MOST LITIGATED ISSUES: Introduction

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.

The Taxpayer Advocate Service (TAS) identified the Most Litigated Issues from June 1, 2012, through May 31, 2013, by using commercial legal research databases. For purposes of this section of the Annual Report, the term "litigated" means cases in which the court issued an opinion.[2] This year's Most Litigated Issues in descending order are:

- Accuracy-related penalty (IRC § 6662(b)(1) and (2));
- Trade or business expenses (IRC § 162(a) and related Code sections);
- Gross income (IRC § 61 and related Code sections);
- Summons enforcement (IRC §§ 7602(a), 7604(a), and § 7609(a));
- Collection due process (CDP) hearings (IRC §§ 6320 and 6330);
- Failure to file penalty (IRC § 6651(a)(1)), failure to pay penalty (IRC § 6651(a)(2), and estimated tax penalty (IRC § 6654);
- Charitable deductions (IRC §170);
- Frivolous issues penalty (IRC § 6673 and related appellate-level sanctions);
- Civil actions to enforce federal tax liens or to subject property to payment of tax (IRC § 7403); and
- Relief from joint and several liability for spouses (IRC § 6015).

The majority of these issues were identified as Most Litigated Issues last year, with the exception of charitable deductions.[3] Accuracy-related penalties became the top issue this year, continuing the trend from 2011 to 2012, which saw a 113 percent increase in cases, followed by a gain of another 52 percent in 2013.[4] The number of CDP cases fell slightly this year after a significant increase in 2012, dropping from 116 cases in 2012 to 105 in 2013.[5] Civil actions to enforce federal tax liens or to subject property to payment of tax saw the largest decrease in cases, with 48 cases in 2012 and 33 in 2013, a 31 percent decrease.[6]

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. Additionally, courts can issue less formal "bench opinions," which are not precedential. The more significant bench opinions are available through www.ustaxcourt.gov.

3 *See* National Taxpayer Advocate 2012 Annual Report to Congress 560.

4 *See id.* at 563, Table 3.0.1; National Taxpayer Advocate 2011 Annual Report to Congress 589.

5 *See id*.

6 *See id.*

Once TAS identified the Most Litigated Issues, it analyzed each one in four sections: summary of findings, description of present law, analysis of the litigated cases, and conclusion. Each case is listed in Appendix III**,** which categorizes the cases by type of taxpayer (*i.e.*, individual or business).[7] Appendix III 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 outcome.[8]

We have also included a "Significant Cases" section summarizing decisions that are not among the top ten issues but are important to tax administration.[9] This year, the Significant Cases discussion includes two decisions issued by the Supreme Court.[10]

AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

Initially, taxpayers can generally litigate a tax matter in four different fora:

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

With limited exceptions, taxpayers have an automatic right of appeal from final decisions of any of these courts.[11]

The Tax Court is generally a "prepayment" forum. In other words, taxpayers can access the Tax Court without first having to pay the disputed tax. The Tax Court has jurisdiction over a variety of issues, including deficiencies, certain declaratory judgment actions, appeals from collection due process hearings, relief from joint and several liability, and determination of employment status.[12]

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,[13] and (2) the taxpayer has filed an administrative claim for refund.[14] 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

7 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.

8 "*Pro se*" means "for oneself; on one's own behalf; without a lawyer." *Black's Law Dictionary* (9th ed. 2009). For purposes of this analysis, we considered the outcome of the case 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.

9 One of the cases discussed in the "Significant Cases" section of this report was decided outside the June 1, 2012, through May 31, 2013, period used to identify the ten most litigated issues, but we nonetheless have included it because of its impact on tax administration.

10 *United States v. Windsor*, 133 S. Ct. 2675 (2013), *aff'g* 699 F.3d 169 (2d Cir. 2012), *aff'g* 833 F. Supp. 2d 394 (S.D.N.Y. 2012) and *PPL Corp. v. Comm'r*, 133 S. Ct. 1897 (2013), *rev'g* 665 F.3d 60 (3d Cir. 2011), *rev'g* 135 T.C. 304 (2010).

11 *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).

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

13 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).

14 IRC § 7422(a).

trial.[15] Bankruptcy courts can adjudicate tax matters that were not adjudicated prior to the initiation of a bankruptcy case.[16]

ANALYSIS OF *PRO SE* LITIGATION

As in previous years, many taxpayers appeared before the courts *pro se*. Table 3.0.1 lists the Most Litigated Issues for the review period of June 1, 2012, through May 31, 2013, and identifies the number of cases, broken down by issue, in which taxpayers appeared without representation. As the table illustrates, the issues with the highest rates of *pro se* appearance are summons enforcement and the frivolous issues penalty.

TABLE 3.0.1, *Pro Se* Cases by Issue

Most Litigated Issue	Litigated Cases Reviewed	*Pro Se* Litigation	Percentage of *Pro Se* Cases
Accuracy-Related Penalty	178	100	56%
Trade or Business Expenses	134	86	64%
Gross Income	117	71	61%
Summons Enforcement	117	91	78%
Collection Due Process	105	70	67%
Failure to File, Failure to Pay, and Estimated Tax Penalties	86	53	62%
Charitable Deductions	40	18	45%
Frivolous Issues Penalty (and related appellate-level sanctions)	36	35	97%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	33	18	55%
Joint and Several Liability	31	11	35%
Total	**877**	**553**	**63%**

Table 3.0.2 affirms our contention that overall, taxpayers are more likely to prevail if they are represented. However, in cases involving relief from joint and several liability for spouses under IRC § 6015, it is interesting to note that taxpayers who appeared *pro se* were far more likely to prevail than taxpayers who were represented. The IRS and taxpayers would benefit from resolving these cases administratively rather than forcing taxpayers to seek relief through the courts.

15 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).

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

TABLE 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	100	20	20%	78	19	24%
Trade or Business Expenses	86	19	22%	48	16	33%
Gross Income	71	12	17%	46	5	11%
Summons Enforcement	91	1	1%	26	5	19%
Collection Due Process	70	7	10%	35	10	29%
Failure to File, Failure to Pay, and Estimated Tax Penalties	53	7	13%	32	8	25%
Charitable Deductions	18	1	6%	22	7	32%
Frivolous Issues Penalty (and related appellate-level sanctions)	35	12	34%	1	1	100%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	18	0	0%	15	3	20%
Joint and Several Liability	11	6	55%	20	5	25%
Total	**553**	**85**	**15%**	**323**	**79**	**24%**

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 *United States v. Windsor*, the Supreme Court held unconstitutional the Defense of Marriage Act's denial of a spousal deduction to a same-sex couple in computing the federal estate tax.[2]

Edith Windsor and her same-sex spouse, Thea Spyer, long-time New York residents, were married in Canada in 2007. Spyer died in 2009, leaving her entire estate to Windsor. Because of the Defense of Marriage Act (DOMA),[3] which prevented them from being treated as married under federal law, Windsor did not qualify for the marital deduction under IRC § 2056(a). Windsor paid the estate tax (in her capacity as executor) and filed a claim for refund. The IRS denied the claim, concluding that under DOMA, Windsor was not a "surviving spouse." Windsor then filed suit, seeking a refund and a declaration that DOMA violates the Equal Protection Clause of the Fifth Amendment of the U.S. Constitution.

After concluding that the couple's marriage would be recognized under New York state law and that Windsor was entitled to a refund, the United States District Court for the Southern District of New York declared that section three of DOMA violated the Equal Protection Clause of the U.S. Constitution.[4] Both the U.S. Court of Appeals for the Second Circuit[5] and the Supreme Court[6] agreed that section three of DOMA is unconstitutional.

In support of its holding, the Supreme Court reasoned that by history and tradition, the regulation of marital relations is virtually within the exclusive providence of the states, necessarily diminishing federal authority in this area. It discussed how section three of DOMA has the impermissible principal purpose and effect of identifying and making unequal a subset of state-sanctioned marriages. Moreover, it observed that DOMA forces same-sex couples to live as married for the purpose of state law but unmarried for the purpose of federal law, thus diminishing the stability and predictability of basic personal relations that New York and other states found it proper to acknowledge and protect.

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1 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2012, and ending on May 31, 2013. For purposes of this section of the report, we generally use the same time period.

2 *United States v. Windsor*, 133 S. Ct. 2675 (2013), *aff'g* 699 F.3d 169 (2d Cir. 2012), *aff'g* 833 F. Supp. 2d 394 (S.D.N.Y. 2012) [hereinafter *Windsor*]. The same issues arose in *Gill v. Office of Pers. Mgmt.*, 699 F. Supp. 2d 374 (D. Mass. 2010), *aff'd sub. nom. Massachusetts v. U.S. Dep't. of Health & Human Servs.*, 682 F.3d 1 (1st Cir. 2012) [hereinafter *Gill*]. For prior coverage of *Gill and Windsor*, see National Taxpayer Advocate 2010 Annual Report to Congress 418, 426-27 (discussing *Gill*) and National Taxpayer Advocate 2012 Annual Report to Congress 564, 567-70 (discussing *Gill* and *Windsor*).

3 For purposes of federal law, section three of DOMA defines "marriage" as "a legal union between one man and one woman as husband and wife," and "spouse" as "a person of the opposite sex who is a husband or a wife." Defense of Marriage Act, Pub. L. No. 104-199, § 3(a), 110 Stat. 2419 (1996) (codified at 1 U.S.C. § 7).

4 *Windsor*, 833 F. Supp. 2d at 406.

5 *Windsor*, 699 F.3d at 188.

6 *Windsor*, 133 S. Ct. at 2696.

This case is particularly significant for tax purposes because every federal statute (including the tax code) that refers to "marriage" or a "spouse" will no longer be tied to the unconstitutional definition provided by DOMA. As Justice Scalia observes in his dissent, this leaves many unanswered questions:[7]

> Imagine a pair of women who marry in Albany and then move to Alabama, which does not 'recognize as valid any marriage of parties of the same sex'… When the couple files their next federal tax return, may it be a joint one? Which State's law controls, for federal-law purposes: their State of celebration (which recognizes the marriage) or their State of domicile (which does not)? (Does the answer depend on whether they were just visiting in Albany?) Are these questions to be answered as a matter of federal common law, or perhaps by borrowing a State's choice-of-law rules? If so, *which* State's? And what about States where the status of an out-of-state same-sex marriage is an unsettled question under local law?[8]

The case will also have an immediate effect on the IRS because many same sex-couples are also likely to amend their returns to change their filing status.[9]

In *PPL Corp. v. Commissioner*, the Supreme Court held that a taxpayer was entitled to a foreign tax credit for the payment of a United Kingdom windfall tax because, in substance, it was a tax on income, notwithstanding its form as a tax on value.[10]

After the United Kingdom (U.K.) privatized 32 then-public utilities between 1984 and 1996, managers quickly cut costs, reaping higher-than-expected profits. In 1997, the U.K. enacted a one-time "windfall tax" to recoup excess profits.

PPL, part owner of a privatized U.K. company subject to the windfall tax, claimed a credit for its share of the windfall tax on its 1997 federal income tax return. PPL relied on IRC § 901(b)(1), which states that any "income, war profits, and excess profits taxes" paid overseas are creditable against U.S. income taxes. A foreign tax is creditable if its "predominant character" is that of an "income tax in the U.S. sense."[11] A foreign tax's predominant character is that of a U.S. income tax if it "is likely to reach net gain in the normal circumstances in which it applies."[12]

In form, the windfall tax was based on the difference between each company's "profit-making value" and "flotation value." It was computed using a complicated valuation formula that incorporated profits, but the tax was not directly imposed on income or profits. However, PPL reasoned that the tax formula could be algebraically recomputed as a tax on income or profits, and that it would reach net gain under normal circumstances. Thus, it argued the windfall tax was creditable.

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7 For further discussion of implementation issues, see Most Serious Problem: *Domestic Partners and Same-Sex Couples Need Federal Tax Guidance, supra*.

8 *Windsor*, 133 S. Ct. at 2675.

9 For a discussion of unanswered federal tax questions posed by state laws governing domestic partnerships, see National Taxpayer Advocate 2010 Annual Report to Congress 211 (Most Serious Problem: *State Domestic Partnership Laws Present Unanswered Federal Tax Questions*); National Taxpayer Advocate 2012 Annual Report to Congress 449 (Status Update: *Federal Tax Questions Continue to Trouble Domestic Partners and Same-Sex Spouses*). The government recently issued Notice 2013-61, and Revenue Ruling 2013-17, which address some of these questions.

10 *PPL Corp. v. Comm'r*, 133 S. Ct. 1897 (2013), *rev'g* 665 F.3d 60 (3d Cir. 2011), *rev'g* 135 T.C. 304 (2010) [hereinafter *PPL*].

11 Treas. Reg. § 1.901-2(a)(1)(ii) (as amended in 2013).

12 Treas. Reg. § 1.901-2(a)(3)(i) (as amended in 2013).

The IRS rejected PPL's claim. It reasoned that any algebraic rearrangement of the windfall tax was improper. The Tax Court disagreed with the IRS,[13] but the U.S. Court of Appeals for the Third Circuit reversed.[14] In a related case, the U.S. Court of Appeals for the Fifth Circuit held the U.K. windfall tax was creditable.[15] In holding in favor of PPL, the Supreme Court agreed with the Fifth Circuit's view that the tax was creditable.

The Supreme Court reasoned that foreign tax creditability depends not on the way a foreign government characterizes its tax, but on its economic substance. For most of the affected companies, the tax formula's substantive effect was to impose a tax on all profits above a threshold. Thus, the Supreme Court held the U.K. windfall tax was creditable against PPL's U.S. income tax.

This case is significant because the IRS argued that form should govern the result rather than substance. In other contexts, the IRS usually argues that economic substance controls tax treatment and vigorously opposes arguments that form should govern.[16]

In *Historic Boardwalk Hall, LLC v. Commissioner*, the U.S. Court of Appeals for the Third Circuit held that an investor was not a bona fide partner in a partnership and could not claim flow-through tax credits because the investor lacked a meaningful stake in the partnership's success or failure.[17]

The New Jersey Sports and Exposition Authority (NJSEA) and Pitney Bowes, Inc. (PB) formed Historic Boardwalk Hall, LLC (HBH), to renovate the East Hall, a popular convention center in Atlantic City, New Jersey. HBH allocated certain rehabilitation expenditures to PB, allowing PB to claim historic rehabilitation tax credits (HRTC) under IRC § 47.[18] Purchase and sale options limited the risk to PB and essentially guaranteed a three-percent return on its investment in addition to the tax credits.

The IRS disallowed PB's rehabilitation tax credits, arguing that the HBH partnership was a sham, lacked economic substance, and was not really a partnership, but rather a vehicle to allow NJSEA to impermissibly sell tax credits to PB.

The Tax Court disagreed, sustaining the allocation of the credits to PB.[19] In its view, the parties intended to form a partnership for a legitimate business purpose (*i.e.*, to rehabilitate the East Hall), and PB's motivation was not limited to the credits.[20] It also expected a three percent return. Moreover, PB's investment

13 *PPL*, 135 T.C. 304 (2010).

14 *PPL*, 665 F.3d 60 (3d Cir. 2011), *rev'g* 135 T.C. 304 (2010).

15 *Entergy Corp. v. Comm'r*, 683 F.3d 233 (5th Cir. 2012), *aff'g* T.C. Memo. 2010-197. Entergy Corporation was an owner of one of the 32 companies that were privatized. This circuit split created the possibility that similarly situated competitors in the same industry could have received different federal income tax credits based solely on which circuit's precedent applied.

16 Substance over form arguments may take on even greater significance now that a taxpayer may be subject to a strict liability penalty of up to 40 percent of any underpayment (or refund claim) resulting from a transaction that lacks economic substance or fails to meet the requirements of "any similar rule of law." Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067 (codified at IRC § 7701(o), 6662(b)(6), 6662(i), and 6676(c) and applicable to transactions entered into after March 30, 2010, the date of enactment). *See also* IRC § 6664(d)(2) (no reasonable cause exception for transactions lacking economic substance).

17 *Historic Boardwalk, LCC v. Comm'r*, 694 F.3d 425 (3d Cir. 2012), *rev'g and remanding* 136 T.C. 1 (2011), *cert. denied*, 133 S. Ct. 2734 (2013) [hereinafter *Boardwalk*].

18 IRC § 47 allows a taxpayer to claim a tax credit equal to 20 percent of the qualified rehabilitation expenditures with respect to a certified historic structure.

19 *Boardwalk*, 136 T.C. 1 (2011).

20 *Boardwalk*, 136 T.C. 24 (2011).

had a potential for loss. Accordingly, it concluded that PB was a partner, HBH was a partnership, and the arrangement had economic substance.[21]

The U.S. Court of Appeals for the Third Circuit disagreed, reversing the Tax Court. The Third Circuit assumed that HBH had economic substance, but concluded that PB was not a bona fide partner.[22] It reasoned that PB's investment was more like debt than equity because PB had no meaningful downside risk or potential for gain in excess of its three percent return. NJSEA had even agreed to reimburse PB for any disallowed HRTCs. Moreover, NJSEA was financially secure and able to complete the project without PB, minimizing the risk the project would not be completed or that it would not be able to honor its obligations to PB.[23]

This decision is significant because it increases the cost and complexity of using partnerships to sell tax credits.[24] While hindering the sale of tax credits likely promotes respect for the tax system, it may also reduce the attractiveness of the credits. According to a consulting firm cited by the U.S. Court of Appeals for the Third Circuit, tax-exempt owners of historic properties (like NJSEA) could have expected an investor to pay $.80 to $.90 per dollar of HRTC.[25] This percentage has likely declined as a result of the court's decision, especially now that an additional penalty may apply to transactions deemed to lack economic substance.[26]

In *Shockley v. Commissioner*, the U.S. Court of Appeals for the Eleventh Circuit held that a protective petition filed with the U.S. Tax Court by persons without actual or apparent authority to represent the taxpayer nonetheless suspended the taxpayer's period of limitations on assessment.[27]

After an audit of the Shockley Communications Corporation's (SCC) 2001 return, the IRS timely mailed a statutory notice of deficiency (SNOD) to SCC to the address shown on the return. SCC did not file a petition with the U.S. Tax Court to dispute the deficiency.

The IRS simultaneously mailed a duplicate SNOD to the Shockleys (SCC's former officers and shareholders), even though the Shockleys no longer had authority to act for SCC. During 2001, another company purchased all the shares of SCC and the Shockleys resigned from their positions. The Shockleys filed a protective petition, alleging that the SNOD they received, which identified both them and SCC as the taxpayer, was invalid because they were not the taxpayer. In addition, the Shockleys alleged that the

21 *Boardwalk*, 136 T.C. 29-30 (2011).

22 *Boardwalk*, 694 F.3d at 449-63. The court cited *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006) (concluding nontaxable foreign banks, which were allocated most of the partnership's taxable income but that did not share in its business risks, were not partners for tax purposes), and *Virginia Historic Tax Credit Fund 2001 LP v. Comm'r*, 639 F.3d 129 (4th Cir. 2011) (holding that those who invested in a partnership in exchange for an allocation of state tax credits without assuming meaningful business risks did not contribute funds to the partnership as partners, but rather paid to purchase tax credits).

23 Although "mindful of Congress's goal of encouraging rehabilitation of historic buildings," the court objected to the "prohibited sale of tax credits" presented by this case. *Boardwalk*, 694 F.3d at 462-63.

24 In light of the new penalty applicable to transactions that lack economic substance (cited above), the decision may also be significant because neither court adopted the IRS's argument that the transaction had no economic substance.

25 *Boardwalk*, 694 F.3d at 434.

26 If policymakers want to provide an incentive to rehabilitate historic properties, this may be an opportune time to reevaluate whether the HRTC is the most effective method for doing so. For a more in-depth discussion, see National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (Research Study: *Evaluate the Administration of Tax Expenditures*) and National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75-104 (Research Study: *Running Social Programs Through the Tax System*).

27 *Shockley v. Comm'r*, 686 F.3d 1228 (11th Cir. 2012), *rev'g and remanding* T.C. Memo. 2011-96.

SNOD was invalid because it was sent to their personal residence and not the address of SCC. The Tax Court dismissed the case on the basis of the Shockleys' unopposed position that they lacked capacity to pursue it on SCC's behalf.

Next, the IRS assessed SCC's liability, issued notices of transferee liability to the Shockleys, and sought to secure payment from them. The Shockleys petitioned the Tax Court, arguing that the notices of transferee liability were not timely.[28]

The IRS generally has to issue a notice of transferee liability within one year after the end of the period of limitations on assessment (POL).[29] The POL generally ends three years after a return is filed.[30] However, the POL is suspended for the 90-day (or 150-day) period during which the taxpayer is permitted to file a petition in the Tax Court, plus 60 days.[31] This suspension is further extended if "a proceeding in respect of the deficiency is placed on the docket of the Tax Court."[32] Thus, the notice of transferee liability would not have been timely unless the Shockleys' earlier protective petition extended the POL with respect to SCC.

The Tax Court held that the Shockleys' petition did not extend the POL for SCC. It first concluded that the notice the IRS sent to the Shockleys was a nullity as to SCC because the IRS did not send it to SCC's last known address. Next, it concluded that the Shockleys' petition did not give rise to "a proceeding in respect of the deficiency." It reasoned that the petition was not filed on behalf of SCC, was not in respect of a valid deficiency notice, and did not prohibit assessment against SCC. Thus, it held the notice of transferee liability was not timely.[33]

The U.S. Court of Appeals for the Eleventh Circuit reversed the Tax Court. It did not disturb the Tax Court's holding that the SNOD the Shockleys received was invalid as to SCC. However, it concluded that the Shockleys' petition was "a proceeding in respect of the [SCC] deficiency" that extended the POL. It relied primarily on the plain language of the statute and the Supreme Court's admonition to construe statutes of limitation strictly in favor of the government.[34]

This case is significant because it may suggest that anyone who files a petition with respect to an IRS notice runs the risk of extending the POL for the taxpayer, even if the IRS knows the petitioner has no actual or apparent authority to represent the taxpayer and even if the notice at issue is not a valid SNOD.[35]

28 The Shockleys' position was consistent with the IRS's published position. *See* Rev. Rul. 88-88, 1988-2 C.B. 354 (stating if an invalid SNOD is issued, "the filing of a Tax Court petition with respect to [that notice] does not stop the running of the period of limitations under section 6503(a)."). The IRS is generally bound by its published positions. *See Rauenhorst v. Comm'r*, 119 T.C. 157 (2002) (refusing to allow the IRS to take a position contrary to its own guidance); IRM 35.7.2.1.8(8) (Aug. 11, 2004) ("Respondent may not argue against his published position"). It is unclear if the parties were aware of the IRS's published position, as we did not locate any citations to Rev. Rul. 88-88 in any of the pleadings filed in the Tax Court.

29 IRC § 6901(c).

30 IRC § 6501(a).

31 IRC § 6213(a), 6503(a)(1). This 90-day (or 150-day) period commences on the date the IRS mails the SNOD to the taxpayer. IRC § 6213(a).

32 IRC § 6503(a)(1).

33 *Shockley v. Comm'r*, T.C. Memo. 2011-96.

34 *Shockley*, 686 F.3d at 1235-1238 (quotations omitted), *rev'g* T.C. Memo. 2011-96.

35 As of this writing, however, the case is still pending before the Tax Court on remand. For further commentary on this case, see Andy Roberson and Kevin Spencer, *11th Circuit Allows Invalid Notice to Suspend Assessment Period*, 2012 TNT 153-3 (July 24, 2012).

In *In re: Grand Jury Subpoena*, the U.S. Court of Appeals for the Fifth Circuit held that the Fifth Amendment privilege against self-incrimination does not apply to the disclosure of foreign bank accounts on Form TD F 90–22.1, Report of Foreign Bank and Financial Accounts (FBAR).[36]

The target of a grand-jury investigation (the "witness") refused to comply with a government subpoena seeking records of foreign bank accounts that he was required to keep and report on Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts*, pursuant to the Bank Secrecy Act (BSA). The witness cited his Fifth Amendment privilege against self-incrimination. The government moved to compel production of the records, arguing that the "Required Records Doctrine," which is in effect an exception to the privilege against self-incrimination, was applicable. The U.S. District Court for the Southern District of Texas denied the motion, and the government appealed.

The U.S. Court of Appeals for the Fifth Circuit reversed, concluding that the Required Records Doctrine applied. Under the doctrine, the government may require that certain records be kept and later produced without implicating the privilege against self-incrimination. The doctrine "does not empower the government to command every citizen to keep a diary of their crimes under the guise of regulation."[37] Rather, it permits the government to inspect records it requires an individual to keep as a condition of voluntarily participating in a regulated activity.[38] The doctrine may apply when (1) the purposes of the inquiry are "essentially regulatory" rather than criminal, (2) the information is of a kind which the regulated party has "customarily kept," and (3) the records are assumed to have "public aspects" that render them analogous to public documents.

The witness argued that because a primary purpose of the BSA is to fight crime, it fails the requirement to be "essentially regulatory." However, the court concluded that the BSA satisfies the requirement because another purpose of the BSA is to support regulatory investigations, as evidenced by the fact that BSA information is distributed to several civil and regulatory agencies.

The witness did not contest that bank account information is "customarily kept." However, he argued that because those subject to the BSA are not regulated and have not engaged in activities with the public or in the public sphere, their banking records lack "public aspects."[39] The court rejected this reasoning. It observed that under the witness's logic, Congress could only require those with foreign accounts to keep and produce records of the accounts if it first placed additional substantive regulatory restrictions on them to inject them with public aspects. Moreover, the court observed that records generally considered private (*e.g.*, medical records) can possess public aspects. It reiterated that the Treasury Department shares foreign bank account information with a number of different agencies, imbuing it with "public aspects." Thus, it concluded the privilege against self-incrimination was not a defense to the subpoena because the Required Records Doctrine was applicable.[40]

36 *In re: Grand Jury Subpoena*, 696 F.3d 428 (5th Cir. 2012). Form TD F 90-22.1 was subsequently replaced by Form 114.

37 *Id*. at 433.

38 For example, the Supreme Court held that the government may require a wholesaler of fruit to keep and produce certain records to enable enforcement of the Emergency Price Control Act, which was passed following World War II to prevent inflation and price gouging. *Shapiro v. United States*, 335 U.S. 1 (1948).

39 *In re: Grand Jury Subpoena*, 696 F.3d at 435.

40 The court also mentioned that affirming the district court would have created a circuit split. *In re: Grand Jury Subpoena*, 696 F.3d at 431 (citing *In re: Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011*, 691 F.3d 903 (7th Cir. 2012) and *In re: Grand Jury Investigation M.H. v. United States*, 648 F.3d 1067 (9th Cir. 2011)).

This case is significant because it suggest the Fifth Amendment privilege against self-incrimination does not apply to a wide range of private information that the IRS may require taxpayers to keep in connection with their tax returns.[41]

In *United States v. Quality Stores, Inc*., the United States Court of Appeals for the Sixth Circuit held that supplemental unemployment benefit (SUB) payments to involuntarily terminated employees are not "wages" subject to Federal Insurance Contributions Act (FICA) taxes.[42]

Quality Stores made payments to employees who were involuntarily terminated in connection with its bankruptcy and discontinuance of operations, as required by its supplemental unemployment benefit (SUB) plans. It treated the payments as wages on Forms W-2, and withheld and paid employment taxes on them. Quality Stores and some of its employees sought a refund of the FICA tax, arguing that the payments were not wages, but rather SUB payments that were not taxable under FICA. The IRS denied the claim because in its view only certain SUB payments — not those at issue — qualify for a narrow exception to FICA described in a series of Revenue Rulings. [43] The bankruptcy court agreed with Quality Stores, as did the district court, and the United States Court of Appeals for the Sixth Circuit, concluding that the SUB payments were not wages for purposes of either FICA or federal income tax (FIT).

Under the court's analysis, Congress adopted a definition of "wages" for FIT purposes that is nearly identical to the definition of "wages" included in FICA. In its 1981 decision in *Rowan*, the Supreme Court confirmed that the term "wages" has the same meaning in both statutes.[44] IRC § 3402(o) states that for FIT purposes a SUB payment is "treated as if it were a payment of wages," and by implication, not actually wages.[45] Legislative history indicates that SUB payments "do not constitute wages."[46] According to the court, Congress allowed SUB payments to be treated as wages under IRC § 3402(o) to facilitate FIT withholding for taxpayers. Thus, the court held that SUB payments are not wages for either FIT or FICA purposes.

The IRS agreed that under IRC § 3402(o), SUB payments are not wages for purposes of FIT. However, it argued that they are wages for purposes of FICA. It reasoned that Congress legislatively superseded *Rowan* when it enacted the "decoupling amendment" in 1983. It cited legislative history and cases indicating that Congress intended the definition of wages to be more broadly construed under FICA.

According to the court, however, the text of the decoupling amendment simply authorized Treasury to promulgate regulations (not administrative guidance) to provide for different exclusions from wages under FICA than under the FIT withholding laws. But, the government has not issued any.

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41 However, some have argued that a person can still assert privilege with respect to certain line items on the FBAR form. *See* Edward M. Robbins, *The Fifth Amendment FBAR Lives!*, 2013 TNT 123-9 (June 26, 2013).

42 *United States v. Quality Stores, Inc.,* 693 F.3d 605 (6th Cir. 2012), *aff'g* 424 B.R. 237 (W.D. Mich. 2010), *aff'g* 383 B.R. 67 (Bankr. W.D. Mich. 2008), *cert. granted*, 82 U.S.L.W. 3177 (2013) [hereinafter *Quality Stores*].

43 *Quality Stores*, 693 F.3d at 619. *See, e.g.*, Rev. Rul. 56-249, 1956-1 C.B. 488 and Rev. Rul. 90-72, 1990-2 C.B. 211 (providing an exception for a stream of payments coordinated with the receipt of unemployment compensation, but not for a lump-sum payment).

44 *Quality Stores*, 693 F.3d at 613 (citing *Rowan Cos. v. United States*, 452 U.S. 247 (1981)).

45 If the SUB payments were actually wages, then some employees might lose the very state unemployment benefits that the SUB payments were intended to supplement. *Id*. at 617.

46 *Quality Stores*, 693 F.3d at 612 (quotations omitted).

The court also distinguished a holding by the Federal Circuit in *CSX* that reached a different conclusion as inconsistent with the Federal Circuit's own precedent.[47] This case is significant because it creates a split of authority, which the Supreme Court has agreed to review, regarding whether SUB payments are subject to FICA, even if they do not meet the exception described in the IRS's administrative guidance. It has also prompted those who made or received SUB payments to file claims to recover FICA taxes.[48]

In *Allcorn v. Commissioner*, the U.S. Tax Court held the IRS has discretionary authority to abate interest on an excessive refund even if the refund was caused, in part, by taxpayer error.[49]

Mr. Allcorn mistakenly reported $4,000 in estimated tax payments as withholding on line 62 (federal income tax withheld) rather than on line 63 (estimated tax payments) of his 2008 Form 1040, *U.S. Individual Income Tax Return*. He included a note with his return, which explained: "Additional $4,000 was sent with Form 1040-ES." He correctly reported his total payments on Line 71.

