INTRODUCTION: Most Litigated Issues

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

TAS identified the Most Litigated Issues (MLI) from June 1, 2014, through May 31, 2015, by using commercial legal research databases. For purposes of this section of the Annual Report, the term "litigated" means cases in which the court issued an opinion.[2] This year's MLI are:

- Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2);[3]
- Trade or Business Expenses Under IRC § 162 and Related Sections;
- Summons Enforcement Under IRC §§ 7602, 7604, and 7609;
- Gross Income Under IRC § 61 and Related Sections;
- Appeals from Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330;
- Failure to File Penalty Under IRC § 6651(a)(1), Failure to Pay an Amount Shown as Tax on Return Penalty Under IRC § 6651(a)(2), and Failure to Pay Estimated Tax Penalty Under IRC § 6654;
- Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403;
- Charitable Deductions Under IRC § 170;
- Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions; and
- Relief from Joint and Several Liability Under IRC § 6015.

All of these issues were identified as MLIs last year, with the exception of relief from joint and several liability for spouses.[4] This issue has appeared in previous MLI sections, most recently in 2013.[5] Accuracy-related penalties remained the top issue this year, although we identified 40 fewer cases than the 153 cases identified last year.[6] This works out to a 26 percent decrease, the largest drop in any category of cases. Summons enforcement cases experienced the second largest percentage decrease, as we identified 84 cases this year and 102 last year, an 18 percent decrease.[7] Cases involving civil actions to enforce federal tax liens or to subject property to payment of tax and trade or business expenses also decreased from previous

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

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

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

4 *See* National Taxpayer Advocate 2014 Annual Report to Congress 423.

5 *See* National Taxpayer Advocate 2013 Annual Report to Congress 322.

6 *See* National Taxpayer Advocate 2014 Annual Report to Congress 443.

7 *Id*. at 462.

year figures by 15 percent and 14 percent, respectively.[8] Overall, the total number of cases identified in the MLIs dropped from 731 in 2014 to 640 this year, a 12 percent decrease from last year and a 27 percent decrease from the 877 cases identified in 2013.[9] Although there has been a decline in the number of cases over the last two years, the relative percentage of cases involving *pro se* taxpayers has remained consistent, with 62 percent this year, as compared to the same percentage last year and 63 percent in 2013.[10]

Once TAS identified the MLI, we analyzed each one in five sections: summary of findings, taxpayer rights impacted, description of present law, analysis of the litigated cases, and conclusion. The taxpayer rights impacted section is new for the MLIs section this year and reflects the relevance of the Taxpayer Bill of Rights (TBOR), which was adopted by the IRS last year on the National Taxpayer Advocate's recommendation.[11] Each case is listed in Appendix 3, which categorizes the cases by type of taxpayer (*i.e.*, individual or business).[12] Appendix 3 also provides the citation for each case, indicates whether the taxpayer was represented at trial or argued the case *pro se* (*i.e.*, without representation), and lists the court's decision.[13]

We have also included a "Significant Cases" section summarizing decisions that are not among the top ten issues but are relevant to tax administration.[14] This year, the Significant Cases discussion includes two decisions issued by the Supreme Court that impact tax adminstration issues and a circuit court of appeals decision that directly affects TAS.[15]

AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

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

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

8 *See* National Taxpayer Advocate 2014 Annual Report to Congress 503; National Taxpayer Advocate 2014 Annual Report to Congress 453.

9 *Id*. at 425; National Taxpayer Advocate 2013 Annual Report to Congress 324.

10 *Id.*

11 *See* TBOR, *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights; National Taxpayer Advocate 2013 Annual Report to Congress 5 (Most Serious Problem: *Taxpayer Rights: The IRS Should Adopt a Taxpayer Bill of Rights as a Framework for Effective Tax Administration*).

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

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

14 Three of the cases discussed in the "Significant Cases" section of this report were decided outside the June 1, 2014, through May 31, 2015, period used to identify the ten most litigated issues, but we nonetheless have included these cases because of their impact on tax administration.

15 *King v. Burwell*, 135 S. Ct. 2480 (June 25, 2015), *aff'g* 759 F.3d 358 (4th Cir. 2014), *aff'g sub. nom. King v. Sebelius*, 997 F. Supp. 2d 415 (E.D. Va. 2014); *Obergefell v. Hodges*, 135 S. Ct. 2584 (June 26, 2015); *Rothkamm v. U.S.*, No. 14-31164, slip op. (5th Cir. 2015), — F.3d —, 116 A.F.T.R. 2d 2015-6198 (2015), *rev'g and remanding*, 114 A.F.T.R. 2d (RIA) 5997, 2014-2 U.S. Tax Cas. (CCH) P50,441 (M.D. La. 2014).

With limited exceptions, taxpayers have an automatic right of appeal from the decisions of any of these courts.[16]

The Tax Court is a "prepayment" forum. In other words, taxpayers can access the Tax Court without having to pay the disputed tax in advance. The Tax Court has jurisdiction over a variety of issues, including deficiencies, certain declaratory judgment actions, appeals from CDP hearings, relief from joint and several liability, and determination of employment status.[17]

The United States District Courts and the United States Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,[18] and (2) the taxpayer has filed an administrative claim for refund.[19] The United States District Courts, along with the bankruptcy courts in very limited circumstances, provide the only fora in which a taxpayer can receive a jury trial.[20] Bankruptcy courts can adjudicate tax matters that were not adjudicated prior to the initiation of a bankruptcy case.[21]

16 *See* IRC § 7482, which provides that the United States Courts of Appeals (other than the United States Court of Appeals for the Federal Circuit) have jurisdiction to review the decisions of the Tax Court. There are exceptions to this general rule. For example, IRC § 7463 provides special procedures for small Tax Court cases (where the amount of deficiency or claimed overpayment totals $50,000 or less) for which appellate review is not available. *See also* 28 U.S.C. § 1294 (appeals from a United States District Court are to the appropriate United States Court of Appeals); 28 U.S.C. § 1295 (appeals from the United States Court of Federal Claims are heard in the United States Court of Appeals for the Federal Circuit); 28 U.S.C. § 1254 (appeals from the United States Courts of Appeals may be reviewed by the United States Supreme Court). *See also Byers v. Comm'r*, 740 F.3d 668 (D.C. 2014), *cert. denied*, 83 U.S.L.W. 3189 (U.S. Oct. 6, 2014) (No. 14-74) (the D.C. Circuit will not transfer cases to another circuit in non-liability CDP cases unless both parties stipulate to transfer the case).

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

18 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).

19 IRC § 7422(a).

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

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

ANALYSIS OF *PRO SE* LITIGATION

As in previous years, many taxpayers appeared before the courts *pro se*. Figure 3.0.1 lists the Most Litigated Issues for the review period June 1, 2014, through May 31, 2015, and identifies the number of cases, categorized by issue, in which taxpayers appeared without representation. As the figure illustrates, the issues with the highest rates of *pro se* appearance are summons enforcement and the frivolous issues penalty.

FIGURE 3.0.1, *Pro Se* Cases by Issue

Most Litigated Issue	Litigated Cases Reviewed	*Pro Se* Litigation	% of Cases Involving *Pro Se* Taxpayers
Accuracy-Related Penalty	113	68	60%
Trade or Business Expenses	99	60	61%
Summons Enforcement	84	61	73%
Gross Income	80	53	66%
Collection Due Process	79	46	58%
Failure to File, Failure to Pay, and Estimated Tax Penalties	63	41	65%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	44	18	41%
Charitable Deductions	28	14	50%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	26	24	92%
Relief From Joint and Several Liability	24	11	46%
Total	**640**	**396**	**62%**

Figure 3.0.2 affirms our contention that taxpayers are more likely to prevail if they are represented. The disparity in the success rate between *pro se* and represented taxpayers is much less than last year. *Pro se* taxpayers prevailed in 19 percent of cases this year as compared to ten percent last year, a remarkable 90 percent increase in success rate. Represented taxpayers fared slightly better than last year, achieving a 28 percent success rate as compared to 26 percent last year, an eight percent increase.

FIGURE 3.0.2, 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
Accuracy-Related Penalty	68	14	21%	45	12	27%
Trade or Business Expenses	60	23	38%	39	19	49%
Summons Enforcement	61	1	2%	23	2	9%
Gross Income	53	7	13%	27	10	37%
Collection Due Process	46	5	11%	33	9	27%
Failure to File, Failure to Pay, and Estimated Tax Penalties	41	7	17%	22	4	18%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	18	0	0%	26	4	15%
Charitable Contributions	14	5	36%	14	5	36%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	24	7	29%	2	0	0%
Relief From Joint and Several Liability	11	5	45%	13	4	31%
Total	**396**	**74**	**19%**	**244**	**69**	**28%**

SIGNIFICANT CASES

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

In *King v. Burwell*, the Supreme Court upheld Treasury regulations that provide a Premium Tax Credit to individuals who obtain health insurance through a federally-facilitated exchange.[2]

Virginia residents who did not want to purchase health insurance or pay a penalty (under Internal Revenue Code (IRC) § 5000A) filed suit. They challenged the validity of Treasury Regulations that grant a health insurance Premium Tax Credit, as applied to residents of states that did not set up their own exchanges.[3] If the regulations were invalid, the plaintiffs would be ineligible for the credit. Without the credit, the plaintiffs would not be required to purchase insurance because they would qualify for the exception applicable to low income taxpayers without access to affordable insurance.[4]

By statute, the Premium Tax Credit is only available to offset premiums available "through an Exchange established by the State."[5] The Commonwealth of Virginia has not established a state-run health insurance exchange and is therefore served by the federally-facilitated exchange (*i.e.*, HealthCare.gov). The plaintiffs allege that the related regulations are invalid because they authorize credits not only for people using "an Exchange established by the State," but also for people using the federally-facilitated exchange.[6]

The district court upheld the regulations and granted the government's motion to dismiss.[7] The United States Court of Appeals for the 4th Circuit affirmed, citing *Chevron*.[8] Under *Chevron*, courts generally defer to an agency's interpretation of ambiguous statutory language.[9]

The Supreme Court affirmed but did not defer to the IRS under *Chevron*. It concluded that the statutory language was ambiguous, but that Congress did not intend to delegate a decision of such deep "economic

1 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2014, and ending on May 31, 2015. For purposes of this section, we generally used the same period, except that we included two Supreme Court decisions issued shortly thereafter and one circuit court decision that directly affects TAS.

2 *King v. Burwell*, 135 S. Ct. 2480 (June 25, 2015), *aff'g* 759 F.3d 358 (4th Cir. 2014), *aff'g sub. nom. King v. Sebelius*, 997 F. Supp. 2d 415 (E.D. Va. 2014).

3 *See generally* Treas. Reg. § 1.36B–2.

4 Low income individuals for whom the annual "cost of coverage" exceeds eight percent of their projected household income are not subject to a penalty for failing to purchase health insurance. IRC § 5000A(e)(1)(A). Under this rule, the cost of coverage may be reduced by the Premium Tax Credit. IRC § 5000A(e)(1)(B)(ii).

5 IRC §§ 36B(b)(2), 36B(c)(2)(A)(i).

6 Treas. Reg. § 1.36B–2 provides that credits shall be available to anyone "enrolled in one or more qualified health plans through an Exchange," and Treas. Reg. § 1.36B-1(k) adopts, by cross-reference, a Health and Human Services (HHS) definition of "Exchange" that includes any Exchange, "regardless of whether the Exchange is established and operated by a State … or by HHS." 45 C.F.R. § 155.20.

7 *King v. Burwell*, 997 F. Supp. 2d 415 (E.D. Va.2014).

8 *King v. Burwell*, 759 F.3d 358 (4th Cir. 2014).

9 *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). On the same day that the 4th Circuit issued its opinion, a panel of the Court of Appeals for the District of Columbia Circuit struck down the regulations, creating a split among the circuits. *Halbig v. Burwell*, 758 F.3d 390 (D.C. Cir. 2014). The Court of Appeals for the District of Columbia later agreed to rehear the case *en banc* and vacated its original decision eliminating the split. *Halbig v. Burwell*, 114 A.F.T.R.2d (RIA) 5868 (2014).

and political significance" to the IRS.[10] Additionally, it noted that the IRS had no particular expertise in crafting health insurance policy to which courts should defer.

Instead, the Court searched for a meaning compatible with the structure and purpose of the law. It noted that the petitioner's literal interpretation could result in the failure of the legislation. It found that Congress intended the Premium Tax Credit to apply broadly, to both state and federal exchanges to maximize insurance coverage. The Court therefore held that Premium Tax Credits are available to individuals purchasing insurance through the federally-facilitated exchange.[11]

This case is significant because those purchasing health insurance through the federally-facilitated exchange will continue to receive tax credits. It is also significant because the Court suggested that Treasury Regulations may not be entitled to *Chevron* deference when they interpret the ACA or other important non-tax laws in areas where the IRS does not have substantive expertise.

In *Obergefell v. Hodges*, the Supreme Court held that states must allow same-sex couples to marry and recognize same-sex marriages performed in other states.[12]

Various district courts held that the state laws in Michigan, Tennessee, Ohio, and Kentucky, which defined marriage as between one man and one woman, violated the U.S. Constitution. The U.S. Court of Appeals for the 6th Circuit consolidated these cases and reversed, upholding the state laws. The Supreme Court reversed, holding that the states cannot "exclude same-sex couples from civil marriage on the same terms and conditions as opposite sex couples"[13] and that states must recognize same-sex marriages performed in other states.

Although same-sex married couples have been treated as married for federal income tax purposes since the Court held the Defense of Marriage Act (DOMA) unconstitutional,[14] this case is significant to federal income tax administration because it affects marital status, parentage, income, property rights, insurance coverage, and state taxes, all of which are reported on federal returns. Couples in common-law marriage states may find themselves legally married on a retroactive basis. For those in community property states, the holding may affect their taxable income for both state and federal income tax purposes, even if they file separately.[15] Determining the parentage of children for federal tax purposes may now be less complicated. These issues may prompt some to amend their federal or state returns. Even those who only amend state returns to change their filing status may also amend their federal returns for consistency (*e.g.*, to adjust their deduction for state and local taxes). While this case should generally simplify tax filing,

10 *King v. Burwell*, 135 S. Ct. 2480, 2489 (2015).

11 As the Court based its decision on its interpretation of the statute, it would be difficult for the IRS to issue regulations that would reinterpret the statue any other way. *See National Cable & Telecommunications Association v. Brand X Internet Services*, 545 U.S. 967 (2005) (suggesting agencies may not adopt a statutory interpretation rejected by the courts).

12 *Obergefell v. Hodges*, 135 S. Ct. 2584 (June 26, 2015).

13 *Id*. at 2605.

14 *U.S. v. Windsor*, 133 S. Ct. 2675 (2013); Rev. Rul. 2013-17, 2013-38 I.R.B. 201. After *Windsor*, the IRS allowed but did not require retroactive joint filing. Rev. Rul. 2013-17, 2013-38 I.R.B. 201. For a discussion of *Windsor* and related tax issues, see, *e.g.*, National Taxpayer Advocate 2013 Annual Report to Congress 326-27 (discussing *Windsor*), National Taxpayer Advocate 2013 Annual Report to Congress (Most Serious Problem: *Domestic Partners and Same-Sex Couples Need Federal Tax Guidance*), and National Taxpayer Advocate 2012 Annual Report to Congress 449 (Status Update: *Federal Tax Questions Continue to Trouble Domestic Partners and Same-Sex Spouses*).

15 Even if married taxpayers file separately, each is generally subject to tax on one-half of any "community income," including income earned by his or her spouse. *See Poe v. Seaborn*, 282 U.S. 101 (1930). Married taxpayers in community property states have "community income" under state law.

there is a long list of state tax issues that will need to be resolved.[16] In addition, the Solicitor General suggested that if the Court held the state laws unconstitutional, as it did, "the tax exemptions of some religious institutions would be in question if they opposed same-sex marriage."[17] Representatives in Congress are reportedly working to address this issue.[18]

In *Rothkamm v. United States*, the United States Court of Appeals for the 5th Circuit held that the period of limitations for filing a wrongful levy claim was suspended by a person's application for a Taxpayer Assistance Order (TAO).[19]

On March 6, 2012, the IRS issued a notice of levy to Mrs. Rothkamm's bank, seeking to collect her husband's tax liability from an account she claimed was her separate property. On April 18, 2012, the bank complied with the levy, transferring the proceeds of her account to the IRS. About two weeks later, on April 30, 2012, she sought assistance from the Taxpayer Advocate Service (TAS), filing a Form 911, *Application for a Taxpayer Assistance Order*. About five and a half months later, on October 11, 2012, TAS closed her case.[20] On May 15, 2013, more than nine months following the levy, Mrs. Rothkamm filed an administrative claim for wrongful levy under IRC § 6343(b).[21] The IRS denied the claim on July 1, 2013. Finally, on September 6, 2013, Mrs. Rothkamm filed a suit for wrongful levy under IRC § 7426(a). The district court held her claim was time barred, but the United States Court of Appeals for the 5th Circuit reversed and remanded.

A person generally must file any administrative claim with the IRS for wrongful levy within nine months of the levy.[22] A person may also file suit for wrongful levy in district court within the same nine-month period.[23] However, a timely filed administrative claim tolls the nine-month period for filing a suit by up to 12 months — the shorter of 12 months from the administrative filing or six months from the date the IRS mails a notice of disallowance.[24]

16 Some same-sex married couples had to file as unmarried for state tax purposes, even on returns that required figures from a federal return. To arrive at the figures needed to fill out the state returns, taxpayers sometimes had to compute "dummy" federal returns that they would not file. *See* Intuit, *Simplifying the Tax Filing Process for Same-Sex Couples* (June 19, 2015), *available at* http://intuittaxandfinancialcenter.com/article/simplifying-the-tax-filing-process-for-same-sex-couples/. These filing burdens, which were particularly severe for those with interests in flow-through entities doing business nationwide, should decrease as a result of this decision.

17 *Obergefell v. Hodges*, 135 S. Ct. 2584, 2626 (June 26, 2015) (J. Roberts, Dissenting).

18 *See, e.g.*, Kaustuv Basu, *Lee's Bill Would Protect Tax-Exempt Status for Religious Groups*, 147 Tax Notes 1138 (June 8, 2015); First Amendment Defense Act, S.1598, 114th Cong. (2015).

19 *Rothkamm v. U.S.*, 802 F.3d 699 (5th Cir. 2015) (hereinafter *Rothkamm II*), *rev'g and remanding*, 114 A.F.T.R. 2d (RIA) 5997, 2014-2 U.S. Tax Cas. (CCH) P50,441 (M.D. La. 2014) (hereinafter *Rothkamm I*).

20 The 5th Circuit Court's dissenting opinion noted that "Rothkamm has not argued that TAS did not inform her about the period of limitation for filing a wrongful levy action." *Rothkamm II* at 718 n. 22.

21 Mrs. Rothkamm filed her administrative claim more than 14 months after the March 6, 2012, notice of levy and nearly 13 months after the bank paid the levy on April 18, 2012.

22 IRC § 6343(b); Treas. Reg. § 301.6343–2(a)(2).

23 IRC §§ 7426(a) and (i) (cross referencing IRC § 6532(c)).

24 IRC § 6532(c)(2); Treas. Reg. § 301.6532–3.

The government first argued that Mrs. Rothkamm's suit was time barred because her nine–month period for filing a wrongful levy suit expired on January 18, 2013.[25] Thus, her suit, filed September 6, 2013, was over seven months late.

Mrs. Rothkamm argued that her suit was timely because the nine-month period for bringing a wrongful levy suit was suspended during the pendency of both: (1) her April 18, 2012 application for a TAO (under IRC § 7811(d)); *and* (2) her timely administrative claim to the IRS filed on May 15, 2013.[26] She reasoned that her TAO application extended the deadline for filing an administrative claim by over five months. Because of this extension, her administrative claim was timely and it extended the period for filing suit until six months after the IRS disallowed it on July 1, 2013 (*i.e.*, until January 1, 2014). Thus, Mrs. Rothkamm's September 6, 2013 suit was timely.

By its terms, IRC § 7811(d) suspends "[t]he running of any period of limitation with respect to any action described in subsection (b) [the terms of a TAO]." IRC § 7811(b) provides:

> The terms of a Taxpayer Assistance Order may require the Secretary within a specified time period — (1) to release property of the taxpayer levied upon, or (2) to cease any action, take any action as permitted by law, or refrain from taking any action, with respect to the taxpayer…

The government argued and the district court agreed that (1) the tolling provided by IRC § 7811(d) only applies to "taxpayers" and that Mrs. Rothkamm was not a "taxpayer" for that purpose, and (2) even if Mrs. Rothkamm *was* a taxpayer, she was not entitled to tolling because it only applies to IRS actions, not taxpayer actions.[27] Thus, the district court concluded it had no subject matter jurisdiction because the claim was not timely.

First, the 5th Circuit concluded that the district court erred by failing to use the definition of "taxpayer" set forth in IRC § 7701(a)(14), which includes "any person subject to any internal revenue tax." It relied on the Supreme Court decision in *Williams*, which held that Lori Williams, "who paid a tax under protest to remove a lien on her property," was a taxpayer under IRC § 7701(a)(14), and therefore, "had standing to bring a refund action under 28 USC § 1346(a)(1), even though the tax she paid was assessed against a third party."[28] The court rejected the government's argument that subsequent case law had altered the Supreme Court's interpretation of IRC § 7701(a)(14).[29]

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25 *Rothkamm I*, slip op. at *2 (referencing the January 18 deadline); Govt. Motion to Dismiss, Dkt. No. 3:13-cv-00589-BAJ-RLB 2 (M.D. La., Nov. 8, 2013) (same). If the nine-month period for filing a wrongful levy claim did not begin until the bank *paid* the levy it would have expired on January 18, 2013, but if it began when the IRS *issued* the notice of levy to the bank it would have expired on December 6, 2012. In other cases cited by the court, and on appeal, the government argued that the period begins on the date the IRS *issues* the notice of levy. *See, e.g.*, Brief for the Appellees, Dkt. No. 14-31164 at 15 (Feb. 2, 2015) (referencing the December 6, 2012 deadline); *United Sand & Gravel Contractors, Inc. v. U.S.*, 624 F.2d 733, 735 (5th Cir.1980) (treating the date of the notice of levy as the date of the levy); Treas. Reg. § 301.6532–3(c)(Ex. 1) (same for notice of seizure).

26 *Rothkamm I*, slip op. at *2. Regulations make clear that wrongful levy claims must be filed with a specific office. Treas. Reg. § 301.6343–2(b). In other cases; however, taxpayers appear to have argued that submissions to TAS were informal claims. *See, e.g.*, *John Purciello v. U.S.*, No. 2:11-cv-4181(DMC)(MF), 2013 WL 6448108 (D.N.J. Dec. 9, 2013). Even if the April 30, 2012, application for a TAO was treated as an informal claim, in the absence of additional tolling, the period for filing suit would arguably have expired 12 months later, on April 30, 2013, and the May 15, 2013 filing may still have been late.

27 *Rothkamm I,* slip op. at *2.

28 *Rothkamm II* at 704 (quoting *U.S. v. Williams*, 514 U.S. 527, 529 (1995)).

29 The government cited *EC Term of Years Trust v. U.S.*, 550 U.S. 429 (2007), which held a court had no jurisdiction to hear a claim for wrongful levy by a trust under 28 U.S.C. 1346(a)(1). The 5th Circuit explained that if the trust could bring suit under IRC § 1346(a)(1), its suit would be timely, but it would be time-barred under IRC § 7426(a)(1)'s stricter nine-month statute of limitations. Therefore, *EC Terms of Years Trust* concerned the remedy available to the trust and had no bearing on whether the trust was a taxpayer.

The 5th Circuit found no reason to conclude that the definition of taxpayer in IRC §§ 7811 or 7803 is different from the general definition of taxpayer found in IRC § 7701(a)(14), observing that at least four of the ten examples of TAOs set forth in regulations involve wrongful levies, and speculating that some of them could have been referring to third parties.[30] It held that the term "taxpayer" in IRC § 7811 includes not only the person against whom a tax is assessed, but also the person who actually pays the tax. Thus, the tolling provisions under IRC § 7811 could apply to Mrs. Rothkamm.

Next, the 5th Circuit rejected the argument that tolling only applies to actions of the IRS. IRC § 7811(d) says tolling applies to "any statute of limitations for any action described in § 7811(b)." The court suggested that tolling applied because "release[ing] property of the taxpayer levied upon," which was at issue in Mrs. Rothkamm's case, is described in IRC § 7811(b)(1).

Because the court's holding was based on the plain language of the statute under *Chevron* step-one,[31] it gave no deference to regulations which state "[A] taxpayer's right to administrative or judicial review will not be diminished or expanded in any way as a result of the taxpayer's seeking assistance from TAS."[32] It nonetheless reasoned that tolling would allow a taxpayer to pursue a TAO without fear that the process would prejudice her rights in the event she does not obtain TAO relief, claiming that its interpretation would not make the IRS or the taxpayer any worse off.[33]

Finally, the 5th Circuit concluded that neither the code nor the regulations make tolling subject to the IRS's discretion, dismissing contrary authorities.[34] It also dismissed the government's statutory arguments. The government apparently argued that Congress directly addressed the question of whether IRC § 7811(d) tolls the running of the nine-month statute of limitations in IRC § 7426(a) because neither statute references the other. According to the court, the government failed to explain how Congress may directly address something by remaining silent on it.[35] The government's other statutory argument was that tolling does not apply to the release of levies under IRC § 7811(b)(1) because that section does not contain the word "action." The court determined that this argument had no merit.[36] It noted that the government had offered no reasonable alternative construction of the plain language

30 *Rothkamm II* at 708 n.29 (citing Treas. Reg. §§ 301.7811-1(a)(Ex. 1), -1(e) (Exs. 1, 2, and 3)).

31 *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). A court only gives deference to agency regulations under *Chevron* step-two, if it first determines the statute is ambiguous under *Chevron* step-one. *Id*.

32 Treas. Reg. § 301.7811-1(b). The court also reasoned that this regulation addresses TAOs and not tolling. *Rothkamm II* at 711.

33 *Rothkamm II* at 709-10. Whether tolling the period of limitations for taking an action makes a person better off depends on whether the person is able to take the action during the tolling period. If they are able to take the action, tolling makes them better off because they get a longer period than otherwise provided by statute. For example, if the ten-year period for the IRS to collect tax is extended during the pendency of a TAO application, the IRS is only better off if it could continue to collect during that period. Assuming it could, the IRS could collect for more than ten years otherwise allowed by law. Citing legislative history, instructions to Form 911, and case law, the dissent argues that IRC § 7811(d) tolls the limitations period only with respect to actions of the IRS on the basis that it cannot take action while an application for a TAO is pending. *Rothkamm II* at 717-18. The dissent also cited various cases for the proposition that "all suspension provisions [including § 7811(d)] are designed and intended to avoid prejudice to the IRS's ability to collect during periods of time in which collection or assessment is prohibited by law [or otherwise impeded]." *Id*. at 717 n.14.

34 *Rothkamm II* at 713 (referencing *Demes v. U.S.*, 52 Fed. Cl. 365, 373 (Fed. Cl. 2002)).

35 *Id.* at 713-14.

36 *Id.* Even if the court had accepted the government's argument that tolling under IRC § 7811(d) only covers "actions" under IRC § 7811(b) that are described using the word "action," it would have lost. IRC § 7811(b)(2)(A) specifically refers to "actions" under "chapter 64," and IRC § 6343, which covers wrongful levies, is located in chapter 64. In addition, IRC § 7811(b)(2)(D) refers to "actions" under "any other provision of law which is specifically described by the National Taxpayer Advocate in such order," which may address wrongful levies.

of IRC § 7811(d).[37] Thus, it held that Mrs. Rothkamm's filing was timely because her application for a TAO tolled the period for filing a wrongful levy claim.

This case is significant because it affirms the National Taxpayer Advocate's authority to issue TAOs to assist those who are subject to levies to collect another person's liability. However, it leaves unanswered questions about whether a "taxpayer" includes other third parties, such as whistleblowers or preparers who seek TAOs in situations where they have not been "subject to" the tax at issue in their cases.[38]

As the dissent notes, it is also significant because it creates administrative difficulties, replacing fixed periods of limitation with indefinite periods.[39] The case is likely to prompt many taxpayers who have sought TAS assistance and subsequently missed a deadline to argue that the deadline was tolled under IRC § 7811(d) by their application to TAS. It also raises a number of questions. The IRS has not implemented IRC § 7811(d) because of technical difficulties in recording and tracking the suspension period.[40] Will the IRS now feel obligated to try to implement those provisions, even in cases where they would penalize taxpayers for seeking TAS assistance?[41] Will taxpayers now seek to toll the period for taking "any" action by simply filing a Form 911 (*e.g.*, filing in tax court, requesting a collection due process hearing, claiming a refund).[42] If IRC § 7811(d) tolls the period for taxpayers to take action, can the National Taxpayer Advocate extend these periods even further?[43]

37 The government did not focus on statutory language that supports the position that only actions of the IRS are tolled: IRC § 7811(d) tolls the statute with respect to actions described in IRC § 7811(b), but the flush language of IRC § 7811(b) provides a TAO "may require the Secretary" to take or not take various actions. In other words, all of the actions described in IRC § 7811(b) must be taken by the IRS and not the taxpayer or a third party. Thus, IRC § 7811(d) can only toll the period of limitations with respect to actions of the IRS.

38 For additional discussion of these and other issues, see *Legislative Recommendation: Statute of Limitations: Repeal or Fix Statute Suspension Under IRC § 7811(d)*, *supra*.

39 *Rothkamm II* at 720.

40 Although TAS drafted procedures for implementing statute suspension under IRC § 7811(d), due to technical difficulties, they were not implemented (*e.g.*, tracking different suspension periods for each spouse and for assessments for the same year made on different dates). *See*, *e.g.*, IRM 13.1.14 (Oct. 31, 2004); Memorandum from Commissioner of Internal Revenue, *Taxpayer Advocate Service Statute Suspension Provisions Under IRC Section 7811(d)* (Nov. 10, 2003). At least one legal memo concludes that if the IRS has authority not to implement IRC § 7811(d), it is because the provision can only benefit the IRS by extending the period for the IRS to take enforcement actions (*e.g.*, by extending the period for collection or assessment). *Compare* IRS Litigation Bulletin 360, 1990 WL 1086174, 1990 GLB LEXIS 12 (1990) (concluding that because IRC § 7811(d) only protects the IRS by tolling collection and assessment periods, the IRS is not legally required to implement it), *with* Memo from Acting Counsel to the National Taxpayer Advocate to Director Taxpayer Account Operations, *Suspension of the Statutes of Limitations Under Section 7811(d)* (Mar. 9, 2001) (assuming statute suspension only applies to protect the IRS's interest, but still declining to conclude its implementation is not mandatory).

41 Taxpayers would be penalized if, for example, collection statutes were tolled but collection actions were not suspended.

42 As noted above, *Rothkamm II* did not directly hold that IRC § 7811(d) extended the period for filing suit. Rather, it held that IRC § 7811(d) extended the period for filing an administrative claim, and that the IRS's denial of the timely-filed administrative claim extended the period for filing suit by operation of IRC § 6532(c)(2). A future decision could clarify that IRC § 7811(d) does not extend jurisdictional deadlines for filing in court, but this case still invites litigation in this area. *Compare Volpicelli v. U.S.*, 777 F.3d 1042 (9th Cir. 2015) (holding the limitations period for filing suit to challenge a wrongful levy was subject to equitable tolling because it was procedural and not jurisdictional, as discussed below) *with Becton Dickinson & Co. v. Wolckenhauer*, 215 F.3d 340 (3d Cir. 2000) (holding that the limitations period for filing suit to challenge a wrongful levy was jurisdictional, and thus, not subject to equitable tolling).

43 IRC § 7811(d)(2) (tolling the period of limitation with respect to "any action described in subsection (b)" by "any period specified by the National Taxpayer Advocate" in a TAO).

In *Mallo v. IRS*, the United States Court of Appeals for the 10th Circuit held that tax debt with respect to late-filed tax returns (except returns filed with IRS assistance) cannot be discharged in bankruptcy.[44]

The taxpayers did not file timely federal income tax returns for 2000 or 2001. Only after the IRS assessed a tax liability did they file returns.[45] More than two years later, the taxpayers filed for bankruptcy, seeking to discharge their tax debts. The IRS argued the tax debts were not dischargeable. In a consolidated appeal of conflicting decisions, the United States District Court for the District of Colorado agreed with the IRS, as did the United States Court of Appeals for the 10th Circuit.

A taxpayer may not discharge in bankruptcy tax liabilities "with respect to which a return … was not filed or given."[46] Tax liabilities with respect to which a late return was filed within two years of the bankruptcy petition are also exempt from discharge.[47] Before 2005, with certain exceptions, a debtor could discharge the portion of a tax debt that he or she self-assessed on a late return, as long as he or she waited two years after filing. As part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Congress attempted to clarify the discharge rules by amending 11 U.S.C. § 523(a) to include a "hanging paragraph."[48] It defines a "return" as "a return that satisfies the requirements of applicable non-bankruptcy law (including applicable filing requirements)." It goes on to state that a late return prepared by the IRS and signed by the taxpayer under IRC § 6020(a) is treated as a return, but a return prepared by the IRS without the taxpayer's cooperation under IRC § 6020(b) is not.[49] Whether a document is a return for tax purposes depends on whether it satisfies the *Beard* test, which requires that it (1) contain sufficient data to calculate tax liability, (2) purport to be a return, (3) be an honest and reasonable attempt to satisfy the law, and (4) be executed under penalties of perjury.[50]

The IRS argued that the tax debt was not dischargeable because it arose from an IRS assessment rather than from a taxpayer's self-assessment on a return. In other words, a debt (or portion thereof) assessed by the IRS before filing was "with respect to which a return … was not filed or given,"[51] and thus, permanently nondischargeable, even if the taxpayer later filed a return. The court rejected this argument, holding that the debt arose from the tax code rather than an assessment.

Instead, the court reasoned that even if a post-assessment filing is a return under *Beard*, late returns are not "returns" for purposes of discharge because they do not satisfy "applicable filing requirements."[52] The taxpayer argued that such an interpretation would make the specific exclusion of late returns filed under IRC § 6020(b) superfluous.[53] The taxpayer also argued that the exclusion for late returns filed less than

44 *In re Mallo*, 774 F.3d 1313 (10th Cir. 2014).

45 Unlike the returns deemed meaningless in *In re Hindenlang*, 164 F.3d 1029 (6th Cir. 1999), these returns did not mirror the IRS's tax assessment.

46 11 U.S.C. § 523(a)(1)(B)(i).

47 11 U.S.C. § 523(a)(1)(B)(ii).

48 BAPCPA, Pub. L. No. 109-8, § 714, 119 Stat. 23, 128 (2005) (modifying 11 U.S.C. § 523(a)).

49 11 U.S.C. § 523(a). Under IRC § 6020(a), the IRS may prepare a late return if a taxpayer cooperates by providing "consent to disclose all information necessary for the preparation thereof" and then signs it. When taxpayers do not provide such consent or signatures, the Secretary may prepare a late return or assessment under IRC § 6020(b) "from his own knowledge and from such information as he can obtain through testimony or otherwise."

50 *Beard v. Comm'r*, 82 T.C. 766, 777 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986) (applying a test set forth in *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934)).

51 11 U.S.C. § 523(a)(1)(B)(i).

52 11 U.S.C. § 523(a) (hanging paragraph).

53 The IRS agreed with the taxpayer on this point. *In re Mallo*, 774 F.3d at 1325 (citing Chief Counsel Notice (CCN) CC-2010-016 (Sept. 2, 2010)).

two years before bankruptcy suggests that late returns should not always be excluded simply because they fail to meet the filing requirements.[54]

The court concluded that the exclusion for liabilities with respect to late IRC § 6020(b) returns was not superfluous because late returns could be discharged if they were filed under IRC § 6020(a). The taxpayer argued that allowing those offered IRS assistance in filing late returns under IRC § 6020(a) to discharge the debt, but not allowing a discharge to similarly situated taxpayers who did not receive IRS assistance in filing late would be arbitrary and inconsistent with the fresh start policy underlying bankruptcy. However, the court reasoned that any such arbitrariness would not provide a basis for it to overlook the plain language of the statute.

This case is significant because taxpayers who are even one day late in filing a return will generally not be able to discharge the liability in bankruptcy unless they can convince the IRS to assist them in filing a return under IRC § 6020(a) and it does so at least two years before the bankruptcy filing. Although IRC § 6020(a) filings may have been more common when BAPCPA was adopted,[55] by 2010 they comprised only a "minute number of cases," according to the IRS Office of Chief Counsel.[56] As this may make the availability of discharge arbitrary, the National Taxpayer Advocate recommended legislation to reverse this rule.[57]

In *Hawkins v. Franchise Tax Board of CA,* the United States Court of Appeals for the 9th Circuit held that a debtor's continued spending in excess of earnings is not by itself sufficient to establish the specific willful intent to evade taxes necessary to avoid their discharge in bankruptcy.[58]

Mr. Hawkins's accountants advised him to invest in tax shelters to offset capital gains he had realized on stock he sold to fund a new venture. That venture ultimately failed. In 2002, the IRS disallowed the losses from the tax shelter, and in 2005, assessed a deficiency. Mr. Hawkins and his wife filed for bankruptcy in 2006.

A debtor may not discharge a debt with respect to which he or she "willfully attempted in any manner to evade or defeat," under 11 U.S.C. § 523(a)(1)(C). The IRS argued that the Hawkins' continued maintenance of a rich lifestyle — spending tens of thousands of dollars more than their income each month — even after learning about their tax debts, constituted a willful attempt to evade taxes. The bankruptcy court agreed, finding they did very little to alter their lavish lifestyle after it became apparent they were insolvent. It concluded that the tax debts were nondischargeable. The district court affirmed.

The United States Court of Appeals for the 9th Circuit reversed and remanded, holding that the discharge exception in 11 U.S.C. § 523(a)(1)(C) did not apply without proof of specific intent. First, the court noted that the term "willful" has different meanings in different contexts. Based on statutory

54 11 U.S.C. § 523(a)(1)(B)(ii).

55 Although *Beard* was decided in 1984, when BAPCPA legislation was enacted in 2005 some authorities suggested that Form 870, *Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment*, and Form 4549, *Income Tax Examination Changes*, would be treated as IRC § 6020(a) returns, even if signed in response to an IRS substitute for return. *See, e.g.*, Rev. Rul. 74-203, 1974-1 C.B. 330 (treating these forms as IRC § 6020(a) returns). It was not until September 12, 2005, that the IRS in Rev. Rul. 2005-59, 2005-37 I.R.B. 505, revoked Rev. Rul. 74-203 and clarified that waivers of assessment do not constitute returns because they do not purport to be returns and are not signed under penalties of perjury, as required under the *Beard* test.

56 CCN CC-2010-016 (Sept. 2, 2010).

57 *See* National Taxpayer Advocate 2014 Annual Report to Congress 417-22 (Legislative Recommendation: *Clarify the Bankruptcy Law Relating to Obtaining a Discharge*).

58 *Hawkins v. Franchise Tax Board of CA*, 769 F.3d 662 (9th Cir. 2014), *rev'g and remanding*, 447 B.R. 291 (N.D. CA 2011), *aff'g* 430 B.R. 225 (Bankr. N.D. CA 2010).

construction, precedent, and policy underlying the bankruptcy code, the term must be construed narrowly in the context of exceptions to discharge.

Next, the court reasoned that the language in 11 U.S.C. § 523(a)(1)(C) almost exactly matches language in IRC § 7201, a criminal statute, which penalizes anyone who "willfully attempts to evade or defeat any tax." According to the Supreme Court, the term "willfully" in IRC § 7201 requires proof of specific intent that the defendant voluntarily and intentionally violated a known legal duty.[59]

The 9th Circuit suggested that evidence of willful intent might include keeping two sets of books, making false bookkeeping entries, destroying records, and concealing assets. Simply spending beyond one's income would not qualify. The court observed that if such spending were enough, there would be few personal bankruptcies in which taxes would be dischargeable.

Finally, the court noted that other cases applying the exception from discharge under 11 U.S.C. § 523(a)(1)(C) involved intentional acts or omissions designed to evade tax, such as criminally structuring transactions to avoid currency reporting requirements, concealing assets through nominee accounts, and similar activities. In contrast, the Hawkins' spending practices after they learned of their tax debts were consistent with their historic spending practices. They invested in property that would be subject to tax liens. They did not transfer assets into nominee accounts or conceal them.[60] Further, the court observed that no other circuit has held that living beyond one's means or failing to pay taxes, by itself, constitutes willful tax evasion within the meaning of 11 U.S.C. § 523(a)(1)(C).

This case is significant because it can be construed as creating a circuit split over the conduct that will render tax debts nondischargeable in bankruptcy (*e.g.*, whether evidence of evasion and concealment is required). The case is also significant because it highlights the need for guidance concerning the meaning of willfulness in different contexts.[61]

In *Estate of Elkins v. Commissioner*, the United States Court of Appeals for the 5th Circuit held that if a taxpayer meets its burden to establish that a valuation discount applies, the court cannot apply a different discount if the IRS does not offer evidence of a more appropriate discount.[62]

When James A. Elkins, Jr. (decedent) died in 2006, his estate claimed a "fractional-ownership discount" on the value of jointly-owned art for purposes of computing the estate tax. The art was subject to a lease agreement governing its use and transferability. On the estate tax return, the estate reported decedent's 73 percent interest in various pieces of art, and based on an appraisal, claimed a 44.75 percent combined fractional interest discount for lack of control and marketability.[63] Although the parties agreed on the undiscounted value of the art, the IRS argued in the Tax Court that the contractual restrictions on alienation should be disregarded under IRC § 2703(a), the discounts used in calculating the fair market value of the

59 *Hawkins*, 769 F.3d at 668 (citing *Spies v. U.S.*, 317 U.S. 492 (1943) and other Supreme Court decisions).

60 The government claimed that a transfer of funds into a trust, which was ordered by the family court, was done with the intent to evade tax. Additionally, Hawkins' bankruptcy attorney testified that Hawkins' intent was not to pay the tax debt, but to discharge it in bankruptcy. This evidence may become more important on remand.

