir. 1984).

14 T.C. Memo. 2006-253.

15 *Leggett v. Comm'r*, T.C. Memo. 2006-277.

16 *See, e.g., Hanloh v. Comm'r*, T.C. Memo. 2006-194.

17 *See, e.g., Link v. Comm'r*, T.C. Memo. 2006-146, *aff'd*, 211 Fed. Appx. 204 (4th Cir. 2006).

18 *See, e.g., Faris v. Comm'r*, T.C. Memo. 2006-254, *appeal docketed*, No. 07-70880 (9th Cir. Mar. 6, 2007).

19 *Id.*

20 T.C. Memo. 2006-121.

Intertribal Council was not taxable because the Council is tax-exempt.[21] The U.S. Court of Appeals for the Seventh Circuit declined to impose any sanctions, but made clear that "Allen will not be so fortunate if he repeats this line of argument for any future tax year."[22]

- **Notices of deficiency are not properly signed:** Taxpayers argued in at least two cases that the notice of deficiency was invalid because it was not signed by the Secretary of the Treasury.[23] Similarly, in *Clough v. Commissioner*, the taxpayer argued that his notice of deficiency was invalid because the Commissioner had not signed it.[24]
- **IRS forms do not display a valid Office of Management and Budget (OMB) control number:** At least three taxpayers argued that the notice of deficiency was invalid without an OMB control number.[25]

In one case, *Jenkins v. Commissioner*, the taxpayer presented a slightly novel argument.[26] The taxpayer asserted that he should be relieved from the burden of the portion of his tax that would be apportioned to military spending. The taxpayer was a religious objector to military spending who asserted three arguments in support of his contention. He argued that "the First and Ninth Amendments afford him a right to withhold a portion of his taxes on account of his religious objections to military expenditures."[27] Further, the taxpayer asserted that the lower court failed to address the issue of "whether accommodating his religious objections would be unduly burdensome under the Religious Freedom Restoration Act of 1993."[28] In affirming the Tax Court's imposition of a $5,000 penalty under IRC § 6673, the U.S. Court of Appeals for the Second Circuit concluded that taxes cannot be avoided for religious reasons under any of the authorities cited by the taxpayer, stating "[a]lthough we do not doubt the sincerity of petitioner's religious convictions, we conclude that his legal arguments are without merit."[29]

Conclusion

As in past years, most cases addressing the IRC § 6673 penalty involved taxpayers raising the same issues that are repeated and rejected by the courts every year.[30] Only one case analyzed this year *(Jenkins)* contained a slightly novel argument and the court still imposed

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21 204 Fed. Appx. 564 (7th Cir. 2006).

22 *Allen*, 204 Fed. Appx. at 565.

23 *See, e.g., Arnett v. Comm'r*, T.C. Memo. 2006-134, *aff'd*, 2007 U.S. App. LEXIS 15005 (10th Cir. 2007).

24 T.C. Memo. 2007-106. This case highlights a situation where the Tax Court can find a taxpayer's conduct warrants a penalty even though the Tax Court decides in the taxpayer's favor on the issue of whether the IRS abused its discretion regarding collection of the taxpayer's tax liability.

25 *See, e.g., Pate v. Comm'r*, T.C. Memo. 2007-132, *appeal docketed*, No. 07-6-731 (5th Cir. Sept. 6, 2007).

26 *Jenkins v. Comm'r*, 483 F.3d 90 (2d Cir. 2007), *cert. denied*, 128 S.Ct. 129, 169 L. Ed. 2d 29 (Oct. 1, 2007).

27 *Id.*

28 *Id.*

29 *Id.*

30 *See, e.g.*, National Taxpayer Advocate 2006 Annual Report to Congress 602-606.

the IRC § 6673 penalty.[31] The court maintained that even in this case "[t]he claim is not new, although it is presented in somewhat unusual garb."[32]

A central theme permeating the decision process in IRC § 6673 penalty cases is the need to warn the taxpayer that he or she may be subject to the penalty at some point prior to raising the issue of the penalty.[33] In cases where the taxpayer was not previously warned about the possibility of the IRC § 6673 penalty, the courts declined to impose the penalty either at the request of the IRS or *sua sponte*; though in many instances the court warned the taxpayer that further assertion of similar arguments would lead to a penalty in future proceedings.[34] Interestingly, however, the courts do not always impose larger sanctions for repeat offenders.[35] In addition, there does not appear to be any uniform amount of penalty for identical conduct by different taxpayers.[36]

Overall, the IRS prevailed in the majority of cases where it sought imposition of the IRC § 6673 penalty and clearly indicated that in most cases where taxpayers assert frivolous arguments, or merely attempt to delay the collection of tax due, it will seek a penalty. Additionally, the courts on occasion will raise the issue of the IRC § 6673 penalty *sua sponte*. 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, 2006, and May 31, 2007, and will often impose further appellate level sanctions on taxpayers who assert frivolous arguments.

31 *Jenkins v. Comm'r*, 483 F.3d 90 (2d Cir. 2007), *cert. denied*, 128 S.Ct. 129, 169 L. Ed. 2d 29 (Oct. 1, 2007).

32 *Id.*

33 *See, e.g., Smith v. Comm'r*, T.C. Memo. 2007-121.

34 *Olmos v. Comm'r*, T.C. Memo. 2007-82, *appeal docketed*, No. 07-2442 (6th Cir. Nov. 7, 2007).

35 *See, e.g.*, $3,000 penalty in *Wheeler v. Comm'r*, T.C. Memo. 2006-109, and then $1,500 penalty seven months later in *Wheeler v. Comm'r*, 127 T.C. 200 (2006), *appeal docketed*, No. 07-9005 (10th Cir. June 26, 2007). *See also* $6,000 penalty in *Leggett v. Comm'r*, T.C. Memo. 2006-253, and then $2,500 penalty one month later in *Leggett v. Comm'r*, T.C. Memo. 2006-277.

36 Compare the result in each of the following cases where the taxpayer argued that there was no statutory authority that made him or her liable for taxes: *Cooper v. Comm'r*, T.C. Memo. 2006-241 ($10,000 penalty); *Dunbar v. Comm'r*, T.C. Memo. 2006-184 ($1,000 penalty); *Webster v. Comm'r*, T.C. Memo. 2006-144, *appeal docketed*, No. 06-74611 (9th Cir. Sept. 25, 2006) ($2,500 penalty).

MLI #6

Failure To File Penalty Under Internal Revenue Code Section 6651(a)(1) and Estimated Tax Penalty Under Internal Revenue Code Section 6654

Summary

We reviewed 82 decisions issued by the federal court system from June 1, 2006, to May 31, 2007, regarding the addition to tax under Internal Revenue Code (IRC) § 6651(a)(1) for failure to file a timely tax return, or the addition to tax under IRC § 6654 for failure to pay estimated income tax.[1] The phrase "addition to tax" is commonly referred to as a penalty, so we will refer to these two additions to tax as the failure to file penalty and the estimated tax penalty. Taxpayers prevailed in full in only three of the 82 cases, although seven other cases resulted in split decisions. Forty-one cases involved the imposition of the estimated tax penalty in conjunction with the failure to file penalty, while only one case involved the imposition of the estimated tax penalty without the failure to file penalty being imposed.

The failure to file penalty is mandatory unless the taxpayer can demonstrate that the failure to timely file a tax return is a result of reasonable cause and is not due to willful neglect.[2] The estimated tax penalty is mandatory unless the taxpayer can meet one of the statutory exceptions.[3] Among the cases analyzed, taxpayers were largely unsuccessful in their attempts to avoid the failure to file penalty based on reasonable cause or the estimated tax penalty based on any of the statutory exceptions.

Present Law

Under IRC § 6651(a)(1), a taxpayer that fails to file a tax return before its due date (including extensions) will be subject to a five percent penalty for each month or partial month the return is late. This penalty generally accumulates for each month the return is not filed, up to a maximum of 25 percent.[4] The penalty is based on the amount of tax due, minus any credit the taxpayer is entitled to receive or payment made by the due date.[5] The failure to file penalty applies to income, estate, gift, and certain excise tax returns.[6] IRC § 6698 provides for a penalty for failure to file partnership returns. This penalty is based on different criteria but also carries a reasonable cause component.

1 IRC §§ 6651(a)(2) and (a)(3) also impose additions to tax for failure to pay taxes. However, because only a small number of cases involved these penalties, we did not include them in our analysis.

2 IRC § 6651(a)(1).

3 IRC § 6654(e).

4 IRC § 6651(a)(1). The penalty is increased to 15 percent per month up to a maximum of 75 percent if the failure to file is fraudulent. IRC § 6651(f).

5 IRC § 6651(b).

6 IRC § 6651(a)(1).

IRC § 6654 imposes a penalty for failure to pay estimated income tax where prepayments of tax, either through withholding or by making estimated quarterly tax payments during the course of a year, do not equal the percentage of total liability required. In general, the amount required to be paid through each estimated quarterly payment is 25 percent of the "required annual payment," where the "required annual payment" is the lesser of 90 percent of the tax shown on the return for that year or 100 percent of the tax shown on the return of the individual for the preceding taxable year.[7] The IRS will determine the amount of the penalty by applying the underpayment rate according to IRC § 6621 to the amount of the underpayment for the period of the underpayment.[8] The estimated tax penalty applies to income tax returns of individuals and certain estates and trusts.[9]

The IRS has the burden of production in any court proceeding with respect to the liability of any individual for the failure to file penalty and the estimated tax penalty.[10] To meet this burden, the IRS must produce sufficient evidence indicating it is appropriate to impose the relevant penalty.[11] Once the IRS meets this burden, the taxpayer has the opportunity to come forward with evidence sufficient to persuade a court that the IRS's determination is incorrect.[12] The taxpayer also bears the burden of proof with regard to issues of reasonable cause.[13] To prove reasonable cause and to avoid the IRC § 6651 penalty, a taxpayer must show that he or she exercised ordinary business care and prudence but was still unable to file by the due date.[14] As discussed below, however, the IRC § 6654 penalty carries only a limited reasonable cause exception. Generally, the § 6654 penalty is mandatory where the estimated payments do not equal the statutorily required percentage.

Analysis of Litigated Cases

We analyzed 82 opinions issued between June 1, 2006, and May 31, 2007, where the failure to file penalty or the estimated tax penalty was in dispute. All but ten of these cases were litigated in the United States Tax Court. A detailed list of these cases appears in Table 6 in Appendix III. Sixty-one cases involved individual taxpayers and 21 involved businesses (including individuals engaged in self-employment or partnerships). Taxpayers were represented by attorneys in only 18 cases. Of the 64 cases in which taxpayers appeared *pro se*, or without counsel, only three cases were resolved in the taxpayer's favor and six cases resulted in split decisions. Thus, taxpayers lacked representation in the vast majority of cases decided in the IRS's favor.

7 IRC § 6654(d).

8 IRC § 6654(a)(1) – (3).

9 IRC §§ 6654(a); 6654(l).

10 IRC § 7491(c). An exception to this rule alleviates the IRS from this initial burden where the taxpayer's petition fails to state a claim for relief from the penalty, such as where the taxpayer only makes frivolous arguments. *Funk v. Comm'r*, 123 T.C. 213 (2004).

11 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001).

12 *Id.* at 447.

13 *Id.*

14 Treas. Reg. § 301.6651-1(c)(1).

Failure to File Penalty

A common basis for the courts ruling against taxpayers was the lack of evidence that the failure to file was due to reasonable cause. In fact, in 42 of the 82 cases analyzed (more than 50 percent), the taxpayers did not present any evidence of reasonable cause.

