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, 2013, through May 31, 2014, by using commercial legal research databases. For purposes of this section of the Annual Report, the term "litigated" means cases in which the court issued an opinion.[2] This year's Most Litigated Issues are:

- Accuracy-related penalty (IRC § 6662(b)(1) (2), and (3));[3]
- Trade or business expenses (IRC § 162(a) and related Code sections);
- Summons enforcement (IRC §§ 7602(a), 7604(a), and 7609(a));
- Gross income (IRC § 61 and related Code sections);
- 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 failure to pay estimated tax penalty (IRC § 6654);
- Civil actions to enforce federal tax liens or to subject property to payment of tax (IRC § 7403);
- Frivolous issues penalty (IRC § 6673 and related appellate-level sanctions);
- Charitable deductions (IRC §170); and
- Passive activity losses and credits (IRC § 469).[4]

All of these issues were identified as Most Litigated Issues last year, with the exception of passive activity losses and credits.[5] Accuracy-related penalties remained the top issue this year, although we identified 25 fewer cases.[6] The number of CDP cases decreased significantly this year with 105 cases in 2013, and only

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 published or precedential.

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

4 This year we identified cases under IRC §§ 7402, 7407, and 7408 which involve injunctions against tax return preparers. While there was a high number of cases, most of the cases were conceded or not decided on the merits. Therefore, we have not included this issue in the top ten this year. However, the frequency of this issue underscores the need for regulation of tax return preparers, which the National Taxpayer Advocate has continuously recommended. *See, e.g.*, National Taxpayer Advocate 2013 Annual Report to Congress 61 (Most Serious Problem: *Regulation of Return Preparers*); National Taxpayer Advocate 2008 Annual Report to Congress 423 (Legislative Recommendation: *The Time Has Come to Regulate Federal Tax 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*).

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

6 *See id.* at 339.

76 in 2014.[7] Cases involving failure to pay and failure to file penalties saw the largest decrease of about 35 percent with 86 cases in 2013, and only 56 in 2014.[8]

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).[9] 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 court's decision.[10]

We have also included a "Significant Cases" section summarizing decisions that are not among the top ten issues but are relevant to tax administration.[11] This year, the Significant Cases discussion includes three decisions issued by the Supreme Court that impact tax adminstration issues.[12]

AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

Initially, taxpayers can generally litigate a tax matter in four different types of courts:

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

With limited exceptions, taxpayers have an automatic right of appeal from decisions of any of these courts.[13]

The Tax Court is a "prepayment" forum. In other words, taxpayers can access the Tax Court without having to pay the disputed tax in advance. The Tax Court has jurisdiction over a variety of issues, including

7 National Taxpayer Advocate 2013 Annual Report to Congress 371.

8 *See id.* at 384.

9 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.

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

11 Two of the cases discussed in the "Significant Cases" section of this report were decided outside the June 1, 2013, through May 31, 2014, period used to identify the ten most litigated issues, but we nonetheless have included these cases because of their impact on tax administration.

12 *United States v. Clarke*, 134 S. Ct. 2361 (2014), *vacating and remanding* 517 F. App'x 689 (11th Cir. 2013), *vacating and remanding* 2012-2 U.S.T.C. (CCH) ¶ 50,732 (S.D. Fla. 2012), *on remand*, 573 F. App'x. 826 (2014); *United States v. Quality Stores, Inc.*, 134 S. Ct. 1395 (2014), *rev'g* 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); *United States v. Woods*, 134 S. Ct. 557 (2013), *rev'g* 471 F. App'x 320 (5th Cir. 2012), *aff'g* 794 F. Supp. 2d 714 (W.D. Tex. 2011).

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

deficiencies, certain declaratory judgment actions, appeals from collection due process hearings, relief from joint and several liability, and determination of employment status.[14]

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,[15] and (2) the taxpayer has filed an administrative claim for refund.[16] The United States District Courts, along with the bankruptcy courts in very limited circumstances, provide the only fora in which a taxpayer can receive a jury trial.[17] Bankruptcy courts can adjudicate tax matters that were not adjudicated prior to the initiation of a bankruptcy case.[18]

ANALYSIS OF *PRO SE* LITIGATION

As in previous years, many taxpayers appeared before the courts *pro se*. Figure 3.0.1 lists the Most Litigated Issues for the review period of June 1, 2013, through May 31, 2014, 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 failure to file, failure to pay, and estimated tax penalties and the frivolous issues penalty.

FIGURE 3.0.1, *Pro se* cases by issue

Most Litigated Issue	Litigated Cases Reviewed	*Pro Se* Litigation	% of Cases Involving *Pro Se* Taxpayers
Accuracy-Related Penalty	153	81	53%
Trade or Business Expenses	115	74	64%
Summons Enforcement	102	70	69%
Gross Income	89	55	62%
Collection Due Process	76	48	63%
Failure to File, Failure to Pay, and Estimated Tax Penalties	56	41	73%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	52	26	50%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	30	28	93%
Charitable Deductions	30	13	43%
Passive Activity Losses and Credits	28	17	61%
Total	**731**	**453**	**62%**

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

15 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).

16 IRC § 7422(a).

17 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).

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

Figure 3.0.2 affirms our contention that overall, taxpayers are more likely to prevail if they are represented.