61 The National Taxpayer Advocate recommended legislation to clarify the meaning of willful Foreign Bank and Financial Account Reporting (FBAR) violations. *See, e.g.*, National Taxpayer Advocate 2014 Annual Report to Congress 331, 339-40.

62 *Est. of Elkins v. Comm'r*, 767 F.3d 443 (5th Cir. 2014), *rev'g* 140 T.C. 86 (2013).

63 *Id.* at 445-46.

decedent's fractional interests were overstated, and no discount was appropriate.[64] Thus, the IRS did not produce any evidence as to an appropriate fractional interest discount.

The Tax Court found that IRC § 2703(a) was applicable to the restrictions in the agreement, and disallowed any discount in the valuation of the art. However, as to the IRS's argument that no discounts should apply to decedent's fractional interest, the court rejected both the IRS's zero-discount position and the 44.75 percent discount applied by the estate.[65] Instead, the Tax Court applied a ten percent discount based on a "preponderance of the evidence," seemingly weighing the analysis of the estate's experts against the IRS's rebuttal witnesses.[66] However, the court had concluded that the testimony of one of the IRS's witnesses was not relevant, and the other merely testified that there was no established or recognized market for fractional interests in the type of art at issue.[67]

The United States Court of Appeals for the 5th Circuit agreed with the Tax Court's conclusion that a fractional-interest discount should apply.[68] It noted that the IRS had apparently overlooked "the venerable lesson of Judge Learned Hand's opinion in *Cohan*: In essence, make as close an approximation as you can, but never use a zero."[69] It concluded; however, that the Tax Court had misapplied the preponderance standard because the IRS had offered no evidence that any specific discount (other than zero) should apply.[70] The Tax Court could not reject the estate's fractional-ownership discounts and apply one of its own without any supporting evidence. Once the estate had met its burden to support a particular discount, the burden shifted to the IRS to introduce evidence to refute those facts with its own estimate.[71] Thus, the 5th Circuit upheld the fractional interest discount applied by the estate.[72]

The 5th Circuit's analysis is significant because it discourages courts (and possibly the IRS's appeals function) from applying a split-the-baby approach to valuation discounts where the IRS presents no evidence as to an appropriate discount. It is also significant because it could prompt the IRS to issue guidance about how to compute valuation discounts.

In *Volpicelli v. United States*, the United States Court of Appeals for the 9th Circuit held that the limitations period for challenging a wrongful levy was subject to equitable tolling.[73]

The IRS levied Logan Volpicelli's account when he was ten years old and applied the money (a $13,000 inheritance) to his father's tax debt. When Mr. Volpicelli was 18, he discovered the levy and promptly filed a wrongful levy suit.[74] The government argued his suit was time barred. Acknowledging that he

64 *Est. of Elkins*, 140 T.C. at 92. *See* IRC § 2703(a) (subject to exceptions for certain bona fide business arrangements, "the value of any property shall be determined without regard to — (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property.").

65 *Id.* at 116.

66 *Id.* at 135.

67 *Est. of Elkins*, 767 F.3d at 448-449.

68 *Id.* at 449.

69 *Id.* at 449 n.7 (citing *Cohan v. Comm'r*, 39 F.2d 540, 543-44 (2d Cir. 1930)).

70 *Id.* at 450.

71 *Id*. *See* IRC § 7491(a)(1) ("If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.").

72 *Est. of Elkins*, 767 F.3d at 453.

73 *Volpicelli v. U.S.*, 777 F.3d 1042 (9th Cir. 2015), *rev'g* 108 A.F.T.R.2d (RIA) 5166 (D. Nev. 2011), *reh'g denied*, No. 12-15029 (9th Cir. Apr. 8, 2015).

74 IRC § 7426(a)(1).

failed to meet the nine-month filing deadline under IRC § 6532(c), he argued that the limitations period was equitably tolled because he was a minor at the time of the levy.

The district court agreed with the government, but the United States Court of Appeals for the 9th Circuit reversed and remanded. The court concluded it was bound by precedent, which held that IRC § 6532(c) was subject to equitable tolling.[75] With certain exceptions that the 9th Circuit found inapplicable, there is a rebuttable presumption that filing deadlines may be equitably tolled unless Congress provides otherwise, according to the Supreme Court's decision in *Irwin*.[76] As the court found no evidence to rebut that presumption, it held that equitable tolling applies to the deadline provided under IRC § 6532(c).

This case is significant because it is inconsistent with decisions in other circuits, presenting the potential for the Supreme Court to resolve the split.[77] It may also be significant to the extent it suggests that tax statutes, like other statutes of limitation, are generally presumed to be subject to equitable tolling.[78]

In *Ridgely v. Lew*, the United States District Court for the District of Columbia held that the IRS exceeded its statutory authority when it prohibited certified public accountants from charging contingent fees for the preparation of refund claims.[79]

Mr. Ridgely, a certified public accountant (CPA), filed suit under the Administrative Procedure Act (APA),[80] challenging a Treasury regulation that prohibits CPAs from charging contingent fees for preparing and filing refund claims.[81] The parties moved for summary judgment. Concluding that the IRS lacks statutory authority to regulate the preparation and filing of ordinary refund claims (*i.e.*, claims filed before adversarial proceedings have begun and before the taxpayer has formally engaged the CPA to represent him), the court granted Mr. Ridgely's motion and issued a permanent injunction barring the IRS from enforcing the regulation.

Congress has authorized the IRS to "regulate the practice of representatives of persons before the Department of the Treasury."[82] In *Loving v. IRS,* the U.S. Court of Appeals for the District of Columbia Circuit held that this statute did not authorize the IRS to regulate tax return preparers because they do not "practice… before the Department" or "represent" taxpayers when preparing a return.[83] Citing *Loving*, the U.S. District Court for the District of Columbia found that CPAs also do not "practice… before the Department" or "represent" taxpayers, prior to adversarial proceedings. Accordingly, the statute does not authorize the IRS to regulate the mere filing of ordinary refund claims by CPAs.

75 *Supermail Cargo, Inc. v. U.S.*, 68 F.3d 1204, 1206–07 (9th Cir. 1995); *Capital Tracing, Inc. v. U.S.*, 63 F.3d 859, 861–62 (9th Cir. 1995).

76 *Irwin v. Department of Veterans Affairs*, 498 U.S. 89 (1990).

77 *See, e.g.*, *Becton Dickinson & Co. v. Wolckenhauer*, 215 F.3d 340 (3d Cir. 2000).

78 For example, at least one commentator has speculated that future litigation could establish that the time periods under IRC § 7433 (giving taxpayers two years to file a suit for civil damages for certain unauthorized collection actions) and § 6532(a) (giving taxpayers two years from the claim disallowance to file a refund lawsuit) are also subject to equitable tolling. *See* Marie Sapirie, *Ninth Circuit Holds Firm on Equitable Tolling*, 2015 TNT 22-9 (Feb. 2, 2015).

79 *Ridgely v. Lew*, 114 A.F.T.R.2d (RIA) 5249 (D.D.C. 2014).

80 5 U.S.C. § 551 *et seq*.

81 31 C.F.R. §§ 10.27(a)-(b) (prohibiting contingent fees except in limited circumstances). This regulation is part of Treasury Department Circular No. 230, *Regulations Governing Practice before the Internal Revenue Service* (2014) (called Circular 230).

82 31 U.S.C § 330(a)(1).

83 *Loving v. Comm'r*, 742 F.3d 1013 (D.C. Cir. 2014), *aff'g* 917 F.Supp.2d 67 (D.D.C. 2013). For a detailed discussion of *Loving*, see National Taxpayer Advocate 2014 Annual Report to Congress 432. *See also* Nina E. Olson, *More Than a "Mere" Preparer: Loving and Return Preparation*, 139 Tax Notes 767 (May 13, 2013).

The court also rejected the IRS's argument that it had authority to regulate all actions of CPAs who at some point "practice" before it, regardless of whether they were acting in a "representational" capacity. First, the statute authorizes regulation of practice, not practitioners. Second, the statute only applies to individuals when they represent taxpayers, not to the actions of every person who may at some point become a representative. Finally, it would lead to absurd results if the IRS could broadly regulate the actions of CPAs, no matter what they were doing, but not regulate other individuals who could assist taxpayers in filing refund claims. The court found no support for this dichotomy in the statute's text, history or structural context.

This case is significant to the extent it suggests that none of the provisions of Circular 230 are valid as to those who merely assist in filing a return or claim for refund (even if they are CPAs or attorneys), at least before the commencement of any adversarial proceedings with the IRS or formal engagement for legal representation. The proliferation of litigation regarding the IRS's regulation of tax return preparers is an indication that Congress should clarify the IRS's authority in this area, as the National Taxpayer Advocate has recommended.[84]

In *Sexton v. Hawkins*, the United States District Court for the District of Nevada enjoined the IRS Office of Professional Responsibility from requesting information from a suspended practitioner or revoking his ability to e-file on behalf of clients.[85]

Mr. Sexton, a tax lawyer, pled guilty to mail fraud and money laundering. As a result, the IRS Office of Professional Responsibility (OPR) suspended him from practice before the IRS for an indefinite period. During his suspension, he provided tax advice and return preparation services. After receiving a demand for information from OPR, including a request for client records and returns, he filed a complaint seeking declaratory relief that he was not subject to OPR's jurisdiction and asked the court to enjoin OPR's request.

According to *Loving*, a person who does not actively represent taxpayers in proceedings with the IRS and only prepares returns is *not* engaged in "practice before the IRS" and is not subject to regulation by OPR under Circular 230.[86] Mr. Sexton argued that because OPR had already suspended him from practice, he was no longer a practitioner covered by Circular 230 and his status as a mere tax return preparer left OPR with no jurisdiction over him. The Justice Department moved to dismiss for lack of jurisdiction and failure to state a claim. The court denied the government's motion and issued a preliminary injunction.

First, the court held that it had jurisdiction to review OPR's information request under the APA because OPR's request for information constituted a "final agency action" that would not otherwise be subject to review.[87] According to the court, OPR's assertion of jurisdiction over Mr. Sexton had immediate consequences, such as his obligation under Circular 230 to respond to its inquiry and the possibility of additional sanctions. If he provided the requested information to OPR, he would have to inform clients that he had turned over their confidential records and doing so would irreparably damage his reputation and business. According to Mr. Sexton, OPR had also threatened to withdraw his ability to e-file returns on behalf of clients if he failed to respond.

84 The National Taxpayer Advocate has long championed the regulation of return preparers. *See, e.g.*, National Taxpayer Advocate 2008 Annual Report to Congress 423 (Legislative Recommendation: *The Time Has Come to Regulate Federal Tax Return Preparers*); National Taxpayer Advocate 2004 Annual Report to Congress 67 (Most Serious Problem: *Oversight of Unenrolled Return Preparers*); National Taxpayer Advocate 2003 Annual Report to Congress 270 (Legislative Recommendation: *Federal Tax Return Preparers Oversight and Compliance*); National Taxpayer Advocate 2002 Annual Report to Congress 216 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*).

85 *Sexton v. Hawkins*, 114 A.F.T.R.2d (RIA) 6482 (D. Nev. 2014), *appeal docketed*, No. 14-17454 (9th Cir. Dec. 16, 2014).

86 *Loving v. Comm'r*, 742 F.3d 1013 (D.C. Cir. 2014), *aff'g* 917 F. Supp. 2d 67 (D.D.C. 2013).

87 5 U.S.C. § 702.

Second, the court found that Mr. Sexton had adequately pleaded facts to raise questions concerning (1) whether Mr. Sexton is a practitioner subject to OPR's jurisdiction, (2) whether OPR had authority to regulate a former practitioner, and (3) whether regulation of tax advice is beyond the scope of OPR's authority. The court entered a preliminary injunction barring the IRS from requesting documents from Mr. Sexton or suspending his ability to e-file. It reasoned that once Mr. Sexton produced the information it could not be "unproduced," and would cause irreparable injury to him and his business. By contrast, waiting would not be a hardship for the IRS or the public interest. The court explained that even if a permanent injunction were granted, the government could continue its investigation by issuing a subpoena.

This case is significant because it illustrates the difficulty OPR now faces in regulating previously-suspended practitioners and the need for Congress to authorize IRS regulation of tax return preparers.[88] It is also significant because it suggests an administrative request for information can be a final agency action, which is subject to judicial review under the APA.

In *Moore v. United States*, the District Court for the Western District of Washington held that the taxpayer did not have reasonable cause for not filing Foreign Bank and Financial Account Reports (FBARs), but found IRS procedures inconsistent with the Administrative Procedure Act (APA).[89]

Mr. Moore owned a foreign corporation that held a foreign bank account containing between $300,000 and $550,000, which he failed to report on Foreign Bank and Financial Account Reports (FBARs).[90] In 2009, he learned about the FBAR filing requirement, applied to the IRS's Offshore Voluntary Disclosure Program (OVD), and then opted out.[91] After interviewing Mr. Moore for five minutes, the Revenue Agent prepared an eight-page memo recommending that the IRS impose a non-willful penalty of $40,000 pursuant to 31 U.S.C. § 5321(a)(5) (the maximum of $10,000 for each of the four years from 2005 through 2008), but did not provide this memo to Mr. Moore.

The IRS sent Mr. Moore a brief letter proposing a penalty of $40,000 for years 2005 through 2008, and then assessed a $10,000 penalty for 2005 before his deadline to appeal had expired. When Mr. Moore appealed, his request for abatement was denied, also without explanation. Mr. Moore filed suit in the District Court for the Western District of Washington. The government counterclaimed and filed a motion for summary judgment.

Applying a *de novo* standard of review, the court held that Mr. Moore's failure to file FBARs was subject to non-willful penalties and was not due to reasonable cause. It declined to review the amount of the penalty under an "abuse of discretion" standard, as urged by the government.

Because "reasonable cause" is not defined in the Bank Secrecy Act (BSA) or in regulations interpreting the BSA, the court drew upon the IRC to define reasonable cause as the exercise of "ordinary business care and prudence" in the context of FBAR. It found Mr. Moore lacked ordinary business care and prudence because he (1) self-prepared his 2005 return without responding to the question on Schedule B about

88 The IRS has conceded that some suspended practitioners may obtain preparer tax identification numbers (PTINs) and prepare returns. *See* IRS, *Some Suspended or Disbarred Tax Practitioners Are Now Permitted to Obtain PTINs and Prepare Tax Returns* (May 23, 2014), *available at* http://www.irs.gov/file_source/pub/irs-utl/OPR%20statement%20052314.pdf. *See also* Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (citing *Loving* and acknowledging the registered tax return preparer program is no longer in effect).

89 *Moore v. U.S.*, 115 A.F.T.R.2d (RIA) 1375 (W.D. Wash. 2015), *dismissed by* 2015 U.S. Dist. LEXIS 99804 (W.D. Wash. 2015).

90 *See* FinCEN Report 114, *Report of Foreign Bank and Financial Accounts* (which superseded TD F 90-22.1).

91 For a discussion of problems with the OVD and recommendations to improve it and the FBAR rules, see, *e.g.*, National Taxpayer Advocate 2014 Annual Report to Congress 79-93, 331-45.

whether he had foreign accounts[92] and (2) responded "no" to a similar question on an organizer he provided to his preparer for his 2007 return. Citing *Williams*, a case that relied on similar facts to hold that an FBAR violation was *willful*, the court concluded that Mr. Moore did not have reasonable cause.[93]

The APA generally requires that an agency's denial of an appeal be accompanied by the "grounds for denial."[94] The court concluded that the government did not sufficiently explain why it denied Mr. Moore's appeal, imposed the maximum penalty for each of the four years, and assessed the 2005 penalty before the agreed date. The court noted that the available evidence, such as the Revenue Agent's internal memo, also failed to explain the IRS's reasons for imposing the maximum penalty.[95] Nor did it explain why the IRS assessed the 2005 penalty before expiration of the period allowed for Mr. Moore's appeal. The court stated that if the government did not supplement the record to explain itself on these issues, it would hold that the IRS's actions were arbitrary and capricious. After the IRS supplemented the record, the court denied the IRS's claim for interest because of its failure to disclose its reasoning but concluded that its actions to assess the penalty were not arbitrary.[96]

Finally, the court concluded the penalty did not violate the *Excessive Fines Clause of the Eighth Amendment*.[97] In *Bajakajian*, the Supreme Court held that a punitive forfeiture of $357,144 in currency (or 100 percent of it) for failure to report it violated the *Excessive Fines Clause* because the penalty was "grossly disproportional" to the gravity of the offense.[98] Although the government provided no evidence as to the harm caused by the offense, the court concluded the $40,000 penalty, which was only about 10 percent of the account balance, was not disproportionate. The court analyzed the proportionality of the FBAR penalties in aggregate, rather than separately for each year or violation.

This case is significant because it suggests that the FBAR penalty (including reasonable cause defenses) is subject to *de novo* review, though the IRS will seek greater judicial deference to its determination of the penalty amount.[99] It also illustrates that a court may rely on the APA in reviewing FBAR penalties and may require the IRS to document and disclose to taxpayers more detailed information concerning the basis for its decisions. Moreover, the court's analysis suggests that it is appropriate to compare the *aggregate* amount of FBAR penalties to the value of the unreported account in determining whether they violate the *Excessive Fines Clause*. Finally, the decision confirms the difficulty taxpayers face in claiming reasonable cause for failure to report an account on an FBAR, if they have not disclosed it to a preparer and have no

92 Mr. Moore admitted he saw the question but did not read the instructions regarding accounts owned by a corporation. Based on those instructions, he should have responded "yes" if he owned more than 50 percent of the stock of a corporation that owned any such accounts.

93 *Williams v. Comm'r*, 489 Fed. App'x. 655 (4th Cir. 2012) (*Williams II*); *Moore v. U.S.*, 115 A.F.T.R.2d (RIA) 1375 (W.D. Wash. 2015) (internal citations omitted) ("the only evidence materially distinguishing the defendant in *Williams II* from Mr. Moore is that defendant pleaded guilty to criminal tax evasion for failing to report the income from the foreign account he had not disclosed.").

94 5 U.S.C. § 555(e).

95 The court did not consider an Appeals memo that was in the IRS's files because the IRS successfully claimed it was privileged.

96 *Moore v. U.S.*, 2015 U.S. Dist. LEXIS 99804 (W.D. Wash. 2015).

97 After applying a balancing test, the court also concluded that the IRS's procedures did not violate the *Due Process Clause*. This analysis confirms that the IRS's procedures must comply with mainstream due process jurisprudence. For commentary on this issue, see Leslie Book, *Procedural Due Process and FBAR*, Procedurally Taxing (May 4, 2015), *available at* http://www.proceduralltaxing.com/procedural-due-process-and-fbar/.

98 *U.S. v. Bajakajian*, 524 U.S. 321 (1998).

99 For further commentary about the significance of this case, see, *e.g.*, Leslie Book, *District Court FBAR Penalty Opinion Raises Important Administrative and Constitutional Law Issues*, Procedurally Taxing (Apr. 6, 2015), *available at* http://www.proceduralltaxing.com/district-court-fbar-penalty-opinion-raises-important-administrative-and-constitutional-law-issues/; Andrew Velarde, *Moore Answers Novel FBAR Questions*, 2015 TNT 71-1 (Apr. 14, 2015).

good explanation for why the question about foreign accounts on Schedule B did not prompt them to read the instructions on the form.

In *Dynamo Holdings Limited Partnership v. Commissioner*, the Tax Court, for the first time, allowed a taxpayer to use predictive coding to limit "e-discovery" to relevant documents.[100]

In consolidated Tax Court proceedings, the IRS moved to compel production of electronically stored information (ESI) on two backup tapes.[101] The taxpayers argued that the IRS's request was excessively burdensome because to avoid producing irrelevant, confidential, and privileged material they would have to review between 3.5 and 7 million documents manually at a cost of $450,000 or more. The taxpayers asked the court to allow them to use predictive coding to limit their response. Predictive coding is a document review tool that uses computer algorithms that learn from a small number of human reviews to predict which documents are likely to be the most relevant. The taxpayers' expert testified that predictive coding could limit the manual document review to 200,000-400,000 documents at a cost of $80,000–$85,000.

The IRS opposed the use of predictive coding, arguing that it is an unproven technology. It also asserted the taxpayers could avoid the cost and expense of reviewing the documents by providing the IRS with access to all data on the tapes, while reserving the right (through a "clawback agreement") to later claim that some or all of the data that the IRS actually tries to introduce is privileged.

Although the court granted the IRS motion to compel production, it found the IRS's proposal of a clawback agreement unreasonable. The court remarked that it is not normally in the position of deciding or imposing a particular *method* of discovery upon the parties, but would make a ruling on the matter as an issue of first impression. Tax Court rules regarding discovery had not yet addressed the issue.[102]

The court relied upon the expert testimony and an article by Magistrate Judge Andrew Peck reviewing the technology.[103] It reasoned that studies have indicated predictive coding is more accurate than keyword searches or even a traditional manual review, as it can reduce human error. The court rejected the IRS's argument that predictive coding is an unproven technology, cited several federal cases that had allowed its use, and granted the taxpayers' request to use it in responding to the IRS request.[104] It concluded that an electronic discovery expert could design an effective search. Finally, the court noted that if the taxpayers did not address all of the IRS's concerns about incomplete discovery, the IRS could file another motion to compel.

This case is significant because it establishes that the Tax Court will allow the use of predictive coding in response to electronic discovery requests. Predictive coding can lessen the significant burden of responding to costly discovery requests by the IRS.

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100 *Dynamo Holdings Ltd. Partnership v. Comm'r*, 143 T.C. No. 9 (2014).

101 The IRS did not want paper copies because it wanted to review the metadata to determine when the ESI was created.

102 *See generally* Tax Court Rule 70(a). However, the court could have relied upon Tax Court Rule 103(a), issuing an order to protect a party from undue burden or expense from a discovery request. Guidance on e-discovery, which the IRS issued in 2012, did not incorporate predictive coding. CCN CC-2012-017 (Sept. 13, 2012).

103 Andrew Peck, Search, *Forward: Will Manual Document Review and Keyboard Searches Be Replaced by Computer-Assisted Coding?*, L. Tech. News (Oct. 2011).

104 *See, e.g.*, *Hinterberger v. Catholic Health Sys., Inc.*, 2013 WL 2250603 (W.D.N.Y. 2013); *Moore v. Publicis Groupe*, 287 F.R.D. 182 (S.D.N.Y 2012); *In Re Actos*, 2012 WL 7861249 (W.D. La. 2012).

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

SUMMARY

Internal Revenue Code (IRC) §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if a taxpayer's negligence or disregard of rules or regulations causes an underpayment of tax or if an underpayment exceeds a computational threshold called a substantial understatement, respectively. IRC § 6662(b) also authorizes the IRS to impose five other accuracy-related penalties.[1]

TAXPAYER RIGHTS IMPACTED[2]

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

PRESENT LAW

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

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

Prior to December 18, 2015, refundable credits could not reduce below zero the amount shown as tax by the taxpayer on a return.[5] However, recently enacted law reversed the Tax Court's decision in *Rand v. Commissioner*, and amended IRC § 6664(a) to be consistent with the rule of IRC § 6211(b)(4), which would allow the IRS to calculate negative tax in computing the amount of underpayment for

1 IRC § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement under chapter 1 [IRC §§ 1-1400U-3]; IRC § 6662(b)(4) authorizes a penalty for any substantial overstatement of pension liabilities; IRC § 6662(b)(5) authorizes a penalty for any substantial valuation understatement of estate or gift taxes; IRC § 6662(b)(6) authorizes a penalty when the IRS disallows the tax benefits claimed by the taxpayer when the transaction lacks economic substance; and IRC § 6662(b)(7) authorizes a penalty for any undisclosed foreign financial asset understatement. We have chosen not to cover them in this report, as those penalties were not litigated nearly as much as IRC §§ 6662(b)(1) and 6662(b)(2) during the period we reviewed.

2 *See* Taxpayer Bill of Rights, *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

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

4 IRC § 6664(a).

5 *Rand v. Comm'r*, 141 T.C. 376 (2013). *See also* National Taxpayer Advocate 2014 Annual Report to Congress 449; IRS, Chief Counsel Notice CC-2014-007, *Application of the Accuracy-Related or Fraud Penalty in Tax Court Cases Involving Disallowed Refundable Credits* (July 31, 2014) (litigation guidelines for cases impacted by the *Rand* decision). The Chief Counsel Notice is deemed to be "effective until further notice," perhaps implying that this is not the last word on the issue from the IRS's perspective. Following *Rand*, there has been a legislative proposal to calculate negative tax in computing the amount of underpayment for accuracy-related penalty purposes. *See* H.R. 1, § 6306, 113th Cong. 2d Sess. (2014). *See also* Joint Committee on Taxation, *Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title VI- Tax Administration and Compliance* (JCX-17-14) (Feb. 26, 2014), at 41-43.

accuracy-related penalty purposes.[6] Thus, for returns filed after December 18, 2015, or for returns filed before that date for which the period of limitations on assessment under IRC § 6501 has not expired, a taxpayer can be subject to an underpayment penalty in IRC § 6662 based on a refundable credit which reduces tax below zero.

The IRS may assess penalties under IRC §§ 6662(b)(1) and 6662(b)(2), but the total penalty rate generally cannot exceed 20 percent (*i.e.*, the penalties are not "stackable").[7] Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith.[8] In addition, a taxpayer will be subject to the negligence component of the penalty only on the portion of the underpayment attributable to negligence. If a taxpayer wrongly reports multiple sources of income, for example, some errors may be justifiable mistakes, while others might be the result of negligence; the penalty applies only to the latter.

Negligence

The IRS may impose the IRC § 6662(b)(1) negligence penalty if it concludes that a taxpayer's negligence or disregard of the rules or regulations caused the underpayment. Negligence is defined to include "any failure to make a reasonable attempt to comply with the provisions of this title, and the term 'disregard' includes any careless, reckless, or intentional disregard."[9] Negligence includes a failure to keep adequate books and records or to substantiate items that give rise to the underpayment.[10] Strong indicators of negligence include instances where a taxpayer failed to report income on a tax return that a payor reported on an information return[11] as defined in IRC § 6724(d)(1),[12] or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.[13] The IRS can also consider various other factors in determining whether the taxpayer's actions were negligent.[14]

Substantial Understatement

Generally, an "understatement" is the difference between (1) the correct amount of tax and (2) the tax reported on the return, reduced by any rebate.[15] Understatements are reduced by the portion attributable to (1) an item for which the taxpayer had substantial authority or (2) any item for which the taxpayer, in the return or an attached statement, adequately disclosed the relevant facts affecting the item's tax treatment and the taxpayer had a reasonable basis for the tax treatment.[16] For individuals, the understatement

6 Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, § 209 (2015).

7 Treas. Reg. § 1.6662-2(c). The penalty rises to 40 percent if any portion of the underpayment is due to a "gross valuation misstatement." IRC § 6662(h)(1); Treas. Reg. § 1.6662-2(c).

8 IRC § 6664(c)(1).

9 IRC § 6662(c).

10 Treas. Reg. § 1.6662-3(b)(1).

11 Treas. Reg. § 1.6662-3(b)(1)(i).

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

13 Treas. Reg. § 1.6662-3(b)(1)(ii).

14 These factors include the taxpayer's history of noncompliance; the taxpayer's failure to maintain adequate books and records; actions taken by the taxpayer to ensure the tax was correct; and whether the taxpayer had an adequate explanation for underreported income. Internal Revenue Manual (IRM) 4.10.6.2.1, *Negligence* (May 14, 1999). *See also* IRM 20.1.5.2(6), *Common Features of Accuracy-Related and Civil Fraud Penalties* (Jan. 24, 2012).

15 IRC §§ 6662(d)(2)(A)(i)-(ii).

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

of tax is substantial if it exceeds the greater of $5,000 or ten percent of the tax that must be shown on the return.[17] For corporations (other than S corporations or personal holding companies), an understatement is substantial if it exceeds the lesser of ten percent of the tax required to be shown on the return (or if greater, $10,000), or $10,000,000.[18]

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

Reasonable Cause

The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.[19] A reasonable cause determination takes into account all of the pertinent facts and circumstances.[20] Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.[21]

Reasonable Basis

An understatement of tax may be reduced by any portion of the understatement attributable to an item for which the tax treatment is adequately disclosed and supported by a reasonable basis.[22] This standard is met if the taxpayer's position reasonably relies on one or more authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii).[23] Applicable authority could include information such as sections of the IRC; proposed, temporary, or final regulations; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; and congressional intent as reflected in committee reports.[24]

17 IRC §§ 6662(d)(1)(A)(i)-(ii).
18 IRC §§ 6662(d)(1)(B)(i)-(ii).
19 IRC § 6664(c)(1).
20 Treas. Reg. § 1.6664-4(b)(1).
21 *Id*.
22 IRC § 6662(d)(2)(B)(ii)(II).
23 Treas. Reg. § 1.6662-3(b)(3).
24 Treas. Reg. § 1.6662-4(d)(3)(iii).

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process[25] and through its Automated Underreporter (AUR) computer system.[26] Theoretically, before a taxpayer receives a notice of deficiency, he or she has an opportunity to engage the IRS on the merits of the penalty.[27] Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC §§ 6211-6213).[28] Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to petition the United States Tax Court to challenge the assessment.[29] Alternatively, taxpayers may seek judicial review through refund litigation.[30] Under certain circumstances, a taxpayer can request an administrative review of IRS collection procedures (and the underlying liability) through a Collection Due Process hearing.[31]

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.[32] The IRS must first present sufficient evidence to establish that the penalty is warranted.[33] The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.[34] Because the reasonable basis standard is a higher standard to meet, it is possible that a taxpayer

25 IRM 4.10.6.2(1), *Recognizing Noncompliance* (May 14, 1999) ("assessment of penalties should be considered throughout the audit"). *See also* IRM 20.1.5.3(1)-(2), *Examination Penalty Assertion* (Jan. 24, 2012).

26 The AUR is an automated program that identifies discrepancies between the amounts that taxpayers reported on their returns and what payors reported via Form W-2, Form 1099, and other information returns. IRM 4.19.3.1(3)-(8), *Overview of IMF Automated Underreporter* (Sept. 30, 2014). IRC § 6751(b)(1) provides the general rule that IRS employees must have written supervisory approval before assessing any penalty. However, IRC § 6751(b)(2)(B) allows an exception for situations where the IRS can calculate a penalty automatically "through electronic means." The IRS interprets this exception as allowing it to use its AUR system to propose the substantial understatement and negligence components of the accuracy-related penalty without human review. If a taxpayer responds to an AUR-proposed assessment, the IRS first involves its employees at that point to determine whether the penalty is appropriate. If the taxpayer does not respond timely to the notice, the computers automatically convert the proposed penalty to an assessment without managerial review. IRM 4.19.3.20.1.4, *Accuracy-Related Penalties* (Sept. 1, 2012). *See also* National Taxpayer Advocate 2014 Annual Report to Congress 404-10 (Legislative Recommendation: *Managerial Approval: Amend IRC § 6751(b) to Require IRS Employees to Seek Managerial Approval Before Assessing the Accuracy-Related Penalty Attributable to Negligence Under IRC § 6662(b)(1)*); National Taxpayer Advocate 2007 Annual Report to Congress 259 ("Although automation has allowed the IRS to more efficiently identify and determine when such underreporting occurs, the IRS's over-reliance on automated systems rather than personal contact has led to insufficient levels of customer service for taxpayers subject to AUR. It has also resulted in audit reconsideration and tax abatement rates that are significantly higher than those of all other IRS examination programs.").

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

28 IRC § 6665(a)(1).

29 IRC § 6213(a). A taxpayer has 150 days rather than 90 days to petition the Tax Court if the notice of deficiency is addressed to a taxpayer outside the United States.

30 Taxpayers may litigate an accuracy-related penalty by paying the tax liability (including the penalty) in full, filing a timely claim for refund, and then timely instituting a refund suit in the appropriate United States District Court or the Court of Federal Claims. 28 U.S.C. § 1346(a)(1); 28 U.S.C. § 1491; IRC §§ 7422(a); 6532(a)(1); *Flora v. United States*, 362 U.S. 145 (1960) (requiring full payment of tax liabilities as a prerequisite for jurisdiction over refund litigation).

31 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 §§ 6320(c), 6330(c)(2)(B).

32 IRC § 7491(c) provides that "the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title."

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

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

may obtain relief from a penalty assessment by successfully arguing a reasonable cause defense, even if that defense does not satisfy the reasonable basis standard.[35]

ANALYSIS OF LITIGATED CASES

We identified 113 opinions issued between June 1, 2014, and May 31, 2015 where taxpayers litigated the negligence/disregard of rules or regulations or substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 87 cases (77 percent), taxpayers prevailed in full in 20 cases (18 percent), and six cases (five percent) resulted in split decisions. Table 1 in Appendix 3 provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 68 of the 113 cases (60 percent) and convinced the court to dismiss or reduce the penalty in 14 (21 percent) of those cases. Represented taxpayers fared approximately the same, achieving full or partial relief from the penalty in 12 of their 45 cases (27 percent). This difference was considerably smaller than the large disparity between represented and unrepresented taxpayers over the same period last year.[36]

In some cases, the court found taxpayers liable for the accuracy-related penalty but failed to clarify whether it was for negligence under IRC § 6662(b)(1) or a substantial understatement of tax under IRC § 6662(b)(2), or both.[37] Regardless of the subsection at issue, the analysis of reasonable cause is generally the same. As such, we have combined our analyses of reasonable cause for the negligence and substantial understatement cases.

Adequacy of Records and Substantiation of Deductions to Show Reasonable Cause and as Proof of Taxpayer's Good Faith

Taxpayers are required to maintain records sufficient to establish the amount of gross income, deductions, and credits claimed on a return.[38] The failure "to keep adequate books and records or to substantiate items properly" was the primary factor in roughly 74 percent of cases (34 out of 46) where the court found a taxpayer liable for an underpayment penalty due to negligence.[39]

In *Sawyer v. Commissioner*,[40] a married couple owned an asphalt business operated by the husband, Mr. Sawyer. Mr. Sawyer paid his day laborers in cash, without issuing Forms W-2, *Wage and Tax Statement*, or 1099-MISC, *Miscellaneous Income*.[41] Customers also paid Mr. Sawyer by cash or check, and he conceded that he deposited only a portion of the payments into his personal bank account. The only records he kept included invoices from his jobs.

As part of the examination, the revenue agent conducted an analysis of bank deposits and was unable to link the invoices provided with specific bank deposits. As a result, the revenue agent determined the business's gross receipts were underreported in tax years (TYs) 2008 and 2009. The revenue agent also denied

35 Treas. Reg. § 1.6662-3(b)(3).

36 *See* National Taxpayer Advocate 2014 Annual Report to Congress 446 (penalties were reduced in 14 percent of the *pro se* cases versus 32 percent of cases involving represented taxpayers).

37 *See, e.g.*, *Coburn v. Comm'r*, T.C. Memo. 2014-113; *Cooper v. Comm'r*, 143 T.C. 194 (2014).

38 IRC § 6001; Treas. Reg. § 1.6001-1(a).

39 *See, e.g.*, *Burrell v. Comm'r*, T.C. Memo. 2014-217; *Kunkel v. Comm'r*, T.C. Memo. 2015-71; *Briley v. Comm'r*, T.C. Memo. 2014-114.

40 T.C. Memo. 2015-55.

41 Form 1099-MISC, *Miscellaneous Income*, is used to report non-employee compensation.

deductions claimed for labor costs for TY 2008 because the taxpayer failed to establish that costs were paid or incurred in TY 2008 (or accounted for as labor completed by Mr. Sawyer or his family).

The court found the Sawyers liable for a penalty under IRC § 6662(b)(1). The Sawyers had argued a reasonable cause defense based on Mr. Sawyer's reliance on his accountant in preparing the tax return. However, the court found that Mr. Sawyer had not provided his accountant with the necessary information for reasonable reliance, as the invoices and receipts had not been provided and labor costs were merely an estimate.

In the more than 30 cases where the court attributed an underpayment to taxpayer negligence primarily due to record keeping, the court found the taxpayer acted with reasonable cause and in good faith in only one instance.[42] Inadequate record keeping was also an important factor in many determinations of whether the reasonable cause and good faith exception applied to a taxpayer's conduct. Some courts examined the issues of negligent record keeping and reasonable cause concurrently.

For example, in *Engstrom, Lipscomb & Lack, APC v. Commissioner*,[43] the taxpayer, a law firm, claimed travel expense deductions in connection with the use of two private jets. Mr. Lack was 50 percent owner of the law firm (hereinafter Engstrom). Mr. Girardi was a close friend of Mr. Lack. Together they had several joint business ventures, including G&L Aviation, a general partnership that owned aircraft and a luxury suite at the Staples Center in Los Angeles. Mr. Lack and Mr. Girardi used the aircraft extensively. Engstrom was not a partner of G&L Aviation and had no financial interest in the aircraft.

Engstrom claimed travel expense deductions for use of the aircraft and luxury suite in the amounts of $1,425,000; $1,157,797; $687,310; and $1,062,469 for years 2007 through 2010, respectively. Engstrom made payments to G&L Aviation and Mr. Lack also made payments to G&L Aviation from his personal account. There was no written agreement between Engstrom and G&L Aviation, and Engstrom did not receive invoices for payments made. However, Mr. Lack's secretary, Ms. Carter, who was employed by Engstrom, also performed recordkeeping duties for G&L Aviation. She prepared revenue schedules to show dates of payments to G&L Aviation, but these schedules did not include flight information, passenger information, or the purpose of each flight. G&L maintained flight logs, but these logs did not show the business purpose for each flight or provide detailed passenger information. Lastly, Mr. Lack maintained an executive calendar but did not include amounts for travel expenditures or detailed information regarding the business purpose for each trip.

IRC § 162 allows for the deduction of all ordinary and necessary expenses paid or incurred while carrying on a trade or business.[44] Such expenses can include the costs of travel.[45] To substantiate its claim for deductions at trial, Engstrom offered a reconstruction of the trips that included the date, destination, and passengers. This information was reconstructed from logs prepared by Ms. Carter and Mr. Lack.

42 *Lain v. Comm'r*, T.C. Summ. Op. 2015-5 (finding that the taxpayers substantiated only a portion of their claimed deductions, however; also finding that a burst water pipe may have prevented the taxpayers from substantiating all of the deductions).

43 T.C. Memo. 2014-221, *appeal docketed*, No. 15-70591 (9th Cir. Feb. 26, 2015).

44 For a detailed discussion of IRC § 162 and deductibility of expenses, see Most Litigated Issue: *Trade or Business Expenses Under IRC § 162 and Related Sections*, *infra*.

45 IRC § 162(a)(2).

Two pertinent issues at trial included whether Engstrom was entitled to travel expense deductions under IRC § 162 and if Engstrom was liable for an accuracy-related penalty under IRC § 6662. To make its determination, the court divided the flights into three categories:

1. Flights on which Mr. Lack and Engstrom employees were passengers;
2. Flights on which Mr. Lack was the only Engstrom employee; and
3. Flights on which neither Mr. Lack nor any other Engstrom employee was a passenger.

The court found that Engstrom would be entitled to deductions for the first category only when the expense for each flight was properly substantiated. For the second category, the court allowed deductions only when it was readily apparent that the flight had a business purpose for Engstrom. No deductions were allowed for flights in the third category. Within this framework, the court found that many of the flights did not meet the heightened requirements for substantiation under IRC § 274(d).[46]

The court noted that the revenue schedules prepared by Ms. Carter included payment information but lacked flight information, such as a list of passengers or the business purpose for the flight. Mr. Lack's executive calendar did not include amounts of travel expenses or the business purpose for each flight. The flight logs kept by the pilots also failed to note any business purpose for the flights and did not contain passenger information. The court deemed the logs prepared by Ms. Carter and Mr. Lack noncontemporaneous and prepared in anticipation of trial. As a result, the court allowed only a portion of the claimed travel expenses to be deducted.

The court imposed a penalty for negligence under IRC § 6662(b)(1) for failure to keep adequate records. In its analysis of reasonable cause, the court found that the "[p]etitioner failed to establish reasonable cause for not keeping sufficient contemporaneous records showing important flight details and the business purpose of the travel."[47] Thus, reasonable cause was rejected based on the same evidence that established negligence.

Reasonable cause and good faith may be found if there is "an honest misunderstanding of fact or law."[48] For example, in *Dabney v. Commissioner*,[49] Mr. Dabney wanted to increase the value of his individual retirement account (IRA) by investing in real estate with funds from his IRA. He researched this investment option on the Internet and found that IRAs could hold property for investment. He spoke with a customer service representative at Charles Schwab, his investment firm, who informed him that Charles Schwab did not allow the purchase and holding of real estate. Mr. Dabney also contacted his accountant, who agreed with Mr. Dabney's assessment after reviewing his research material.

Mr. Dabney went through with his plan and had $114,000 withdrawn from his IRA. The money was wired directly to a title company in order to purchase real estate for investment purposes. He requested that the title be issued in his name along with the name of his IRA account with Charles Schwab. He later sold the property and had the proceeds of the sale sent directly to his account at Charles Schwab as a

46 To be deductible as a business expense under IRC § 162, travel expenses require sufficient evidence of (1) the amount of the expense; (2) the time and place of the travel; (3) the business purpose of the expense; and (4) the business relationship of the taxpayer to the person using the property. IRC § 274(d). While a contemporaneous record is not required, "a record of the elements of an expenditure or of a business use of listed property made at or near the time of the expenditure or use, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall." Treas. Reg. § 1.274-5T(c)(1).

47 T.C. Memo. 2014-221.

48 Treas. Reg. § 1.6664–4(b)(1).

49 T.C. Memo. 2014-108.

rollover contribution. Charles Schwab issued a Form 1099 to the Dabneys, though Mr. Dabney did not recall receiving it. Mr. Dabney did not report this withdrawal as income on the couple's 2009 tax return. The IRS subsequently determined a deficiency of $42,431 against the couple and imposed an accuracy-related penalty of $8,486.