In cases where taxpayers presented evidence of reasonable cause in defense of their failures to file timely (or at all), the arguments included the following:

- **Medical Illness:** Depending on the facts and circumstances, a medical illness may establish reasonable cause for failing to file.[15] For illness or incapacity to constitute reasonable cause, the taxpayer must show incapacitation to a degree that he or she could not file a return on time.[16] Thus, the fact that a return preparer had a brain tumor did not constitute reasonable cause for the taxpayers (husband and wife) failing to file without explanation as to why the taxpayers could not find another preparer to file their return timely.[17] In addition, while a court may be sympathetic to a taxpayer's medical condition, the condition does not constitute reasonable cause if it was not present at the time the return was due.[18] When, however, a taxpayer showed his illness came amid other family issues that prevented him from devoting proper care to his financial information, the court did find reasonable cause.[19]
- **Mistaken Belief as to Filing Obligation:** Often taxpayers mistakenly believe they have not earned enough income during the tax year to require a return. If, however, a taxpayer's belief about the filing requirement is based on "misguided interpretations of the Constitution" or other frivolous arguments, the taxpayer does not have reasonable cause.[20] Thus, a taxpayer did not have reasonable cause for his failure to file when his decision not to file was based on the belief that money he received for his labor was a nontaxable exchange of equal value, as courts have consistently found such an argument to be frivolous.[21] Similarly, a taxpayer's failure to file based on the belief that pension income was a nontaxable exchange of equal value for labor was not reasonable.[22]
- **Reliance on Tax Professional:** The Supreme Court held in *United States v. Boyle* that taxpayers have a non-delegable duty to file a return on time, and a taxpayer's reliance

15 *Harbour v. Comm'r,* T.C. Memo. 1991-532. In *Harbour*, the taxpayer was in a coma during the month before his tax return was due. He was not able to work during this time or participate in any other life activities. Therefore, the Tax Court determined that this medical condition was a reasonable cause for failure to timely file his tax return.

16 *Williams v. Comm'r*, 16 T.C. 893, 905-06 (1951), *acq.*, 1951-2 C.B. 1.

17 *Bhattacharyya v. Comm'r*, T.C. Memo. 2007-19.

18 *Wright v. Comm'r,* T.C. Memo. 2007-50.

19 *Irving v. Comm'r*, T.C. Memo. 2006-169.

20 *Yoder v. Comm'r*, T.C. Memo. 1990-116 (citation omitted).

21 *Shinault v. Comm'r*, T.C. Memo. 2006-136.

22 *Link v. Comm'r*, T.C. Memo. 2006-146, *aff'd*, 211 Fed. Appx. 204 (4th Cir. 2006).

on an agent does not excuse failure to file.[23] When a taxpayer argued that reliance on her counsel was the reason for failing to timely file her returns, the Tax Court held this was not reasonable cause and the Fourth Circuit Court of Appeals affirmed the decision.[24]

- **Reliance on Spouse or Other Agent:** The *Boyle* rule against reliance on third parties to file tax returns also applies to reliance on family members or other agents.[25] The failure of the taxpayer's employee to properly prepare a company check to cover tax liabilities and the company's tax return did not constitute reasonable cause, because in large part the employee's failure to act properly demonstrated a lack of corporate oversight and reasonable care on the part of the corporation.[26]
- **"Zero Return" Filers/Returns Filed Under Protest, Disclaiming Liability:** Under the longstanding decision in *Beard v. Commissioner*, a return must be signed under penalties of perjury, purport to be a return, and represent an honest and reasonable attempt to satisfy the requirements of the tax laws.[27] Some taxpayers protested their obligation to pay taxes by filing tax returns with zeroes on every line of the tax return.[28] These taxpayers argued unsuccessfully that because they filed a tax return, they should not be assessed a failure to file penalty. However, a "zero return" does not constitute a tax return for purposes of IRC § 6651. Similarly, where a taxpayer filed a return and listed total tax as "N/A," the taxpayer was liable for the failure to file penalty because the IRS properly rejected the return as "frivolous."[29]

The one constant theme throughout these different types of cases is that the existence of reasonable cause in any given case depends on all the facts and circumstances of the case,[30] and what one court may find reasonable, another court may not. Moreover, to the extent that the Tax Court finds that a taxpayer's argument for reasonable cause is frivolous or groundless, the court may require a taxpayer to pay a penalty under IRC § 6673 of up to $25,000.[31]

Estimated Tax Penalty

Although the estimated tax penalty under IRC § 6654(a) is almost always imposed in conjunction with IRC § 6651(a)(1), the analyses under the two sections are different. One

23 469 U.S. 241, 252 (1985) ("It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for a late filing under § 6651(a)(1).").

24 *Messina v. Comm'r*, 99 A.F.T.R.2d (RIA) 1201 (4th Cir. 2007), *aff'g* T.C. Memo. 2006-107.

25 469 U.S. at 252.

26 *Lanco Inns, Inc. v. I.R.S.*, 98 A.F.T.R.2d (RIA) 5238 (N.D. N.Y. 2006).

27 82 T.C. 766, 777 (1986) (citation omitted), *aff'd,* 793 F.2d 139 (6th Cir. 1986).

28 *Arnett v. Comm'r*, T.C. Memo. 2006-134, *aff'd*, 2007 U.S. App. LEXIS 15005 (10th Cir. 2007), *petition for reh'g en banc denied* (Aug. 22, 2007); *Zigmont v. Comm'r*, T.C. Memo. 2006-233.

29 *George v. Comm'r*, T.C. Memo. 2006-121.

30 *See* IRM 20.1.1.3.1(1) (July 31, 2001).

31 *See Arnett v. Comm'r*, T.C. Memo. 2006-134 (taxpayer subject to $1,000 penalty for frivolous argument).

of the most significant differences is that IRC § 6654(a) does not provide for a broadly applicable reasonable cause exception. To avoid the estimated tax penalty, the taxpayer has the burden of proving one of the following exceptions:

- The tax is a small amount;[32]
- There is no tax liability for the preceding year;[33]
- The Secretary determines that by reason of casualty, disaster, or other unusual circumstances the imposition of the penalty would be against equity and good conscience;[34] or
- The taxpayer retired after reaching the age of 62, or became disabled in the taxable year for which estimated payments were required to be made or in the taxable year preceding such year, and the underpayment was due to reasonable cause and not willful neglect.[35]

The IRS's burden of production under IRC § 7491(c) with respect to the estimated tax penalty was met in numerous cases by proof at trial that the taxpayer had a tax liability, failed to file a return, had no withholding credits, did not make any estimated tax payments for that year, and offered no evidence to refute the IRS's evidence.[36] In all seven cases where the taxpayers prevailed on the estimated tax penalty, their success was a result of the IRS failing to meet its burden of production regarding the appropriateness of the penalty.

Conclusion

The United States tax system relies on taxpayers' willingness to voluntarily and accurately report their income, file returns, and pay taxes. Penalties can encourage this type of compliance and deter noncompliance, while also attempting to establish fairness in the system by imposing an additional cost on the noncompliant taxpayer. The penalties for failure to file and failure to pay estimated tax were implemented to encourage voluntary compliance and make it clear that noncompliance would not be tolerated.[37] Further, both penalties seek to establish fairness by penalizing those taxpayers who do not comply with the filing deadline and tax payment responsibilities.

In regard to the failure to file and estimated tax penalties, the IRS should determine whether this penalty positively influences compliance as intended. Congress should again consider the National Taxpayer Advocate's recommendation of a one-time abatement of the

32 IRC § 6654(e)(1).
33 IRC § 6654(e)(2).
34 IRC § 6654(e)(3)(A).
35 IRC § 6654(e)(3)(B).
36 *See, e.g.*, *Belmont v. Comm'r*, T.C. Memo. 2007-68; *Charlton v. Comm'r*, T.C. Memo. 2007-122.
37 *See* Policy Statement 20-1 (formerly P-1-18), IRM 1.2.20.1.1 (Aug. 28, 2007).

penalty for taxpayers who comply with their filing obligations but in an untimely manner.[38] This proposal would both broaden the definition of reasonable cause, providing the IRS the authority to abate a late filing penalty for inadvertent taxpayer mistakes, and still encourage the IRS's goal of voluntary compliance.

38 National Taxpayer Advocate 2001 Annual Report to Congress 188. This provision was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003. *See* H.R. 1528, 108th Cong. § 106 (2003).

MLI #7 Trade or Business Expenses Under Internal Revenue Code Section 162 And Related Sections

Summary

The deductibility of trade or business expenses is perennially among the ten most litigated tax issues in the federal courts. We identified 77 cases that included a trade or business expense issue and were litigated between June 1, 2006, and May 31, 2007. The courts affirmed the IRS position in nearly two-thirds of the cases, while taxpayers prevailed five percent of the time.[1] The remaining cases resulted in split decisions.

Present Law

Internal Revenue Code (IRC) § 162 allows deductions for ordinary and necessary trade or business expenses paid or incurred during a taxpayer's taxable year. Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance. The IRS, the Department of the Treasury, Congress, and the courts continue to provide legal guidelines about whether a taxpayer is entitled to certain trade or business expense deductions. The litigated cases analyzed for this report illustrate that this process is ongoing. When a taxpayer seeks judicial review of the IRS's determination of a tax liability stemming from the deductibility of a particular trade or business expense, the courts must often address a series of questions, including those discussed below.

What is a trade or business expense under IRC § 162?

Although "trade or business" is one of the most widely used terms in the IRC, neither the Code nor any Treasury Regulation provides a definition.[2] The definition of "trade or business" comes from common law, where the concepts have been developed and refined by the courts.[3] 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 making income or a profit.[4]

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 in order to be deductible. In *Welch v. Helvering*, the Supreme Court stated that the words "ordinary" and "necessary" have different

1 The IRS prevailed in full in 52 of the 77 cases, while taxpayers prevailed in full in only four cases.

2 In 1986 the term "trade or business" appeared in at least 492 subsections of the IRC and 664 Treasury Regulation provisions. F. Ladson Boyle, *What is a Trade or Business?*, 39 Tax Law. 737 (Summer 1986).

3 Carol Duane Olson, *Toward a Neutral Definition of "Trade or Business" in the Internal Revenue Code*, 54 U. Cin. L. Rev. 1199 (1986).

4 *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987).

meanings, and both must be satisfied for a taxpayer to benefit from the deduction.[5] The Supreme Court describes an "ordinary" expense as customary or usual and of common occurrence in the taxpayer's trade or business.[6] The Court describes a "necessary" expense as one that is appropriate and helpful for development of the business.[7]

Common law also requires that in addition to being ordinary and necessary, the amount of the expense must be reasonable in order for the expense to be deductible. In *Commissioner v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held "the element of reasonableness is inherent in the phrase 'ordinary 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.[8]

Is the expense a currently deductible expense or a capital expenditure?

A currently deductible expense is an ordinary and necessary expense that is paid or incurred during the taxable year in the course of carrying on a trade or business.[9] No deductions are allowed for the cost of acquisition, construction, improvement, or restoration of an asset that is expected to last more than one year.[10] Instead, capital expenditures may be subject to amortization, depletion, or depreciation over the useful life of the property.[11]

Determining whether to deduct expenditures under IRC § 162(a) or to capitalize them under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach in applying principles of capitalization and deductibility.[12]

When is an expense paid or incurred during the taxable year?

IRC § 162(a) requires an expense to be "paid or incurred during the taxable year" to be deductible. The Code also requires a taxpayer to maintain books and records that substantiate income, deductions, and credits – including adequate records to substantiate deductions claimed as trade or business expenses.[13] If a taxpayer is unable to substantiate deductions by documentary evidence (*e.g.*, invoice, paid bill, or canceled check) but can establish that he or she had some deductible business expenditures, the courts may opt to employ the *Cohan* rule to grant the taxpayer a reasonable amount of deductions.

5 290 U.S. 111, 113 (1933).

6 *Deputy v. Du Pont*, 308 U.S. 488, 495 (1940) (citations omitted).

7 *Comm'r v. Tellier*, 383 U.S. 687, 689 (1966) (citations omitted).

8 176 F.2d 815, 817 (6th Cir. 1949) (citation omitted).

9 IRC § 162(a).

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

11 IRC § 167.

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

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

The *Cohan* rule is a rule of "indulgence" established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.[14] The court held that the taxpayer's business expense deductions were not adequately substantiated, but "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."[15]

The *Cohan* rule may not be utilized in situations where IRC § 274(d) applies. Section 274(d) provides that unless a taxpayer complies with strict substantiation rules, no deduction is allowable for:

1. Traveling expenses;
2. Entertainment expenses;
3. Gifts; or
4. Certain "listed property."[16]

A taxpayer is required to substantiate a claimed IRC § 274(d) expense with adequate records or sufficient evidence that corroborates the taxpayer's statement establishing the amount, time, place, and business purpose of the expense.[17]

Who has the burden of proof in a substantiation case?