FIGURE 3.0.2, Outcomes for *pro se* and represented taxpayers

	Pro Se Taxpayers			Represented Taxpayers		
Most Litigated Issue	Total Cases	Taxpayer prevailed in whole or in part	Percent	Total Cases	Taxpayer prevailed in whole or in part	Percent
Accuracy-Related Penalty	81	11	14%	72	23	32%
Trade or Business Expenses	74	17	23%	41	11	27%
Summons Enforcement	70	0	0%	32	5	16%
Gross Income	55	4	7%	34	12	35%
Collection Due Process	48	2	4%	28	6	21%
Failure to File, Failure to Pay, and Estimated Tax Penalties	41	4	10%	15	3	20%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	26	2	8%	26	3	12%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	28	4	14%	2	1	50%
Charitable Contributions	13	2	15%	17	3	18%
Passive Activity Losses and Credits	17	1	6%	11	4	36%
Total	**453**	**47**	**10%**	**278**	**71**	**26%**

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. Clarke*, the Supreme Court held that to obtain a hearing concerning whether an IRS summons was issued for an improper purpose, a taxpayer must produce circumstantial evidence that plausibly raises an inference of bad faith.[2]

In 2010, the IRS examined returns filed by Dynamo Holdings Limited Partnership (Dynamo) for tax years 2005-2007. In August 2010, the revenue agent signed, but did not mail, a notice of Final Partnership Administrative Adjustment (FPAA).[3] In September and October 2010, immediately following Dynamo's refusal to extend the statute of limitations on assessment, the agent issued summonses to various parties, including Mr. Clarke, the chief financial officer for both Dynamo and Beekman Vista, Inc. (Beekman).[4] In December 2010, the IRS mailed the FPAA to Dynamo.

In February 2011, Dynamo filed suit in the Tax Court to challenge the adjustments reflected in the FPAA. In April 2011, the government sought to enforce the summons in the District Court for the Southern District of Florida so that it could use the information in the case pending before the Tax Court.[5]

By way of background, a district court will enforce a summons under Internal Revenue Code (IRC) § 7604 if the IRS demonstrates it issued the summons for a legitimate purpose, seeks information relevant to that purpose, which the IRS does not possess, and that it followed the administrative steps required by the Code.[6] In a typical case, the IRS satisfies these requirements by producing a sworn affidavit from the investigating agent, which then shifts the burden to the person resisting the summons to raise a "substantial question" as to whether the summons is an abuse of process.[7] If he meets this burden, then an "adversary hearing" is granted at which he may "challenge the summons on any appropriate ground."[8]

1 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2013, and ending on May 31, 2014. For purposes of this section, we generally used the same period, except that we discuss one Supreme Court case decided shortly thereafter and another case that was reversed on appeal after this discussion had been drafted.

2 *United States v. Clarke*, 134 S. Ct. 2361 (2014) [*hereinafter Clarke III*], *vacating and remanding* 517 F. App'x 689 (11th Cir. 2013) [*hereinafter Clarke II*], *vacating and remanding* 2012-2 U.S.T.C. (CCH) ¶ 50,732 (S.D. Fla. 2012) [*hereinafter Clarke I*], *on remand*, 573 F. App'x. 826 (2014) [*hereinafter Clarke IV*].

3 Brief for Respondents at 3, *Clarke III* (No. 13-301). While summons is one of the ten most litigated issues covered elsewhere in this report, we are including a discussion of *Clarke* in this section because it is a decision of the Supreme Court that was decided outside of the reporting period. For a discussion of other notable summons cases, see Most Litigated Issue: *Summons Enforcement*, *infra*.

4 In issuing the summons after signing the FPAA, Mr. Clarke suggests that the agent did not follow the reasoning of Internal Revenue Manual (IRM) 25.5.4.4.8, which states that once a taxpayer's liability has been finally determined, "the examination has been concluded," and "[t]he Service should no longer be in the process of gathering the data to support a determination." Brief for Respondents at 4, *Clarke III* (No. 13-301). However, the IRM only instructs agents not to issue a summons "after a Statutory Notice of Deficiency (SND) *is mailed* to the taxpayer." IRM 25.5.4.4.8(3) (Oct. 4, 2006) (emphasis added).

5 Transcript of Oral Argument at 52, *Clarke III* (No. 13-301).

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

7 *See*, *e.g.*, *United States v. Lawn Builders of New England, Inc.*, 856 F.2d 388, 392 (1st Cir. 1988). The IRS presented such an affidavit in this case. *Clarke I* at *5. Although Mr. Clarke alleged the agent's declaration was unsworn, the district court characterized this allegation as "baseless." *Id*.

8 *Powell*, 379 U.S. at 58.