The IRS double-counted Mr. Allcorn's $4,000 payment and sent him a refund of $4,000 more than he requested. When the IRS discovered its error, it demanded $4,514 — the $4,000 plus a $300 late payment penalty and $214 in interest. The IRS abated the penalty, but declined to abate the interest.

Pursuant to IRC § 6602, when the IRS issues an erroneous refund, it must charge interest on the amount. Section 6404(e)(2), however, requires the IRS to abate interest on any "erroneous refund under section 6602," provided the refund did not exceed $50,000 and the taxpayer (or a related party) had not caused the refund. Mr. Allcorn believed he had not caused the $4,000 erroneous refund, and thus petitioned the Tax Court with respect to the IRS's determination not to abate the interest.

The IRS first argued that IRC § 6404(e)(2) did not apply because the payment was not an "erroneous refund under section 6602." IRC § 6602 only applies to refunds "recoverable by suit pursuant to section 7405."[50] Thus, the IRS asserted that because it could recover the refund using summary assessment procedures under IRC § 6201(a)(3) (*i.e.*, the IRS authority to make "math error" adjustments), the requirement to abate interest under IRC § 6404(e)(2) did not apply.[51] The court rejected this argument, reasoning that the IRS could have chosen to recover the erroneous refund by filing a civil suit under IRC § 7405.[52]

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47 *Id*. at 615-16 (citing *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008) [hereinafter *CSX*], as a decision contrary to the court's holding in *Anderson v. U.S.*, 929 F.2d 648 (Fed. Cir. 1991)). In *CSX*, the Federal Circuit concluded that "the text of section 3402(o) does not require that FICA be interpreted to exclude from 'wages' all payments that would satisfy the definition of SUB in section 3402(o)(2)(A)." *CSX*, 518 F.3d at 1342.

48 In the government's petition for a writ of certiorari, it indicated that the same issue is pending in 11 cases and more than 2,400 administrative refund claims, with a total amount at stake of more than $1 billion. *Quality Stores, petition for cert. filed*, 2013 WL 2390247 (May 31, 2013) (No. 12-1408). On October 1, 2013, the United States Supreme Court granted this petition, see 82 U.S.L.W. 3177 (2013).

49 *Allcorn v. Comm'r*, 139 T.C. 53 (2012).

50 Sections 7405(a) and (b) authorize the government to file a civil action to recover certain erroneous refunds. An erroneous refund suit is not, however, the sole means for the IRS to collect an erroneous refund. *See, e.g.*, CCDM 34.6.2.7(2)(a) (June 12, 2012) ("Assessable erroneous refunds may also be recovered by administrative action within the applicable period of limitation upon assessment and collection.").

51 *Allcorn*, 139 T.C. at 59.

52 *Id*. at 59-60.

Next, the IRS argued that IRC § 6404(e)(2) was inapplicable because Mr. Allcorn's error contributed to the erroneous refund. The court agreed that because of Mr. Allcorn's error, the IRS was not required to abate the interest.

However, the court went on to conclude that the IRS had discretionary authority to abate interest under IRC § 6404(e)(2), despite Mr. Allcorn's error. The court cited (1) cases applying IRC § 6404(e)(2) in situations where the taxpayer was somewhat at fault, (2) the legislative history of IRC § 6404(e)(2), which suggests Congress intended to increase the IRS's authority to abate interest, and (3) an Internal Revenue Manual provision that suggests the IRS has discretionary authority under IRC § 6404(e)(2) to abate interest on erroneous refunds in excess of the $50,000 amount provided by law.[53]

This case is significant because it clarifies the IRS's discretionary authority to abate interest on erroneous refunds under IRC § 6404(e)(2), even if taxpayer error contributes to the refund, the refund exceeds $50,000, and the IRS can recover it using summary assessment procedures (*i.e.*, math error authority).

In *Loving v. Internal Revenue Service*, the District Court for the District of Columbia held the IRS lacked authority to issue regulations governing the conduct of registered tax return preparers, and enjoined the IRS from enforcing them.[54]

In June 2011, the Treasury Department issued regulations governing "registered tax return preparers," a previously unregulated group of 600,000 to 700,000 paid preparers.[55] In order to protect the consumers and the public fisc, the regulations require each preparer to obtain a valid preparer tax identification number (PTIN), pass a background check and an exam, pay an annual fee, and take fifteen hours of continuing education courses each year. Sabina Loving and two other preparers who had not previously been regulated by the IRS filed suit, claiming the regulations were not authorized by law and would cause them to increase prices or go out of business.

The IRS first argued that it did not need statutory authority to regulate preparers because each agency has inherent authority to regulate those who practice before it. However, the court concluded that this general authority does not apply because a specific statutory provision (*i.e.*, 31 U.S.C. § 330) defines the agency's authority.

Under the framework set forth in *Chevron*, agency regulations are entitled to deference unless they (1) contradict an unambiguous statute, or (2) adopt an unreasonable construction of it.[56] In this case, 31 U.S.C. § 330 authorizes Treasury to "regulate the practice of representatives," and to "require that the representative demonstrate…competency to advise and assist persons in presenting their cases," before

53 *Id*. at 63-66 (citing *Converse v. United States*, 839 F. Supp. 1274 (N.D. Ohio 1993); *Lindstedt v. United States*, 78 A.F.T.R.2d (RIA) 6211 (Fed. Cl. 1996); H.R. Rept. No. 99-426, at 844 (1985); and IRM 20.2.7.5(2) (Mar. 9, 2010)).

54 *Loving v. Comm'r*, 920 F. Supp. 2d 108 (D.D.C. 2013).

55 *See* T.D. 9527 (June 3, 2011), 76 Fed. Reg. ¶ 32,286, 32,299. These persons are sometimes referred to as "unenrolled" preparers. *See* Treas. Reg. § 601.502(b)(5)(iii); Rev. Proc. 81-38, 1981-2 C.B. 592. Attorneys, certified public accountants, enrolled agents and enrolled actuaries were already subject to IRS regulation under Circular 230. The National Taxpayer Advocate has long championed the regulation of return preparers as necessary to protect consumers. *See* 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*); Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 2013 TNT 92-31 (May 13, 2013).

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

admitting a "representative to practice."[57] In addition, 31 U.S.C. § 330(b) authorizes Treasury to suspend or disbar "a representative" from "practice" before the Treasury Department in certain circumstances, and also to impose a monetary penalty.

The IRS argued that the terms "practice" and "representative" are ambiguous and that it reasonably interpreted them as covering tax return preparers. Thus, the court should uphold the regulations under the second prong of *Chevron*.

The court disagreed, finding that the D.C. Circuit had previously "rejected the argument that a statute is ambiguous when it fails to define a broad term."[58] It concluded that the statute unambiguously fails to authorize the government to regulate tax return preparers — failing under the first prong of *Chevron*. According to the court, 31 U.S.C. § 330(a)(2)(D) equates "practice" with advising and assisting with the presentation of a "case," not the filing of a tax return.[59] Thus, the statutory definition of practice "makes sense only in connection with those who assist taxpayers in the examination and appeals stages of the process."[60]

Next, the court reasoned that because Congress has enacted at least ten penalties targeting specific misconduct by tax return preparers with specific sanctions, 31 U.S.C § 330(b) should not be interpreted to provide the IRS with overlapping discretion to penalize preparers for the same conduct.[61] It went on to observe that IRC § 6103(k) specifically authorizes the IRS to disclose information about violations triggering these specific penalties to state and local agencies that license, register or regulate preparers, but does not authorize the IRS to disclose violations of 31 U.S.C. § 330. One explanation for this omission, according to the court, is that 31 U.S.C. § 330 does not apply to preparers.[62]

Finally, the court observed that if the IRS's arguments were accepted, then the IRS could disbar a preparer pursuant to its authority under 31 U.S.C. § 330 for the same conduct that would enable it to seek an injunction against the preparer under IRC § 7407. Thus, an injunction would rarely be necessary. According to the court, this weighed against interpreting 31 U.S.C. § 330 as granting the IRS authority to regulate return preparers. Accordingly, the court granted Loving's motion for summary judgment, holding that the IRS lacked statutory authority to issue and enforce the regulations governing "registered tax return preparers," and enjoined the IRS from enforcing them.

57 31 U.S.C. § 330(a)(1), (a)(2)(D).

58 *Loving*, 917 F. Supp. 2d 67, 74 (D.D.C. 2013) (citing *Goldstein v. SEC*, 451 F.3d 873, 878 (D.C. Cir. 2006)).

59 The court stated that because the law was enacted before the federal income tax, Congress could not have contemplated that it would authorize the regulation of income tax return preparers. For an alternative analysis and different conclusion, see Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 2013 TNT 92-31 (May 13, 2013). *See also* Lawrence B. Gibbs, *Loving v. IRS: Treasury's Authority to Regulate Tax Return Preparers*, 2013 TNT 203-50 (Oct. 21, 2013).

60 *Loving*, 917 F. Supp. 2d at 74. Unenrolled tax return preparers are generally authorized to represent a taxpayer before the IRS during the examination of a return that they prepared, but not before IRS appeals or collection functions. *See* 26 C.F.R. § 601.502(b)(5)(iii).

61 The court did not comment on the fact that the IRS did not have authority to impose a monetary penalty until 2004. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title VIII, § 822(a)(1), (b), 118 Stat. 1418, 1586-587.

62 Another explanation is that IRC § 6103 does not prevent the disclosure of sanctions under Title 31. Indeed, the IRS Office of Professional Responsibility (OPR) posts on its website sanctions imposed under Title 31, including censure, suspension or disbarment from practice before the IRS, as well as all final agency decisions following an appeal. *See, e.g.*, OPR, Announcement of Disciplinary Sanctions, http://www.irs.gov/Tax-Professionals/Enrolled-Agents/Announcements-of-Disciplinary-Sanctions. Thus, state and local agencies could simply check the OPR website on a regular basis.

The government filed a motion to suspend the injunction pending appeal. The court denied the motion but then modified the terms of the injunction.[63] On February 25, 2013, the government filed a motion for a stay pending appeal. On March 27, 2013, the U.S. District Court for the District of Columbia denied the motion for stay.[64] The government has appealed the district court's decision to the U.S. Court of Appeals for the District of Columbia Circuit. This case is significant because it will affect hundreds of thousands of tax return preparers and the taxpayers they serve.

In *Dorrance v. United States*, the United States District Court in Arizona held that a taxpayer must allocate basis between the life insurance policy and stock received when a mutual insurance carrier demutualizes.[65]

In 1995, a trust purchased policies from various mutual life insurance companies. As a policyholder it had certain ownership rights (mutual rights) normally held by stockholders, such as the right to vote and the right to receive the mutual company's "surplus" should it liquidate. Between 1998 and 2001, each of the insurance companies demutualized, distributing shares of stock (or cash in lieu of stock) to compensate for the loss of the mutual rights. The trust received stock valued at about $1.8 million, and in 2003, sold it for about $2.2 million. It reported the entire $2.2 million as gain, paid the resulting tax, and then filed for a refund, claiming that its basis should be allocated to the stock to offset the gain. The IRS did not pay the claim, and the trust filed suit.

The IRS argued that the trust did not meet its burden to prove it had paid for the mutual rights or that the stock had any basis at all. Accordingly, it should not be entitled to recover any basis in connection with the stock sale. The court rejected this argument because it concluded the trust had paid something for the mutual rights (and thus the stock) when it paid premiums for policies that included both the policy rights and mutual rights. It reasoned that if it is clear that a taxpayer is entitled to some deduction, but cannot establish the full amount claimed, it is improper to deny the deduction in its entirety.[66]

The trust argued it should recover its basis pursuant to the "open transaction" doctrine because it was impractical or impossible to allocate the basis in the mutual life insurance policy between the property it received in the demutualization transaction (*i.e.*, the stock and non-mutual policy).[67] If applicable, the doctrine would allow the trust to use its full basis in the policy to offset any gain on the stock sale before allocating any remaining basis to the non-mutual policy.

The court rejected this argument. While acknowledging that the Court of Federal Claims had concluded in the *Fisher* case that the open transaction doctrine applied to a demutualization transaction, it observed that neither of the parties in *Fisher* analyzed how much the taxpayer paid for the mutual rights — with the IRS arguing they paid nothing and the taxpayer arguing the amount could not be determined.[68]

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63 *See Loving*, 920 F. Supp. 2d 108 (D.D.C. 2013) (modifying the injunction to make clear that the IRS is not required to suspend the PTIN program and not required to shut down all of its testing and continuing-education centers).

64 *See Government Files Brief in D.C. Circuit Court in Return Preparer Oversight Case*, 2013 TNT 62-20 (Apr. 3, 2013).

65 *Dorrance v. United States*, 877 F. Supp. 2d 827 (D. Ariz. 2012).

66 *Id*. at 831 (citing *Cohan v. Comm'r*, 39 F.2d 540, 543 (2d Cir.1930)).

67 *See, e.g., Burnet v. Logan*, 283 U.S. 404 (1931); *Pierce v. United States*, 49 F. Supp. 324 (Ct. Cl. 1943).

68 *Fisher v. United States*, 82 Fed. Cl. 780 (2008), *aff'd without opinion*, 333 F. App'x 572 (Fed. Cir. 2009) [hereinafter *Fisher*]. For prior coverage of *Fisher*, see National Taxpayer Advocate 2008 Annual Report to Congress 468-469 (speculating: "We wonder if the [Fisher] court would have reached a different conclusion if the IRS's expert had valued the ownership components of the policy at an amount greater than zero.").

The court was also concerned that open transaction treatment would produce a windfall. In effect, all of the basis would be allocated to the stock — the asset that would be sold — while the asset that does not require basis — the policy — would have its basis reduced.[69]

Moreover, unlike the taxpayer in *Fisher* who had received cash at the time of the demutualization, the taxpayer in this case received stock that had appreciated before being sold. Thus, even gains on the stock following the demutualization could be offset by basis increases — increases resulting from post-demutualization payments on the policy – if it applied the open transaction doctrine.

Finally, the court reasoned that because the value of both the mutual rights and the policy itself could be determined at the time of the demutualization, there was no concern that the taxpayer might pay tax on a transaction that might later show a loss. Thus, it concluded that the parties must equitably apportion basis between the stock and the policy pursuant to Treasury Regulation § 1.61-6(a).

The district court later amended its opinion, holding the trust's basis was about $1 million, which represented the value of shares received to compensate for relinquishing voting rights and for past (but not future) contributions to surplus, as determined by the companies.[70]

This case is significant because it highlights how the tax treatment of stock or cash received in a demutualization transaction remains unsettled.[71] It suggests that taxpayers who receive stock (or cash) from mutual insurance companies in demutualization transactions must report taxable gains by allocating basis between the policy and the mutual rights (*i.e.*, stock or cash), rather than deferring gains under the open transaction doctrine.

In *United States v. McBride*, the United States District Court in Utah held that a taxpayer's failure to file Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts*, was willful because the government showed by a preponderance of the evidence that the taxpayer either knew or, deliberately or with reckless disregard, avoided learning of his filing requirement.[72]

Mr. McBride, a partner in a U.S. business, hired a financial management firm to move business profits offshore to avoid U.S. income tax. The firm's promotional materials informed Mr. McBride about the FBAR reporting requirements. When presented with the tax avoidance plan, Mr. McBride's first reaction was that "this is tax evasion." Yet, he did not obtain a second opinion or disclose his interest in the offshore accounts to his accountant or tax return preparer. He checked the box on Schedule B of his federal income tax returns "no" to indicate that he had no interests in foreign accounts exceeding the reporting threshold. The IRS imposed a civil penalty against Mr. McBride for willfully failing to file an FBAR, and ultimately sued in district court to collect the penalty.

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69 *Dorrance*, 877 F. Supp. 2d at 834 (quoting commentators).

70 *Dorrance*, 111 A.F.T.R.2d (RIA) 1280 (D. Ariz. 2013).

71 *See, e.g.*, Mark Persellin and Kent Royalty, *The Demutualized Stock Basis Conundrum: Update And Planning Implications*, Corporate Taxation, 39 WGL-CTAX 17 (Nov./Dec. 2012). Although the IRS has not issued an Action on Decision, it disagrees with *Fisher* and had been holding claims for refund pending a decision in *Dorrance*. *See Cadrecha v. United States*, 104 Fed. Cl. 296 (2012); Letter from IRS Associate Chief Counsel (Income Tax & Accounting) to Senator Harkin (May 23, 2011), *reprinted as*, IRS Will Not Refund Tax Paid on Sale of Life Insurance Company Stock, 2011 TNT 180-28 (Sept. 16, 2011); IMRS 11-0001391 (2011), http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Issues-Closed-in-Calendar-Year-2011-Sorted-by-Subject. It is now denying them. *See Reuben v. United States*, 111 A.F.T.R.2d (RIA) 620 (D. Cal. 2013).

72 *United States v. McBride*, 908 F. Supp. 2d 1186 (D. Utah 2012).

The court first decided that the U.S. has the burden to prove Mr. McBride's violation was willful by only a "preponderance of evidence," rather than by the higher "clear and convincing evidence" standard that applies to fraud.[73] The court also stated that the IRS could establish willfulness on the basis of reckless conduct, such as making a conscious effort to avoid learning about the FBAR reporting requirements — requirements explained on the face of a tax return (*i.e.*, willful blindness).

In this case, however, the IRS met is burden by showing that Mr. McBride had actual knowledge of the FBAR filing requirements because his financial management firm had informed him about them. Mr. McBride testified that the purpose of the scheme was to avoid disclosure and reporting the existence of the foreign interests, because "if you disclose the accounts on the form, then you pay tax on them,"[74] which went against the purpose of the scheme. The court also found that he deliberately withheld information about the accounts from his preparer and accountant. It reasoned that Mr. McBride either knew he was violating the FBAR reporting requirements or intentionally avoided learning whether he was violating the FBAR reporting requirements. Thus, the court held that Mr. McBride's violation was willful.

This case is significant because it confirms that the government has the burden to prove its case by a preponderance of the evidence when it seeks to impose the penalty applicable to willful FBAR violations. It may also suggest that the government can meet its burden if it can show that the taxpayer intentionally avoided learning about whether his or her actions violated the FBAR reporting requirements. Because the government established Mr. McBride *actually* knew about the FBAR reporting requirements and deliberately concealed the offshore accounts from his accountant and preparer, however, this conclusion might be characterized as dicta. Notably, this case does not stand for the proposition that if the government establishes a taxpayer signed a return, which failed to report the existence of an interest in a foreign account on Schedule B, then it has automatically met its burden to prove willfulness.[75]

73 IRC § 7454(a); Tax Court Rule 142(b) ("In any case involving the issue of fraud with intent to evade tax, the burden of proof in respect of that issue is on the respondent, and that burden of proof is to be carried by clear and convincing evidence. See Code sec. 7454(a).").

74 *McBride*, 908 F. Supp. 2d at 1199.

75 Analysis in other cases may support that conclusion, however. *See, e.g., United States v. Sturman*, 951 F.2d 1466, 1477 (6th Cir. 1991) ("It is reasonable to assume that a person who has foreign bank accounts would read the information specified by the government in tax forms. Evidence of acts to conceal income and financial information, combined with the defendant's failure to pursue knowledge of further reporting requirements as suggested on Schedule B, provide a sufficient basis to establish willfulness on the part of the defendant."). *But see* IRM 4.26.16.4.5.3(6) (July 1, 2008) ("The mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, by itself, to establish that the FBAR violation was attributable to willful blindness.").

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 caused an underpayment of tax, or if an underpayment exceeded a computational threshold called a substantial understatement, respectively. IRC § 6662(b) also authorizes the IRS to impose five other accuracy-related penalties.[1] We did not analyze these other accuracy-related penalties because during our review period of June 1, 2012, through May 31, 2013, taxpayers litigated these penalties less frequently than the negligence and substantial understatement penalties.[2]

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] The IRS may assess penalties under both IRC § 6662(b)(1) and IRC § 6662(b)(2), but the total penalty rate cannot exceed 20 percent (*i.e.*, the penalties are not "stackable").[4] 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.[5] 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 items 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."[6] Negligence includes a failure to keep adequate books and records or to substantiate items that gave rise to the underpayment.[7] Strong indicators of negligence include instances where a taxpayer failed to report income on a tax return that a payor reported on

1 IRC § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement for income taxes; 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.

2 Note, however, that there has been some recent significant litigation involving IRC § 6662(h) (the 40 percent penalty in the case of a gross valuation misstatement). *See, e.g., United States v. Woods*, 471 F. App'x 320 (5th Cir. 2012), *aff'g per curiam* 794 F. Supp. 2d 714 (W.D. Tex. 2011), *cert. granted*, 133 S. Ct. 1632 (Mar. 25, 2013); *Nevada Partners Fund L.L.C. v United States*, 111 A.F.T.R.2d (RIA) 2416 (5th Cir. 2013), *aff'g* 714 F. Supp. 2d 598 (S.D. Miss. 2010).

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

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

5 IRC § 6664(c)(1).

6 IRC § 6662(c).

7 Treas. Reg. § 1.6662-3(b)(1).

an information return as defined in IRC § 6724(d)(1),[8] or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.[9] The IRS can also consider various other factors in determining whether the taxpayer's actions were negligent.[10]

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.[11] 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.[12] For individuals, the understatement of tax is substantial if it exceeds the greater of $5,000 or ten percent of the tax that must be shown on the return.[13] 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.[14]

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.[15] A reasonable cause determination takes into account all of the pertinent facts and circumstances.[16] Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.[17]

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

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

10 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).

11 IRC § 6662(d)(2)(A)(i)-(ii).

12 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).

13 IRC § 6662(d)(1)(A)(i)-(ii).

14 IRC § 6662(d)(1)(B)(i)-(ii).

15 IRC § 6664(c)(1).

16 Treas. Reg. § 1.6664-4(b)(1).

17 *Id.*

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process[18] and through its Automated Underreporter (AUR) computer system.[19] Before a taxpayer receives a notice of deficiency, he or she has opportunities to engage the IRS on the merits of the penalty.[20] Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC § 6211-6213).[21] 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.[22] Alternatively, taxpayers may seek judicial review through refund litigation.[23] Under certain circumstances, a taxpayer can request an administrative review of IRS collection procedures (and the underlying liability) through a Collection Due Process (CDP) hearing.[24]

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.[25] The IRS must first present sufficient evidence to establish that the penalty is warranted. The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.[26]

ANALYSIS OF LITIGATED CASES

We identified 178 opinions issued between June 1, 2012 and May 31, 2013 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 139 cases (78 percent), the taxpayers prevailed in full in 28

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18 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).

19 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. *See* IRM 4.19.2, *Liability Determination, IMF Automated Underreporter (AUR) Control* (Aug. 16, 2013). 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. *See* 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.").

20 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).

21 IRC § 6665(a)(1).

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

23 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 of the Court of Federal Claims. 28 U.S.C. § 1346(a)(1); 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).

24 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).

25 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."

26 IRC § 7491(a). *See also* Tax Court Rule 142(a).

cases (16 percent) and 11 cases (six percent) resulted in split decisions. Table 1 in Appendix III provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 100 of the 178 cases (56 percent) and convinced the court to dismiss or reduce the penalty in 20 (20 percent) of those cases. Represented taxpayers fared slightly better, achieving full or partial relief from the penalty in 19 of their 78 cases (24 percent).

In some cases, the court found taxpayers liable for the accuracy-related penalty but failed to clarify whether it was for negligence under § 6662(b)(1), or a substantial understatement of tax under § 6662(b)(2), or both.[27] Regardless of the subsection at issue, the analysis of reasonable cause is 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.[28] Taxpayers were most successful in establishing a defense for an asserted underpayment when they produced adequate records or proved they made a reasonable attempt to comply with the requirements of law. For example, in *Bauer v. Commissioner*,[29] the taxpayer engaged in a household goods transport business and sought to deduct contract labor expenses. Although a deduction is allowed for ordinary and necessary expenses paid or incurred by a taxpayer in carrying on a trade or business,[30] the IRS disallowed the contract labor expenses for failure to substantiate the deduction. In *Bauer*, the taxpayer kept a logbook of contract labor expenses that the court deemed inadequate to substantiate the deduction taken on Schedule C.[31] Pursuant to the *Cohan* rule,[32] however, the court was able to estimate the amount of deductible expense. The court did not uphold the accuracy-related penalty asserted against the taxpayer because his logbook demonstrated that he made a good faith effort to maintain a record of his contract labor expenses even though his attempt at recordkeeping fell short for substantiation purposes.[33]

While the Tax Court has been sympathetic to honest misunderstandings of a complex tax code,[34] it will still impose an accuracy-related penalty on taxpayers not demonstrating a good faith effort to comply with

27 *See, e.g., Snow v. Comm'r*, T.C. Memo. 2013-114 (IRS proposed accuracy-related penalties against the taxpayer for both § 6662(b)(1) and (b)(2), but the Tax Court ultimately held him liable for "the accuracy-related penalty under section 6662(a)," without identifying which subsection applied). *Compare with Holmes v. Comm'r*, T.C. Memo. 2012-251 (IRS proposed accuracy-related penalties under both § 6662(b)(1) and (b)(2); however, once the IRS established that the taxpayer had substantially understated his income under § 6662(b)(2), the court declined to consider the negligence claim).

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

29 T.C. Memo. 2012-156.

30 IRC § 162(a).

31 *Bauer*, T.C. Memo. 2012-156.

32 *See Cohan v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930) (holding that if a taxpayer establishes that he or she paid a deductible business expense but cannot substantiate the precise amount, the court may estimate the amount of the deductible expense, "bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making").

33 *Bauer*, T.C. Memo. 2012-156.

34 *See, e.g., Armstrong v. Comm'r*, 139 T.C. No. 18 (2012) (declining to impose an accuracy-related penalty on a taxpayer who improperly claimed a dependency exemption but was not sufficiently experienced in tax accounting and law to be found negligent); *Chien v. Comm'r*, T.C. Memo. 2012-277 (relieving from the accuracy-related penalty a taxpayer who failed to understand that she was liable for self-employment tax because of her inexperience and honest misunderstanding, after consulting instructions for Form 1040, of her employment status).

the law. For example, in *Striefel v. Commissioner*,[35] the taxpayer destroyed records because he was told he would die soon. Although the court acknowledges the taxpayer was understandably upset, it found the taxpayer's actions negligent and not justifiable pursuant to IRC § 6001, which requires the maintenance of tax records.[36] In *Fitch v. Commissioner*,[37] the taxpayers sought to deduct a net operating loss carried over from prior years pursuant to IRC § 172(a). The IRS disallowed the deduction for failure to substantiate, and the taxpayers were responsible for an accuracy-related penalty. Although the husband, who worked as a certified public accountant (CPA), suffered a brain aneurysm during the tax year, the deterioration of his health did not suffice to support a finding that the married couple acted with reasonable cause sufficient to avoid the accuracy-related penalty.[38] While the court sympathized with the taxpayer's health circumstances, it relied on Mr. Fitch's continued practice as a CPA to show that the illness alone did not support a reasonable cause or good faith defense sufficient to avoid the penalty.[39]

While expectations for compliance with the tax code are high, taxpayers avoided an accuracy-related penalty by adequately substantiating deductions to show reasonable cause and proof of good faith in connection with an unresolved legal issue. For example, in *Patel v. Commissioner*,[40] the taxpayers claimed a charitable contribution when they donated their house to the local fire department to conduct live fire training exercises on the property. The state of the law regarding the type of ownership interest in the house that the taxpayers transferred to the fire department was unsettled. The Tax Court denied the deduction but declined to impose the accuracy-related penalty. The IRS disagrees with the Tax Court's conclusion that the uncertain state of the law is a factor that supports a finding of reasonable cause when the taxpayers failed to obtain competent professional advice or do their own investigation of the state of the law.[41]

In *Olive v. Commissioner*,[42] the taxpayer was found negligent for failure to keep adequate books and records, and he substantially understated income in connection with his medical marijuana dispensary. The taxpayer deducted costs of goods sold and other business expenditures, some of which were properly substantiated while others were not. Accuracy-related penalties were imposed on the portion of the understatement that arose from unsubstantiated deductions, but not on the portion of the understatement stemming from properly substantiated deductions. Because the correct treatment of expenditures for the sale of marijuana was not resolved at the time the taxpayer filed the returns, the court focused the penalty application on whether the expenses had been properly substantiated as a sign of a good faith effort to comply with the tax code.[43]

35 T.C. Memo. 2013-102.

36 *See supra*, note 28.

37 T.C. Memo. 2012-358.

38 *Id.*

39 *Id. See also Perry v. Comm'r*, T.C. Memo. 2012-237 (holding an accuracy-related penalty was appropriate where the taxpayer was a certified public accountant (CPA) and former IRS revenue agent and failed to substantiate deductions for travel expenses and depreciation on his home).

40 138 T.C. 395 (2012).

41 *See Patel*, 138 T.C. at 395, *action on dec.*, 2013-7 (Feb. 11, 2013).

42 139 T.C. 19 (2012).

43 139 T.C. 19 (2012).

Negligence by Creation of Artificial Capital Loss

We also reviewed several cases in which the taxpayer contested an accuracy-related penalty after creating an artificial capital loss by implementing a scheme called CARDS (Custom Adjustable Rate Debt Structure). In *Kerman v. Commissioner*,[44] the taxpayer was held liable for an accuracy-related penalty for a substantial understatement in tax resulting from the implementation of a CARDS scheme to generate tax losses to offset the capital gain realized from the sale of securities. A CARDS strategy begins with a foreign borrower taking a loan from a foreign bank in foreign currency. The taxpayer for whom the strategy is designed would then receive some of the funds from the company, agreeing to be jointly liable for the full amount of the loan. The taxpayer would then exchange the foreign currency for United States dollars. As the exchange of foreign currency is a taxable event, the taxpayer claims a basis in the foreign currency equal to the entire value of the loan taken from the foreign financial institution. The U.S. currency is then paid to the foreign company and the loan is paid off after a year, so as to avoid discharge of indebtedness income. This scheme lacks economic substance as it creates noneconomic losses to be used for tax benefits.[45]

The taxpayer in *Kerman* had been warned in the CARDS promotional materials "that tax losses from transactions similar to CARDS that are designed to produce noneconomic tax losses by artificially overstating basis are not allowable as deductions for Federal income tax purposes."[46] Relying in part on the copy of Notice 2000-44 the taxpayer received prior to engaging in the CARDS strategy, the court held that the taxpayer did not act with reasonable cause when entering into a transaction that lacked economic substance and was, therefore, a sham. Other courts besides the Tax Court have disallowed deductions resulting from this strategy and they impose accuracy-related penalties accordingly,[47] often times increasing the penalty to 40 percent for a gross misstatement penalty under IRC § 6662(h).[48]

Reliance on 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 or her reliance on tax advice was reasonable.[49] 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.[50]

44 713 F.3d 849 (6th Cir. 2013), *aff'g* T.C. Memo. 2011-54.

45 *See* IRS Notice 2000-44, 2000-2 C.B. 255 ("Taxpayers and their representatives are alerted that the purported losses arising from certain types of transactions are not properly allowable for federal income tax purposes."); IRS Notice 2002-21, 2002-1 C.B. 730 (where CARDS transactions are listed).

46 *Kerman*, 713 F.3d at 870.