Generally, a taxpayer bears the burden of proving that he or she is entitled to the business expense deductions and the IRS's proposed determination of tax liability is incorrect.[18] Section 7491(a) provides that the burden of proof shifts to the IRS when a taxpayer:

- Introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer's liability;
- Complies with the requirements to substantiate deductions;
- Maintains all records required as defined in the IRC; and
- Cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.[19]

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14 39 F.2d 540 (2d Cir. 1930).

15 *Cohan v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930).

16 "Listed property" means any passenger automobile; any 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); any cell phones (or similar telecommunications equipment); or other property specified by regulations. IRC § 280F(d)(4)(A) and (B).

17 Treas. Reg. § 1.274-5T(b).

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

19 IRC § 7491(a)(1) applies to a court proceeding in which the examination started after July 22, 1998, and if there is no examination, to the taxable period or events which started or occurred after July 22, 1998.

Analysis of Litigated Cases

Trade or business expenses have been identified as one of the ten most litigated tax issues in the federal courts since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.[20] We reviewed 77 cases involving various trade or business expense issues that were litigated in federal courts from June 1, 2006, through May 31, 2007. Table 7 in Appendix 3 contains a detailed listing of those cases.

Table 3.7.1 categorizes the main trade or business expense issues raised by taxpayers from June 1, 2006, through May 31, 2007. Cases involving more than one issue are included in more than one category. In *Pillay v. Commissioner*,[21] for example, the taxpayer raised five distinct trade or business expense issues, so *Pillay* is included in five categories.

TABLE 3.7.1, Trade or Business Expense Issues

Issue	TYPE OF TAXPAYER	
	Individual	Business (including Sole Proprietors)
Substantiation of Expenses, including application of the *Cohan* rule[22]	9	38
Profit Objective[23]	0	18
Ordinary and Necessary Trade or Business Expenses[24]	0	13
Personal vs. Business Expenses[25]	4	12
Travel, Entertainment, and Gift expenses[26]	4	9
Business Expense vs. Capital Expenditure[27]	0	4
Compensation Expense Issues[28]	0	3
Self-employed health insurance deduction[29]	0	2
Education Expenses[30]	0	1

20 National Taxpayer Advocate 1998-2006 Annual Reports to Congress.

21 T.C. Summ. Op. 2006-93.

22 IRC § 6001 and Treas. Reg. § 1.6001-1 require a taxpayer to maintain books and records that substantiate income, deductions, and credits. Treasury Regulation § 1.162-17 provides guidance regarding maintaining adequate records to substantiate deductions claimed as trade or business expenses in connection with the performance of services as an employee. The *Cohan* rule allows courts to estimate certain expenses not properly substantiated. *Cohan v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930).

23 IRC § 183(a) provides that no deduction attributable to an activity shall be allowed if such activity is not engaged in for profit.

24 IRC § 162(a) allows deductions for ordinary and necessary trade or business expenses paid or incurred during the taxable year.

25 IRC § 262(a) provides that personal, living, and family expenses are generally not deductible.

26 IRC § 162(a)(2) allows a deduction for ordinary and necessary business-related expenses for traveling "while away from home in the pursuit of a trade or business"; entertaining clients and customers; and giving gifts to customers, employees, and others with whom they have a business relationship. A taxpayer's "home" for purposes of IRC § 162(a)(2) is his or her principal place of business. *Kroll v. Commissioner*, 49 T.C. 557, 561-62 (1968) (citations omitted). *See also* IRS Fact Sheet FS-2007-10, (Jan. 2007).

27 Under IRC § 263(a), generally no deduction is allowed for capital expenditures, where capital expenditures include any amount paid for permanent improvements made to increase the value of any property.

28 IRC § 162(a)(1) allows a trade or business expense deduction for a "reasonable allowance for salaries or other compensation for personal services actually rendered."

29 Under IRC § 162(l), a self-employed taxpayer may deduct the cost of medical insurance premiums under certain conditions. However, a self-employed taxpayer may not deduct the cost of medical insurance premiums, if he or she is eligible to participate in a subsidized health plan of another employer or of his or her spouse's employer. *See* IRC § 162(l)(2)(B).

Over three-quarters of the taxpayers litigating trade or business deduction issues represented themselves (*pro se*). In terms of percentage, represented taxpayers fared better than their *pro se* counterparts; taxpayers with representation received full or partial relief in 43 percent of litigated cases (nine of 21), while *pro se* taxpayers received partial relief in only 29 percent of litigated cases (16 of 56). None of the *pro se* taxpayers received full relief.

Court Decisions

Individual Taxpayers

Thirteen of the 77 cases analyzed were litigated by individual taxpayers, all but one of whom appeared *pro se*. None of these taxpayers received full relief and only five of the 13 cases resulted in split decisions. The most prevalent issue was the substantiation of the claimed trade or business expense deductions. For example, in *Nicely v. Commissioner*,[31] the taxpayer failed to provide consistent and credible documentation to satisfy the strict substantiation requirements of IRC § 274(d). In testimony at the trial, the taxpayer admitted the offered document was not prepared contemporaneously or near the time when he incurred the automobile and meal expenditures he claimed. As for clothing deductions, the taxpayer failed to prove that gloves, clothes, and work boots (which he wore at trial) were not suitable for personal wear, and were required in his business. Consequently, the Tax Court sustained the IRS's determination.

Only one of the 13 decisions involving individual taxpayers was issued as a regular opinion of the Tax Court.[32] In *Bissonnette v. Commissioner*,[33] the IRS denied the taxpayer's full-day per diem deductions[34] claimed for meal and incidental expenses incurred while working as a ferryboat captain. The taxpayer worked 15 to 17 hours per day with a six-to-seven-hour layover at a distant port. The IRS denied the deductions because the taxpayer was not "away from home" within the meaning of IRC § 162(a)(2) and his turnaround trips did not

30 Treas. Reg. § 1.162-5(a) provides that a taxpayer may deduct educational expenses under IRC § 162(a) if the education maintains or improves skills required by the individual in his or her employment or other trade or business, or meets the express requirements of the individual's employer.

31 T.C. Memo, 2006-172. This case illustrates the typical outcome in a substantiation case where the taxpayer has failed to provide adequate records for travel, meal, and other miscellaneous expenses that cannot be estimated under the Cohan rule and are subject to the strict substantiation requirements of IRC § 274(d).

32 Tax Court reported decisions fall into three categories: 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 significant. In addition, "S" case decisions (for disputes involving $50,000 or less) are not appealable and, thus, have no precedential value. See, generally, IRC §§ 7459; 7463(b). See also U.S. Tax Court Rules of Practice and Procedure, Rules 170-175.

33 *Bissonnette v. Comm'r*, 127 T.C. 124 (2006).

34 The taxpayer did not provide receipts to substantiate his meal and incidental expenses, but instead used the allowable federal rate calculated according to Rev. Proc. 2000-39, *Per Diem Allowances*, corrected by IRS Announcement 2001-73.

require him to stay for extended periods of time for sleep or rest.[35] The Tax Court concluded the demands of the taxpayer's job were such that he needed sleep or rest and the six-to-seven-hour layovers were sufficient in duration to be related to an increase in expenses. Consequently, the Tax Court held that the taxpayer was "away from home" for purposes of IRC § 162(a)(2), but reduced these expenses by 50 percent as required by IRC § 274(n).

Business Taxpayers

Sixty-four of the 77 litigated trade or business expense cases involved business taxpayers. These taxpayers had slightly less success than individual taxpayers in obtaining a favorable outcome, receiving full or partial relief in 31 percent of cases (20 of 64) compared to 38 percent for individuals (five of 13). Notably, four of these cases resulted in full relief for business taxpayers, while none of the individual taxpayers prevailed in full. In all four favorably decided cases, the business taxpayers were represented by counsel.

As with individual taxpayers, substantiation of expenses was the most prevalent issue. In some instances, the courts denied business taxpayers' deductions for failure to substantiate.[36] In other cases, however, where taxpayers did not have contemporaneous records but nonetheless demonstrated that they incurred business expenses, the courts permitted taxpayers to claim a reasonable amount of deductions through application of the *Cohan* rule.[37] At least one taxpayer prevailed when the IRS tried to use IRC § 274 to limit a taxpayer's deductions. For example, in *Transp. Labor Contract/Leasing, Inc. v. Commissioner*,[38] the IRS reduced the taxpayer's[39] business expense deductions for allowable per diem meal expenses reimbursed to employee drivers by 50 percent pursuant to IRC § 274(n). The Tax Court upheld the IRS's determination.[40] The United States Court of Appeals for the Eighth Circuit reversed the decision because the taxpayer maintained substantial documentation and provided testimonial evidence that the strict substantiation requirements of IRC § 274(d) were satisfied and the exception under IRC § 274(e)(3) applied.[41]

Another common issue litigated by business taxpayers was whether the business expense deductions were attributable to a legitimate "for profit" activity constituting an actual trade

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35 The "sleep or rest" rule is discussed in detail in *Williams v. Patterson*, 286 Fed.2d 333, 339 (1961). The IRS acknowledged in Rev. Rul. 61-221, 1961-2 C.B. 34, that it will follow the "sleep or rest" rule set forth in *Williams*. Essentially, the rule states that if (1) sleep or rest is needed for the taxpayer to meet the demands of his employment, and (2) the sleep or rest is of significant duration that it would lead to an increase in expenses; the expenses for the purpose of obtaining sleep or rest are deductible traveling expenses under IRC § 162. The Supreme Court recognized the validity of the rule in *United States v. Correll*, 389 U.S. 299 (1967).

36 *See, e.g., Alemasov v. Comm'r*, T.C. Memo. 2007-130, *appeal docketed,* No. 07-73968 (9th Cir. Sep. 25, 2007).

37 *See, e.g., Davis v. Comm'r,* T.C. Memo. 2006-272.

38 461 F.3d 1030 (8th Cir. 2006), *rev'd and remanded* T.C. Memo. 2005-173 and 123 T.C. 154 (2004).

39 The taxpayer was a professional employer organization, which provided "essential services such as paying employees, employment taxes, and workers' compensation premiums, and administering employee benefit plans." *Transp. Labor Contract/Leasing, Inc.*, 461 F.3d at 1031 (citation omitted).

40 *Transp. Labor Contract/Leasing, Inc. v. Comm'r,* 123 T.C. 154 (2004).

41 In general, IRC § 274(n) provides that a taxpayer is limited to claiming a deduction of only 50 percent of meal and entertainment expenses. IRC § 274(n)(2) provides that the 50 percent limitation does not apply to any expense described in IRC § 274(e)(3). IRC § 274(e)(3)(B) allows a deduction for expenses reimbursed to employees under a "reimbursement or other expense allowance arrangement" that satisfies the strict substantiation requirements of IRC § 274(d) and the employee performs services for a person other than an employer.

or business. In *Topping v. Commissioner*,[42] the taxpayer was involved in an interior design business and claimed deductions for expenditures related to her equestrian activities. The taxpayer's involvement in an equestrian club generated virtually all of her interior design clients, who were wealthy individuals relying on her knowledge and reputation in designing recreational houses for equestrian activities. The IRS disallowed deductions on the grounds that equestrian activities were not an integral part of the taxpayer's business and were not conducted for profit under IRC § 183 as a single activity. The Tax Court found to the contrary, holding that a close organizational and economic relationship existed between the equestrian and the design undertakings because taxpayer's exposure and reputation as a professional equestrian rider materially benefited her design business. The Tax Court further held the equestrian club and the design business were a single, for profit activity for purposes of IRC § 183(a), and consequently she could deduct the equestrian-related expenses under IRC § 162(a).