However, challenging a summons generally extends the statute of limitations in IRC § 6501 (assessment and collection) and IRC § 6531 (criminal prosecutions).[9]

In this case, Mr. Clarke sought a pre-enforcement hearing and discovery to challenge the summonses, alleging among other things that the IRS issued the summons (1) in retaliation for Dynamo's refusal to extend the period of limitations, (2) to examine another taxpayer (Beekman), and (3) to circumvent the Tax Court's discovery process.[10]

The district court denied Mr. Clarke's request for a hearing and ordered the summons enforced. It observed that events occurring after issuance of the summons (*e.g.*, a Tax Court proceeding) are irrelevant to its validity. It explained that the possibility the summons might enable the IRS to obtain information about Beekman would not render it unenforceable. It also concluded that a hearing was not required based on Mr. Clarke's "mere allegation" of improper purpose to retaliate.[11]

On appeal, the U.S. Court of Appeals for the Eleventh Circuit vacated and remanded the case, holding that the district court abused its discretion in denying a hearing at which Mr. Clarke could question the IRS examining agent about his motives for issuing the summons (though the court declined to authorize discovery). The court reasoned that Mr. Clarke's allegations of retaliation, if true, would make enforcement of the summons improper. It stated that "requiring the taxpayer to provide factual support for an allegation of improper purpose, without giving the taxpayer a meaningful opportunity to obtain such facts, saddles the taxpayer with an unreasonable circular burden, creating an impermissible 'Catch 22.'"[12]

The Supreme Court vacated the judgment of the Court of Appeals and remanded the case, concluding that the taxpayer is entitled to a hearing to examine an IRS agent about his or her purpose for issuing a summons only when the taxpayer can point to specific facts or circumstances that plausibly raise an inference of bad faith. Naked allegations of improper purpose are not enough, but circumstantial evidence can suffice to meet that burden. The Court stated that the U.S. Court of Appeals for the Eleventh Circuit had concluded a naked allegation of bad faith was sufficient. It had not evaluated whether the affidavits presented in the case were sufficient to raise a plausible inference of bad faith. However, the Supreme Court expressly avoided deciding whether using a summons to retaliate for a taxpayer's refusal to extend the statute of limitations or to circumvent the Tax Court's rules of discovery were improper purposes.

This case is significant because it clarifies that a taxpayer is entitled to a hearing to examine an IRS agent about his or her purpose for issuing a summons if the taxpayer presents circumstantial evidence that plausibly raises an inference of bad faith. However, it is still not clear how this standard will be applied.[13] Mr. Clarke could be deemed to have satisfied the standard on remand. If the IRS is concerned that such

9 In general, these limitations periods are tolled if the taxpayer with respect to whose liability the summons is issued, or an agent, nominee, or other person acting under the direction or control of the taxpayer, takes any action to intervene or quash the summons or if the summons remains unresolved for six months. *See generally* IRC § 7609(e); Treas. Reg. § 301.7609-5.

10 For example, a summons can compel a taxpayer to submit to a deposition that he or she might not be required to provide in litigation before the Tax Court. *See* Tax Ct. R. 70(a) ("Discovery is not available under these Rules through depositions except to the limited extent provided in Rule 74.") and Tax Ct. R. 74(c)(1)(B) (treating non-consensual depositions as "an extraordinary method of discovery.").

11 *Clarke I* at *10.

12 *Clarke II* at 691.

13 On remand, the U.S. Court of Appeals for the Eleventh Circuit remanded the case to the district court without providing more specific direction. *See Clarke IV*.

hearings could delay cases, it could take steps to avoid the appearance that summonses have been issued for an improper purpose, and thus reduce requests for hearings.[14]

In *United States v. Woods*, the Supreme Court held the 40 percent gross valuation misstatement penalty applied to partners who claimed outside basis in a partnership deemed a sham.[15]

Mr. Woods formed several partnerships to implement a tax shelter. After the IRS audited the partnerships' tax returns, it disregarded the partnerships as "shams" because they lacked "economic substance." Therefore, the IRS disallowed losses attributable to outside basis in the partnerships that Mr. Woods had claimed.

The 40 percent gross valuation misstatement penalty applies to the portion of any underpayment on a return that is "attributable to… the value of any property (or the adjusted basis of any property) claimed" that exceeds a threshold amount.[16] When an asset's true value or adjusted basis is zero, "[t]he value or adjusted basis claimed ... is considered to" exceed the gross valuation misstatement threshold.[17] Accordingly, the IRS determined that Mr. Woods was subject to the gross valuation misstatement penalty for claiming outside basis in the partnerships.[18]

The U.S. District Court for the Western District of Texas held that the partnerships were properly disregarded as shams but that the valuation misstatement penalty did not apply to the partners.[19] The court explained that when the IRS totally disallows a deduction, it may not penalize the taxpayer for a valuation overstatement included in that deduction. The underpayment is attributable to the improper deduction, rather than a valuation overstatement.[20] Accordingly, the court applied the 20 percent penalty for negligence instead of the 40 percent gross valuation misstatement penalty. The U.S. Court of Appeals for the Fifth Circuit affirmed,[21] but the Supreme Court reversed.

First, the Supreme Court addressed jurisdictional issues. Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),[22] a court in a partnership-level proceeding has jurisdiction to determine

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14 For example, the IRS could audit returns more promptly so that summonses are less likely to coincide with a taxpayer's refusal to extend the statute of limitations on assessment. Moreover, Congress has expressed a policy preference for prompt adjustments by enacting IRC § 6404(g), which suspends interest and penalties against individuals if the IRS does not timely provide the taxpayer with a notice specifically stating the amount of any increased liability and the basis for that liability, as further discussed below. *See Corbalis v. Comm'r, infra*. Improving the timeliness of any assessments may also reduce the need for the IRS to enforce summonses when a case is docketed in the Tax Court. In addition, the IRS could rely on the discovery process, rather than enforcement of previously issued administrative summonses, when cases are docketed in the Tax Court. As noted above, it is unclear if these alleged purposes would be improper. In any event, the IRS should avoid any appearance of impropriety.