47 *See Crispin v. Comm'r*, 708 F.3d 507 (3d Cir. 2013), *aff'g* T.C. Memo. 2012-70; *Gustashaw v. Comm'r*, 696 F.3d 1124 (11th Cir. 2012), *aff'g* T.C. Memo. 2011-195.

48 IRC § 6662(h) (an overstatement in the basis of property by 400 percent or more will be treated as a gross valuation misstatement, thus doubling the penalty from 20 to 40 percent of the underpayment of income tax).

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

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

Taxpayers argued their good faith reliance on a competent tax professional in several cases this year,[51] including *Meinhardt v. Commissioner*.[52] In *Meinhardt*, the IRS imposed an accuracy-related penalty for a substantial understatement of income tax resulting from a failure to substantiate business expense deductions. The taxpayers, having recognized their relative unfamiliarity with tax law, hired a practicing attorney to help them prepare their returns. Their attorney regularly handled tax returns in the community, and the taxpayers gave him all of the materials they thought were relevant to their tax return. Having established good faith reliance on a competent tax professional, the court declined to uphold the accuracy-related penalty.

In *Romanowski v. Commissioner*,[53] the IRS imposed an accuracy-related penalty on the taxpayers for income tax deficiencies related to the improper deduction of expenses of their horse-breeding activity. The Tax Court found that the horse-breeding activity was not engaged in for profit, and therefore disallowed the deductions.[54] The taxpayers, however, presented credible evidence of good faith reliance on a competent tax professional. The taxpayers were unsophisticated in the field of tax and they hired a "very experienced and highly accomplished accountant" and an "accomplished lawyer familiar with tax law," upon whose advice they relied.[55] The taxpayers were able to establish the three criteria above, and the court held they were not liable for any accuracy-related penalties.

In several cases, the taxpayer could not establish all three of the above-mentioned criteria. For example, in *Mills v. Commissioner*,[56] the taxpayers hired their tax preparer to advise whether the LLC they had formed could amortize the value of the husband's time and expertise in real estate management. The tax preparer was an accountant, but he was not a lawyer or a CPA. He was an enrolled agent who had passed a written examination administered by the IRS Office of Professional Responsibility, but his status became inactive while working with the taxpayers. At the time of trial, the tax preparer resided in a Colorado Federal penitentiary after stealing from clients' individual retirement accounts using forged power of attorney forms. As the taxpayers were not able to establish the competence of the tax preparer, they failed to meet the *Neonatology* test and were liable for an accuracy-related penalty.

There are many more examples of taxpayers' failure to establish the competence of their tax preparers.[57] While some taxpayers choose to use tax software to prepare their tax returns, the Tax Court does not find reliance on tax preparation software justifiable to avoid an accuracy-related penalty. In this regard, the Tax

51 *See, e.g., Cook v. Comm'r*, T.C. Memo. 2012-167 (finding the taxpayer reasonably relied on his CPA with respect to misplacement of commission expense on the wrong schedule for which the taxpayer provided proper documentation to his CPA; also finding the taxpayer failed to show that he had provided adequate documentation to his CPA for non-commission expenses and was, therefore, liable for an accuracy-related penalty for that portion of the underpayment in tax).

52 T.C. Memo. 2013-85.

53 T.C. Memo. 2013-55.

54 IRC § 183(a) ("In the case of an activity engaged in by an individual, … if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.").

55 *Romanowski*, T.C. Memo. 2013-55.

56 T.C. Memo. 2013-4.

57 *See, e.g., Yates v. Comm'r*, T.C. Memo. 2013-28, appeal filed (4th Cir. July 1, 2013) (holding taxpayers liable for an accuracy-related penalty because they offered no evidence concerning the expertise of their accountant); *Deutsch v. Comm'r*, T.C. Memo. 2012-318 (finding the taxpayer liable for an accuracy-related penalty because he failed to establish his CPA had adequate expertise). Taxpayers may have a difficult time demonstrating the competency of the majority of return preparers if the government is barred from regulating unenrolled preparers. *See Loving v. Internal Revenue Service*, 111 A.F.T.R.2d (RIA) 589 (D.D.C. 2013); Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 2013 TNT 92-31 (May 13, 2013).

Court has observed that "[t]he misuse of tax preparation software, even if unintentional or accidental, is no defense to accuracy-related penalties under section 6662." [58]

In *Bartlett v. Commissioner*,[59] the taxpayer admitted to underpayment of tax due to misreporting the amount of taxable pension benefits received. The taxpayer sought to avoid an accuracy-related penalty by claiming the underpayment was an "honest mistake" and that she believed that the tax preparation software would "catch any mistakes she otherwise might make."[60] The Tax Court found that the information the taxpayer had entered into the preparation software was incorrect, and the system was "only as good as the information entered into its software program."[61] The Tax Court found the taxpayer liable for an accuracy-related penalty as the mistakes were not made by the software, but by the taxpayer herself. Unless the taxpayer proves the software itself is flawed, the Tax Court is unlikely to accept reliance on tax preparation software as a justification to avoid an accuracy-related penalty.[62]

No Affirmative Defense Offered by the Taxpayer

Many litigants offered no affirmative defense for the understatement in tax, failing completely to claim the reasonable cause and good faith defense under IRC § 6664(c). In *Powers v. Commissioner*,[63] the taxpayers were negligent in keeping adequate books and records related to their telephone company. In addition, the taxpayers failed to report income and claimed deductions to which they were not entitled, which resulted in a substantial understatement of income tax. While the taxpayers claimed that their 44 years of tax compliance should be a significant factor in determining the existence of negligence, the court held that evidence of prior compliance with the Code was insufficient on its own to avoid the accuracy-related penalty.[64] The taxpayers failed to raise any affirmative defense and were, therefore, held liable for the penalty.

CONCLUSION

Of the 178 cases we reviewed, the courts upheld the underlying tax deficiency, or portions of the deficiency, determined by the IRS in all cases. In over a fifth of the cases, the courts abated the accuracy-related penalties, partially or in full, where the taxpayer showed a reasonable and good faith attempt to ascertain the correct amount of tax due. The courts most commonly found reasonable cause on the bases of maintenance of adequate records to substantiate deductions and reasonable reliance on a competent tax professional. Taxpayers should also be aware that they must raise an affirmative defense to the penalty in order to have a chance at avoiding liability for the penalty.

58 *See Langley v. Comm'r*, T.C. Memo. 2013-22, 2013 Tax Ct. Memo. LEXIS 22 at *10 (citations omitted).

59 T.C. Memo. 2012-254.

60 *Id*.

61 *Id*.

62 *See Morales v. Comm'r*, T.C. 2012-341.

63 T.C. Memo. 2013-134.

64 *Id*.

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 in the Annual Report. We identified 134 cases involving a trade or business expense issue that were litigated between June 1, 2012, and May 31, 2013. The courts affirmed the IRS position in the vast majority (approximately 74 percent) of cases, while taxpayers fully prevailed only about two percent of the time.[1] The remaining cases resulted in split decisions.

PRESENT LAW

Internal Revenue Code (IRC or the "Code") § 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. When a taxpayer seeks judicial review of the IRS's determination of a tax liability stemming from 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 § 162?

Although "trade or business" is one of the most widely used terms in the IRC, neither the Code nor the Treasury Regulations provide a definition.[2] The definition of a "trade or business" comes from common law, where the concepts have been developed and refined by the courts.[3] The Supreme Court has interpreted "trade or business" for purposes of IRC § 162 to mean an activity conducted with "continuity and regularity" and with the primary purpose of earning income or making profit.[4]

What is an ordinary and necessary expense?

IRC § 162(a) requires a trade or business expense to be both "ordinary" and "necessary" in relation to the taxpayer's trade or business in order to be deductible. In *Welch v. Helvering*, the Supreme Court stated that the words "ordinary" and "necessary" have different meanings, both of which must be satisfied for the taxpayer to benefit from the deduction.[5] The Supreme Court describes an "ordinary" expense

1 The IRS prevailed in full in 99 out of 134 cases, while taxpayers prevailed in full in only three cases.

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

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

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

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

as customary or usual and of common or frequent occurrence in the taxpayer's trade or business.[6] The Court describes a "necessary" expense as one that is appropriate and helpful for development of the business.[7]

Common law also requires that in addition to being ordinary and necessary, the amount of the expense must be reasonable for the expense to be deductible. In *Commissioner v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held "the element of reasonableness is inherent in the phrase 'ordinary and necessary.' Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount."[8]

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

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

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.[12]

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 Code also requires a taxpayer to maintain books and records that substantiate income, deductions, and credits — including adequate records to substantiate deductions claimed as trade or business expenses.[13] If a taxpayer 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 *Deputy v. du Pont*, 308 U.S. 488, 495 (1940) (citation omitted).

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

8 176 F.2d 815, 817 (6th Cir. 1949), *cert. denied,* 338 U.S. 949 (1950).

9 IRC § 162(a).

10 IRC § 263. *See also INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1950).

11 IRC § 167.

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

13 IRC § 6001. *See also* Treas. Reg. §§ 1.6001-1 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 Second Circuit in *Cohan v. Commissioner*.[14] The court held that the taxpayer's business expense deductions were not adequately substantiated, but stated that "the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent."[15]

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

1. Travel expenses;
2. Entertainment, amusement, or recreation expenses;
3. Gifts; and
4. Certain "listed property."[16]

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.[17]

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.[18] 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;
- Maintains all records required under the Code; and
- Cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.

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14 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 Second Circuit concluded that Cohan's testimony established that legitimate deductible expenses had been incurred. As a result, the Second Circuit remanded the case back to the Board of Tax Appeals with instructions to estimate the amount of deductible expenses.

15 *Id*. at 544 (2d Cir. 1930), *aff'g and remanding* 11 B.T.A. 743 (1928).

16 "Listed property" means any passenger automobile; any property used as a means of transportation; any property of a type generally used for purposes of entertainment, recreation, or amusement; any computer or peripheral equipment (except when used exclusively at a regular business establishment and owned or leased by the person operating such establishment); and any other property specified by regulations. IRC § 280F(d)(4)(A) and (B).

17 Treas. Reg. § 1.274-5T(b).

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

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.[19] This year, we reviewed 134 cases involving trade or business expenses issues that were litigated in federal courts from June 1, 2012, through May 31, 2013. Table 2 in Appendix III contains a list of the main issues in those cases. Table 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

Issue	Type of Taxpayer	
	Individual	Business (including sole proprietorships)
Substantiation of expenses, including application of the ***Cohan*** rule[1]	9	78
Profit objective[2]	0	19
Ordinary and necessary trade or business expenses[3]	0	34
Personal vs. business expenses[4]	4	26
Business expenses vs. capital expenditures[5]	0	1
Did the taxpayer establish the carrying on of a trade or business?	0	7
Gambling expenses[6]	1	0

Approximately 64 percent of the taxpayers litigating trade or business deduction issues represented themselves (*pro se*). However, those represented by counsel fared better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in approximately 33 percent of cases (16 of 48). By contrast, *pro se* taxpayers received full or partial relief in just 22 percent of cases (19 of 86).

19 *See* National Taxpayer Advocate 1998-2012 Annual Reports to Congress.

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

21 IRC § 183(a) provides the general rule that no deduction attributable to an activity engaged in by an individual or an S corporation shall be allowed if such activity is not engaged in for profit. Treas. Reg. § 1.183-2(b) provides the following nonexhaustive list of nine factors to consider in determining whether an activity is conducted for profit: (1) manner in which the taxpayer carries on the activity; (2) expertise of the taxpayer or his advisors; (3) time and effort expended by the taxpayer in carrying on the activity; (4) expectation that assets used in the activity may appreciate in value; (5) success of the taxpayer in carrying on similar or dissimilar activities; (6) taxpayer's history of income or losses with respect to the activity; (7) amount of occasional profits, if any, which are earned; (8) financial status of the taxpayer; and (9) elements of personal pleasure or recreation.

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

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

24 Under IRC § 263(a), generally no deduction is allowed for capital expenditures, where capital expenditures include any amount paid for permanent im¬provements made to increase the value of any property. Under IRC § 195(a), start-up expenditures generally cannot be deducted unless a taxpayer makes an expense/amortization election according to IRC § 195(b). Taxpayers who make the election may generally deduct up to $5,000 of start-up expenditures in the tax year in which an active trade or business begins and amortize any excess over 180 months. The $5,000 deduction is reduced by a dollar for every dollar that total start-up expenditures exceed $50,000. *See* IRC § 195(b)(1)(A), (B). (These amounts are increased to $10,000 and $60,000 for taxable years beginning in 2010. *See* IRC § 195(b)(3).)

25 IRC § 165(d) provides that "[l]osses from wagering transactions shall be allowed only to the extent of the gains from such transactions."

Individual Taxpayers

None of the 11 decisions involving individual taxpayers (where the term "individual" excludes a sole proprietorship) was issued as a regular opinion of the Tax Court.[26] Nine of the 11 individual taxpayers appeared *pro se*. No individual taxpayers received full relief, while only one earned a split decision; the court upheld the IRS position in ten of 11 cases (91 percent).

The most prevalent issue was the substantiation of claimed trade or business expense deductions, which appeared in nine cases. For example, in *Noz v. Commissioner*,[27] the Tax Court denied several claimed business expense deductions for failure to substantiate. The claimed deductions included travel expenses, meals and entertainment, and computer-related equipment. The taxpayers, two university professors, were unable to substantiate travel expenses for trips around the United States to give lectures in connection with their appointments as professors. The taxpayers provided no evidence as to the price of their plane tickets or the dates of their travel. As there was no evidence establishing the business purpose of the travel aside from the taxpayer's testimony, the court denied those deductions. It also denied expense deductions for meals and entertainment while traveling in the absence of evidence as to the cost, time and place of the meals, and the business purpose of the expenses. Deductions for computer equipment were also denied as there was no evidence indicating purchase price or purchase date.

The taxpayers, one of whom lived in Sweden while the other lived in New York, also sought to deduct travel expenses for trans-Atlantic travel. Because the court deemed this travel personal, rather than associated with a business purpose, it also denied those deductions. Because travel expenditures, meals and entertainment and listed property, such as computer equipment, are enumerated in IRC § 274(d), no deductions are allowed absent proper substantiation. As a result, the court could not invoke the *Cohan* rule.[28]

Business Taxpayers

We reviewed 123 cases involving business taxpayers, who had a far greater success rate than individual taxpayers. While individual taxpayers did not win a single case in full, splitting one case and losing ten of 11 others, business taxpayers received full or partial relief in approximately 28 percent of cases (34 of 123). Business taxpayers were represented by counsel in nearly half of the favorably decided cases (16 of 34) and in 34 percent of the cases that the IRS won (30 of 89).

26 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 significant. Finally, "S" case decisions (for disputes involving $50,000 or less) are not appealable and, thus, have no precedential value. *See* IRC § 7463(b). *See also* U.S. Tax Court Rule of Practice and Procedure, Rules 170-175. With respect to the cases we reviewed this year, more than half the cases involving individual taxpayers (excluding sole proprietorships) were "S" cases.

27 T.C. Memo. 2012-272.

28 There were other examples of individual taxpayers who failed to substantiate claimed business expense deductions. *See, e.g., Harris v. Comm'r*, T.C. Memo. 2012-312 (holding deductions were improper for unreimbursed employee expenses related to lodging, meals and vehicle mileage for failure to substantiate).

As with the individual taxpayers, substantiation of expenses was by far the most prevalent issue,[29] and in most instances, the court denied the business taxpayers' deductions for failure to substantiate.[30] Courts did, however, allow some of these deductions when the taxpayer produced sufficient evidence.[31] 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.[32] IRC § 274(d), however, makes the *Cohan* rule unavailable in certain circumstances in which the taxpayer must substantiate the deductions.

Another common difficulty was the failure to prove that expenses were ordinary and necessary to the taxpayer's business. For example, in *Curcio v. Commissioner*,[33] the taxpayers sought to deduct contributions to life insurance plans for employees, but because they failed to prove this was an ordinary and necessary business expense, the court denied the deduction. The court discussed the possibility that employee incentive programs, such as those involving contributions to life insurance plans, could be made primarily in furtherance of a profit objective, and, therefore, may be eligible as an ordinary and necessary business expense. In *Curcio*, however, the life insurance plans covered only four principal owners and the owner's stepson, and the court consequently ruled the payments were not "normal, useful, or helpful for the development of the taxpayer's business, and were not made in furtherance of a profit objective or for any viable business purpose, but rather, were a mechanism by which taxpayers could divert company profits." [34] As the expense was not ordinary and necessary to the taxpayer's business, it was not deductible as a trade or business expense pursuant to IRC § 162(a).[35]

In *Consolidated Edison Co. of NY, Inc. v. United States,*[36] the United States Court of Appeals for the Federal Circuit, reversing the Court of Federal Claims, disallowed certain business expense deductions that the taxpayer took in connection with a leasing arrangement. The taxpayer claimed on its tax return multiple deductions pertaining to a lease-in/lease-out ("LILO") tax shelter transaction in which it leased property from a foreign company, not subject to U.S. taxation, and subleased the property immediately back to the foreign entity. The tax scheme is designed to accelerate losses to the taxpayer and defer gains, thereby taking advantage of the time value of money by delaying tax payments.

29 Substantiation of expenses was at issue in 78 out of 123 cases (63 percent) involving business taxpayers.

30 *See Schoppe v. Comm'r*, 711 F.3d 1190 (10th Cir. 2013), *aff'g* T.C. Memo 2012-153 (deduction denied for real estate practice expenses for failure to substantiate), *Christine v. Comm'r*, 475 F. App'x 259 (9th Cir. 2012), *aff'g* T.C. Memo 2010-144 (deduction denied for failure to substantiate), *MacGregor v. Comm'r*, 501 F. App'x 663 (9th Cir. 2012), *aff'g* T.C. Memo 2010-187 (deduction denied for marketing expenses for failure to substantiate expenses), *Natkunanathan v. Comm'r*, 479 F. App'x 775 (9th Cir. 2012), *aff'g* T.C. Memo 2010-15 (deduction for business expenses denied for failure to substantiate).

31 *See Striefel v. Comm'r*, T.C. Memo. 2013-102 (deduction allowed for lodging and meal expenses to the extent substantiated; deduction denied for failure to meet strict substantiation requirement for car and truck expenses), *Longino v. Comm'r*, T.C. Memo. 2013-80 (deduction allowed for utility and extermination expense in personal residence to extent substantiated as held exclusively for business purposes).

32 *See Bauer v. Comm'r*, T.C. Memo. 2012-156 (deduction allowed under *Cohan* for contract labor expenditures).

33 689 F.3d 217 (2d Cir. 2012), *aff'g* T.C. Memo. 2010-115.

34 *Id*. at 226.

35 *See* IRC § 162(a)(3) (There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including … rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property …"). For other examples of cases examined in which the court denied deductions for failure to prove the expense was ordinary and necessary in business, see *DiDonado v. Comm'r*, T.C. Memo. 2013-11 (deduction denied for firearm expense for failure to prove ordinary and necessary in business), *Abarca v. Comm'r*, T.C. Memo. 2012-245 (deduction denied for car and truck rental expenses for failure to prove ordinary and necessary in business).

36 703 F.3d 1367 (Fed. Cir. 2013), *rev'g* 90 Fed.Cl. 228 (2009).

Applying the substance-over-form doctrine,[37] the United States Court of Appeals for the Federal Circuit disallowed the deductions because "there was a reasonable likelihood that the tax-indifferent entity in the LILO Transaction (the lessor of the master lease) would exercise its purchase option at the conclusion of the ConEd sublease, thus rendering the master lease illusory."[38] Accordingly the court ruled the deductions were not properly allowable under IRC § 162(a)(3).

Taxpayers were also denied business expense deductions when the courts found the expenses related to personal, rather than business, activities[39] pursuant to § 262(a).[40] To illustrate, the taxpayers in *Robinson v. Commissioner*[41] sought to deduct expenses for vehicle use and travel, but the court held the expenses were personal and, therefore, not eligible for deduction under § 162. The taxpayers deducted expenditures for family trips to Disneyland and Disney World, hotel stays, airfare, and retail merchandise, claiming the family took trips and visited tourist sites for business purposes. The husband, a professor at Temple University, also claimed a deduction for the business use of his car in travel to and from the university. Although he taught for relatively few days at Temple, he deducted expenses corresponding to tens of thousands of miles traveled. The taxpayers also deducted expenses related to the personal use of their home office, including the use of a cellular phone and computer. As the taxpayers failed to present any evidence establishing the business use of any of these expenses, they were denied as business expense deductions. Additionally, the taxpayers failed to demonstrate that their expenses were related to a business purpose and were not primarily personal.

Courts generally upheld the IRS's determination that the business expense deductions were not attributable to an activity that was engaged in for profit within the meaning of § 183.[42] In *DKD Enterprises v. Commissioner*,[43] the taxpayers sought to deduct expenses related to a cat breeding activity. The taxpayers claimed that they intended to operate the activity for profit, and they entered their kittens in several national tournaments. The kittens were valued from $1,000-$5,000, and the owners won four national championships in two years. The taxpayers operated a website for marketing the kittens, and did earn some income from sales during the years in question. However, the Eighth Circuit Court of Appeals held the taxpayers had not engaged in cat breeding for profit. In doing so, the court noted that it "should find the trade or business venture lacked a genuine profit motive only if the court finds, as a factual matter, the taxpayer lacked a good-faith, subjective intention to make a profit and was engaged in the activity for wholly different reasons."[44] The expenses related to the activity, therefore, were not deductible.

37 The Court of Appeals for the Federal Circuit followed the substance-over-form doctrine it articulated in *Wells Fargo & Co. v. U.S.*, 641 F.3d 1319 (Fed. Cir. 2011) (the tax consequences of a transaction are based on the substance of the transaction rather than its legal form).

38 *Consolidated Edison Co.*, 703 F.3d at 1369.

39 *See, e.g., Sernett v. Comm'r*, T.C. Memo. 2012-334 (deduction denied because expenses related to sprint car racing activity were personal), *Johnson v. Comm'r*, T.C. Memo. 2012-231 (deduction denied because expenses related to drag racing activity were personal).

40 *See supra*, note 23.

41 487 F. App'x 751 (3d Cir. 2012), *aff'g* T.C. Memo. 2011-99.

42 *See, e.g., Pederson v. Comm'r*, T.C. Memo. 2013-54 (deduction denied for horse breeding activity for failure to show engaged in for profit under § 183).

43 685 F.3d 730 (8th Cir. 2012), *aff'g* T.C. Memo. 2011-29.

44 *Id*.

The taxpayers in *Romanowski v. Commissioner*[45] sought to deduct expenses related to their horse breeding activity under IRC § 162(a), but the Tax Court denied the deduction because the activity was not engaged in for profit pursuant to § 183. In upholding the IRS's disallowance of the deductions, the court ultimately determined the enterprise was not conducted for profit under the nine factors of Treasury Regulation § 1.183-2(b).[46] Even though the married taxpayers were not motivated exclusively by recreational elements, the court still found the activity was not engaged in for profit since:

- The taxpayers did not conduct the activity in a businesslike manner;
- They lacked expertise in the industry;
- The activity was never profitable; and
- The taxpayers lacked reasonable belief that it would be profitable.

CONCLUSION

Taxpayers continue to challenge the IRS's denials of trade or business deductions. From June 1, 2012, through May 31, 2013, those represented by counsel fared better than those who represented themselves in these cases. Represented taxpayers prevailed in full or in part in 33 percent (16 of 48) of the cases while the IRS's denials were upheld in 78 percent (67 of 86) of cases in which the taxpayers appeared *pro se*. The courts generally favored the IRS's denial of business expense deductions, but specific facts and circumstances yielded some victories for taxpayers. The definition of an allowable business expense, therefore, remains open to interpretation and is highly fact-specific.

It appears that many individual taxpayers remain confused over the Code's requirements, especially with respect to IRC § 274(d) related to strict substantiation of listed items. Several additional cases dealt with whether an activity was engaged in for profit. The courts, relying on Treas. Reg. § 1.183-2(b) and the nine factors there provided, found that the activity was not engaged in for profit and sustained the IRS's position. Given the relative frequency of hobby loss litigation, we recommend that the IRS highlight the available hobby loss guidance on its website and undertake additional efforts to educate taxpayers and tax preparers through news releases and similar outreach. Through education, outreach, and collaboration with stakeholders, the IRS can help taxpayers understand what trade or business deductions are allowable and how best to substantiate them.

45 T.C. Memo. 2013-55.

46 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.

MLI #3 Gross Income Under IRC § 61 and Related Sections

SUMMARY

When preparing tax returns, taxpayers must report gross income for the taxable year to determine the tax they must pay. The reporting of gross income has been among the most litigated issues in each of the National Taxpayer Advocate's Annual Report to Congress.[1] For this report, we analyzed 117 cases decided between June 1, 2012, and May 31, 2013. The majority of cases this year 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]

PRESENT LAW

IRC § 61 broadly defines gross income as "all income from whatever source derived."[6] The U.S. Supreme Court has defined gross income as any accession to wealth.[7] However, over time, Congress has carved out numerous exceptions to and exclusions from this broad definition and has based other elements of tax law on the definition.[8]

The Commissioner may identify particular items of unreported income or reconstruct a taxpayer's gross income using methods such as the bank deposits method.[9] If the Commissioner determines a tax deficiency, the IRS issues a Statutory Notice of Deficiency.[10] If the taxpayer challenges the deficiency, the Commissioner's notice is entitled to a presumption of correctness; the taxpayer bears the burden of proving that the determination is erroneous or inaccurate.[11]

ANALYSIS OF LITIGATED CASES

In the 117 opinions 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 all cases analyzed appears in Table 3 of Appendix III.

1 *See, e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress 637-642; National Taxpayer Advocate 2011 Annual Report to Congress 619-625.

2 Internal Revenue Code (IRC) § 61(a)(1). *See, e.g., Garber v. Comm'r*, 500 F. App'x 540 (7th Cir. 2013), *reh'g denied*, 2013 U.S. App. LEXIS 10454 (7th Cir. May 9, 2013), *aff'g* T.C. Memo. 2012-47.

3 IRC § 61(a)(4). *See, e.g., Cox v. Comm'r*, T.C. Memo. 2013-75.

4 IRC § 61(a)(7). *See, e.g., Clayton v. Comm'r*, T.C. Memo. 2012-188, *appeal docketed*, No. 12-73904 (9th Cir. Nov. 28, 2012).

5 IRC § 61(a)(9). *See, e.g., Buckardt v. Comm'r*, 474 F. App'x 612 (9th Cir. 2012), *aff'g* T.C. Memo. 2010-145.

6 IRC § 61(a).

7 *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431-33 (1955) (interpreting § 22 of the Internal Revenue Code of 1939, the predecessor to IRC § 61).

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

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

10 Internal Revenue Manual (IRM) 4.8.9.2 (July 9, 2013).

11 *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).

In 46 cases (more than 39 percent), taxpayers were represented, while the rest appeared *pro se* (without representation). Five of the 46 represented taxpayers (about 11 percent) prevailed in full or in part in their cases. Twelve of the 71 *pro se* taxpayers (almost 17 percent) prevailed in full or in part. Overall, taxpayers prevailed in full or in part in 17 of 117 cases (almost 15 percent).

Drawing on the full list in Table 3 of Appendix III, we have chosen to discuss cases involving damage awards, retirement distributions, discharge of indebtedness, and partnership income, as those issues were some of the most commonly litigated.

Damage Awards

When a damage award is received, the nature of the claim that was the basis for the settlement determines whether the proceeds are excludible from gross income.[12] In six of the cases we reviewed, the taxpayers challenged the inclusion of damage awards in gross income, and the IRS won every case.

IRC § 104(a)(2) specifies that damage awards (and settlement proceeds[13]) for injuries or sickness are taxable as gross income unless the amount was received "on account of personal physical injuries or physical sickness."[14] Congress added the "physical injury or physical sickness" requirement in 1996.[15] The legislative history of the 1996 amendments to IRC §104(a)(2) states that "[if] 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."[16]

Thus, a court cannot consider damage awards for emotional distress to be excludible from income, even if the emotional distress has resulted in "insomnia, headaches, [or] stomach disorders."[17] Note, however, that "[t]he injury need not be defined as a tort under state or common law."[18]

In five cases, the taxpayers argued that their damage awards compensated, in whole or in part, for personal physical injuries or personal sickness, and the IRS won every case. For example, in *Blackwood v. Commissioner*, the taxpayers (husband and wife) alleged the termination of the wife's employment exacerbated her depression, resulting in numerous symptoms, including insomnia, migraines, and nausea.[19] The wife alleged wrongful termination, which resulted in her former employer awarding her $100,000 in a settlement agreement. The taxpayers did not report the award on their joint return, relying on *Domeny v. Commissioner*[20] to argue that the flare-up of the wife's symptoms was a physical sickness under IRC § 104(a)(2).[21] In *Domeny*, the taxpayer's multiple sclerosis caused vertigo, shooting pain in her legs, and

12 IRC § 104(a); *Comm'r v. Schleier*, 515 U.S. 323, 329-30 (1995).

13 *See* Treas. Reg. § 1.104-1(c)(1) (damages received, for purposes of IRC § 104(a)(2), "means an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution").

14 IRC § 104(a)(2).

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

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

17 H.R. Conf. Rep. No. 104-737, at 301 (1996). The exclusion does apply to damages received as reimbursement for amounts paid for medical care attributable to emotional distress for which deductions are allowed under IRC § 213. IRC § 104(a)(2)

18 Treas. Reg. § 1.104-1(c)(2).

19 T.C. Memo. 2012-190, *appeal filed* (4th Cir. Jan. 17, 2013).

20 T.C. Memo. 2010-9.

21 T.C. Memo. 2012-190.

difficulty walking due to numbness in her feet.[22] The Tax Court distinguished *Domeny* because Mrs. Blackwood's symptoms were not as severe as those Ms. Domeny suffered.[23]

Specifically, five of the eight symptoms that Mrs. Blackwood alleged at trial were very similar to the non-exclusive list of emotional distress symptoms in the legislative history of § 104(a).[24] In addition, unlike the facts at issue in *Domeny*, a medical doctor did not diagnose Mrs. Blackwood's illness. Consequently, the court concluded that Mrs. Blackwood's depression and corresponding physical symptoms were not physical injuries or sickness, and that the damage award was not excludible from gross income.[25]

Damage awards may also be excluded from gross income under common law doctrines. For instance, courts have ruled that settlement proceeds representing a return of capital, rather than lost profits, are excludible from gross income.[26] To determine whether a damage award is taxable, the court will ask, "[i]n lieu of what were the damages awarded?"[27]

In *Cung v. Commissioner,*[28] the taxpayer viewed an online advertisement, listing a vehicle for a discounted price. When the taxpayer attempted to purchase the vehicle, the dealer said it would not honor the advertised price.[29] The taxpayer filed suit alleging breach of contract and other various violations of statutory law. The taxpayer and the dealer reached a settlement, which he excluded from his gross income, claiming "the award represented compensation to offset a loss."[30] However, the taxpayer had sought specific performance, compensatory damages, and punitive damages, and the settlement agreement was silent as to the allocation of the award.[31] The court ruled that the taxpayer "failed to carry his burden of showing that the proceeds represent what he claims they represent, lost value."[32] Moreover, because the taxpayer never owned the vehicle, the court ruled that there was no sale or exchange from which to determine lost value.[33]

IRA Distributions

IRC § 61(a) defines gross income as "all income from whatever source derived, including (but not limited to)… (9) Annuities; … and (11) Pensions."[34] IRC § 408(d)(1) governs the tax treatment of distributions from individual retirement accounts (IRAs), and provides that they are included in gross income as amounts received as an annuity under IRC § 72.