The court found that, as a matter of policy, the Charles Schwab IRA did not allow real property to be held for investment and therefore the transfer of funds was not between trustees, as required for a rollover contribution. As a result, Mr. Dabney was required to report this withdrawal as income on his tax return. However, the court declined to impose an accuracy-related penalty on the Dabneys. In reaching this determination, the court analyzed Mr. Dabney's good faith attempt at compliance. The court noted that Mr. Dabney was not a sophisticated taxpayer, had no background in tax or accounting, and had gone to great lengths to ensure that using funds from his IRA would be non-taxable. Mr. Dabney's research confirmed that IRAs are permitted to hold real property, he made sure the property was held for investment purposes, he obtained a scrivener's affidavit to fix an issue with the title, and made sure the funds were wired directly. He also conferred with a Charles Schwab customer service representative and his accountant on multiple occasions regarding the transaction. Although Mr. Dabney was mistaken, the court found that he had acted with reasonable cause and in good faith.[50]

Reasonable Basis

In some situations, a taxpayer may not be certain as to how the IRS will respond to the tax treatment employed for a specific set of circumstances. Disclosing the tax treatment used for an issue on the return, supported by a reasonable basis, can reduce the amount of an underpayment for purposes of the accuracy-related penalty.[51] A tax position supported by a reasonable basis will also defeat a negligence claim.[52]

For example, in *Wells Fargo & Co. v. United States*,[53] the taxpayer, a bank, claimed foreign tax credits from income taxes paid to the United Kingdom and expenses attributable to a Structured Trust Advantaged Repackaged Securities (STARS) transaction. Wells Fargo entered into the STARS transaction with Barclays, a bank based in the United Kingdom (U.K.).[54] The transaction was intended to provide tax benefits to both banks from the same income tax payments in the United Kingdom, but the IRS viewed it as a sham transaction and imposed an accuracy-related penalty on negligence grounds.

50 Though this case involved a deficiency on a joint return and liability for the accuracy-related penalty for both Mr. and Mrs. Dabney, the court granted a motion to dismiss Mrs. Dabney for lack of prosecution and held that it would hold her to a liability consistent with the opinion.

51 IRC § 6662(d)(2)(B)(ii).

52 Treas. Reg. § 1.6662-3(b)(1) ("A return position that has a reasonable basis… is not attributable to negligence.").

53 114 A.F.T.R.2d (RIA) 5414 (D. Minn. 2014).

54 In general, a STARS transaction is a multistep transaction that enables a U.S. participant to realize an economic benefit by claiming foreign tax credits. The STARS transaction in *Wells Fargo* consisted of a loan and a trust component. Wells Fargo transferred income-producing assets to a U.K.-based trust. The assets had no relation to the U.K. However, the trust was considered a resident of the U.K., and thus, the income generated by the trust was subject to U.K taxes. The income realized by the U.K. trust and the U.K. income taxes paid by it were treated as received and paid by Wells Fargo. Under U.K. law, almost all of the after-U.K. tax income of the trust was treated as a distribution to Barclays. The after-U.K. tax trust income allocated to Barclays was immediately credited to a blocked account ("Bx") in the name of Barclays that was maintained by Wells Fargo and then reinvested in the trust. Barclays was obligated to pay consideration to Wells Fargo of a fixed amount each month that was calculated to be a percentage of the U.K. tax credits that Barclays expected to enjoy as a result of the allocation of trust income. Barclays also deducted the Bx amounts in the calculation of its U.K. income tax liability. The combination of U.K. tax credits and U.K. deductions (for the amounts allocated to the blocked account and contributed back to the trust and the Bx payments) created a net profit to Barclays under U.K. tax law as a result of its involvement in the STARS transaction. Barclays effectively loaned $1.25 billion to Wells Fargo at an interest rate of 0.2 percent. *See also* Ajay Gupta, *Interest Deductibility in Stars Cases*, Tax Notes Today, Jan. 26, 2015, 2015 TNT 16-4.

The IRS argued that taxpayer participation in a sham transaction is necessarily negligent, requiring that the issue of the transaction's economic substance be determined. The court found there was insufficient support for the IRS's position. It held that the negligence penalty would be avoided if Wells Fargo's position was supported by a reasonable basis, even if the sham transaction issue is eventually lost. The court held that Wells Fargo had established a reasonable basis, supported by (1) the tax code, (2) regulations, (3) tax treaties, and (4) judicial decisions; and granted the taxpayer's motion for partial summary judgment that there was a reasonable basis for the STARS transaction reporting.

Reliance on the Advice of a Tax Professional as Reasonable Cause

Another commonly litigated question was whether reliance on a tax professional established reasonable cause. The taxpayer's education, sophistication, and business experience are relevant in determining whether his reliance on tax advice was reasonable.[55] To prevail, a taxpayer must establish that:

1. The adviser was a competent professional who had sufficient expertise to justify reliance;
2. The taxpayer provided necessary and accurate information to the adviser; and
3. The taxpayer actually relied in good faith on the adviser's judgment.[56]

Taxpayers argued their good faith reliance on a competent tax professional in several cases this year, including *Evans v. Commissioner*.[57] In *Evans*, the married taxpayers ran a construction company, Dave Evans Construction (DEC). The taxpayers sponsored their son's successful motocross racing as a promotional activity for DEC. They deducted these expenses (including the purchase of a motorhome, a Mirage trailer, and a utility trailer) as ordinary and necessary expenses for their company pursuant to IRC § 162. The IRS argued that such expenses were not ordinary and necessary for the business and instead were personal expenses that should not have been deducted.[58]

The court ruled in favor of Mr. and Mrs. Evans. The court found that the expenses were business in nature, as the promotion of motocross led to increased exposure to clients, investors, and subcontractors. In particular, the court noted the local construction industry's significant involvement in motocross racing. Further, only one child's expenses were deducted, other corporate support was acquired for his racing, and their deductions stopped when the son became a professional racer. The court held that the expenses were reasonable in amount, as they totaled less than one percent of gross receipts for DEC. Additionally, the court found that the motorhome was not primarily used for lodging as it had a ramp and was used to store, transport, and repair motorbikes as well. The court did not allow expenses to be deducted in association with the utility trailer, as the taxpayers did not prove it was used for an advertising purpose.

The taxpayers hired Ms. Chacon, a certified public accountant (CPA), who testified that she provided necessary documents to Mr. Anderson, a separate CPA, and answered questions as he prepared the returns. The court held that taxpayers had reasonably relied in good faith on Mr. Anderson's judgment for the disallowed deductions and, therefore, were not subject to a penalty under IRC § 6662.

In *Gardner v. Commissioner*,[59] Mr. Gardner was involved in many businesses, including insurance and home construction. In 2001, he entered into agreements with David Pearl and John Pearl to breed

55 Treas. Reg. § 1.6664-4(c)(1). *See also* IRM 20.1.5.6.1(6), *Reasonable Cause* (Jan. 24, 2012).

56 *Neonatology Associates, P.A. v. Comm'r*, 115 T.C. 43, 99 (2000) (citations omitted), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

57 T.C. Memo. 2014-237. *See also VisionMonitor Software, LLC v. Comm'r.*, T.C. Memo. 2014-182.

58 For information on business expenses deductions, see IRC § 162 and Most Litigated Issue: *Trade or Business Expenses Under IRC § 162 and Related Sections*, *infra*.

59 T.C. Memo. 2014-148.

genetically superior cattle, which would be jointly owned. Mr. Gardner executed 24 promissory notes with entities owned by the Pearls, with the cattle as collateral. The cattle operation amassed $991,842 in expenses over ten years for a net reported loss of $621,677. Although the only evidence of payment was checks totaling $74,618, the taxpayer deducted all of these losses as business expenses under IRC § 162. The court held that the Mr. Gardner was not eligible to claim these deductions because the cattle operation was an activity not engaged in for profit.[60]

Mr. Gardner argued for a reasonable cause and good faith exception based on his reliance on his CPA. His accountant relied solely upon income and expense summaries prepared by David Pearl for the cattle operation. While the court found the CPA to be a competent professional, it found that Mr. Gardner had, in fact, relied upon David Pearl for tax purposes and not the CPA. As David Pearl had no expertise in accounting or taxation, the court found Mr. Gardner failed the first prong of the reasonable reliance test. The court further found that he had failed to provide the necessary and accurate information to his CPA, a requirement under the second prong in *Neonatology Associates, P.A. v. Commissioner*.

Reliance on tax advice from the promoter of a transaction or an advisor with an inherent conflict of interest may also not be reasonable. For example, in *Salem Financial, Inc. v. United States*, Salem Financial, a subsidiary of Branch Banking and Trust (BB&T), sought a tax refund related to a STARS transaction.[61]

In 2002, BB&T entered into the STARS transaction with Barclays Bank, which was located in the United Kingdom (U.K.). Barclays developed the STARS transaction along with KPMG LLP, an international accounting firm. KPMG also recommended that BB&T hire Sidley, Austin, Brown & Wood LLP (Sidley) as its tax advisor on the STARS transaction. BB&T followed this recommendation and also requested that its accounting firm PricewaterhouseCoopers (PwC) review the transaction, but not for tax compliance purposes.

Essentially, BB&T created a trust and contributed $5.755 billion of assets to it. Barclays gave $1.5 billion to the trust in return for an interest in the trust. The terms of this part of the agreement meant the $1.5 billion was a loan from Barclays to BB&T. BB&T appointed a U.K. trustee to the trust, subjecting the trust to taxation in the U.K. BB&T used trust funds to pay the U.K. tax on the trust's income. Barclays then received U.K. tax deductions and credits, and it made a monthly payment to BB&T, which was equal to 51 percent of the U.K. taxes paid by the trust. BB&T then claimed a foreign tax credit. The ability for there to be a profit from this transaction relied on both BB&T and Barclays being able to successfully obtain their respective tax credits.

On March 30, 2007, the IRS issued proposed regulations addressing schemes such as the STARS transaction. BB&T terminated the trust six days later. It filed returns claiming foreign tax credits and interest deductions. Upon review, the IRS denied both claims and imposed accuracy-related penalties. BB&T sued in the Court of Federal Claims for federal tax credits and interest deductions disallowed by the IRS as well as accuracy-related penalties imposed.[62] The Court of Federal Claims denied the claim finding that it was not reasonable for Salem Financial to have relied on KPMG, Sidley, or PwC for tax advice, and BB&T appealed.

60 *See generally* IRC § 183 and the nine-factor test in Treas. Reg. § 1.183-2(b).

61 786 F.3d 932 (Fed. Cir. 2015), *aff'g in part*, *reversing in part and remanding*, 112 Fed. Cl. 543 (2013), *petition for cert. filed*, No. 15-380 (Sept. 29, 2015). See footnote 53, *supra*, for a detailed discussion of the same STARS transaction involving Barclays and Wells Fargo.

62 *Salem Fin., Inc. v. United States*, 112 Fed. Cl. 543 (2013), *rev'd in part and remanded by* 786 F.3d 932 (Fed. Cir. 2015), *petition for cert. filed*, No. 15-380 (Sept. 29, 2015).

On appeal, the Court of Appeals for the Federal Circuit found the STARS transaction to be a sham and disregarded all of its tax consequences. The court also upheld the imposition of accuracy-related penalties against Salem Financial. At trial, Salem Financial asserted that it reasonably relied upon the favorable tax opinion from Sidley and supportive advice from its accounting firm, PwC.

In its decision, the court notes that reliance on an advisor is not reasonable if that advisor has a conflict of interest that the taxpayer is aware of or if the transaction is "too good to be true." The court found reliance on Sidley to be unreasonable because Sidley had been selected by Salem Financial on recommendation of KPMG, the principal marketer of the STARS transaction. KPMG and Sidley were also involved with putting the transaction together; therefore, KPMG and Sidley had an interest in the transaction and their advice was deemed suspect by the court.

The court also rejected reasonable reliance upon the opinion of PwC. PwC had not been tasked with reviewing the tax compliance of the STARS transaction. As a result, PwC did not provide a tax opinion. Even so, PwC explicitly informed Salem Financial that it was not providing an opinion regarding the larger transaction and had qualified its advice by suggesting a low level of comfort that the IRS would accept the STARS transaction.

Lastly, the court rejected a reasonable reliance defense because Salem Financial should have known that the STARS transaction was "too good to be true." The court reached this conclusion based on the education and experience of the company's executives. The court upheld the accuracy-related penalty but required reassessment of the amount to allow for interest deductions on part of the transaction.

No Affirmative Defense Offered by the Taxpayer

Many taxpayers offered no affirmative defense for the underpayment of tax, failing completely to claim the reasonable cause and good faith defense under IRC § 6664(c). Nearly two-thirds (21 cases out of 32 cases) of those failing to make an argument or present evidence of good faith were unrepresented in this reporting period.[63] The burden of proof to raise an affirmative defense is on the taxpayer and as a result, taxpayers must provide documentation to substantiate any disputed deductions or credits, explain why the records were inadequate, or show reliance on a tax professional.[64] When the taxpayer fails to present any evidence for an affirmative defense, courts may do a cursory examination of the *pro se* taxpayer's reliance on a tax professional.[65] While some *pro se* taxpayers may be unaware of the good faith exception, in many cases the taxpayer did not keep adequate records to support his or her position.[66]

An exception is *Nguyen v. Commissioner*, where evidence of reasonable reliance on the tax return preparer might have made a difference in the court's decision to impose the penalty under IRC § 6662.[67] The taxpayers, a married couple, were audited for TYs 2009 and 2010. The audit focused on the hardwood floor installation business owned and operated by Mr. Nguyen. A flood in the taxpayers' house destroyed some of Mr. Nguyen's records for 2009. Mr. Nguyen provided the surviving records to Mr. Wynn, a tax return preparer, who prepared a 2009 return for the taxpayers. Mr. Wynn reported cost of goods sold for Mr. Nguyen's business as $43,503 and supplies totaling $5,675. Mr. Wynn did not explain the difference between these two elements to the taxpayers. Ultimately, the IRS allowed only $18,095.66 for cost of

63 *See* Table 1 in Appendix 3, *infra*.

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

65 *See, e.g.*, *Peterson v. Comm'r*, T.C. Memo. 2015-23, *appeal docketed*, No. 15-73092 (9th Cir. Oct. 8, 2015); *Smith v. Comm'r*, T.C. Memo. 2014-203.

66 *See, e.g.*, *Duong v. Comm'r*, T.C. Memo. 2015-90; *Flores v. Comm'r*, T.C. Memo. 2015-9.

67 T.C. Memo. 2014-199.

goods sold but did allow the entire amount claimed for supplies. The Nguyens used a different return preparer in 2010, but this preparer relied on the 2009 return in preparing the 2010 return. While the taxpayers' 2010 return claimed $39,894 for supplies, the IRS allowed only $24,668.26.

At trial, the Nguyens, who had representation, provided an incomplete bank statement for 2009 and some bank statements for 2010. They provided no additional testimony to substantiate expenses. The court allowed deductions equal to the amounts calculated by the IRS. The court then considered a reasonable cause defense prior to imposing a penalty on the Nguyens. First, the court determined that the 2009 flood could not be a reason for lack of substantiation because Mr. Nguyen had explained that most of his transactions would appear in his bank account statements, which he could have obtained for the trial.

The court then considered Mr. Nguyen's background. Mr. Nguyen had come to the United States from Vietnam and had obtained a ninth grade education. He had limited English skills but had successfully operated his business since 1997. Mr. Nguyen testified that he trusted Mr. Wynn and relied on his judgment. Mr. Wynn did not appear in court, despite the fact that Mr. Nguyen had issued him a subpoena to appear. However, Mr. Nguyen also did not submit any evidence to show Mr. Wynn's credibility or experience. Without this information, the taxpayers were unable to show that they relied on Mr. Wynn in good faith.

CONCLUSION

Over this last reporting period, the issue of accuracy-related penalties was decided by the courts in 113 cases. Litigation on the issue has continued to decline over the last two periods.[68]

Courts most often cited inadequate maintenance of records when imposing an accuracy-related penalty. When accepting a defense for reasonable cause and good faith, courts were most likely to cite reliance on a tax professional and manifestations of taxpayer efforts to comply with the tax code. About one-third of *pro se* taxpayers (21 cases out of 68 cases) and nearly one-fifth of represented taxpayers (11 cases out of 45 cases) failed to argue or present evidence of good faith.

As mentioned above, the IRS has the burden to prove the existence of an underpayment attributable to negligence/disregard of rules or regulations or an underpayment attributable to a substantial understatement.[69] However, if the taxpayer does not raise the issue of penalty assessment in the court pleadings, the taxpayer is deemed to have conceded the issue and the IRS is not required to provide evidence that the penalty is appropriate.[70] Likewise, the rules of the Tax Court require the taxpayer to include all arguments in the petition.[71]

Finally, it is important to note that Congress enacted law reversing the Tax Court's decision in *Rand v. Commissioner*, in which the Tax Court had held that refundable credits cannot reduce the amount shown as tax, by the taxpayer on a return, below zero.[72] IRC § 6664(a) was amended to be consistent with the rule of IRC § 6211(b)(4), which would allow the IRS to calculate negative tax in computing the amount

68 *See* National Taxpayer Advocate 2013 Annual Report to Congress 341 and National Taxpayer Advocate 2014 Annual Report to Congress 446.

69 IRC § 7491(c).

70 *Swain v. Comm'r*, 118 T.C. 358 (2002).

71 Tax Ct. R. 34(b)(4) ("Any issue not raised in the assignments of error shall be deemed to be conceded.").

72 Consolidated Appropriations Act, 2016, § 209 (2015). *See also Rand v. Comm'r*, 141 T.C. 376 (2013).

of underpayment for accuracy-related penalty purposes.[73] Thus, for returns filed after December 18, 2015, or for returns filed before that date for which the period of limitations on assessment under IRC § 6501 has not expired, a taxpayer can be subject to an underpayment penalty in IRC § 6662 based on a refundable credit which reduces tax below zero.

73 Consolidated Appropriations Act, 2016, § 209 (2015).

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

SUMMARY

The deductibility of trade or business expenses has long been among the ten Most Litigated Issues since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.[1] We identified 99 cases involving a trade or business expense issue that were litigated between June 1, 2014, and May 31, 2015. The courts affirmed the IRS position in 57 of these cases, or about 58 percent, while taxpayers fully prevailed in 11 cases, or about 11 percent. The remaining 31 cases, or 31 percent, resulted in split decisions.

TAXPAYER RIGHTS IMPACTED[2]

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*

PRESENT LAW

Internal Revenue Code (IRC) § 162 allows deductions for ordinary and necessary trade or business expenses paid or incurred during the course of a 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 guidance about whether a taxpayer is entitled to claim certain deductions. The cases analyzed for this report illustrate that this process is ongoing and involves the analysis of facts and circumstances particular to each case. When a taxpayer seeks judicial review of the IRS's determination of a tax liability relating to the deductibility of a particular expense, the courts must often address a series of questions, including 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 Treasury Regulations provide a definition.[3] The definition of a "trade or business" comes from common law, where the concepts have been developed and refined by the courts.[4] The Supreme Court has interpreted "trade or business" for purposes of IRC § 162 to mean an activity conducted with "continuity and regularity" and with the primary purpose of earning income or making profit.[5]

1 See National Taxpayer Advocate 1998-2014 Annual Reports to Congress.

2 See Taxpayer Bill of Rights, *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

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

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

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

What is an ordinary and necessary expense?

IRC § 162(a) requires a trade or business expense to be both "ordinary" and "necessary" in relation to the taxpayer's trade or business to be deductible. In *Welch v. Helvering*, the Supreme Court stated that the words "ordinary" and "necessary" have different meanings, both of which must be satisfied for the taxpayer to benefit from the deduction.[6] The Supreme Court describes an "ordinary" expense as customary or usual and of common or frequent occurrence in the taxpayer's trade or business.[7] The Court describes a "necessary" expense as one that is appropriate and helpful for development of the business.[8]

Common law also requires that in addition to being ordinary and necessary, the amount of the expense must be reasonable for the expense to be deductible. In *Commissioner v. Lincoln Electric Co.*, the Court of Appeals for the 6th 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."[9]

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

A currently deductible expense is an ordinary and necessary expense paid or incurred during the taxable year in the course of carrying on a trade or business.[10] No current deductions are allowed for the cost of acquisition, construction, improvement, or restoration of an asset expected to last more than one year.[11] Instead, those types of expenses are generally considered capital expenditures, which may be subject to depreciation, amortization, or depletion over the useful life of the property.[12]

Whether an expenditure is deductible under IRC § 162(a) or is a capital expenditure under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach to applying principles of capitalization and deductibility.[13]

When is an expense paid or incurred during the taxable year, and what proof is there that the expense was paid?

IRC § 162(a) requires an expense to be "paid or incurred during the taxable year" to be deductible. The IRC also requires 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.[14] If a taxpayer cannot substantiate the exact amounts of deductions by documentary evidence (*e.g.*, invoice, paid bill, or canceled check) but can establish that he or she had some business expenditures, the courts may employ the *Cohan* rule to grant the taxpayer a reasonable amount of deductions.

6 290 U.S. 111, 115 (1933) (suggesting an examination of "life in all its fullness" will provide an answer to the issue of whether an expense is ordinary and necessary).

7 *Deputy v. du Pont*, 308 U.S. 488, 495 (1940) (citation omitted).

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

9 176 F.2d 815, 817 (6th Cir. 1949), *cert. denied*, 338 U.S. 949 (1950).

10 IRC § 162(a).

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

12 IRC § 167.

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

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

The *Cohan* rule

The *Cohan* rule is one of "indulgence" established in 1930 by the Court of Appeals for the 2nd Circuit in *Cohan v. Commissioner*.[15] The court held that the taxpayer's business expense deductions were not adequately substantiated, but stated that "the [Tax Court] should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent."[16] In *Estate of Elkins v. Commissioner*, the 5th Circuit recently described "the venerable lesson of Judge Learned Hand's opinion in *Cohan*: In essence, make as close an approximation as you can, but never use a zero."[17]

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

- Travel expenses;
- Entertainment, amusement, or recreation expenses;
- Gifts; and
- Certain "listed property."[18]

A taxpayer must substantiate a claimed IRC § 274(d) expense with adequate records or sufficient evidence to establish the amount, time, place, and business purpose.[19] A contemporaneous log is not explicitly required, but a statement not made at or near the time of the expenditure has the same degree of credibility only if the corroborative evidence has "a high degree of probative value."[20] In addition, entertainment expenses require proof of a business relationship to the taxpayer.[21]

Who has the burden of proof in a substantiation case?

Generally, the taxpayer bears the burden of proving that he or she is entitled to the business expense deductions and the IRS's proposed determination of tax liability is incorrect.[22] IRC § 7491(a) provides that the burden of proof shifts to the IRS when the taxpayer:

- Introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer's liability;
- Complies with the requirements to substantiate deductions;

15 39 F.2d 540 (2d Cir. 1930). George M. Cohan was an actor, playwright, and producer who spent large sums travelling and entertaining actors, employees, and critics. Although Cohan did not keep a record of his spending on travel and entertainment, he estimated that he incurred $55,000 in expenses over several years. The Board of Tax Appeals, now the Tax Court, disallowed these deductions in full based on Cohan's lack of supporting documentation. Nevertheless, on appeal, the 2nd Circuit concluded that Cohan's testimony established that legitimate deductible expenses had been incurred. As a result, the 2nd Circuit remanded the case back to the Board of Tax Appeals with instructions to estimate the amount of deductible expenses.

16 39 F.2d 540 (2d Cir. 1930) at 544 (2d Cir. 1930), *aff'g and remanding* 11 B.T.A. 743 (1928).

17 767 F.3d 443, 449, n. 7 (5th Cir. 2014), *rev'g* 140 T.C. 86 (2013).

18 "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); and any other property specified by regulations. IRC §§ 280F(d)(4)(A) and (B).

19 Treas. Reg. § 1.274-5T(b).

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

21 Treas. Reg. § 1.274-5T(b)(3)(v).

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

- Maintains all records required under the Code; and
- Cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.

ANALYSIS OF LITIGATED CASES

The deductibility of trade or business expenses has been one of the ten Most Litigated Issues since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.[23] This year, we reviewed 99 cases involving trade or business expenses that were litigated in federal courts from June 1, 2014, through May 31, 2015. Table 2 in Appendix 3 contains a list of the main issues in those cases. Figure 3.2.1 categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

FIGURE 3.2.1, Trade or Business Expense Issues in Cases Reviewed[24]

Issue	Type of Taxpayer	
	Individual	Business
Substantiation of Expenses, Including Application of the *Cohan* Rule	14	60
Ordinary and Necessary Trade or Business Expenses	1	11
Personal vs. Business Expense	4	19
Trade or Business Carried on for Profit	2	19
Economic Substance	0	4
Home Office	1	10

Taxpayers represented themselves (*pro se*) in 60 of 99 cases. Taxpayers represented by counsel (39 of 99 cases) fared slightly better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in approximately 49 percent of cases (19 of 39). By contrast, *pro se* taxpayers received full or partial relief in 38 percent of cases (23 of 60).

Individual Taxpayers

None of the 16 decisions involving individual taxpayers (where the term "individual" excludes a sole proprietorship) were issued as a regular opinion of the Tax Court.[25] Eleven of the 16 individual taxpayers appeared *pro se*. Two individual taxpayers received full relief, while nine earned split decisions. The court fully upheld the IRS position in five of 16 cases (31 percent).

23 See National Taxpayer Advocate 1998-2014 Annual Reports to Congress.

24 Multiple issues can appear within one case; therefore, these issue-spotting breakdown figures will not match the total case count.

25 Tax Court 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 legally significant. Finally, "S" case decisions (for disputes involving $50,000 or less where the taxpayer has elected Small Case status) are not appealable and, thus, have no precedential value. *See* IRC § 7463(b). *See also* U.S. Tax Court Rules of Practice and Procedure, Rules 170-175. More than half of the cases reviewed this year involving individual taxpayers (excluding sole proprietorships) were "S" cases.

The most prevalent issue was the substantiation of claimed trade or business expense deductions. For example, in *Garza v. Commissioner*, the Tax Court denied a travel expense deduction for failure to substantiate.[26] The taxpayer, a direct sales representative for Time Warner Cable, used his personal vehicle to make service calls and maintained a calendar planner in which he recorded his vehicle's odometer readings at the beginning and end of each month, sometimes also including intermediate readings and personal notes. Although the taxpayer's calendar planner was contemporaneous, it lacked information detailing the amount, date, and business purpose of each use of his vehicle. As a result, the Court denied the taxpayer a deduction for these claimed travel expenses.[27]

Business Taxpayers

We reviewed 83 cases involving business taxpayers. As it turned out, business taxpayers had a much lower success rate compared to individual taxpayers. Individual taxpayers received full or partial relief in approximately 69 percent of cases (11 of 16). Meanwhile, business taxpayers received full or partial relief in only 37 percent of cases (31 of 83).

Business taxpayers were represented by counsel in 55 percent (17 of 31) of favorably decided cases, including eight cases in which the taxpayer received full relief. Business taxpayers were represented by counsel in 33 percent (17 of 52) of the cases the IRS won. To the extent that *pro se* taxpayers were successful in court, these favorable outcomes stemmed mostly from their ability to provide records substantiating deductions in cases where such substantiation was in controversy.

As was the case for the individual taxpayers, substantiation of expenses was by far the most prevalent issue, and in most instances, the courts denied the business taxpayers' deductions for failure to substantiate.[28] Courts did, however, allow some of these deductions when the taxpayer produced sufficient evidence.[29] Courts occasionally applied the *Cohan* rule where the taxpayer presented sufficient documentation to prove an expense was incurred but had limited documentation of the precise amount.[30] As previously mentioned, however, IRC § 274(d) makes the *Cohan* rule unavailable in certain circumstances in which the taxpayer must substantiate the deductions.

Taxpayers were also denied business expense deductions under IRC § 262(a) when the courts found the expenses were related to personal rather than business activities.[31] In *Peterson v. Commissioner*, the taxpayer was a full-time police officer for the city of Chicago and also owned and operated a private security company.[32] The taxpayer claimed deductions for vehicle, transportation, and travel expenses resulting

26 T.C. Memo. 2014-121.

27 *See also Flores v. Comm'r*, T.C. Memo. 2015-9 (denying deductions for vehicle and other Schedule A expenses for insufficient or absent documentation).

28 *See Sheridan v. Comm'r*, T.C. Memo. 2015-25 (finding that taxpayer was not entitled to annual theft loss deductions of $1 million for alleged smokeless tobacco vaporizer patent infringement); *Robinson v. Comm'r*, T.C. Memo. 2014-120, *aff'd*, No. 15-1380 (4th Cir. Sept. 3, 2015) (denying deductions for vehicle, home office, and other personal expenses).

29 *See ABC Beverage Corp. v. U.S.*, 756 F.3d 438 (6th Cir. 2014), *aff'g* 577 F. Supp. 2d 935 (W.D. Mich. 2008) (holding that a portion of the purchase price from a burdensome lease buyout was deductible); *Cooper v. Comm'r*, 143 T.C. 194 (2014) (finding that reverse engineering expenses were sufficiently related to taxpayer's business as an inventor and were deductible as a result), *appeal docketed*, No. 15-70863 (9th Cir. Mar. 20, 2015).

30 *See Mylander v. Comm'r*, T.C. Memo. 2014-191 (allowing deduction for continuing dental education based on approximated expense of class hour and annual education requirement); *Sawyer v. Comm'r*, T.C. Memo. 2015-55 (allowing deduction for labor costs approximated from taxpayer's testimony and invoices).

31 IRC § 262(a) provides that personal, living, and family expenses are generally not deductible. *See, e.g.*, *Lussy v. Comm'r*, T.C. Memo. 2015-35 (denying deductions for legal fees, travel, and other expenses personal in nature), *appeal docketed*, No. 15-11626 (11th Cir. Apr. 13, 2015).

32 T.C. Memo. 2015-23.

from his off-duty work activities. He also deducted expenses for meals and entertainment, an additional bulletproof vest, and classes towards a master's degree in emergency management.

The Tax Court did not allow deductions for an additional bullet proof vest or expenses towards the taxpayer's master degree as these expenses were personal in nature.[33] Similarly, the Tax Court found that the taxpayer failed to substantiate travel, meal, and entertainment expenses to the strict degree required by IRC § 274(d). As a result, no deductions whatsoever were allowed.

Similarly, in *Engstrom, Lipscomb & Lack, APC v. Commissioner*, a law firm (Engstrom) challenged the IRS's disallowance of business-related air travel expenses.[34] The Tax Court denied all deductions for flights where no Engstrom personnel were present because they lacked a business purpose and failed to meet the strict IRC § 274(d) substantiation requirements. By contrast, the substantiation requirements and other prerequisites for deductibility, such as a business purpose, were held to have been satisfied with respect to many of the air travel expenses for flights on which the firm's owner or employees were passengers.[35]

Courts likewise generally sustained IRS determinations that business expense deductions were not attributable to an activity engaged in for profit within the meaning of IRC § 183. However, in *Crile v. Commissioner*, the taxpayer successfully established that she engaged in art making as a for profit business activity.[36] To arrive at this determination, the Tax Court proceeded to examine the taxpayer's deductions using the nine-factor test of Treas. Reg. § 1.183-2(b).[37]

The Tax Court stated that the taxpayer's business plan, credentials as an artist, time and effort spent on her art business, and the expectation of appreciation in the value of her artwork weighed in favor of her art making being for profit. According to the Court, these factors weighed more heavily in favor of the taxpayer's art making being for profit than the fact that she earned profits in only two of the multiple years in which she claimed deductions.[38]

Another common theme was the difficulty in proving that expenses were ordinary and necessary to the taxpayer's business.[39] The Tax Court in *Guardian Industries Corp. v. Commissioner* denied the taxpayer a deduction for a fine it paid to the Commission of the European Community (the Commission).[40] Guardian Industries and its Luxembourg subsidiary manufactured and sold fabricated-glass products. The Commission began an investigation of Guardian Industries and ultimately concluded that Guardian

33 39 F.2d 540 (2d Cir. 1930).

34 *Engstrom, Lipscomb & Lack, APC v. Comm'r*, T.C. Memo. 2014-221, *appeal docketed*, No. 15-70591 (9th Cir. Feb. 26, 2015).

35 For a more detailed discussion of this case, see Most Litigated Issue: *Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)*, *supra*.

36 T.C. Memo. 2014-202.

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

38 *Crile*, T.C. Memo. 2014-202.

39 *See* IRC § 162(a). For examples of cases examined in which the court denied deductions for failure to prove the expense was ordinary and necessary to the taxpayer's business, *see*, *e.g.*, *Fargo v. Comm'r*, T.C. Memo. 2015-96 (holding that payments made by the taxpayer's S corporation were not ordinary and necessary business expenses and therefore not deductible); *Midwest Eye Ctr., S.C. v. Comm'r*, T.C. Memo. 2015-53 (holding that taxpayer's $1 million bonus to sole executive and shareholder was not an ordinary and necessary business expense because it was not reasonable).

40 143 T.C. 1 (2014).

Industries had engaged in a cartel with its subsidiary, violating a European treaty on price fixing. A fine was issued against Guardian Industries as a result.

Guardian Industries attempted to deduct the fine it paid to the Commission as an "ordinary and necessary" business expense under IRC § 162. The IRS denied Guardian Industries this deduction, explaining that the fine paid to the Commission was more appropriately categorized as a non-deductible "fine or similar penalty paid to a government for the violation of any law."[41] The Tax Court agreed, ruling that the Commission is an "entity serving as an agency or instrumentality" of "[t]he government of a foreign country," and holding that the fine paid by Guardian Industries to the Commission therefore was not a deductible "ordinary and necessary" business expense.[42]

Taxpayers also had difficulty validating their home office deductions, losing cases where business use of a personal residence was in question.[43] One example of this issue was *Longino v. Commissioner*, where the taxpayer, an attorney, sought to claim a number of IRC § 162 expenses, including home office deductions for the use of his apartment.[44] The taxpayer, however, failed to substantiate that he used the apartment exclusively as his principal place of business, as his testimony provided "almost no details" about business activities conducted in the rooms in question.[45] Consequently, the 11th Circuit affirmed the denial of the home office expense deductions on appeal.

Another issue addressed by the courts this year deals with the question of whether a transaction has economic substance, which is a prerequisite for deductibility.[46] For example, in *Reddam v. Commissioner*, the taxpayer sought to offset his potential tax liability from the sale of a company he founded.[47] To realize this offset, the taxpayer engaged in the trading of foreign bank stock through a series of interrelated entities. The culmination of these trades and transactions created a sizable capital loss that the taxpayer sought to claim for tax purposes. In 2001, however, the IRS had announced it would not recognize tax benefits from the type of transactions in which the taxpayer had engaged.[48] The Tax Court held that the taxpayer was not entitled to claim the capital loss at issue, and the taxpayer appealed.

On appeal, the 9th Circuit utilized the "economic substance doctrine" to determine if the taxpayer's claimed capital loss should be disregarded for income tax purposes.[49] The court concluded from the facts of the case that the taxpayer pursued his foreign bank stock transactions solely for their tax benefits and that any potential economic gain from these transactions was vastly outweighed by their designed purpose

41 IRC § 162(f).

42 *Guardian Indus.*, 143 T.C. 1, 20 (2014). Treas. Reg. § 1.162-21(a) states that "[n]o deduction shall be allowed under section 162(a) for any fine or similar penalty paid to— (1) The government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico; (2) The government of a foreign country; or (3) A political subdivision of, or corporation or other entity serving as an agency or instrumentality of, any of the above."

43 IRC § 280(A)(c)(1) allows the deduction of "a portion of the dwelling unit which is exclusively used on a regular basis… as the principal place of business for any trade or business of the taxpayer." If the taxpayer is an employee, the home office deduction is only allowable if the exclusive use is for the convenience of the employer.

44 *Longino v. Comm'r*, 593 F. App'x 965 (11th Cir. 2014), *aff'g* T.C. Memo. 2013-80.

45 *Id.* at 969.

46 Taxpayers lost all four cases focused on the economic substance inquiry. *See Reddam v. Comm'r*, 755 F.3d 1051 (9th Cir. 2014), *aff'g* T.C. Memo. 2012-106; *Kenna Trading, LLC v. Comm'r*, 143 T.C. No. 18 (2014) (disallowing deductions for bad debt derived from sham partnership that lacked economic substance); *Vanney Assocs., Inc. v. Comm'r*, T.C. Memo. 2014-184 (holding that the taxpayer's payment of year-end bonus to shareholder-CEO was not deductible as officer compensation); *Graffia v. Comm'r*, 580 F. App'x 474 (7th Cir. 2014), *aff'g* T.C. Memo. 2013-211 (denying deductions for flow-through losses from sham transactions that lacked economic substance).

47 755 F.3d 1051 (9th Cir. 2014), *aff'g* T.C. Memo. 2012-106.

48 IRS Notice 2001-45, 2001-2 C.B. 129.

49 *Reddam*, 755 F.3d at 1059.

of creating capital losses. As a result, the court held that these transactions lacked economic substance and therefore the capital loss was not deductible.

CONCLUSION

The existence and amounts of allowable business expenses are highly fact-specific and are often open to interpretation. This circumstance continues to generate substantial controversy between the IRS and taxpayers regarding the scope and extent of properly claimed business deductions. This year, as in prior years, the IRS actively scrutinized and challenged many such deductions, while taxpayers were often willing to resort to litigation where the disallowance could not be resolved administratively within the IRS. From June 1, 2014, through May 31, 2015, courts generally favored the IRS's denial of business expense deductions, but specific facts and circumstances yielded some victories for taxpayers.

Eleven of these full or partial victories by taxpayers involved the courts' application of the *Cohan* rule. Use of this common law doctrine allowed taxpayers to deduct estimated expenses in cases where the expenses clearly existed but where available documentation made certainty regarding the amount of these expenses difficult or impossible. The IRS Office of Appeals also utilizes the *Cohan* rule in assessing hazards of litigation and in seeking to reach settlements with taxpayers.[50] The Examination process that often leads to Appeals, however, does not employ the *Cohan* rule and has adopted a more stringent document request policy to close cases and bypass Appeals in several instances.[51]

Given the relative frequency of business expense substantiation litigation, we recommend that IRS Compliance functions adopt the *Cohan* rule as a tool for evaluating and resolving tax controversies. This step would reduce potential hazards of litigation that the IRS may face and would lead to a higher rate of mutually beneficial settlements at the earliest possible stage of administrative proceedings. By embracing the opportunities for education, outreach, and collaboration with stakeholders that increased use of the *Cohan* rule would bring, the IRS can help taxpayers better understand business expense deductions and can effectively reduce the costly litigation to which both taxpayers and the government are currently subject. This education, outreach, and collaboration likewise would promote taxpayers' *right to be informed* and *right to challenge the IRS's position and be heard*.

50 *See* National Taxpayer Advocate 2015 Annual Report to Congress (Most Serious Problem: *Appeals: The Appeals Judicial Approach and Culture Project Is Reducing The Quality and Extent of Substantive Administrative Appeals Available to Taxpayers*), *supra*.

51 *Id.*

MLI #3 Summons Enforcement Under IRC §§ 7602, 7604, and 7609

SUMMARY

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

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

We identified 84 federal cases decided between June 1, 2014, and May 31, 2015 involving IRS summons enforcement issues. The government was the initiating party in 59 cases, while the taxpayer was the initiating party in 25 cases. Overall, taxpayers fully prevailed in two cases, while one case was split. The IRS prevailed in the remaining 81 cases.

TAXPAYER RIGHTS IMPACTED[10]

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

1 IRC § 7602(a)(1); Treas. Reg. § 301.7602-1.
2 IRC § 7602(a).
3 IRC § 7604(b).
4 *U.S. v. Powell*, 379 U.S. 48, 58 (1964).
5 IRC § 7609(b).
6 *U.S. v. LaSalle Nat'l Bank*, 437 U.S. 298, 316 (1978).
7 *U.S. v. Clarke*, 134 S. Ct. 2361, 2367 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S. Tax Cas. (CCH) ¶ 50,732 (S.D. Fla. 2012).
8 *Id.* (stating that "[t]he taxpayer need only make a showing of facts that give rise to a plausible inference of improper motive").
9 *Id.* at 2367-68.
10 *See* Taxpayer Bill of Rights, *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

PRESENT LAW

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

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

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

For example, the IRS does not have to give notice to the taxpayer or person named in the summons if it is attempting to determine whether the taxpayer has an account in a certain bank with sufficient funds to pay an assessed tax because such notice might seriously impede the IRS's ability to collect the tax.[20] Courts have interpreted this "aid in collection" exception to apply only if the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned.[21] Additionally,

11 IRC § 7602(a). *See also LaMura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985) (citing *U.S. v. Bisceglia*, 420 U.S. 141, 145-46 (1975)).

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

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

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

15 IRC § 7604.

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

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

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

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

20 H.R. Rep. No. 94-658, at 310, *reprinted in* 1976 U.S.C.C.A.N. at 3206. *See also* S. Rep. No. 94-938, pt. 1, at 371, *reprinted in* 1976 U.S.C.C.A.N., at 3800-01 (containing essentially the same language).

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

the IRS is not required to give notice when, in connection with a criminal investigation, an IRS criminal investigator serves a summons on any person who is not the third-party record-keeper.[22]

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

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

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

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

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

- Fifth Amendment privilege against self-incrimination;
- Attorney-client privilege;[31]

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

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

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

25 *Fortney v. U.S.*, 59 F.3d 117, 119-20 (9th Cir. 1995).

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

27 *Id*.

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

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

30 *Id*. at 2367-68.

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

- Tax practitioner privilege;[32] or
- Work product privilege.[33]

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

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

1. The documents' existence;
2. The documents' authenticity; and
3. The possession or control of the documents by the person to whom the summons was issued.[37]

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

In June 2014, the IRS issued temporary regulations providing that outside parties hired by the IRS may receive and examine any summoned books, papers, records, or other data and may take testimony of any

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

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

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

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

36 *See, e.g.*, *U.S. v. Ali*, 113 A.F.T.R.2d (RIA) 1863 (D. Md. 2014) (citing *U.S. v. Wujkowski*, 929 F.2d 981, 983 (4th Cir. 1991)).