15 *United States v. Woods*, 134 S. Ct. 557 (2013), *rev'g* 471 F. App'x 320 (5th Cir. 2012), *aff'g* 794 F. Supp. 2d 714 (W.D. Tex. 2011).

16 IRC §§ 6662(b), 6662(e)(1)(A), and 6662(h)(1).

17 Treas. Reg. § 1.6662–5(g).

18 IRC § 6662(h); Treas. Reg. § 1.6662–5(g). For transactions entered into after March 30, 2010, a 40 percent penalty also applies to transactions that lack economic substance, potentially reducing the importance of determining whether an amount was disallowed on the basis of a gross valuation misstatement or a lack of economic substance. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111–152, § 1409, 124 Stat. 1029, 1067-1070 (2010) (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).

19 *Woods*, 794 F. Supp. 2d at 717.

20 *Id*. at 717-19.

21 *Woods*, 471 F. App'x at 320.

22 Pub. L. No. 97-248, Title IV, 96 Stat. 648 (1982) (codified at IRC §§ 6221–6232).

partnership items and "the applicability of any penalty … which relates to an adjustment to a partnership item."[23] The court reasoned that the partner-level gross valuation misstatement penalty "relates to" the determination that the partnerships are shams because the trigger for the partners' valuation overstatement calculation is the conclusion that a sham partnership has zero basis. Thus, it held that the district court had jurisdiction to determine if the penalty could apply to the partners.

The Supreme Court rejected Mr. Woods's argument that a penalty cannot "relate to" a partnership-item adjustment if it requires a partner-level determination, such as a determination of the partner's outside basis. The Court observed that several statutory provisions assume a penalty can relate to a partnership-item adjustment even if the IRS must make partner-level determinations before it may impose the penalty.[24] Thus, it concluded that TEFRA authorizes courts in partnership-level proceedings to determine that a penalty could result from an adjustment to a partnership item, even if actually imposing the penalty may also require other partner-level determinations.[25]

Finally, the Supreme Court held that the gross valuation misstatement penalty provisionally applied to the partners. It rejected the Fifth Circuit's premise that the total disallowance of a deduction is inconsistent with the gross valuation misstatement penalty. It also rejected the taxpayer's argument that the valuation misstatement penalty applies only to factual misrepresentations about an asset's worth or cost, not to misrepresentations that rest on legal errors (like the use of a sham partnership).[26] According to the Supreme Court, the statute references both "value" and "adjusted basis," and "adjusted basis" is a legal term. Thus, both factual and legal errors may trigger the penalty.[27]

This case is significant because it abrogates precedent that made it difficult for the IRS to impose the 40 percent gross valuation misstatement penalty in TEFRA cases involving sham partnerships.[28] Following this decision, if a court in a partnership proceeding makes a "provisional" determination that a penalty applies to the partners, the IRS could then assess the penalty without issuing a deficiency notice. If it did,

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23 IRC § 6226(f).

24 *See* IRC § 6664(c)(1) (requiring omissions from income to be "substantial" enough in comparison to a person's overall income to trigger certain penalties); IRC § 6230(a)(2)(A)(i) (requiring the IRS to use deficiency proceedings for computational adjustments that rest on "affected items which require partner level determinations (other than penalties … that relate to adjustments to partnership items)."); IRC § 6230(c)(4) (stating that while a partnership-level determination "concerning the applicability of any penalty … which relates to an adjustment to a partnership item" is "conclusive" in a subsequent refund action, that does not prevent the partner from "assert[ing] any partner level defenses that may apply.").

25 For example, the IRS would have to adjust each partner's outside basis before it could impose the gross valuation misstatement penalty based on an outside basis overstatement. Moreover, each partner would remain free to raise, in subsequent, partner-level proceedings, reasons why the penalty should not be imposed on him or her specifically.

26 *Woods*, 134 S. Ct. at 566.

27 Because the Court based its decision on statutory language, it did not analyze legislative history. Moreover, it commented that the Joint Committee on Taxation's General Explanation (*i.e.*, the Blue Book) has the same weight as a law review article—relevant only to the extent persuasive. *Woods*, 134 S. Ct. at 568.

28 For prior coverage of these issues, see, *e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress 574–76, which discussed *Belmont* and *Tigers Eye Trading, LLC v. Comm'r*, 138 T.C. 67 (2012). In *Belmont*, the U.S. Court of Appeals for the Fifth Circuit held that the 40 percent gross valuation misstatement penalty did not apply because the IRS totally disallowed the loss. *Belmont Invs., LLC v. United States*, 679 F.3d 339, 347–48 (5th Cir. 2012). In *Tigers Eye*, the U.S. Tax Court held that it had jurisdiction to determine the partners' outside bases and accuracy-related penalties in a partnership-level proceeding, notwithstanding a seemingly contrary holding by the court to which an appeal would lie (a holding by the Court of Appeals for the D.C. Circuit in *Petaluma FX Partners, LLC v. Comm'r*, 591 F.3d 649 (D.C. Cir. 2010)). *Tigers Eye*, 138 T.C. at 132. As noted in the 2012 report, *Petaluma* was in accord with *Jade Trading, LLC v. United States*, 598 F.3d 1372 (Fed. Cir. 2010). *Belmont*, *Petaluma*, and *Jade* are all abrogated by *Woods*.

then the partners could not contest the penalty in court—or the IRS's determination (if any) concerning partner-level defenses—without first paying it.[29]

In *United States v. Quality Stores, Inc.*, the Supreme Court held that supplemental unemployment benefit (SUB) payments to involuntarily terminated employees were subject to Federal Insurance Contributions Act (FICA) taxes.[30]

In connection with its bankruptcy, Quality Stores made severance payments to employees who were involuntarily terminated, 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" within the meaning of IRC § 3121(a), but rather SUB payments that were not taxable under FICA.