Of the 64 business taxpayer cases, only three resulted in regular decisions of the Tax Court. One of those cases involved IRC § 280E, which provides that no deduction is allowed for amounts paid or incurred in carrying on a trade or business if such trade or business consists of trafficking in controlled substances that is prohibited by federal or state law. In *Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner*,[43] the IRS denied deductions claimed by a charitable organization providing caregiving services and medical marijuana to its members, who were suffering from AIDS and other diseases, on the basis that those expenses were incurred in connection with the sale of an illegal drug. The Tax Court agreed with the taxpayer's argument that Congress did not intend to deny all business expense deductions to those taxpayers involved in trafficking in controlled substances.[44] Consequently, the Tax Court apportioned business expenses to caregiving and trafficking activities as separate businesses, allowing business expense deductions for the former and denying them for the latter.

Conclusion

Taxpayers continue to challenge IRS denials of trade or business expense deductions, and represented taxpayers again fared better than their *pro se* counterparts in the cases reviewed. While the IRS generally prevailed, the courts did not always favor the IRS's application of the law to the taxpayers' facts and circumstances. Thus, the definition of an allowable trade or business expense remains open to interpretation.

Many of the analyzed cases demonstrate taxpayer confusion over the legal requirements. The IRS can minimize litigation by providing clear guidance on the deductibility of trade

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42 *Topping v. Comm'r*, T.C. Memo. 2007-92.

43 128 T.C. 173 (2007).

44 Although it is legal under California law to obtain and use marijuana for medical purposes, the Tax Court disagreed with the taxpayer's argument that supplying medical marijuana to AIDS patients was not trafficking within the meaning of IRC § 280E. *See Californians Helping to Alleviate Med. Problems, Inc.*, 128 T.C. at 182.

or business expenses. Through education, outreach, and partnering with stakeholders, the IRS can help taxpayers understand what trade or business expense deductions are allowable and how to substantiate them. By helping self-employed and small business taxpayers understand the requirements for deducting trade or business expenses, the IRS will encourage compliance and minimize litigation.

MLI #8 Accuracy-Related Penalty Under Internal Revenue Code Sections 6662(b)(1) and (2)

Summary

Internal Revenue Code (IRC) §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if, under (b)(1) a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if under (b)(2) an underpayment of tax exceeded a computational threshold called a substantial understatement. IRC § 6662(b) also authorizes the IRS to impose three other accuracy-related penalties.[1] However, between June 1, 2006, and May 31, 2007, taxpayers litigated these other penalties less frequently than they litigated the negligence and substantial understatement penalties; therefore, this analysis does not address the three other accuracy-related penalties.

Present Law

The amount of the accuracy-related penalty equals 20 percent of the portion of the underpayment that is attributable to the taxpayer's negligence or disregard of rules or regulations, or a substantial understatement.[2] For example, if a taxpayer wrongly reports a handful of income tax items, some errors may be justifiable mistakes, while others might be the result of negligence. The 20 percent penalty would apply against only the underpayment of tax as a result of the items attributable to negligence.

The IRS may assess penalties under both subsections of the accuracy-related statute. The total penalty rate, however, may not exceed 20 percent, *i.e.*, the penalties are not "stackable."[3] Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and they acted in good faith.[4]

Negligence

The IRS may impose the IRC § 6662(b)(1) negligence penalty if it concludes a taxpayer's negligence or disregard of the rules or regulations caused the underpayment. Negligence includes a failure by the taxpayer to make a reasonable attempt to comply with the internal revenue laws, including a failure to keep adequate books and records or to substantiate items that gave rise to the underpayment.[5] Strong indicators of negligence include

1 IRC § 6662(b)(3) authorizes a penalty for substantial valuation misstatement for income taxes; IRC § 6662(b)(4) authorizes a penalty for substantial overstatement of pension liabilities; and IRC § 6662(b)(5) authorizes a penalty for substantial valuation understatements of estate and gift taxes.

2 IRC § 6662(a).

3 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. *See* IRC § 6662(h)(1).

4 IRC § 6664(c)(1).

5 Treas. Reg. § 1.6662-3(b)(1).

instances where a taxpayer failed to report income on a tax return that a payer reported on an information return, as defined in IRC § 6724(d)(1),[6] or the taxpayer failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return.[7] The IRS may also consider various other factors in determining whether the taxpayer's actions were negligent.[8]

Substantial Understatement

In general, an "understatement" is the difference between (1) the correct amount of tax, and (2) the amount of tax the taxpayer reported on the return, reduced by any rebate.[9] Understatements are generally reduced by the portion of an understatement attributable to (1) an item for which the taxpayer had substantial authority, or (2) any item if the taxpayer adequately disclosed the relevant facts affecting the item's tax treatment in the return or in an attached statement, and the taxpayer had a reasonable basis for the tax treatment of the item.[10] For individuals, the understatement of tax is substantial if the understatement exceeds the greater of $5,000 or ten percent of the tax that the law required the taxpayer to report.[11] 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 or $10 million.[12]

For example, if the correct amount of tax should have been $10,000 and the taxpayer reported $6,000, the substantial understatement penalty does not apply, because although the $4,000 shortfall is more than the ten percent test ($1,000 is ten percent of $10,000), it is less than the fixed $5,000 threshold. Conversely, if the same taxpayer reported a tax of $4,000, then the substantial understatement penalty would apply because the $6,000 shortfall is more than $1,000 (ten percent of $10,000), and is also greater than $5,000.

Reasonable Cause

The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.[13] The determination of reasonable cause takes into account all of the pertinent facts and circumstances.[14] The most important factor is the extent of the taxpayer's effort to determine the proper tax liability.[15] Reliance

6 IRC § 6724(d)(1) provides cross-references to other subsections that define various information returns, *e.g.*, IRC § 6724(d)(1)(A)(ii) references IRC § 6042(a)(1) for reporting of dividend payments.

7 Treas. Reg. § 1.6662-3(b)(1)(i), (ii).

8 These factors include: the taxpayer's history of noncompliance; 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. IRM 4.10.6.2.1 (May 14, 1999).

9 IRC § 6662(d)(2)(A).

10 IRC § 6662(d)(2)(B). No reduction is permitted, however, for any item attributable to a tax shelter. *See* IRC § 6662(d)(2)(C).

11 IRC § 6662(d)(1)(A)(i), (ii).

12 *Id.*

13 IRC § 6664(c)(1).

14 Treas. Reg. § 1.6664-4(b)(1).

15 *Id.*

upon the advice or opinion of a tax professional may constitute reasonable cause if: (1) the advisor is a competent professional who has sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the professional, and (3) the taxpayer in truth relied in good faith on the professional's judgment.[16]

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process[17] and through its Automated Underreporter (AUR) computer system.[18] Before a taxpayer receives a notice of deficiency, he or she has opportunities to engage the IRS on the merits of the penalty.[19] Once the IRS concludes an accuracy-related penalty is warranted, it must follow the same deficiency procedures, *i.e.*, IRC §§ 6211-6213, that it follows with other assessments.[20] Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to timely petition the U.S. Tax Court.[21] Alternatively, taxpayers may seek judicial review through refund litigation.[22] Generally later, in response to IRS collection actions, *e.g.*, an IRS notice of an intent to levy, the taxpayer may under certain circumstances request an administrative appeal of IRS collection procedures through a Due Process hearing.[23]

Burden of Proof

In court proceedings, the IRS bears the initial burden of production as to the accuracy-related penalty.[24] The burden means that the IRS must first present sufficient evidence to

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16 *Neonatology Associates, P.A. v. Comm'r*, 115 T.C. 43, 99 (2000) (citations omitted); Treas. Reg. § 1.6664-4(c)(1).

17 IRM 20.1.5.3(1) (Oct. 1, 2005).

18 The AUR is an automated IRS computer program that the IRS utilizes to determine discrepancies between amounts that taxpayers reported to the IRS against amounts that payers reported to the IRS via Form W-2, Form 1099, and other information returns. IRC § 6751(b)(1) provides that IRS employees must have written supervisory approval before assessing any penalty. However, IRC § 6751(b)(2)(B) provides an exception for situations where the IRS is able to calculate a penalty automatically "through electronic means." The IRS interprets the exception language as allowing the Service to use its AUR system to propose the substantial understatement and negligence components of the accuracy-related penalty without human review. If a taxpayer responds to an AUR proposed assessment, then at that point, the IRS first involves its employees to determine whether the penalty is appropriate. If the taxpayer does not respond timely to the notice, then the IRS computers automatically convert the proposed penalty to an assessment. *See* Most Serious Problem, *Exam Strategy: The Accuracy-Related Penalty in the Automated Underreporter Units, supra.*

19 For example, when the IRS proposes to adjust a taxpayer's liability, including additions to tax such as the accuracy-related penalty, it typically sends a notice ("30 day letter") of proposed adjustments to the taxpayer. A taxpayer has 30 days to contest the proposed adjustments to IRS Appeals during which time the taxpayer may raise issues related to the deficiency including the reasonable cause exception. If the issue is not resolved after the 30 day letter, the IRS sends a statutory notice of deficiency ("90 day letter") to the taxpayer. *See* IRS Publication 5 (Jan. 1999), *Your Appeal Rights and How to Prepare a Protest if You Don't Agree*; IRS Publication 3498 (Nov. 2004), *The Examination Process.*

20 IRC § 6665(a)(1).

21 IRC § 6213(a).

22 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 instituting a refund suit in the appropriate United States District Court or the Court of Federal Claims. 28 U.S.C. § 1346; IRC § 7422(a); *Flora v. U.S.*, 362 U.S. 145 (1960) (requiring full payment of tax liabilities as a precondition for jurisdiction over refund litigation).

23 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 receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute such liability. IRC § 6330(c)(2).

24 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."

establish that the penalty is warranted. The burden of proof then shifts to the taxpayer to establish any exception to the accuracy-related penalty, such as reasonable cause.[25]

Analysis of Litigated Cases

For the period from June 1, 2006, through May 31, 2007, we identified 75 cases where taxpayers litigated the negligence or disregard of rules or regulations or the substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 47 (63 percent) of the cases, the taxpayers prevailed in full in 18 cases (24 percent), and eight cases (11 percent) resulted in split decisions. Two (three percent) of the outcomes were indeterminate because a post-decision computation was necessary to determine whether a substantial understatement still existed mathematically in light of the Tax Court's decision in favor of the taxpayers on some but not all of the substantive issues. Thus, taxpayers prevailed partially or fully in more than one-third of the penalty disputes.

Taxpayers appeared *pro se* in 42 (56 percent) of the 75 cases. The *pro se* taxpayers had some success in convincing the courts to dismiss the penalty or reduce the penalty in 26 percent of their suits.[26] In contrast, taxpayers who had representation achieved full or partial relief from the penalty 52 percent of the time. Thus, representation was seemingly a major factor in the outcome of penalty litigation.

In some cases, the courts ruled on the accuracy-related penalty without specifying which subsection of the penalty applied, (b)(1) or (b)(2). In Table 8 in Appendix lll, we have indicated, where possible, which subsection was at issue. The analysis of reasonable cause is the same regardless of which subsection is at issue. Therefore, we have combined our analysis of the negligence and substantial understatement cases.

Reasonable Cause

Reliance on Advice of Tax Professional as Reasonable Cause

Reliance on a tax professional was the most common litigated element of reasonable cause. Certain common elements existed among the taxpayers who prevailed on this factor. The taxpayers established that they provided all necessary information to the professional, the professional was competent, and the taxpayers acted in good faith on the professional's opinion or tax return preparation.

Three examples of where taxpayers successfully claimed reasonable reliance on a tax professional include:

25 IRC § 7491(c).

26 In determining the taxpayer success rates, we counted the two unclear results (one was *pro se*, the other was with representation) as at least a partial success for the taxpayers because the two courts did not sustain the entire penalty amount that the IRS sought.