22 T.C. Memo. 2010-9.

23 T.C. Memo. 2012-190.

24 *Id*. (*citing* H.R. Conf. Rept. No. 104-737, at 301 n.56 (emotional distress includes symptoms such as "*e.g.*, insomnia, headaches, stomach disorders")).

25 T.C. Memo. 2012-190.

26 *See, e.g., Milenbach v. Comm'r*, 318 F.3d 924, 933 (9th Cir. 2003) (citations omitted), *aff'g* 106 T.C. 184 (1996).

27 *Milenbach v. Comm'r*, 318 F.3d 924, 932 (9th Cir. 2003) (quotations omitted), *aff'g* 106 T.C. 184 (1996).

28 T.C. Memo. 2013-81.

29 *Id*.

30 *Id*.

31 *Id*.

32 *Id*. (*citing* Milenbach, 318 F.3d at 933).

33 T.C. Memo. 2013-81.

34 IRC § 61(a).

Taxpayers in at least eight cases argued that a portion of their IRA distributions were excluded from gross income, and a taxpayer prevailed in part in only one case. For example, in *Bernard v. Commissioner*, the taxpayers (husband and wife) mischaracterized IRA distributions as proceeds of sale instead of ordinary income.[35] The taxpayers argued that because capital gains within their IRAs increased the cost basis in the accounts, they were entitled to report part of the distributions as return of capital not subject to tax, and part as long-term capital gains, which are taxed at a lower rate than ordinary income.[36] The court corrected the taxpayer by stating, "Gains within IRAs are not taxed, but accumulated income included in distributions is taxed in accordance with the provisions of section 408(d)."[37] In other words, the entire IRA distribution is generally taxable as ordinary income unless part of it represents a return of nondeductible contributions to the account, or the taxpayer transfers the funds into a qualified retirement account. Consequently, the taxpayers had to include their IRA distributions in gross income.

At least five taxpayers challenged the taxability of their IRA distributions arguing the "rollover provision" under § 408(d) applied. The "rollover provision" generally excludes from gross income IRA distributions that are transferred into an eligible retirement account within 60 days of receipt.[38] For example, in *Phillips v. Commissioner*, the taxpayer withdrew funds from an IRA, and elected to transfer the funds to a savings account rather than a qualified retirement account or IRA.[39] The taxpayer claimed the amount of the distribution was not includible in gross income because he merely made an error in rolling over the funds.[40] Because the taxpayer did not transfer the funds into a qualified retirement account once he discovered his mistake, he did not meet his burden of proving he took "every reasonable expected step" in making a rollover contribution to a qualified retirement account.[41]

Discharge of Indebtedness

We reviewed eight cases in which taxpayers disputed the IRS's determination that a discharge of indebtedness was taxable income, and in four cases taxpayers prevailed in full or in part. A taxpayer's gross income generally includes income from any discharge of indebtedness.[42] Under certain circumstances, however, a taxpayer can exclude the amount of discharged indebtedness from gross income. In this regard, IRC § 108(a) provides, subject to limitation, that a taxpayer may exclude income from the discharge of indebtedness if the discharge occurs in bankruptcy, when the taxpayer is insolvent, if the indebtedness is qualified farm or business real estate debt, or if the indebtedness is qualified principal residence indebtedness discharged before January 1, 2014.[43] The creditor issues a Form 1099-C, *Cancellation of Debt*, to the taxpayer for cancelled debts of $600 or more.[44] If a creditor has discharged a debt the taxpayer owes, the taxpayer must include the discharged amount in gross income, even if it is less than $600, unless one of the exceptions in IRC § 108(a) applies. The issuance of a Form 1099-C is not dispositive of whether or

35 T.C. Memo. 2012-221.
36 *Id*.
37 *Id*.
38 IRC § 408(d)(3)(A)(i), (ii); *Schoof v. Comm'r*, 110 T.C. 1, 7 (1998).
39 T.C. Memo. 2013-42.
40 *Id*.
41 *Id*. (*citing Wood v. Comm'r*, 93 T.C. 114, 115-18 (1989)).
42 IRC § 61(a)(12).
43 IRC § 108(a)(1)(A)-(E).
44 IRS, Instruction for Forms 1099-A and 1099-C, *Acquisition or Abandonment of Secured Property and Cancellation of Debt* (2013).

when the debt is discharged.[45] A debt is deemed to have been discharged, and Form 1099-C is required, if (and only if) an "identifiable event" has occurred.[46]

In *Pinn v. Commissioner*, the taxpayers (brothers) each received loans from a trust secured by the cash values of their death benefits sufficient to cover the loans.[47] The taxpayers defaulted on the loans but the trust did not cancel the loans or consider them uncollectible.[48] The Commissioner argued the balances of the loans were discharged indebtedness because the taxpayers failed to pay the loans when due and the taxpayers' rights to the death benefit were too contingent to be a sufficient form of collateral.[49] While the court recognized that the death benefits were contingent on certain future events, their usefulness as collateral for the loans was still sufficient.[50] The court held the Commissioner was premature in asserting income from the discharged debts because future events to divest the collateral from the taxpayers had not occurred.[51] Therefore, the "identifiable event" had yet to occur, and the taxpayers' defaulted loans did not result in a discharge of indebtedness includible in their gross incomes.[52]

Another exception to the inclusion of discharge of indebtedness income is taxpayer insolvency at the time of the discharge.[53] The amount of gross income excluded cannot exceed the amount by which the taxpayer is insolvent.[54] The amount by which the taxpayer is insolvent is defined as the excess of liabilities over the fair market value of the taxpayer's assets immediately before the discharge.[55]

In *McAllister v. Commissioner*[56], the Commissioner argued that the amount shown on a Form 1099-MISC the taxpayer received from his former employer was fully includible in gross income as nonemployee compensation, rather than income from the cancellation of a loan extended by the employer. The court determined that the 1099-MISC memorialized the forgiveness of the debt, and analyzed whether the taxpayer's gross income should be reduced due to insolvency.[57] The court generally accepted the taxpayer's valuation of his assets and liabilities, except for the value of two real properties he owned in different states.[58] The taxpayer valued one of the properties based on a comparable sale in the same neighborhood, and another based on the local property tax assessment.[59] In both instances, the court held the taxpayer did not meet his burden of proving his valuation, and valued each property based on the taxpayer's purchase price.[60] Thus, the court's property values for insolvency purposes were greater than the amount

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

46 Treas. Reg. § 1.6050P-1(a)(1), (b)(2)(i)(A)-(H) (describing different scenarios that signify when an "identifiable event" has occurred). *See also Friedman v. Comm'r*, 216 F.3d 537, 547-49 (6th Cir. 2000), *aff'g* T.C. Memo. 1998-196.

47 T.C. Memo. 2013-45.

48 T.C. Memo. 2013-45. The IRS learned of the default when the trust listed the loans as in default on an information return it filed with the IRS.

49 *Id*.

50 *Id*.

51 *Id*.

52 *Id*.

53 IRC § 108(a)(1)(B).

54 IRC § 108(a)(1)(3).

55 IRC § 108(d)(3).

56 T.C. Memo. 2013-96.

57 *Id*.

58 T.C. Memo. 2013-96.

59 *Id*.

60 *Id*.

the taxpayer claimed in his insolvency argument. Consequently, the taxpayer was only entitled to exclude from gross income a portion of the amount shown on the Form 1099-MISC.

Partnership Income

A partnership's income is not taxed at the entity level, but generally is reported on the partners' individual income tax returns.[61] Partners recognize "pass-through" income from the partnership equal to their distributive shares of the partnership items.[62] The partner's adjusted basis in his or her interest in the partnership equals the amount of his or her cash contributions plus the basis of other contributed property, and the basis is increased by the partners' distributive share of partnership income and decreased by distributions and losses.[63] Partners generally do not recognize gain or income on partnership distributions except to the extent that the distribution exceeds the partner's adjusted basis in the partnership interest immediately before the distribution.[64]

In *Cvancara v. Commissioner*, the taxpayers (husband and wife) formed a partnership to operate a private elementary school.[65] Two of the taxpayers' children were enrolled in the school,[66] and the taxpayers continuously made contributions to the partnership during the time their children were enrolled.[67] The Commissioner challenged certain of the Cvancaras' claimed deductions for partnership losses on the grounds that they had insufficient bases in their partnership interests.[68] The taxpayers argued that the amounts they contributed to the partnership were capital contributions and had properly increased their interests' bases. The Commissioner argued that the amounts should be recast as tuition payments and should not augment the partnership interests' bases. The court held that the taxpayers' payments constituted capital contributions because the school needed operating capital and the taxpayers did not make payments in anticipation of receiving a benefit from the school.[69] As a result, the payments increased the taxpayers' bases in their partnership interests and the court allowed the taxpayers' claimed losses.

Accounting Method

If the IRS determines that a method of accounting "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."[70] Under the cash receipts and disbursements method (cash method), all items that constitute gross income shall be reported in the taxable year in which they were actually or constructively received.[71] On the other hand, under the accrual method, income must be reported in the taxable year when all the events have occurred that fix the right to receive the income and the amount of income can be determined

61 IRC § 701.
62 IRC § 702(a).
63 IRC §§ 705, 722.
64 IRC § 731(a)(1).
65 *Cvancara v. Comm'r*, T.C. Memo. 2013-20.
66 *Id*.
67 *Id*.
68 *See* IRC § 704(d) (partner's distributive share of a partnership loss allowed only to the extent of the partner's adjusted basis in the partnership).
69 T.C. Memo. 2013-20.
70 IRC § 446(b).
71 Treas. Reg. §1.446-1(c)(1)(i).

with reasonable accuracy.[72] Unlike the cash method, income realized under the accrual method may or may not be recognized in the year of receipt.

Another issue litigated in *Cvancara v. Commissioner, supra,* was whether the partnership employed the proper accounting method to reflect its income. The partnership received advance payments for tuition whose recognition it deferred until the subsequent year under the accrual method.[73] The Tax Court held that the partnership had properly elected the accrual method and properly deferred reporting the advance payments. The Commissioner contended that the partnership's use of the cash method for expenses showed the accrual method was not in fact in use. The court held that since the Commissioner had not exercised his discretion to require the partnership to change to the cash method, its finding that the partnership had adopted the accrual method was dispositive and that the partnership's "purported use of the cash method to calculate its expenses [did] not alter our conclusions."[74] Consequently, the partnership was entitled to use the accrual method of accounting and the taxpayers reported their share of the partnership income in the correct year.

CONCLUSION

Taxpayers litigate many of the same issues regarding gross income year after year, due to the complex nature of what constitutes gross income. Over the years, the courts have consistently interpreted gross income broadly and construed exclusions and exceptions narrowly. Most cases considering the inclusion of income under IRC § 61 were decided for the IRS. A major source of gross income litigation again this year was the inclusion of damage awards. However, the number declined from ten such cases litigated last year down to six this year. Notwithstanding this decrease, all taxpayers that challenged the inclusion of their damage award in gross income were overruled by the courts just as they were last year. 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.

Another source of litigation this year was disputes about the classification of IRA distributions. This litigated matter increased from only two cases last year to eight this year. Out of those cases, five taxpayers litigated the rollover provision of IRC § 408. The court upheld the Commissioner's determination, and ordered partial relief in one case.

Taxpayers litigated eight discharge of indebtedness income cases, and prevailed, in whole or in part, in half of those cases. We anticipate an increase in discharge of indebtedness cases particularly with respect to the insolvency exception in the future because of the expiration of qualified principal residence indebtedness exclusion under IRC § 108(a)(1) on January 1, 2014.

72 Treas. Reg. §1.446-1(c)(1)(ii).

73 T.C. Memo. 2013-20. The payments were made in 2005 and 2006, but were tuition payments for 2006 and 2007, respectively.

74 *Id*.

MLI #4

Summons Enforcement Under IRC §§ 7602, 7604, and 7609

SUMMARY

Pursuant to 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 section 7602 neglects or refuses to obey the summons, or 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 pertaining to summons enforcement. 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]

We identified 117 federal cases decided between June 1, 2012, and May 31, 2013, that included issues of IRS summons enforcement. In 80 cases, the government initiated the litigation by filing a petition to enforce the summons. In 37 cases, the taxpayer or a third party initiated the litigation by filing a motion to quash the summons. Of the 117 cases, the parties contesting the summonses prevailed fully in four cases, with two other cases resulting in split decisions. The IRS prevailed in full in the remaining 111 decisions. Of the 117 cases, 56 included a discussion of the law and interaction between the taxpayer and the government.[7] Of these 56 cases, the parties contesting the summonses prevailed fully in four cases, with two other cases resulting in split decisions. The IRS prevailed in the remaining 50 cases.

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.[8] 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

1 Internal Revenue Code (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 These 56 cases do not include cases for which there was reported solely (1) an order to show why the case should not be decided on the basis of the government's allegations once the government established a *prima facie* case; (2) an order to obey a summons; or (3) a dismissal for failure to prosecute.

8 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, 145-146 (1975)).

or other person identified in the summons.[9] 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.[10] However, the IRS cannot issue a summons after referring the matter to the Department of Justice (DOJ).[11]

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.[12] If the United States files a petition to enforce the summons, the taxpayer may contest the validity of the summons in that proceeding.[13] 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.[14]

A taxpayer or other person named in a third-party summons is generally entitled to notice,[15] but exceptions may apply. 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."[16] This exception reflects congressional recognition of 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, notice to the taxpayer or person named in the summons is not required where the IRS 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.[17] The courts have interpreted this "aid in collection" exception to apply only where the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned.[18] Another situation in which notice is not required is when an IRS criminal investigator serves a summons, in connection with a criminal investigation, on any person who is not the third-party record-keeper.[19]

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9 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).

10 IRC § 7609(f). 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).

11 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).

12 IRC § 7604.

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

14 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).

15 IRC § 7609(a)(1); *Shaw v. U.S.*, 109 A.F.T.R.2d (RIA) 1333 (M.D. Fla. 2012), *adopted by* 109 A.F.T.R.2d (RIA) 2364 (M.D. Fla. 2012), *affirmed by* 111 A.F.T.R.2d (RIA) 1754 (11th Cir. 2013).

16 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).

17 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 371-371, *reprinted* in 1976 U.S.C.C.A.N. at 3800-01 (containing essentially the same language).

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

19 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).

Regardless of 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.[20] 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:

- The investigation must be conducted for a legitimate purpose;
- The information sought must be relevant to that purpose;
- The IRS must not already possess the information; and
- All required administrative steps must have been taken.[21]

The IRS bears the initial burden of establishing that these requirements have been satisfied.[22] However, this burden is minimal, as the government need only introduce a sworn affidavit of the agent who issued the summons declaring that each of the *Powell* requirements has been satisfied.[23] 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.[24]

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

- Attorney-client privilege;[25]
- Tax practitioner privilege;[26] or
- Work product privilege.[27]

However, these privileges are limited. For example, the attorney-client privilege protects "tax advice," but not tax return preparation materials.[28] 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.[29] 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" that is "in

20 *Villarreal v. U.S.*, 111 A.F.T.R.2d (RIA) 778 (D. Nev. 2013), *aff'g* 110 A.F.T.R.2d (RIA) 6777 (D. Colo. 2012).

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

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

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

24 *Id*.

25 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 John Henry Wigmore, *Evidence in Trials at Common Law* § 2292 (John T. McNaughten rev. 1961)).

26 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, 810-812 (7th Cir. 2003), *cert. denied, Roes v. U.S.*, 540 U.S. 1178 (2004).

27 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).

28 *U.S. v. Frederick*, 182 F.3d 496, 500 (7th Cir. 1999), *cert. denied*, 528 U.S. 1154 (2000).

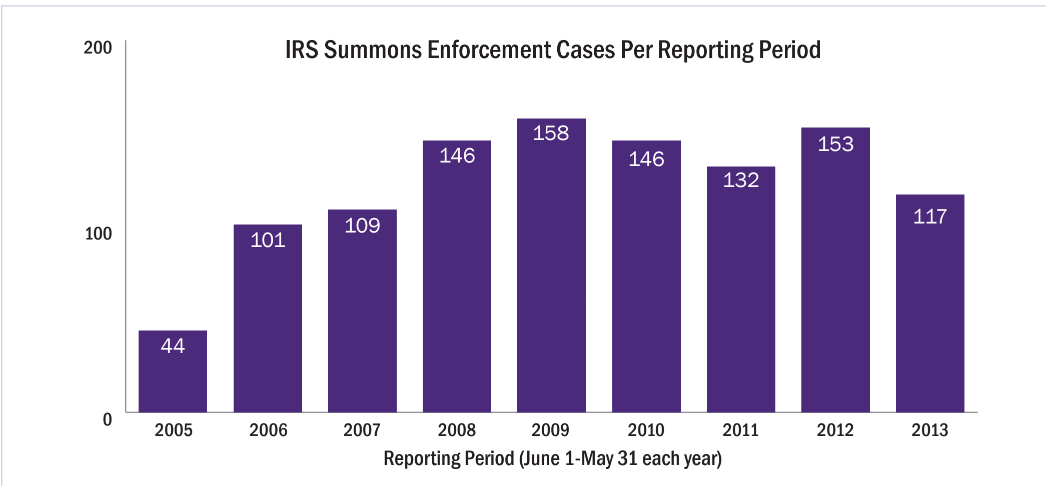
29 IRC § 7525(b); *Valero Energy Corp. v. U.S.*, 569 F.3d 626 (7th Cir. 2009).

connection with the promotion of the direct or indirect participation of the person in any tax shelter."[30] A tax shelter is defined as "a partnership or any other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."[31]

ANALYSIS OF LITIGATED CASES

Summons enforcement has appeared as a Most Litigated Issue in the National Taxpayer Advocate's Annual Report to Congress every year since 2005. In 2005, we identified only 44 cases but predicted the number would rise as the IRS became more aggressive in its enforcement initiatives. The volume of identified cases rose to 101 during the reporting period ending on May 31, 2006, peaked at 158 cases for the reporting period ending on May 31, 2009, and stands at 117 during this year's reporting period as shown in Figure 3.1.1 below. A detailed list of these cases appears in Table 4 of Appendix III.

FIGURE 3.4.1, SUMMONS ENFORCEMENT CASES, 2005-2013



The IRS recently issued guidance that requires examiners, when they do not receive information they request from a taxpayer, to issue delinquency notices followed by a pre-summons letter, and to then proceed to issue a summons.[32] The National Taxpayer Advocate is concerned about the increased use of summons the guidance is likely to trigger, and will scrutinize such use to determine whether it is appropriate and necessary.

Of the 117 cases we reviewed this year, the IRS prevailed in full in 111 cases. Taxpayers were represented in 26 cases and appeared *pro se (i.e.*, on their own behalf) in 91 cases. Eighty-eight cases involved individual taxpayers, while the remaining 29 involved business taxpayers, including sole proprietorships (16 of whom appeared through a representative). There were 56 cases where the taxpayer or a third party actually appeared in the proceeding, and the court issued an opinion discussing the law. Of these 56 cases, the IRS prevailed in full in 50 cases. The parties contesting the summonses prevailed fully in four

30 IRC § 7525(b).

31 IRC § 6662(d)(2)(C)(ii).

32 LB&I directive LB&I-04-1113-009, 2013 Tax Notes Today 214-19 (Nov. 5, 2013).

cases with two others ending in split decisions. Taxpayers were represented in 22 cases and appeared *pro se* in 34 cases. Thirty-six cases involved individual taxpayers, while the remaining 20 involved business taxpayers, including sole proprietorships (14 of whom appeared through a representative). The arguments the litigants raised against IRS summonses generally fell into the following categories:

***Powell* Requirements:** Taxpayers frequently argued that the IRS did not meet one or more of the *Powell* requirements, but such arguments met with little success. This outcome is due in large part to the substantial burden placed upon the taxpayers to rebut the IRS's *prima facie*[33] showing that the summons should be enforced. The U.S. Court of Appeals for the Eighth Circuit has described the IRS's burden here as slight, and the taxpayer's burden as heavy.[34]

Criminal Referral: The IRS may issue summonses for the purpose of investigating a possible criminal offense, so long as the matter has not yet been referred to the DOJ.[35] Many taxpayers argued that because the IRS issued a summons pursuant to a possible criminal investigation, it violated the IRC § 7602(d) restriction on issuing a summons after referring the matter to the DOJ. However, the courts are careful to distinguish between a *referral* to the DOJ, which prevents the IRS from issuing a summons, and a *criminal investigation* by the IRS, which does not.

Constitutional Arguments: Courts reiterated the longstanding rule that taxpayers cannot use the Fourth Amendment as a defense against a third-party summons.[36] Courts also continued to reject blanket assertions of the Fifth Amendment protection,[37] but noted that taxpayers may have valid Fifth Amendment claims regarding specific documents or testimony.[38] However, even if a taxpayer may assert the claim on behalf of himself or herself, he or she may not assert it on behalf of a business entity.[39]

Taxpayers may not be able to rely on the Fifth Amendment privilege to withhold self-incriminatory evidence of a testimonial or communicative nature if summoned documents fall within the "foregone conclusion" exception to the Fifth Amendment. The forgone conclusion exception applies where the government establishes its independent knowledge of three elements:

- The documents' existence;
- The documents' authenticity; and
- The possession or control of the documents by the person to whom the summons was issued.[40]

In *United States v. Sideman & Bancroft*, *LLP*,[41] the court considered the applicability of the foregone conclusion exception. In that case, the IRS executed a search warrant in connection with an ongoing criminal investigation of the taxpayer but failed to locate the relevant documents. During the investigation, the IRS learned that the taxpayer's tax return preparer had previously become very familiar with

33 *Prima facie* means "at first sight, on appearance but subject to further review or evidence." *Black's Law Dictionary* (9th Ed. 2009).

34 *U.S. v. Claes*, 747 F.2d 491, 494 (8th Cir. 1984).

35 IRC § 7602(d); *see, e.g., Peterson v. U.S.*, 110 A.F.T.R.2d (RIA) 6562 (D. Neb. 2012).

36 *See, e.g., Peterson v. U.S.*, 110 A.F.T.R.2d (RIA) 6562 (D. Neb. 2012).

37 *See, e.g., U.S. v. Amabile*, 109 A.F.T.R.2d (RIA) 2392 (E.D. Pa. 2012), *adopted by* 110 A.F.T.R.2d (RIA) 5017 (E.D. Pa. 2012).

38 *U.S. v. Amabile*, 109 A.F.T.R.2d (RIA) 2392 (E.D. Pa. 2012), *adopted by* 110 A.F.T.R.2d (RIA) 5017 (E.D. Pa. 2012).

39 *U.S. v. Christensen*, 110 A.F.T.R.2d (RIA) 5421 (D. Ariz. 2012).

40 *U.S. v. Sideman & Bancroft*, LLP, 107 A.F.T.R.2d (RIA) 1780 (N.D. Cal. 2011), *affirmed by* 111 A.F.T.R.2d (RIA) 460 (9th Cir. 2013).

41 *U.S. v. Sideman & Bancroft, LLP*, 107 A.F.T.R.2d (RIA) 1780 (N.D. Cal. 2011), *affirmed by* 111 A.F.T.R.2d (RIA) 460 (9th Cir. 2013).

the sought-after documents and could identify numerous distinct features of those documents. The preparer later delivered the documents to the taxpayer's civil tax attorney, who delivered them to the taxpayer's counsel handling the IRS criminal investigation. The taxpayer's criminal tax counsel refused to comply with a subsequent IRS summons for the documents, arguing that producing the documents would be a communicative act that would tacitly concede the existence of the summoned documents and their possession or control by the taxpayer.[42] The court concluded that the IRS knew with "reasonable particularity" prior to issuing the summons, from the information provided by the taxpayer's tax return preparer, that those documents existed and were in the possession of the taxpayer's criminal tax counsel.[43] The court further noted that the information provided by the taxpayer's tax return preparer could sufficiently authenticate the summoned documents, thus satisfying each element of the foregone conclusion exception.[44]

One court held that a taxpayer is not precluded from invoking the Fifth Amendment privilege for the first time at a contempt proceeding for failure to comply with a summons. In *United States v. St. John*,[45] the IRS issued two summonses requesting that the taxpayer give testimony and produce records and documents for the purpose of determining his personal tax liability. The taxpayer appeared before the Revenue Officer named in the summons but refused to produce the records and refused to answer most questions on Fifth Amendment grounds.[46] Appearing *pro se* at a summons enforcement hearing, the taxpayer failed to assert his Fifth Amendment privilege. In a subsequent proceeding, however, when the taxpayer was ordered to show cause why he should not be held in contempt and appropriately sanctioned, he invoked the privilege.[47] The court rejected the argument that the taxpayer waived the Fifth Amendment privilege by failing to raise the defense at the enforcement stage of the proceedings and failing to object to the report and recommendation on the enforcement order.[48] The court stated that every reasonable presumption against waiver of the Fifth Amendment privilege, a fundamental constitutional right, should be indulged.[49] The taxpayer could invoke the privilege for the first time as late as a contempt hearing.

A court this year affirmed a lower court's rejection of a claim that IRS agents had attempted to "deter or chill" the right to speak out against "harassing agent conduct" in violation of the taxpayer's First Amendment rights.[50] Courts also rejected taxpayers' arguments that summons enforcement violated their rights under federal privacy laws.[51] Some taxpayers argued, without success, that summonses were unconstitutionally overbroad.[52]

42 *U.S. v. Sideman & Bancroft, LLP*, 107 A.F.T.R.2d (RIA) 1780 (N.D. Cal. 2011), *affirmed by* 111 A.F.T.R.2d (RIA) 460 (9th Cir. 2013).

43 *Id*.

44 *Id*.

45 111 A.F.T.R.2d (RIA) 723 (M.D. Fla. 2013), *adopting in part* 111 A.F.T.R.2d (RIA) 719 (M.D. Fla. 2012).

46 *Id*.

47 *Id*.

48 *Id*.

49 *Id*.

50 *See, e.g., Canatella v. U.S.*, 108 A.F.T.R.2d (RIA) 5256 (N.D. Cal. 2011), *affirmed by* 111 A.F.T.R.2d (RIA) 1996 (9th Cir. 2013).

51 *See, e.g., U.S. v. Williams*, 111 A.F.T.R.2d (RIA) 850 (D. Or. 2013), *adopted by* 111 A.F.T.R.2d (RIA) 853 (D. Or. 2013).

52 *See, e.g., U.S. v. Lano Equipment, Inc.*, 2012 U.S. Dist. LEXIS 77900 (D. Minn. 2012), *adopted by* 2012 U.S. Dist. LEXIS 77392 (D. Minn. 2012).

Privilege: Courts generally reject claims of attorney-client privilege. In *Gjerde v. United States*,[53] the court rejected the taxpayer's argument that the attorney-client privilege protected his bank records from being summoned. The taxpayer, a licensed California attorney, argued that examination of his bank records, which included two of his client trust accounts, would contravene his duty under state law to preserve client confidences and would violate the attorney-client privilege.[54] The court concluded that the bank records were not communications made in the attorney's capacity as a legal adviser in the course of receiving or giving legal advice and therefore were not protected by the attorney-client privilege.[55]

In *United States v. Eaton Corp.*,[56] the taxpayer challenged multiple summonses, asserting various privileges including attorney-client privilege. In the first summons the court reviewed, a business failed to provide the IRS with a document-by-document privilege log but asserted that the information sought had been compiled in the course of seeking legal advice and provided a corroborating declaration from its vice president of federal tax strategy.[57] The court concluded that, pursuant to Federal Rule of Civil Procedure 26(b)(5),[58] the declaration was insufficient to establish the attorney-client privilege because it did not provide enough information about the documents withheld to enable the government to assess the claim of privilege.[59] In the second and third summonses it reviewed, the court found the privilege was sufficiently substantiated by the vice president's declaration in conjunction with logs that included the subject matter of the documents to which a privilege was asserted, the document type, the author, and the privilege claimed.[60] Accordingly, the court denied the government's petitions for enforcement of the second and third summonses.

International Treaty Obligations: Courts denied two taxpayer motions to quash summonses and granted one government motion to enforce a summons based on the government's compliance with international agreements. In *United States v. Villarreal*,[61] the court considered the enforceability of an IRS summons issued pursuant to the Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes ("TIEA"). In that case, an official of the taxing authority for Mexico, the Servicio de Administracion Tributaria ("SAT"), requested that the IRS obtain records from an American bank through which SAT believed the taxpayer's business transferred funds affecting the taxpayer's Mexican income tax liability.

The court noted that the same four-part *Powell* test applies where the IRS issues a summons at the request of a treaty partner.[62] The taxpayer asserted that the IRS summons was not issued for a legitimate purpose because it was being used to advance a "harassment campaign" by the SAT, and that the information

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53 110 A.F.T.R.2d (RIA) 5581 (E.D. Cal. 2012).

54 *Id*.

55 *Id*.

56 110 A.F.T.R.2d (RIA) 5638 (N.D. Ohio 2012).

57 *U.S. v. Eaton Corp*., 110 A.F.T.R.2d (RIA) 5638 (N.D. Ohio 2012).

58 Federal Rule of Civil Procedure 26(b)(5) provides that a party withholding information based on a claim of privilege must: "expressly make the claims; and (ii) describe the nature of the documents, communications, or tangible things not produced or disclosed—and do so in a manner that, without revealing information itself privileged or protected, will enable other parties to assess the claim." Fed. R. Civ. P. 26(b)(5).

59 *U.S. v. Eaton Corp*. 110 A.F.T.R.2d (RIA) 5638 (N.D. Ohio 2012).

60 *Id*. The court also found that the tax practitioner privilege applied to the information requested in the second and third summonses and the work product privilege applied to the information requested in the third summons.

61 *Villarreal v. U.S.*, 111 A.F.T.R.2d (RIA) 1713 (10th Cir. 2013), *aff'g* 109 A.F.T.R.2d (RIA) 1522 (D. Colo. 2012).