By way of background, for SUB plans to supplement (rather than supplant) state unemployment benefits, it may be necessary to avoid having the SUB payments defined as "wages." Some states only provide unemployment benefits if terminated employees are not earning wages from their employers. If the payments are not wages for purposes of federal income tax (FIT) withholding, however, terminated employees could face significant tax liability at the end of the year because SUB payments are still taxable as income. In the IRS's view, only certain SUB payments that are coordinated with state unemployment benefits—not those at issue—are excluded from wages under FICA, as described in a series of revenue rulings.[31]

In this case, Quality Stores petitioned the bankruptcy court to obtain a refund. 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 severance payments were not wages for purposes of either FICA or FIT.[32]

According to the Court of Appeals for the Sixth Circuit, IRC § 3402(o) states that a severance payment is "treated as if it were a payment of wages," and by implication, not actually wages.[33] It reasoned that Congress allowed SUB payments (*i.e.*, a type of severance) to be treated as wages under IRC § 3402(o) to facilitate FIT withholding for taxpayers. Thus, the court held that SUB payments were not wages.

The Supreme Court disagreed, concluding that the severance payments at issue were wages under a plain reading of the statute.[34] It reasoned that severance payments, like traditional wages, varied based on factors such as length of service, function, and seniority. Moreover, it observed that during a brief period Congress had specifically exempted certain severance payments from the definition of wages.[35] If severance payments were not wages, then repeal of that exemption would have been superfluous.

29 IRC § 6230(a).

30 *United States v. Quality Stores, Inc.*, 134 S. Ct. 1395 (2014), *rev'g* 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).

31 *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).

32 According to the Court of Appeals for the Sixth Circuit, Congress adopted a definition of "wages" for FIT purposes that is nearly identical to the definition of "wages" included in FICA. *Quality Stores*, 693 F.3d at 613 (citing *Rowan Cos. v. United States*, 452 U.S. 247, 255–57 (1981)).

33 As noted above, 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.

34 *Quality Stores*, 134 S. Ct. at 1399-1400.

35 *Id*. at 1401 (citing Social Security Act Amendments of 1939, 53 Stat. 1384, which Congress repealed in 1950).

Next, the Court rejected the argument that if severance payments were wages, then IRC § 3402(o)'s[36] directive to treat them "as if" wages would be superfluous. It reasoned that when Congress enacted IRC § 3402(o), it was aware that only some severance payments were treated as wages pursuant to IRS rulings, but sought to treat all severance payments as wages to prevent workers from facing large tax liabilities at the end of the year. In other words, to the extent IRC § 3402(o) suggests that some severance payments might be excluded from wages (*i.e.*, certain SUB payments coordinated with state unemployment benefits) it does not suggest that all severance payments are excluded.[37]

Finally, the Court reaffirmed "that the meaning of 'wages' should be in general the same for income-tax withholding and for FICA calculations."[38] However, it expressly declined to address the validity of current IRS rulings that exempt from the FICA wage base SUB payments that are coordinated with state unemployment benefits because such payments were not at issue.[39]

This case is significant because it clarifies that severance payments (including SUB payments) that are not coordinated with state unemployment benefits are wages for both FIT and FICA purposes. It is also significant because it leaves unanswered questions about the validity of the IRS's conclusion, set forth in Revenue Rulings 56-249 and 90-72, that SUB payments that are coordinated with state unemployment benefits are not subject to FICA. Moreover, it is unclear if states will seek to use the Supreme Court's holding—that SUB payments are wages—to reduce unemployment benefits to workers eligible for SUB payments.

In *Loving v. Internal Revenue Service*, the United States Court of Appeals for the District of Columbia Circuit held that the Treasury Department lacked authority to regulate the conduct of registered tax return preparers.[40]

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.[41] It issued them pursuant to 31 U.S.C. § 330(a)(1), which grants the Secretary of the Treasury authority to "regulate the practice of representatives of persons before the Department of the Treasury." Sabina Loving and two other preparers challenged the regulations as unauthorized. The District Court for the District of Columbia agreed, and the U.S. Court of Appeals for the District of Columbia Circuit affirmed.[42]

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36 In relevant portion, the statute states that "any supplemental unemployment compensation benefit paid to an individual … shall be treated as if it were a payment of wages." IRC § 3402(o).

37 By analogy, "[T]he statement that 'all men shall be treated as if they were six feet tall does not imply that no men are six feet tall." *Quality Stores*, 134 S. Ct. at 1402 (quoting *CSX Corp. v. United States*, 518 F.3d 1328, 1342 (Fed. Cir. 2008)).

38 *Quality Stores*, 134 S. Ct. at 1405.

39 *Id*.