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

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

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

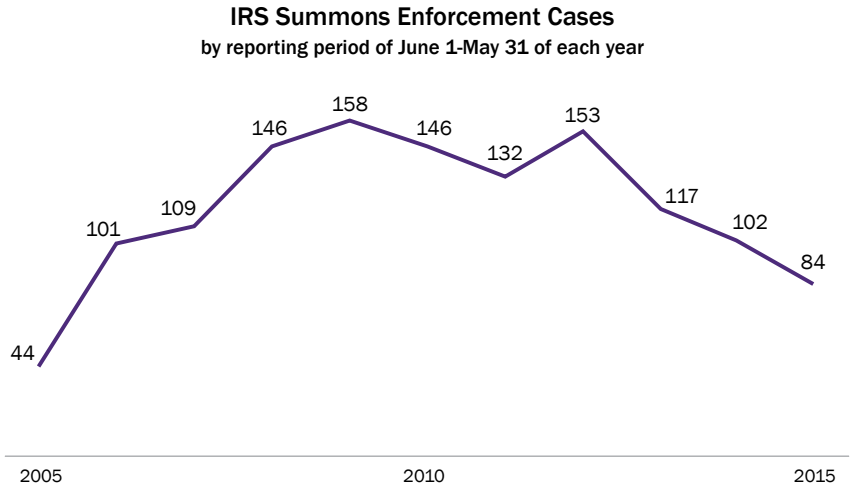
40 *Id*.

summoned person under oath.[41] These outside parties are also permitted to fully participate in a summons interview.[42]

ANALYSIS OF LITIGATED CASES

Summons enforcement has been a Most Litigated Issue in the National Taxpayer Advocate's Annual Report to Congress every year since 2005, when TAS identified only 44 cases but predicted the number would rise as the IRS became more aggressive in its enforcement initiatives. The number of cases peaked at 158 for the reporting period ending on May 31, 2009, but has steadily declined, except for a one-year increase for the year ending May 31, 2012, as shown in Figure 3.3.1. This year, the decline in the number of summons enforcement cases continues, as we identified 84 cases for the reporting period ending on May 31, 2015, a drop from the 102 cases during last year's reporting period. A detailed list of these cases appears in Table 3 of Appendix 3.

FIGURE 3.3.1, Summons Enforcement Cases, 2005–2015



Of the 84 cases TAS reviewed this year, the IRS prevailed in full in 81, a 96 percent success rate. Taxpayers had representation in 23 cases and appeared *pro se* (*i.e.*, on their own behalf) in the

41 Temp. Treas. Reg. § 301.7602-1T(b)(3). There is notable current summons enforcement litigation involving the IRS's use of an outside law firm in an audit of Microsoft Corporation's transfer pricing arrangements. *See* Dolores W. Gregory, *Transfer Pricing: Microsoft Pushes for Evidentiary Hearing, Cites IRS's 'Illegal' Deal With Quinn Emanuel*, Tax Notes Today (Apr. 27, 2015). Although it is outside of the reporting period for the Most Litigated Issues section, Microsoft was successful in obtaining an evidentiary hearing in the summons enforcement case. *See U.S. v. Microsoft Corp.*, 2015 WL 4496749 (W.D. Wash. 2015). Commentators have come out both for and against the IRS's use of outside attorneys in cases such as Microsoft's. *Cf.* Roger A. Pies, *IRS Prerogative to Hire Outside Counsel*, Tax Notes Today (July 7, 2015) (arguing that the IRS should be allowed to retain outside counsel in a big document case) and Stuart Gibson, *If the IRS needs Good Lawyers, it Should Look Across the Street*, Tax Notes Today (Mar. 30, 2015) (questioning why the IRS did not seek assistance from the DOJ in the Microsoft case).

42 Temp. Treas. Reg. § 301.7602-1T(b)(3). The regulations provide that full participation includes, but is not limited to, receipt, review, and use of summoned materials, being present during summons interviews, questioning the person giving testimony, and asking the summoned person's representative to clarify an objection or assertion of a privilege. These temporary regulations went into effect for all summons interviews held on or after June 18, 2014 and will expire on June 16, 2017.

remaining 61. Sixty-four cases involved individual taxpayers, while the remaining 20 involved business taxpayers, including sole proprietorships.[43] Cases generally involved one of the following themes.

Petitions to Enforce and *Powell* Requirements

The United States petitioned to enforce a summons in 59 cases and successfully met its burden under *Powell* in 58 cases. In only one case, *United States v. Taylor*, did the IRS fail to satisfy the *Powell* requirements.[44] In *Taylor*, the IRS was investigating the taxpayer for the collection of tax liabilities for the taxable year ending December 31, 2007.[45] However, the revenue officer issued a summons for all documents and records from December 1, 2013 to present.[46] The district court declined to enforce the summons and held that the IRS did not meet the relevance prong of the *Powell* requirements because the documents requested were not necessary to determine the taxpayer's tax liability for 2007.[47]

Abuse of Process

Several taxpayers claimed that the IRS issued summonses in bad faith or for an improper purpose, and therefore enforcement would be an abuse of the court's process.[48] However, taxpayers were unsuccessful proving either bad faith or improper purpose because they were unable to allege facts and circumstances that could plausibly imply bad faith. For example, in *United States v. Artex Risk Solutions, Inc.*, one of the taxpayer's claims of bad faith was that the IRS did not provide reasonable deadlines to produce the necessary information.[49] The court held that the summons was not issued in bad faith because the taxpayer failed to substantiate its claims as to the burdens it faced to comply with the summonses and did not show that IRS deadlines were unreasonable.[50]

Petitions to Quash and Lack of Subject Matter Jurisdiction

Taxpayers petitioned to quash an IRS summons to a third party in 26 instances;[51] however, in 13 of these cases, courts dismissed the petitions for lack of jurisdiction on procedural or notice grounds.[52] For example, a court dismissed a *pro se* taxpayer's petition to quash for lack of jurisdiction because the taxpayer filed the petition more than 60 days after the IRS had issued the summons.[53] Another court dismissed a *pro se*

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

44 *U.S. v. Taylor*, 115 A.F.T.R.2d (RIA) 1165 (C.D. Cal. 2015).

45 *Id*.

46 *Id*.

47 *Id*. The court stated that the Government could amend its Petition and Declaration to establish a "realistic expectation" of potential relevance for the requested information.

48 *See U.S. v. Anderson*, 114 A.F.T.R.2d (RIA) 6731 (N.D. Cal. 2014), *stay denied*, 115 A.F.T.R.2d (RIA) 468 (N.D. Cal. 2015), *appeal docketed*, No. 15-15130 (9th Cir. Jan. 26, 2015); *U.S. v. Artex Risk Solutions, Inc.*, 2014 U.S. Dist. LEXIS 126932 (N.D. Ill. 2014); *Haw. Pac. Fin., Ltd. v. U.S.*, 114 A.F.T.R.2d (RIA) 5640 (D. Haw. 2014; *Highland Capital Mgmt., L.P. v. U.S.*, 51 F. Supp. 3d 544 (S.D.N.Y. 2014), *aff'd in part and vacated in part*, 2015 U.S. App. LEXIS 17112 (2d Cir. 2015); *Schwartz v. U.S.*, 115 A.F.T.R.2d (RIA) 1942 (S.D. Fla. 2015).

49 *U.S. v. Artex Risk Solutions, Inc.*, 2014 U.S. Dist. LEXIS 126932, at *14-15 (N.D. Ill. 2014).

50 *Id*. at *15.

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

52 In 13 of the 26 cases, the petitions to quash were denied on substantive grounds.

53 *Abusch v. U.S.*, 114 A.F.T.R.2d (RIA) 5535 (M.D. La. 2014), *adopting* 114 A.F.T.R.2d (RIA) 5533 (M.D. La. 2014), *cert. denied*, No. 14-948 (Mar. 23, 2015). Under IRC § 7609(b)(2)(A), a taxpayer seeking to quash a third-party summons must file a petition with the appropriate district court within 20 days after the date the notice of the summons is mailed to the taxpayer. Under IRC § 7609(b)(2)(B), the taxpayer must send a copy of the petition to quash to the party summoned and to the IRS within this 20-day timeframe. The court in *Abusch* noted that the petition was neither timely filed nor mailed to the required parties.

taxpayer's petition to quash a summons issued to the taxpayer's bank.[54] The court held that the summons was to aid in the collection of a tax liability, and the taxpayer was therefore not entitled to notice.[55]

In *Xoriant Corp. v. United States*, two corporations petitioned to quash IRS third-party summonses they received as part of the investigation of another corporation.[56] However, because the summons was issued directly to the two corporations, the court dismissed their petition to quash for lack of jurisdiction since "the functional effect of § 7609 is to preclude a summoned party from filing a motion to quash."[57]

Privileges

Taxpayers attempted to invoke various privileges, including Fifth Amendment, attorney-client, or other privileges in response to an IRS summons. For example, in *United States v. Ali*, the IRS summoned an individual taxpayer to produce certain documents and provide testimony.[58] The taxpayer appeared in response but refused to produce any documents or answer any questions, invoking the Fifth Amendment privilege against self-incrimination.[59] The court held that the summons was proper and ordered the taxpayer to comply. While the taxpayer appeared a second time and answered many questions, she declined to answer over 200 questions, again invoking the Fifth Amendment privilege.[60] She also claimed attorney-client privilege for a specific document. The IRS petitioned the court a second time to compel the taxpayer to answer the remaining questions and produce documents.[61] The court found that the taxpayer was not entitled to invoke the Fifth Amendment for certain documents, because these documents fell under the foregone conclusion exception to the Fifth Amendment and because the act of production was not in itself incriminating.[62] The court also held that the taxpayer had waived her Fifth Amendment rights by disclosing them previously.[63] However, the taxpayer was able to invoke Fifth Amendment protections for other documents and the remaining testimony, because the documents and testimony could prove that the taxpayer willfully misrepresented her income.[64] Finally, the court held that the taxpayer successfully invoked the attorney-client privilege for a list of foreign bank accounts she had provided to her attorneys.

In another case involving attorney-client privilege, *United States v. Sanmina Corp. & Subsidiaries*, the IRS issued a summons seeking two memoranda referenced in a footnote in a report prepared by the

54 *Knudsen v. U.S.*, 114 A.F.T.R.2d (RIA) 5848 (E.D.N.Y. 2014).

55 *Id*. Under IRC § 7609(c)(2)(D)(i), the IRS is not required to provide notice to the taxpayer and the taxpayer therefore has no right to quash the summons if the summons is issued to aid in the collection of the taxpayer's liability.

56 *Xoriant Corp. v. U.S.*, 114 A.F.T.R.2d (RIA) 6461 (N.D. Cal. 2014).

57 *Id.*

58 *U.S. v. Ali*, 114 A.F.T.R.2d (RIA) 6524 (D. Md. 2014). *See also U.S. v. Ali*, 113 A.F.T.R.2d (RIA) 1863 (D. Md. 2014) (discussing the taxpayer's first summons enforcement proceeding).

59 *U.S. v. Ali*, 114 A.F.T.R.2d (RIA) 6524 (D. Md. 2014).

60 *Id.*

61 *Id.*

62 *Id*. The court also addressed the taxpayer's request to reconsider its previous ruling that certain documents relating to the taxpayer's foreign bank accounts fell under the required records doctrine, which is another exception to the Fifth Amendment privilege. Essentially, the required records doctrine provides that the Fifth Amendment privilege does not apply to business records that are customarily kept in accordance with government regulation. The court noted that one of the rationales behind the required records doctrine is that the government or a regulatory agency should be able to overcome the assertion of the Fifth Amendment Privilege to inspect the records it requires an individual to keep as a condition of voluntarily participating in that regulated activity. Therefore, the court held that because the taxpayer chose to engage in transactions with foreign banks and entities that have specific statutory reporting requirements, she consented to present these records to the government if asked and could not invoke the Fifth Amendment privilege to avoid doing so.

63 *Id.*

64 *Id.*

taxpayer's attorneys to substantiate a significant deduction.[65] The business taxpayer resisted, claiming the attorney-client and work product privileges protected the memoranda.[66] The court held that the taxpayer sufficiently demonstrated that the memoranda "constituted tax advice from lawyers," therefore the attorney-client privilege attaches. The court also held that the work product privilege applied because the memoranda were prepared in anticipation of litigation. In addition, the court found that the taxpayer did not waive either privilege.[67]

Civil Contempt

A taxpayer who "neglects or refuses to obey" an IRS summons may be held in civil contempt.[68] This year, six taxpayers were held in civil contempt for failing to comply with a court order enforcing an IRS summons.[69] Overall, contempt proceedings accounted for approximately seven percent of all summons-related cases. Unless the taxpayers complied with the court order, they were subject to arrest,[70] fines,[71] or both.[72]

The Impact of *United States v. Clarke*

The Supreme Court's decision in *Clarke* had an immediate impact, as taxpayers sought evidentiary hearings to challenge a summons. First, in *United States v. Ali* (discussed above), the taxpayer argued that the Supreme Court relaxed the standard to obtain an evidentiary hearing, thus changing the law for summons enforcement.[73] However, the district court believed that *Clarke* did not change the law; instead, *Clarke* simply resolved a circuit split.[74]

In *Schwartz v. United States*, the taxpayers alleged that the IRS issued a third-party summons in bad faith; however, the court held that the taxpayers were not entitled to an evidentiary hearing because their allegations did not "rise above conclusory allegations."[75] Similarly, in *Masciantonio v. United States*, the taxpayer also made conclusory assertions that did not "provide a basis for an evidentiary hearing."[76]

In addition to the themes above, one case raised the issue of who may be present at a summons hearing on behalf of the taxpayer. In *United States v. McEligot*, the IRS summoned a taxpayer's accountant in connection with an audit of the taxpayer.[77] The accountant appeared at the hearing but refused to testify unless the taxpayer's attorney was present.[78] The court found that IRC § 7609(b), which gives certain individuals the right to intervene in an enforcement proceeding, does not provide a right to intervene

65 *U.S. v. Sanmina Corp. & Subsidiaries*, 2015 U.S. Dist. LEXIS 66123 (N.D. Cal. 2015), *appeal docketed*, No. 15-16416 (9th Cir. July 15, 2015).

66 *Id.*

67 *Id.*

68 IRC § 7604(b).

69 *See U.S. v. Bowler*, 2015 U.S. Dist. LEXIS 57862 (D. Minn. 2015); *U.S. v. Erickson*, 115 A.F.T.R.2d (RIA) 684 (M.D. Fla. 2015); *U.S. v. Nichols*, 2015 U.S. Dist. LEXIS 59444 (E.D. Mich. 2015); *U.S. v. Snow*, 115 A.F.T.R.2d (RIA) 1002 (E.D. Tenn. 2015); *U.S. v. Thornton*, 115 A.F.T.R.2d (RIA) 1258 (D. Minn. 2015), *appeal docketed*, No. 15-1774 (8th Cir. Apr. 15, 2015); *U.S. v. Vanderpool*, 114 A.F.T.R.2d (RIA) 6968 (W.D. Mo. 2014).

70 *U.S. v. Bowler*, 2015 U.S. Dist. LEXIS 57862 (D. Minn. 2015).

71 *U.S. v. Erickson*, 115 A.F.T.R.2d (RIA) 684 (M.D. Fla. 2015).

72 *U.S. v. Thornton*, 115 A.F.T.R.2d (RIA) 1258 (D. Minn. 2015), *appeal docketed*, No. 15-1774 (8th Cir. Apr. 15, 2015).

73 *U.S. v. Ali*, 114 A.F.T.R.2d (RIA) 6524 (D. Md. 2014).

74 *Id.* The 11th Circuit had held that "a bare allegation of improper motive is sufficient," contrary to other circuits.

75 *Schwartz v. U.S.*, 115 A.F.T.R.2d (RIA) 1942 (S.D. Fla. 2015), *adopting* 115 A.F.T.R.2d (RIA) 1939 (S.D. Fla. 2015).

76 *Masciantonio v. U.S.*, 114 A.F.T.R.2d (RIA) 7010 (W.D. Pa. 2014), *appeal docketed*, No. 15-1072 (3d Cir. Jan. 9, 2015).

77 *U.S. v. McEligot*, 115 A.F.T.R.2d (RIA) 1433 (N.D. Cal. 2015), *appeal docketed*, Nos. 15-16128 and 15-16134 (9th Cir. 2015).

78 *Id.*

in a summons hearing.[79] The court held that "a taxpayer does not have an absolute right to be present at a third-party summons hearing concerning the taxpayer's liabilities."[80] The proper test is "the usual process of balancing opposing equities" between the government's interest in obtaining information in a non-adversarial manner and the taxpayer's interest in preventing improper disclosure of records.[81] Under this test, the court found that the equities were in favor of the government because no attorney-client or work product privileges were implicated, and the accountant could raise the tax practitioner privilege if necessary.[82]

CONCLUSION

The IRS may issue a summons to obtain information to determine whether a tax return is correct or if a return should have been filed to ascertain a taxpayer's tax liability or to collect a liability.[83] Accordingly, the IRS may request documents and testimony from taxpayers who have failed to provide that information voluntarily.

While the number of summons enforcement cases has decreased since 2012, summons enforcement continues to be a significant source of litigation.[84] The IRS also continues to be successful in the vast majority of summons enforcement litigation. Taxpayers and third parties rarely succeed in contesting IRS summonses due to the significant burden of proof and strict procedural requirements. In addition, the IRS's temporary regulations allowing the use of outside parties to assist in examinations and participate in summons interviews have generated controversy and litigation.[85] Depending on the outcome of this litigation, there may be additional cases on this issue in future years.

79 *U.S. v. McEligot*, 115 A.F.T.R.2d (RIA) 1433 (N.D. Cal. 2015), *appeal docketed*, Nos. 15-16128 and 15-16134 (9th Cir. 2015).

80 *Id*.

81 *Id*.

82 *Id*.

83 IRC § 7602(a).

84 In the summons enforcement Most Litigated Issue section of the 2014 Annual Report to Congress, we noted that the IRS's Large Business and International Division (LB&I) issued guidance to examiners in November 2013 on how to handle cases where the taxpayer does not provide a complete response to an Information Document Request (IDR) by the response date. This guidance required the examiner to issue a delinquency notice and then a pre-summons letter prior to issuing a summons. LB&I created these new procedures, that focus on enhanced pre-summons communications, because it believed the new process will improve the IRS's "ability to gather information timely and reduce the need to enforce IDRs through summonses." We remarked that "if effective, these new procedures could reduce the number of summonses issued, and as a consequence, we may see less litigation in this area in the future." It is possible that LB&I's guidance and procedures have contributed to this year's significant decline in summons enforcement cases.

85 *See supra* note 41. There is notable current summons enforcement litigation involving the IRS's use of an outside law firm in an audit of Microsoft Corporation's transfer pricing arrangements. *See* Dolores W. Gregory, *Transfer Pricing: Microsoft Pushes for Evidentiary Hearing, Cites IRS's 'Illegal' Deal With Quinn Emanuel*, Tax Notes Today (Apr. 27, 2015). Although it is outside of the reporting period for the Most Litigated Issues section, Microsoft was successful in obtaining an evidentiary hearing in the summons enforcement case. *See U.S. v. Microsoft Corp.*, 2015 WL 4496749 (W.D. Wash. 2015). Commentators have come out both for and against the IRS's use of outside attorneys in cases such as Microsoft's. *Cf.* Roger A. Pies, *IRS Prerogative to Hire Outside Counsel*, Tax Notes Today (July 7, 2015) (arguing that the IRS should be allowed to retain outside counsel in a big document case) and Stuart Gibson, *If the IRS needs Good Lawyers, it Should Look Across the Street*, Tax Notes Today (Mar. 30, 2015) (questioning why the IRS did not seek assistance from the DOJ in the Microsoft case).

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

SUMMARY

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.[1] For this report, we reviewed 80 cases decided between June 1, 2014, and May 31, 2015. The majority of cases involved taxpayers failing to report items of income, including some specifically mentioned in Internal Revenue Code (IRC) § 61 such as wages,[2] interest,[3] dividends,[4] and annuities.[5]

TAXPAYER RIGHTS IMPACTED[6]

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

IRC § 61 broadly defines gross income as "all income from whatever source derived."[7] The U.S. Supreme Court has defined gross income as any accession to wealth.[8] Over time, however, Congress has carved out numerous exceptions and exclusions from this broad definition of gross income and has based other elements of tax law on the definition.[9]

The Commissioner may identify particular items of unreported income or reconstruct a taxpayer's gross income using methods such as the bank deposits method.[10] If the Commissioner determines a tax deficiency, the IRS issues a Statutory Notice of Deficiency.[11] If the taxpayer challenges the deficiency, the Commissioner's notice is entitled to a presumption of correctness; the taxpayer generally bears the burden of proving that the determination is erroneous or inaccurate.[12]

1 *See, e.g.*, National Taxpayer Advocate 2014 Annual Report to Congress 472-76; National Taxpayer Advocate 2013 Annual Report to Congress 355-61.

2 IRC § 61(a)(1). *See, e.g.*, *Nix v. Comm'r*, 580 F. App'x 887 (11th Cir. 2014).

3 IRC § 61(a)(4). *See, e.g.*, *Shi v. Comm'r*, T.C. Memo. 2014-173.

4 IRC § 61(a)(7). *See, e.g.*, *Ebert v. Comm'r*, T.C. Memo. 2015-5.

5 IRC § 61(a)(9). *See, e.g.*, *Robertson v. Comm'r*, T.C. Memo. 2014-143.

6 *See* Taxpayer Bill of Rights, *available at* www.Taxpayer.Advocate.irs.gov/taxpayer-rights.

7 IRC § 61(a).

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

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

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

11 IRC § 6212. *See also* Internal Revenue Manual (IRM) 4.8.9.2, *Notice of Deficiency Definition* (July 9, 2013).

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

ANALYSIS OF LITIGATED CASES

In the 80 opinions involving gross income issued by the federal courts and reviewed for this report, gross income issues most often fall into two categories: (1) what is included in gross income under IRC § 61 and (2) what can be excluded under other statutory provisions. A detailed list of the cases appears in Table 4 of Appendix 3.

In 27 cases (34 percent), taxpayers were represented, while the rest were *pro se* (without counsel).[13] Ten of the 27 cases where taxpayers had representation (about 37 percent) prevailed in full or in part in their cases, whereas *pro se* taxpayers prevailed in full or in part in seven cases. Overall, taxpayers prevailed in full or in part in 17 of 80 cases (about 21 percent).

Drawing on the full list in Table 4 of Appendix 3, we have chosen to discuss cases involving damage awards and IRA distributions. In addition, we discuss a case of first impression involving the characterization of refundable state tax credits.

Damage Awards

Taxation of damage awards continues to generate litigation. This year, taxpayers in at least four cases (five percent of those reviewed) challenged the Commissioner's inclusion of damage awards in their gross income, but no taxpayers prevailed in these cases.[14]

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

To justify exclusion from income under IRC § 104, the taxpayer must show settlement proceeds are in lieu of damages for physical injury or sickness.[20] One case presented a unique issue regarding the characterization of payments made to a taxpayer for contracting to comply with the process to become an egg donor. In *Perez v. Commissioner*, the taxpayer petitioned the U.S. Tax Court to exclude from her income

13 One case involved three consolidated cases, where one case docket showed the taxpayers were *pro se* while the other two case dockets showed representation. *See Worth v. Comm'r*, T.C. Memo. 2014-232, *appeal docketed*, No. 15-70665 (9th Cir. Mar. 3, 2015). For the purpose of calculating the number and percentage of cases where taxpayers appeared *pro se*, we have included *Worth* in the *pro se* category.

14 *See, e.g.*, *Duffy v. U.S.*, 120 Fed. Cl. 55 (Fed. Cl. 2015), *appeal docketed*, No. 15-5076 (Fed. Cir. Apr. 28, 2015).

15 *See* Treas. Reg. § 1.104-1(c) (damages received, for purposes of IRC § 104(a)(2), means amounts received "through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of such prosecution").

16 IRC § 104(a)(2).

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

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

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

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

payments received as compensation for the pain and suffering associated with donating her eggs to a fertility clinic under the theory that the payments should be construed as damages.[21]

Ms. Perez entered contracts with the fertility clinic and the intended recipients of her donor eggs. The contracts detail that the payments are compensation for Ms. Perez's time, effort, pain, and suffering and in no way are the payments for her eggs or for the sale of body parts. Ms. Perez would be paid regardless of the outcome of the egg retrieval; that is, payment was not contingent on her producing usable eggs or on the intended recipients conceiving a viable pregnancy. Although the fertility clinic issued a Form 1099 to Ms. Perez for the payments she received, Ms. Perez, after conferring with other donors on the internet, did not report the payments on her tax return under the theory that the payments were not taxable since they compensated her only for pain and suffering.[22]

The court looked to the question of whether Ms. Perez was compensated for services rendered or for the sale of property.[23] The contract agreement characterized the payments as compensation for her compliance with the egg donor procedure.[24] The Tax Court found the payments to be for services rendered and then looked to the question of whether the payments may be excluded as damages. The court looked at Ms. Perez's challenge to the validity of the Secretary of Treasury's interpretation of "damages" in the regulations.[25] In applying the framework set forth in *Chevron*, the court determined the regulation is a reasonable interpretation and therefore valid.[26] The court then concluded that Ms. Perez voluntarily contracted to undergo the prospective pain and suffering and was compensated for the risk, rendering the compensation not damages.[27]

As illustrated by continuing litigation of the characterization of settlement damages, the question of when damage awards can be excluded from gross income continues to confuse taxpayers. Although we did not identify any cases this year involving mental illness, the National Taxpayer Advocate remains concerned that taxpayers continue to disagree with the IRS's and courts' interpretation that mental illness equates to emotional distress as opposed to physical sickness or injury. In the same way that a physical injury or sickness may have emotional side effects, many mental illnesses manifest themselves as physical symptoms. For instance, many people who have severe depression experience the following physical symptoms: stomachaches, indigestion, constant headaches, tightness in the chest, difficulty breathing, and fatigue.[28] Physical symptoms occur in other mental disorders, such as Post-Traumatic Stress Disorder (PTSD), which affects people who have experienced a traumatic event, such as mugging, rape, torture, being kidnapped or held captive, child abuse, car accidents, train wrecks, plane crashes, bombings, natural or human-caused disasters, or military combat.[29] Current research shows that the experience of trauma can cause neurochemical changes in the brain that create a vulnerability to hypertension and atherosclerotic

21 144 T.C. 51 (2015).

22 *Id*.

23 *Id.*

24 *Id.*

25 *See* Treas. Reg. § 1.104-1(c) (damages received, for purposes of IRC § 104(a)(2), means amounts received "through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of such prosecution").

26 *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (agency regulations are entitled to deference unless they (1) contradict an unambiguous statute or (2) adopt an unreasonable construction of it).

27 *Perez v. Comm'r*, 144 T.C. 51 (2015).

28 National Institute of Mental Health, *Signs and Symptoms of Depression*, *available at* http://www.nimh.nih.gov/health/topics/depression/men-and-depression/signs-and-symptoms-of-depression/persistent-physical-symptoms.shtml (last visited Oct. 6, 2015).

29 National Institute of Mental Health, *Post-Traumatic Stress Disorder*, *available at* http://www.nimh.nih.gov/health/topics/post-traumatic-stress-disorder-ptsd/index.shtml#part_145373 (last visited Oct. 6, 2015).

heart disease, abnormalities in thyroid and other hormone functions, and increased susceptibility to infections and immunologic disorders that are associated with PTSD.[30] As discussed in the 2009 Annual Report to Congress, the interpretation that mental illness equates to emotional distress seems particularly outdated when considering the medical communities' advancements in understanding the physical cause and symptoms of mental illness.[31]

Individual Retirement Accounts Distributions

IRC § 61(a) defines gross income as "all income from whatever source derived, including (but not limited to)… (9) Annuities; … and (11) Pensions."[32] IRC § 408(d)(1) governs the tax treatment of distributions from individual retirement accounts (IRAs) and provides that they are generally included in gross income as amounts received as an annuity under IRC § 72.

Taxpayers in at least ten cases argued that portions of their IRA distributions, pensions, or retirement accounts were excluded from gross income, prevailing, in part, in one case.[33] Taxpayers in at least two cases challenged the taxability of the distributions, arguing the "rollover provision" under IRC § 408(d) applied.[34] The "rollover provision" generally excludes from gross income IRA distributions that are transferred into an eligible retirement account within 60 days of receipt.[35] Taxpayers are limited, however, under IRC § 408(d)(3)(B) to one nontaxable rollover per year.[36]

For example, in *Bohner v. Commissioner*, the taxpayer initiated two withdrawals from his IRA and characterized the withdrawals as a rollover to repay a loan he took from a friend and his own funds earlier that year to pay an extra amount to the Office of Personnel Management to boost his federal retirement pay.[37] The court found the distributions includible in gross income. The federal retirement system is not required to accept tax-free rollovers as a form of deposit, and even if it did, the court found that the taxpayer did not make the retirement plan aware of his attempt to complete a rollover and, therefore, the plan would not have been able to determine the proper tax treatment of the contribution.[38]

Refundable State Tax Credits

The Tax Court decided a case of first impression regarding the characterization and taxability of targeted New York State tax credits. In *Maines v. Commissioner*, the taxpayers (husband and wife) petitioned for

30 *See* U.S. Department of Veterans Affairs, National Center for PTSD, *available at* http://www.ptsd.va.gov/professional/co-occurring/ptsd-physical-health.asp (last visited Oct. 6, 2015).

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

32 IRC § 61(a).

33 *See Morles v. Comm'r*, T.C. Summ. Op. 2015-13 (portion of IRA distribution allocable to income was included in gross income; portion allocable to the taxpayer's investment in the contract was not included in gross income).

34 *See Bohner v. Comm'r*, 143 T.C. 224 (2014); *Dabney v. Comm'r*, T.C. Memo. 2014-108.

35 IRC § 408(d)(3)(A)(i), (ii); *Schoof v. Comm'r*, 110 T.C. 1, 7 (1998).

36 IRC § 408(d)(3)(B).

37 143 T.C. 224 (2014).

38 *Id*. at 230.

redetermination of income tax deficiencies arising from receipt of refundable tax credits passed through their S Corporation and Limited Liability Company.[39]

New York state offers certain refundable state tax credits to businesses that either expand or enter into business in targeted impoverished areas and maintain the business in those areas with a required number of employees. The business must meet all requirements to be eligible for the credits. New York characterizes the credits as refunds of overpayments of state income tax, the same position the taxpayers maintained, with the result that the payments should not be included in gross income.[40] In contrast, the Commissioner asserted the credits were taxable income.[41] The court determined that the label for the credits by New York is not binding on the federal government for federal taxation purposes.

Three different credits were at issue in *Maines*. Each has distinct qualifications, and the court determined that the credits fall into two categories. Two credits were not tied to state taxes previously paid to New York and were, therefore, subsidies to the business and as such were fully includible in the taxpayers' gross income.[42] The third credit was partially refundable to the taxpayers above the amount of the credit used to reduce the taxpayers' property tax liability. As a result, the taxpayers were required to include in gross income the amount of the credit refunded above their property tax liability.[43] The court's decision will impact a number of other New York residents who were similarly challenging the tax treatment of these credits.[44]

CONCLUSION

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

While the number of cases involving the tax treatment of settlements and awards continued to decrease, from five in 2014 to four this year, it remains a perennial area of confusion for taxpayers. The National Taxpayer Advocate has previously recommended a legislative change that would clarify the tax treatment of court awards and settlements by permitting taxpayers to exclude any payments received as a settlement or judgment for mental anguish, emotional distress, or pain and suffering.[45]

Cases involving the tax treatment of distributions from IRAs and pensions made up a larger percentage of overall cases this year, with almost 13 percent of cases compared to about 11 percent in 2014. Taxpayers litigated this issue with only minor success this year, prevailing, in part, in only one case.

39 144 T.C. No. 8 (2015).

40 State tax refunds are not income unless a taxpayer claimed a deduction for them by itemizing for the previous year. *See* IRC § 111.

41 *Maines v. Comm'r*, 144 T.C. No. 8 (2015).

42 *Id*.

43 *Id*.

44 *Id*. at n. 5 (acknowledging that there were 11 related but unconsolidated cases pending before the Tax Court that were filed by New York residents involving this issue).

45 National Taxpayer Advocate Annual 2009 Report to Congress 351-56 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*).

MLI #5 Appeals From Collection Due Process Hearings Under IRC §§ 6320 and 6330

SUMMARY

The IRS Restructuring and Reform Act of 1998 (RRA 98)[1] created Collection Due Process (CDP) hearings to provide taxpayers with an independent review by the IRS Office of Appeals of the decision to file a Notice of Federal Tax Lien (NFTL) or the IRS's proposal to undertake a levy action. In other words, a CDP hearing gives taxpayers an opportunity for a meaningful hearing before the IRS issues its first levy or immediately after it files its first NFTL with respect to a particular tax liability. At the 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 the collection action, collection alternatives, spousal defenses, and under certain circumstances, the underlying tax liability.[2]

Taxpayers have the right to judicial review of Appeals' determinations if they timely request the CDP hearing and timely petition the United States Tax Court.[3] Generally, the IRS suspends levy actions during a levy hearing and any judicial review that may follow.[4]

Since 2001, CDP has been one of the federal tax issues most frequently litigated in the federal courts and analyzed in the National Taxpayer Advocate's Annual Reports to Congress. The trend continues this year, with our review of litigated issues finding 79 opinions on CDP cases during the review period of June 1, 2014, through May 31, 2015.[5] Taxpayers prevailed in full in 11 of these cases (nearly 14 percent) and, in part, in three others (nearly four percent). Of the 14 opinions where taxpayers prevailed in whole or in part, five taxpayers appeared *pro se*[6] and nine were represented.

The cases discussed below demonstrate that CDP hearings serve an important role in providing taxpayers with a venue to raise legitimate issues before the IRS deprives them of property. Many of these decisions shed light on substantive and procedural issues.

CDP hearings are particularly valuable because they provide taxpayers with an enforceable remedy with respect to several rights articulated in the Taxpayer Bill of Rights, which was adopted by the IRS in 2014 in response to National Taxpayer Advocate recommendations.[7] In particular, by providing an opportunity for a taxpayer to challenge the underlying liability and raise alternatives to the collection action, the CDP hearing enables the taxpayer's *right to challenge the IRS position and be heard*. If the taxpayer does

1 RRA 98, Pub. L. No. 105-206, § 3401, 112 Stat. 685, 746 (1998).

2 Internal Revenue Code (IRC) §§ 6320(c) (lien) and 6330(c) (levy). IRC § 6320(c) generally requires Appeals to follow the levy hearing procedures under IRC § 6330 for the conduct of the lien hearing, the review requirements, and the balancing test.

3 IRC § 6330(d) (setting forth the time requirements for obtaining judicial review of Appeals' determination); IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B) (setting forth the time requirements for requesting a CDP hearing for lien and levy matters, respectively).

4 IRC § 6330(e)(1) provides that generally, levy actions are suspended during the CDP process (along with a corresponding suspension in the running of the limitations period for collecting the tax.). However, IRC § 6330(e)(2) allows the IRS to resume levy actions during judicial review upon a showing of "good cause," if the underlying tax liability is not at issue.

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

6 *Pro se* means "[f]or oneself; on one's own behalf; without a lawyer." Black's Law Dictionary (10th ed. 2014), *available at* http://westlaw.com.

7 IRS, Taxpayer Bill of Rights, *available at* http://www.irs.gov/Taxpayer-Bill-of-Rights. *See also* National Taxpayer Advocate 2013 Annual Report to Congress 5-19 (Most Serious Problem: *Taxpayer Rights: The IRS Should Adopt a Taxpayer Bill of Rights as a Framework for Effective Tax Administration*).

not agree with the Appeals determination, he or she may file a petition in Tax Court, which furthers the taxpayer's *right to appeal an IRS decision in an independent forum*. Lastly, since the Appeals Officer must consider whether the IRS's proposed collection action balances the overall need for efficient collection of taxes with the legitimate concern that the IRS's collection actions are no more intrusive than necessary, the CDP hearing protects a taxpayer's *right to privacy* while also ensuring the taxpayer's *right to a fair and just tax system*.

TAXPAYER RIGHTS IMPACTED[8]

- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of an NFTL filed by the IRS or of a proposed levy action.[9] As discussed above, 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.[10] The hearing allows taxpayers to raise issues relating to collection of the liability, including:

- The appropriateness of collection actions;[11]
- Collection alternatives such as an installment agreement (IA), offer in compromise (OIC), posting a bond, or substitution of other assets;[12]
- Appropriate spousal defenses;[13]
- The existence or amount of the underlying tax liability, but only if the taxpayer did not receive a statutory notice of deficiency or have another opportunity to dispute the liability;[14] and
- Any other relevant issue relating to the unpaid tax, the NFTL, or proposed levy.[15]

A taxpayer cannot raise an issue considered at a prior administrative or judicial hearing if the taxpayer participated meaningfully in that hearing or proceeding.[16]

8 *See* Taxpayer Bill of Rights, *available at* www.Taxpayer.Advocate.irs.gov/taxpayer-rights.

9 IRC §§ 6320 and 6330. *See* RRA 98, Pub. L. No. 105-206, § 1001(a), 112 Stat. 685 (1998).

10 Prior to RRA 98, the U.S. Supreme Court had held that a post-deprivation hearing was sufficient to satisfy due process concerns in the tax collection arena. *See U.S. v. Nat'l Bank of Commerce*, 472 U.S. 713, 726-31 (1985); *Phillips v. Comm'r*, 283 U.S. 589, 595-601 (1931).

11 IRC § 6330(c)(2)(A)(ii).

12 IRC § 6330(c)(2)(A)(iii).

13 IRC § 6330(c)(2)(A)(i).

14 IRC § 6330(c)(2)(B).

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

16 IRC § 6330(c)(4).

Procedural Collection Due Process Requirements

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

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

Requesting a CDP Hearing

Under both lien and levy procedures, the taxpayer must return a signed and dated written request for a CDP hearing within the applicable period.[21] The Code and regulations require taxpayers to provide their reasons for requesting a hearing. Failure to provide the basis may result in denial of a face-to-face hearing.[22] Taxpayers who fail to timely request a CDP hearing will be afforded an "equivalent hearing," which is similar to a CDP hearing but lacks judicial review.[23] Taxpayers must request an equivalent hearing within the one-year period beginning the day after the five-business day period following the filing of the NFTL, or in levy cases, within the one-year period beginning the day after the date of the CDP notice.[24]

Conduct of a CDP Hearing

The IRS generally will suspend levy action throughout a CDP hearing involving a notice of intent to levy. However, the requirement to suspend levy action is inapplicable in certain circumstances where the IRS is not required to provide a CDP hearing prior to the levy and is only required to provide the CDP hearing within a reasonable time after the levy.[25] These circumstances occur when the IRS determines that:

- The collection of tax is in jeopardy;

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

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

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

20 *Id*.

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

22 IRC §§ 6320(b)(1) and 6330(b)(1); Treas. Reg. §§ 301.6320-1(c)(2) A-C1, 301.6330-1(c)(2) A-C1, 301.6320-1(d)(2) A-D8 and 301.6330-1(d)(2) A-D8. The regulations require the IRS to provide the taxpayer an opportunity to "cure" any defect in a timely filed hearing request, including providing a reason for the hearing. Form 12153 includes space for the taxpayer to identify collection alternatives that he or she wants Appeals to consider, as well as examples of common reasons for requesting a hearing. *See* IRS Form 12153, *Requests for Collection Due Process or Equivalent Hearing* (Mar. 2011).

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

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

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

- The collection resulted from a levy on a state tax refund;
- The IRS has served a disqualified employment tax levy; or
- The IRS has served a federal contractor levy.[26]

The IRS also suspends levy action throughout any judicial review of Appeals' determination, unless the IRS obtains an order from the court permitting levy on the grounds that the underlying tax liability is not at issue, and the IRS can demonstrate good cause to resume collection activity.[27]

CDP hearings are informal. When a taxpayer requests a hearing with respect to both a lien and a proposed levy, Appeals will attempt to conduct one hearing.[28] Courts have determined that a CDP hearing need not be face-to-face but can take place by telephone or correspondence,[29] and Appeals will conduct the hearing by telephone unless the taxpayer requests a face-to-face conference.[30] The CDP regulations state that taxpayers who provide non-frivolous reasons for opposing the IRS collection action will generally be offered but not guaranteed face-to-face conferences.[31] Taxpayers making frivolous arguments are not entitled to face-to-face conferences.[32] A taxpayer will not be granted a face-to-face conference concerning a collection alternative, such as an IA or OIC, unless other taxpayers would be eligible for the alternative under similar circumstances.[33] For example, the IRS will not grant a face-to-face conference to a taxpayer who proposes an OIC as the only issue to be addressed but failed to file all required returns and is therefore ineligible for an offer. Appeals may, however, at its discretion, grant a face-to-face conference to explain the eligibility requirements for a collection alternative.[34]

The CDP hearing is to be held by an impartial officer from Appeals, who is barred from engaging in *ex parte* communication with IRS employees about the substance of the case and who has had "no prior

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

27 IRC § 6330(e)(1) and (e)(2).

28 IRC § 6320(b)(4).

29 *Katz v. Comm'r*, 115 T.C. 329, 337-38 (2000) (finding that telephone conversations between the taxpayer and the Appeals Officer constituted a hearing as provided in IRC § 6320(b)). Treas. Reg. §§ 301.6320-1(d)(2) A-D6, A-D8 and 301.6330-1(d)(2) A-D6, A-D8.

30 *See, e.g.*, *Appeals Letter 4141* (rev. Aug. 2012) (acknowledging the taxpayer's request for a CDP hearing and providing information on the availability of face-to-face conference). The National Taxpayer Advocate has repeatedly raised concerns regarding the inadequacy of Appeals' communication to taxpayers on how to request a face-to-face hearing and where this information is included in the letter. *See* National Taxpayer Advocate 2005 Annual Report to Congress 136 (Most Serious Problem: *Appeals Campus Centralization*); National Taxpayer Advocate 2009 Annual Report to Congress 70 (Most Serious Problem: *Appeals' Efficiency Initiatives Have Not Improved Customer Satisfaction or Confidence in Appeals*); National Taxpayer Advocate 2010 Annual Report to Congress 128 (Most Serious Problem: *The IRS's Failure to Provide Timely and Adequate Collection Due Process Hearings May Deprive Taxpayers of an Opportunity to Have Their Cases Fully Considered*). For information regarding the availability of Virtual Service Delivery (VSD) teleconferencing, which provides virtual face-to-face meeting in remote locations, see National Taxpayer Advocate 2012 Annual Report to Congress 462 (Status Update: *The IRS Has Made Significant Progress in Delivering Virtual Face-to-Face Service and Should Expand Its Initiatives to Meet Taxpayer Needs and Improve Compliance*). *See also* Director, Policy, Quality and Case Support, *Implementation of Virtual Service Delivery (VSD)*, Memorandum AP-08-0714-0007 (July 24, 2014).