62 *Id*.

sought was irrelevant. The court held that the taxpayer's assertion of improper purpose was conclusory and therefore insufficient to meet his burden of proof. Moreover, relying on Supreme Court precedent, the court held that it is not the good faith of the foreign tax authority that is relevant in the analysis of proper purpose but rather the good faith of the IRS.[63] The court also held that the information requested by the summons need only be *potentially* relevant to an ongoing investigation; the information about the taxpayer's transferred funds satisfied this standard.[64]

The IRS prevailed in 33 cases involving motions to quash summonses, in part because the courts lacked jurisdiction to hear the cases. The courts dismissed these cases for lack of jurisdiction for the following reasons:

Lack of Jurisdiction Due to Procedural Requirements: The United States is immune from suit unless Congress has expressly waived its sovereign immunity.[65] Because a motion to quash service of an IRS summons is a suit against the United States, a court has jurisdiction only when Congress has expressly waived this immunity. When a taxpayer wishes to challenge an IRS summons issued to a third party, federal law sets forth the exclusive method by which the taxpayer can proceed. IRC § 7609(b) allows a taxpayer to initiate a proceeding in U.S. District Court for the district in which the third party resides, but the proceeding must be initiated no later than 20 days from the date the notice of summons was given. Courts have strictly construed the IRC § 7609(b) deadline when determining whether sovereign immunity has been waived. For example, a court dismissed a *pro se* taxpayer's motion to quash for lack of jurisdiction because the taxpayer filed the motion two days after the 20-day limit expired.[66] Another court held that it lacked subject matter jurisdiction over a petition to quash a third-party summons, where the third parties neither resided in nor were found within the jurisdiction of the district court.[67]

Lack of Jurisdiction Due to Notice Requirements: Courts denied multiple motions to quash because the parties contesting the summonses were not entitled to notice of the summonses due to one of the IRC § 7609(c) exceptions and therefore lacked standing to contest their validity.[68] In *Bybee v. United States*, the government served third-party summonses on the taxpayer's son and the son's business during an investigation into potential tax evasion by the taxpayer.[69] The taxpayer moved to quash the summonses, arguing that the IRS failed to give him proper statutory notice. The court rejected this argument because the summonses were not issued to third-party record-keepers and therefore the taxpayer had no right to notice of the summons.[70] The court held that sovereign immunity had not been waived and the court lacked subject matter jurisdiction.

63 *U.S. v. Stuart*, 489 U.S. 353, 370 (1989).

64 *Villarreal v. U.S.*, 111 A.F.T.R.2d (RIA) 1713 (10th Cir. 2013), *aff'g* 109 A.F.T.R.2d (RIA) 1522 (D. Colo. 2012).

65 *U.S. v. Dalm*, 494 U.S. 596, 608 (1990).

66 *U.S. v. Chavira*, 111 A.F.T.R.2d (RIA) 1931 (C.D. Cal. 2013).

67 *Maxwell v. U.S.*, 876 F. Supp. 2d 22 (D.D.C. 2012).

68 IRC § 7609(c)(2)(E); *See, e.g., U.S. v. Bybee*, 110 A.F.T.R.2d (RIA) 6212 (D. Utah 2012), *adopted by* 110 A.F.T.R.2d (RIA) 6215 (D. Utah 2012).

69 110 A.F.T.R.2d (RIA) 6212 (D. Utah 2012), adopted by 110 A.F.T.R.2d (RIA) 6215 (D. Utah 2012).

70 IRC § 7609 does not apply to any summons served on any person who is not a third-party record-keeper (as defined in IRC § 7603(b)). IRC § 7609(c)(2)(E)(ii).

CONCLUSION

The IRS may issue a summons to obtain information needed 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.[71] Accordingly, the IRS may request documents and testimony from taxpayers who have failed to provide that information voluntarily. The IRS may also summon information from taxpayers at the request of a foreign taxing authority with which the United States is a treaty partner. Taxpayers and third parties rarely succeed in contesting IRS summonses due to the significant burden of proof and strict procedural requirements. Courts have justified broad readings of the summons enforcement statutes to ensure IRS investigatory powers are not unduly restricted.[72] Thus, taxpayers seldom challenge summons enforcement at the appellate level.[73] It appears that the IRS will continue to rely heavily on its summons enforcement power to effectively administer the IRC, and as a result, there will be challenges to these administrative actions that will be decided by the courts.

71 IRC § 7602(a).

72 *Flight Vehicles Consulting, Inc. v. U.S.*, 110 A.F.T.R.2d (RIA) 5487 (N.D. Cal. 2012), *adopting* 110 A.F.T.R.2d (RIA) 5484 (N.D. Cal. 2012).

73 Appeals were docketed in eight of the 117 cases reviewed herein.

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

SUMMARY

Collection Due Process (CDP) hearings were created by the IRS Restructuring and Reform Act of 1998 (RRA 98).[1] CDP hearings provide taxpayers with an independent review by the IRS Office of Appeals (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 2003, 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 105 opinions on CDP cases during the review period of June 1, 2012, through May 31, 2013.[5] Taxpayers prevailed in full in eight of these cases (nearly eight percent) and in part in nine others (nearly nine percent). Of the 17 opinions where taxpayers prevailed in whole or in part, seven taxpayers appeared *pro se* and ten were represented.

The cases discussed below demonstrate that CDP hearings serve an important function by providing taxpayers with a forum to raise legitimate issues before the IRS deprives them of property. Many of these decisions provide guidance on substantive issues. The Court imposed sanctions for inappropriate use of the CDP process in three of the 105 cases reviewed.[6]

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of an NFTL filed by the IRS or of a proposed levy action.[7] As noted above, the purpose of CDP rights is to give taxpayers adequate

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 Internal Revenue Code (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 4 in Appendix III, *infra*.

6 The Tax Court imposed penalties for frivolous proceedings under IRC § 6673 in the following three cases: *Klingenberg v. Comm'r*, T.C. Memo. 2012-292; *Mattson v. Comm'r*, 508 F. App'x 653 (9th Cir. 2013); and *Zook v. Comm'r*, T.C. Memo. 2013-128.

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

notice of IRS collection activity and a meaningful hearing before the IRS deprives them of property.[8] The hearing allows taxpayers to raise issues relating to collection of the liability, including:

- The appropriateness of collection actions;[9]
- Collection alternatives such as an installment agreement (IA), offer in compromise (OIC), posting a bond, or substitution of other assets;[10]
- Appropriate spousal defenses;[11]
- 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;[12] and
- Any other relevant issue relating to the unpaid tax, the NFTL, or the proposed levy.[13]

A taxpayer cannot raise an issue considered at a prior administrative or judicial hearing if the taxpayer participated meaningfully in that hearing or proceeding.[14]

Procedural Collection Due Process Requirements

The IRS must provide a CDP notice to the taxpayer after it has filed the first NFTL or generally before its first intended levy for the particular tax and tax period.[15] 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.[16] 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.[17] 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.[18]

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.[19] 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 hear-

8 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. National Bank of Commerce*, 472 U.S. 713, 719-722 (1985); *Phillips v. Comm'r*, 283 U.S. 589, 595-601 (1931).

9 IRC § 6330(c)(2)(A)(ii).

10 IRC § 6330(c)(2)(A)(iii).

11 IRC § 6330(c)(2)(A)(i).

12 IRC § 6330(c)(2)(B).

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

14 IRC §§ 6330(c)(4).

15 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).

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

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

18 IRC § 6330(a)(3)(B); Treas. Reg. § 301.6320-1(b)(1).

19 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).

ing.[20] Taxpayers who fail to timely request a CDP hearing will be afforded an "equivalent hearing," which is similar to a CDP hearing, but without judicial review.[21] 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.[22]

Conduct of a CDP Hearing

The IRS generally will suspend levy action throughout a CDP hearing involving a notice of intent to levy, unless it determines that:

- The collection of tax is in jeopardy;
- 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.[23]

The IRS also suspends collection activity throughout any judicial review of Appeals' determination, except if an appeal is pending, the underlying tax liability is not at issue, and the IRS can demonstrate good cause to resume collection activity.[24]

CDP hearings are informal. When a taxpayer requests a hearing with respect to both a lien and a proposed levy, Appeals will attempt to conduct one hearing.[25] Courts have determined that a CDP hearing need not be face-to-face but can take place by telephone or correspondence,[26] and Appeals will conduct the hearing by telephone unless the taxpayer requests a face-to-face conference.[27] The CDP regula-

20 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).

21 Treas. Reg. §§ 301.6320-1(i)(2) Q&A-I16 and 301.6330-1(2) Q&A-I16; *Business Integration Services, Inc. v. Comm'r*, T.C. Memo. 2012-342; *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 5.19.8.4.3, *Equivalent Hearing (EH) Requests and timeliness of EH Requests* (Nov. 1, 2007).

22 Treas. Reg. §§ 301.6320-1(i)(2)A-17 and 301.6330-1(i)(2)A-17.

23 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 *Dora v. Comm'r*, 119 T.C. 356 (2002)).

24 IRC § 6330(e)(1) and (e)(2).

25 IRC § 6320(b)(4).

26 *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.

27 *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*). In response to taxpayers' and their representatives' dissatisfaction with the Appeals' CDP hearings, including the difficulty of receiving a face-to-face hearing, TAS worked with Appeals to test the use of "telepresence" or "virtual" face-to-face hearings. This test began in 2011 between two Low Income Taxpayer Clinics and two campus Appeals units and is ongoing. For a further discussion, see 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*, *supra*.

tions 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.[28] Taxpayers making frivolous arguments are not entitled to face-to-face conferences.[29] A taxpayer will not be granted a face-to-face conference concerning a collection alternative, such as an installment agreement (IA) or offer in compromise (OIC), unless other taxpayers would be eligible for the alternative under similar circumstances.[30] 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 has 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.[31]

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 involvement" in the case.[32] 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.[33] In its determination, Appeals must weigh the issues raised by the taxpayer and decide 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."[34]

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.[35] 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.[36] 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 the Federal tax laws."[37] 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(c), 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. The court found

28 Treas. Reg. § 301.6320-1(d)(2) A-D8.

29 Treas. Reg. §§ 301.6320-1(d)(2) A-D7 and 301.6330-1(d)(2) A-D8.

30 Treas. Reg. §§ 301.6320-1(d)(2) A-D8 and 301.6330-1(d)(2) A-D8.

31 Treas. Reg. §§ 301.6320-1(d)(2) A-D8 and 301.6330-1(d)(2) A-D8.

32 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. 2006-93, *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).

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

34 IRC § 6330(c)(3)(C).

35 IRC § 6330(g). Section 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.

36 The frivolous submission penalty applies to the following submissions: CDP hearing request, OIC, IA, and application for a Taxpayer Assistance Order.

37 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.

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.[38]

Judicial Review of CDP Determination

Within 30 days of Appeals' determination, the taxpayer may petition the Tax Court for judicial review.[39] The Tax Court will only consider issues, including challenges to the underlying liability, that were properly raised during the CDP hearing.[40] An issue is not properly raised if the taxpayer fails to request Appeals consideration of the issue or the taxpayer requests consideration but fails to present any evidence regarding that issue after being given a reasonable opportunity.[41] 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.[42] When the case is remanded, the Tax Court retains jurisdiction.[43] 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.[44]

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* basis.[45] 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.[46]

ANALYSIS OF LITIGATED CASES

We identified and reviewed 105 CDP court opinions, a nine percent decrease from the 116 cases in last year's report. As shown in the chart below, litigation of CDP cases considered by the court has been averaging about 110 cases per year over the past four years since 2010. The 105 opinions identified this year do not reflect the full number of CDP cases because the court does not issue an opinion in all cases. Some are resolved through settlements, and in other cases taxpayers do not pursue litigation after filing a petition with the court. The Tax Court also disposes of some cases by issuing unpublished orders. Table 5 in Appendix III provides a detailed list of the CDP opinions, including specific information about the issues, the types of taxpayers involved, and the outcomes of the cases.

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

39 IRC § 6330(d)(1).

40 *Giamelli v. Commissioner*, 129 T.C. 107 (2007).

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

42 *Churchill v. Commissioner*, 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.

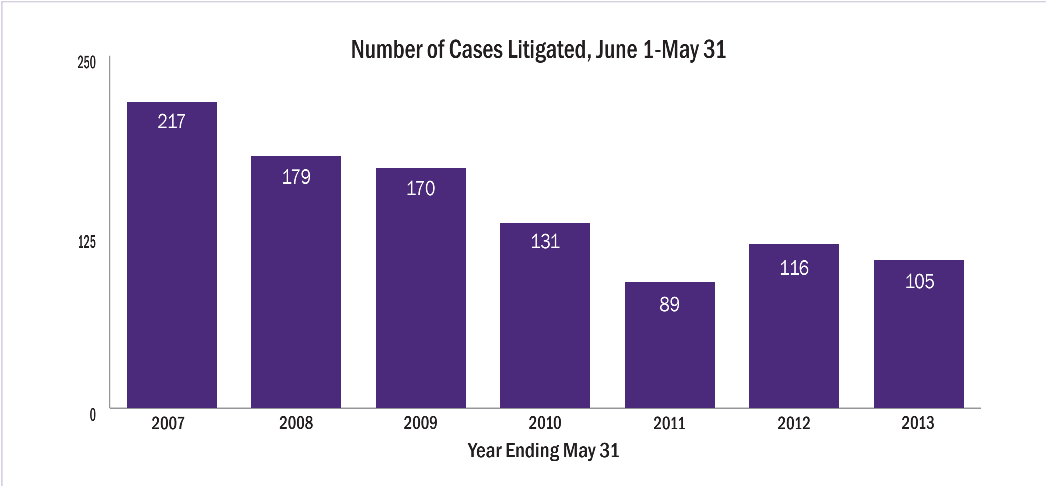
43 *Pomeroy v. Comm'r*, T.C. Memo 2013-26.

44 *Wadleigh v. Commissioner*, 134 T.C. 280, 299 (2010).

45 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.). The term *de novo* means anew. *Black's Law Dictionary*, 447 (7th Ed. 1999).

46 *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).

FIGURE 3.5.1, CDP Cases Litigated Between 2007 and 2013[47]



Litigation Success Rate

Taxpayers prevailed in full in eight of the 105 cases brought during the year ending May 31, 2013 (nearly eight percent).[48] Taxpayers prevailed in part in nine other cases (nearly nine percent). Of the cases in which the courts found for the taxpayer in whole or in part, the taxpayers appeared *pro se* in seven cases and were represented in ten others. The IRS prevailed fully in 84 percent of cases, the lowest percentage since 2003 when CDP first appeared as a Most Litigated Issue in the Annual Report to Congress.

FIGURE 3.5.2, Success Rates in CDP Cases[49]

Court Decision	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Decided for IRS	96%	95%	89%	90%	92%	90%	92%	89%	92%	86%	84%
Decided for Taxpayer	1%	4%	8%	8%	5%	8%	4%	10%	3%	7%	8%
Split Decision	3%	1%	3%	2%	3%	2%	4%	2%	3%	6%	9%
Neither	N/A	N/A	N/A	N/A	Less than 1%	N/A	N/A	N/A	1%	Less than 1%	N/A

47 National Taxpayer Advocate 2007 Annual Report to Congress 569; National Taxpayer Advocate 2008 Annual Report to Congress 476; National Taxpayer Advocate 2009 Annual Report to Congress 418; National Taxpayer Advocate 2010 Annual Report to Congress 436; National Taxpayer Advocate 2011 Annual Report to Congress 619; National Taxpayer Advocate 2012 Annual Report to Congress 595.

48 *Antioco v. Comm'r*, T.C. Memo. 2013-35; *ENSYC Technologies v. Comm'r*, T.C. Summ. Op. 2012-55; *Fielder v. Comm'r*, T.C. Memo. 2012-284; *JAG Brokerage v. Comm'r*, T.C. Memo. 2012-315; *Jones v. Comm'r*, T.C. Memo. 2012-274; *Lane v. Comm'r*, T.C. Memo. 2013-121; *Lepore v. Comm'r*, T.C. Memo. 2013-135; *Moore v. Comm'r*, T.C. Summ. Op. 2012-116; *Pomeroy v. Comm'r* T.C. Memo. 2013-26.

49 Numbers have been rounded to nearest percentage and may not add to 100% 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.

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 general, in both application and execution.

Dalton v. Commissioner

In *Dalton v. Commissioner*,[50] the United States Court of Appeals for the First Circuit decided the proper standard of review with respect to subsidiary legal and factual findings made by Appeals during the CDP process. In this case, the taxpayers (husband and wife) owned and operated a construction business that failed to pay its payroll taxes. The business went bankrupt, and the IRS assessed trust fund recovery penalties (TFRPs) under IRC § 6672 against the taxpayers for the unpaid taxes, which with interest exceeded $400,000. When the IRS sent the taxpayers a CDP levy notice, they requested a CDP hearing, at which they requested an OIC based on doubt as to collectibility and proposed to pay $10,000 to fully settle the liabilities.[51] The Appeals Officer (AO) rejected the offer because it did not include the value of property held by a trust. The AO included the trust property when calculating an acceptable offer amount because the AO concluded the trust was the nominee of the taxpayer. The taxpayers argued they held no legal interest in the trust property and appealed to the Tax Court.

The Tax Court initially remanded the case to Appeals with the instruction that the nominee question be reconsidered under state law principles.[52] On remand, Appeals issued a supplemental Notice of Determination (NOD) concluding again that the trust was the nominee of the taxpayers, as a Maine court would likely borrow nominee principles from federal law, and again rejected the taxpayers' OIC. The Tax Court reviewed the AO's supplemental determination to include the trust property when evaluating the OIC under a *de novo* standard. It found in analyzing the state law that the taxpayers were not the owners of the trust property and thus held that the AO's supplemental determination to proceed with the levy was an abuse of discretion.[53]

The IRS appealed the Tax Court's decision to the First Circuit, which reversed the Tax Court's decision, holding that the proper standard of review with respect to subsidiary factual and legal determinations made by Appeals during the CDP process is abuse of discretion, not *de novo*. The First Circuit reasoned that the Tax Court should not review Appeals' factual and legal determinations anew under the *de novo* standard but should instead should just analyze whether Appeals' subsidiary determinations are reasonable.

Under this more deferential standard of review, the Court found that Appeals did not abuse its discretion when it rejected the OIC based on its legal finding that the trust property was the property of the taxpayer. It found the IRS's determination that the trust was a nominee was reasonable based on the

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50 682 F.3d 149 (1st Cir. 2012).

51 An OIC is an agreement between a taxpayer and the government that settles a tax liability for payment of less that the full amount the IRS believes is owed. IRC § 7122. There are several grounds for an OIC, doubt as to collectibility, doubt as to liability, and effective tax administration. Doubt as to collectibility exists when the taxpayer's assets and income are less than the liability. Treas. Reg. § 301.7122-1(b).

52 *Dalton v. Comm'r*, T.C. Memo 2008-165.

53 *Dalton v. Comm'r*, 135 T.C. 393 (2010).

facts known by Appeals at the time of the hearing. Significant facts cited by the IRS that supported the nominee finding included the following:

- The taxpayers received only one dollar at the property's sale to the grantor of the trust;
- The taxpayers continued to maintain sole possession without payments of rent;
- The trust beneficiaries were the taxpayers' children; and
- The taxpayers paid the mortgage and property taxes.

Finally, the First Circuit reiterated that Congress intended CDP hearings to be informal, including the investigation of facts. In light of the informalities of the CDP hearings, the First Circuit held that a reviewing court's objective should be to evaluate the reasonableness of Appeals' subsidiary determination. As long as Appeals has reached a reasonable conclusion on questions of fact and law during the CDP process, Appeals has not abused its discretion.[54]

Antioco v. Commissioner

In *Antioco v. Commissioner*,[55] a 71-year-old taxpayer sold her primary residence, which doubled as a bed and breakfast, to pay marital debts following a divorce. The taxpayer received her portion of the sale proceeds, which were substantial, and used these proceeds (believing the sale of the residence was exempt from tax) as a down payment to purchase a five-unit apartment building. The taxpayer lived in one unit, used a second unit to house her 96-year-old mother, and rented the three others. Learning later that she was obliged to report the income, she did so in August 2008, but without remitting payment.

In response to the CDP levy notice, the taxpayer requested a CDP hearing and offered to pay $1,000 a month until she could refinance the building to satisfy the tax. The taxpayer was experiencing difficulty in securing an agreement to refinance because her income was too low. Since her elderly mother was suffering from health issues and the taxpayer relied on rental income to survive, she argued that the levy would create an "economic hardship" for them both. Nevertheless, Appeals issued an NOD sustaining the proposed levy action and rejecting the taxpayer's proposal for an installment agreement due to failure to submit a new financial information statement. The taxpayer sought Tax Court review of the NOD.

Prior to trial, the Commissioner requested, and was granted, a motion to remand the case. At that time, the Commissioner conceded the AO had abused her discretion by not asking for revised financial forms and by not addressing the taxpayer's "economic hardship" argument.[56]

On remand, a new AO issued a supplemental NOD sustaining the proposed levy on the basis that the taxpayer could afford to pay her tax liabilities. The AO alleged the taxpayer committed fraud when she subsequently put her mother's name on the apartment building's deed to meet the terms of a refinancing agreement. The AO also alleged the taxpayer had deliberately transferred all her equity in the building to

54 As of the writing of this report, *Dalton* has been cited in ten decisions as well as two amicus briefs. Reactions to the *Dalton* decision are mixed. *See* Susan Simmons, *First Circuit Uses New Standard in CDP Case*, 136 Tax Notes 159 (July 9, 2012) ("The First Circuit appears to have broken new ground in applying a reasonableness standard to findings of law in CDP determinations. Whether that's helpful or reasonable remains to be seen."). *See also* Adam Cole, *Student Case Note: A Preference for Deference: The Benefits of the First Circuit's Customized Standard of Review for Collection Due Process Appeals in Dalton v. Commissioner*, 58 Vill. L. Rev. 239 (2013) (arguing that the First Circuit reached the correct result because the Dalton standard of review increases efficiency and fairness, and is consistent with the purpose of CDP).

55 T.C. Memo. 2013-35.

56 T.C. Memo. 2013-35 at 3.

her ailing mother by including her on the deed. Additionally, the AO refused to consider the taxpayer's "economic hardship" argument, labeling the issue of her 96-year-old mother a "diversionary argument."[57]

The Tax Court could not uphold the supplemental NOD on any of the stated grounds and found the AO had abused his discretion in sustaining the proposed levy. The court found the AO's determination was not supported by the administrative record and the AO drew conclusions of fraud without performing an insolvency analysis. The Tax Court found an abuse of discretion in that the AO failed to consider the economic hardship argument and failed to ask the taxpayer to submit revised financial forms, which the court had ordered. The court remanded the case for a second time and instructed the AO to consider the taxpayer's revised financial information, proposed installment agreement, special circumstances, and "economic hardship" claims.

Pomeroy v. Commissioner

In *Pomeroy v. Commissioner*,[58] the taxpayers (husband and wife) timely requested a CDP hearing in response to the CDP lien notice. In their hearing request, the taxpayers stated they planned to submit an offer in compromise to settle their tax liabilities. The taxpayers then submitted an OIC based on doubt as to collectibility offering to settle the debt for $25,000. After the OIC was sent to the centralized offer unit (COIC), the taxpayers notified the offer examiner that the husband had suffered a severe stroke and was on his deathbed. The examiner responded by asking the taxpayers to provide more information, including a doctor's written prognosis, if they wanted the medical condition to be considered in the OIC review. The taxpayers submitted additional documentation stating a doctor's prognosis was forthcoming. However, because the examiner did not receive the documentation within ten days of the request, she determined that the taxpayers could fully pay and returned the case to Appeals. Upon receiving the new documentation, Appeals assigned a Settlement Officer (SO) to review the OIC. The SO issued a NOD approving the examiner's calculations, rejecting the OIC, and sustaining the NFTL filing.

The taxpayers appealed to the Tax Court and argued, among other things, that the husband's medical condition qualified them for an OIC based on effective tax administration (ETA) even though the taxpayers had submitted the OIC based on doubt as to collectibility.[59] In particular, the taxpayers argued that Appeals did not properly consider Mr. Pomeroy's stroke when determining whether the taxpayers could full pay. The court found that because the administrative record was incomplete with regard to the husband's medical condition, it could not determine whether Appeals abused its discretion when it rejected the OIC and remanded the case so the record could be supplemented. The Tax Court also noted that the SO did not make adequate efforts to ascertain the current status of the taxpayer husband's health or his prognosis. The case was remanded to the Appeals Office to supplement the record accordingly.

Brombach v. Commissioner

In *Brombach v. Commissioner*,[60] the IRS filed an NFTL and sent the taxpayer a CDP lien notice. The taxpayer timely requested a CDP hearing and proposed an OIC in which he would pay $28,000 in full

57 T.C. Memo. 2013-35 at 4.

58 T.C. Memo. 2013-26.

59 An ETA offer may be entered into when the IRS determines that although collection in full is possible, it would cause the taxpayer economic hardship or where public policy or equity considerations support compromise. Treas. Reg. § 301.7122-1(b).

60 T.C. Memo. 2012-265.

settlement of his tax liabilities, which exceeded $150,000. The taxpayer explained in a letter submitted with the OIC that his monthly expenses exceeded the national standards the IRS adopted, pointing to a number of "special circumstances." The AO rejected this offer, finding no special circumstances making the offer acceptable.

The Tax Court, in determining whether the IRS abused its discretion in rejecting the taxpayer's OIC, considered the IRS's "reasonable collection potential" (RCP) calculations. The court held that the IRS did not abuse its discretion in determining that taxpayer's interest in motorcycles, which he jointly owned with his wife, was half the motorcycles' realizable value; in allowing housing expenses less than the taxpayer claimed; or in determining that no special circumstances existed to require acceptance of the OIC. The Tax Court agreed in part that the IRS abused its discretion in estimating the taxpayer's monthly tax expenses, using an unusually short payout period. Despite this mistake, the Tax Court held the proposed offer of $28,000 was still lower than the taxpayer's RCP and therefore Appeals did not abuse its discretion in rejecting the OIC.

Cantrell v. Commissioner

In *Cantrell v. Commissioner*,[61] the taxpayer requested a CDP hearing after receiving a CDP lien and levy notice relating to tax year 2001. After requesting the hearing, the taxpayer filed an amended 2001 tax return. The AO provided the taxpayer with a payoff amount to settle his tax liabilities based on the amended return. The taxpayer provided the AO with a check for that amount, but the AO forwarded the amended return to a Revenue Agent who then informed the taxpayer that the return was under examination. Ultimately, the Revenue Agent sent the amended return back to the AO with the recommendation that it be rejected. The AO then issued a notice of determination sustaining the NFTL filing and the proposed levy. In response, the taxpayer filed a petition with the Tax Court, arguing that his prior payment by check, which he presented to the AO, should have settled his entire liabilities for 2001.

The Tax Court noted that only authorized agents or officials representing the Commissioner are empowered to enter into settlement agreements, and AOs are not authorized agents for these purposes. Thus, the court determined the AO's acceptance of the check did not settle the taxpayer's liability. The court reviewed the underlying liability *de novo*, since the taxpayer did not receive a notice of deficiency or otherwise have an opportunity to contest the liability. The court found the petitioner failed to provide documentation to support the deductions claimed on the amended return. Thus, the IRS did not abuse its discretion in deciding to proceed with the proposed collection actions.

Hinerfeld v. Commissioner

In *Hinerfeld v. Commissioner*,[62] the taxpayer sought Tax Court review of Appeals' determination to sustain a proposed levy. The taxpayer, a corporate officer, owed TFRPs stemming from various unpaid quarterly employment tax periods for Thermacon Industries, Inc. (Thermacon).[63] During the CDP hearing, the SO indicated she would accept the taxpayer's amended OIC, because it proposed to pay the amount that the SO calculated as the taxpayer's RCP. However, the OIC was subject to review by Area Counsel as

61 T.C. Memo. 2012-257.

62 139 T.C. 277 (2012).

63 The taxpayer did not dispute the liability. The quarterly periods owed were for the quarters ending September 30 and December 31, 2002; March 31, September 30, and December 31, 2003; and June 30, 2004.

prescribed in IRC § 7122(b) for OICs made in cases with tax assessments of $50,000 or more.[64] Area Counsel's review discovered the taxpayer was involved in pending litigation over asset transfers from Thermacon to corporations owned by the taxpayer's immediate family. The complaint filed in this litigation alleged the taxpayer and his wife made fraudulent conveyances that left Thermacon unable to pay its creditors.[65] Since the assets transferred were valued at $2.2 million, the taxpayer made conflicting statements, and since the wife was suspected of serving as the taxpayer's nominee, Area Counsel recommended the SO reject the taxpayer's amended OIC. The SO's manager agreed and notified the taxpayer that his account could be placed in "currently not collectible" (CNC) status until the litigation was resolved. The taxpayer disagreed with Appeals' determination to reject the OIC and petitioned the Tax Court.

The taxpayer argued that Appeals participated in prohibited *ex parte* communications with Area Counsel. The court analyzed administrative guidelines prohibiting certain *ex parte* communications and found in favor of the IRS. First, the court determined that the *ex parte* communications did not fall within the limitations prescribed in Rev. Proc. 2000-43,[66] because there was some evidence the Appeals manager had exercised independent judgment in rejecting the offer. Second, the court found the Area Counsel's *ex parte* communications were mandated by statute under IRC § 7122(b). The court reviewed original legislative intent to reconcile IRC § 1001(a)(4)[67] and IRC § 7122(b). It concluded the *ex parte* communications in this instance fulfilled supervisory responsibilities and were therefore not prohibited. Finally, the court found no abuse of discretion because it concluded no undue influence was exerted by Area Counsel over Appeals during its independent review of the case and found all procedures were properly followed.

Imposition of Sanctions

IRC § 6673(a)(1) authorizes the Tax Court to impose sanctions when it appears the taxpayer instituted or maintained proceedings primarily for delay or when the taxpayer's position is frivolous or groundless.[68] As we found in last year's analysis, the court imposed these penalties in only a few CDP cases. Of the 105 cases reviewed this year, the court imposed sanctions in only three, or approximately three percent.[69] Last year, with 116 CDP cases decided, the court imposed sanctions in eight cases, or seven percent.[70] This low number may be attributable to IRC § 6330(g), which allows the IRS to disregard a frivolous hearing request.

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64 Section 7122(b) provides that if the Secretary makes a compromise in a civil case in which the unpaid amount of the tax assessed is $50,000 or more, an opinion of the General Counsel for the Department of the Treasury, or his delegate, shall be placed on file in the office of the Secretary. *See also* Treas. Reg. 301.7122-1(e)(6); CCDM 33.3.2.1(2), *Authority to Compromise* (Nov. 4, 2010).

65 Area Counsel discovered that the taxpayer and his wife were named as codefendants in a lawsuit filed in the U.S. District Court for the District of New Jersey on Oct. 2, 2007. The pending lawsuit, *Multi-Glass Atlantic, Inc. v. Alnor Assocs., LLC*, No. 1:07-cv-04760 (D.N.J. filed Oct. 2, 2007), concerned the sale of substantially all of Thermacon's assets pursuant to an asset purchase agreement the taxpayer signed on Thermacon's behalf on September 13, 2004, to Reelan Industries, Inc., a corporation wholly owned by the taxpayer's children and RJTL, Inc., a corporation wholly owned by Ruth Hinerfeld and the taxpayer's children.

66 The taxpayer cited Rev. Proc. 2000-43, 2000-2 C.B. 404 (superseded by Rev. Proc. 2012-12, 2012-10 I.R.B. 455, effective after May 15, 2012.) Rev. Proc. 2000-43, Q&A-11, 2000-2 C.B. at 406, specifically addresses communications between Appeals and the Office of Chief Counsel, A-11 provides three limitations on communications between Appeals employees and Office of Chief Counsel attorneys: (1) Appeals employees must not communicate with Chief Counsel attorneys who have previously provided advice to the IRS employees who made the determination Appeals is reviewing; (2) requests for legal advice where the answer is uncertain should be referred to the Chief Counsel's National Office and handled as requests for field service advice or technical advice; and (3) although Appeals employees may obtain legal advice from the Office of Chief Counsel, they remain responsible for making independent evaluations and judgments concerning the cases appealed to them, and Counsel attorneys are prohibited from offering advice that includes settlement ranges for any issues in an appealed case.