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

41 *See* T.D. 9527, 76 Fed. Reg. 32,286, 32,299 (June 3, 2011). They are sometimes called "unenrolled" preparers. *See* 26 C.F.R. § 601.502(b)(5)(iii); Rev. Proc. 81–38, 1981-2 C.B. 592, *modified and superseded by* Rev. Proc. 2014–42, 2014–29 I.R.B. 192 for tax returns and claims for refund prepared and signed (or prepared if there is no signature space on the form) after December 31, 2015. Attorneys, certified public accountants, enrolled agents and enrolled actuaries are already subject to IRS regulation under Circular 230. The National Taxpayer Advocate has long championed the regulation of return preparers. *See, e.g.*, National Taxpayer Advocate 2008 Annual Report to Congress 423 (Legislative Recommendation: *The Time Has Come to Regulate Federal Tax Return Preparers*); National Taxpayer Advocate 2004 Annual Report to Congress 67 (Most Serious Problem: *Oversight of Unenrolled Return Preparers*); National Taxpayer Advocate 2003 Annual Report to Congress 270 (Legislative Recommendation: *Federal Tax Return Preparers Oversight and Compliance*); National Taxpayer Advocate 2002 Annual Report to Congress 216 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*).

42 For a discussion of the district court decision, see National Taxpayer Advocate 2013 Annual Report to Congress 334–336 (Significant Cases); National Taxpayer Advocate 2013 Annual Report to Congress 61–74 (Most Serious Problem: *Regulation of Return Preparers*). *See also* Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 139 Tax Notes 767 (2013).

Agency regulations are generally given *Chevron* deference and upheld unless they (1) contradict the unambiguously stated intent of Congress or (2) adopt an unreasonable construction of an ambiguous statute.[43] The IRS argued that the terms "practice" and "representative" were ambiguous and that it reasonably interpreted them as covering tax return preparers. Thus, the court should give the agency *Chevron* deference.

The court disagreed, concluding that the statute unambiguously fails to authorize the government to regulate tax return preparers making the regulations inconsistent with congressional intent – failing the first prong of *Chevron*. It went on to conclude that even if the statute was ambiguous, the regulations were unreasonable in light of the statute's text, history, structure, and context – failing the second prong.

First, the court reasoned that the term "representative" is commonly defined as an agent authorized to act for someone else. However, a preparer is not necessarily authorized to act for the taxpayer unless he or she obtains a power of attorney. Thus, a preparer is not necessarily a "representative."

Second, the court observed that the statute references "practice … before the Department." It reasoned that unlike practicing in the abstract, practice "before" an agency generally refers to an adversarial proceeding. Although commentators had argued that filing a return constitutes presenting a case before the agency, the IRS did not make that argument.[44] Rather, the IRS argued that the statutory language in 31 U.S.C. § 330(a)(2), which authorizes it to consider a person's competency to "assist persons in presenting cases," was irrelevant in determining the meaning of "practice" because Congress meant to use the disjunctive "or" rather than the conjunctive "and" in connecting the list of attributes a person must have before being admitted as a "representative to practice."[45]

The court found the IRS's argument unpersuasive and inconsistent with the original statutory language enacted in 1884 and re-codified in 1982 "without substantive change."[46] It covered "agents, attorneys, or other persons representing claimants before … [the Treasury]" and authorized the Treasury to require them to be competent to "assist such claimants in the presentation of their cases," presumably cases presented in an adversarial proceeding.[47] The court also noted that subsequent Congresses had enacted many specific penalties targeting specific misconduct by tax return preparers with specific sanctions – sanctions that would have been unnecessary if the IRS was already authorized to penalize preparers for the same conduct.[48] Thus, the court concluded that preparers do not necessarily "practice … before the Department," within the meaning of the statute.

As further support, the court cited the *Brown & Williamson* principle "that courts should not lightly presume congressional intent to implicitly delegate decisions of major economic or political significance."[49] Finally, it cited the IRS's past approach to the statute—the IRS never suggested that it possessed this

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

44 *See, e.g.*, Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 139 Tax Notes 767 (2013); Lawrence B. Gibbs, *Loving v. IRS: Treasury's Authority to Regulate Tax Return Preparers*, 141 Tax Notes 331 (2013).

45 *Loving*, 742 F.3d at 1018-19.

46 Act of Sept. 13, 1982, Pub. L. No. 97-258, 96 Stat. 877 (1982).

47 Act of July 7, 1884, ch. 334, sec. 3, 23 Stat. 258 (1884).

48 *Loving*, 742 F.3d at 1020. 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, 1586–87 (2004).

49 *Loving*, 742 F.3d at 1021 (citing *F.D.A. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 160 (2000)).

authority before.[50] Accordingly, the court held that the Treasury Department lacked statutory authority to issue and enforce the regulations governing registered tax return preparers.

This case is significant because it affects hundreds of thousands of return preparers and the taxpayers they serve.[51] As a result of this litigation, the Treasury Department and the IRS have established an Annual Filing Season Program designed to encourage tax return preparers who are not attorneys, certified public accountants, or enrolled agents to improve their knowledge of tax law and to protect taxpayers from preparer errors.[52] On July 15, 2014, the American Institute of Certified Public Accountants (AICPA) filed suit in the U.S. District Court for the District of Columbia, challenging this new voluntary program.[53] The proliferation of litigation regarding the IRS's authority to regulate tax return preparers is an indication that Congress should take action.[54]

In *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, the United States Court of Appeals for the First Circuit held that a private equity firm was engaged in a "trade or business" for purposes of the Employee Retirement Income Security Act of 1974 (ERISA).[55]

Marc Leder and Roger Krouse founded private equity companies, including Sun Fund III and Sun Fund IV (the Sun Funds), to acquire poorly managed companies, install competent management, and sell them within two to five years. Mr. Leder and Mr. Krouse owned affiliated companies, including Sun Capital Advisors, Inc. (collectively, SCAI Companies), and retained control of the Sun Funds' general partners (GPs).