1. Although a taxpayer recognized revenue in the wrong year from a litigation settlement award, the taxpayer in good faith provided all relevant information and discussed the timing with a competent preparer;[27]
2. Even though a taxpayer improperly deducted pass-through losses from a foreign currency tax shelter partnership, the taxpayer reasonably sought out and relied in good faith on a competent tax counsel's opinion; [28] and
3. Although a taxpayer mistakenly deducted officer compensation twice for an S Corporation whose profit passed through to the taxpayer as the sole stockholder, the taxpayer reasonably relied on a competent accounting firm to prepare his return and the return of the corporation. The issue was complex and the error by one of the firm's associates was a one-time mistake, the kind of isolated mistake generally intended to give rise to reasonable cause.[29]

Three examples where taxpayers unsuccessfully claimed reliance on a tax professional include:

- The taxpayer did not establish that the professional was competent;[30]
- The taxpayer did not provide the necessary documentation to the professional;[31] and
- The taxpayer failed to show that he or she followed the professional's advice.[32]

In addition, some courts even went so far as to conclude that the taxpayers should have consulted an independent tax professional, and the failure to do so was not reasonable. Prime examples of this situation were three cases where the courts held that investors should not have relied solely on a promoter to prepare the taxpayers' individual tax returns, which contained "too good to be true" losses from a cattle breeding tax shelter partnership.[33] The courts held that reliance on promoters is not reasonable because their advice is biased.[34]

Adequacy of Records and Substantiation of Deductions as Reasonable Cause and as an Indicator of Taxpayer's Good or Bad Faith Compliance Effort

The second most frequent determinate of reasonable cause was the adequacy of the taxpayer's records. Courts held that a lack of adequate records or insufficient substantiation was not reasonable cause and showed a bad faith effort by taxpayers to comply with

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27 *Houchin v. Comm'r*, T.C. Memo. 2006-119, *motion for recons. denied*, (Aug. 10, 2006).

28 *Klamath Strategic Invest. Fund, LLC v. U.S.*, 472 F. Supp. 2d 885 (E.D. Tex. 2007), *appeal docketed*, No. 07-40861 (5th Cir. Sept. 6, 2007).

29 *Thrane v. Comm'r*, T.C. Memo. 2006-269.

30 *See, e.g., Calvao v. Comm'r*, T.C. Memo. 2007-57. *See also Chaplin v. Comm'r*, T.C. Memo. 2007-58.

31 *See, e.g., Connolly v. Comm'r*, T.C. Memo. 2007-98, *appeal docketed*, No. 07-3237 (2nd Cir. July 23, 2007).

32 *See, e.g., Green v. Comm'r*, T.C. Memo. 2007-39, *appeal docketed*, No. 07-73111 (9th Cir. July 30, 2007). *See also United States v. Davenport*, 2006-2 U.S.T.C. (CCH) ¶50,394 (W.D. Okla. 2006), *appeal docketed*, No. 06-6251 (10th Cir. Aug. 4, 2006).

33 *Hansen v. Comm'r*, 471 F.3d 1021 (9th Cir. 2006), *aff'g* T.C. Memo. 2004-269; *Keller v. Comm'r*, T.C. Memo. 2006-131, *appeal docketed*, No. 06-75441 (9th Cir. Nov. 17, 2006); *McDonough v. Comm'r*, T.C. Memo. 2007-101, *appeal docketed*, No. 07-70644 (9th Cir. Feb. 9, 2007).

34 *Id.*

tax laws. In a typical example, the Tax Court sustained the IRS's denial of about $524,000 in unsubstantiated gambling losses that taxpayers (a husband and wife) claimed over two years as itemized deductions.[35] The Tax Court held the taxpayers' failure to maintain adequate records was not only evidence of negligence, but also of intentional disregard of the regulations.[36] The court concluded that the taxpayers failed to establish reasonable cause, act in good faith, and do what a reasonable person would do.[37] Consequently, the taxpayers were liable for the negligence penalty for both years.

Conversely, a court may rule in favor of the taxpayer when the taxpayer makes a good faith effort at recordkeeping. For example, in *Irving v. Commissioner*, the Tax Court sustained the IRS's denial of most Schedule C expenses for a school uniform embroidery business because the taxpayers, a husband and wife, could not substantiate the expenses.[38] A computer malfunction destroyed the electronic records and the couple destroyed the paper records when they abandoned the business.[39] The Tax Court, nonetheless, dismissed the penalty because the couple had acted with reasonable cause and in good faith by using software to contemporaneously maintain the records, employing a bookkeeper, asking a friend to help prepare their returns, and cooperating with the IRS during the audit.[40]

Other Factors as Reasonable Cause

Tax Sophistication of the Taxpayer

For taxpayers with special knowledge or experience in tax law, the courts sustained the penalty because the taxpayers should have known better. For example, courts held that taxpayers sophisticated in tax matters lacked reasonable cause and did not act in good faith in the following instances:

- A former accounting firm tax manager and former 17-year IRS employee whose last position was as a large case manager did not substantiate the purchase price and ownership for deducting depreciation and first year expensing on equipment that his brother used in a podiatry business.[41]
- A certified financial planner failed to report income and reported $250,000 in unsubstantiated business expenses.[42]
- A Ph.D. professor in a rental property partnership with his brother, a full-time IRS examiner with an MBA degree, submitted non-credible and changing diaries in an un-

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35 *Hartsock v. Comm'r*, T.C. Memo. 2006-205, *appeal docketed*, No. 07-1217 (4th Cir. Mar. 6, 2007).

36 *Hartsock v. Comm'r*, T.C. Memo. 2006-205 (*citing* Treas. Reg. § 1.6662-3(b)(1) and *Magnon v. Comm'r*, 73 T.C. 980, 1008 (1980)), *appeal docketed*, No. 07-1217 (4th Cir. Mar. 6, 2007).

37 *Hartsock v. Comm'r*, T.C. Memo. 2006-205, *appeal docketed*, No. 07-1217 (4th Cir. Mar. 6, 2007).

38 *Irving v. Comm'r*, T.C. Memo. 2006-169.

39 *Id.*

40 *Id.*

41 *Karason v. Comm'r*, T.C. Memo. 2007-103.

42 *Lam v. Comm'r*, T.C. Memo. 2006-265.

successful attempt to show that they worked the hours necessary to convert the passive activity into an active and deductible rental loss.[43]

- A full-time (2,800 to 3,100 hours per year) CPA and practicing attorney, who represented clients before the IRS, was wrong to characterize and deduct his own hobby losses from his family farm as Schedule F active farming losses when he did not have an honest objective to make a profit.[44]

In contrast, taxpayers without specialized tax knowledge achieved better results. For example, in two cases, unsophisticated taxpayers underreported the tax arising from their exercise of stock options.[45] Though the courts upheld the deficiencies, they did not sustain the IRS's penalty determinations, finding that the taxpayers had reasonable cause because they did not have experience in tax law, they relied on counsel, and the issues were complex.[46]

Complex and Novel Issues Were Reasonable Cause

The courts found reasonable cause to dismiss the penalty when taxpayers litigated a complex or novel issue. For example, a court sustained the IRS's determination that a widow owed the ten percent additional tax pursuant to IRC § 72(t) for a premature distribution of IRA money that four years earlier, she had inherited from her deceased husband's account and rolled over into her own IRA account.[47] However, the Tax Court dismissed the penalty for a substantial understatement because the post-death distribution matter was novel, noting that judicial precedent does not impose a penalty on *bona fide* legal issues of first impression.[48]

Likewise, the Tax Court sustained the IRS's determination that a telecommunications company co-founder and his wife owed additional income tax and Alternative Minimum Tax (AMT) from the exercise of stock options worth more than $100,000.[49] The Tax Court nonetheless dismissed the penalty for a substantial understatement and gave the following rationale: "Considering that the complex issues underlying the deficiency in this case had yet to be litigated at the time petitioners filed their return for 2000, we are persuaded that petitioners had reasonable cause."[50]

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43 *Lee v. Comm'r*, T.C. Memo. 2006-193.

44 *Mitchell v. Comm'r*, T.C. Memo. 2006-145.

45 *Racine v. Comm'r*, T.C. Memo. 2006-162, *aff'd on other grounds*, 493 F.3d 777 (7th Cir. 2007); *Spitz v. Comm'r*, T.C. Memo. 2006-168, *appeal docketed*, No. 07-71889 (9th Cir. May 4, 2007).

46 *Racine v. Comm'r*, T.C. Memo. 2006-162, *aff'd on other grounds*, 493 F.3d 777 (7th Cir. 2007); *Spitz v. Comm'r*, T.C. Memo. 2006-168, *appeal docketed*, No. 07-71889 (9th Cir. May 4, 2007).

47 *Gee v. Comm'r*, 127 T.C. 1 (2006).

48 *Gee v. Comm'r*, 127 T.C. 1, 6 (2006) (*quoting Hitchins v. Comm'r*, 103 T.C. 711, 719-20 (1994)).

49 *Montgomery v. Comm'r*, 127 T.C. 43 (2006), *appeal docketed*, No. 07-70983 (9th Cir. Mar. 8, 2007).

50 *Id.* at 67.

Bad Faith by Taxpayers Who Deducted Personal Expenses

Courts sustained the penalty in some instances where a taxpayer deducted personal expenses. For example, a married couple filed a return with unsubstantiated deductions from the wife's medical practice claimed on Schedule C and improper itemized deductions for personal medical expenses.[51] The Tax Court dismissed the penalty related to the Schedule C unsubstantiated deductions because of reasonable cause; the wife relied on a competent enrolled agent to prepare the return, and the agent inadvertently lost the records.[52] However, the Tax Court sustained the penalty on deductions for personal medical expenses because the husband's medical insurance had reimbursed some of the expenses, and other expenses were personal in nature, *i.e.*, the couple had included the cost of vitamins, nonprescription drugs, and cosmetic procedures.[53]

Conclusion

In the 75 litigated cases reviewed for this report, the courts often sustained the IRS's determination of a deficiency or a portion of the deficiency. However, the mere fact that the courts held against taxpayers on the substantive issues did not require the courts to hold for the IRS on the penalties. This result is evidenced by the courts dismissing or reducing the penalty in more than one-third of the cases. Further, taxpayers who had representation were twice as successful in contesting the penalty as were those who were *pro se*.

The results indicate that courts are willing to find reasonable cause where taxpayers make a legitimate effort to determine the correct amount of tax, even though the taxpayers were usually wrong on the underlying tax issue. In determining reasonable cause, the preeminent factors were whether the taxpayer relied on a competent tax professional and whether the taxpayer had adequate records for claimed deductions. Courts also assessed the sophistication of the taxpayers' tax knowledge, the novelty and complexity of the substantive legal issues, and whether the taxpayers claimed personal expenses.

The IRS should review the cases where the courts did not sustain the penalty and incorporate the courts' analyses into training for its agents. Thereafter, when cases go to trial on a substantive underlying matter, the penalty might not be at issue, thereby lessening the burden on taxpayers, the government, and the courts.

51 *Davis v. Comm'r*, T.C. Memo. 2006-272.

52 *Id.*

53 *Id.*

MLI #9

Relief From Joint And Several Liability Under Internal Revenue Code Section 6015

Summary

Married persons may elect to file their federal income tax returns jointly or separately. Spouses filing joint returns are jointly and severally liable for any deficiency[1] or tax due. Joint and several liability enables the IRS to collect the entire amount due from either taxpayer.

Internal Revenue Code (IRC) § 6015 provides three avenues for relief from joint and several liability. Section 6015(b) provides "traditional" relief for deficiencies. Section 6015(c) provides relief for deficiencies for certain spouses who are divorced, separated, widowed, or not living together by allocating the liability between each spouse. Section 6015(f) provides "equitable" relief from both deficiencies and underpayments, but only applies if a taxpayer is not eligible for relief under § 6015(b) or (c). A taxpayer generally files Form 8857, Request for Innocent Spouse Relief, to request relief.

We reviewed 46 federal court opinions involving relief under § 6015 that were issued between June 1, 2006, and May 31, 2007. The jurisdiction of the court and the taxpayer's knowledge were frequent subjects of litigation. In December 2006, Congress enacted legislation[2] proposed by the National Taxpayer Advocate in the 2001 Annual Report,[3] providing that the U.S. Tax Court has jurisdiction in stand-alone cases[4] to review § 6015(f) determinations where no deficiency had been asserted. The National Taxpayer Advocate has also recommended eliminating joint and several liability and the consequent need to inquire about one spouse's knowledge.[5]

Present Law

Traditional Innocent Spouse Relief Under IRC § 6015(b)

IRC § 6015(b) provides full or partial relief from joint and several liability if the requesting spouse can demonstrate that:

1. A joint return was filed;

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1 IRC § 6013(d)(3). We use the terms "deficiency" and "understatement" interchangeably for purposes of this discussion and the case table in Appendix III.