67 RRA 98, Pub. L. No. 105-206, § 1001(a)(4), 112 Stat. 685, 689 (1998). RRA 98 § 1001(a)(4) states, "ensure an independent appeals function within the Internal Revenue Service, including the prohibition in the plan of ex parte communications between appeals officers and other Internal Revenue Service employees to the extent that such communications appear to compromise the independence of the appeals officers."

68 *See* Most Litigated Issue: *Frivolous Issues Penalty Under IRC § 6673 and Related Appellate Level Sanctions*, *infra*

69 *Klingberg v. Comm'r*, T.C. Memo. 2012-292; *Mattson v. Comm'r*, 508 F. App'x 653 (9th Cir. 2013); *Zook v. Comm'r*, T.C. Memo. 2013-128.

70 National Taxpayer Advocate 2012 Annual Report to Congress 608.

Pro Se *Analysis*

Pro se taxpayers (those without the benefit of counsel) litigated 70 (or 67 percent) of the 105 cases brought before the Tax Court, a decrease from the previous year. Table 3.5.3 shows the breakdown of *pro se* and represented cases and the decisions rendered by the court indicating that 17 taxpayers, represented or unrepresented (or about 16 percent of the 105 cases), received some relief on judicial review.

FIGURE 3.5.3, *Pro Se* and Represented Taxpayer Cases and Decisions[71]

	Pro Se Taxpayers		Represented Taxpayers	
Court Decisions	Volume	Percentage of Total	Volume	Percentage of Total
Decided for IRS	63	90%	25	71%
Decided for Taxpayer	2	3%	6	17%
Split Decisions	5	7%	4	11%
Totals	**70**		**35**	

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 opinions reviewed this year suggest the communication process between the taxpayer and the Appeals Officers occasionally breaks down. For example, in one case, the taxpayer did not provide the requested documentation.[72] In another, the taxpayer provided the documentation but it was not timely, and once associated with the case was not fully considered.[73] In a third case, the AO did not request the documentation needed, including revised financial documentation.[74] As illustrated by these cases, when the facts of the case are not sufficiently developed, the taxpayer may not obtain the collection alternative or liability determination that he or she would be eligible for if all the facts were known.

The First Circuit set forth a new standard for Tax Court review of Hearing Officers' determinations of law, ruling that they can only be reversed for abuse of discretion.[75] In *Dalton v. Commissioner*, the court found no abuse of discretion where the Hearing Officer made a "reasonable" conclusion based on the facts known, regardless of whether that conclusion was legally correct.

As discussed in the Most Serious Problem on Collection Due Process, communication improvements need to be made in the collection process from its inception.[76] Taxpayers should have an opportunity to work with Collection employees and provide documentation to support their ability to pay before the IRS sends a CDP lien or levy notice, because it is better for both the taxpayer and the government to resolve

71 Due to rounding, the percentages may not add up to exactly 100 percent.

72 *See, e.g., Cantrell v. Comm'r*, T.C. Memo 2012-257.

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

74 *See, e.g., Antioco v. Comm'r*, T.C. Memo 2013-35.

75 682 F.3d 149 (1st Cir. 2012).

76 See Most Serious Problem: *Collection Due Process Hearings: Current Procedures Allow Undue Deference to Collection Decisions and Fail to Give the Taxpayer a Fair and Impartial Hearing*, *supra*.

the tax debt as early as possible. Some cases, however, will not be resolved before CDP rights are provided. Thus, to make CDP hearings more valuable for taxpayers, Appeals Officers and Settlement Officers may need to make special efforts to ensure that taxpayers know what documentation to provide, are given an opportunity to provide the documentation, and are encouraged to do so.

Virtual CDP hearings might also improve the process. Appeals conducts CDP hearings by telephone as a default if the taxpayer does not request a face-to-face meeting. However, a single telephone conversation may not be the best way for Appeals employees to communicate to taxpayers what documentation they need and to ensure taxpayers understand what the IRS is asking of them. The use of virtual face-to-face (VFTF) service should be explored in greater depth. Expansion of VFTF service could give taxpayers visual interaction with an AO in CDP hearings and break down some of the current communication barriers, so taxpayers fully understand what Appeals has asked for and can provide all applicable information. In addition, the increased interaction between the taxpayer and Appeals employee during a virtual meeting could encourage the employee to ask for further information based on the issues raised and documents viewed during the conversation. In several cases this year, Appeals denied a collection alternative because the taxpayer did not provide the information requested. Virtual hearings may enable Appeals to gather more relevant information that would not otherwise be presented if the hearing was conducted by telephone.

In sum, changes are needed both before the IRS sends a CDP notice and while a case is open. If taxpayers provide the full documentation to prove their cases, the IRS can make determinations on collection cases that better take into account the taxpayer's facts and circumstances.

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 86 decisions issued by federal courts from June 1, 2012, to May 31, 2013, 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);
- Failure to pay estimated tax under IRC § 6654; or
- Some combination of the three.[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. Nineteen cases involved the imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties, 14 involved both the failure to file and failure to pay penalties, one case involved only the estimated tax penalty, three cases involved only the failure to pay penalty, and 39 cases involved only the failure to file penalty.

The failure to file and failure to pay penalties are imposed unless the taxpayer can demonstrate that 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] In 71 out of the 86 cases, taxpayers were unable to avoid a penalty.

PRESENT LAW

Under IRC § 6651(a)(1), a taxpayer who fails to file a return on or before its due date (including extensions) will be subject to a penalty of five percent of the tax due (minus any credit the taxpayer is entitled to receive and payments made by the due date) for each month or partial month the return is late, up to a maximum of 25 percent, unless the failure is due to reasonable cause and not willful neglect.[4] To establish reasonable cause, the taxpayer must show that he or she exercised ordinary business care and prudence but was still unable to file by the due date.[5] The failure to file penalty applies to income, estate, gift, employment and self-employment, and certain excise tax returns.[6]

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 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).

5 Treas. Reg. § 301.6651-1(c)(1).

6 IRC § 6651(a)(1).

The failure to pay penalty applies to a taxpayer who fails to pay an amount shown as tax on his or her return. The penalty accrues at a rate of 0.5 percent per month on the unpaid balance for as long as the balance due remains unpaid, up to a maximum of 25 percent of the amount due.[7] When both the failure to file and failure to pay penalties are imposed for the same month, the amount of the failure to pay penalty reduces the amount of the failure to file penalty by 0.5 percent for each month.[8]

The failure to pay penalty applies to income, estate, gift, employment and self-employment, and certain excise tax returns.[9] The taxpayer will not be held liable if he or she can establish reasonable cause, *i.e.*, the taxpayer must show that he or she exercised ordinary business care and prudence but still could not pay by the due date, or that payment on the due date would have caused undue hardship.[10] Courts will consider "all the facts and circumstances of the taxpayer's financial situation" to determine whether the taxpayer exercised ordinary business care and prudence.[11] In addition, "consideration will be given to the nature of the tax which the taxpayer has failed to pay."[12]

IRC § 6654 imposes a penalty on any underpayment of estimated tax by an individual or by certain estates or trusts.[13] The law requires four installments per taxable year, each generally 25 percent of the annual payment.[14] 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 shown on the return for the previous year.[15] 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.[16]

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;[17]
- 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 that year;[18]
- The IRS determines that because of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;[19] or

7 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).

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

9 IRC § 6651(a)(2).

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

11 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).

12 Treas. Reg. § 301.6651-1(c)(2).

13 IRC § 6654(a), (l).

14 IRC § 6654(c)(1), (d)(1)(A).

15 IRC § 6654(d)(1)(B).

16 IRC § 6654(a).

17 IRC § 6654(e)(1).

18 IRC § 6654(e)(2).

19 IRC § 6654(e)(3)(A).

- 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.[20]

In any court proceeding, the IRS has the burden of producing sufficient evidence that it appropriately imposed the failure to file, failure to pay, or estimated tax penalties.[21]

ANALYSIS OF LITIGATED CASES

We analyzed 86 opinions issued between June 1, 2012, and May 31, 2013, where the failure to file penalty, failure to pay penalty, or estimated tax penalty was in dispute. All but seven of these cases were litigated in the United States Tax Court. A detailed list appears in Table 6 in Appendix III. Fifty-one cases involved individual taxpayers and 35 involved businesses (including individuals engaged in self-employment or partnerships). Of the 53 cases in which taxpayers appeared *pro se* (without counsel), taxpayers prevailed in full in one case, and six resulted in split decisions. Of the 32 cases in which taxpayers appeared with representation, taxpayers prevailed in full in two cases, and six were split decisions.[22]

Failure to File Penalty

A common basis for the courts' ruling against taxpayers on the failure to file penalty was that the taxpayer could not establish that the failure was due to reasonable cause. Among the 63 cases where the court considered whether there was evidence to establish reasonable cause, taxpayers showed reasonable cause in only four cases. The most common arguments raised by taxpayers for reasonable cause included the following.

Medical Illness

Depending on the facts and circumstances, a medical illness may establish reasonable cause for failing to file, if the taxpayer can show incapacitation to such a degree that he or she could not file a return on time.[23] 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 period of illness.[24] In *Hardin v. Commissioner*, the taxpayer's mental disorders (attention deficit and hyperactive disorder, bipolar disorder, and post-traumatic stress disorder) did not rise to the level of reasonable cause because the taxpayer was able to continue his business affairs.[25] Specifically, during the time the return was due, the taxpayer managed two rental properties and worked full time for the Department of Defense as an engineer, performing complex analyses of military equipment. In light of the taxpayer's management of

20 IRC § 6654(e)(3)(B).

21 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001) (quoting 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), such as where the taxpayer only makes frivolous arguments. *Funk v. Comm'r*, 123 T.C. 213 (2004).

22 In *Cryer v. Comm'r*, T.C. Memo. 2013-69, the taxpayer died before the court hearing and no substitution of any personal representative was ever made; therefore, this case is neither marked as *pro se* or not *pro se* and constitutes the 86th case in our total case review.

23 *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).

24 *Judge v. Comm'r*, 88 T.C. 1175, 1189–1191, 1987 WL 49322 (1987).

25 T.C. Memo. 2012-162.

these activities, the court held the disorders were not severe enough to establish reasonable cause and the penalty was properly assessed.

Conversely, in *Wright v. Commissioner*, the court held that a stay in a hospital and a rehabilitation center for an injured leg during the time that the taxpayer's 2006 return was due, in conjunction with the fact that her financial documents were not easily accessible, was enough to establish reasonable cause.[26] The IRS argued that the taxpayer's ability to carry on negotiations with her insurance company[27] during this time negated reasonable cause, but the court was not persuaded. These cases illustrate how a reasonable cause determination can easily turn on the specific facts of the taxpayer's situation.

Reliance on Agent

The U.S. Supreme Court, in *United States v. Boyle*,[28] held that taxpayers have a nondelegable duty to file a return on time, and a taxpayer's reliance on an agent to file that return does not excuse a failure to comply with a known filing requirement. In *Tesoriero v. Commissioner*,[29] the taxpayer relied on his accountant to file a request for an extension, but the IRS never received it. The court held that filing an extension request is tantamount to filing a return and a taxpayer's reliance on an agent to file the request does not establish reasonable cause for the delay.[30]

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 advice or that the taxpayer made a good-faith effort to ascertain return filing requirements.[31] In order to reasonably rely on the advice of a tax professional, the taxpayer must present evidence of the professional's expertise and show that he or she provided the practitioner with all necessary and accurate information.[32] In *Thousand Oaks Residential Care Home I, Inc. v. Commissioner*,[33] the court held the taxpayer reasonably relied on advice from its accountant regarding the reasonableness of certain compensation payments, making the payments deductible, and rendering the filing of Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans,* and the payment of the amount due unnecessary.[34] Since the advisor was an accountant, the court determined that reliance on the accountant's advice after consultation was reasonable and the taxpayer was not liable for IRC § 6651(a)(1) or (2) penalties for failure to file Form 5330 and pay the associated tax.

26 T.C. Memo. 2013-129.

27 The taxpayer had filed a claim for reimbursement from her insurance company due to water damage to her apartment and personal belongings.

28 469 U.S. 241 (1985).

29 T.C. Memo. 2012-261.

30 *Tesoriero v. Comm'r*, T.C. Memo. 2012-261.

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

32 *Id*.

33 T.C. Memo. 2013-10.

34 IRC § 162(a)(1) permits a deduction for ordinary and necessary business expenses, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." The deductibility of compensation is determined through a two-prong test: the amount of compensation must be reasonable, and the payment must be purely for services rendered. In *Thousand Oaks Residential Care Home I, Inc. v. Comm'r*, the court held that the compensation payments were not reasonable and, therefore, not deductible.

"Zero Return" Filers and Other Frivolous Arguments

Under the longstanding four-part test articulated in *Beard v. Commissioner*,[35] 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 accurately reported on a Form W-2.[36] A "zero" return does not constitute a tax return under the *Beard* test because it is devoid of financial data and does not provide sufficient information to calculate the tax liability.[37] Thus, when the taxpayer in *Nelson v. Commissioner* filed returns containing zeros for taxable income, the Tax Court sustained the failure to file penalty.[38]

Failure to Pay an Amount Shown Penalty

A taxpayer can file his or her return by the applicable due date and still be liable for a penalty if the amount shown on the return is not paid. In cases where taxpayers disputed that they were subject to the failure to pay penalty, many of the justifications were similar to those used for the failure to file penalty under IRC § 6651(a)(1). To refute the failure to pay penalty, individual taxpayers often unsuccessfully argued medical illness or reliance on an agent.[39]

However, taxpayers succeeded in disputing the penalty when the IRS was unable to meet its burden of production under IRC § 7491(c).[40] Specifically, the IRC § 6651(a)(2) penalty applies only when the return filed by the taxpayer shows the amount due.[41] If the taxpayer did not file a return, the IRS can only assess the penalty if it has prepared a substitute for return (SFR) that satisfies the requirements of IRC § 6020(b). If the IRS cannot produce the SFR, it falls short of satisfying its burden of production under IRC § 7491.[42] For example, in *Gardner v. Commissioner*, the IRS stated it prepared a valid SFR for the taxpayers for each year in issue. However, no SFRs were introduced into evidence, and the parties did not stipulate that valid SFRs were prepared.[43] Instead, the IRS relied upon account transcripts, which stated "substitute tax return prepared by IRS" and listed a corresponding date. Despite the transcripts, the court held that the IRS did not meet its burden of production under IRC § 7491(c), because the transcripts did not adequately prove the SFRs had been created.

35 82 T.C. 766, 777 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986).

36 *See, e.g., Parker v. Comm'r*, T.C. Memo. 2012-66 (concluding that there was no evidence of reasonable cause presented when the taxpayer reported all "zeros" on his return and offered only frivolous arguments).

37 *See Turner v. Comm'r*, T.C. Memo. 2004-251, and the numerous cases cited therein.

38 *Nelson v. Comm'r*, T.C. Memo. 2012-232.

39 *See, e.g., Kuretski v. Comm'r*, T.C. Memo. 2012-262 (illness); *Knappe v. U.S.*, 713 F.3d 1164 (9th Cir. 2013), *petition for cert. filed*, *aff'g* 2013-1 U.S.T.C. (CCH) ¶ 60,662 (C.D. Cal. 2010) (agent).

40 *See, e.g., Arroyo v. Comm'r*, T.C. Memo. 2013-112; *Jenkins v. Comm'r*, T.C. Memo. 2012-181.

41 IRC § 6651(a)(2), (g)(2).

42 *See Wheeler v. Comm'r*, 127 T.C. 200, 210, (2006), *aff'd*, 521 F.3d 1289 (10th Cir. 2008).

43 *Gardner v. Comm'r*, T.C. Memo. 2013-67.

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, and made no estimated tax payments for that year, and the taxpayer offered no evidence to refute the IRS.[44]

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). We found six cases where the taxpayer prevailed regarding the estimated tax penalty because of the IRS's failure to put forth evidence that the penalty was appropriate. In *Kuretski v. Commissioner*, the IRS did not produce any evidence the taxpayers (husband and wife) did not file a return or that they had a tax liability for 2006.[45] Without the 2006 return, and without knowing if the taxpayers had a liability for that year, the court was unable to calculate the taxpayers' estimated annual payment for 2007, if any. Therefore, the IRS did not meet its burden of production of information showing that the taxpayers had a required payment under IRC § 6654.

Penalty for Raising Frivolous Arguments

In three cases where the IRS had asserted either the failure to file penalty, failure to pay penalty, estimated tax penalty, or some combination, the courts also imposed the IRC § 6673 penalty for making frivolous arguments.[46] Among the frivolous argument cases is one where the taxpayer failed to file a return because he believed neither compensation nor dividends were taxable income.[47] The Tax Court held the taxpayer liable for the failure to file and failure to pay penalties, and imposed a $2,500 penalty under IRC § 6673.

CONCLUSION

The IRS failed to prevail in full in 15 of 86 (or 17 percent) of the failure to file penalty, failure to pay penalty, and the estimated tax penalty cases analyzed in this report. This unsuccessful litigation represents a significant waste of IRS resources, as well as a burden on taxpayers. Typically, the IRS did not meet its burden of production in these cases.

The IRS's incorrect assessment of penalties in these 15 cases, and its failure to appropriately resolve them during the administrative process, may reflect a trend in litigation results because of the IRS's heavy reliance on automatic application of penalties, and its use of the Reasonable Cause Assistant (RCA).[48] The RCA software is designed to help IRS employees make fair and consistent abatement determinations.[49]

44 *See, e.g., Haury v. Comm'r*, T.C. Memo. 2012-215.

45 T.C. Memo. 2012-262.

46 *See* Most Litigated Issue: *Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions*, *infra*.

47 *Winslow v. Comm'r*, 139 T.C. 270 (2012).

48 See Most Serious Problem: *Accuracy-Related Penalties: The IRS Assessed Penalties Improperly, Refused to Abate Them, and Continues to Assess Them Automatically, Violating Taxpayer Rights and Reducing Respect for the Law*, *supra*.

49 The Reasonable Cause Assistant can only consider Failure to File or Failure to Pay penalties on certain individual tax returns, and the Failure to Deposit penalty only on certain business returns.

However, as discussed in the National Taxpayer Advocate's 2010 Annual Report to Congress,[50] the IRS's reliance on the RCA has actually eroded the accuracy of abatements.[51]

Further, the cases illustrate how establishing reasonable cause can turn on the very specific facts of the individual case. The cases once again illuminate the importance of the IRS looking closely and thoroughly at the case facts, rather than solely relying on the RCA when assessing reasonable cause claims. A close consideration of the relevant facts for each reasonable cause claim is essential to ensure that the penalty is appropriate. To promote voluntary compliance, it is crucial that taxpayers believe the facts of their individual case have been carefully considered.

As another way to promote voluntary compliance, the National Taxpayer Advocate reiterates her recommendation that Congress implement a one-time abatement of the failure to file penalty for taxpayers who comply with their filing obligations, but in an untimely manner.[52] Further, she urges a repeal of the failure to pay penalty, which could be replaced by a market rate of interest equal to the rate on an unsecured loan.[53]

50 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*).

51 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.

52 *See* National Taxpayer Advocate 2001 Annual Report to Congress 188. A provision to waive the failure to file penalty for first-time, unintentional, minor errors was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003. *See* H.R. 1528, 108th Cong. § 106 (2003). Although the IRS has provided for a one-time administrative waiver of the failure to file penalty in IRM 20.1.1.3.6.1 (Nov. 25, 2011), the National Taxpayer Advocate continues to recommend a statutory waiver similar to IRC § 6656(c).

53 *See* National Taxpayer Advocate 2001 Annual Report to Congress 182.

MLI #7

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] In order to take a charitable deduction, taxpayers must contribute to a qualifying organization[2] and must substantiate contributions of $250 or more. Litigation generally arises over one or more of these four issues:

- Whether the organization to which a donation is made is charitable;
- 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 40 cases decided between June 1, 2012, and May 31, 2013, with charitable deductions as a contested issue. The IRS prevailed in 32 cases, with taxpayers prevailing in five cases and with the remaining three cases resulting in split decisions. Taxpayers represented themselves (appearing *pro se*) in 18 of the 40 cases (45 percent), with one of these *pro se* cases resulting in a split decision and the IRS prevailing in the remaining 17 cases.

PRESENT LAW

Taxpayers must itemize in order to claim any charitable contribution deduction[3] and generally are able to take a deduction for charitable contributions made within the taxable year. Transfers to charitable organizations are deductible only if they are contributions or gifts[4] and not if they are payments for goods or services.[5] A contribution or gift will be allowed as a deduction under IRC § 170 only if it is made "to" or "for the use of" a qualifying organization.[6]

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).[7] However, subject to certain limitations, individual taxpayers can carry forward unused charitable contributions in excess of the 50 percent contribution base for up to

1 Internal Revenue Code (IRC) § 170.

2 To claim a charitable contribution deduction, a taxpayer must establish that a gift was made 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 IRC §§ 63(d) and (e); 161; 170(a).

4 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).

5 Treas. Reg. § 1.170A-1(g) (no deduction for contribution of services).

6 IRC § 170(c).

7 IRC §§ 170(b)(1)(A), (G).

five years.[8] Corporate charitable deductions are generally limited to ten percent of the taxpayer's taxable income.[9] Taxpayers cannot deduct services that they offer to charitable organizations; however, incidental expenditures incurred while serving a charitable organization and not reimbursed may constitute a deductible contribution.[10]

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.[11] Deductions for single charitable contributions of $250 or more are disallowed in the absence of a contemporaneous written acknowledgement from the charitable organization.[12] 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 the 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.[13]

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.[14] When property other than money is contributed, the amount of the allowable deduction is the fair market value of the property at the time of the contribution.[15] This general rule is subject to certain exceptions that in some cases limit the deduction to the taxpayer's cost basis in the property.[16] Moreover, for claimed contributions exceeding $5,000, a qualified appraisal prepared by a qualified appraiser is required.[17]

8 IRC § 170(d)(1).

9 IRC § 170(b)(2).

10 Treas. Reg. § 1.170A-1(g). Meal expenditures in conjunction with offering services to qualifying organizations are not deductible unless the expenditures are away from the taxpayer's home. *Id*. Likewise, travel expenses associated with contributions are not deductible if there is a significant element of personal pleasure involved with the travel. IRC § 170(j).

11 Treas. Reg. § 1.170A-13(a)(1).

12 IRC § 170(f)(8); *see also* Treas. Reg. § 1.170A-13(f).

13 IRS Pub. 1771, *Charitable Contributions Substantiation and Disclosure Requirements* (Rev. 7-2013).

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

15 Treas. Reg. § 1.170A-1(c)(1).

16 *Id*. Note that the deduction is reduced for certain contributions of ordinary income and capital gain property. *See* IRC § 170(e).

17 IRC § 170(f)(11)(C). A qualified appraisal is defined in IRC § 170(f)(11)(E)(i), and a qualified appraiser is defined in IRC § 170(f)(11)(E)(ii).

ANALYSIS OF LITIGATED CASES

We reviewed 40 decisions entered between June 1, 2012, and May 31, 2013, involving charitable contribution deductions claimed by taxpayers. Table 7 in Appendix III contains a detailed list of those cases. Of the 40 cases, 25 cases involved the taxpayers' substantiation (or lack thereof) of the claimed contribution, 14 cases involved a dispute over the valuation of property contributed, and four cases involved the issue of whether the recipient was a qualified charitable organization. Various other challenges were raised by the IRS primarily involving claimed qualified conservation contribution deductions.

Qualifying Charitable Organization

A gift will qualify as a deductible contribution under IRC § 170 only if it is made "to" or "for the use of" a qualifying organization.[18] Courts rejected claimed charitable deductions in four cases for taxpayer failure to establish that the donee organization qualified as a charitable organization under IRC § 170(c). In *Gunkle v. Commissioner*,[19] the taxpayers deducted amounts for claimed charitable contributions to a church that they had operated. The taxpayer husband dissolved the church three years prior to the year for which the charitable deduction was claimed, and the IRS issued notification to the taxpayers at the time of dissolution that the church's charitable status had been terminated.[20] The court noted that for a church to be characterized as a qualifying organization under IRC § 170(c), it must meet organizational and operational tests in IRC § 501(c)(3).[21] The court held that the deductions were inappropriate because the taxpayers did not provide evidence that the organization qualified as a charitable organization under IRC § 501(c)(3).[22]

Qualified 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.[23] For example, in *Patel v. Commissioner*,[24] the taxpayers claimed a charitable deduction contribution for donating their existing house to the local fire department but maintained possession of the real property on which the house stood. The fire department subsequently burned the house down in a training exercise. The IRS disallowed the deduction, believing that the taxpayers donated merely a right for the fire department to use the property, and therefore the taxpayers only contributed a partial interest in the property. The court noted that "[w]here a taxpayer contributes to a charity an interest in a building that is part of the land under State law but retains all title to and interest in the remaining land, the taxpayer has donated less than his entire interest

18 IRC § 170(c).

19 T.C. Memo. 2012-305, *appeal filed* (5th Cir. Apr. 5, 2013).

20 *Id*.

21 *Id*.

22 *Id*.

23 IRC § 170(f)(3)(A) generally requires that taxpayers relinquish all rights, title, and interest in property contributed.

24 138 T.C. 395 (2012).

in the land."[25] The court disallowed the deduction concluding that the taxpayers donated only a partial interest in their property, namely the right to use the existing house for training purposes.[26]

As exemplified in the *Patel* holding, taxpayers generally are not permitted to deduct gifts of property consisting of less than the taxpayers' entire interest in that property.[27] Nevertheless, taxpayers may deduct the value of a contribution of a partial interest in property that constitutes a "qualified conservation contribution,"[28] known more colloquially as a conservation easement. A contribution will constitute a qualified conservation contribution only if it is of a "qualified real property interest" made to a "qualified organization" "exclusively for conservation purposes."[29]

In *Belk v. Commissioner*,[30] the Tax Court addressed for the first time what constitutes a "qualified real property interest."[31] In that case, the taxpayers (a husband and wife) executed a conservation easement in favor of a qualifying organization prohibiting the taxpayers' entire golf course from being used for "residential, commercial, institutional, industrial, or agricultural purposes."[32] The conservation easement agreement, however, permitted the taxpayers and donee to change what property would be subject to the easement, presumably to allow the taxpayers to reconfigure the golf course.[33] As a result, the court determined that the contribution comprised neither the entire interest of the donor nor a remainder interest. The court then examined whether the contribution qualified as a use restriction granted in perpetuity, which is a permitted type of qualified real property interest described in IRC § 170(h)(2)(C).[34] Nevertheless, the court concluded that there was no agreement that the golf course would not be developed in the future because the taxpayers had the ability to remove portions of the golf course and replace them with property currently not subject to the conservation easement.[35] Accordingly, the substitution provision disqualified the conservation easement from characterization as a qualified real property interest and by extension as a qualified conservation contribution.[36]

A conservation easement subject to a mortgage will not qualify as a qualified conservation contribution unless the taxpayer obtains consent from the mortgagee to subordinate its interest in the property to the easement.[37] In *Minnick v. Commissioner*,[38] the taxpayer donated a conservation easement to a qualified

25 138 T.C. 406 (2012).

26 As support for its holding, the Tax Court looked to similar cases, explaining "As with this case, taxpayers usually grant a fire department license to destroy a building on their land because they wish to have it removed from the land, either to increase the value of the land (*Scharf*) or so that they may construct a new building on the land (*Rolfs*)." *Patel*, 138 T.C. at 415 (citing *Scharf v. Comm'r*, T.C. Memo. 1973-265, and *Rolfs v. Comm'r*, 135 T.C. 471 (2010)). For a further discussion of *Rolfs*, see also National Taxpayer Advocate 2011 Annual Report to Congress 673-674.

27 IRC § 170(f)(3).

28 IRC § 170(b)(1)(E).

29 IRC § 170(h)(1)(A)-(C).

30 140 T.C. 1 (2013), *reconsideration denied*, T.C. Memo. 2013-154.

31 A "qualified real property interest" is defined as any of the following interests in real property: (A) the entire interest of the donor other than a qualified mineral interest, (B) a remainder interest, and (C) a restriction (granted in perpetuity) on the use which may be made of the real property. IRC § 170(h)(2)(A)-(C).

32 *Belk*, 140 T.C. at 3.

33 *Id*.

34 *See also* Treas. Reg. § 1.170A-14(b)(2).

35 *Belk*, 140 T.C. at 10-11.

36 *Id*. at 14-15.

37 Treas. Reg. § 1.170A-14(g)(2).

38 T.C. Memo. 2012-345.

donee but did not execute an agreement under which the mortgagee of the subject property subordinated its interest in the property to the easement until after the conservation easement was granted. The court held that the taxpayer was not entitled to a charitable contribution deduction for the conservation easement donation because a subordination agreement was not in place at the time that the conservation easement was granted. Consequently, during the period when no subordination agreement existed, the mortgagee had the ability to seize the easement in the event of default on the mortgage, thus owning the land free of the conservation easement.[39] The court also noted that the intent of the taxpayer to seek subordination of the mortgagee's interest in the property at the time the conservation easement was granted was irrelevant.[40]

Valuation

In order 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.[41] In *Estate of Evenchik v. Commissioner*,[42] the taxpayers donated shares in a corporation to a charity and reported a charitable contribution deduction exceeding $5,000. The taxpayers provided a qualified appraisal of the corporation's two assets for which the stock was issued, rather than a valuation of the donated stock itself.[43] In addition to other shortcomings in the qualified appraisal,[44] the court concluded that not valuing the property actually donated is a defect that "goes to the essence of the information required" because without knowing the specific property contributed, the Commissioner is unable to determine whether the contributed property interest was overvalued by the taxpayers.[45] Thus, the court denied the deductions claimed with respect to the charitable contributions of stock.

Although charitable contribution deductions are generally disallowed when the taxpayer receives a benefit for a donation, a taxpayer who receives goods or services in exchange for a contribution of property may still be entitled to a charitable contribution deduction if he or she makes a contribution that exceeds the fair market value of the benefit received and makes the excess payment with the intention of making a gift.[46] In *Boone Operations Co., L.L.C. v. Commissioner*,[47] the taxpayer sold fill dirt to the City of Tucson at what the taxpayer claimed to be a price below fair market value. After finding that the taxpayer did not provide a contemporaneous written acknowledgement from the city as required by IRC § 170(f)(8), the court noted that the taxpayer failed to prove that the fair market value of the fill dirt exceeded the amount received by the taxpayer.[48] The court focused particularly on defects in the taxpayer's expert's appraisals of the fill dirt including, *inter alia*, inconsistent valuation methodologies applied to different orders of dirt delivered to the city, the inclusion of labor and delivery costs in the valuation calculation, and failure

39 T.C. Memo. 2012-345.

40 *Id*.