Although the Sun Funds had no employees, SCAI Companies provided employees and consulting services to portfolio companies for a fee. The GPs would reduce the fees they charged the Sun Funds for managing portfolio companies by the amount the portfolio companies paid the SCAI Companies.

The Sun Funds acquired Scott Brass Inc. (SBI). SBI ultimately stopped contributing to its employees' multiemployer pension plan, the Trucking Industry Pension Fund (TPF), and SBI was forced into bankruptcy by its creditors. TPF asserted that the Sun Funds were liable for SBI's unpaid pension contributions under the Employee Retirement Income Security Act of 1974 (ERISA).[56] The Sun Funds filed suit seeking a declaratory judgment that they were not liable, in relevant part, because they were not in a "trade or business," as explained below. The district court agreed, citing tax cases for the proposition that mere investment activity is not a trade or business. However, the United States Court of Appeals for the First Circuit reversed and remanded on this point.

By way of background, entities under common control may be jointly and severally liable as a "single employer" under ERISA if they are engaged in a "trade or business."[57] The Pension Benefits Guarantee

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50 The court cited an IRS publication and testimony before Congress by the head of the IRS Criminal Investigation Division and the National Taxpayer Advocate as evidence that the IRS had not previously claimed it had authority to regulate preparers.

51 *Loving v. Comm'r*, 742 F.3d at 1021.

52 Rev. Proc. 2014–42, 2014-29 I.R.B. 192.

53 The U.S. District Court for the District of Columbia dismissed the case after determining the AICPA lacked standing. *AICPA v. IRS*, No. 14-1190 (D.D.C. Oct. 27, 2014).

54 *See* National Taxpayer Advocate Fiscal Year 2015 Objectives Report to Congress 71.

55 *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, 724 F.3d 129 (1st Cir. 2013), *rev'g and remanding* 903 F. Supp. 2d 107 (D. Mass 2012), *cert. denied*, 134 S. Ct. 1492 (Mar. 3, 2014) [*hereinafter Sun Capital*].

56 Pub. L. No. 93-406, 88 Stat. 829 (codified at 29 U.S.C. § 1001 *et seq.*), *as amended by* Multiemployer Pension Plan Amendments Act of 1980, Pub. L. No. 96-364, 94 Stat. 1208 (*codified at* 29 U.S.C. § 1381 *et seq.*).

57 29 U.S.C. § 1301(b)(1).

Corporation (PBGC) is authorized to issue regulations defining trade or business "consistent and coextensive with regulations prescribed for similar purposes by the Secretary of the Treasury under section 414(c) of Title 26," but it has not issued any such regulations.[58]

Instead, the PBGC issued an unpublished ruling. The ruling concluded that while a fund conducting mere investment activity is not a trade or business, a fund that acquires companies to turn them around and sell them is a trade or business because it is for the "primary purpose of income or profit" and conducted with "continuity and regularity."[59] PBGC's "investment plus" test was purportedly derived from *Groetzinger*, a tax case decided by the Supreme Court.[60] Although PBGC argued in an amicus brief that its ruling should be given deference, neither the district court nor the First Circuit gave any special deference to the PBGC.[61] Nonetheless, all three courts analyzed tax cases to determine the statutory meaning of a "trade or business" under ERISA.[62]

The First Circuit ultimately adopted an "investment plus" test in concluding that Sun Fund IV was a trade or business, and thus liable for SBIs unpaid pension contributions. It acknowledged that the absence of trade or business income on the Sun Funds' tax returns cut against treating them as a trade or business. However, it reasoned that Sun Fund IV would receive a direct economic benefit from its active involvement in the management of SBI that a passive investor would not ordinarily derive—an offset to the management fee payable to its general partner.[63]

This case may be significant in two respects. First, it confirms that an agency's unpublished determinations are not necessarily entitled to any special deference in subsequent litigation. Second, it suggests that when a passive investor receives a direct economic benefit as a result of services its agents or affiliates provide to one or more portfolio companies, the investor may be treated as engaged in a trade or business for purposes of ERISA, and potentially, the IRC.[64] If otherwise passive investors in private equity funds are treated as engaged in a trade or business for tax purposes, some could be subject to additional taxes (*e.g.*, foreign investors, tax-exempt investors, and managers holding "profits" interests). This case has prompted significant debate in the tax community.[65]

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58 29 U.S.C. § 1301(b)(1).

59 *Sun Capital*, 724 F.3d at 139.

60 *Id*. (citing *Comm'r v. Groetzinger*, 480 U.S. 23 (1987)).