2 Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432 § 408, 120 Stat. 2922, 3061 (2006).

3 *See* National Taxpayer Advocate 2001 Annual Report to Congress 159-165.

4 The filing of a Tax Court petition in response to the final notice of determination or after the claim is pending for six months is often referred to as a stand-alone proceeding because jurisdiction is predicated on § 6015(e) and not deficiency jurisdiction under § 6213.

5 *See* National Taxpayer Advocate 2001 Annual Report to Congress 129-145; National Taxpayer Advocate 2005 Annual Report to Congress 407 (Key Legislative Recommendation: Another Marriage Penalty: Taxing the Wrong Spouse).

2. There was an understatement of tax[6] attributable to erroneous items[7] of the nonrequesting spouse;
3. Upon signing the return, the requesting spouse did not know or have reason to know of the understatement;
4. Taking into account all the facts and circumstances, it is inequitable to hold the requesting spouse liable; and
5. The requesting spouse elected relief within two years after the IRS began collection activities[8] with respect to him or her.

Allocation of Liability Under IRC § 6015(c)

IRC § 6015(c) relieves the requesting spouse of liability for deficiencies allocable to the nonrequesting spouse. To obtain relief under this section, the requesting spouse must demonstrate that:

1. A joint return was filed;
2. At the time relief is elected, the joint filers are unmarried, legally separated, widowed, or have not lived in the same household for the 12 months immediately preceding the election; and
3. The election was made within two years after the IRS began collection activities with respect to him or her.

This election allocates to each joint filer that portion of the deficiency on the joint return attributable to each joint filer as calculated under the allocation provisions of § 6015(d).

A taxpayer is ineligible to make an election under § 6015(c) if the IRS demonstrates that, at the time the return was signed, the requesting taxpayer had "actual knowledge" of any item giving rise to the deficiency. Additionally, relief is denied for amounts attributable to fraud, fraudulent schemes, or certain transfers of disqualified assets.[9]

6 There is an understatement of tax when the amount of tax required to be shown on the return is greater than the amount of tax actually shown on the return. *See* IRC §§ 6015(b)(3); 6662(d)(2)(A).

7 An erroneous item is any income, deduction, credit, or basis that is omitted from or incorrectly reported on the joint return. *See* Treas. Reg. § 1.6015-1(h)(4).

8 Not all actions that involve collection will trigger the two-year limitations period. Under the regulations, only the following four events constitute "collection activity" that will commence the two-year period: (1) a § 6330 notice, which notifies a taxpayer of the IRS's intent to levy and the taxpayer's right to a collection due process hearing; (2) an offset of an overpayment of the requesting spouse against a liability under § 6402; (3) the filing of a suit by the United States against the requesting spouse for the collection of the joint tax liability; and (4) the filing of a claim by the United States in a court proceeding in which the requesting spouse is a party or which involves property of the requesting spouse. Treas. Reg. § 1.6015-5(b)(2).

9 IRC §§ 6015(c)(4); 6015(d)(3)(C).

Equitable Relief Under IRC § 6015(f)

IRC § 6015(f) provides equitable relief from both understatements and underpayments[10] for taxpayers who can demonstrate that:

1. Relief under § 6015(b) or (c) is unavailable;
2. Taking into account all the facts and circumstances, it would be inequitable to hold the taxpayer liable for the underpayment or deficiency; and
3. The election was made within two years after the IRS began collection activities[11] with respect to him or her.

Revenue Procedure 2003-61 lists some of the factors considered by the IRS in determining whether equitable relief is appropriate.[12] These factors include marital status, economic hardship, knowledge or reason to know, legal obligations of the nonrequesting spouse, significant benefit to the requesting spouse, compliance with income tax laws, and spousal abuse. Unlike §§ 6015(b) and (c), which relieve taxpayers from deficiencies in tax, equitable relief under § 6015(f) is available for both deficiencies and underpayments.

Judicial Review

Taxpayers seeking relief under § 6015 generally file Form 8857, Request for Innocent Spouse Relief. The IRS revised Form 8857 in June 2007 to reduce taxpayer mistakes and speed processing.[13] After reviewing the request, the IRS issues a final notice of determination, granting or denying relief in whole or in part. The taxpayer has 90 days from the date the IRS mails the final notice of determination to file a petition with the Tax Court.[14] The taxpayer may also petition the Tax Court if he or she does not receive a final notice of determination within six months of filing Form 8857.[15] The taxpayer may also raise relief from joint and several liability in a Collection Due Process hearing,[16] a deficiency proceeding,[17] a bankruptcy proceeding,[18] or a refund suit.[19]

10 There is an underpayment of tax when the tax is properly shown on the return but is not paid. *Washington v. Commissioner*, 120 T.C. 137, 158-59 (2003).

11 Treas. Reg. § 1.6015-5(b). *See* Footnote 8 for a discussion of what constitutes "collection activity" under § 6015.

12 Rev. Proc. 2003-61, 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1 C.B. 447.

13 *See* IRS Form 8857, *Request for Innocent Spouse Relief, Instructions* (June 2007).

14 IRC § 6015(e)(1)(A)(ii).

15 IRC § 6015(e)(1)(A)(i)(II).

16 IRC §§ 6320(c); 6330(c)(2)(A)(i).

17 IRC § 6213; *Corson v. Comm'r*, 114 T.C. 354, 363 (2000).

18 11 U.S.C.A. § 505(a)(1).

19 IRC § 7422. The issue of whether relief from joint and several liability can be raised as a defense in a suit under § 7402 to reduce a liability to judgment or a suit under § 7403 to foreclose a tax lien remains unclear, as will be discussed later. The National Taxpayer Advocate has proposed legislation in this report to clarify that relief under § 6015 or § 66 may be raised as a defense in such proceedings. *See* Additional Legislative Recommendation, *Allow Taxpayers to Raise Relief under IRC §§ 6015 and 66 as a Defense in Collection Actions*, *supra*.

Analysis Of Litigated Cases

We analyzed 46 opinions issued between June 1, 2006, and May 31, 2007. Forty-three cases were decided in the Tax Court, one was decided in the United States Court of Appeals for the Ninth Circuit, and two were decided in United States District Courts. Seventy percent of the cases (32 of 46) were decided in favor of the IRS, and 30 percent (14 of 46) in favor of the taxpayer. In about 54 percent (25 of 46) of the cases, the taxpayers were *pro se* (*i.e.*, they represented themselves). The nonrequesting spouse intervened[20] in approximately 28 percent of the cases (13 of 46).

Only about 57 percent of the cases (26 of the 46) involved an analysis of whether to grant relief. The other 43 percent (20 cases) involved procedural issues. Of the cases involving procedural issues, 85 percent (17 of 20) were decided in favor of the IRS and 15 percent (three of 20) in favor of the taxpayer (including two cases where only the intervenor opposed granting relief and was dismissed for failure to prosecute the claims or defenses he may have had). Twelve of the 17 procedural cases decided in the IRS's favor involved the Tax Court's jurisdiction over claims for relief under § 6015(f) in which no deficiency had been asserted. As discussed in more detail below, after these decisions were rendered, the Tax Relief and Health Care Act of 2006 (TRHCA)[21] amended § 6015(e)(1) to provide that the Tax Court has jurisdiction over such cases.

Of the 26 cases decided on the merits, 58 percent (15 of 26) were decided in favor of the IRS, and 42 percent (11 of 26) in favor of the taxpayer (including two cases where only the intervenor opposed granting relief). See Table 9 in Appendix lll for a detailed breakdown of the decided cases.

Procedural Issues

Uncertainty associated with procedural issues was a significant subject of litigation. As noted above, 43 percent of the cases involved procedural issues such as whether the court had jurisdiction,[22] whether the taxpayer properly requested relief,[23] and whether *res judicata*[24]

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20 When the requesting spouse files a Tax Court petition seeking § 6015 relief, the IRS must notify the nonrequesting spouse of the action and the right to become a party to the case. T.C. Rule 325. The nonrequesting spouse may then intervene by filing a "notice of intervention" with the Tax Court. T.C. Rule 325.

21 Pub. L. No. 109-432 § 408, 120 Stat. 2922, 3061 (2006).

22 *See, e.g., Billings v. Comm'r*, 127 T.C. 7 (2006), *appeal docketed*, No. 06-9006 (10th Cir. Oct. 27, 2006), *appeal vacated and case remanded* (June 14, 2007), *ruling for taxpayer on remand*, T.C. Memo. 2007-234 (no jurisdiction to review stand-alone IRC § 6015(f) case where IRS had not asserted a deficiency); *United States v. Cawog*, 97 A.F.T.R.2d (RIA) 3069 (W.D. Pa. 2006), *appeal dismissed* (3d Cir. July 5, 2007) (jurisdiction over § 6015 determination lies with the Tax Court, not United States District Court).

23 *See, e.g., United States v. Boynton*, 99 A.F.T.R.2d (RIA) 920 (S.D. Cal. 2007) (district court not the proper forum to apply for relief when not requested administratively first); *Glenn v. Comm'r*, T.C. Summ. Op. 2007-14 (no jurisdiction because petition was not timely filed).

24 IRC § 6015(g)(2) provides that if a court, in a final decision, either considered whether to grant the requesting spouse relief from joint liability and decided not to do so or did not consider whether to grant a requesting spouse relief from joint liability but the requesting spouse meaningfully participated in the proceeding and could have asked for relief, such decision shall be conclusive.

barred the request for relief.[25] The most important procedural issue, addressed in 12 of the 20 procedural cases, involved whether the Tax Court had jurisdiction to review § 6015(f) determinations in stand-alone cases when no deficiency had been asserted. The Tax Court issued two precedential opinions involving procedural issues.

Billings v. Commissioner[26]

In March 2001, the taxpayer filed an amended joint return for 1999 reporting income embezzled by his spouse. The amended return also reflected a substantial increase in the tax due, but the additional tax was not paid. The taxpayer sought relief from the unpaid tax liability under IRC § 6015(f). The IRS denied relief in November 2002, and the taxpayer petitioned the Tax Court.

Following the Ninth Circuit's holding in *Ewing v. Commissioner*[27] and the Eighth Circuit's holding in *Bartman v. Commissioner*,[28] the Tax Court overruled its own prior decision in *Ewing v. Commissioner*[29] and held that the Tax Court has no jurisdiction to review a § 6015(f) determination in a stand-alone proceeding where no deficiency has been asserted. The Tax Court based its decision in *Billings* on the language in § 6015(e)(1) that provides for Tax Court jurisdiction "[i]n the case of an individual against whom a deficiency has been asserted." The court characterized such language as a "clear, though perhaps inadvertent, deprivation of our jurisdiction over nondeficiency stand-alone petitions."[30]

In response to these decisions, Congress enacted legislation proposed earlier by the National Taxpayer Advocate,[31] granting the Tax Court jurisdiction to review § 6015(f) determinations in stand-alone cases where no deficiency has been asserted.[32] Specifically, the TRHCA[33] amended § 6015(e)(1) to provide for Tax Court review "[i]n the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply, *or in the case of an individual who requests equitable relief under subsection (f)*" (emphasis added). The amendment applies only with respect to liability for taxes aris-

25 *See Huynh v. Comm'r*, T.C. Memo. 2006-180, *appeal docketed*, No. 06-9006 (9th Cir. Dec. 18, 2006) (petitioner not eligible for relief, per IRC § 6015(g)(2) *res judicata* exception, because petitioner "meaningfully participated" in a prior proceeding); *Lincir v. Comm'r*, T.C. Memo. 2007-86 (petitioner denied summary judgment on issue of whether *res judicata* barred current proceeding because of stipulated concession that she meaningfully participated in prior proceeding).