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

32 *Id*.

33 *Id*.

34 *Id*.

involvement."[35] In addition to addressing the issues raised by the taxpayer, the Appeals Officer must verify that the IRS has met the requirements of all applicable laws and administrative procedures.[36] An integral component of the CDP analysis is the balancing test, which requires the IRS Appeals Officer to 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."[37] The balancing test is central to a CDP hearing because it instills a genuine notion of fairness into the process from the perspective of the taxpayer.[38]

Special rules apply to the IRS's handling of hearing requests that raise frivolous issues. IRC § 6330(g) provides that the IRS may disregard any portion of a hearing request based on a position the IRS has identified as frivolous or that reflects a desire to delay or impede the administration of tax laws.[39] Similarly, IRC § 6330(c)(4) provides that a taxpayer cannot raise an issue if it is based on a position identified as frivolous or reflects a desire to delay or impede tax administration.

IRC § 6702(b) allows the IRS to impose a penalty for a specified frivolous submission, including a frivolous CDP hearing request.[40] A request is subject to the penalty if any part of it "(i) is based on a position which the Secretary has identified as frivolous... or (ii) reflects a desire to delay or impede the administration of Federal tax laws."[41] In *Thornberry v. Commissioner*, the Tax Court held that if Appeals determines a request for an administrative hearing is based entirely on a frivolous position under IRC § 6702(b)(2)(A) and issues a notice stating that Appeals will disregard the request, the Tax Court does have jurisdiction to review Appeals' decision if the taxpayer timely petitions for review.[42] The court found

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

36 IRC § 6330(c)(1); *Hoyle v. Comm'r*, 131 T.C. 197 (2008).

37 IRC § 6330(c)(3)(C); IRM 8.22.4.2.2, *Summary of CDP Process* (Sept. 25, 2014). *See also* H.R. Rep. No. 105-599, at 263 (1998) (Conf. Rep.). For simplicity, we use the term "proposed collection action" referring to both the actions taken and proposed. IRC § 6330 requires the IRS to notify the taxpayer of the right to request a CDP hearing not less than 30 days before issuing the first levy to collect a tax. Pursuant to IRC § 6320, the taxpayer is notified of the right to request a CDP hearing within five business days *after* the first NFTL for a tax period is filed. Thus, Treasury Regulations under IRC § 6320 require a Hearing Office to consider "[w]hether the continued existence of the filed [NFTL] represents a balance between the need for the efficient collection of taxes and the legitimate concern of the taxpayer that any collection action be no more intrusive than necessary." *See* Treas. Reg. § 301.6320–1(e)(3) A-E1(vi). Similarly, a levy action can be taken before a hearing in the following situations: collection of the tax was in jeopardy; levy on a state to collect a federal tax liability from a state tax refund; disqualified employment tax levies; or a federal contractor levy under the Federal Payment Levy Program. *See* IRC § 6330(f); IRM 8.22.4.2.2, *Summary of CDP Process* (Sept. 25, 2014).

38 *See* National Taxpayer Advocate 2014 Annual Report to Congress 185-96 (Most Serious Problem: *Collection Due Process: The IRS Needs Specific Procedures for Performing the Collection Due Process Balancing Test to Enhance Taxpayer Protections*). *See also* Nina E. Olson, *Taking the Bull by Its Horns: Some Thoughts on Constitutional Due Process in Tax Collection*, 2010 Erwin N. Griswold Lecture Before the American College of Tax Counsel, 63 Tax Law. 227 (2010).

39 IRC § 6330(g). IRC § 6330(g) is effective for submissions made and issues raised after the date on which the IRS first prescribed a list of frivolous positions. Notice 2007-30, 2007-1 C.B. 883, which was published on or about April 2, 2007, provided the first published list of frivolous positions. Notice 2010-33, 2010-17 C.B. 609, contains the current list.

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

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

42 *See Thornberry v. Comm'r*, 136 T.C. 356, 367 (2011). The Tax Court recently declined to overturn *Thornberry* in *Buczek v. Comm'r*, 143 T.C. No. 16 (2014), which will be discussed in the Analysis of Litigated Cases below.

Appeals' letter disregarding the hearing request was a determination conferring jurisdiction under IRC § 6330(d)(1), because it authorized the IRS to proceed with the disputed collection action.[43]

Judicial Review of CDP Hearing

Within 30 days of Appeals' determination, the taxpayer may petition the Tax Court for judicial review.[44] The court will only consider issues, including challenges to the underlying liability, that were properly raised during the CDP hearing.[45] An issue is not properly raised if the taxpayer fails to request Appeals' consideration of the issue or requests consideration but fails to present any evidence regarding that issue after being given a reasonable opportunity.[46] The Tax Court, however, may remand a case back to Appeals for more fact finding when the taxpayer's factual circumstances have materially changed between the hearing and the trial.[47] When the case is remanded, the court retains jurisdiction.[48] The resulting hearing on remand provides the parties with an opportunity to complete the initial hearing while preserving the taxpayer's right to receive judicial review of the ultimate administrative determination.[49]

Where the validity of the underlying tax liability is properly at issue in the hearing, the court will review the amount of the tax liability on a *de novo*[50] basis.[51] Where the Tax Court is reviewing the appropriateness of the collection action or subsidiary factual and legal findings, the court will review these determinations under an abuse of discretion standard.[52]

Appellate Venue from Decisions of the Tax Court

Generally, the correct venue for appeals from the Tax Court is the D.C. Circuit unless one of the rules specified in IRC § 7482(b)(1) or exceptions specified in IRC §§ 7482(b)(2) or (b)(3) applies. For instance, IRC § 7482(b)(1)(A) provides that in cases where a petitioner other than a corporation seeks redetermination of a tax liability, venue for review by the United States Court of Appeals lies with the Court of Appeals for the circuit based upon the taxpayer's legal residence.[53] Pursuant to IRC § 7482(b)(2), the taxpayer and the IRS may stipulate the venue for an appeal in writing.

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43 *Thornberry v. Comm'r*, 136 T.C. 356, 364 (2011). The Office of Chief Counsel disagrees with the *Thornberry* holding and will continue to file motions to dismiss for lack of jurisdiction if the taxpayer petitions for Tax Court review of a denial, under § 6330(g), of a CDP hearing request that was determined to be based on a frivolous position. *See* Chief Counsel Directives Manual (CCDM) 35.3.23.5.1, *Motion to Dismiss for Lack of Jurisdiction When CDP Hearing Request Denied Under Section 6330(g)* (July 25, 2012).

44 IRC § 6330(d)(1).

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

46 Treas. Reg. §§ 301.6320-1(f)(2) (Q&A-F3), 301.6330-1(f)(2) (Q&A-F3).

47 *Churchill v. Comm'r*, T.C. Memo. 2011-182; *see also* CCN-2013-002 (Nov. 30, 2012), which provides Counsel attorneys with instructions on when a remand based on changed circumstances might be appropriate.

48 *See, e.g.*, *Pomeroy v. Comm'r*, T.C. Memo 2013-26 at 20.

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

50 *De novo* means "anew." Black's Law Dictionary (10th ed. 2014), *available at* http://westlaw.com.

51 The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing Appeals' CDP determinations. H.R. Rep. No. 1059-99, at 266 (Conf. Rep.).

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

53 IRC § 7482(b)(1) also provides that the proper venue lies with the court of appeals for the circuit in which is located: in the case of a corporation seeking redetermination of tax liability, the principal place of business or principal office or agency of the corporation, or if it has no principal place of business or principal office or agency in any judicial circuit, then the office to which was made the return of the tax in respect of which the liability arises; in the case of a person seeking a declaratory decision under IRC § 7476, the principal place of business or principal office or agency of the employer; in the case of an organization seeking a declaratory decision under IRC § 7428, the principal office or agency of the organization; in the case of a petition under IRC §§ 6226, 6228(a), 6247, or 6252, the principal place of business of the partnership; and in the case of a petition under section IRC § 6234(c), (i) the legal residence of the petitioner if the petitioner is not a corporation, and (ii) the place or office applicable under subparagraph (B) if the petitioner is a corporation.

It has been the longstanding practice of taxpayers and the IRS to appeal CDP, innocent spouse, and interest abatement cases to the circuit of the petitioner's legal residence, principal place of business, or principal office or agency. The Tax Court has also followed this approach. Under the rule established in *Golsen v. Commissioner*,[54] the Tax Court follows the precedent of the circuit court to which the parties have the right to appeal regardless of whether the taxpayer's tax liability was at issue.

In *Byers v. Commissioner*, the D.C. Circuit held that the D.C. Circuit will not transfer cases in non-liability CDP cases unless both parties stipulate to the transfer.[55] The D.C. Circuit did not answer the question of whether another Court of Appeals could hear an appeal of a non-liability CDP decision without stipulation.[56] The court acknowledged that in some CDP cases involving both challenges to the tax liability and collection issues, the venue presumably would be in the appropriate regional circuit.[57]

The IRS Office of Chief Counsel recently issued a notice that provides litigation guidelines to Chief Counsel attorneys about appellate venue for collection due process, innocent spouse, interest abatement, and other non-deficiency cases in light of the decision in *Byers*.[58] In litigating Tax Court cases, Chief Counsel attorneys are instructed to continue asserting the IRS's longstanding position that, for purposes of the *Golsen* rule, venue generally lies in the circuit of the taxpayer's legal residence, principal place of business, or principal office or agency, regardless of whether the issues in the case involve liability. In CDP cases in which liability is at issue, Chief Counsel attorneys are instructed to argue, in the alternative, that venue lies in the regional circuit, which is consistent with *Byers*. The notice further instructs Chief Counsel attorneys not to object to venue if a taxpayer appeals a non-liability case not enumerated in IRC § 7482(b) to the D.C. Circuit[59] or if a taxpayer appeals a non-liability case to the proper regional circuit.[60] To address the uncertainty and confusion among taxpayers and practitioners that impact *the right to be informed*, the National Taxpayer Advocate recommended that Congress amend IRC § 7482(b)(1)(A) to provide that proper appellate venue for all CDP cases lies with the circuit court of appeals based on the taxpayer's legal residency.[61]

ANALYSIS OF PUBLISHED OPINIONS

We identified and reviewed 79 CDP court opinions, a four percent increase from the 76 published opinions in last year's report. As shown in Figure 3.5.1, we have identified on average about 131 opinions per year since 2001.

From 2003 to 2007, the average number of published opinions was approximately 200. Since 2011, however, the average number of published opinions has dropped to 93. At first glance, this decline may be

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

55 *Byers*, 740 F.3d 668 (D.C. Cir. 2014). For a more detailed discussion of the *Byers* case, see National Taxpayer Advocate 2014 Annual Report to Congress 477-94 (Most Litigated Issue: *Appeals From Collection Due Process Hearings Under IRC §§ 6320 and 6330*).

56 740 F.3d at 677. The court noted that it had "no occasion to decide… whether a taxpayer who is seeking review of a CDP decision on a collection method may file in a court of appeals other than the D.C. Circuit if the parties have not stipulated to venue in another circuit."

57 *Id*. at 676.

58 IRS Office of Chief Counsel, Notice CC-2015-006, *Venue for Appeals from Decisions of the Tax Court* (June 30, 2015).

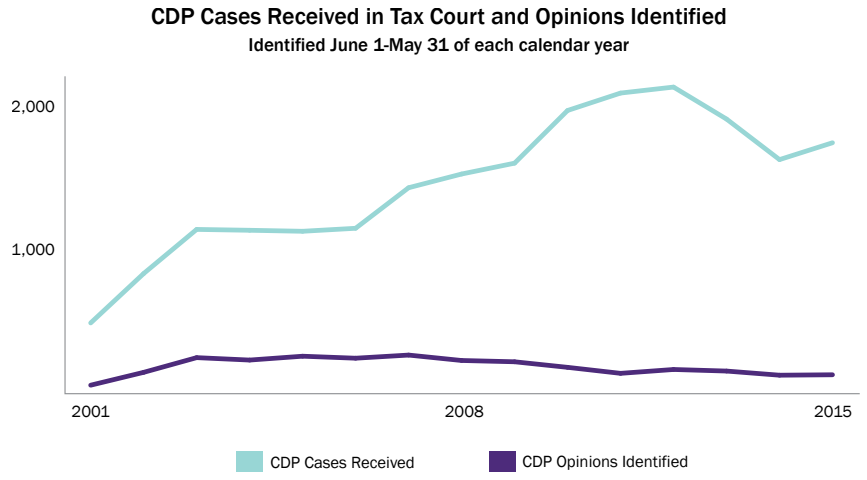
59 *Byers* is controlling in the D.C. Circuit.

60 This is consistent with the IRS Office of Chief Counsel longstanding position.

61 *See* National Taxpayer Advocate 2014 Annual Report to Congress 387-91 (Legislative Recommendation: *Appellate Venue in Non-Liability CDP Cases: Amend IRC § 7482 to Provide That The Proper Venue to Seek Review of a Tax Court Decision in All Collection Due Process Cases Lies With the Federal Court of Appeals for the Circuit in Which the Taxpayer Resides*).

attributed, in part, to a series of operational changes in fiscal years 2011 and 2012, collectively known as the "Fresh Start" initiative, which led to fewer NFTL filings and more accepted OICs in the past few years, and had a positive impact on many taxpayers and revenue collection.[62] However, it is not clear that the reduction in CDP published opinions is attributable to the reduced number of lien filings. Of the over 21,000 CDP cases petitioned to the Tax Court between June 1, 2000, and May 31, 2015, only 282 were classified as lien cases.[63] Furthermore, the number of CDP cases petitioned has actually increased over time.

FIGURE 3.5.1, CDP Cases Received in Tax Court and Opinions Identified



The increase in CDP cases received suggests that the reduced number of CDP opinions identified may not be the result of fewer taxpayers requesting a CDP hearing and then contesting the CDP determination by filing a Tax Court petition. Instead, it could be the result of more taxpayers deciding not to pursue litigation after filing a petition, more settlements, or more non-precedential CDP orders or bench opinions that do not result in a published opinion.[64] Moreover, the decline in litigated cases may be due to taxpayers litigating many issues of first impression in the years immediately following the enactment of IRC §§ 6320 and 6330, which now have been resolved by the courts.

62 For instance, in fiscal year (FY) 2014, the IRS filed about 49 percent fewer NFTLs than in FY 2011, including a corresponding 58 percent reduction in liens filed by the Automated Collection System. In FY 2011, the IRS filed 1,042,230 liens. *See* IRS, Collection Workload Indicators 5000-23 (Oct. 11, 2011). In FY 2014, the IRS filed 535,580 liens. *See* IRS, Collection Activity Report 5000-25 (Sept. 29, 2014). Additionally, the dollars collected increased from about $17 billion in FY 2011 to about $18.5 billion in FY 2014. *See* IRS, Collection Activity Report 5000-2 (Oct. 3, 2011), IRS, Collection Activity Report 5000-6 (Oct. 3, 2011), IRS, Collection Activity Report 5000-108 (Oct. 5, 2011); IRS, Collection Activity Report 5000-2 (Sept. 29, 2013), IRS, Collection Activity Report 5000-6 (Sept. 30, 2014), IRS, Collection Activity Report 5000-108 (Sept. 29, 2014). We also note that the IRS has accepted 38 percent more offers in compromise than during FY 2011, and that the actual number of accepted offers has almost doubled when compared to FY 2010. Considering FY 2014, the offer acceptance rate of 42 percent is the highest we have seen in many years. *See* IRS, Collection Activity Report 5000-108 (Oct. 5, 2010); IRS, Collection Activity Report 5000-108 (Oct. 5, 2011); IRS, Collection Activity Report 5000-108 (Sept. 29, 2014). During FY 2014, thousands of financially struggling taxpayers have successfully obtained lien withdrawals to help regain their financial viability. *See* IRS, *FY 2014 C-25 Report*.

63 IRS, Chief Counsel Reports, *CDP Cases with Specific UIL Codes Received Between 06/01/2000 To 05/31/2015* (Oct. 7, 2015); IRS, Chief Counsel Reports, *CDP Cases Received Between 06/01/2000 To 05/31/2015* (Oct. 7, 2015). CDP cases received refers to cases where the taxpayer petitioned Tax Court to contest a CDP determination.

64 For a discussion regarding the number of CDP unpublished opinions, see Carlton Smith, *Unpublished CDP Orders Dwarf Post-trial Bench Opinions in Uncounted Tax Court Rulings*, Procedurally Taxing (Jan. 29, 2015), *available at* http://www.procedurallytaxing.com/unpublished-cdp-orders-dwarf-post-trial-bench-opinions-in-uncounted-tax-court-rulings/.

Thus, the 79 published opinions identified this year do not reflect the full number of CDP cases. Table 5 in Appendix 3 provides a detailed list of the published CDP opinions, including specific information about the issues, the types of taxpayers involved, and the outcomes of the cases.

Litigation Success Rate

Taxpayers prevailed in full in 11 of the 79 published opinions issued during the year ending May 31, 2015 (nearly 14 percent).[65] Taxpayers prevailed, in part, in three other cases (nearly four percent). Of the published opinions in which the courts found for the taxpayer, in whole or in part, the taxpayers appeared *pro se* in five cases and were represented in nine others. The IRS prevailed fully in approximately 82 percent of published opinions reviewed, a decrease from the higher recorded success of 89 percent last year. The 18 percent success rate[66] for the taxpayer is the highest since the inception of CDP hearings and may be an indication that the IRS is not addressing collection alternatives adequately at the administrative hearing.

FIGURE 3.5.2, Success Rates in CDP Opinions Identified[67]

Court Decision	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Decided for IRS	95%	95%	89%	90%	92%	90%	92%	89%	92%	86%	84%	89%	82%
Decided for Taxpayer	1%	3%	8%	8%	5%	8%	4%	10%	3%	7%	8%	7%	14%
Split Decision	4%	2%	3%	2%	3%	2%	4%	2%	3%	6%	9%	4%	4%
Neither	n/a	n/a	n/a	n/a	<1%	n/a	n/a	n/a	1%	<1%	n/a	n/a	n/a

Issues Litigated

The cases discussed below are those the National Taxpayer Advocate considers significant or noteworthy. Their outcomes can provide important information to Congress, the IRS, and taxpayers about the rules and operation of CDP hearings. Equally important, all of the cases offer the IRS an opportunity to improve the CDP process and collection practices in both application and execution.

Buczek v. Commissioner

In *Buczek v. Commissioner*, the IRS sent the taxpayer a final notice of intent to levy for unpaid taxes for tax year (TY) 2009.[68] The taxpayer timely requested a CDP hearing with an additional seven pages attached to the request. Each additional page contained phrases such as "Pursuant to UCC 3-501," "Refused from the cause," "Consent not given," and "Permission DENIED." The taxpayer did not

65 *Budish v. Comm'r*, T.C. Memo. 2014-239; *Crosswhite v. Comm'r*, T.C. Memo. 2014-179; *Duarte v. Comm'r*, T.C. Memo. 2014-176; *Gurule v. Comm'r*, T.C. Memo. 2015-61; *Knudsen v. Comm'r*, T.C. Memo. 2015-69; *Lee v. Comm'r*, 144 T.C. 40 (2015); *Reinhart v. Comm'r*, T.C. Memo. 2014-218; *Yuska v. Comm'r*, T.C. Memo. 2015-77; *Ding v. Comm'r*, T.C. Memo. 2015-20; *Sanfilippo, Estate of v. Comm'r*, T.C. Memo. 2015-15; *Synergy Envtl., Inc. v. Comm'r*, T.C. Memo. 2014-148.

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

67 Numbers may not total to 100 percent due to rounding. A "split" decision refers to a case with multiple issues where both the IRS and the taxpayer prevail on one or more substantive issues. A "neither" decision refers to a case where the court's decision was not in favor of either party.

68 *Buczek v. Comm'r*, 143 T.C. 301 (2014).

request a collection alternative, did not assert he could not pay the underlying tax, and did not raise any other issue. The IRS sent a disregard letter stating that the taxpayer's request for a CDP hearing had been disregarded in its entirety due to the taxpayer raising frivolous arguments and that the IRS could proceed with collection.[69] The taxpayer then appealed the IRS's determination to the Tax Court.

The main issue was whether the Tax Court had the jurisdiction to review an Appeals determination that a CDP hearing request was frivolous in its entirety and would be disregarded. *Thornberry* held that while IRC § 6330(g) denied judicial review of the portions of CDP hearing requests identified as frivolous under IRC § 6702(b)(2)(A), it did not prohibit judicial review of the determination by the Appeals Office that the hearing request was frivolous in its entirety and that collection action could proceed.[70] The IRS requested the court overturn *Thornberry*, arguing that it undermined IRC § 6330(g), which precludes from judicial review any portion of a CDP request deemed frivolous.

Although the court found that IRC § 6330(g) applied to this case, it distinguished it and upheld *Thornberry*. The judge noted that the taxpayers in *Thornberry* had actually raised proper issues in their request but were still denied a hearing because the IRS deemed their issues frivolous. In contrast, the taxpayer in the present case did not challenge the collection action, offer any collection alternatives, challenge the underlying liability, or raise any spousal defenses.[71] The court concluded that since the taxpayer did not raise any issues that could have been considered in the CDP hearing, there were no issues that were deemed to be excluded from the portions of the request deemed frivolous. Because this resulted in the entire request being treated as if it were never made, the court found it lacked jurisdiction to review the Appeals determination, that collection action would proceed, and thus dismissed the case for lack of jurisdiction.

This opinion has two important ramifications. First, it upheld the *Thornberry* decision, providing an important protection for taxpayers and preventing the IRS from denying CDP hearings by simply labeling hearing requests as entirely frivolous. Second, the court adhered to IRC § 6330(g) by finding that if the taxpayer failed to raise any legitimate issues that could be excluded from the frivolous positions, the court did not have jurisdiction to review the Appeals determination that collection would proceed.[72]

Budish v. Commissioner

In *Budish v. Commissioner*,[73] the IRS issued a notice of intent to levy to the taxpayer, a sculptor who works in cast bronze and sells his artwork through a wholly owned S corporation. The taxpayer timely requested and received a CDP hearing. During the hearing, the taxpayer and Appeals Officer (AO) agreed on the payment amount for an IA that would full-pay the outstanding tax liability, but the AO insisted upon the filing of an NFTL as a condition to the IA, stating that it was in the government's best interest since the taxpayer's tax liability exceeded $200,000. The taxpayer's counsel provided a letter from the taxpayer's supplier substantiating that should the IRS file an NFTL, the taxpayer's longstanding business relationship with the foundry would be drastically altered. The taxpayer also argued that an NFTL would result in the buyers of sculptures not financing him by paying upfront for artwork they might never receive, because it may be encumbered by the tax lien. Finally, the taxpayer argued that the NFTL would

69 *Buczek v. Comm'r*, 143 T.C. 301 (2014) at 4.

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

71 *Buczek v. Comm'r*, 143 T.C. 301 (2014) at 12.

72 For further analysis of *Buczek*, see Howard A. Dawson, *Tax Court Won't Bite at IRS Request to Overturn CDP Opinion*, 2014 TNT 194-14 Tax Notes Today (Oct. 7, 2014). *See also* Stephen Olsen, *Summary Opinions for 10/03/14*, Procedurally Taxing (Oct. 13, 2014), *available at* http://www.procedurallytaxing.com/summary-opinions-for-100314/.

73 *Budish v. Comm'r*, T.C. Memo. 2014-239.

adversely affect his credit rating and, as a result, the taxpayer would be unable to pay the foundry using his credit card. Despite all these arguments, the AO insisted upon the filing of an NFTL as a condition to the IA, and the taxpayer declined to enter into the IA with those terms.

Not being able to secure a collection alternative, the AO then issued to the taxpayer a notice of determination sustaining the proposed levy action. In an attachment to the notice, the AO gave two specific reasons for insisting that a notice of lien be filed, both based on interpretations of the Internal Revenue Manual (IRM):

(1) The liability was over $200,000, so the lien must be filed to protect the government's interest;[74] and

(2) The installment agreement request did not meet streamlined, guaranteed, or in-business trust fund express criteria, so the lien was required to be filed as a condition of the installment agreement.[75]

The court determined that the AO misinterpreted and overstated the directives set forth in the IRM and erroneously concluded that the IRM required the NFTL filing. Importantly, the IRM uses the term "in general", which the court interprets to mean that there may be occasions when a lien does not have to be filed.[76] The court went on to state that IRM 5.12.2.4, relied upon by the AO, lists circumstances in which a lien *determination* must be made; it did not say these circumstances lead to a lien *filing*.[77] Furthermore, the court discussed how the IRM allows for revenue officers to defer filing a lien if it would impede the collection of tax. Thus, the court concluded that the IRM did not require the AO to file a lien.

Regarding the balancing test, the court was not persuaded by the AO's statement that the petitioner "failed to show how withholding the lien filing would be in the best interest of the government and facilitate collection," and found that this language "was, in effect, surplusage or boilerplate, included merely for the sake of completeness."[78] The AO did not explain how she came to her conclusion and did not show that she thoroughly considered the taxpayer's contention that the lien would severely impair his ability to pay off the underlying liability. The court found the AO's determination lacked any analysis of "what might have led [the AO] to conclude that levy action will balance the need for efficient collection of tax with petitioner's concern that it would be unnecessarily intrusive." The court further held that the AO failed to discuss balancing factors and thus did not properly balance the need for the efficient collection of the taxpayer's liability with the legitimate concern of the taxpayer that any collection be no more intrusive than necessary as required by IRC § 6330(c)(3)(C).[79]

By failing to perform proper balancing, the AO abused discretion in sustaining the levy. The court remanded the case to Appeals for a supplemental CDP hearing with directions to perform the balancing of factors before determining the appropriate collection action, including the impact of a proposed collection action (NFTL) on the taxpayer's ability to remain in business and generate sufficient income to not default on the proposed installment agreement; the value of the taxpayer's assets and the amount of cash flow; any

74 *See* IRM 5.12.2.4.1, *Integrated Collection System (ICS) Documentation When Deferring the Filing of an NFTL or Choosing Do Not File* (Oct. 14, 2013). The court assumed that the AO "felt constrained" to file an NFTL by this IRM.

75 The AO cited IRM 5.12.2.4.

76 *Budish*, T.C. Memo. 2014-239 at 18.

77 *See* IRM 5.12.2.4, *Determination Criteria for Do-Not-File or Deferring the NFTL Filing* (Oct. 30, 2009).

78 *Budish*, T.C. Memo. 2014-239 at 21. For a detailed discussion of the importance of specific procedures for performing the CDP Balancing test, see National Taxpayer Advocate 2014 Annual Report to Congress 185-96 (Most Serious Problem: *Collection Due Process: The IRS Needs Specific Procedures for Performing the Collection Due Process Balancing Test to Enhance Taxpayer Protections*).

79 *Budish*, T.C. Memo. 2014-239.

reasonable alternatives to the proposed collection action (a bond in lieu of the NFTL) under the circumstances; and the validity and the priority of the lien and whether it will attach to the taxpayer's assets.[80]

Gurule v. Commissioner

Gurule v. Commissioner involved a husband (Mr. Gurule) and wife (Mrs. Gurule) who generated a 2009 tax liability as a result of Mr. Gurule taking distributions from a 401(k) retirement plan, which he intended to use for a down payment on a house after he was relocated for his job.[81] Subsequently, Mr. Gurule lost his job and was not able to buy the new house. Accordingly, the taxpayers moved back to their prior house, but it was foreclosed upon shortly thereafter. In 2013, Mr. Gurule took out three separate loans (in addition to two existing loans) from his 401(k) plan to pay expenses for foreclosure, moving, a security deposit, and the first month's rent on a new residence, in addition to substantial medical expenses for Mrs. Gurule and their son and the cost of their son's funeral in 2013. Mrs. Gurule had a severe neurological condition causing seizures, preventing her from working and requiring expenses for surgery, medication, and doctor visits. The Gurule's son, who suffered a brain injury as a child, had numerous medical problems until he passed away in August 2013.[82]

In 2011, the IRS sent the taxpayers a notice proposing adjustments to their 2009 income tax based on the 401(k) distributions; however, it is unclear whether the taxpayers ever received a statutory notice of deficiency. In response to a Notice of Intent to Levy issued on May 7, 2012, the taxpayers timely requested a CDP hearing, stating that collection would cause a hardship. The taxpayers submitted an OIC to the Settlement Officer (SO), proposing to settle their liability for $950, paid over five months, based on doubt as to collectibility. The Centralized OIC Unit preliminarily rejected the proposed OIC, finding the taxpayers could full pay based upon their net realizable equity and future income. The SO made a separate calculation as to the taxpayers' income and reasonable collection potential (RCP). The SO allowed the expense for the payment of the 401(k) loans shown on Mr. Gurule's pay stub, but allowed only one-half of the expense because she did not realize that Mr. Gurule was paid bi-weekly. Furthermore, the SO did not reduce the taxpayers' net realizable equity by the amount of the third and fourth 401(k) loans, explaining that these could be considered dissipated assets, because the taxpayers chose to take out the loans knowing they owed federal taxes.[83] The SO offered the taxpayers the choice of either increasing their OIC or accepting an installment agreement based on their net monthly income as calculated by the SO and the filing of an NFTL. The SO also determined that the taxpayers did not meet the requirements for currently not collectible status. After rejecting an additional OIC proposal from the taxpayers, the SO issued a notice of determination that did not address their claim of financial hardship.

The Tax Court remanded the case back to the IRS, finding the record from the CDP hearing was insufficient to allow the court to determine: (1) whether the IRS properly mailed a statutory notice of deficiency; (2) whether the SO abused her discretion by upholding the levy despite the economic hardship claim; (3) whether the SO properly calculated their RCP; and (4) whether the SO properly considered the taxpayers' special circumstances before rejecting the OIC.

Regarding the statutory notice of deficiency, the court found there was not a copy in the record and the notice of determination did not state whether the SO had verified the mailing of the notice of deficiency.

80 *Budish*, T.C. Memo. 2014-239.
81 T.C. Memo. 2015-61.
82 *Id*. at 3-4.
83 *Gurule*, T.C. Memo 2015-61 at 4.

The court was especially concerned because the notice of determination stated that the SO had verified each of the other statutory requirements.

Concerning the economic hardship claim, the court cited *Vinatieri v. Commissioner* for the principle that an SO in a CDP hearing cannot proceed with the proposed levy action when a taxpayer establishes that it would create an economic hardship because the levy would then have to be immediately released.[84] Further the court referenced an IRM provision that only allows levies of retirement accounts when the taxpayer's conduct has been flagrant and the taxpayer does not depend on the funds for necessary living expenses.[85] Because the notice of determination did not show that the SO considered the economic hardship claim and the administrative record showed no consideration of the IRM provision above, the court found it could not determine whether the SO abused her discretion.

Regarding the SO's calculation of the taxpayers' RCP, the court stated that the SO may have made a material error by not adjusting the taxpayers' net realizable equity of the retirement plan account after the third loan. The court found the SO's treatment of the loans as dissipated assets was not justified, based on the administrative record, which did not establish that Mr. Gurule took out the additional 401(k) loan with intent to disregard the outstanding tax liability. Furthermore, the court noted that the loans appeared to have been used for necessary living expenses.[86] The court also noted that a remand may be appropriate when a taxpayer has experienced a material change in circumstances between the time of the IRC § 6630 hearing and the trial that affects the RCP calculation. It then noted that the taxpayers' middle son passed away after the notice of determination was issued. That event caused taxpayers to take out an additional loan from the 401(k), which affected their RCP and ability to pay the tax liability, and they were still unable to afford to bury his ashes. Finally, the court found the administrative record suggested that the SO rejected the taxpayers' proposed OIC without giving any consideration to their special circumstances, such as Mrs. Gurule's neurological condition and the loans necessary to pay medical expenses for her and their now deceased son.

Ligman v. Commissioner

In *Ligman v. Commissioner*, the taxpayer timely requested a CDP hearing after receiving a levy notice from the IRS for the unpaid tax liabilities for TY 2008.[87] At the hearing, the taxpayer's representative stated that the taxpayer's only source of income was his Railroad Retirement Board benefits and offered a $25 per month partial payment IA. The AO concluded that the petitioner's disposable monthly income was $946 and counter-offered an IA of $765 per month.[88] After not hearing back from the taxpayer's representative, the AO closed the case and sustained the levy. The taxpayer then appealed the determination to the Tax Court.

The taxpayer argued that the AO abused his discretion by including his retirement benefits while calculating his ability to pay, contending that these benefits were partially levy proof. The IRS agreed that

84 *Gurule*, T.C. Memo 2015-61 at 8 (citing *Vinatieri v. Comm'r*, 133 T.C. 392, 400 (2009)). This principle, which supports a taxpayer's *right to a fair and just tax system*, was incorporated into the IRM as a result of TAS's advocacy efforts. *See* IRM 5.11.1.3.1, Pre-Levy Considerations (Aug. 1, 2014).

85 *Id.* (citing IRM 5.11.6.2 (Dec. 2, 2011)). For a detailed discussion of how the IRS's guidance regarding levies on retirement accounts is inadequate and infringes on taxpayer rights, see Most Serious Problem: *Levies on Assets in Retirement Accounts: Current IRS Guidance Regarding Levies on Retirement Accounts Does Not Adequately Protect Taxpayer Rights and Conflicts with Retirement Security Public Policy*, *supra*.

86 *Gurule,* T.C. Memo 2015-61 at 12.

87 *Ligman v. Comm'r*, T.C. Memo. 2015-79.

88 *Id.* at 9.

railroad retirement benefits were partially levy proof under IRC §§ 6334(a)(6) and 6331(h). However, the IRS argued that it is not barred from considering the benefits (in its determination of the taxpayer's income and ability to pay) for purposes of determining availability of a collection alternative.

The court agreed with the IRS's argument, acknowledging that the IRM does not specify whether railroad retirement benefits are included in income calculation.[89] The court stated that the railroad retirement benefits are similar to Social Security benefits, which are specifically included in the IRM's calculation of income, despite being partially levy proof. Thus, including the taxpayer's railroad retirement benefits when calculating his ability to pay was not an abuse of discretion by the AO.[90]

Sanfilippo v. Commissioner

This case involved the payment of estate taxes.[91] Martha E. Sanfilippo died testate and left Garrett Rajkovich (Rajkovich) interests in various properties. On receipt of the interests, Rajkovich's ownership in the Hacienda Shopping Center increased from 65.7 to 75.7 percent. In addition to the interests, the decedent's will forgave Rajkovich's debt of $21,268,186 that he owed to the estate.[92]

In March 2005, the estate filed for an extension to file an estate tax return. The IRS granted the extension, and the estate subsequently sent a completed estate tax return in October 2005. The return valued the gross estate at over $62 million, which included Rajkovich's discharged loan and assets from one of the estate's trusts, and reported an estate tax liability of about $15 million. Over the course of 2006 through 2010, the estate requested six additional extensions of time to pay the estate tax, due to liquidity problems of both the estate and Rajkovich. After all but the last extension was granted, the estate, Rajkovich, and the IRS entered into a three-way security agreement. The agreement gave the IRS a first priority security in an estate property, GMK Oakley (GMK), for as long as the liability was unpaid.[93]

On June 21, 2011, IRS sent the estate a notice of intent to levy and notice of the taxpayer's right to a CDP hearing. The estate timely requested a CDP hearing and indicated that it would like to submit an OIC. Rajkovich and his representative then met with SO Pobre to discuss the case. The taxpayer informed the SO that GMK had interest from a potential buyer and the sale funds would be used to satisfy the estate tax liability.[94] After the hearing, the estate submitted a proposal to compromise the liability for a payment of approximately $5 million, to be paid with the proceeds from the potential GMK sale. SO Pobre decided that the RCP of the estate would go up after the potential sale, so he decided to put the case on hold. He subsequently placed the estate in currently not collectible status, taking into account Rajkovich's obligations, independent of the estate, under the security agreement. Unfortunately, the sale of the property was delayed and SO Pobre transferred out of the Appeals Office shortly thereafter. Before SO Pobre transferred, the two sides agreed to meet again to come up with a "common plan" on how to move forward. SO Pobre was then replaced by SO Owyang.

SO Owyang emailed his team manager, stating that he did not feel comfortable working on an estate case, since he was not well versed in the subject area.[95] Even though the underlying liability was not at issue in

89 IRM 5.15.1 and 5.15.1.11(2)(e). Generally all household income will be used to determine the taxpayer's ability to pay. *See* IRM 5.15.1, *Financial Analysis Handbook*.

90 *Ligman v. Comm'r*, T.C. Memo. 2015-79 at 9.

91 *Sanfilippo v. Comm'r*, T.C. Memo. 2015-15.

92 *Id.* at 3.

93 *Id.* at 5.

94 *Id.* at 9.

95 *Sanfilippo v. Comm'r*, T.C. Memo. 2015-15 at 14.

the CDP hearing and the estate had been examined by the IRS, SO Owyang focused his analysis on the estate's transfer to Rajkovich of the Hacienda Shopping Center interest, valued at under $2 million, and the use of this interest by Rajkovich to obtain an almost $10 million loan. SO Owyang's analysis questioning the valuation of the interest ignored the facts that Rajkovich already held a 65.7 percent majority interest in the property before the estate transferred the additional ten percent interest to him and that the IRS had previously determined the interest's value during examination. SO Owyang closed the case and sustained the levy, citing the taxpayer's failure to provide a collection alternative to satisfy the liability. The estate appealed the case to the Tax Court.

The estate argued that SO Owyang abused his discretion when he sustained the levy. The IRS argued that SO Owyang committed a harmless error regarding analysis of the estate assets and that the estate did not submit a proper OIC.[96] The court disagreed with the IRS's harmless error argument because SO Owyang's miscalculation of Rajkovich's Hacienda Shopping Center interest was instrumental in his decision to sustain the levy. The court also found the estate did in fact propose an OIC, and SO Owyang did not give any consideration to the discussions between Rajkovich and SO Pobre regarding the collection alternative or to the three-way security agreement in place. The court held that the SO abused his discretion and remanded the case to Appeals to consider any collection alternatives proposed by the estate.[97]

Gyorgy v. Commissioner

In *Gyorgy v. Commissioner*,[98] the taxpayer did not file tax returns for 2001 through at least 2007. Relying on information reported on third-party information returns, the IRS prepared substitute for returns (SFRs) for the taxpayer for TYs 2001-2003. From 2004 through 2007, the IRS sent notices of deficiency for all three tax years to the address used on the taxpayer's most recently filed return, which was his address on file.[99] The IRS also sent a Form 2797 "R-U-There" letter to one of many possible addresses for the taxpayer that was reported on third-party information returns. The IRS received no responses to any of its correspondence, other than the postal service returning the letters as undeliverable. The IRS took no further steps to locate the taxpayer or reissue notices. Between the years of 2004 and 2007, the IRS assessed the liabilities for all three tax years in which SFRs had been prepared (2001, 2002, and 2003). Then, in 2009, the IRS moved forward with collection activities by filing an NFTL and sending to the taxpayer's current residence a notice of his right to request a CDP hearing. The taxpayer timely requested a CDP hearing, where he challenged the underlying liability and whether the IRS followed proper procedures. The AO sustained the NFTL, finding the IRS followed legal and administrative procedures during the assessment and collection process and the taxpayer did not challenge the IRS's calculation of his liability.[100] The taxpayer then petitioned the Tax Court.

Noting that the taxpayer did not notify the IRS of address changes and presented no evidence to contest the liabilities, the court found the IRS had mailed the statutory notices of deficiency to the taxpayer's last

96 An error is harmless if it does not cause prejudice or does not affect the ultimate determination in the case. *See, e.g.*, *Estate of Mangiardi v. Comm'r*, T.C. Memo. 2011–24, *aff'd*, 442 Fed. Appx. 526 (11th Cir. 2011).

97 *Sanfilippo v. Comm'r*, T.C. Memo. 2015-15 at 26.

98 779 F.3d 466 (7th Cir. 2015), *aff'g* T.C. Docket No. 19240-11 (Mar. 25, 2013).

99 "When a notice or document is sent to a taxpayer's 'last known address,' it is legally effective even if the taxpayer never receives it." Rev. Proc. 2010-16, I.R.B. 2010-19 (May 10, 2010). This revenue procedure explains the IRS's procedures for determining the last known address.

100 *Gyorgy v. Comm'r*, 779 F.3d 466, 470 (7th Cir. 2015), *aff'g* T.C. Docket No. 19240-11 (Mar. 25, 2013).

known address and sustained the lien for TYs 2002 and 2003.[101] The taxpayer appealed the Tax Court's decision to the Court of Appeals for the 7th Circuit.

Three interesting points of discussion were raised in this case. The first was whether judicial review of a CDP decision was limited to the administrative record. The 7th Circuit observed that the Tax Court looked beyond the record when it considered trial testimony. Instead of determining definitively if judicial review should be restricted to the administrative record, the 7th Circuit declined to rule on this issue because neither party raised it, and considered the administrative record as well as evidence presented at the Tax Court trial.[102]

Second, the 7th Circuit addressed what the proper standard of review is when considering whether the IRS followed proper procedures in assessing the liability. It is well established that a challenge to the underlying tax liability requires a *de novo* review, while the Appeal's Office's determination with regard to the collection action is reviewed under an abuse of discretion standard.[103] This case was unique because a standard had to be chosen to review the taxpayer's challenge to the IRS's mailing procedure, which in turn was a challenge to the IRS's assessment of the underlying liability. The 7th Circuit agreed with the Tax Court in applying an abuse of discretion standard for the mailing issue, since it was an administrative decision unrelated to the amount of the underlying liability.[104] Additionally, the Court found that the taxpayer presented no evidence or arguments to challenge the amount of the liability, further precluding applying a *de novo* standard.