41 IRC § 170(f)(11)(C).

42 T.C. Memo. 2013-34.

43 *Id*.

44 Treas. Reg. § 1.170A-13(c)(3)(ii) contains a detailed set of requirements that a qualified appraisal must contain. The two appraisals that the taxpayers provided failed to meet all of those requirements.

45 *Estate of Evenchik*, T.C. Memo. 2013-34.

46 Treas. Reg. § 1.170A-1(h).

47 T.C. Memo. 2013-101.

48 *Id*.

to introduce evidence of the claimed highest and best use of the fill dirt.[49] Consequently, the Tax Court sustained the IRS's determination to disallow the claimed charitable contribution deductions.

Substantiation

Twenty-five cases involved the substantiation of deductions for charitable contributions. When determining whether or not a claimed charitable contribution deduction is adequately substantiated, courts tend to follow a strict interpretation of IRC § 170. For example, in *Longino v. Commissioner*,[50] the taxpayer alleged that he made a cash contribution of $25,000 to a qualifying organization and claimed a deduction for the donation. The court denied the deduction because the taxpayer failed to provide a contemporaneous written acknowledgement from the donee indicating whether or not it furnished any goods or services in exchange for the cash as required under IRC § 170(f)(8)(B)(ii).[51]

Further, in *Riether v. United States*,[52] the taxpayers donated Chevrolet vans to religious organizations and claimed charitable contribution deductions for the donations. The court denied the deductions because the taxpayers did not submit a "qualified appraisal" meeting each of the requirements as described in Treasury Regulation § 1.170A-13(c)(3)(ii).[53]

Although gifts of charitable contributions of $250 or more must be substantiated by a contemporaneous written acknowledgement from the donee organization, that acknowledgement need not take any particular form. For example, in *Averyt v. Commissioner*,[54] the court addressed the question of whether a conservation easement deed can function as a contemporaneous written acknowledgment. In that case, the taxpayers conveyed a conservation easement to a charitable organization so as to protect the land as a wildlife habitat.[55] The IRS challenged the taxpayers' charitable contribution deduction, arguing that the taxpayers' contemporaneous written acknowledgment did not comply with the requirements under IRC § 170(f)(8).[56] Among other things, the taxpayers contended that the conservation deed constituted a satisfactory contemporaneous acknowledgment. The court observed that the conservation deed contained a signature from a representative of the qualifying donee, provided a detailed description of the donated property, and was executed contemporaneously with the contribution.[57] Moreover, the court observed that the conservation deed stated the property was an unconditional gift for which no consideration was received. The court held that, taken as a whole, the conservation deed met all requirements under IRC § 170(f)(8) and served as a satisfactory contemporaneous written acknowledgement to support the charitable contribution deduction.[58]

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49 T.C. Memo. 2013-101.

50 T.C. Memo. 2013-80.

51 *Id*.

52 *Riether v. Comm'r*, 919 F. Supp. 2d 1140 (D.N.M. 2012).

53 A "qualified appraisal" requires the following: a detailed description of the property, the physical condition of the property, the date of contribution, the terms of any agreement by the donor or donee relating to the use, sale, or disposition of the property, the name, address, and identification number of the appraiser, the appraiser's qualifications, a statement that the appraiser prepared the appraisal for income tax purposes, the date on which the appraiser appraised the property, the appraised fair market value of the property, the method of valuation used, and the specific basis for the valuation. Treas. Reg. § 1.170A-13(c).

54 T.C. Memo. 2012-198.

55 *Id*.

56 *Id*.

57 *Id*.

58 T.C. Memo. 2012-198.

Charitable Contribution Deduction Limitations: Fair Market Value v. Cost Basis

The manner in which a taxpayer holds his or her donated property prior to donation may limit a charitable contribution to the donated property's cost basis.[59] In *Flood v. Commissioner*,[60] the taxpayers operated a real estate business, which included purchasing and selling vacant lots. The taxpayers donated 11 of the lots to charity and claimed charitable contributions consistent with the fair market value of the lots.[61] The court, however, determined that the charitable contributions were inappropriate because the donated lots had been purchased as part of the taxpayers' business venture and only a cost-basis deduction is allowable when property held primarily for sale to customers in the ordinary course of business is later donated.[62]

A charitable deduction is also allowable for the appreciated portion of long-term capital gain[63] property. Nevertheless, if the property is not held as a capital asset for more than one year, the deduction is limited to the taxpayer's basis in the property at the time of the property's contribution.[64] In *Williams v. Commissioner*,[65] the court was required to determine whether execution by the taxpayer of an Art Purchase Agreement triggered the holding period required for long-term capital gain. In that case, the taxpayer signed an agreement to purchase unidentified artwork that was to be donated to charitable organizations.[66] Upon execution of the agreement, the taxpayer did not obtain title to the unidentified artwork, paid only five percent of the purchase price with the remainder being due when the taxpayer took physical possession of the artwork, had no obligation to honor the contract, and bore none of the expenses and risk in the transaction.[67] The court held that the Art Purchase Agreement was not a contract for sale but rather an option contract and that the date on which the taxpayer actually paid for and acquired a present interest in the art was the date that must be used to calculate the holding period for purposes of determining if the property was long-term capital gain property.[68] The holding period when measured from this date was less than one year; consequently, the taxpayer's charitable contribution deduction for donating the art was limited to his basis in the property.[69]

59 IRC § 170(e).

60 T.C. Memo. 2012-243.

61 *Id*.

62 *Id*.

63 "Long-term capital gain" means "gain from the sale or exchange of a capital asset held for more than one year, if and to the extent such gain is taken into account in computing gross income." IRC § 1222(3).

64 IRC § 170(e)(1)(A).

65 498 F. App'x 284 (4th Cir. 2012), *aff'g* T.C. Memo. 2011-89.

66 *Id.*

67 *Id*.

68 *Id*.

69 *Id*.

CONCLUSION

IRC § 170 and the accompanying Treasury Regulations provide detailed requirements which must be complied with strictly and become more stringent as deductions increase in size. As one court has observed, the "hoops become longer and tighter as the value of donated property rises."[70] Taxpayers must be careful to include every statutorily required item of information in any mandated agreement and ensure the integrity of any necessary valuations of donated property. Taxpayers donating conservation easements would be advised to pay particular attention to the technicalities of qualified conservation contributions, especially where mortgages are attached to the donated easement and where easement deeds may be ambiguous as to whether use restrictions are truly granted in perpetuity to the donee.

70 *Estate of Evenchik v. Comm'r*, T.C. Memo. 2013-34.

MLI #8 Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions

SUMMARY

From June 1, 2012, through May 31, 2013, the federal courts issued decisions in at least 34 cases involving the Internal Revenue Code (IRC) § 6673 "frivolous issues" penalty and at least four cases involving an analogous penalty at the appellate level.[1] These penalties may be imposed when a taxpayer maintains 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 include these cases in our analysis to illustrate what conduct will and will not be tolerated by the courts.

PRESENT LAW

The U.S. Tax Court is authorized to impose a penalty against a taxpayer if the taxpayer institutes or maintains a proceeding primarily for delay, takes a frivolous position in a proceeding, or unreasonably fails to pursue available administrative remedies.[4] The maximum penalty is $25,000.[5] In some cases, the IRS requests that the Tax Court impose the penalty;[6] in other cases, the Tax Court exercises its discretion, *sua sponte*,[7] to do so.

Taxpayers who institute actions under IRC § 7433[8] for certain unauthorized collection actions can be subject to a maximum penalty of $10,000 if the court determines the taxpayer's position in the proceeding is frivolous or groundless.[9] In addition, IRC § 7482(c)(4),[10] §§ 1912 and 1927 of title 28 of the U.S.

1 Two of the four appellate cases involved taxpayers appealing the Tax Court's decision regarding the IRC § 6673 penalty, but also involved an analogous appellate level penalty. Thus, we reviewed a total of 36 cases this year.

2 The Tax Court generally imposes the penalty under IRC § 6673(a)(1). Other courts impose the penalty under IRC § 6673(b). The United States 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., Good v. Comm'r*, T.C. Memo. 2012-323; *Flint v. Comm'r*, T.C. Memo. 2012-287.

4 IRC § 6673(a)(1)(A), (B), and (C).

5 IRC § 6673(a)(1).

6 The standards for the IRS's decision to seek sanctions under IRC § 6673(a)(1) are found in the Chief Counsel Directives Manual (CCDM). *See* CCDM 35.10.2, *Special Procedures When Attorneys' Fees and Sanctions Are Sought, Penalties and Sanctions* (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* CCDM 35.10.2.2.3, *Sanctions Requiring National Office Review* (Aug. 11, 2004).

7 "*Sua sponte*" means without prompting or suggesting; on its own motion. *Black's Law Dictionary* (9th ed. 2009). In other words, if the Tax Court finds conduct particularly offensive, it can impose a § 6673 penalty even if the IRS has not requested such penalty. See, e.g., *Burt v. Comm'r*, T.C. Memo. 2013-58, *appeal filed* (6th Cir. July 5, 2013).

8 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.

9 IRC § 6673(b)(1).

10 IRC § 7482(c)(4) provides that the United States Courts of Appeals and the Supreme Court have the authority to impose a penalty in any case where the Tax Court's decision is affirmed and the appeal was instituted or maintained primarily for delay or the taxpayer's position in the appeal was frivolous or groundless.

Code,[11] and Rule 38[12] of the Federal Rules of Appellate Procedure authorize federal courts to impose penalties against a taxpayer for raising frivolous arguments or litigating cases primarily to delay the collection process. Because the sources of authority for imposing appellate-level sanctions are numerous and some of these sanctions may be imposed in nontax cases, the report focuses primarily on the IRC § 6673 penalty.

ANALYSIS OF LITIGATED CASES

We analyzed 34 opinions issued between June 1, 2012, and May 31, 2013, that addressed the IRC § 6673 penalty. Thirty of these opinions were issued by the U.S. Tax Court and four were issued by U.S. Courts of Appeals in cases brought by taxpayers who sought review of the Tax Court's imposition of the penalty. The Courts of Appeals sustained the Tax Court's position in all four cases.[13]

In ten cases, the Tax Court imposed penalties under IRC § 6673, ranging from $2,000 to the maximum of $25,000. In 11 cases, taxpayers prevailed when the IRS asked the court to impose a penalty, but in each case the court warned that they would be issued a penalty if they brought the same arguments in a subsequent proceeding.[14] One taxpayer went to court with representation; all 33 others appeared *pro se* (represented themselves). The taxpayers in these cases presented a wide variety of arguments that the courts have generally rejected on numerous occasions. Upon encountering these arguments, the courts almost invariably cited the language set forth in *Crain v. Commissioner*:

> We perceive no need to refute these arguments with somber reasoning and copious citation of precedent; to do so might suggest that these arguments have some colorable merit. The constitutionality of our income tax system — including the role played within that system by the Internal Revenue Service and the Tax Court — has long been established.[15]

In the cases we reviewed, taxpayers raised the following issues that the court deemed frivolous. Consequently, the taxpayers were subject 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 position in a subsequent case):

- **Taxpayers who claim that broadly applicable Internal Revenue Code terms do not apply to their circumstances:** Taxpayers in at least ten cases argued that, in some way or another, they fell

11 28 U.S.C. § 1912 provides that when the Supreme Court or a United States Court of Appeals affirms a judgment, the court has the discretion to award to the prevailing party just damages for the delay, and single or double costs. 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.

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

13 In every appellate case we have reviewed since June 1, 2005, the Courts of Appeals have not reversed the imposition of the Tax Court's IRC § 6673 penalty in any case brought before them. *See* National Taxpayer Advocate 2012 Annual Report to Congress 640-642; National Taxpayer Advocate 2011 Annual Report to Congress 666-669; National Taxpayer Advocate 2010 Annual Report to Congress 479-482; National Taxpayer Advocate 2009 Annual Report to Congress 461-464; National Taxpayer Advocate 2008 Annual Report to Congress 533-536; National Taxpayer Advocate 2007 Annual Report to Congress 599-603; National Taxpayer Advocate 2006 Annual Report to Congress 2006 602-606.

14 *See, e.g., Weatherly v. Comm'r*, T.C. Memo. 2012-320; *Trescott v. Comm'r*, T.C. Memo. 2012-321.

15 737 F.2d 1417, 1417-18 (5th Cir. 1984).

outside the parameters of the IRC and, therefore, were not obligated to pay federal income taxes.[16] Five of those taxpayers argued they did not earn "wages" as defined in the IRC.[17] One taxpayer argued he was not a "person" as defined in the IRC.[18] Most of these taxpayers avoided penalties, but the court warned them that further similar conduct could lead to a penalty.

- **Taxpayers who claim the IRS lacked authority to issue a notice of deficiency:** In at least five cases, taxpayers argued the IRS did not have authority to determine deficiencies or assess tax against them.[19] In three out of five cases, the court imposed the § 6673 sanction on the taxpayer.[20] In one case, the taxpayer argued that both the person certifying his substitutes for returns and the person issuing the notices of deficiency lacked authority to do so.[21]
- **Taxpayers who object to the admission of their IRS form W-2 as hearsay:** Taxpayers (husband and wife) in at least one case[22] argued the information returns filed by their employers were hearsay under Federal Rule of Evidence 802, and therefore, not admissible to show they received unreported income. The court declined to impose the § 6673 penalty but warned the taxpayers that continuing to advance frivolous or groundless arguments could result in a penalty in the future.

CONCLUSION

Taxpayers in the cases analyzed this year presented the same arguments raised and repeated year after year.[23] When the taxpayer is asserting a frivolous argument for the first time or, in raising the frivolous argument, has at least one other valid claim, then the court appears reluctant to impose a penalty on the taxpayer.[24] However, when the taxpayer is only asserting frivolous and groundless claims and has previously been warned about bringing such claims, the court will almost invariably impose a penalty.[25] If the court has already imposed a penalty in an earlier case against the taxpayer (or has admonished the taxpayer about his or her behavior in an earlier proceeding), the court is more likely to impose the maximum (or close to the maximum) penalty.[26] Where the IRS has not requested a penalty, the court may nonetheless raise the issue *sua sponte,* and in many cases imposes the penalty or at least cautions the taxpayer that

16 *See, e.g., Snow v. Comm'r*, T.C. Memo. 2013-114 (taxpayer argued his activities were not taxable because his employers were not "Subtitle C statutory employers"); *Flint v. Comm'r*, T.C. Memo. 2012-287 (taxpayer argued he did not have income as he was not a federal employee or corporate officer).

17 *See, e.g., Grandy v. Comm'r*, T.C. Memo. 2012-196; *Nix v. Comm'r*, T.C. Memo. 2012-304, *appeal filed* (11th Cir. May 20, 2013).

18 *Crites v. Comm'r*, T.C. Memo. 2012-267.

19 *See, e.g., Rice v. Comm'r*, T.C. Memo. 2012-301 (taxpayer argued that the IRS was merely a debt collector and therefore not a part of the U.S. government); *Roye v. Comm'r*, T.C. Memo. 2012-246 (taxpayer argued that the IRS lacked the authority under section 6020(b) to prepare substitutes for returns).

20 The court imposed the penalty in *Roye v. Comm'r*, T.C. Memo. 2012-246 and *Winslow v. Comm'r*, 139 T.C. 270 (2012), but declined to impose the penalty in *Leyshon v. Comm'r*, T.C. Memo. 2012-248, and *Rice v. Comm'r*, T.C. Memo. 2012-301 and instead strongly warned the taxpayers that future similar conduct in court would result in the imposition of the penalty. In *Palmer v. Comm'r*, 503 F. App'x 596 (10th Cir. 2012), *aff'g* T.C. Docket No. 1398-10 (Feb. 6, 2012), the Court of Appeals affirmed the Tax Court's imposition of the penalty.

21 *Winslow v. Comm'r*, 139 T.C. 270.

22 *Davenport v. Comm'r*, T.C. Memo. 2013-41.

23 *See, e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress 640-642.

24 *See, e.g., Crites v. Comm'r*, T.C. Memo. 2012-267.

25 *See, e.g., Roye v. Comm'r*, T.C. Memo. 2012-246.

26 *See, e.g., Curtis v. Comm'r*, T.C. Memo. 2013-12 ($25,000 penalty when the court had imposed $15,000 in an earlier case); *Burt v. Comm'r*, T.C. Memo. 2013-58, *appeal filed* (6th Cir. July 5, 2013) ($20,000 penalty when the court had admonished the taxpayer in an order in an earlier case that the court would impose the penalty if the taxpayer continued to advance frivolous arguments).

similar future behavior will result in a penalty.[27] Finally, the U.S. Courts of Appeals have shown their willingness to uphold the penalties imposed by the Tax Court without fail in the cases analyzed since June 1, 2005.

27 *See, e.g., Davenport v. Comm'r*, T.C. Memo. 2013-41 (court raised the penalty *sua sponte* and imposed sanctions of $4,000).

MLI #9 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 33 opinions issued between June 1, 2012, and May 31, 2013, that involved civil actions to enforce liens under IRC § 7403. The IRS prevailed in 30 of these cases. The number of cases represents a 31 percent decrease from the previous year.[1]

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.[2] All parties having liens on or otherwise claiming interest in the relevant property shall be made parties to the action.[3] The law of the state where the property is located determines the nature of a taxpayer's legal interest in the property.[4] 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.[5]

The court may order that the property be sold by an officer of the court and the proceeds applied to the delinquent tax liability.[6] 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.[7] 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;
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.[8]

1 National Taxpayer Advocate 2012 Annual Report to Congress 634-639.

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

3 IRC § 7403(b).

4 *U.S. v. National Bank of Commerce*, 472 U.S. 713, 722 (1985).

5 *U.S. v. Rodgers*, 466 U.S. 677 (1983).

6 IRC § 7403(c).

7 466 U.S. 677 (1983).

8 *Rodgers*, 461 U.S. at 709-11.

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.[9] 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.[10] The United States may also remove the case to a U.S. District Court if the case was initiated in a state court.[11] 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.[12] The IRC also 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, may appoint a receiver with all powers of a receiver in equity to preserve and operate the property prior to the sale.[13]

Recently, the IRS clarified its procedures for referring cases to the Department of Justice (DOJ) when seeking to recommend a suit to foreclose on a taxpayer's principal residence.[14] 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).[15]

In explaining what steps the IRS must take prior to requesting that the DOJ obtain a court order allowing administrative seizure of a principal residence under IRC § 6334(e)(1), the Treasury Regulations clearly state that among other things, the IRS must consider who is living in the residence.[16] The Treasury Regulation on requesting the commencement of a foreclosure action of a principal residence under § 7403 is not as clear about the considerations the IRS should make prior to referring a case to the DOJ for potential foreclosure on a principal residence.[17] Thus, the IRS recently issued interim guidance to employees to explain that the procedures for developing suit referral recommendations under IRC § 6334(e) apply to such recommendations under IRC § 7403 as well.[18] The guidance also emphasizes that the IRS

9 IRC § 7403(c).

10 28 U.S.C. § 1444. 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.

11 28 U.S.C. § 1444.

12 *U.S. v. Brosnan*, 363 U.S. 237 (1960).

13 IRC §§ 7403(d) and 7402(a).

14 Interim Guidance Memorandum (IGM), *Principal Residence Suit Foreclosure Recommendations*, SBSE-05-0413-035 (Apr. 30, 2013). This guidance 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 Department of Justice. 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 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 537-543 (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 the IGM, which adopted the recommendations set forth by the National Taxpayer Advocate.

15 IRC § 6334(e)(1) requires that the IRS obtain court approval prior to administratively seizing a principal residence.

16 Treas. Reg. § 301.6334-1(d)(1).

17 Treas. Reg. § 301-7403-1.

18 The IGM follows the legislative recommendation made by the National Taxpayer Advocate in 2012. National Taxpayer Advocate 2012 Annual Report to Congress, 537-543 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*).

should pursue a suit to foreclose a lien on a residence only when it has considered hardship issues and there are no reasonable administrative remedies.

ANALYSIS OF LITIGATED CASES

We reviewed 33 opinions issued between June 1, 2012 and May 31, 2013 that involved civil actions to enforce federal tax liens. Table 9 in Appendix III contains a detailed list of those cases. Fifty-five percent of the taxpayers appeared *pro se* and 45 percent were represented. Taxpayers with representation received full relief in two cases and partial relief in one case. No *pro se* taxpayer received relief in any of the opinions reviewed.

In *United States v. Marciello*, the IRS had referred the suit to foreclose to the DOJ under IRC § 7403. The court applied the *Rodgers* factors to deny the government's motion for summary judgment with respect to property owned by the taxpayer and his estranged wife.[19] The court noted that the forced sale of the taxpayer's marital home could foreseeably cause the taxpayer's 65-year-old wife significant emotional distress and detriment stemming from dislocation. Although the court felt some of the factors might weigh in favor of the government, it concluded the taxpayer's wife raised a genuine factual issue regarding the proper evaluation of the remaining *Rodgers* factors, and denied the government's motion for summary judgment with respect to the marital home.

In determining the appropriateness of foreclosure, the courts frequently consider whether a transfer of the property to another party extinguished the federal tax lien. For example, in *United States v. Dickert*, the taxpayer failed to file an income tax return for the 1999 tax year.[20] Based on information provided by third parties, the IRS computed the taxpayer's tax liability and sent the taxpayer a statutory notice of deficiency (SNOD) proposing an assessment. The taxpayer did not file a Tax Court petition or otherwise respond to the SNOD; thus, the liabilities proposed in the SNOD were assessed. After the assessment, but before a notice of federal tax lien (NFTL) was filed, the taxpayer transferred real property to a third party who did not pay full or give adequate consideration. Based on these facts, the court determined that the government had demonstrated it properly assessed the liabilities after notice and demand for payment, these liabilities remained unpaid, and a federal lien tax arose upon assessment that attached to all the taxpayer's property, including the property transferred to the third party.[21] The court found that because the third party did not qualify as a "purchaser" under 26 U.S.C. § 6323(h)(6), the tax lien remained on the property and thus was subject to foreclosure.[22]

In *United States v. Aiello*,[23] the court considered whether it was appropriate to foreclose on property transferred to the taxpayer's wife after the IRC § 6321 tax lien arose and the IRS filed an NFTL. The court looked at whether the tax liabilities were assessed prior to or after transfer of title. Once it determined the

19 2013 U.S. Dist. LEXIS 43582 (D. Mass. 2013) *adopting* 2013 U.S. Dist. LEXIS 43589 (D. Mass. 2013). For an explanation of the *Rodgers* factors, see footnote 8, *supra*.

20 2012 U.S. Dist. LEXIS 187223 (N.D. Fla. 2012).

21 IRC § 6321. This lien that arises upon assessment and notice and demand for payment is known as the "secret lien" because its existence is generally known only by the IRS and the taxpayer.

22 If a taxpayer transfers property subject to a federal tax lien to a purchaser before the government files an NFTL, the lien no longer attaches and the purchaser acquires the property free of the lien. IRC § 6323(a). A purchaser is defined in the Code as a person who for adequate consideration acquires an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice. IRC § 6323(h)(6).

23 2013 U.S. Dist. LEXIS 77854 (E.D.N.Y. 2013).

liabilities were assessed prior to the transfer of property to the wife, the court found the tax lien remained on the property, notwithstanding the transfer.[24] Applying similar reasoning, the court in *United States v. Johnson* found that because the taxpayer transferred properties to his daughter after the IRC § 6321 lien arose and an NFTL was filed, the federal tax liens remained on the properties.[25]

A number of the opinions 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."[26] 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 control; and
- The transferor continues to enjoy the benefits of property.[27]

In *United States v. Smith*, the court held the revocable living trust set up by the taxpayer was the alter-ego/nominee of the taxpayer.[28] The court based this conclusion on the fact that the taxpayer admitted he owned the property held by the trust, had exclusive use of the subject properties, and personally paid the property expenses.

In *United States v. Zaccardi*, the taxpayer transferred title of his house to Grace Christian Fellowship, an entity that the government argued was not functionally a church but was simply the taxpayer's nominee.[29] The court agreed with the government, noting that the transfers of the home were made without exchange of money or other items of value.[30]

The court in *United States v. Hopkins* reached a similar decision.[31] The taxpayers established two trusts and a corporation and the husband, an emergency room physician, instructed his employers to send his compensation to one of these entities. After the taxes were assessed, the taxpayers transferred their residence and adjoining real property to one of these entities and acquired new properties in the name of one of these entities. After noting that the taxpayers themselves were the chief officers of these entities, the court held that these trusts and corporations were the nominees of the taxpayers and thus ordered the foreclosure of the tax liens on the properties held by the nominee entities.[32]

24 2013 U.S. Dist. LEXIS 77854 (E.D.N.Y. 2013).

25 111 A.F.T.R.2d (RIA) 1551 (S.D. Tex. 2013).

26 *U.S. v. Smith*, 109 A.F.T.R.2d (RIA) 2359 (W.D. Wash. 2012) quoting *Scoville v. U.S.*, 250 F.3d 1198, 1202 (8th Cir. 2001).

27 *Id*.

28 *Id*.

29 110 A.F.T.R.2d (RIA) 6679 (D. Utah 2012).

30 *Id*.

31 2013-1 U.S.T.C (CCH) ¶ 50,218 (D.N.M. 2013).

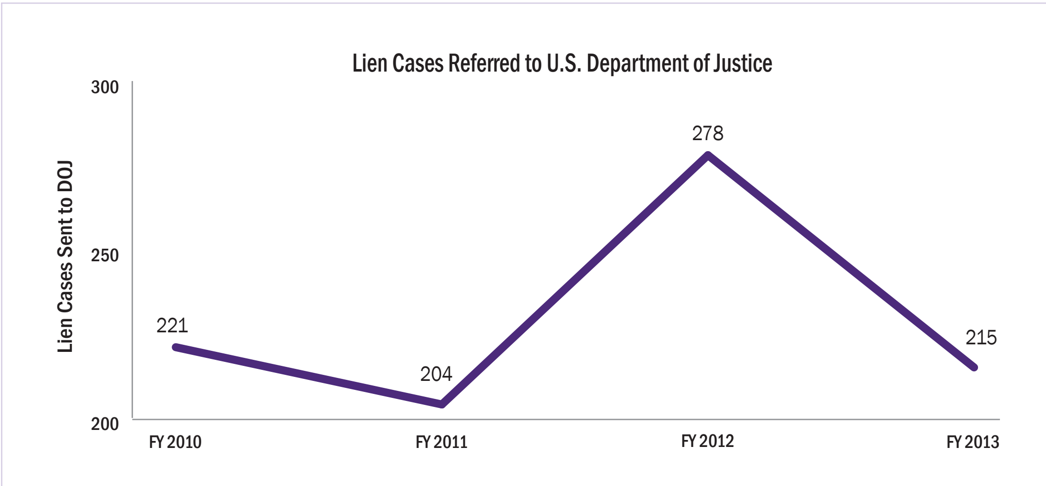
32 2013-1 U.S.T.C (CCH) ¶ 50,218 (D.N.M. 2013).

CONCLUSION

In the 2012 Annual Report to Congress, we predicted that we might see more court opinions involving lien enforcement in the coming years due to an increase of cases referred to the Department of Justice by the IRS.[33] While we did not find that outcome this year, factors such as delays in litigation or settlement prior to trial may have contributed to the smaller number of court opinions this year and a spike in cases may be seen in coming years.

Figure 3.9.1 below shows the number of cases referred to the DOJ by fiscal year.[34]

FIGURE 3.9.1, Lien Cases Referred to U.S. Department of Justice by Year, FY 2010–2013



More importantly, the National Taxpayer Advocate and her staff raised concerns about inadequate protections for taxpayers in lien enforcement mechanisms, as evidenced in specific cases open in the Taxpayer Advocate Service. With the issuance of interim guidance clarifying when the IRS should seek to refer a foreclosure case to the Department of Justice, referrals of cases may decrease in coming years and we may then see a further decline in court opinions on lien enforcement.

33 National Taxpayer Advocate 2012 Annual Report to Congress 639.

34 Department of Justice (DOJ), Tax Division, *Suits to Foreclose Tax Lien - Summary by Fiscal Year of Case Receipt* (Oct. 3, 2012) and Department of Justice (DOJ), Tax Division, *Suits to Foreclose Tax Lien - Summary by Fiscal Year of Case Receipt* (Oct. 18, 2013).

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. Section 6015(b) provides "traditional" relief for deficiencies. Section 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. Section 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 reviewed 31 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2012, and May 31, 2013. The most significant issues the courts addressed this year are the Tax Court's scope and standard of review of claims for relief under IRC § 6015(f) and whether district courts have jurisdiction to decide innocent spouse claims raised as a defense in a collection suit or in an interpleader suit.[3] The Tax Court also noted how proposed guidance, if applicable, would have affected its analysis of claims for relief under IRC § 6015(f).

PRESENT LAW

Three Avenues for Relief from Joint and Several Liability

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]
3. Upon signing the return, the requesting spouse did not know or have reason to know of the understatement;

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1 IRC § 6013(d)(3). We use the terms "deficiency" and "understatement" interchangeably for purposes of this discussion and the case table in Appendix 3, even though IRC § 6015(b)(1)(D) and IRC § 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 Rule 22 of the Federal Rules of Civil Procedure permits a party to a lawsuit to join others to the suit — to interplead them — when the party may otherwise be exposed to double or multiple liability. For example, a party may hold property to which more than one other person claims an interest, and honoring one claim may expose the party to liability to other claimants. By joining interested parties in an interpleader suit, the claimants litigate among themselves to resolve the competing claims.

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).

4. Taking into account all the facts and circumstances, it is inequitable to hold the requesting spouse liable; and
5. The requesting spouse elected relief within two years after the IRS began collection activities 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. At the time relief was elected, the joint filers were unmarried, legally separated, widowed, or had not lived in the same household for the 12 months immediately preceding the election; and
3. The election was made within two years after the IRS began collection activities with respect to the requesting spouse.

This election allocates to each joint filer the portion of the deficiency attributable to each 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. Taking into account all the facts and circumstances, it would be inequitable to hold the taxpayer liable for the underpayment or deficiency.

Previously, the IRS incorporated the statutory two-year deadline found in IRC § 6015 (b)(1)(E) and (c)(3)(B) into the § 6015 regulations and thereby imposed the two-year rule on requests for equitable

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 note 19 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).

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 U.S. Courts of Appeal 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 U.S. Courts of Appeal.[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) submitted after July 25, 2011, without regard to when the first collection activity was taken.[16] Proposed Treasury regulations to reflect the change in the two-year rule were published on August 13, 2013.[17] Requests for equitable relief may be filed 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]

Revenue Procedure 2003-61 lists some of the factors the IRS has considered in determining whether equitable relief is appropriate.[20] In January 2012, the IRS issued a proposed revenue procedure to supersede Revenue Procedure 2003-61.[21] IRS Chief Counsel attorneys immediately applied the provisions of the proposed revenue procedure in docketed Tax Court cases.[22] However, taxpayers were advised to notify the IRS in their applications for relief (or supplement existing applications) if they would receive more favorable treatment under one or more of the factors provided in Revenue Procedure 2003-61. The IRS

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 U.S. Court of Appeals decision which is squarely on point where appeal from the Tax Court decision lies to that U.S. 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*); vol. 2 at 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 provides 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 Nov. 12, 2013.