26 127 T.C. 7 (2006), *appeal docketed*, No. 06-9006 (10th Cir. Oct. 27, 2006), *appeal vacated and case remanded* (June 14, 2007), *ruling for taxpayer on remand*, T.C. Memo. 2007-234.

27 439 F.3d 1009 (9th Cir. 2006), *rev'g Ewing v. Comm'r*, 118 T.C. 494 (2002).

28 446 F.3d 785 (8th Cir. 2006).

29 118 T.C. 494 (2002).

30 *Billings v. Comm'r,* 127 T.C. at 17.

31 *See* National Taxpayer Advocate 2001 Annual Report to Congress 159-165.

32 TRHCA also modified IRC § 6015(e)(1)(B), the provision regarding collection restrictions, to include § 6015(f) claims. As a result, the IRS is now prohibited by law from pursuing certain collection activity against taxpayers who request relief only under § 6015(f), and the statute of limitations on collection is likewise suspended while the collection restrictions remain in effect. If, however, a § 6015 claim was filed before the December 20, 2006 effective date of the amendment, the statute of limitations on collection will be suspended beginning on December 20, 2006, and not from the date the claim was originally filed. Notice CC-2007-13 (June 8, 2007).

33 Pub. L. No. 109-432 § 408, 120 Stat. 2922, 3061 (2006).

ing or remaining unpaid on or after December 20, 2006. The Tax Court therefore cannot hear appeals from § 6015(f) determinations where the liability arose and was paid before December 20, 2006.[34]

United States v. Boynton[35]

In *United States v. Boynton*,[36] the United States filed suit under § 7402 seeking to reduce to judgment the taxpayer's joint income tax liability. The taxpayer raised as her only defense her entitlement to relief under § 6015. The district court, relying on *United States v. Feda*,[37] granted summary judgment in favor of the United States holding that the district court only has jurisdiction to consider a § 6015 claim in the context of a refund suit and that exclusive jurisdiction lies with the Tax Court in all other circumstances. The Tax Court, however, has taken a different view. In *Thurner v. Commissioner*,[38] it held that *res judicata* barred the taxpayer from raising § 6015 as a defense in the Tax Court proceeding because the taxpayer could have raised § 6015 as a defense in a prior collection suit.

United States. v. Cawog[39]

In general, a taxpayer can raise the merits of the underlying tax in a suit to foreclose tax liens on real property commenced under § 7403.[40] In *United States v. Cawog*,[41] however, the court held that exclusive jurisdiction to review a § 6015 determination lies with the Tax Court, and it did not allow the taxpayer to raise this defense in the collection suit.[42]

Kovitch v. Commissioner[43]

The taxpayer and her husband filed a joint return for tax year 2002, but subsequently divorced. In 2005, the IRS issued a notice of deficiency to both former spouses. The taxpayer filed a Tax Court petition, raising only the issue of whether she was entitled to relief under § 6015. Her ex-husband intervened in the Tax Court proceeding, and shortly thereafter filed bankruptcy. The court questioned whether the automatic stay provisions of § 362 of the Bankruptcy Code prohibited the Tax Court case from proceeding.

Once a bankruptcy petition is filed, the automatic stay generally bars any Tax Court proceedings "concerning the debtor."[44] The Tax Court determined the Tax Court proceeding

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34 *See Bock v. Comm'r*, T.C. Memo. 2007-41; *Smith v. Comm'r*, T.C. Memo. 2007-117. *See also* Notice CC- 2007-13 (June 8, 2007) which provides procedures for Chief Counsel attorneys handling cases impacted by the new legislation.

35 99 A.F.T.R.2d (RIA) 920 (S.D. Cal. 2007).

36 *Id.*

37 97 A.F.T.R.2d (RIA) 1985 (N.D. Ill. 2006).

38 121 T.C. 43 (2003).

39 97 A.F.T.R.2d (RIA) 3069 (W.D. Pa. 2006), *appeal dismissed* (3d Cir. July 5, 2007).

40 *United States v. O'Connor*, 291 F.2d 520, 526-27 (2d Cir. 1961).

41 97 A.F.T.R.2d (RIA) 3069 (W.D. Pa. 2006), *appeal dismissed* (3d Cir. July 5, 2007).

42 The court did, however, state that if it had jurisdiction, it would have denied the taxpayer's request for § 6015 relief.

43 128 T.C. 108 (2007).

44 11 U.S.C.A. § 362(a).

regarding the taxpayer's entitlement to § 6015 relief would not affect the debtor/former spouse's tax liability as he would remain liable for the tax whether or not relief was granted. The Tax Court, therefore, held the § 6015 proceeding was not a proceeding "concerning the debtor" and the automatic stay did not preclude either the court from determining whether the taxpayer was entitled to § 6015 relief or the debtor/former spouse from intervening in the proceeding.

Review on the Merits

While the courts considered many factors in determining the appropriateness of relief on the merits under § 6015, the most significant was whether the requesting taxpayer had actual or constructive knowledge of the tax deficiency. All three avenues for relief contain a knowledge element or factor, making it the linchpin in most of the courts' analyses.[45] Actual or constructive knowledge was a factor in all but two of the 26 decisions on the merits.[46] The National Taxpayer Advocate has proposed legislation that would reduce or eliminate the need for innocent spouse relief as well as any inquiry into a spouse's knowledge, and would tax each spouse on only his or her own income.[47]

Notably, the requesting spouse prevailed in 42 percent of the cases decided on the merits. This represents a sizeable increase from the prior year period in which 18 percent of cases decided on the merits were in favor of the requesting spouse.[48] The requesting spouses' success rate on the merits of the cases included in this year's review is also much higher than that seen in other most litigated issues. For example, taxpayers prevailed in only approximately seven percent of collection due process cases decided between June 1, 2005 and May 31, 2006 (and discussed in last year's report).[49] Given the high rate of taxpayers succeeding on the merits, the National Taxpayer Advocate recommends that the IRS examine the analysis of IRC § 6015 cases and provide better training to the employees working such cases. The National Taxpayer Advocate will work with the IRS to improve training in this area.

Conclusion

The passage of the TRHCA amendments, which provided the Tax Court with jurisdiction in stand-alone cases to review IRC § 6015(f) determinations where no deficiency has been asserted, will likely decrease the amount of litigation regarding procedural issues in this area. Nonetheless, the cases reviewed for this report suggest that determining what a taxpayer

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45 *See* IRC §§ 6015(b)(1)(C); 6015(c)(3)(C); Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.02(1)(b), § 4.03(2)(a)(iii).

46 *See Goode-Parker v. Comm'r,* T.C. Summ. Op. 2007-40 (failure to add the lines for income tax and employment tax due did not constitute a math error, and the liability thus was not an understatement or deficiency); *Lipton v. Comm'r*, T.C. Summ. Op. 2007-36 (denying § 6015 relief because petitioner's bigamous marriage did not entitle her to file a joint return).

47 National Taxpayer Advocate 2005 Annual Report to Congress 407 (Key Legislative Recommendation: Another Marriage Penalty: Taxing the Wrong Spouse).

48 National Taxpayer Advocate 2006 Annual Report to Congress 617 (Most Litigated Issue: Relief from Joint and Several Liability under IRC § 6015).

49 National Taxpayer Advocate 2006 Annual Report to Congress 560 (Most Litigated Issue: Appeals from Collection Due Process (CDP) Hearings under IRC §§ 6320 and 6330).

knew or should have known is a difficult analysis, for which better training of IRS employees is needed, and one that will continue to generate a significant amount of controversy unless the need for it is eliminated by legislation.

MLI #10

Family Status Issues Under Internal Revenue Code Sections 2, 24, 32, and 151

Summary

Family status issues involve exemptions, credits, and filing status claimed by taxpayers on their federal income tax returns. Litigated cases often involve multiple family status issues with similar factual determinations. This discussion includes the following issues in the "family status" category:

- Head of household filing status;[1]
- Child tax credit;[2]
- Earned Income Tax Credit (EITC);[3] and
- Dependency exemption.[4]

We reviewed 41 federal court opinions issued between June 1, 2006, and May 31, 2007. More than two-thirds of these cases dealt with multiple family status issues, with the determination of one issue often affecting others. For example, a denial of the dependency exemption will result in the summary denial of the child tax credit and may jeopardize eligibility for head of household filing status.

Present Law

Uniform Definition of Qualifying Child

Prior to 2005, there were multiple definitions of a "child" for purposes of the most basic provisions of the Internal Revenue Code (IRC).[5] These family status provisions potentially affect 81 million taxpayers and 79 million children.[6] Effective for tax years after December 31, 2004, the Working Families Tax Relief Act (WFTRA)[7] established a Uniform Definition of Qualifying Child (UDOC) with respect to five family status provisions: head of

1 IRC § 2(b).

2 IRC § 24.

3 IRC § 32.

4 IRC § 151.

5 *E.g.*, IRC § 2(b) (head of household); IRC § 21 (child and dependent care credit); IRC § 24 (child tax credit); IRC § 32 (EITC); IRC § 151 (dependency exemption); National Taxpayer Advocate 2001 Annual Report to Congress 76; IRC § 7703(b) provides an exception to the general determination of whether an individual is married and states that certain married persons who are living apart from their spouses may be treated as unmarried. Although the new uniform definition did not alter the rules in § 7703(b), there is a proposal in the 2008 budget that will improve upon the current rules. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals* (Feb. 2007), 51-54.

6 IRS Compliance Data Warehouse, *Tax Year 2004 Individual Return Transaction File.*

7 The Working Families Tax Relief Act, Pub. L. No. 108-311, § 201, 118 Stat. 1166, 1169 (2004).

household filing status, the child tax credit, the child and dependent care credit,[8] the Earned Income Tax Credit (EITC), and the dependency exemption.[9] The effect of the UDOC legislation was to bring about some uniformity for the vast majority of taxpayers who had to meet multiple tests to determine whether they were eligible to claim an exemption, credit, or filing status under the basic family status provisions.[10] Under UDOC, a dependent must be either a "qualifying child" or a "qualifying relative."[11] The other family status provisions incorporate the definition of a qualifying child, but retain rules specific to each code section (such as age and income restrictions). Because family status is by definition complex and often in flux, these cases are inherently difficult. Thus, UDOC is only the beginning of true reform.[12]

Qualifying Child

In general, four tests must be met to claim someone as a qualifying child under UDOC.

1. **Relationship Test.** The child must be the taxpayer's child (including an adopted child, stepchild, or eligible foster child), brother, sister, stepbrother, stepsister, or descendent of one of these relatives. An adopted child includes a child lawfully placed with a taxpayer for legal adoption, even if the adoption is not final. An eligible foster child is any child placed with a taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.[13]
2. **Residency Test.** The child must live with the taxpayer for more than half of the tax year. Exceptions apply for temporary absences for special circumstances: children who were born or died during the year, children of divorced or separated parents, and kidnapped children.[14]
3. **Age Test.** The child must be under a certain age, depending on the tax benefit claimed.[15]
4. **Support Test.** The child cannot provide more than half of his or her own support during the year.[16]

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8 The child and dependent care credit will not be discussed as we only located two cases dealing with this provision during the June 1, 2006, through May 31, 2007, reporting period.

9 Furthermore, UDOC applies to determining whether a taxpayer qualifies for an income inclusion under § 129.

10 Nina E. Olson, *Uniform Qualifying Child Definition: Uniformity for Most Taxpayers*, 111 Tax Notes 225 (Apr. 10, 2006). *See also* National Taxpayer Advocate, 2006 Annual Report to Congress, vol. 1 at 463 (Key Legislative Recommendation, *Uniform Definition of Qualifying Child*).

11 IRC § 152(a).

12 *See* National Taxpayer Advocate 2005 Annual Report to Congress 397 for a legislative recommendation proposing additional reforms to family status provisions under the Code.

13 IRC §§ 152(c)(1)(A); 152(c)(2); 152(f)(1).

14 IRC §§ 152(c)(1)(B); 152(f)(6); Treas. Reg. § 1.152-2(a)(2)(ii).

15 IRC § 152(c)(1)(C).

16 IRC § 152(c)(1)(D).

Qualifying Relative

If an individual does not meet the requirements of a qualifying child, he or she may be claimed as a dependent if the individual meets the requirements of a qualifying relative. In general, the taxpayer must meet four tests to claim someone as a qualifying relative.