The last significant issue was whether the IRS had used reasonable diligence in finding the taxpayer's correct address.[105] It agreed that the IRS had to take certain steps to determine the taxpayer's last known address. In the present case though, the court found that the taxpayer made that job difficult for the IRS by not filing tax returns for many years, moving frequently, and keeping the IRS "in the dark concerning his whereabouts."[106] It concluded that the IRS properly relied on the address listed on his most recently filed tax return and determined that the Appeals Office properly sustained the NFTL against the taxpayer.

CONCLUSION

CDP hearings provide an invaluable opportunity for taxpayers to meaningfully address the appropriateness of IRS collection actions. Given the important protection that CDP hearings offer, it is unsurprising that CDP remains one of the most frequently litigated issues. The cases discussed this year were important for a variety of reasons. They affirmed an important protection for the taxpayer, elaborated upon the Tax Court's test for abuse of discretion, and addressed procedural issues.

The *Buczek* case may have been the most important this year, in that it supported a taxpayer's *right to appeal an IRS decision in an independent forum*. In *Buczek*, the court reaffirmed its holding in Thornberry that the court has jurisdiction to review whether the Office of Appeals properly determined that the taxpayer's CDP hearing request was entirely frivolous or for purposes of delay and correctly treated as

101 The court vacated the lien notice for TY 2001 because the IRS could not produce a copy of the deficiency notice or other proof that a notice was mailed. *Gyorgy v. Comm'r*, 779 F.3d 466, 471 (7th Cir. 2015), *aff'g* T.C. Docket No. 19240-11 (Mar. 25, 2013).

102 *Gyorgy v. Comm'r*, 779 F.3d 466, 473 (7th Cir. 2015), *aff'g* T.C. Docket No. 19240-11 (Mar. 25, 2013).

103 *Murphy v. Comm'r*, 469 F.3d 27 (1st Cir. 2006).

104 *Gyorgy v. Comm'r*, 779 F.3d 466, 472, 480-81 (7th Cir. 2015), *aff'g* T.C. Docket No. 19240-11 (Mar. 25, 2013).

105 *Id*.

106 *Id*.

if never submitted, and to review only legitimate issues properly raised in the hearing request. *Buczek* suggests that courts continue to value the protection provided to taxpayers in *Thornberry*. Although the taxpayers in *Buczek* had presented arguments to delay collection, the court understood that overturning *Thornberry* would have detrimental effects on taxpayers beyond just *Buczek*. If *Thornberry* were reversed, not only would a taxpayer's *right to appeal an IRS decision in an independent forum* be weakened, but such a decision would also compromise a taxpayer's *right to challenge an IRS decision and be heard*. This ruling protects taxpayers from the IRS erroneously labeling a request as frivolous to preclude it from judicial review, thus also upholding a taxpayer's *right to a fair and just tax system*.

Sanfilippo shows that there is value in assigning hearing officers to cases in which they have proper knowledge and expertise of the issues. The decision to keep the SO on the case after he complained of his difficulties resulted in needless administrative and judicial costs. To mitigate these costs in the future, the IRS should place hearing officers on cases where they have substantive expertise of issues being presented at a CDP hearing. Further, they should try to make sure that hearing officers see a case through to its completion.[107] This will reduce confusion and rework that occurs when a new hearing officer takes over a case before it is resolved and fully carry out a taxpayer's *right to challenge the IRS's position and be heard*, as well as the *right to appeal an IRS decision in an independent forum*.

The *Budish* decision provides an important development regarding the CDP balancing test. While the vast majority of cases discussing the balancing test have ruled in favor of the IRS over the years, the IRS often merely stated (without elaboration or proper analysis) in these cases it had performed the balancing test. Prior to *Budish*, there was little scrutiny or indepth review, if any, from most courts regarding Appeals' analysis of factors related to balancing the legitimate concerns of taxpayers regarding the intrusiveness of the proposed collection action with the government's interest to collect. The low number of remands may be largely due to the abuse of discretion judicial standard of review, not because Appeals conducted the balancing test properly or analyzed any balancing factors. Thus, the *Budish* decision is significant in describing balancing test factors Appeals should consider upon remand. Moving away from *pro forma* statements and boilerplate language (without proper analysis) and encouraging hearing officers to fully explain which balancing test factors they considered could go a long way in reducing future litigation. By not giving proper attention to the balancing test, the IRS is missing opportunities to improve compliance, enhance taxpayer trust and confidence, relieve undue burden on taxpayers, and support a taxpayer's *right to privacy*.[108]

Gurule was significant in its reaffirmation of *Vinatieri v. Commissioner*, which found an appeals officer in a CDP hearing cannot proceed with the proposed levy action when a taxpayer establishes that it would create an economic hardship, because the levy would then have to be immediately released.[109] Although TAS has advocated extensively on this issue and worked to incorporate this principle into the official explanation of a taxpayer's *right to a fair and just tax system* in the IRM, both TAS employees and tax practitioners have still seen too many cases where the IRS continues to issue levies on taxpayers it knows are experiencing economic hardship.[110]

107 For more information about the problems with Appeals Officers transferring cases, see Most Serious Problem: *Appeals: The Appeals Judicial Approach and Culture Project is Reducing the Quality and Extent of Substantive Administrative Appeals Available to Taxpayers*, *supra*.

108 *See* National Taxpayer Advocate 2014 Annual Report to Congress 185-96 (Most Serious Problem: Collection Due Process: The IRS Needs Specific Procedures for Performing the Collection Due Process Balancing Test to Enhance Taxpayer Protections).

109 *Gurule*, T.C. Memo 2015-61 at 8 (citing *Vinatieri v. Comm'r*, 133 T.C. 392, 400 (2009)).

110 *See* National Taxpayer Advocate 2013 Annual Report to Congress 84-93 (Most Serious Problem: *Hardship Levies: Four Years After the Tax Court's Holding in Vinatieri V. Commissioner, the IRS Continues to Levy on Taxpayers It Acknowledges Are in Economic Hardship and Then Fails to Release the Levies*).

In sum, the CDP hearing is a powerful tool for the taxpayer. Further education of taxpayers about the importance of a full and complete administrative records as well as assignment of hearing officers who have substantive knowledge of the area of tax law and are familiar with the facts and circumstances of a particular case will only strengthen protections for taxpayers intended by Congress. Clarifying the interpretation of IRC § 6330(g) in accord with the *Thornberry* decision would go a long way in reaffirming important due process protections afforded to taxpayers and further the taxpayer *rights to challenge the IRS position and be heard*, *to appeal an IRS decision in an independent forum*, and *to a fair and just tax system*.

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

SUMMARY

We reviewed 63 decisions issued by federal courts from June 1, 2014, to May 31, 2015, regarding the additions to tax for:

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

The phrase "addition to tax" is commonly referred to as a penalty, so we will refer to these additions to tax as the failure to file penalty, the failure to pay penalty, and the estimated tax penalty. Eighteen cases involved the imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties; 44 involved the failure to file or failure to pay penalties; one case involved only the estimated tax penalty.

The IRS imposes the failure to file and failure to pay penalties unless the taxpayer can demonstrate the failure is due to reasonable cause and not willful neglect.[2] The estimated tax penalty is imposed unless the taxpayer can meet one of the statutory exceptions.[3] Taxpayers were unable to avoid a penalty in 59 of the 63 cases.

TAXPAYER RIGHTS IMPACTED[4]

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

Under IRC § 6651(a)(1), a taxpayer who fails to file a return on or before the due date (including extensions) will be subject to a failure to file penalty of five percent of the tax due (minus any credit the taxpayer is entitled to receive and payments made by the due date) for each month or partial month the return is late. This penalty will accrue up to a maximum of 25 percent, unless the failure is due to reasonable cause and not willful neglect.[5] To establish reasonable cause, the taxpayer must show he or she

1 IRC § 6651(a)(3) imposes an addition to tax for failure to pay a tax liability not shown on a return. However, because only a small number of cases involved this penalty, we did not include it in our analysis.

2 IRC §§ 6651(a)(1), (a)(2).

3 IRC § 6654(e).

4 *See* Taxpayer Bill of Rights *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

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

exercised ordinary business care and prudence but was still unable to file by the due date.[6] The failure to file penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.[7]

The failure to pay penalty, IRC § 6651(a)(2), applies to a taxpayer who fails to pay an amount shown as tax on the return. The penalty accrues at a rate of 0.5 percent per month on the unpaid balance for as long as it remains unpaid, up to a maximum of 25 percent of the amount due.[8] When IRS imposes both the failure to file and failure to pay penalties for the same month, it reduces the failure to file penalty by the amount of the failure to pay penalty (0.5 percent for each month).[9]

The failure to pay penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.[10] The taxpayer will not be held liable if he or she can establish reasonable cause, *i.e.*, the taxpayer must show he or she has exercised ordinary business care and prudence but was still unable to pay by the due date, or that payment on that date would have caused undue hardship.[11] Courts will consider "all the facts and circumstances of the taxpayer's financial situation" to determine whether the taxpayer exercised ordinary business care and prudence.[12] In addition, "consideration will be given to the nature of the tax which the taxpayer has failed to pay."[13]

IRC § 6654 imposes a penalty on any underpayment of estimated tax by an individual or by certain estates or trusts.[14] The law requires four installments per taxable year, each generally 25 percent of the required annual payment.[15] The required annual payment is generally the lesser of 90 percent of the tax shown on the return for the current taxable year or 100 percent of the tax for the previous taxable year.[16] 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 applicable period.[17]

To avoid the penalty, the taxpayer has the burden of proving that one of the following exceptions applies:

- The tax due (after taking into account any federal income tax withheld) is less than $1,000;[18]
- The preceding taxable year was a full 12 months, the taxpayer had no liability for the preceding taxable year, and the taxpayer was a U.S. citizen or resident throughout the preceding taxable year;[19]

6 Treas. Reg. § 301.6651-1(c)(1).

7 IRC § 6651(a)(1).

8 IRC § 6651(a)(2). Note that if the taxpayer timely files the return (including extensions) but an installment agreement is in place, the penalty will continue accruing at the lower rate of 0.25 percent rather than 0.5 percent of the tax shown. IRC § 6651(h).

9 IRC § 6651(c)(1). When both the failure to file and failure to pay penalties are accruing simultaneously, the failure to file will max out at 22.5 percent and the failure to pay will max out at 2.5 percent, thereby abiding by the 25 percent maximum limitation.

10 IRC § 6651(a)(2).

11 Treas. Reg. § 301.6651-1(c)(1). Even when a taxpayer shows undue hardship, the regulations require him or her to also prove reasonable cause.

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

13 Treas. Reg. § 301.6651-1(c)(2).

14 IRC §§ 6654(a), (l).

15 IRC §§ 6654(c)(1), (d)(1)(A).

16 IRC § 6654(d)(1)(B).

17 IRC § 6654(a).

18 IRC § 6654(e)(1).

19 IRC § 6654(e)(2).

- The IRS determines that because of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;[20] or
- The taxpayer retired after reaching age 62 or became disabled in the taxable year for which estimated payments were required, or in the taxable year preceding that year, and the underpayment was due to reasonable cause and not willful neglect.[21]

In any court proceeding, the IRS has the burden of producing sufficient evidence that it imposed the failure to file, failure to pay, or estimated tax penalties appropriately.[22]

ANALYSIS OF LITIGATED CASES

We analyzed 63 opinions issued between June 1, 2014, and May 31, 2015, where the failure to file penalty, failure to pay penalty, or estimated tax penalty was in dispute. All but 14 of these cases were litigated in the United States Tax Court. A detailed list appears in Table 6 in Appendix 3. Twenty-three cases involved individual taxpayers and 40 involved businesses (including individuals engaged in self-employment or partnerships). Last year, individual filers outnumbered businesses nearly two to one.

Of the 41 cases in which taxpayers appeared *pro se* (without counsel), taxpayers prevailed in full in one case, and six resulted in split decisions. Of the 22 cases in which taxpayers had representation, taxpayers prevailed in full in three cases, and one was a split decision.

Failure to File Penalty

One recurring basis for taxpayer success in IRC § 6651 litigation is IRS failure to meet its burden of production. For example, in *Crawford v. Commissioner*, the IRS and the taxpayer stipulated that the taxpayer's return was timely filed.[23] Despite this agreed upon stipulated fact, at the time of the trial, the IRS argued that the taxpayer failed to file his return timely. However, the court noted that stipulations are treated as conclusive admissions by the parties.[24] The court went on to note that it can relieve parties of a stipulation that is contrary to the record or if justice requires.[25] The court did not ignore the stipulated fact in this case because it determined that it may have the effect of prejudicing the *pro se* taxpayer. Because the IRS previously stipulated that the taxpayer filed his return timely, the IRS had not met its burden of production regarding the appropriateness of the failure to file penalty. Consequently, the court held that the taxpayer was not liable for the failure to file penalty.

In most of the cases reviewed, taxpayers could not successfully establish that the failures to file were due to reasonable cause. Circumstances suggesting reasonable cause are typically outside the taxpayer's control.[26] Frequent reasonable cause claims included medical illness and reliance on an agent.

20 IRC § 6654(e)(3)(A).

21 IRC § 6654(e)(3)(B).

22 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001) (applying IRC § 7491(c)). An exception to this rule relieves the IRS of this burden where the taxpayer's petition fails to state a claim for relief from the penalty (and therefore is deemed to concede the penalty). *Funk v. Comm'r*, 123 T.C. 213 (2004).

23 T.C. Memo. 2014-156.

24 *Crawford v. Comm'r*, T.C. Memo. 2014-156 (citing U.S. Tax Court Rules of Practice and Procedure, Rule 91(e), and *Chapman Glen Ltd. v. Comm'r*, 140 T.C. 294, 317 (2013)).

25 U.S. Tax Court Rules of Practice and Procedure (as Amended Through July 6, 2012), Rule 91(e): "Binding Effect: A stipulation shall be treated, to the extent of its terms, as a conclusive admission by the parties to the stipulation, unless otherwise permitted by the Court or agreed upon by those parties. The Court will not permit a party to a stipulation to qualify, change, or contradict a stipulation in whole or in part, except that it may do so where justice requires."

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

Medical Illness

Depending on the facts and circumstances, a medical illness may establish reasonable cause for failure to file, if the taxpayer can show incapacitation to such a degree that he or she could not file a return on time.[27] When considering whether the severity of the illness suffices to establish reasonable cause, the court will analyze a taxpayer's management of his or her business affairs during the illness.[28]

In *Estate of Stuller v. United States*, the IRS assessed a failure to file penalty for the late filing of the taxpayers' (Mr. and Mrs. Stuller) 2003 individual income tax return.[29] On August 27, 2009, Mrs. Stuller (in her capacity individually as well as the executor of Mr. Stuller's estate) fully paid the assessed failure to file penalty. Mrs. Stuller then timely filed a claim for refund for the failure to file penalty.[30] After Mrs. Stuller did not hear from the IRS within six months from the time the claim for refund was filed, she filed a refund suit claiming that the failure to file penalty should be refunded because the failure was due to reasonable cause.[31]

Mrs. Stuller claimed that she was prevented from filing timely tax returns by her inability to locate documents needed to file the 2003 return (*i.e.*, bank statements). She claimed that this inability was due to her being disorganized as a result of extenuating circumstances. More specifically, in early 2003, Mr. Stuller died in a fire, and Mrs. Stuller was hospitalized with pneumonia for several weeks. Some tax records were lost in the fire while others were deposited in storage in unmarked boxes. Mrs. Stuller testified that she experienced stress, depression, and chronic bronchitis following the fire. The granddaughter they cared for also had health and behavioral problems following the death of Mr. Stuller that required additional care. Further, the death of Mr. Stuller created additional work for Mrs. Stuller as trustee.

However, the court pointed out that Mrs. Stuller's 2002 tax return was timely filed in the year of the fire. She actively ran a restaurant business during 2003, firing one director of operations and hiring another. The new director testified that Mrs. Stuller was attentive to the necessary issues of the business and addressed any problems in a timely manner. Additionally, Mrs. Stuller was involved in the reconstruction of her home and competed in several horse shows, which required a significant investment of time for training.

Moreover, Mrs. Stuller had not specified which tax records she could not locate when the search for them began or the length of time she looked. The court remarked that because bank statements were the primary record used, Mrs. Stuller could have requested duplicate bank records but did not.[32] The court found it had no basis on which to conclude that the taxpayer could not produce the necessary records in time to file the return and therefore held the taxpayer liable for the late filing of the 2003 return. However, the court left open an avenue for an appeal, which Mrs. Stuller subsequently filed, by suggesting

27 *Williams v. Comm'r*, 16 T.C. 893, 905-06 (1951) (interpreting § 291 of the 1939 Code, a predecessor to IRC § 6651), *acq.*, 1951-2 C.B. 1. *See, e.g.*, *Harbour v. Comm'r*, T.C. Memo. 1991-532 (finding reasonable cause for failing to timely file because the taxpayer was in a coma the month before the due date of his tax return).

28 *Judge v. Comm'r*, 88 T.C. 1175, 1189-91 (1987).

29 55 F. Supp. 3d 1091 (C.D. Ill. 2014), *appeal docketed*, No. 15-1545 (7th Cir. Mar. 13, 2015).

30 Under IRC § 6511(a), a taxpayer generally has within three years from the time the return was filed or two years from the time the tax was paid, whichever period expires the later, to file a claim for refund.

31 IRC § 6532(a)(1). If a taxpayer has not received a response from the IRS regarding a claim for refund within six months from the time the refund claim was filed, the taxpayer can file a suit for refund in a United States District Court or the United States Court of Federal Claims.

32 *Estate of Stuller*, 55 F.Supp.3d at 1091, *appeal docketed*, No. 15-1545 (7th Cir. Mar. 13, 2015).

that evidence of a futile search for the records for weeks or months prior to the tax filing deadline might be sufficient for reasonable cause, in conjunction with the other circumstances.[33]

Reliance on Agent

The U.S. Supreme Court, in *United States v. Boyle*, held that taxpayers have a non-delegable duty to file a return on time.[34] The Court noted that "[i]t requires no special training or effort to ascertain a deadline and make sure that it is met."[35] Therefore, a taxpayer's reliance on an agent to file a return does not excuse any failure to comply with a known filing requirement.

For example, in *Specht v. United States*, Mrs. Specht (a co-fiduciary of the Escher estate), sought to recover penalties and interest in the amount of $1,198,261.38 imposed for failing to timely file the estate tax return and pay estate taxes.[36] Mrs. Specht, a 73-year-old high school-educated homemaker and the cousin of the deceased, was asked to be executor of the estate and formally accepted this role in February 2009. She hired Ms. Escher's former attorney, Mary Backsman, who had over 50 years of experience in estate planning, to represent the estate. Unknown to Mrs. Specht, Ms. Backsman was fighting brain cancer.

Ms. Backsman informed Mrs. Specht that the federal estate tax return was due by September 30, 2009, though she did not file it by that date. Additionally, Ms. Backsman failed to arrange for an agreed upon sale of stock to pay off the estate tax and lied to Mrs. Specht about it. She failed to file a first accounting of assets for the estate, missed probate deadlines, lied to Mrs. Specht about filing an extension, failed to file state estate tax returns, and failed to file the federal estate tax return. Ms. Backsman lied repeatedly about her handling of the situation. After discovering that Ms. Backsman had failed to request sale of the stock, Mrs. Specht fired her and hired another attorney on November 1, 2010. The estate filed a malpractice suit against Ms. Backsman that was settled.

Despite the above failures on the part of Ms. Backsman, the court determined that Mrs. Specht's reliance on her was unjustified. First, Mrs. Specht could not confirm if she had timely completed her listed obligations as a fiduciary and showed no concern about that duty. She stated in testimony that she was unsurprised Ms. Backsman had missed the filing deadline. She took no steps to proceed with the sale of stock before the deadline and received numerous warnings that Ms. Backsman was missing filing dates. Mrs. Specht did not attend probate hearings prior to the filing deadline. She received four notices from the probate court before the deadline, warning that Ms. Backsman was not performing her duties and that she had missed deadlines. After the deadline for filing the federal estate tax return had passed, Mrs. Specht received two more notices and was contacted in July and September 2010 by another client of Ms. Backsman, who warned her that Ms. Backsman was incompetent. In August 2010, she received a letter from the Ohio Department of Taxation alerting her that Ms. Backsman had not responded to their inquiries, and it could impose penalties. Lastly, in September 2010, she contacted an attorney who told her she needed to replace Ms. Backsman.

The court noted the precedent of *United States v. Boyle*, which established a distinction between relying on an attorney for legal advice and relying on an attorney to file tax returns, a non-delegable duty which

33 *Estate of Stuller v. U.S.*, *appeal docketed*, No. 15-1545 (7th Cir. Mar. 13, 2015).

34 *U.S. v. Boyle*, 469 U.S. 241 (1985).

35 *Id.* at 252.

36 *Specht v. U.S.*, 115 A.F.T.R.2d (RIA) 357 (S.D. Ohio 2015), *appeal docketed*, No. 15-3095 (6th Cir. Feb. 6, 2015).

requires no particular expertise.[37] "'Ordinary care and prudence' requires more than mere delegation."[38] The court also cited *Valen Mfg. Co. v. United States*, where a corporation's reliance on a bookkeeper who actively concealed a failure to file, did not establish reasonable cause.[39] This court clearly felt constrained by precedent, noting that while Ohio had refunded the estate tax penalties after the malpractice suit, it was "truly unfortunate that the United States did not follow the State of Ohio's lead."[40]

A taxpayer may establish reasonable cause for a failure to file if he or she can prove reasonable reliance on a professional tax advisor's substantive legal advice.[41] To reasonably rely on the advice of a tax professional, the taxpayer must present evidence of the professional's expertise and show he or she provided the professional with all necessary and accurate information.[42]

In *Cavallaro v. Commissioner*, the IRS issued a notice of deficiency to Mr. and Mrs. Cavallaro, determining a liability for the addition to tax under IRC § 6651(a)(1) in the amount of $29.6 million for the failure to file gift tax returns.[43] The court held that the IRS showed the additions to tax were applicable but sustained the Cavallaros' defenses of "reasonable cause."

Mr. and Mrs. Cavallaro had little to no advanced education, including no formal accounting, legal, or business education. They hired *advisers* who were competent professionals with sufficient expertise to justify reliance. They engaged professionals from a well-known accounting firm and a well-known law firm to structure the tax-free merger of their S corporation, Knight Tool Co., with their sons' S corporation, Camelot Systems, Inc. The merger transaction was eventually structured according to the advice given by the Cavallaros' attorney. Under this advice, it was determined that rights to technology developed by Knight Tool Co. (*i.e.*, a computer-controlled liquid dispensing machine known as CAM/ALOT) were previously transferred to Camelot Systems, Inc. prior to the merger and therefore could not be gifted to Camelot Systems, Inc. at the time of the merger.

The court found that taxpayers had reasonably relied upon their advisors. They had no formal legal, accounting, or business education and had hired competent professionals. Those professionals had

37 *Specht v. U.S.*, 115 A.F.T.R.2d (RIA) 357 (S.D. Ohio 2015) (citing *U.S. v. Boyle*, 469 U.S. 241 (1985)).

38 *Id.* (quoting *In re Carlson*, 126 F.3d 915, 922 (7th Cir.1997)).

39 *Id.* (S.D. Ohio 2015) (citing *Valen Mfg. Co. v. U.S.*, 90 F.3d 1190 (6th Cir.1996)).

40 *Id*. 115 A.F.T.R.2d (RIA) 357 (S.D. Ohio 2015), *appeal docketed*, No. 15-3095 (6th Cir. Feb. 6, 2015).

41 *Estate of La Meres v. Comm'r*, 98 T.C. 294, 315-17 (1992) (citations omitted).

42 *Id.* In her Annual Reports to Congress, the National Taxpayer Advocate has emphasized the need for minimum competency standards for paid unenrolled return preparers. *See* National Taxpayer Advocate 2013 Annual Report to Congress 61-74 (Most Serious Problem: *Regulation of Return Preparers: Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS Is Enjoined From Continuing Its Efforts to Effectively Regulate Unenrolled Preparers*); National Taxpayer Advocate 2009 Annual Report to Congress 41-69 (Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy*); National Taxpayer Advocate 2008 Annual Report to Congress 504-12 (Most Litigated Issue: *Accuracy-Related Penalty Under Internal Revenue Code Sections 6662(b)(1) and (2)*). In June 2014, the IRS announced that it would be offering a new voluntary program designed to encourage education and filing season readiness for such preparers. This program allows unenrolled return preparers to obtain a record of completion when they voluntarily complete a required amount of continuing education, including a course in basic tax return filing issues and updates, ethics, and other federal tax law courses. Tax return preparers who elect to participate in the program and receive a record of completion from the IRS are included in a database on irs.gov to help taxpayers determine return preparer qualifications. *See* IRS Press Release, *New IRS Filing Season Program Unveiled for Tax Return Preparers*, IR-2014-75 (June 26, 2014); Rev. Proc. 2014-42, 2014-29 I.R.B. 192. The American Institute of Certified Public Accountants (AICPA) filed suit in the District Court for the District of Columbia, alleging that the IRS lacks the authority to implement the voluntary program. The government subsequently filed a motion to dismiss. On October 27, 2014, the District Court for the District of Columbia granted the IRS's motion to dismiss. On December 16, 2014, the AICPA filed an appeal with the Court of Appeals for the District of Columbia that has not yet been decided. *AICPA v. IRS*, 114 A.F.T.R.2d (RIA) 6451 (D.D.C. 2014), *appeal docketed*, No. 14-5309 (D.C. Cir. Dec. 16, 2014).

43 *Cavallaro v. Comm'r*, T.C. Memo. 2014-189, *appeal docketed*, No. 15-1368 (1st Cir. Mar. 24, 2015).

explicitly considered the relevant issue. Citing *Boyle*, the court noted that taxpayers are not required to challenge an attorney's tax advice to satisfy ordinary business care and prudence.[44] The court found the Cavallaros had provided accurate and necessary information to their advisors. They had relied sufficiently upon the advisors, and their tax positions were not attributable to themselves but to their advisors. The court concluded that the Cavallaros had reasonable cause for not filing a gift tax return and were not liable for the failure to file penalty.

"Zero Return" Filers and Other Frivolous Arguments

Under the longstanding four-part test articulated in *Beard v. Commissioner*,[45] a valid return must:

1. Contain sufficient data to calculate the tax liability;
2. Purport to be a return;
3. Represent an honest and reasonable attempt to satisfy the requirements of the tax laws; and
4. Be signed under penalties of perjury.

Each year, some taxpayers claim they have no obligation to pay taxes by filing returns reporting zero income when they have earned substantial wages that were accurately reported on a Form W-2. A "zero" return does not constitute a tax return under the *Beard* test because it is devoid of financial data and lacks sufficient information to calculate the tax liability.[46] Thus, when the taxpayers in *Waltner v. Commissioner* filed a return containing zeros for taxable income and total tax, the court upheld the failure to file penalty against the husband and wife.[47]

Failure to Pay an Amount Shown Penalty

A taxpayer can file a return by the due date and still be liable for a penalty under IRC § 6651(a)(2) if the amount shown on the return is not timely paid. In cases where individual taxpayers disputed that they were subject to the failure to pay penalty, many of their arguments for reasonable cause were similar to those used for the failure to file penalty under IRC § 6651(a)(1). The taxpayers often unsuccessfully argued medical illness or reliance on an agent or failed to make a separate and distinct argument relevant to the failure to pay.[48]

However, a taxpayer can prevail on the failure to pay penalty when the IRS cannot meet its burden of production under IRC § 7491(c). Specifically, the IRC § 6651(a)(2) penalty applies only when the taxpayer's filed return shows an amount due.[49] If the taxpayer did not file a return, the IRS can only assess the penalty if it has introduced a Substitute for Return (SFR) that satisfies the requirements of IRC § 6020(b). If the IRS cannot produce the SFR, it fails to meet its burden of production under IRC § 7491.[50]

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44 *Cavallaro v. Comm'r*, T.C. Memo. 2014-189 (citing *U.S. v. Boyle*, 469 U.S. 241 (1985)).

45 82 T.C. 766, 777 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986).

46 *See Cabirac v. Comm'r*, 120 T.C. 163 (2003). *See also U.S. v. Moore*, 627 F.2d 830, 835-36 (7th Cir.1980); *Turner v. Comm'r*, T.C. Memo. 2004-251.

47 *Waltner v. Comm'r*, T.C. Memo. 2014-133.

48 *See, e.g.*, *Central Motorplex, Inc. v. Comm'r*, T.C. Memo. 2014-207 (reliance on agent); *Akey v. Comm'r*, T.C. Memo. 2014-211 (medical illness); *U.S. v. Chelsea Brewing Co., LLC*, 114 A.F.T.R.2d (RIA) 5348 (S.D.N.Y. 2014) (financial hardship); *Villegas v. Comm'r,* T.C. Memo. 2015-33 (taxpayer offered "same excuses" for failure to pay as for failure to file); *Sodipo v. Comm'r*, T.C. Memo. 2015-3 (inability to file a tax return not reasonable cause for failure to pay), appeal docketed, No. 15-2089 (4th Cir. Sept. 16, 2015).

49 IRC §§ 6651(a)(2), (g)(2).

50 *See Wheeler v. Comm'r*, 127 T.C. 200, 210 (2006), *aff'd*, 521 F.3d 1289 (10th Cir. 2008).

For example, in *El v. Commissioner*, the taxpayer failed to file a return and pay taxes for 2009.[51] The IRS determined a deficiency and imposed penalties under IRC §§ 6651(a)(1) and (2) for failure to file and failure to pay.

To impose the failure to pay penalty in the case, the IRS was required to introduce an SFR, because the taxpayer did not file an original return for 2009.[52] The IRS conceded that it failed to meet its burden of production, as an SFR had not been introduced into evidence. On that basis, the court held the taxpayer not liable for the IRC § 6651(a)(2) failure to pay penalty.

Estimated Tax Penalty

Courts routinely found taxpayers liable for the IRC § 6654 estimated tax penalty when the IRS proved the taxpayer:

- Had a tax liability;
- Had no withholding credits;
- Made no estimated tax payments for that year; and
- Offered no evidence to refute the IRS.

The IRS has the burden of production under IRC § 7491(c) to produce evidence that a taxpayer was required to make an annual payment under IRC § 6654(d)(1)(B).

For example, in *Muncy v. Commissioner*, the taxpayer, who worked at a tire store, failed to file income tax returns and pay estimated taxes for tax years 2000 through 2005.[53] He insisted on halting his tax withholding and claimed the status of independent contractor though no aspect of his job was altered. A third-party entity would receive his wages and disburse them to the taxpayer's trusts or nominee accounts. The entity receiving his wages did not issue him Forms W-2, 1099, or any other forms for the income distributions, at his instruction. In 2010, he pleaded guilty to one criminal count of willfully attempting to evade income taxes for 2004. The taxpayer was placed on probation by the court and was required to file income tax returns as a condition of his probation.[54] In 2011, the IRS sent a notice of deficiency for tax years 2000 through 2005, which included estimated tax penalties under IRC § 6654.

In regard to the estimated tax penalty imposed, the court noted that the IRS burden of production requires evidence that there was a "required annual payment" under IRC § 6654(d)(1)(B). The required annual payment is the lesser of: (1) 90 percent of the reported tax for that year (or the tax due, if no return is filed), or (2) 100 percent of the tax shown on the return for the immediately preceding taxable year.[55] In situations where there was no return filed for the preceding year, the second clause is ignored.[56] Thus, the taxpayer's required payment in this case was 90 percent of the tax due, as determined by the IRS, for each of the tax years 2001 through 2005. For 2000, the IRS was obligated to introduce the tax return filed in 1999 so that the court could calculate the required annual payment from the lesser of the

51 *El v. Comm'r*, 144 T.C. No. 9 (2015).
52 *See* IRC §§ 6651(g), 6020(b); *Cabirac v. Comm'r*, 120 T.C. 163, 170 (2003).
53 *Muncy v. Comm'r*, T.C. Memo. 2014-251, *appeal docketed*, No. 15-1626 (8th Cir. Mar. 26, 2015).
54 *U.S. v. Muncy*, No. 4:10-cr-00018-BSM (E.D. Ark. filed Jan. 8, 2010).
55 IRC § 6654(d)(1)(B).
56 *Id*.

two amounts under IRC § 6654(d)(1)(B).[57] As that return was not provided, the court was unable to conclude that there was a required annual payment for 2000. It held the taxpayer liable for the failure to pay estimated tax penalty for the years 2001 through 2005, but not for 2000.

A similar issue arose in *United States v. Nichols*, where the taxpayers filed "zero returns."[58] A zero return is filed with the IRS but erroneously lists zero as the amount of tax due. It is not considered a valid return as there was no honest intent to provide the required information.[59] The IRS provided Forms 4340, *Certificate of Assessments, Payments, Other Specified Matters*, instead of SFRs to the court. The court held these as sufficient to impose the failure to file penalties but not for the failure to pay estimated tax penalties. Because the IRS calculates the required annual payment under IRC § 6654 using the tax due as reported by the taxpayer on his return, the estimated payment for the taxpayers' zero returns was zero.[60]

Penalty for Raising Frivolous Arguments

In four cases where the IRS had asserted either the failure to file penalty, failure to pay penalty, estimated tax penalty, or some combination thereof, the courts also imposed the IRC § 6673 penalty for making frivolous arguments.[61] In general, the courts are hesitant to impose this penalty without prior warning and in seven cases this period, the courts warned the taxpayers against making future frivolous arguments.[62]

In *Rader v. Commissioner*, the taxpayer did not report income from his plumbing business and did not file tax returns for five years.[63] The taxpayer argued that he was not legally required to file a return and that SFRs were not valid for purposes of a failure to pay penalty. He also claimed a Fifth Amendment privilege against self-incrimination. The court rejected these claims as meritless. A frivolous position is one contrary to established law and unsupported by a reasoned argument for change in the law.[64] At the conclusion of the trial, the court invoked the IRC § 6673(a)(1) penalty for frivolous arguments and held the taxpayer liable for a $10,000 penalty. Penalties for failure to file, failure to pay, and failure to pay estimated tax were also upheld.

CONCLUSION

The IRS did not prevail in full in 11 of 63 (or 17 percent) of the failure to file, failure to pay, and the estimated tax penalty cases analyzed in this report. Considering the limited resources most taxpayers have when litigating a case against the IRS, and the immense resources possessed by the IRS, a 17 percent success rate seems unexpectedly high. This is similar to the prior year, when the IRS did not prevail in 13 percent of cases.[65] In the cases the IRS lost, the most common problem was the IRS's failure to meet its burden of production.

57 *See Wheeler v. Comm'r*, 127 T.C. 200, 211–12 (2006) (requiring evidence of the prior year's return to determine the required annual payment).

58 *U.S. v. Nichols*, 115 A.F.T.R.2d (RIA) 1971 (E.D. Wash. 2015).

59 *See Cabirac v. Comm'r*, 120 T.C. 163 (2003).

60 *U.S. v. Nichols*, 115 A.F.T.R.2d (RIA) 1971 (E.D. Wash. 2015) (citing *Linmar Prop. Mgmt. Trust v. Comm'r*, T.C. Memo. 2008-219 (2008)).

61 *See* Most Litigated Issue: *Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions*, *infra*.

62 *See, e.g.*, *Kernan v. Comm'r*, T.C. Memo. 2014-228 (imposing no IRC § 6673 penalty on a taxpayer who believed he was not required to file a return unless personally invited to file), *appeal docketed*, No. 15-70574 (9th Cir. Feb. 25, 2015).

63 *Rader v. Comm'r*, 143 T.C. 376 (2014).

64 *Goff v. Comm'r*, 135 T.C. 231, 237 (2010).

65 National Taxpayer Advocate 2014 Annual Report to Congress 495.

It is critical that IRS employees look closely and thoroughly at the case facts when assessing reasonable cause claims rather than solely relying on the Reasonable Cause Assistant (RCA) software,[66] which is designed to help IRS employees make fair and consistent abatement determinations.[67] The RCA program allows IRS employees to override the results in certain circumstances, but employees must understand the definition of reasonable cause to apply the override.[68] Thus, a close review by an employee is essential to ensure the failure to file penalty or the failure to pay penalty is imposed appropriately. To promote voluntary compliance and to uphold a taxpayer's *right to a fair and just tax system* and the *right to pay no more than the correct amount of tax*, the facts of taxpayers' individual cases must be carefully considered.

66 The Reasonable Cause Assistant can only consider failure to file or failure to pay penalties for certain individual tax returns, and the failure to deposit penalty only for certain business returns.

67 National Taxpayer Advocate 2010 Annual Report to Congress 198 (Most Serious Problem: *The IRS's Over-Reliance on Its "Reasonable Cause Assistant" Leads to Inaccurate Penalty Abatement Determinations*). *See also* IRS, *Reasonable Cause Assistant (RCA) Usability Test Final Report Summary* 4 (May 28, 2010). The test showed that employees using the RCA determined penalty abatement requests correctly in only 45 percent of the cases. An even more disturbing finding was that all of the employees in the study believed they were making correct legal determinations based on reasonable cause.

68 IRM 20.1.1.3.6.10(3) (Nov. 25, 2011) ("[F]air and consistent application of penalties requires employees to make a final penalty relief determination consistent with the RCA conclusion … [U]nderstanding that the individual facts and circumstances vary for each case and that there may be unique facts and circumstances in certain cases that RCA cannot consider, an 'override (abort)' function is available in RCA.").

MLI #7 Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403

SUMMARY

Internal Revenue Code (IRC) § 7403 authorizes the United States to file a civil action in U.S. District Court against a taxpayer who has refused or neglected to pay any tax, to enforce a federal tax lien, or subject any of the delinquent taxpayer's property to the payment of tax. We identified 44 opinions issued between June 1, 2014, and May 31, 2015, that involved civil actions to enforce liens under IRC § 7403. The IRS prevailed in 40 of these cases. The total number of cases represents an approximate 15 percent decrease from the previous year.[1]

TAXPAYER RIGHTS IMPACTED[2]

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

PRESENT LAW

IRC § 7403 authorizes the United States to enforce a federal tax lien with respect to a taxpayer's delinquent tax liability or to subject any property, right, title, or interest in property of the delinquent taxpayer to the payment of a liability, by initiating a civil action against the taxpayer in the appropriate United States District Court.[3] All parties having liens on or otherwise claiming interest in the relevant property shall be made parties to the action.[4] The law of the state where the property is located determines the nature of a taxpayer's legal interest in the property.[5] However, if it is determined that the taxpayer has an interest in the property, federal law controls whether the property is exempt from attachment of the lien.[6]

The court may order an officer of the court to sell the property and apply the proceeds to the delinquent tax liability.[7] However, based on the Supreme Court case *United States v. Rodgers*, the court is not required to authorize a forced sale and may exercise limited equitable discretion.[8] When a forced sale involves the interests of a non-delinquent third party, the court should consider four factors from *Rodgers* when determining whether the property should be sold:

1. The extent to which the government's financial interests would be prejudiced if they were relegated to a forced sale of the partial interest of the delinquent taxpayer;

1 National Taxpayer Advocate 2014 Annual Report to Congress 503.
2 See Taxpayer Bill of Rights, *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.
3 IRC § 7403(a); Treas. Reg. § 301.7403-1(a).
4 IRC § 7403(b).
5 *U.S. v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985).
6 *U.S. v. Rodgers*, 461 U.S. 677 (1983).
7 IRC § 7403(c).
8 461 U.S. 677 (1983).

2. Whether the innocent third party with a separate interest in the property, in the normal course of events, has a legally recognized expectation that the property would not be subject to a forced sale by the delinquent taxpayer or taxpayer's creditors;
3. The likely prejudice to the third party in personal dislocation costs and inadequate compensation; and
4. The relative character and value of the non-liable and liable interests held in the property.[9]

At the sale of the property in which it holds a first lien, the United States may bid an amount equal to or less than the amount of the lien, plus selling expenses.[10] Additionally, the United States may intervene in foreclosure actions initiated by other creditors to assert any lien on the property that is the subject of such action.[11]

The United States may also remove the case to a U.S. District Court if the case was initiated in a state court.[12] However, junior federal tax liens may be effectively extinguished in a foreclosure and sale under state law, even if the United States is not a party to the proceeding.[13] The IRC specifically authorizes the court to appoint a receiver to enforce the lien and upon the government's certification that it is in the public interest, to appoint a receiver with all powers of a receiver in equity to preserve and operate the property prior to the sale.[14]

In 2015, the IRS issued an updated Internal Revenue Manual (IRM) incorporating the interim guidance detailing the procedures the IRS should use when referring cases to the Department of Justice (DOJ) when seeking to recommend a suit to foreclose on a taxpayer's principal residence.[15] When a tax lien attaches to the principal residence of a taxpayer or a residence owned by the taxpayer but occupied by the taxpayer's spouse, former spouse, or minor child, the IRS can use two methods to enforce the tax lien. The IRS can request that the DOJ:

- File suit to foreclose the federal tax lien against the principal residence under IRC § 7403; or
- Commence a proceeding to obtain a court order allowing administrative seizure of a principal residence under IRC § 6334(e)(1).[16]

9 461 U.S. 677 (1983) at 709-11.

10 IRC § 7403(c).

11 However, if the application of the United States to intervene is denied, the adjudication will have no effect upon the federal tax lien on the property. IRC § 7424. Under 28 U.S.C. § 2410, the United States may be named a party in any civil action or suit in any district court, or in any state court having jurisdiction of the subject matter. IRC § 7424.

12 28 U.S.C. § 1444.

13 *U.S. v. Brosnan*, 363 U.S. 237 (1960).

14 IRC §§ 7403(d) and 7402(a).

15 IRM 5.17.4.8.2.5, *Lien Foreclosure on a Principal Residence* (Mar. 30, 2015). This updated IRM is the result of action by TAS leadership. In 2012, TAS Systemic Advocacy developed and issued to the IRS an Advocacy Proposal recommending that the IRS consider the negative impact on the taxpayer of a suit to foreclose on a principal residence prior to forwarding the case to the DOJ. TAS, *Memorandum for Director, Collection Policy* (Aug. 20, 2012). The National Taxpayer Advocate followed this advocacy proposal with a legislative recommendation that Congress amend IRC § 7403 to require that the IRS, before recommending that the Attorney General file a suit to foreclose, first determine whether the taxpayer's other property or rights to property, if sold, are insufficient to pay the amount due, and that the foreclosure and sale of the residence will not create an economic hardship due to the financial condition of the taxpayer. National Taxpayer Advocate 2012 Annual Report to Congress 537-43 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*). Following this recommendation, Systemic Advocacy consulted extensively with the IRS to develop an Internal Guidance Memorandum. *See* IRS Interim Guidance Memorandum SBSE-0413-035 (Apr. 30, 2013). This guidance was later reissued in IRS Interim Guidance Memorandum SBSE-0414-0032 (Apr. 18, 2014).