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).

20 Rev. Proc. 2003-61, 2003-2 C.B. 296.

21 Notice 2012-8 (Jan. 5, 2012), 2012-4 C.B. 309, *available at* http://www.irs.gov/irb/2012-04_IRB/ar09.html. The Department of Treasury and the IRS invited public comment on the proposed guidance and on the administration of the IRS's innocent spouse program by Feb. 21, 2012.

22 Notice CC-2012-004 (Jan. 5, 2012).

would then apply those factors until the proposed revenue procedure was finalized. The proposed revenue procedure was finalized as Revenue Procedure 2013-34 and became effective for requests for equitable relief pending on September 16, 2013.[23] As discussed below, the Tax Court continued to apply Revenue Procedure 2003-61 pending finalization of the new revenue procedure. However, it occasionally considered whether the revenue procedure as proposed would change its analysis.[24]

Factors common to Revenue Procedure 2003-61, the proposed revenue procedure, and Revenue Procedure 2013-34 include

- Marital status;
- Economic hardship;
- Knowledge or reason to know of the understatement or that the tax would not be paid;
- Legal obligations of the nonrequesting spouse;
- Significant benefit to the requesting spouse; and
- Compliance with income tax laws.

Abuse was an additional factor under Revenue Procedure 2003-61; the new guidance removed abuse as a separate factor, but clarified the effect abuse has on the analysis generally and on the knowledge factor and significant benefit factors specifically.[25]

Rights of 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.[26] 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.[27] 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.[28]

If the requesting spouse files a Tax Court petition, the nonrequesting spouse must receive notice of the Tax Court proceeding and has an unconditional right to intervene in the proceeding to dispute or support the requesting spouse's claim for relief.[29] However, an intervening spouse has no standing to appeal the Tax Court's decision to the United States Court of Appeals.[30]

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23 2013-42 I.R.B. 1.

24 *Sriram v. Comm'r*, T.C. Memo. 2012-91, was the first case in which the Tax Court analyzed the IRC § 6015(f) claim under the provisions of both Rev. Proc. 2003-61 and Notice 2012-8. More recent examples of this approach are discussed below.

25 Notice 2012-8 and Rev. Proc 2013-34, §§ 4.01(5), (7)(d); 4.02(3); 4.03(2)(c)(iv), (e).

26 IRC § 6015(h)(2).

27 Rev. Proc. 2003-19, 2003-5 C.B. 371.

28 *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).

29 *Van Arsdalen v. Comm'r*, 123 T.C. 135 (2004).

30 *Baranowicz v. Comm'r*, 432 F.3d 972 (9th Cir. 2005).

Judicial Review

Taxpayers seeking relief under IRC § 6015 generally file Form 8857, *Request for Innocent Spouse Relief*.[31] After reviewing the request, the IRS issues a final notice of determination granting or denying relief in whole or in part. The taxpayer has 90 days from the date the IRS mails the notice to file a petition with the Tax Court.[32] The Tax Relief and Health Care Act of 2006 amended IRC § 6015(e) 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.[33]

ANALYSIS OF LITIGATED CASES

We analyzed 31 opinions issued between June 1, 2012, and May 31, 2013, including 21 Tax Court opinions, one each from the United States Courts of Appeals for the First, Fifth, Ninth, Eleventh, and Federal Circuits, two from the Court of Appeals for the Sixth Circuit, and three from U.S. District Courts. Sixty-five percent of the cases (20 of 31) were decided in favor of the IRS and 32 percent (10 of 31) in favor of the requesting spouse (including two cases in which only the intervenor opposed granting relief). One case (three percent) ended in a split decision. In 35 percent (11 of 31) of the cases, the taxpayers appeared *pro se* (*i.e.*, they represented themselves). Taxpayers who proceeded *pro se* prevailed in spite of opposition from the IRS in three cases out of 11 (27 percent).[34] One *pro se* taxpayer obtained a split decision. The nonrequesting spouse intervened in 23 percent of the cases (seven of 31).

Seventy-one percent of the cases (22 of 31) involved an analysis of whether to grant relief. Twenty-nine percent of the cases (nine of 31) involved procedural issues, with 78 percent (seven of nine) of these cases decided in favor of the IRS, and 22 percent (two of nine) in favor of the taxpayer.

Of the 22 cases decided on the merits, 59 percent (13 of 22) were decided in favor of the IRS, and 36 percent (eight of 22) in favor of the taxpayer. In five percent (one case) the court split its decision. See Table 10 in Appendix 3 for a detailed breakdown of the cases.

Procedural Issues

The Court of Appeals for the Ninth Circuit affirmed the Tax Court's holding in *Wilson v. Commissioner*, discussed in the National Taxpayer Advocate's 2011 Annual Report to Congress, that the Tax Court provides *de novo* review of claims for relief under IRC § 6015(f).[35] Additionally, two district courts

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31 *See* IRS Form 8857, *Request for Innocent Spouse Relief, Instructions* (Sept. 2010).

32 IRC § 6015(e)(1)(A)(ii).

33 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 "stand-alone" proceeding, because jurisdiction is predicated on IRC § 6015(e) and not deficiency jurisdiction under IRC § 6213.

34 Taxpayers who proceeded *pro se* prevailed in an additional two cases in which only the intervenor (and not the IRS) opposed relief.

35 *Wilson v. Comm'r*, 705 F.3d 980 (9th Cir. 2013) *aff'g* T.C. Memo. 2010-134; National Taxpayer Advocate 2011 Annual Report to Congress 655 (Most Litigated Issue: *Relief from Joint and Several Liability under IRC § 6015*) at 661.

continued the disturbing trend of holding that a taxpayer was not entitled to raise innocent spouse relief as a defense in a collection suit.[36] A third district court refused to allow the defense in an interpleader suit.[37]

Wilson v. Commissioner

In *Wilson v. Commissioner*,[38] Mr. Wilson, an insurance salesman, generated additional income by steering people into a Ponzi scheme. Mrs. Wilson was aware of the additional income but believed it derived from legitimate business operations. The additional income, which arose in 1997-1999, was not reported on the joint returns the couple filed for 1997 or 1998. The couple later filed amended 1997 and 1998 returns that reported the income, and included the additional income on their 1999 joint return. The resulting $540,000 tax debt from the returns for the three years remained unpaid. In 2002, Mrs. Wilson requested innocent spouse relief under IRC § 6015(f) in a stand-alone petition.[39]

In the Tax Court proceeding, pursuant to *Porter v. Commissioner* (*Porter I*),[40] the Tax Court's scope of review was *de novo*, which means that the court could and did consider evidence introduced at trial that was not part of the administrative record. The Tax Court's decision in *Porter I* was in turn based on its earlier holding in *Ewing v. Commissioner*,[41] in which the Tax Court found that the Administrative Procedure Act (APA),[42] which limits the scope of judicial review to the administrative record, was not applicable to Tax Court proceedings, including IRC § 6015 proceedings. Further, the Tax Court found that the use of the word "determine" in IRC § 6015 is similar to the use of the word "redetermination" in IRC § 6213(a) under which it is unquestioned that the scope of its review is *de novo*. The Tax Court concluded that the use of this term meant that Congress intended the court to have *de novo* review authority for IRC § 6015 cases. The Court of Appeals for the Eleventh Circuit had also held that *de novo* review is appropriate for Tax Court review of stand-alone claims under IRC § 6015(f).[43] However, the IRS did not agree with the decision in *Porter I*, and instructed Chief Counsel attorneys to, among other things, continue to raise the scope of review argument whenever appropriate.[44]

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36 *U.S. v. Popowski*, 110 A.F.T.R.2d (RIA) 6997 (D.S.C. 2012); *U.S. v. Elman*, 110 A.F.T.R.2d (RIA) 6993 (N.D. Ill. 2012). 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*).

37 *Simmons Perrine Moyer Bergman, PLC v. Coleman*, 1111 A.F.T.R.2d (RIA) 1237 (N.D. Iowa 2013).

38 T.C. Memo. 2010-134, *aff'd by* 705 F.3d 980 (9th Cir. 2013).

39 The trial began in 2005, but the Tax Court suspended the case due to the questioned jurisdiction of the Tax Court over stand-alone innocent spouse cases. *See Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), *rev'g* 118 T.C. 494 (2002) and vacating 122 T.C. 32 (2004). As discussed *supra*, the Tax Relief and Health Care Act of 2006 amended IRC § 6015(e) to expressly provide that the Tax Court has jurisdiction to review IRC § 6015(f) determinations even when no deficiency has been asserted, permitting Mrs. Wilson's case to go forward.

40 130 T.C. 115 (2008) (*Porter I*). In *Porter I*, the Tax Court denied the IRS's motion *in limine* (*i.e.*, as a preliminary matter), which sought to preclude the taxpayer from offering evidence not already contained in the administrative record.

41 118 T.C. 494 (2002), vacated on other grounds sub nom. *Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006).

42 5 U.S.C. §§ 551-559, 701-706 (2000).

43 *Neal v. Comm'r*, 557 F.3d 1262 (11th Cir. 2009), *aff'g* T.C. Memo. 2005-201.

44 Notice CC-2009-021 (June 30, 2009) supplementing Notice CC-2004-26 (July 12, 2004).

Pursuant to its decision in *Porter v. Commissioner (Porter II)*,[45] the Tax Court used the *de novo* standard of review, rather than an abuse of discretion standard of review. Under a *de novo* standard, the court considers the facts of the case anew and determines whether it is inequitable to hold the requesting spouse liable for the unpaid tax or deficiency. Under an abuse of discretion standard, the court reviews the IRS's denial of relief and overturns that determination only where it is shown to be arbitrary, capricious, or without sound basis in fact, and the requesting spouse bears the burden of proving that the Commissioner abused his discretion in denying relief.[46] The IRS also did not agree with the decision in *Porter II*, and instructed Chief Counsel attorneys to, among other things, continue to raise the standard of review argument whenever appropriate.[47]

The Tax Court held that Mrs. Wilson was entitled to relief under IRC § 6015(f), and articulated the ways in which its conclusions, based on *de novo* review, differed from the IRS's conclusions that were based solely on the administrative record.[48] The IRS appealed the Tax Court's decision to the Court of Appeals for the Ninth Circuit. While the appeal was pending, the National Taxpayer Advocate recommended that Congress clarify that the scope and standard of Tax Court determinations under IRC § 6015(f) is *de novo*.[49]

The Court of Appeals for the Ninth Circuit affirmed the Tax Court's decision. The court noted that the statutory mandate in IRC § 6015(e) that the Tax Court "determine" the appropriate relief "in light of all the facts and circumstances" suggests a *de novo* scope of evidentiary review; the Court of Appeals for the Eleventh Circuit had arrived at this conclusion; and a different approach would produce inconsistencies in different types of IRC § 6015(f) claims.[50] The court did not decide whether the APA applies to Tax Court proceedings (although it acknowledged that there is "considerable doubt" on this point).[51] However, it noted that even if the APA applies, an exception to the general rule that review is limited to the agency record permits a reviewing court to require supplementation of an incomplete administrative record, and that "[t]he ability to supplement the administrative record is particularly important in equitable relief cases, which require a fact-intensive inquiry of sensitive issues that may not come to light during the administrative phase of review."[52] Supplementing the administrative record was critical to determining whether the IRS had properly considered Mrs. Wilson's claim, and the Tax Court properly considered the additional evidence.[53]

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45 132 T.C. 203 (2009); *Porter II* is a continuation of the same case that produced the 2008 holding (*Porter I, see supra* note 40) that Tax Court review of denials of relief under IRC § 6015(f) is not limited to the administrative record.

46 *Jonson v. Comm'r*, 118 T.C. 106, 125, *aff'd* by 353 F.3d 1181 (10th Cir. 2003).

47 Notice CC-2009-021 (June 30, 2009), supplementing Notice CC-2004-26 (July 12, 2004).

48 For a complete discussion of the Tax Court's analysis of the relevant factors, see National Taxpayer Advocate 2011 Annual Report to Congress (Most Litigated Issue: *Relief from Joint and Several Liability Under IRC § 6015*) at 661.

49 National Taxpayer Advocate 2011 Annual Report to Congress 531 (Legislative Recommendation: *Clarify that the Scope and Standard of Tax Court Determinations Under Internal Revenue Code Section 6015(f) is De Novo*).

50 705 F.3d 980, 988-989. For example, if a taxpayer petitions the Tax Court after the request for relief has been pending for six months, as permitted by IRC § 6015(e)(1)(A)(i)(II), there may be no administrative record. As another example, a taxpayer may, in a deficiency proceeding, raise IRC § 6015(f) as an affirmative defense. Again, there would be no administrative record to consult, and the scope of review would be *de novo*. Moreover, Congress provided for intervention by nonrequesting spouses, which suggests it intended trials *de novo* under IRC § 6015(f) to permit the other spouse to offer evidence.

51 705 F.3d 980, 990, n. 16.

52 705 F.3d 980, 991, citing the National Taxpayer Advocate 2011 Annual Report to Congress (Most Serious Problem: *The IRS Does Not Sufficiently Recognize and Address Domestic Violence and Abuse and its Effects on Tax Administration*).

53 The court noted that many taxpayers claiming innocent spouse relief like Mrs. Wilson proceed *pro se*, citing the National Taxpayer Advocate 2011 Annual Report to Congress 589 (Most Litigated Issues: *Introduction, Analysis of Pro Se Litigation*).

The court also held that the Tax Court properly reviewed Wilson's claim anew, rather than for an abuse of discretion. Because the Tax Court may consider a claim in which there is no administrative record at all, it would be illogical to require review only for abuse of discretion. The IRS agreed that a *de novo* scope of review is incompatible with review for abuse of discretion because such an approach may result in the Tax Court finding the IRS abused its discretion in denying relief based on evidence not before the IRS. The court noted that it would be pointless for the Tax Court to compile a *de novo* record by considering evidence not in the administrative record if the court could then only review the claim for an abuse of discretion.[54] "Finally," the court noted, "the nature of equitable relief also favors de novo review. … The award of equitable spouse relief often turns on credibility, which is best tested in the crucible of trial rather than in a bureaucratic office in which the officer is unlikely even to meet the claimant. In this unique context, de novo review of the agency decision is particularly appropriate."[55]

On June 17, 2013, the IRS announced its acquiescence in the *Wilson* decision, stating that "[a]lthough the Service disagrees that section 6015(e)(1) provides both a *de novo* standard and a *de novo* scope of review, the Service will no longer argue that the Tax Court should review section 6015(f) cases for an abuse of discretion or that the court should limit its review to the administrative record."[56] Chief Counsel attorneys were instructed to proceed accordingly.[57]

U.S. v. Popowsi, U.S. v. Elman, and Simmons v. Coleman

The *Popowski* and *Elman* cases[58] further illustrate the need for legislative clarification to counter the judicial view, identified by the National Taxpayer Advocate in past Annual Reports to Congress, that a taxpayer may not raise IRC § 6015 as a defense in district court proceedings.[59] IRC § 6015 (e)(1)(A) provides that an individual who seeks relief from joint liability may, "in addition to any other remedy provided by law," petition the Tax Court to determine the appropriate relief available. At least one district court has considered the defense in a suit to reduce joint federal tax assessments to judgment and to foreclose federal tax liens.[60] Other statutory provisions and judicial precedent support the conclusion that taxpayers may raise IRC § 6015 in a variety of contexts.[61] However, in the *Popowski* and *Elman* cases, two district courts, one in South Carolina and one in Illinois, held that they do not have jurisdiction over IRC

54 705 F.3d 980, 992-993.

55 705 F.3d 980 at 993. The court added that the IRC § 6015(e) jurisdictional grant to the Tax Court to "determine" whether relief is appropriate buttressed its conclusion that *de novo* review is appropriate. The Tax Court had always reviewed claims under IRC § 6015 (b) and (c) *de novo*, and the 2006 statutory direction that the Tax Court determine the appropriate relief available under subsections (b), (c), and (f), indicated that uniformity in the standard of review was intended for all claims under IRC § 6015.

56 Action on Dec., 2012-07 (June 17, 2013).

57 Notice CC-2013-11 (June 7, 2013), obsoleting Notice CC-2009-021 (June 30, 2009), and Notice CC-2004-26 (July 12, 2004), *supra* notes 44 and 47.

58 *U.S. v. Popowski*, 110 A.F.T.R.2d (RIA) 6997 (D.S.C. 2012); *U.S. v. Elman*, 110 A.F.T.R.2d (RIA) 6993 (N.D. Ill. 2012).

59 *See* 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. Moreover, the National Taxpayer Advocate three times recommended that legislation clarify that taxpayers may raise relief under IRC §§ 6015 and 66 as a defense in collection actions. *See* National Taxpayer Advocate 2010 Annual Report to Congress 377; National Taxpayer Advocate 2009 Annual Report to Congress 378; National Taxpayer Advocate 2007 Annual Report to Congress 549.

60 *U.S. v. Melot*, 109 A.F.T.R.2d (RIA) 1568 (D.N.M. 2012), *appeal dismissed* (10th Cir. Aug. 1, 2012) (holding that relief under IRC § 6015 was not available because the taxpayer requesting relief had not filed a joint return, and that relief under IRC § 66 was not available because the taxpayer did not establish that she did not know, and had no reason to know, of the item of community income giving rise to the unpaid tax).

61 *See* IRC §§ 6320(c) and 6330(c)(2)(A)(i) (pertaining to collection due process proceedings); IRC § 6213 and *Corson v. Comm'r*, 114 T.C. 354, 363 (2000) (pertaining to deficiency proceedings); 11 U.S.C.A.§ 505(a) (pertaining to bankruptcy proceedings); and IRC § 7422 (pertaining to refund suits).

§ 6015 claims raised as a defense in an action to reduce joint federal tax assessments to judgment or in a lien foreclosure suit.

In *Popowski*, Mrs. Popowski alleged that she had sought innocent spouse relief from the IRS, which was denied.[62] Mrs. Popowski did not petition the Tax Court for review of the determination. When Mrs. Popowski sought to raise a claim for innocent spouse relief as a defense in a suit to reduce joint tax liabilities to judgment, the court found that she had not made any evidentiary showing that she qualified for innocent spouse relief. The court held that even if Mrs. Popowski had submitted such evidence, "the Court has no authority to hear it. The defendant essentially concedes and the plaintiff amply demonstrates that the 'innocent spouse' defense may only be heard by the Tax Court."[63] Mrs. Popowski was not permitted to raise her innocent spouse claim as a defense, and the court granted the government's motion for summary judgment.

In *Elman*, Mrs. Elman sought innocent spouse relief as a defense in a suit to reduce to judgment joint tax liabilities from tax years 1996, 1998, and 1999 and to enforce federal tax liens on her home.[64] The IRS had rejected Mrs. Elman's request for relief under IRC § 6015(b), (c), and (f) because she did not request relief within two years of August 4, 2003, the date the IRS commenced its first collection activity against her.[65] In addition, the IRS rejected the claim under IRC § 6015(f), because, it said, Mrs. Elman had not shown that at the time the returns were filed, she had reason to believe Mr. Elman (who died in 2005) would pay the tax, and she had not proven her claim of economic hardship. The IRS Office of Appeals agreed with the denial of relief, and Mrs. Elman did not petition the Tax Court for review. The court, citing *U.S. v. Boynton*, noted "[a]lthough the statute itself does not address whether the Tax Court's jurisdiction is exclusive, courts interpreting the statute have concluded that it is."[66] The court held that exclusive jurisdiction over Mrs. Elman's innocent spouse claim lies with the Tax Court and that it lacked jurisdiction to entertain the innocent spouse defense. It therefore granted the government's motion for summary judgment to reduce the tax liabilities to judgment.[67]

As the National Taxpayer Advocate has pointed out, these district court decisions are inconsistent with the statutory language of IRC § 6015, which does not give the Tax Court exclusive jurisdiction to determine innocent spouse claims, but rather confers Tax Court jurisdiction "in addition to any other remedy

62 *U.S. v. Popowski*, 110 A.F.T.R.2d (RIA) 6997 (D.S.C. 2012).

63 *Popowski*, 110 A.F.T.R.2d (RIA) 6997 (D.S.C. 2012), slip op. at 7.

64 *U.S. v. Elman*, 110 A.F.T.R.2d (RIA) 6993 (N.D. Ill. 2012).

65 Mrs. Elman requested relief on May 18, 2006. As discussed above, claims for relief under IRC § 6015(b) or (c) must be made within this two-year timeframe, and at the time Mrs. Elman requested relief, the IRS adhered to Treas. Reg. 1.6015-5(b)(1), which imposed the same two-year deadline on requests for relief under IRC § 6015(f). As described above, the IRS no longer applies the two-year deadline to requests for relief under IRC § 6015(f).

66 *U.S. v. Elman*, 110 A.F.T.R.2d (RIA) 6993, slip op. at 8, citing *U.S. v. Boynton*, 99 A.F.T.R.2d (RIA) 920 (S.D. Cal. 2007) (holding that the district court has no jurisdiction to consider the innocent spouse defense when the taxpayer has not first sought such relief with the IRS, reasoning that otherwise a district court and the Tax Court would have concurrent jurisdiction over the claim and might be placed in the position of adjudicating the same issues at the same time). District courts in California have continued to refuse the defense in collection suits, and district courts in other jurisdictions have also not permitted the defense. *See U.S. v. LeBeau*,109 A.F.T.R.2d (RIA)1369 (S.D. Cal. 2012) (relying on *Boynton*); *U.S. v. Miles*, 109 A.F.T.R.2d (RIA) 1602 (N.D. Cal. 2012) (relying on *Boynton*); *U.S. v. Wallace*, 105 A.F.T.R.2d 2827 (S.D. Ohio 2010), *adopted by* 105 A.F.T.R.2d (RIA) 2831 (S.D. Ohio 2010) (relying on *Boynton*); *U.S. v. Bucy*, 100 A.F.T.R.2d (RIA) 6666 (S.D. W. Va. 2007); *U.S. v. Feda*, 97 A.F.T.R.2d (RIA) 1985, 1989 (N.D. Ill. 2006) (taxpayer could not raise IRC § 6015 as a defense in a suit to reduce joint federal tax assessments to judgment); *U.S. v. Cawog*, 97 A.F.T.R.2d (RIA) 3069 (W.D. Pa. 2006), *appeal dismissed* (3d Cir. July 5, 2007) (taxpayer could not raise IRC § 6015 as a defense in a suit to foreclose tax liens).

67 Because the government anticipated that proceeds from the sale of Mrs. Elman's home would be insufficient to pay her tax liabilities, it had invited Mrs. Elman to enter into a compromise of the liability. The court therefore denied without prejudice the government's motion for summary judgment to foreclose on the liens on Mrs. Elman's home and strongly urged the parties to settle the dispute.

provided by law." Nothing in IRC § 6015 prevents a district court from determining, in a collection suit, whether innocent spouse relief is available. As noted above, another district court actually did so last year.[68] Moreover, the refusal to allow a taxpayer to raise IRC § 6015 as a defense in a collection suit may create hardship because a taxpayer may be left without a forum in which to raise IRC § 6015 as a defense before losing her home to foreclosure by the IRS.

This year, a district court also refused to allow a taxpayer to raise innocent spouse relief as a defense in an interpleader suit. In *Simmons v. Coleman*,[69] Mr. Coleman had been injured in a motor vehicle accident, and he and Mrs. Coleman settled a suit for damages for Mr. Coleman's personal injuries and for Mrs. Coleman's loss of consortium.[70] The settlement proceeds had been deposited with the Clerk of the Court. Mr. Coleman's automobile insurance company had paid medical bills resulting from the accident and claimed it was entitled to a portion of the settlement proceeds. The United States also claimed that it was entitled to apply the proceeds to the Colemans' unpaid joint tax liabilities and to taxes owed by Mr. Coleman separately.[71] The state of Iowa also claimed it was entitled to a portion of the settlement proceeds to satisfy unpaid taxes. Mrs. Coleman claimed she was not liable for the unpaid taxes because she was an innocent spouse under IRC § 6015(f) and that because 40-50 percent of the settlement proceeds were attributable to her loss of consortium claim, she was entitled to those amounts free of any claim for unpaid taxes. The court, citing the *Elman* case, agreed with the government that it did not have jurisdiction to hear Mrs. Coleman's innocent spouse claim in the interpleader action before it and that she therefore remained jointly and severally liable for unpaid taxes.[72] Even if some of the settlement proceeds were Mrs. Coleman's separate property, they would still be subject to the government's tax lien. The court therefore granted the government's motion for summary judgment on the innocent spouse issue, but noted that its decision did not prevent Mrs. Coleman from seeking a refund by pursuing her innocent spouse claim with the IRS.[73]

Although not addressed by the court in *Simmons*, unlike a suit to reduce an assessment to judgment or to foreclose a tax lien where a taxpayer can challenge the merits of the assessment as part of the proceeding, normally when an interpleader is brought and the Government's sovereign immunity is waived under 28 U.S.C. § 2410, a taxpayer can only challenge the procedural validity of the federal tax lien, not the merits of the assessment.[74] Because seeking relief under section 6015 would be a challenge to the underlying assessment, prohibiting a taxpayer from raising innocent spouse in an interpleader action seems to be consistent with the existing statutory scheme. Thus, the "in addition to any other remedy provided by law" language found in section 6015 would not provide a basis for raising section 6015 as a defense in

68 *U.S. v. Melot*, 109 A.F.T.R.2d (RIA) 1568 (D.N.M. 2012), *appeal dismissed* (10th Cir. Aug. 1, 2012) (holding, in a suit to reduce joint federal tax assessments to judgment and to foreclose federal tax liens, that relief under IRC § 6015 was not available because the taxpayer requesting relief had not filed a joint return, and that relief under IRC § 66 was not available because the taxpayer did not establish that she did not know, and had no reason to know, of the item of community income giving rise to the unpaid tax).

69 *Simmons Perrine Moyer Bergman, PLC v. Coleman*,111 A.F.T.R.2d (RIA) 1237 (N.D. Iowa 2013).

70 The Restatement (Second) of Torts § 693 describes the elements of a claim for loss of consortium: "One who by reason of his tortious conduct is liable to one spouse for illness or other bodily harm is subject to liability to the other spouse for the resulting loss of the society and services of the first spouse, including impairment of capacity for sexual intercourse, and for reasonable expense incurred by the second spouse in providing medical treatment." *See also* Iowa Code § 613.15. *Injury or Death of Spouse—Measure of Recovery*.

71 In pertinent part, 28 U.S.C. § 2410(a) provides: "[T]he 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—…5) of interpleader or in the nature of interpleader with respect to, real or personal property on which the United States has or claims a mortgage or other lien."

72 *Simmons Perrine Moyer Bergman, PLC v. Coleman*,111 A.F.T.R.2d (RIA) 1237, slip op. at 22-24.

73 *Simmons Perrine Moyer Bergman, PLC v. Coleman*,111 A.F.T.R.2d (RIA) 1237, slip op. at 30, n. 20.

74 *Elias v. Connett*, 908 F.2d 521, 527 (9th Cir. 1990).

an interpleader action. However, as the court points out, the taxpayer in this situation is not without recourse, as he or she can file a refund claim.

Relief on the Merits

While the courts considered many factors in determining the appropriateness of relief on the merits under IRC § 6015, the most significant factor was whether the requesting taxpayer had actual or constructive knowledge that there was a deficiency or that the nonrequesting spouse would not pay the tax. All three avenues for relief contain a knowledge element or factor, making it the linchpin in most of the courts' analyses.[75] Actual or constructive knowledge was a factor in 21 of the 22 cases decided on the merits. These cases suggest that determining what a taxpayer knew or should have known will continue to generate a significant amount of controversy as long as joint filers are taxed on their combined incomes and remain jointly and severally liable for the tax that must be shown on the return.

In addition, five Tax Court cases considered the effect that Notice 2012-8, if final, would have had on the analysis of a claim for relief under IRC § 6015(f). In three of the cases, the court noted that the factors taken into account in evaluating the claim would have weighed the same way (in favor of or against relief) under both Revenue Procedure 2003- 61 and the proposed guidance in Notice 2012-8.[76] In two cases, the court noted that a factor would have weighed differently under Notice 2012-8 than under Revenue Procedure 2003-61.

In *Cutler v. Commissioner*,[77] the court found that Mrs. Cutler, who obtained relief from underpayments, did not significantly benefit (beyond normal support) from the unpaid tax liabilities. Revenue Procedure 2003-61 identifies significant benefit as a "relevant" factor, but does not specify whether the absence of significant benefit should weigh in favor of relief.[78] Relying on its own precedent, the Tax Court found this factor weighed in favor of granting relief.[79] In contrast, Notice 2012-8 provides that "[i]f the amount of unpaid tax or understated tax was small such that neither spouse received a significant benefit, then this factor is neutral."[80] The Tax Court found that neither spouse received a significant benefit from the unpaid liabilities, so this factor would change from favorable to neutral if Notice 2012-8 applied.

In *Hudgins v. Commissioner*,[81] the court found that Mrs. Hudgins did not show that she would suffer economic hardship if denied relief under IRC § 6015(f), a factor Revenue Procedure 2003-61 also identifies as "relevant" without specifying how the absence of the factor should be treated.[82] The Tax Court applied its own precedent and held the absence of economic hardship weighed against granting relief.[83] In contrast, Notice 2012-8 provides that the absence of economic hardship would be considered neutral.[84]

75 *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.

76 *Henson v. Comm'r*, T.C. Memo. 2012-288; *Stanwyck v. Comm'r*, T.C. Memo. 2012-180, *appeal docketed*, No. 12-73136 (9th Cir. Oct. 1, 2012); *Deihl v. Comm'r*, T.C. Memo. 2012-176, *appeal docketed*, No. 12-74169 (9th Cir. Dec. 21, 2012).

77 T.C. Memo. 2013-119.

78 *See* Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.03(2)(a)(v).

79 *Cutler v. Comm'r*, T.C. Memo. 2013-119, 19-21.

80 Notice 2012-8, § 4.03(2)(e).

81 T.C. Memo. 2012-260.

82 Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.03(2)(a)(ii).

83 *Hudgins v. Comm'r*, T.C. Memo. 2012-260 at 34.

84 Notice 2012-8, § 4.03(2)(b).

The court noted this difference, but also noted it would have denied relief even if the proposed guidance applied.[85]

CONCLUSION

This year, the Tax Court's holding that its review of IRC § 6015(f) claims is *de novo* was affirmed by a court of appeals and the IRS acquiesced to that position. District courts continued the troubling trend of not permitting the innocent spouse defense in collection actions before them. For this reason, the National Taxpayer Advocate again urges Congress to state definitively that innocent spouse claims can be raised as a defense in collection actions. The Tax Court, in evaluating claims for innocent spouse relief under IRC § 6015(f), indicated in two cases how its analysis would change if the proposed guidance in Notice 2012-8 had applied. The proposed guidance has now been finalized as Revenue Procedure 2013–34. We expect future cases to provide additional insight on how the new guidance affects innocent spouse cases.

85 *Hudgins v. Comm'r*, T.C. Memo. 2012-260 at 40, n. 18.