1. **Relationship Test.** The individual must be a child or a descendant of a child; a brother, sister, stepbrother, or stepsister; the father or mother, or an ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister of the taxpayer; a brother or sister of the father or mother of the taxpayer; a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or an individual (other than the spouse) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.[17]
2. **Gross Income Test.** A qualifying relative must have gross income below the exemption amount for the taxable year.[18]
3. **Support Test.** The taxpayer must provide more than one-half of the individual's support for the calendar year in which the taxable year begins.[19]
4. **Not a Qualifying Child.** A qualifying relative may not be a qualifying child of such taxpayer or of any other taxpayer for any taxable year beginning in the calendar year in which the taxable year begins.[20]

Tie-Breaker Rule

Sometimes a child meets the tests to be a qualifying child for more than one person. However, only one taxpayer can claim the child as a qualifying child. If multiple taxpayers meet the test with respect to the same qualifying child, they may decide among themselves who will claim the child. If they cannot agree and more than one taxpayer files a return claiming the same child, the IRS will use the tie-breaker rules explained in the table below to determine which taxpayer will be allowed to claim the child.[21] In the past, these tie-breaker rules applied only to a qualifying child for the EITC. Since 2005, these rules have applied to the five family status provisions explained earlier. Generally, the same taxpayer is entitled to all of the applicable family status benefits with respect to the same qualifying child – or to put it another way, taxpayers generally may not "split the baby" and divide the family status benefits among themselves.[22]

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17 IRC §§ 152(d)(1)(A); 152(d)(2). However, IRC § 152(f)(3) provides that an individual shall not be treated as a member of the taxpayer's household if at any time during the taxable year the relationship between such individual and the taxpayer is in violation of local law.

18 IRC § 152(d)(1)(B).

19 IRC § 152(d)(1)(C).

20 IRC § 152(d)(1)(D).

21 IRC § 152(c)(4).

22 *See* Notice 2006-86, 2006-41 I.R.B. 680. This notice provides interim guidance to clarify the rule under § 152(c)(4), as amended by WFTRA, for determining which taxpayer may claim a qualifying child when two or more taxpayers claim the same child, and discusses the § 152(e) exception to the prohibition against "splitting the baby" which is only available for divorced or separated parents.

TABLE 3.10.1, Tie-Breaker Rule
When More Than One Person Files a Return Claiming the Same Qualifying Child

IF. . .	THEN the child will be treated as the qualifying child of the. . .
Only one of the persons is the child's parent,	Parent.
Both persons are the child's parent,	Parent with whom the child lived for the longer period of time. If the child lived with each parent for the same amount of time, then the child will be treated as the qualifying child of the parent with the highest adjusted gross income (AGI).
None of the persons is the child's parent,	Person with the highest AGI.

Special Rule for Divorced or Separated Parents

A child will be treated as the qualifying child or qualifying relative of his or her noncustodial parent if all the following apply:

- The parents are divorced or legally separated or lived apart at all times during the last six months of the year;
- The child received over half of his or her support from the parents;
- The child is in custody of one or both parents for more than half the year; and
- The custodial parent releases the claim to the dependency exemption in a written declaration that the noncustodial parent attaches to the noncustodial parent's tax return.[23]

A custodial parent is the parent having custody of the child for the greater part of the calendar year.[24] The noncustodial parent is the parent who is not the custodial parent.[25] The special rule for divorced or separated parents allows the noncustodial parent to claim the dependency exemption and child tax credit; it does not allow the noncustodial parent to claim head of household filing status, the credit for child and dependent care expenses, or the EITC.

Furthermore, the statute does not define "custody." When a child resides with one parent for part of the day and the other parent for rest of the day, it can be difficult to calculate how much time is spent in the custody of each parent. Proposed regulations published on May 2, 2007 provide guidance on how to calculate the time spent by each parent in these circumstances. Under the proposed regulation, the custodial parent is the parent who resides with the child for the greater number of nights during the calendar year.[26] The proposed regulations also adopt the rule enunciated by the Tax Court in

23 IRC § 152(e); Notice 2006-86, 2006-41 I.R.B. 680. *See also* Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents (used to release the dependency exemption to the noncustodial parent). The custodial parent may, in lieu of using Form 8332, use a similar written statement that meets the requirements of the form. Proposed regulations were published on May 2, 2007, requiring that the declaration include an unconditional statement that the custodial parent will not claim the child as a dependent for the years covered by the declaration. Prop. Treas. Reg. § 1.152-4(d)(i), 72 Fed. Reg. 24,194 (May 2, 2007).

24 IRC § 152(e)(4)(A).

25 IRC § 152(e)(4)(B).

26 Prop. Treas. Reg. § 1.152-4(e)1, 72 Fed. Reg. 24,194 (May 2, 2007).

King v. Commissioner,[27] that the § 152(e) special rules for divorced or separated parents also apply to parents who were never married to each other.[28]

Analysis of Litigated Cases

The opinions discussed below were based on law in effect for tax years prior to the effective date of UDOC. There is no discussion of the UDOC or other novel issues of law in the cases examined for this report. The opinions discussed factual disputes and clarified misconceptions regarding the law. Therefore, the discussion focuses on typical contested issues rather than novel issues of law. A majority of the cases litigated during this period were small tax cases.[29]

Pro Se Analysis

Taxpayers were represented by counsel in only two of the 41 cases litigated this year. Because many of the cases were highly fact-specific and involved a complicated web of statutory provisions, the assistance of counsel might have made a difference in the outcome of these cases. A detailed listing of all family status cases analyzed appears in Table 10 in Appendix lll.

Head of Household Filing Status – IRC § 2(b)

We reviewed 15 cases involving head of household status during the reporting period, with only one taxpayer prevailing on his claim.[30]

In *Tarikh v. Commissioner*,[31] both the taxpayer and the mother of his children claimed their children as dependents on their respective 2003 income tax returns. The taxpayer also claimed head of household status for 2003. The couple was never married and did not live together during the year. The court, in citing to § 2(b), held the taxpayer was entitled to the head of household filing status because he maintained (for more than one-half of the taxable year) a household that served as the principal abode of the taxpayer's three children.[32] The court found credible evidence that the petitioner's children lived with their father for more than six months and he provided for the greater portion of their support during the year at issue.[33]

27 121 T.C. 245 (2003).

28 Prop. Treas. Reg. § 1.152-4(b)2(iii), 72 Fed. Reg. 24,194 (May 2, 2007).

29 In certain tax disputes before the United States Tax Court involving $50,000 or less, taxpayers may elect to have their case conducted under the simplified small tax case procedure. Trials in small tax cases generally are less formal and result in a speedier disposition. However, decisions entered pursuant to small tax case procedures may not be appealed or cited as precedent. *See* IRC § 7463.

30 *Tarikh v. Comm'r*, T.C. Summ. Op. 2007-12.

31 T.C. Summ. Op. 2007-12.

32 *Tarikh v. Comm'r*, T.C. Summ. Op. 2007-12 (*citing to* IRC § 2(b)(1)(A)(i)).

33 *Tarikh v. Comm'r*, T.C. Summ. Op. 2007-12.

Child Tax Credit – IRC § 24

We reviewed 23 cases involving the child tax credit. Before 2005, one of the requirements for a taxpayer to claim the child tax credit was for the taxpayer to be able to claim a dependency exemption for the child. Because qualifying for the dependency exemption was required to claim the child tax credit, the credit was often summarily denied where the dependency exemption was denied. In the two cases where the taxpayer prevailed, the U.S. Tax Court held the taxpayers were entitled to claim the child tax credit because they were entitled to dependency exemption deductions under § 151.[34]

Earned Income Tax Credit – IRC § 32

We analyzed 23 cases involving the EITC during the reporting period. The taxpayers prevailed in two of those cases.[35]

In *Rowe v. Commissioner*,[36] the taxpayer claimed the EITC for her two children. In June 2002, the taxpayer was arrested and charged with murder, and remained in jail for the duration of 2002 prior to and during trial. Upon the taxpayer's arrest, the children's father provided for their care. When the taxpayer was initially incarcerated, she received wages and other state benefits which she used to provide for her children's care. On July 2, 2002, however, the state of Oregon began providing these benefits directly to the children. The IRS issued a notice of deficiency claiming the taxpayer was not entitled to the EITC because she did not share the same principal place of abode with her children for more than half of 2002, due to her being incarcerated since June. The petitioner filed a Tax Court petition arguing that while she was arrested and physically separated from her children since June of 2002, she was in fact eligible to file for the EITC for her two children. The court applied the holding in *Hein v. Commissioner*, which stated that a taxpayer has changed abodes when the taxpayer has chosen a new abode.[37] Because the taxpayer did not choose to leave her children and she continued to financially provide for her children until July 2, the court found the taxpayer was eligible for the EITC.

The taxpayer in *Tarikh v. Commissioner*[38] lived with his children for seven months during the 2003 tax year. The IRS argued the taxpayer had not demonstrated that he spent the requisite six months or more sharing the same abode with his children and therefore was not entitled to the EITC. The Tax Court, however, found the evidence at trial established that the taxpayer resided with his children for seven months. As a result, the court found the taxpayer was entitled to the EITC.

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34 *Shinault v. Comm'r*, T.C. Memo. 2006-136; *Tarikh v. Comm'r*, T.C. Summ. Op. 2007-12.

35 *Rowe v. Comm'r*, 128 T.C. 13 (2007); *Tarikh v. Comm'r*, T.C. Summ. Op. 2007-12.

36 128 T.C. 13 (2007).

37 28 T.C. 826 (1957).

38 T.C. Summ. Op. 2007-12.

Dependency Exemption – IRC § 151

We analyzed 36 cases involving the dependency exemption, with taxpayers prevailing in only two of them.[39]

In *Tarikh v. Commissioner*,[40] the taxpayer claimed dependency exemptions for each of his three children. The IRS denied the taxpayer's right to the exemptions, arguing that he did not spend the requisite one-half of the tax year sharing an abode with his children. As discussed above, the IRS failed to provide evidence challenging the taxpayer's testimony that he lived with his children and provided their support for seven months in 2003. Accordingly, the Tax Court held in favor of the taxpayer.

In *Shinault v. Commissioner*,[41] the taxpayer filed for dependency exemptions for both his child and his wife, who was not employed during the taxable year. The taxpayer's wife did not file a tax return for 2000, and the IRS properly identified the taxpayer's filing status as married filing separately. The taxpayer argued that despite his status as married filing separately, he was entitled to claim both his son and his wife as dependents. Under § 151(b), a taxpayer may claim a spouse as a dependent "if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer."[42] The taxpayer testified credibly that his spouse had no income in 2000. Based on this testimony, the court upheld the petitioner's claim of an exemption for his wife in 2000.

Conclusion

Family status provisions are fundamental components of the tax code, yet they have complicated eligibility standards. Because of this complexity, tax filing can be a difficult and confusing exercise for low and middle income families. Taxpayers who wish to claim the family status credits and deductions often do not understand the qualification requirements or how to properly satisfy them. Further, such taxpayers often lack legal representation when they go before the courts, which may adversely affect the outcomes of their cases.

The changes to family status provisions made by the WFTRA may ease the burden of proving eligibility somewhat through UDOC. Before UDOC, there were multiple tests for each provision. Now, after UDOC, many taxpayers need only satisfy the qualifying child test and an age test to qualify for all provisions. UDOC replaced the support test with the residency test, which may be easier for a taxpayer to prove. The courts often looked to custody agreements, calendars or planners, and testimony as evidence of where the child resided

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39 *Shinault v. Comm'r*, T.C. Memo. 2006-136; *Tarikh v. Comm'r*, T.C. Summ. Op. 2007-12.

40 T.C. Summ. Op. 2007-12.

41 T.C. Summ. Op. 2006-136.

42 IRC § 151(b).

on various days. Because the family status provisions incorporating the uniform definition of child were not effective until tax year 2005, it may be another year or two before courts issue opinions involving these provisions.