16 IRC § 6334(e)(1) requires that the IRS obtain court approval prior to administratively seizing a principal residence.

Prior to the interim guidance, IRM provisions related to referring a case to the DOJ for administrative seizure of a principal residence under IRC § 6334(e)(1) required the IRS to consider who is living in the residence and to verify if economic hardship currently exists (or would be created by the seizure) in determining whether referral was appropriate, but not if the IRS was referring the matter to the DOJ for a foreclosure suit under IRC § 7403.[17] The updated IRM states that the IRS would refer a case to DOJ to pursue a suit to foreclose only when there are no reasonable administrative remedies and hardship issues. The IRM now requires the suit recommendation narrative to contain the results of the following actions:

- Attempt to personally contact the taxpayer and inform them that a suit to foreclose the tax lien on the principal residence is the next planned action;
- Attempt to identify the occupants of the principal residence;
- Discuss administrative remedies with the taxpayer such as an offer in compromise (including Effective Tax Administration offer or an offer with consideration of special circumstances);
- Advise the taxpayer about TAS, provide Form 911, *Request for Taxpayer Advocate Assistance (and Application for Taxpayer Assistance Order*), and explain its provisions;[18] and
- Include a summary statement in the case history, along with the information on the taxpayer and the occupants of the principal residence including children.[19]

ANALYSIS OF LITIGATED CASES

We reviewed 44 opinions issued between June 1, 2014, and May 31, 2015 that involved civil actions to enforce federal tax liens. Table 7 in Appendix 3 contains a detailed list of those cases. Forty-one percent of the taxpayers appeared *pro se*, and 59 percent were represented. Taxpayers with representation received full relief in three cases and partial relief in one case. *Pro se* taxpayers did not receive full or partial relief in any cases.

Foreclosure of Tax Liens Against Property With Non-Liable Spouse

In *Cardaci v. United States*,[20] a husband and wife purchased a residence as joint tenants by the entirety in 1978. The home was the only real property owned by the taxpayers (Mr. and Mrs. Cardaci) and had been their marital residence since the purchase. The United States filed suit to foreclose the tax lien on the taxpayers' residence to satisfy, in whole or in part, the taxes assessed against Mr. Cardaci for unpaid employment taxes his business owed. Mr. Cardaci's business had failed to remit withheld payroll taxes to the IRS for tax year 2000 and one-quarter of tax year 2001 while simultaneously paying its employees and suppliers.

The court held a bench trial to determine if it should exercise its discretion and declined to order the foreclosure sale of the residence. Since the wife was a non-liable third party, the court applied the *Rodgers* factors to determine whether foreclosure of the tax lien on the residence was appropriate.[21] The court

17 *Cf*. IRM 5.10.2.18(5) (Aug. 4, 2015), IRM 5.10.2.19(1) 5.10.2.19(1) (Aug. 4, 2014) and IRM 5.17.4.8.2.5, *Lien Foreclosure on a Principal Residence* (Mar. 30, 2015).

18 If the taxpayer indicates that the planned foreclosure of the principal residence would create a hardship, the Revenue Officer (RO) is instructed to assist the taxpayer with the preparation of Form 911 and should forward the form to the local TAS office if the RO cannot or will not provide the requested relief.

19 IRM 5.17.4.8.2.5, *Lien Foreclosure on a Principal Residence* (Mar. 30, 2015).

20 114 A.F.T.R.2d (RIA) 6744 (D.N.J. 2014), *appeal docketed*, No. 14-4237 (3d Cir. Oct. 27, 2014).

21 *Id*. For discussion of the *Rodgers* factors, see Present Law section, *supra*.

considered all factors and found that the factor concerning the value of liable and non-liable interests weighed substantially in favor of not forcing a sale of the property.

The government argued Mr. and Mrs. Cardaci's interests in the property were equal (50/50) because they both were roughly the same in age and owned a half interest. The court rejected that argument and instead found the valuation was more complicated as it had to take into account the value of Mrs. Cardaci's right to survivorship. The court reasoned that the Cardacis owned the property as tenants by the entirety, and as such, each spouse was a tenant in common with the other spouse during the joint lives of the couple. A forced sale would sever the tenancy much like a divorce decree or voluntary sale. However, in such situations, the division of the proceeds would occur after the spouses freely surrendered their survivorship interest. In this case the tenancy had not yet been severed, and Mrs. Cardaci had not surrendered the equivalent of a life estate nor her right to withhold consent of the sale. Thus, the valuation of her interest was deemed more complicated than in a divorce case because it had to account for the value of her survivorship interest. Accordingly, the court agreed that Mrs. Cardaci's right of survivorship had value and determined that the government would only be entitled to 14 percent of the sale price of the home, amounting to only a little over $14,000 for the government after expenses.[22] The court further determined that this result would be nominal compared to Mr. Cardaci's tax debt of over $80,000. It ordered the Cardacis to pay one-half of the fair market rental value of their home every month until the tax debt was satisfied. In the event that Mr. Cardaci survives Mrs. Cardaci, the court held that the government could then seek the forced sale of the residence to satisfy any remaining portion of the tax debt.[23]

In *United States v. Baker*,[24] the United States filed suit to foreclose tax liens on two parcels of land located in New Hampshire to satisfy in part the delinquent tax liabilities of the taxpayer, Scott Baker. The taxpayer married Robin Baker in 1998. In 2000, the taxpayer and his wife purchased the property the government sought to foreclose as joint tenants with the rights of survivorship. In 2008, the couple divorced. Pursuant to the divorce judgment, the taxpayer's wife was awarded the properties in question. The divorce judgment required the judgment and deed transferring the properties be recorded. However, neither the taxpayer nor the taxpayer's wife ever recorded the deeds or the judgment. In 2009, the IRS made assessments against the taxpayer and filed a Notice of Federal Tax Lien.

The government argued in the foreclosure proceeding that the tax lien for the taxpayer's liabilities attached to the properties that the wife, a non-liable third party, received pursuant to the divorce. The government claimed that its tax liens are "entitled to priority over the divorce judgment because neither the judgment nor any related deed was ever recorded."[25]

The court applied New Hampshire state law which provides that an undivided interest in real estate, apportioned by a divorce judgment, vests in the grantee spouse "by the mere force of the decree."[26] Thus, the court ruled against the government holding that the taxpayer had no rights to the properties to which the tax lien could attach. The court found that the taxpayer lost his right to own, transfer, or encumber the properties when the divorce judgment became final.

22 *U.S. v. Cardaci*, 114 A.F.T.R.2d (RIA) 6744 (D.N.J. 2014), *appeal docketed*, No. 14-4237 (3d Cir. Oct. 27, 2014).
23 *Id*.
24 *U.S. v. Baker*, 114 A.F.T.R.2d (RIA) 5772 (D.N.H. 2014).
25 *Id*.
26 The *Baker* court cited *Swett v. Swett*, 49 N.H. 264, 264 (1870) (quoting *Whittier v. Whittier*, 31 N.H. 452, 458-59 (1855)).

Foreclosure of Tax Liens Against Property Held by a Taxpayer's Nominee or Alter Ego

At least 13 opinions identified this year involved foreclosure of federal tax liens against property titled in the name of a taxpayer's nominee or alter ego. A nominee is one "who holds bare legal title to property for the benefit of another."[27] Courts typically look at a number of factors to determine whether an entity is a nominee of a taxpayer, such as whether:

- The nominee paid no or inadequate consideration;
- The property was placed in the name of the nominee in anticipation of the tax debt or litigation;
- There is a close relationship between the transferor and the nominee;
- The parties to the transfer never recorded the conveyance;
- The transferor retained possession (or control); and
- The transferor continues to enjoy the benefits of property.[28]

For example, in *United States v. Jones*,[29] the court held the trust set up by the taxpayer was the nominee of the taxpayer. The court based this conclusion on the fact that the taxpayer admitted he had "full use, enjoyment, and control over the subject property," which included residing there, renting out the property and receiving the rents, and paying all utilities and taxes associated with the property.[30] Since Jones' transfer to the trust was invalid because the trust served as the taxpayer's nominee, the court found the title to the property was in the name of the taxpayer, and therefore, the United States was entitled to foreclose its lien on the property.

In *United States v. O'Shea*,[31] the court determined that married taxpayers who had dealings with a trust promoter convicted of tax evasion crimes held their properties in sham trusts. The court considered the totality of circumstances, finding that the taxpayers exercised control over the parcels of land when the properties were held by the trusts.

The factors weighing in favor of a determination of control were the inadequate consideration received for the conveyance of the property and the taxpayers continuing to enjoy the benefits of ownership, including using the properties for their residence and their business and paying all the property expenses. As the property was held by nominees or alter egos of the taxpayers, the United States was entitled to foreclose on the four parcels of land. The court ordered the sham trusts be set aside and disregarded for tax purposes. In a subsequent appeal of this case, the U.S. Court of Appeals for the 4th Circuit affirmed the U.S. District Court for the Southern District of West Virginia in favor of the government.[32]

CONCLUSION

In the 2012 Annual Report to Congress, we anticipated an increase in court opinions involving lien enforcement in the coming years because the number of cases IRS referred to the DOJ spiked from 204

27 Black's Law Dictionary (10th ed. 2014), *available at* http://westlaw.com. *See also U.S. v. Sabby*, 113 A.F.T.R.2d (RIA) 1335 (D. Minn. 2014) (quoting *Scoville v. U.S.*, 250 F.3d 1198, 1202 (8th Cir. 2001)).

28 *See, e.g.*, *U.S. v. Jones*, 114 A.F.T.R.2d (RIA) 6126 (D. Wyo. 2014) (quoting *Holman v. U.S.*, 505 F.3d 1060, 1065 (10th Cir. 2007)); *U.S. v. Sabby*, 113 A.F.T.R.2d (RIA) 1335 (D. Minn. 2014) (quoting *Scoville v. U.S.*, 250 F.3d 1198, 1202 (8th Cir. 2001)).

29 114 A.F.T.R.2d (RIA) 6126 (D. Wyo. 2014).

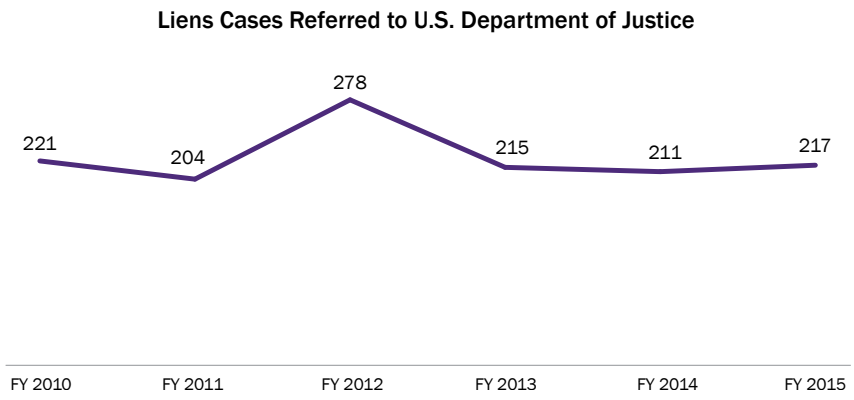
30 *Id*.

31 *U.S. v. O'Shea*, 115 A.F.T.R.2d (RIA) 887 (S.D.W. Va. 2015), *aff'd by* 116 A.F.T.R.2d (RIA) 5389 (4th Cir. 2015).

32 *U.S. v. O'Shea*, 116 A.F.T.R.2d (RIA) 5389 (4th Cir. 2015).

in fiscal year (FY) 2011 to 278 in FY 2012.[33] While there was a marked increase in lien enforcement opinions issued in reporting year 2014, from 33 in 2013 to 52 in 2014, the number of opinions issued this year fell to 44.[34] It is unclear whether the 2014 increase in the number of litigated cases was directly related to a greater number of cases referred to DOJ in FY 2012. The number of referrals decreased to 215 in FY 2013, and slightly fluctuated thereafter, with 211 cases referred in FY 2014 and 217 in FY 2015, as shown on Figure 3.7.1 below.[35]

FIGURE 3.7.1, The Number of Cases Referred to the DOJ by Fiscal Year.[36]



The National Taxpayer Advocate anticipates the updated IRM will have a positive effect on taxpayer rights in future years, as the IRS refers fewer suits to foreclose tax liens on taxpayers undergoing a hardship or in situations where there are reasonable alternatives. The National Taxpayer Advocate continues to recommend that Congress adopt the previous legislative recommendation to codify the approach used in the IRM.[37]

To address taxpayer burden and enhance the taxpayer *rights to privacy, to a fair and just tax system*, and *to appeal an IRS's decision in an independent forum*, the National Taxpayer Advocate has also recommended that Congress amend IRC §§ 6320 and 6330 to extend Collection Due Process rights to "affected third parties," known as nominees, alter egos, and transferees, who hold legal title to property subject to IRS collection actions.[38] Such cases represented about 30 percent (13 of 44) of lien cases seen in this reporting period.

33 National Taxpayer Advocate 2012 Annual Report to Congress 639.

34 There were 48 opinions issues in 2012. National Taxpayer Advocate 2012 Annual Report to Congress 634.

35 National Taxpayer Advocate 2014 Annual Report to Congress 508 (FY 2010 to FY 2013). DOJ Tax Division, *Suits to Foreclose Tax Lien – Summary by Fiscal Year of Case Receipt* (Oct. 2014), and DOJ Tax Division, *Suits to Foreclose Tax Lien – Summary by Fiscal Year of Case Receipt* (Oct. 2015).

36 *Id*.

37 The National Taxpayer Advocate recommended Congress amend IRC § 7403 to require that the IRS, before recommending that the Attorney General file a suit to foreclose, first determine that the taxpayer's other property or rights to property, if sold, are insufficient to pay the amount due, and that the foreclosure and sale of the residence will not create an economic hardship due to the financial condition of the taxpayer. National Taxpayer Advocate 2012 Annual Report to Congress 537-43 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*).

38 National Taxpayer Advocate 2012 Annual Report to Congress 544-52 (Legislative Recommendation: *Amend IRC §§ 6320 and 6330 to Provide Collection Due Process Rights to Third Parties (Known as Nominees, Alter Egos, and Transferees) Holding Legal Title to Property Subject to IRS Collection Actions*).

MLI #8 Charitable Deductions Under IRC § 170

SUMMARY

Subject to certain limitations, taxpayers can take deductions from their adjusted gross incomes for contributions of cash or other property to or for the use of charitable organizations.[1] To take a charitable deduction, taxpayers must contribute to a qualifying organization[2] and substantiate contributions of $250 or more. Litigation generally arises over one or more of these four issues:

- Whether the donation is made to a charitable organization;
- Whether contributed property qualifies as a charitable contribution;
- Whether the amount taken as a charitable deduction equals the fair market value of the property contributed; and
- Whether the taxpayer has substantiated the contribution.

We reviewed 28 cases decided between June 1, 2014 and May 31, 2015, with charitable deductions as a contested issue. The IRS prevailed in 18 cases, taxpayers in seven cases, and the remaining three cases resulted in split decisions. Taxpayers represented themselves (appearing *pro se*) in 14 of the 28 cases (50 percent), with taxpayers prevailing in four cases, the IRS in nine cases, and the remaining one resulted in a split decision.

TAXPAYER RIGHTS IMPACTED[3]

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

Taxpayers must itemize to claim any charitable contribution deduction and generally are able to take a deduction for charitable contributions made within the taxable year.[4] Transfers to charitable organizations are deductible only if they are contributions or gifts,[5] not payments for goods or services.[6] A contribution or gift will be allowed as a deduction under Interal Revenue Code (IRC) § 170 only if it is made "to" or "for the use of" a qualifying organization.[7]

1 Internal Revenue Code (IRC) § 170.

2 To claim a charitable contribution deduction, a taxpayer must establish that he or she made a gift to a qualified entity organized and operated exclusively for an exempt purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual. IRC § 170(c)(2).

3 *See* Taxpayer Bill of Rights, *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

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

5 The Supreme Court of the United States has defined "gift" as a transfer proceeding from a "detached and disinterested generosity." *Comm'r v. Duberstein*, 363 U.S. 278, 285 (1960).

6 *See also* Treas. Reg. § 1.170A-1(g) (no deduction for contribution of services).

7 IRC § 170(c).

For individuals, charitable contribution deductions are generally limited to 50 percent of the taxpayer's contribution base (adjusted gross income computed without regard to any net operating loss carryback to the taxable year under IRC § 172).[8] However, subject to certain limitations, individual taxpayers can carry forward unused charitable contributions in excess of the 50 percent contribution base for up to five years.[9] Corporate charitable deductions are generally limited to ten percent of the taxpayer's taxable income.[10] Taxpayers cannot deduct services that they offer to charitable organizations; however, incidental expenditures incurred while serving a charitable organization and not reimbursed may constitute a deductible contribution.[11]

Substantiation

For cash contributions, taxpayers must maintain receipts from the charitable organization, copies of cancelled checks, or other reliable records showing the name of the organization, the date, and the amount contributed.[12] Deductions for single charitable contributions of $250 or more are disallowed in the absence of a contemporaneous written acknowledgement from the charitable organization.[13]

The donor is generally required to obtain the contemporaneous written acknowledgment no later than the date he or she files the return for the year in which the contribution is made, and it must include:

- The name of the charitable organization;
- The amount of any cash contribution;
- A description (but not the value) of any non-cash contribution;
- A statement that no goods or services were provided by the organization in return for the contribution, if that was the case;
- A description and good faith estimate of the value of goods or services, if any, that an organization provided in return for the contribution; and
- A statement that goods or services, if any, that an organization provided in return for the contribution consisted entirely of intangible religious benefits, if that was the case.[14]

For each contribution of property other than money, taxpayers generally must maintain a receipt showing the name of the recipient, the date and location of the contribution, and a description of the property.[15] When taxpayers contribute property other than money, the amount of the allowable deduction is the fair market value of the property at the time of the contribution.[16] This general rule is subject to certain exceptions that in some cases limit the deduction to the taxpayer's cost basis in the property.[17]

8 IRC §§ 170(b)(1)(A) and (G).

9 IRC § 170(d)(1).

10 IRC § 170(b)(2).

11 Treas. Reg. § 1.170A-1(g). Meal expenditures in conjunction with offering services to qualifying organizations are not deductible unless the expenditures are away from the taxpayer's home. *Id*. Likewise, travel expenses associated with contributions are not deductible if there is a significant element of personal pleasure involved with the travel. IRC § 170(j).

12 Treas. Reg. § 1.170A-13(a)(1).

13 IRC § 170(f)(8). *See also* Treas. Reg. § 1.170A-13(f).

14 IRS Pub. 1771, *Charitable Contributions Substantiation and Disclosure Requirements* (Rev. July 2013).

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

16 Treas. Reg. § 1.170A-1(c)(1).

17 *Id*. Note that the deduction is reduced for certain contributions of ordinary income and capital gain property. *See* IRC § 170(e).

For claimed contributions exceeding $5,000, the taxpayer must obtain a qualified appraisal prepared by a qualified appraiser.[18]

ANALYSIS OF LITIGATED CASES

We reviewed 28 decisions entered between June 1, 2014 and May 31, 2015, involving charitable contribution deductions claimed by taxpayers. Table 8 in Appendix 3 contains a detailed list of those cases. Of the 28 cases, 16 involved the taxpayers' substantiation (or lack thereof) of the claimed contribution, nine cases involved a dispute over the valuation of property contributed, another ten involved the contribution of an easement, and one case involved a trust's payments to a scholarship.[19]

Qualified Conservation Contribution

For a gift to constitute a qualified contribution under IRC § 170, the donor-taxpayer must possess a transferrable interest in the property and intend to irrevocably relinquish all rights, title, and interest to the property without any expectation of some benefit in return.[20] Taxpayers generally are not permitted to deduct gifts of property consisting of less than the taxpayers' entire interest in that property.[21] Nevertheless, taxpayers may deduct the value of a contribution of a partial interest in property that constitutes a "qualified conservation contribution,"[22] also known as a conservation easement. A contribution will constitute a qualified conservation contribution only if it is of a "qualified real property interest" made to a "qualified organization" "exclusively for conservation purposes."[23]

In *Belk v. Commissioner*, the taxpayers, a married couple who filed a joint return, purchased a large tract of land outside of Charlotte, North Carolina for the development of a residential community.[24] They formed a limited liability company (LLC) to develop the land into a golf course and 402 residential lots and then contributed the property to the LLC.[25] Several years later, the taxpayers executed a conservation easement over 184 acres that contained the golf course and transferred the easement to Smoky Mountain National Land Trust, Inc.[26] Although the easement was "for outdoor recreation" and prohibited further development, the taxpayers had granted the easement in perpetuity, subject to certain "Reserved Rights," including the right for the taxpayers to "substitute an area of land owned by [it] which is contiguous to the Conservation Area for an equal or lesser area of land comprising a portion of the Conservation Area."[27] This "Reserved Right" essentially provided the taxpayers with the ability to "swap land in and

18 IRC § 170(f)(11)(C). "Qualified appraisal" and "qualified appraiser" are defined in IRC §§ 170(f)(11)(E)(i) and (ii), respectively.

19 Cases addressing more than one described issue are counted for each issue. For example, cases addressing the valuation of easements are counted once as a valuation issue case and again as a conservation easement issue case. As a result, the breakdown of case issues above will not add up to the total number of cases reviewed by TAS.

20 IRC § 170(f)(3).

21 *Id*.

22 IRC § 170(b)(1)(E).

23 IRC § 170(h)(1)(A)-(C). IRC § 170(h)(4)(B)(i) provides that, in the case of a contribution that consists of a restriction with respect to the exterior of a certified historic structure, the contribution must satisfy two requirements in order to be considered "exclusively for conservation purposes": 1) the interest must include a restriction which preserves the entire exterior of the building, and 2) the interest must prohibit any change to the exterior of the building that is inconsistent with the historic character of the exterior.

24 774 F.3d 221, 223 (4th Cir. 2014), *aff'g* 140 T.C. 1 (2013).

25 *Id*.

26 *Id*.

27 *Id*. The substitution right is conditional upon the Trust's agreement that the "substitution property is of the same or better ecological stability," the "substitution shall have no adverse effect on the conservation purposes," and that "the fair market value of the substituted property is at least equal to that of the property originally subject to the Easement." *Id*.

out of the Easement" and to shift the use restriction from one parcel of land to another.[28] The taxpayers claimed a deduction of over $10.5 million for the donation of the easement in 2004, along with carryover in 2005 and 2006, but the IRS disallowed the deduction on the basis that it was not a "qualified conservation contribution."[29] The Tax Court upheld the IRS's determination finding that the taxpayers "failed to donate an interest in real property that is subject to a use restriction granted in perpetuity."[30]

On appeal, the 4th Circuit affirmed the disallowance and ruled that the easement failed to meet the requirements of IRC § 170(h)(2) since it was not subject to a use restriction in perpetuity.[31] The court explained that because the "taxpayer may remove land from the defined parcel and substitute other land," the restriction on "the real property" is not in perpetuity.[32] The court found that a conservation easement is not a "qualified real property interest," as described in IRC § 170(h)(2)(C), if the terms of the easement agreement allow the grantor to change which property is subject to the easement.[33]

In *Mitchell v. Commissioner*, the taxpayers, a married couple, purchased land subject to a mortgage.[34] Several years later, the taxpayers contributed the land, subject to the mortgage, to a family limited liability partnership. The partnership then granted a conservation easement of almost 200 acres of unimproved land to the Montezuma Land Conservancy to be used as open space for wildlife and agricultural purposes in 2003.[35] The deed of conservation easement in gross purported to transfer the easement to the Montezuma Land Conservancy in perpetuity; however, at the time of the donation, the taxpayers had not obtained a mortgage subordination agreement from a third party.[36] The taxpayers claimed a deduction for the transfer on their 2003 income tax return, but it was not until 2005 that the third party agreed to subordinate his interest in the property to the easement.

In 2010, the IRS disallowed the deduction due to the fact that Montezuma Land Conservancy's interest in the property was subject to a third party's unsubordinated mortgage at the time of donation, thus, the conservation purpose was not protected in perpetuity.[37] Although the IRC does not specifically define "protected in perpetuity," under IRC § 170(h)(5)(A), the IRS has issued regulations on this subject and has excluded deductions where there is not a mortgage subordination.[38] The taxpayers argued that the regulations did not specify an explicit timeframe for subordinating the mortgage; however, the court rejected this and determined that the plain language of the regulation required the mortgage subordination to have occurred prior to the donation for it to be eligible for a deduction.[39] The 10th Circuit affirmed the Tax Court's determination that the conservation easement donation failed to comply with

28 *Belk,* 774 F.3d at 223-24).

29 *Id*. at 224.

30 *Belk v. Comm'r*, 140 T.C. 1, 10-11 (2013).

31 *Belk*, 774 F.3d at 226.

32 *Id.*

33 *Id.* at 227. The Tax Court made a similar determination and cited *Belk v. Comm'r* in *Balsam Mountain Invs., LLC v. Comm'r*, T.C. Memo. 2015-43 (holding that a conservation easement that allows for a future boundary adjustment is not a "qualified real property interest" and thus not eligible for a charitable contribution deduction), *appeal docketed*, No. 15-2010 (4th Cir. Sept. 3, 2015).

34 775 F.3d 1243 (10th Cir. 2015), *aff'g* 138 T.C. 324 (2012).

35 *Id*. at 1245-46.

36 *Id*. at 1246.

37 *Id*.

38 *Id. See* Treas. Reg. § 1.170A-14(g).

39 *Mitchell*, 775 F.3d at 1248, 1250-51.

the mortgage subordination requirements due to the fact that the third party's mortgage encumbering on the land was not subordinated until after the donation.[40]

As both cases illustrate, it is vital for a conservation easement to be protected in perpetuity for it to qualify as a "qualified conservation contribution" pursuant to the IRC and Treasury regulations.[41] To be considered protected in perpetuity, the conservation easement must be limited to a "single, immutable parcel" for the life of the easement,[42] and the property upon which the easement is granted must not be subject to an unsubordinated mortgage.[43]

Conservation Easement Valuation

To receive a deduction for most contributions of property in excess of $5,000, taxpayers must provide a qualified appraisal of the property that is donated.[44] In *Scheidelman v. Commissioner*, the taxpayer lived in a townhouse in a historic district.[45] She donated an architectural façade conservation easement to the National Architectural Trust and claimed a charitable deduction for the contribution.[46] The taxpayer retained a real estate appraiser to value the donation,[47] which was found to be $115,000. The IRS determined the taxpayer had failed to establish a fair market value for the easement, and the Tax Court agreed.[48]

In determining the fair market value of a conservation easement, the "before and after" valuation, which compares the values of the property with and without the easement, is generally accepted.[49] The valuation also takes into consideration "any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use."[50] Both the taxpayer and the IRS relied heavily on expert opinion testimony as to the pre- and post-contribution values of the property. However, the taxpayers' experts were found to be flawed and the Tax Court concluded that the evidence presented by the experts was not entitled to any weight.[51] Contrary to the taxpayer's experts, the IRS's expert determined that due to the historical nature of the neighborhood, there was no negative impact in valuation due to the restrictions of the easement, and, in fact, the "preservation of historic facades is a benefit, not a detriment, to the value of … property."[52] The 2nd Circuit affirmed the Tax Court's finding that the value of the property was unchanged after the taxpayer granted the easement, and therefore, the court further held that the façade easement had no fair market value when conveyed to the National Architectural Trust.[53]

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40 *Mitchell*, 775 F.3d at 1251, 1255.

41 IRC § 170(h)(1); Treas. Reg. § 1.170A-14(g).

42 *Belk*, 774 F.3d at 227.

43 *Mitchell*, 775 F.3d at 1255.

44 IRC § 170(f)(11)(C).

45 755 F.3d 148, 150 (2d Cir. 2014), *aff'g* T.C. Memo. 2013-18.

46 *Id*.

47 The Tax Court initially determined that the appraisal was not a "qualified appraisal" pursuant to Treas. Reg. § 1.170A-13(c)(2)(i)(A), and therefore, the taxpayer was not entitled to a deduction. *See Scheidelman v. Comm'r*, T.C. Memo. 2010-151, *vacated by*, 682 F.3d 189 (2d Cir. 2012), *remanded*, T.C. Memo. 2013-18, *aff'd*, 775 F.3d 148 (2d Cir. 2014).

48 *Scheidelman*, 755 F.3d at 150-51.

49 *Id.* at 152. *See also Hilborn v. Comm'r*, 85 T.C. 677, 688 (1985); Treas. Reg. § 1.170A-14(h)(3)(i).

50 Treas. Reg. § 1.170A-14(h)(3)(ii).

51 *Scheidelman*, 755 F.3d at 152.

52 *Id.* at 153.

53 *Id.* at 153-54.

When using the before and after test to determine the value of an easement placed on property that a taxpayer later claims as a charitable contribution, the property's "highest and best use" is used to determine the property's value before an easement. Many of these "highest and best use" cases, including the U.S. Court of Appeals for the 5th Circuit's decision in *Whitehouse Hotel Limited Partnership v. Commissioner*, involve very complex and specific fact patterns.[54] In *Whitehouse Hotel Limited Partnership*, the taxpayers appealed the Tax Court's conclusion that the "highest and best use" of a historical building was not a luxury hotel or even a non-luxury hotel, but, on the date of the easement, the correct valuation was a "shell building [] …suitable for conversion to [a] hotel."[55] The "highest and best use" of a property is the "reasonable and probable use that supports the highest present value," and the vital question is "what a hypothetical willing buyer would consider in deciding how much to pay for the property."[56] The 5th Circuit affirmed the Tax Court's determination that the "highest and best use" of the easement could be either a luxury hotel or a non-luxury hotel and that the valuation of the easement would not vary as a result of that determination.[57] The "highest and best use" element for valuation is very fact-specific and due to the lack of clear regulations and bright-line interpretations in the case law, subject to frequent and prolonged litigation.[58]

Substantiation

Sixteen cases involved the substantiation of deductions for charitable contributions. When determining whether a claimed charitable contribution deduction is adequately substantiated, courts tend to follow a strict interpretation of IRC § 170. Treasury Regulation § 1.170A–13(a)(1) requires the taxpayer to maintain a canceled check or a receipt from the donee organization to substantiate a cash contribution. In the absence of a canceled check or a receipt from the donee organization, the taxpayer must maintain other reliable written records showing the name of the donee and the date and the amount of the contribution.

In *Anyanwu v. Commissioner*, the taxpayer, who had recently divorced, claimed charitable deductions in the amount of $21,500 for 2006 and $26,600 for 2007, all of which had been disallowed by the IRS.[59] The taxpayer provided copies of canceled checks payable to her church and an "Individual Tithes and Offerings Summary" for 2006 and 2007, showing $24,730 and $26,600 respectively. The summaries stated that the church did not provide any goods or services in exchange for the contributions. Although the summaries did not list the date on which they were prepared, the court found that the summaries were contemporaneous.[60]

Although the taxpayer was divorced in 2005, the summaries of contributions were addressed to both herself and her former husband, Mr. Anyanwu, and the taxpayer admitted to altering the summaries to remove her former husband's name.[61] Despite having altered the summaries, the taxpayer provided canceled checks, which had only the taxpayer's name on them, not her ex-husband, matching the altered summaries.[62] However, the court disallowed five contributions that the taxpayer was not able to substantiate with canceled checks and only allowed $1,000 for one contribution, which was the amount listed on

54 *Whitehouse Hotel Ltd. P'ship v. Comm'r*, 755 F.3d 236 (5th Cir. 2014), *aff'g in part, vacating in part* 130 T.C. 304.
55 *Id.* at 241 (quoting *Whitehouse Hotel Ltd. P'ship v. Comm'r*, 139 T.C. 304, 337 (2012)).
56 *Id.* (quoting *Whitehouse Hotel Ltd. P'ship v. Comm'r*, 615 F.3d 321, 335 (5th Cir. 2010), *remanded to* 130 T.C. 304 (2012)).
57 *Id.* at 244
58 *See id.*; *Whitehouse Hotel Ltd. P'ship*, 615 F.3d at 340.
59 T.C. Memo. 2014-123.
60 *Id.*
61 *Id.*
62 *Id.*

the summary, even though the taxpayer showed a canceled check for $2,800. The Tax Court determined that the taxpayer had successfully substantiated the majority of her contributions and allowed a charitable contribution deduction of $19,700 for 2006 and $26,600 for 2007.[63]

Gifts of charitable contributions of $250 or more must be substantiated by a contemporaneous written acknowledgement from the donee organization that must include:

- The amount of cash and a description (but not value) of any property other than cash contributed;
- Whether the donee organization provided any goods or services in consideration, in whole or in part; and
- A description and good faith estimate of the value of any goods or services or, if such goods or services consist solely of intangible religious benefits, a statement to that effect.[64]

For non-cash gifts of charitable contributions exceeding $500, the taxpayer must also maintain written records that include:

- The approximate date the property was acquired and the manner of its acquisition (*i.e.*, purchase, gift, inheritance, etc.);
- A description of the property in detail reasonable under the circumstances;
- The cost or other basis of the property;
- The fair market value of the property at the time it was contributed; and
- The method used in determining its fair market value.[65]

In *Kunkel v. Commissioner*, the IRS disallowed a charitable contribution deduction of $37,315 for noncash charitable contributions by the taxpayers.[66] The taxpayers claimed to have donated a variety of property to four charitable organizations: the Upper Dublin Lutheran Church, Goodwill Industries, the Military and Order of the Purple Heart Service Foundation (Purple Heart), and Vietnam Veterans of America.[67] The taxpayers claimed a contribution totaling $13,115 in noncash items to their church's 2011 annual flea market; however, they did not produce a receipt or acknowledgement from the church of their donations,[68] nor did they provide any evidence that the church actually received delivery of them. The taxpayers also allegedly contributed $24,200 in noncash donations, including over $20,000 in clothing, to the three additional charitable organizations. Similar to the church donations, the taxpayers did not provide any documentary evidence and could not remember which items went to which organization and when they had donated them.[69] The only evidence the taxpayers provided, other than their own

63 *Anyanwu*, T.C. Memo. 2014-123.

64 IRC §§ 170(f)(8)(A) and (B). The IRS issued a Notice of Proposed Rulemaking on September 17, 2015, that would implement the exception to the "contemporaneous written acknowledgement" requirement for substantiating charitable contribution deductions of $250 or more and would provide rules concerning the time and manner for donee organizations to file information returns that report the requirement information about contributions. *See* Prop. Treas. Reg. § 1.170A-13(f)(18)-(19), 80 Fed. Reg. 55,802 (Sept. 17, 2015).

65 IRC § 170(f)(11)(B); Treas. Reg. §§ 1.170A-13(b)(2)(ii)(C) and (D), (3)(i)(A) and (B).

66 T.C. Memo. 2015-71.

67 *Id*.

68 The taxpayers provided a receipt for their 2012 donations to the flea market; thus, the church was equipped to provide this documentation.

69 *Kunkel*, T.C. Memo. 2015-71.

testimony, was doorknob hangers left by charities stating "thank you for your contribution," but not listing the date, property, or name of contributor.[70]

The taxpayers, who did not provide a "contemporaneous written acknowledgement" from any of the charities, alleged this acknowledgement was not necessary because all of their contributions were under $250.[71] The Tax Court did not find the taxpayer's assertion credible, due to the fact that the taxpayers would have had to make 97 distinct donations all with donations less than $250, despite the fact that the taxpayers testified to assigning the value of donations while completing their tax returns in 2012.[72] The Tax Court also noted that the taxpayers did not maintain written records establishing when or how they acquired items, their cost bases, their condition, and how the fair market value was calculated, nor did the taxpayers furnish a qualified appraisal, all of which is needed for contributions exceeding $500.[73] Although the Tax Court acknowledged that the taxpayers did donate some property during the tax year at issue, the lack of a written contemporaneous acknowledgment and failure to provide evidence as to value, date, location, and condition of goods donated did not satisfy the requirements of IRC § 170, and the entire deduction was disallowed.[74]

CONCLUSION

IRC § 170 and the accompanying Treasury Regulations provide detailed requirements with which taxpayers must strictly comply. The statutory and regulatory requirements to qualify for a deduction become more stringent as deductions increase in size. Most of the charitable contribution cases reviewed this year addressed issues regarding substantiation of contributions or the complex rules governing the donation of a conservation easement. It is vital that taxpayers include all information required by the IRC and regulations to substantiate any charitable contributions and their value. The courts have consistently upheld the regulations and disallowed deductions that do not comply with the statutory and regulatory requirements.

When donating a conservation easement, taxpayers should pay particular attention to the valuation of the easement, ensuring the valuation determination can be adequately supported. Additionally, the cases pertaining to a qualified conservation contribution illustrate the importance of paying close attention to the technicalities of the regulations. Easement deeds should be reviewed for ambiguity, especially as to whether use restrictions have been granted in perpetuity to the donee.

70 *Kunkel*, T.C. Memo. 2015-71. The taxpayers testified that they created index cards noting the items as they were delivered to Goodwill or left for pickup by Purple Heart of Vietnam Veterans. They aggregated this information into a master list and assigned estimated values to the items at the time they prepared their tax returns. However, the taxpayers did not provide any evidence of the index cards nor did they prepare any other contemporaneous records to support their alleged gifts. They also did not provide any evidence regarding their cost bases in items or how they determined the fair market value.

71 *Id.*

72 *Id.*

73 *Id.*

74 *Id.*

MLI #9 Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions

SUMMARY

From June 1, 2014, through May 31, 2015, the federal courts issued decisions in at least 22 cases involving the Internal Revenue Code (IRC) § 6673 "frivolous issues" penalty and at least four additional cases involving analogous penalties at the appellate level.[1] These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal.[2] In many of the cases we reviewed, taxpayers escaped liability for the penalty but were warned they could face sanctions for similar conduct in the future.[3] Nonetheless, we included these cases in our analysis to illustrate what conduct will and will not be tolerated by the courts.

TAXPAYER RIGHTS IMPACTED[4]

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

PRESENT LAW

The U.S. Tax Court is authorized to impose a penalty against a taxpayer if the taxpayer institutes or maintains a proceeding primarily for delay, takes a frivolous position in a proceeding, or unreasonably fails to pursue available administrative remedies.[5] The maximum penalty for taxpayers is $25,000.[6] In some cases, the IRS requests that the Tax Court impose the penalty;[7] in other cases, the Tax Court exercises its discretion, *sua sponte*,[8] to do so.

1 Analogous penalties at the appellate level include those under IRC § 7482 (c)(4), Fed. R. App. P. 38, or other authority.

2 The Tax Court generally imposes the penalty under IRC § 6673(a)(1). Other courts may impose the penalty under IRC § 6673(b)(1). U.S. Courts of Appeals 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.*, *Kaye v. Comm'r*, T.C. Memo. 2014-145.

4 *See* Taxpayer Bill of Rights, *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

5 IRC §§ 6673(a)(1)(A), (B), and (C). Likewise, the Tax Court may impose a penalty under IRC § 6673(a)(2) against any person admitted to practice before the Tax Court for unreasonably and vexatiously multiplying the proceedings in any case.

6 IRC § 6673(a)(1).

7 The standards for the IRS's decision to seek sanctions under IRC § 6673(a)(1) are found in the Chief Counsel Directives Manual. *See* CCDM 35.10.2 (Aug. 11, 2004). For sanctions under IRC § 6673(a)(2) of attorneys or other persons admitted to practice before the Tax Court, all requests for sanctions are reviewed by the designated agency sanctions officer (currently the Associate Chief Counsel (Procedure & Administration)). This review ensures uniformity on a national basis. *See, e.g.*, CCDM 35.10.2.2.3 (Aug. 11, 2004).

8 *"Sua sponte"* means without prompting or suggestion; on its own motion. Black's Law Dictionary (10th ed. 2014). Thus, for conduct that it finds particularly offensive, the Tax Court can choose to impose a penalty under IRC § 6673 even if the IRS has not requested the penalty. *See, e.g.*, *Patton v. Comm'r*, T.C. Memo. 2015-75, *appeal docketed*, No. 15-2007 (6th Cir. Aug. 25, 2015).

Taxpayers who institute actions under IRC § 7433[9] for certain unauthorized collection actions can be subject to a maximum penalty of $10,000 if the court determines that the taxpayer's position in the proceedings is frivolous or groundless.[10] In addition, IRC § 7482(c)(4),[11] §§ 1912 and 1927 of Title 28 of the U.S. Code,[12] and Rule 38 of the Federal Rules of Appellate Procedure[13] (among other laws and rules of procedure) authorize federal courts to impose penalties against taxpayers or their representatives for raising frivolous arguments or using litigation tactics primarily to delay the collection process. Because the sources of authority for imposing appellate-level sanctions are numerous and some of these sanctions may be imposed in non-tax cases, this report focuses primarily on the IRC § 6673 penalty.

ANALYSIS OF LITIGATED CASES

We analyzed 22 opinions issued between June 1, 2014, and May 31, 2015, in which courts addressed the IRC § 6673 penalty. Twenty-one of these opinions were issued by the Tax Court, and one was issued by a U.S. Court of Appeals in a case brought by a taxpayer who sought review of the Tax Court's imposition of the penalty. The Court of Appeals sustained the Tax Court's position. Four additional case decisions were issued by the Courts of Appeals on analogous appellate level penalties under IRC § 7482 (c)(4), FRAP Rule 38, or other authority. Table 9 in Appendix 3 includes all 26 of these opinions in total.

In ten cases, the Tax Court imposed penalties under IRC § 6673, with the amounts ranging from $500 to $25,000. In seven cases before the Tax Court, taxpayers prevailed when the IRS requested a penalty. In each of these cases, the Tax Court warned the taxpayers not to bring similar arguments in the future.[14] Two taxpayers were represented by an attorney; the taxpayers in the remaining 20 cases appeared *pro se* (represented themselves). In at least one case, the Tax Court noted that the *pro se* taxpayer may not be familiar with all the rules and procedures of the court and thus opted to not impose the penalty. But the Tax Court nonetheless made clear that "*Pro se* status, however, isn't a license to litter the dockets of the Federal courts with ridiculous allegations concerning the Code."[15]

The taxpayers presented a wide variety of arguments challenging the U.S. tax system that the courts have generally rejected on numerous occasions. Upon encountering these arguments, the courts in nine of 22 cases cited the language set forth in *Crain v. Commissioner*:

> We perceive no need to refute these arguments with somber reasoning and copious citation of precedent; to do so might suggest that these arguments have some colorable merit. The

9 IRC § 7433(a) allows a taxpayer a civil cause of action against the United States, if an IRS employee intentionally or recklessly, or by reason of negligence, disregards any IRC provision or Treasury regulation in connection with collecting the taxpayer's federal tax liability.

10 IRC § 6673(b)(1).

11 IRC § 7482(c)(4) provides that the United States Courts of Appeals and the Supreme Court have the authority to impose a penalty in any case where the Tax Court's decision is affirmed and the appeal was instituted or maintained primarily for delay or the taxpayer's position in the appeal was frivolous or groundless.

12 28 U.S.C. § 1912 provides that when the Supreme Court or a United States Court of Appeals affirms a judgment, the court has the discretion to award to the prevailing party just damages for the delay, and single or double costs. 28 U.S.C. § 1927 authorizes federal courts to sanction an attorney or any other person admitted to practice before any court of the United States or any territory thereof for unreasonably and vexatiously multiplying proceedings; such person may be required to personally pay the excess costs, expenses, and attorneys' fees reasonably incurred because of his or her conduct.

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

14 *See, e.g.*, *Bowers v. Comm'r*, T.C. Memo. 2014-130.

15 *Id.*

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.[16]

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

- **Taxes and procedures to collect taxes are unconstitutional:** We only identified one case this year where a taxpayer made an argument that taxes or how they are collected are unconstitutional.[17] Previous years have seen additional taxpayers advance similar arguments to no avail.[18] The taxpayer in the one case who made constitutional arguments this year advanced many facets of the various common constitutional arguments seen in other cases over the years, including the 16th Amendment only authorizes excise taxes, and levies violate both the Fourth and Fifth Amendments. The court found sanctions were appropriate in this case.
- **The IRS lacks proper authority:** Taxpayers in at least four cases argued that the IRS lacked the authority to take the proposed actions.[19] In two of these cases, taxpayers asserted that the employees who issued various notices did not have the proper delegation of authority to authorize the proposed action.[20] The IRS prevailed in two cases,[21] and although the taxpayers prevailed in the remaining two cases, the court warned the taxpayers not to pursue similar arguments in the future.[22]
- **Taxpayers are not United States persons or United States income is not taxable:** Taxpayers in three cases presented arguments that they are not United States persons subject to tax or that United States income is not taxable.[23] In one case, a taxpayer argued that he was a resident of the independent area of Harris County, TX, which is not in the United States.[24] The court imposed a penalty of $8,000 under Rule 38 of the Federal Rules of Appellate Procedure.

CONCLUSION

Taxpayers in the cases analyzed this year presented the same arguments raised and repeated year after year that the courts routinely and universally reject.[25] Taxpayers avoided the IRC § 6673 penalty in only seven cases where the IRS requested it, and in each of these cases, the courts warned the taxpayer not to bring similar arguments in the future, demonstrating the willingness of the courts to penalize taxpayers when they offer frivolous arguments or institute a case merely for delay. Moreover, even when the Tax Court

16 *Crain v. Comm'r*, 737 F.2d 1417, 1417-18 (5th Cir. 1984). *See, e.g.*, *Rader v. Comm'r*, 143 T.C. 376 (2014).

17 *Taliaferro v. Freeman*, 595 F. App'x 961 (11th Cir. 2014), *aff'g Taliaferro v. U.S.*, 113 A.F.T.R.2d (RIA) 1840 (M.D. Ga. 2014).

18 *See, e.g.*, National Taxpayer Advocate 2014 Annual Report to Congress 510-12.

19 *See, e.g.*, *Muncy v. Comm'r*, T.C. Memo. 2014-251, *appeal docketed*, No. 15-1626 (8th Cir. Mar. 26, 2015).

20 *May v. Comm'r*, T.C. Memo. 2014-194; *Muncy v. Comm'r*, T.C. Memo. 2014-251, *appeal docketed*, No. 15-1626 (8th Cir. Mar. 26, 2015).

21 *Banister v. Comm'r*, T.C. Memo. 2015-10, *appeal docketed*, No. 15-71103 (9th Cir. Apr. 9, 2015); *May v. Comm'r*, T.C. Memo. 2014-194.

22 *Bowers v. Comm'r*, T.C. Memo. 2014-130; *Muncy v. Comm'r*, T.C. Memo. 2014-251, *appeal docketed*, No. 15-1626 (8th Cir. Mar. 26, 2015).

23 *See, e.g.*, *U.S. v. Trowbridge*, 591 F. App'x 298 (5th Cir. 2015), *aff'g* Docket No. 4:14-CV-00027 (S.D. Tex. May 22, 2014), *cert. denied*, 135 S.Ct. 2816 (June 8, 2015); *Bennett v. Comm'r*, T.C. Memo. 2014-256, *appeal docketed*, No. 15-71228 (9th Cir. Apr. 21, 2015); *Banister v. Comm'r*, T.C. Memo. 2015-10, *appeal docketed*, No. 15-71103 (9th Cir. Apr. 9, 2015).

24 *U.S. v. Trowbridge*, 591 F. App'x 298 (5th Cir. 2015), *aff'g* Docket No. 4:14-CV-00027 (S.D. Tex. May 22, 2014), *cert. denied*, 135 S.Ct. 2816 (June 8, 2015).

25 *See, e.g.*, National Taxpayer Advocate 2014 Annual Report to Congress 510-12.

acknowledges that a penalty will likely not dissuade the taxpayer from raising frivolous arguments in the future, the Tax Court nonetheless recognizes that "serious sanctions also serve to warn other taxpayers to avoid pursuing similar tactics."[26] Further, when the IRS has not requested the penalty, the court may nonetheless raise the issue *sua sponte*, and in all cases identified, either imposed the penalty or cautioned the taxpayer that similar future behavior will result in a penalty.[27]

26 *Bennett v. Comm'r*, T.C. Memo. 2014-256, *appeal docketed*, No. 15-71228 (9th Cir. Apr. 21, 2015). *See also Banister v. Comm'r*, T.C. Memo. 2015-10, *appeal docketed*, No. 15-71103 (9th Cir. Apr. 9, 2015).

27 *See, e.g.*, *Kaye v. Comm'r*, T.C. Memo. 2014-145 (court raised the issue *sua sponte* and warned the taxpayer not to assert similar arguments in the future).

MLI #10 Relief From Joint and Several Liability Under IRC § 6015

SUMMARY

Married couples may elect to file their federal income tax returns jointly or separately. Spouses filing joint returns are jointly and severally liable for any deficiency or tax due.[1] Joint and several liability permits the IRS to collect the entire amount due from either taxpayer.[2]

Internal Revenue Code (IRC) § 6015 provides three avenues for relief from joint and several liability. IRC § 6015(b) provides "traditional" relief for deficiencies. IRC § 6015(c) also provides relief for deficiencies for certain spouses who are divorced, separated, widowed, or not living together by allocating the liability between the spouses. IRC § 6015(f) provides "equitable" relief from both deficiencies and underpayments but only applies if a taxpayer is not eligible for relief under IRC §§ 6015(b) or (c).

We identified 24 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2014, and May 31, 2015. Courts granted relief to the requesting spouse in seven cases (29 percent). The IRS prevailed in 15 cases (63 percent). The remaining two cases resulted in split decisions. Significant issues that arose this year include: (1) the Tax Court's jurisdiction over requests for equitable relief, and (2) intervening spouses opposing equitable relief after the IRS conceded that requesting spouses were entitled to relief at trial.

TAXPAYER RIGHTS IMPACTED[3]

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

PRESENT LAW

Traditional Innocent Spouse Relief Under IRC § 6015(b)

IRC § 6015(b) provides that a requesting spouse shall be partially or fully relieved from joint and several liability, pursuant to procedures established by the Secretary, if the requesting spouse can demonstrate that:

1. A joint return was filed;
2. There was an understatement of tax attributable to erroneous items of the nonrequesting spouse;[4]

1 IRC § 6013(d)(3). We use the terms "deficiency" and "understatement" interchangeably for purposes of this discussion and the case table in Appendix 3, even though IRC §§ 6015(b)(1)(D) and 6015(f) expressly use the term "deficiency" and IRC § 6015(b)(1)(B) refers to an "understatement of tax."

2 The National Taxpayer Advocate, in the 2005 Annual Report to Congress, proposed legislation that would eliminate joint and several liability for joint filers. *See* National Taxpayer Advocate 2005 Annual Report to Congress 407.

3 *See* Taxpayer Bill of Rights, *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

4 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).

3. The requesting spouse did not know or have reason to know of the understatement, upon signing the return;
4. It is inequitable to hold the requesting spouse liable, taking into account all the facts and circumstances; and
5. The requesting spouse elected relief within two years after the IRS began collection activities against him or her.[5]

A requesting spouse is eligible for a refund under this subsection, so long as the requesting spouse made the payment and the requirements of IRC § 6511 have been met.[6]

Allocation of Liability Under IRC § 6015(c)

IRC § 6015(c) provides that the requesting spouse shall be relieved from liability for deficiencies allocable to the nonrequesting spouse, pursuant to procedures established by the Secretary. To obtain relief under this section, the requesting spouse must demonstrate that:

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

This election allocates the portion of the deficiency attributable to each joint filer as calculated under the allocation provisions of IRC § 6015(d). A taxpayer is ineligible to make an election under IRC § 6015(c) if the IRS demonstrates that, at the time he or she signed the return, the requesting taxpayer had "actual knowledge" of any item giving rise to the deficiency.[7] Relief is not available for amounts attributable to fraud, fraudulent schemes, or certain transfers of disqualified assets.[8] Finally, no credit or refund is allowed as a result of relief granted under IRC § 6015(c).[9]

Equitable Relief Under IRC § 6015(f)

IRC § 6015(f) provides that the Secretary may relieve a taxpayer from liability for both deficiencies and underpayments[10] where the taxpayer demonstrates that:

1. Relief under IRC § 6015(b) or (c) is unavailable; and
2. It would be inequitable to hold the taxpayer liable for the underpayment or deficiency, taking into account all the facts and circumstances.

5 Not all actions that involve collection will trigger the two-year period of limitations. Under the regulations, only the following four events constitute "collection activity" that will start the two-year period: (1) an IRC § 6330 notice; (2) an offset of an overpayment of the requesting spouse against the joint income tax liability under IRC § 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 to collect the joint tax liability 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).

6 IRC § 6015(g)(1). *See infra* note 18 for an explanation of the general time period for filing refund claims under IRC § 6511.

7 IRC § 6015(c)(3)(C).

8 IRC §§ 6015(c)(4), (d)(3)(C).

9 IRC § 6015(g)(3).

10 An underpayment of tax occurs when the tax is properly shown on the return but is not paid. *Washington v. Comm'r*, 120 T.C. 137, 158-59 (2003).

Previously, the IRS incorporated the statutory two-year deadline found in IRC §§ 6015 (b)(1)(E) and (c)(3)(B) into the IRC § 6015 regulations and thereby imposed the two-year rule on requests for equitable relief under IRC § 6015(f).[11] In 2009, the Tax Court, in *Lantz v. Commissioner*, held the regulation imposing the two-year rule invalid.[12] The IRS appealed *Lantz* and similar decisions, and three courts of appeals ultimately held that the regulation was valid.[13] In the meantime, the Tax Court continued, where permitted, to hold the regulation invalid, and the issue was appealed to other courts of appeals.[14] The National Taxpayer Advocate consistently advocated for removal of the two-year rule that prevented taxpayers from obtaining equitable relief.[15] In July 2011, the IRS changed its position and now considers requests for equitable relief under IRC § 6015(f) without regard to when the first collection activity was taken.[16] The IRS proposed regulations to codify the change in the two-year rule on August 13, 2013.[17] Taxpayers may now file requests for equitable relief within the period of limitation on collection in IRC § 6502[18] or, for any credit or refund of tax, within the period of limitation in IRC § 6511.[19]

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11 Treas. Reg. §1.6015-5(b)(1).

12 132 T.C. 131 (2009).

13 *Mannella v. Comm'r*, 631 F.3d 115 (3d Cir. 2011) *rev'g and remanding* 132 T.C. 196 (2009); *Jones v. Comm'r*, 642 F.3d 459 (4th Cir. 2011), *rev'g and remanding* T.C. Docket No. 17359-08 (May 28, 2010); *Lantz v. Comm'r*, 607 F.3d 479 (7th Cir. 2010) *rev'g and remanding* 132 T. C. 131 (2009).

14 Adhering to the rule in *Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd* 445 F.2d 985 (10th Cir. 1971), that the Tax Court will defer to a Courts of Appeals decision which is squarely on point where appeal from the Tax Court decision lies to that Court of Appeal, the Tax Court continued to hold the regulation invalid in cases appealable to other circuits. *See, e.g.*, *Young v. Comm'r*, T.C. Docket No. 12718-09 (May 12, 2011); *Pullins v. Comm'r*, 136 T.C. 432 (2011); *Stephenson v. Comm'r*, T.C. Memo. 2011-16; *Hall v. Comm'r*, 135 T.C. 374, *appeal dismissed* (6th Cir. Aug. 2, 2011); *Buckner v. Comm'r*, T.C. Docket No. 12153-09, *appeal dismissed* (6th Cir. July 27, 2011); *Carlile v. Comm'r*, T.C. Docket No. 11567-09, *appeal dismissed* (9th Cir. Dec. 8, 2010); *Payne v. Comm'r*, T.C. Docket No. 10768-09, *appeal dismissed* (9th Cir. July 25, 2011); *Coulter v. Comm'r*, T.C. Docket No. 1003-09, *appeal dismissed* (2d Cir. Aug. 4, 2011).

15 National Taxpayer Advocate 2010 Annual Report to Congress 377 (Legislative Recommendation: *Allow Taxpayers to Request Equitable Relief Under Internal Revenue Code Section 6015(f) or 66(c) at Any Time Before Expiration of the Period of Limitations on Collection and to Raise Innocent Spouse Relief as a Defense in Collection Actions*); National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 1-12 (*Unlimit Innocent Spouse Equitable Relief*); National Taxpayer Advocate 2006 Annual Report to Congress 540 (Legislative Recommendation: *Eliminate the Two-Year Limitation Period for Taxpayers Seeking Equitable Relief under IRC § 6015 or 66*).

16 Notice 2011-70, 2011-2 C.B. 135 (July 25, 2011), *available at* http://www.irs.gov/pub/irs-drop/n-11-70.pdf. The notice provides transitional rules and applies to requests submitted on or after July 25, 2011. The notice also states that pending litigation will be managed consistently with the removal of the two-year rule. *See also* CC-Notice 2011-017 (July 25, 2011) (providing direction for Chief Counsel attorneys handling cases docketed with the Tax Court that involve the two-year deadline).

17 78 Fed. Reg. 49,242 (Aug. 13, 2013). Written or electronic comments were invited. Comments and requests for a public hearing were to be received by November 12, 2013. As of the date of this report, the IRS has not promulgated a final regulation.

18 The statutory period of limitations on collection is generally ten years after the date the tax is assessed. IRC § 6502(a). However, a variety of statutory provisions may extend or suspend the collection period. For example, if a court proceeding to collect the tax is brought, such as a suit to reduce a tax liability to judgment, the period of limitations on collection is extended. Therefore, the period of limitations on collection could exceed ten years, and a claim for innocent spouse relief would be valid at any point during that time.

19 Generally, taxpayers must request a refund within three years from the date their return was filed or two years from the time the tax was paid, whichever occurs later, or, if no return was filed, within two years from the time the tax was paid. IRC § 6511(a). If taxpayers meet the three-year requirement, they can recover payments made during the three-year period that precedes the date of the refund request, plus the period of any extension of time for filing the return. However, taxpayers who do not meet the three-year requirement can recover only payments made during the two-year period preceding the date of the refund request. IRC § 6511(b)(2). Senator Cardin and Representative Becerra introduced companion bills that include the National Taxpayer Advocate's recommendation to codify the removal of the two-year rule that prevented taxpayers from obtaining equitable relief. S. 2333, 114th Cong. (2015) and H.R. 4128, 114th Cong. (2015).

Revenue Procedure 2013-34 provides a nonexclusive list of factors that the IRS considers when determining whether equitable relief is appropriate.[20] Factors include:

- Marital status;
- Economic hardship;
- Knowledge or reason to know of the understatement or underpayment, including abuse by the nonrequesting spouse;
- Legal obligation to pay the outstanding tax liability;
- Significant benefit from the understatement or underpayment;
- Compliance with income tax laws; and
- Mental or physical health.[21]

Rights of the Nonrequesting Spouse

The individual with whom the requesting spouse filed the joint return is generally referred to as a "nonrequesting spouse" and is granted certain rights by IRC § 6015. The nonrequesting spouse must be notified and given an opportunity to participate in any administrative proceedings concerning a claim under IRC § 6015.[22] Further, if during the administrative process, full or partial relief is granted to the requesting spouse, the nonrequesting spouse can file a protest and receive an administrative conference in the IRS Appeals function.[23] The nonrequesting spouse does not have the right to petition the Tax Court in response to the IRS's administrative determination regarding IRC § 6015 relief.[24] If the requesting spouse files a Tax Court petition, the nonrequesting spouse must receive notice of the Tax Court proceeding, and the nonrequesting spouse has an unconditional right to intervene in the proceeding to dispute or support the requesting spouse's claim for relief.[25] However, an intervening spouse has no standing to appeal the Tax Court's decision to the United States Courts of Appeals.[26]

Judicial Review

Taxpayers seeking relief under IRC § 6015 generally file Form 8857, *Request for Innocent Spouse Relief*.[27] After reviewing the request, the IRS ultimately issues a final notice of determination granting or denying relief in whole or in part.[28] The taxpayer has 90 days from the date the IRS mails the notice to file a petition with the Tax Court.[29] The Tax Relief and Health Care Act of 2006 amended IRC § 6015(e)

20 Rev. Proc. 2013-34, 2013-43 I.R.B. 397. Revenue Procedure 2013-34 superseded Revenue Procedure 2003-61, 2003-2 C.B. 296.

21 *Id*. at 400-03.

22 IRC § 6015(h)(2).

23 Rev. Proc. 2003-19, 2003-5 C.B. 371.

24 *Maier v. Comm'r*, 119 T.C. 267 (2002), *aff'd*, 360 F.3d 361 (2d Cir. 2004) (holding that there are no provisions in IRC § 6015 that allow the nonrequesting spouse to petition the Tax Court from a notice of determination).

25 *Van Arsdalen v. Comm'r*, 123 T.C. 135 (2004).

26 *Baranowicz v. Comm'r*, 432 F.3d 972 (9th Cir. 2005).

27 *See* IRS Form 8857, *Request for Innocent Spouse Relief, Instructions* (Sept. 2010).

28 There are several types of preliminary determination letters that the IRS may send to the requesting or nonrequesting spouse before issuing a final determination.

29 IRC § 6015(e)(1)(A)(ii).

to expressly provide that the Tax Court has jurisdiction in "stand-alone" cases to review IRC § 6015(f) determinations, even where no deficiency has been asserted.[30]

ANALYSIS OF LITIGATED CASES

We identified 24 opinions issued between June 1, 2014, and May 31, 2015. The Tax Court issued the majority of the opinions (20 opinions, or 83 percent). The IRS prevailed in full in 15 cases (63 percent), while the requesting spouse prevailed in seven cases (29 percent). Two cases had split decisions (eight percent). Taxpayers had representation in 13 cases (54 percent) and appeared *pro se* (*i.e.*, they represented themselves) in the remaining 11 cases (46 percent). *Pro se* taxpayers prevailed in full in four cases (36 percent), while one *pro se* taxpayer obtained a split decision. The nonrequesting spouse intervened in ten cases (42 percent).

Procedural Issues

Of the 24 cases, five presented procedural issues. Courts were faced with issues such as whether a requesting spouse may voluntarily withdraw a petition to review the IRS's denial of relief from joint liability and whether district and bankruptcy courts have jurisdiction over petitions for equitable relief filed under IRC § 6015(f).

In *Davidson v. Commissioner*, the Tax Court examined its authority to dismiss a request for relief without entering a decision in a "stand-alone" case.[31] After the IRS denied her request for innocent spouse relief, Ms. Davidson petitioned the Tax Court for redetermination.[32] However, after the IRS submitted its answer, Ms. Davidson requested to voluntarily withdraw her petition, to which the IRS did not object.[33] The court first distinguished dismissals in deficiency cases, where IRC § 7459(d) controls, with other controversies. In deficiency cases, which comprise the majority of cases before the Tax Court, a taxpayer "may not withdraw a petition to avoid a decision."[34] Should the Tax Court dismiss a deficiency proceeding, the effect is a decision for the IRS, unless the dismissal is for lack of jurisdiction.[35] In *Davidson*, a non-deficiency case, the Tax Court looked to the Federal Rules of Civil Procedure (FRCP) for guidance, since IRC § 7459(d) did not apply.[36]

30 Pub. L. No. 109-432, Div. C, § 408(a), (c), 120 Stat. 2922, 3061-62 (2006). Prior to amendment, IRC § 6015(e) provided for Tax Court review of determinations under IRC §§ 6015(b) or (c), but it was not clear that the Tax Court had jurisdiction to review requests for relief made only under IRC § 6015(f) when no deficiency had been asserted. The 2006 amendment followed the National Taxpayer Advocate's recommendation that IRC § 6015(e) be amended to clarify that taxpayers have the right to petition the Tax Court for review of determinations made only under IRC § 6015(f). *See* National Taxpayer Advocate 2001 Annual Report to Congress 159-65 (Key Legislative Recommendation: *Joint and Several Liability Final Determination Rights*). The filing of a Tax Court petition in response to the final notice of determination or after the IRC § 6015 claim is pending for six months is often referred to as a "standalone" proceeding, because jurisdiction is predicated on IRC § 6015(e) and not deficiency jurisdiction under IRC § 6213.

31 *Davidson v. Comm'r*, 144 T.C. No. 13 (2015). A "stand-alone" case refers to a petition for redetermination that is independent of a deficiency proceeding.

32 *Id*.

33 *Id*.

34 *Id*.

35 *Id*. *See also* IRC § 7459(d). If a petition for redetermination of a deficiency has been filed by the taxpayer, a decision of the Tax Court dismissing the proceeding shall be considered as its decision that the deficiency is the amount determined by the Secretary.

36 *Id*.

Rule 41 of the FRCP allows for voluntary dismissal by the plaintiff under certain circumstances; otherwise the voluntary dismissal must be by court order.[37] A court must use its discretion to "weigh the relevant equities and do justice between the parties."[38] The Tax Court distinguished the present case from *Vetrano v. Commissioner*, a decision in which the Tax Court did not have authority to grant a request to withdraw a request for innocent spouse relief.[39] In *Vetrano*, the taxpayer requested innocent spouse relief as an affirmative defense in a petition to redetermine a deficiency, which is one of three ways a taxpayer may invoke innocent spouse relief.[40] The Tax Court held that the taxpayer was liable for the deficiency but reserved judgment on the relief issue. The taxpayer sought to withdraw her request for relief without prejudice; however, the Tax Court could not grant the request to dismiss because "the court's final decision is conclusive with respect to an individual's later claim for § 6015 relief."[41]

In contrast, the requesting spouse in *Davidson* raised the issue of relief in a separate petition and not as a defense to a deficiency proceeding.[42] The Tax Court held that the *res judicata* provisions in IRC § 6015 are only applicable when there is a prior proceeding.[43] Since there is no prior proceeding when relief is requested in a "stand-alone" case, the Tax Court found that it has authority to dismiss a "stand-alone" case if there are no objections by the other party.[44]

In *United States v. Hirsch*, the District Court for the Eastern District of New York considered whether the taxpayer, Ms. Hirsch, was barred from raising innocent spouse relief as a defense in a suit to reduce assessment to judgment.[45] Prior to the suit being commenced, in September 2000, Ms. Hirsch had filed a request for innocent spouse relief with the IRS. The IRS contended it sent a notice of determination denying the request for innocent spouse relief to Ms. Hirsch in July 2003.[46] Ms. Hirsch did not petition the Tax Court for review of the IRS's determination. On March 5, 2010, the United States initiated a civil action to obtain a judgment against Ms. Hirsch, who appeared *pro se*, for her unpaid joint income tax liabilities for 1992 through 1997.[47] Subsequently, on October 20, 2013, the government filed a motion for summary judgment arguing judgment should be entered in its favor. Ms. Hirsch objected to the motion arguing that she should be relieved of the liabilities because she was an innocent spouse. Ms. Hirsch contended that she never received a determination with respect to her request for innocent spouse relief,

37 Fed. R. Civ. P. 41(a). A plaintiff may voluntarily dismiss an action without a court order by filing (i) a notice of dismissal before the opposing party serves either an answer or a motion for summary judgment; or (ii) a stipulation of dismissal signed by all parties who have appeared.

38 *Davidson v. Comm'r*, 144 T.C. No. 13 (2015) (quoting *McCants v. Ford Motor Co.*, 781 F.2d 855, 857 (11th Cir. 1986)).

39 *Vetrano v. Comm'r*, 116 T.C. 272 (2001).

40 *Davidson v. Comm'r*, 144 T.C. No. 13 (2015). The Tax Court has jurisdiction to review a taxpayer's request for innocent spouse relief in only three circumstances: (1) where a stand-alone petition is filed pursuant to IRC § 6015(e)(1)(A); (2) where a petition for review of a lien or levy action is filed pursuant to collection due process provisions of IRC §§ 6230 or 6330; and (3) as an affirmative defense where a petition for redetermination of a deficiency is filed pursuant to IRC § 6213(a). *See Maier v. Comm'r*, 119 T.C. 267, 270-71 (2002), *aff'd*, 360 F.3d 361 (2d Cir. 2004); *Butler v. Comm'r*, 114 T.C. 276, 287-89 (2000); IRC §§ 6015(e)(1)(A), 6320(c), and 6330(c)(2)(A)(i). A "stand-alone" petition must be filed no later than the close of the 90th day after the Commissioner has issued a final determination. IRC § 6015(e)(1)(A)(i).

41 *Davidson v. Comm'r*, 144 T.C. No. 13 (2015). *See also* IRC § 6015(g)(2) (*res judicata*).

42 *Davidson v. Comm'r*, 144 T.C. No. 13 (2015).

43 *Id*.

44 *Id*.

45 114 A.F.T.R.2d (RIA) 5896 (2014). The factual background of this case is convoluted as it involves a divorce proceeding and a subsequent bankruptcy of Ms. Hirsch's husband.

46 *U.S. v. Hirsch*, 114 A.F.T.R.2d (RIA) 5896 (E.D.N.Y. 2014). The taxpayer claims that she never received the notice of determination, but she did file an administrative appeal to the IRS appeals office prior to the final denial in July 2003.

47 *Id*.

and the parties disputed whether the notice of determination was in fact sent to Ms. Hirsch's last known address as required by law.[48]

The court denied the motion for summary judgment concluding that the government did not establish that the Tax Court had jurisdiction over Ms. Hirsch's non-deficiency, stand-alone innocent spouse claim under IRC § 6015(f). Currently, IRC § 6015(e)(1) gives the Tax Court jurisdiction to hear IRC § 6015(f) claims;[49] however, that provision took effect on December 20, 2006 and only applies to tax liabilities that arise or are unpaid on or after that date.[50] Prior to the 2006 amendment, courts were unsure whether the Tax Court had jurisdiction to review "nondeficiency stand-alone petitions."[51] In 2002, the Tax Court held it had jurisdiction in these cases.[52] In 2004, however, the 2nd Circuit expressed doubt regarding whether the Tax Court had jurisdiction. In subsequent decisions, the 9th Circuit, 8th Circuit, and Tax Court held that the Tax Court lacked jurisdiction to hear IRC § 6015(f) appeals absent express statutory language.[53] Because Ms. Hirsch's tax liabilities arose before December 20, 2006, the court stated: "it appears that the Tax Court lacked jurisdiction to review [her innocent spouse] application."[54] The court also denied the motion because a question of material fact existed as to whether IRS actually mailed the notice of determination denying Ms. Hirsch's innocent spouse application to her last known address. This opinion is important because the decision leaves open the possibility that this district court might allow the taxpayer to raise IRC § 6015(f) as an affirmative defense in a suit to reduce an assessment to judgment, and that the Tax Court may not have exclusive jurisdiction.[55] It has been a longstanding position of the National Taxpayer Advocate that taxpayers should be able to raise innocent spouse claims as an affirmative defense in an action to reduce joint federal tax assessments to judgment or in a lien foreclosure suit.[56]

In *Nunez v. Commissioner*, the 9th Circuit addressed whether the Tax Court maintains its jurisdiction when the IRS, in a change of its position, no longer opposes a request for innocent spouse relief. Ms. Nunez petitioned the Tax Court after the IRS denied her request for relief; however, before trial, the IRS changed its position and would not oppose a ruling in favor of the taxpayer.[57] Nevertheless, the Tax Court denied her motion, and the taxpayer appealed the Tax Court's denial of her motion to vacate its

48 The notice of determination must be sent to the taxpayer's last known address. IRC § 6015(e)(1)(A)(i)(I). Generally, a taxpayer's last known address is the address on the taxpayer's most recent return unless the IRS has been given clear and concise notification of a different address. Treas. Reg. § 301.6212-2(a).

49 The parties agreed that since there was no understatement, Ms. Hirsch's claim had to be under IRC § 6015(f).

50 *U.S. v. Hirsch*, 114 A.F.T.R.2d (RIA) 5896 (E.D.N.Y. 2014).

51 *Id*.

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

53 *See Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006); *Bartman v. Comm'r*, 446 F.3d 484 (8th Cir. 2006). Upon reconsideration, the Tax Court overruled its holding in the *Ewing* case. *See Billings v. Comm'r*, 127 T.C. 7 (2006). The previous version of IRC § 6015(e) expressly granted the Tax Court jurisdiction only in IRC § 6015(b) and (c) cases. Congress amended IRC § 6015(e) in 2006 to expressly grant authorization in IRC § 6015(f) cases.

54 *U.S. v. Hirsch*, 114 A.F.T.R.2d (RIA) 5896 (E.D.N.Y. 2014). Although the court was correct in its analysis, prior to 2006, the Tax Court routinely reviewed stand-alone IRC § 6015(f) claims and made determinations on them.

55 The statute permits a taxpayer to petition the Tax Court "in addition to any other remedy provided by law." Thus, U.S. district courts and the Tax Court may have concurrent jurisdiction. IRC § 6015(e)(1)(A). However, the United States has argued that a taxpayer cannot raise innocent spouse as an affirmative defense in a district court or bankruptcy court action on jurisdictional grounds and prevailed in a number of cases. *See, e.g.*, *U.S. v. Elman*, 110 A.F.T.R.2d (RIA) 6993 (2012); *U.S. v. Boynton*, 99 A.F.T.R.2d (RIA) 920 (2007); *U.S. v. Feda*, 97 A.F.T.R.2d 1985 (2006); *In re Mikels*, 524 B.R. 805, 807 (Bankr. S.D. Ind. 2015).

56 *See, e.g.*, National Taxpayer Advocate 2013 Annual Report to Congress 415-16. *See also* National Taxpayer Advocate 2012 Annual Report to Congress 648; National Taxpayer Advocate 2010 Annual Report to Congress 504; National Taxpayer Advocate 2009 Annual Report to Congress 487; National Taxpayer Advocate 2008 Annual Report to Congress 524; National Taxpayer Advocate 2007 Annual Report to Congress 631.

57 *Nunez v. Comm'r*, 599 F. App'x 629 (9th Cir. 2015), *aff'g* T.C. Docket No. 15168-10 (Feb. 15, 2013).

decision.[58] The taxpayer argued that because the IRS did not oppose granting her relief, the Tax Court lost jurisdiction.[59] The 9th Circuit affirmed the Tax Court, holding that "nothing in § 6015 provides that the Tax Court loses jurisdiction once the Commissioner changes his position and supports, or stops opposing, a grant of relief in the requesting or electing spouse's favor."[60] The Tax Court loses jurisdiction only in the case where either spouse files a refund suit in a district court, which did not happen in this instance.[61] As a result, Ms. Nunez was not entitled to relief from joint and several liability for the tax years in dispute.[62]

In *In re Mikels*, the Bankruptcy Court for the Southern District of Indiana concluded that it lacks jurisdiction to make a determination of innocent spouse relief under IRC § 6015(f). In response to deficiencies assessed for the 2008 and 2009 tax years, Mr. Mikels filed for innocent spouse relief for several tax years.[63] The IRS granted relief for 2008 and 2009 but denied relief for the other tax years.[64] The IRS later abated tax liabilities for 2008 and 2009; however, Mr. Mikels filed an objection to the IRS's determinations for tax years 2003-05, 2007, and 2010, claiming that he was entitled to relief under either IRC § 6015(c) or (f), since the liability was related to his ex-wife's daycare business.[65] The court concluded that IRC § 6015(c) did not apply, since the only deficiencies that were assessed were subsequently abated, rendering the issue of innocent spouse relief under IRC § 6015(c) moot. For Mr. Mikels' IRC § 6015(f) relief for the remaining tax years, the court acknowledged that section "[6015(e)(1)] does not address whether the Tax Court's jurisdiction is exclusive;" however, the court followed district court precedent concluding that the Tax Court has exclusive jurisdiction regarding stand-alone petitions for innocent spouse relief.[66]

In the 2013 Annual Report to Congress, the National Taxpayer Advocate stated that nothing in the language of IRC § 6015 gives the Tax Court exclusive jurisdiction to determine innocent spouse claims.[67] Instead, the language of IRC § 6015(e) permits a taxpayer to petition the Tax Court for relief "in addition to any other remedy provided by law."[68] The view taken by the bankruptcy court and district courts may leave taxpayers without a forum in which to raise innocent spouse relief as a defense to a collection suit. The National Taxpayer Advocate has made legislative recommendations to clarify this issue.[69]

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58 *Nunez v. Comm'r*, 599 F. App'x 629 (9th Cir. 2015), *aff'g* T.C. Docket No. 15168-10 (Feb. 15, 2013).

59 *Id.*

60 *Id.*

61 *Id.*

62 *Id.*

63 *In re Mikels*, 524 B.R. 805 (Bankr. S.D. Ind. 2015). Mr. Mikels sought innocent spouse relief for the 2003-2005, 2007-2009, and 2010 tax years. Mr. Mikel filed late joint returns for the years 2003-2005, 2007, and 2010 and did not file returns for the years 2008 and 2009.

64 *Id.*

65 *Id.*

66 *Id.* (citing *U.S. v. Boynton*, 99 A.F.T.R.2d (RIA) 920 (S.D. Cal. 2007)).

67 National Taxpayer Advocate 2013 Annual Report to Congress 408-19.

68 IRC § 6015(e).

69 The National Taxpayer Advocate has recommended that Congress address this issue in three Annual Reports to Congress. National Taxpayer Advocate 2010 Annual Report to Congress 377 (Legislative Recommendation: *Allow Taxpayers to Request Equitable Relief Under Internal Revenue Code Section 6015(f) or 66(c) at Any Time Before Expiration of the Period of Limitations on Collection and to Raise Innocent Spouse Relief as a Defense in Collection Actions*); National Taxpayer Advocate 2009 Annual Report to Congress 378 (Legislative Recommendation: *Allow Taxpayers to Raise Relief Under Internal Revenue Code Sections 6015 and 66 as a Defense in Collection Actions*); National Taxpayer Advocate 2007 Annual Report to Congress 549 (Legislative Recommendation: *Allow Taxpayers to Raise Relief Under Internal Revenue Code Sections 6015 and 66 as a Defense in Collection Actions*).

Relief on the Merits

Nineteen cases were decided on the merits. Taxpayers received full relief in five cases and partial relief in two cases. Two issues were frequently discussed in these decisions: (1) whether the requesting spouse knew or had reason to know of the underpayment, and (2) the nonrequesting spouse's right to intervene to support or oppose relief. First, the requesting spouse's knowledge that there was a deficiency or that the nonrequesting spouse would not pay the tax was a factor in 15 of the 19 decisions, including all seven of the decisions where taxpayers received full or partial relief.[70] Second, the nonrequesting spouse intervened to oppose relief in ten of the 19 cases. Of these ten cases, the IRS either originally granted relief or changed its position and determined relief was appropriate before trial in five instances.

The Tax Court reviewed both of these themes in *Molinet v. Commissioner* and *Varela v. Commissioner*. In *Molinet*, Ms. Molinet, a Cuban born taxpayer who did not have a good understanding of the United States banking system yet shared a joint bank account with her spouse who handled all of their finances, requested innocent spouse relief after her former spouse failed to pay taxes on a 401(k) distribution.[71] The IRS initially denied the request for relief but conceded the issue at trial; however, the former spouse intervened and opposed the request for relief.[72] The Tax Court reviewed Ms. Molinet's request for relief under the equitable relief provision in IRC § 6015(f) and examined her knowledge or reason to know of the underpayment as a factor in its analysis.

The Tax Court listed four factors it considered in determining whether the requesting spouse had reason to know of the underpayment:

1. The requesting spouse's level of education;
2. The requesting spouse's degree of involvement in the activity leading to the tax liability;
3. The requesting spouse's involvement in business and household financial matters; and
4. The requesting spouse's business or financial expertise.[73]

The Court found that Ms. Molinet did not have reason to know of the underpayment for three reasons. First, she had "minimal input" in financial decisions because of her difficulty understanding the United States banking system.[74] Second, she did not agree with her former spouse's decision to take taxable distributions from his 401(k) account but "reluctantly signed" the required forms because she "did not feel she had a choice in the matter."[75] Third, she "reasonably believed that she and [her former spouse] did not have any financial problems and that [her former spouse] could pay the tax due."[76] After weighing these factors in Ms. Molinet's favor, the Tax Court found that she was entitled to relief.[77]

70 All three methods of relief under IRC § 6015 contain a knowledge element. Knowledge may be actual or constructive, and the absence of knowledge weighs in favor of relief. *See* IRC §§ 6015(b)(1)(C), 6015(c)(3)(C); Rev. Proc. 2003-61, 2003-2 C.B. 296, §§ 4.02(1)(b) and 4.03(2)(a)(iii); *see also* Notice 2012-8, §§ 4.02(3) and 4.03(2)(c), 2012-4 C.B. 309.

71 *Molinet v. Comm'r*, T.C. Memo 2014-109. The IRS debt was assigned to Ms. Molinet's former spouse in their divorce settlement, and Ms. Molinet was convinced her former spouse could pay the debt.

72 *Id*.

73 *Id*. (citing Rev. Proc. 2013-34, § 4.03(2)(c)(iii), 2013-43 I.R.B. at 402).

74 *Id*.

75 *Id*.

76 *Id*.

77 *Id*.

In *Varela*, Ms. Varela petitioned for innocent spouse relief under all three provisions, and the government agreed at trial that she was entitled to full relief under IRC § 6015(b).[78] In 2003, Ms. Valera began an action to divorce her husband but discontinued the action before it was completed. Following that action, however, Ms. Varela and her former spouse separated their financial assets and responsibilities. Ms. Varela and her former spouse separated in 2009 and eventually divorced in 2012. The IRS agreed that Ms. Varela was entitled to relief, but her former spouse objected. The Tax Court found that Ms. Varela did not have knowledge or reason to know of the understatements because she did not have access to her former spouse's or the corporation's bank accounts since they separated their finances.

CONCLUSION

While the overall number of cases decreased from 2013, the last time innocent spouse relief appeared as a Most Litigated Issue, jurisdiction over innocent spouse relief continues to be an issue. Based on their interpretation of IRC § 6015(e), courts have determined that the Tax Court has exclusive jurisdiction over stand-alone claims for innocent spouse relief, when in fact the statute permits a taxpayer to petition the Tax Court "in addition to any other remedy provided by law."[79] Greater clarity in the statutory language would likely prevent future litigation over jurisdiction and provide taxpayers additional forums in which to pursue their claims. For this reason, the National Taxpayer Advocate has made three legislative recommendations to address this issue and reiterates her position that taxpayers should be able to raise innocent spouse relief as a defense in collection actions.[80]

Courts' interpretation of IRC § 6015(e) prevents innocent spouses from claiming relief in deficiency cases in any forum other than Tax Court, thus limiting their opportunity to challenge and obtain relief from tax liabilities. These restrictions impact the taxpayer's *right to challenge the IRS's position and be heard*, *to pay no more than the correct amount of tax*, *to appeal an IRS decision in an independent forum*, and *to a fair and just tax system*.

78 *Varela v. Comm'r*, T.C. Memo 2014-222.

79 See IRC § 6015(e)(1)(A). This is consistent with the National Taxpayer Advocate's position that nothing in the language of IRC § 6015 confers exclusive jurisdiction the Tax Court for innocent spouse claims. *See* National Taxpayer Advocate 2013 Annual Report to Congress 408-19.

80 The National Taxpayer Advocate has recommended that Congress address this problem in three Annual Reports to Congress. National Taxpayer Advocate 2010 Annual Report to Congress 377 (Legislative Recommendation: *Allow Taxpayers to Request Equitable Relief Under Internal Revenue Code Section 6015(f) or 66(c) at Any Time Before Expiration of the Period of Limitations on Collection and to Raise Innocent Spouse Relief as a Defense in Collection Actions*); National Taxpayer Advocate 2009 Annual Report to Congress 378 (Legislative Recommendation: *Allow Taxpayers to Raise Relief Under Internal Revenue Code Sections 6015 and 66 as a Defense in Collection Actions*); National Taxpayer Advocate 2007 Annual Report to Congress 549 (Legislative Recommendation: *Allow Taxpayers to Raise Relief Under Internal Revenue Code Sections 6015 and 66 as a Defense in Collection Actions*).