61 Although the PBGC argued in an amicus brief that its letter should be entitled to *Auer* deference under *Auer v. Robbins*, 519 U.S. 452 (1997)—deference to an agency's interpretation of its own regulations—the First Circuit concluded that it was entitled to *Skidmore* deference—deference only to the extent its underlying reasoning has the power to persuade—under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). The court reasoned that *Auer* deference is inappropriate where significant monetary liability would be imposed for conduct that took place at a time when that party lacked fair notice of the interpretation at issue. *Sun Capital*, 724 F.3d at 140. It also noted that the PBGC had not actually defined trade or business in its regulations and that *Auer* deference is inapplicable where regulations simply parrot the statute under the "anti-parroting" principle. *Id*. at 141.

62 However, the First Circuit expressly rejected "the proposition that, apart from the provisions covered by 26 U.S.C. § 414(c), interpretations of other provisions of the Internal Revenue Code are determinative." *Sun Capital*, 724 F.3d at 144.

63 The court remanded the case for further factual development because it could not determine if Sun Fund II received a similar economic benefit from the offset. *Sun Capital*, 724 F.3d at 143 n.20.

64 *See, e.g.*, Tax Analysts, *ABA Meeting: Sun Capital May Provide Opportunity to Reassess 'Trade or Business,' Treasury Says*, 2013 TNT 184-5 (Sept. 23, 2013) (quoting Craig Gerson, Attorney-Adviser, Treasury Office of Tax Legislative Counsel, as saying the decision "may give us [the Treasury Department] an opportunity to reassess what trade or business means" for tax purposes). As for the importance of the decision under ERISA, Sun Funds' appeal asserts that, "by significantly deterring investment funds from providing … financing to distressed companies with multiemployer pension plan obligations, the First Circuit's opinion will deprive such companies of their primary avenue for avoiding bankruptcy." Petition for a Writ of Certiorari at 33–34, *Sun Capital Partners III, LP v. TPF*, 134 S. Ct. 1492 (2014) (No. 13-648).

65 *See, e.g.*, Tax Analysts, *Transcript Available of Tax Analysts' Forum on Implications of Sun Capital*, 2013 TNT 190-29 (Oct. 1, 2013) (roundtable discussion of "the tax implications of the First Circuit's trade or business determination in *Sun Capital*").

In *Morehouse v. Commissioner*, the United States Court of Appeals for the Eighth Circuit held that Conservation Reserve Program (CRP) payments received by an investor were not subject to Self-Employment Contributions Act ("SECA") taxes.[66]

Mr. Morehouse, a Minnesota investor who owned farmland in South Dakota, received annual rents under the Conservation Reserve Program (CRP) from the U.S. Department of Agriculture (USDA) in exchange for implementing a conservation plan.[67] He hired a farmer to carry out most of the plan, but performed minor activities such as purchasing seed and regularly inspecting the property. He reported the CRP payments as rental income from real estate. The IRS issued a notice of deficiency, determining that the CRP payments were subject to Self-Employment Contributions Act (SECA) tax under IRC § 1401.

Generally, SECA tax is imposed on a taxpayer's net earnings from self-employment, which usually include the gross income derived from any trade or business carried on by the taxpayer either personally or through agents or employees, minus qualifying deductions.[68] However, Congress excluded certain "rentals from real estate" from SECA tax.[69]

According to Revenue Ruling 60-32, payments under the Soil Bank Act (a predecessor of the CRP) received by a person who does not materially participate in the production of commodities (*i.e.*, farming), or management of such production, qualify as "rentals from real estate."[70] Subsequently, in *Wuebker*, the United States Court of Appeals for the Sixth Circuit held that a farmer was subject to SECA tax on CRP payments because the farmer's obligations under the CRP contract were so similar to his normal farming activities that they did not rise to the level of "occupancy or use" by the government needed to qualify for the rentals from real estate exception.[71]

Following *Wuebker*, the IRS issued Notice 2006-108, asking for comments on a proposal to obsolete Revenue Ruling 60-32 on the basis that CRP payments could not qualify for the "rentals from real estate" exclusion because they could not be considered rents (even if paid to non-farmers).[72] However, Revenue Ruling 60-32, was never officially obsoleted and therefore still represents the IRS's official position.

Mr. Morehouse argued that the CRP payments were not includible in his self-employment income because they were not derived from (*i.e.*, had no nexus to) his trade or business. Alternatively, he argued that the CRP payments were excluded from SECA tax as rentals from real estate.

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66 *Morehouse v. Comm'r*, 769 F.3d 616 (8th Cir. 2014), *rev'g* 140 T.C. 350 (2013).

67 According to a 2013 USDA news release,

> [P]roducers will receive payments on almost 700,000 CRP contracts on 390,000 farms covering 26.8 million acres. In exchange for a yearly rental payment provided by USDA on contracts ranging from 10 to 15 years, farmers and ranchers enrolled in CRP agree to remove environmentally sensitive land from agricultural production and plant grasses or trees that will improve water quality and improve waterfowl and wildlife habitat.

USDA Farm Service Agency, *USDA Issues Conservation Reserve Program Rental Payments, Direct Payments and ACRE Payments*, USDA News Release 0181.13 (Oct. 21, 2013).

68 IRC §§ 1402(a) (defining "net earnings from self-employment"), 1402(b) (defining "self-employment income"), and 1402(c) (defining "trade or business" by reference to IRC § 162); Treas. Reg. § 1.1402(a)-2(b) (providing that the"[t]he trade or business must be carried on by the individual, either personally or through agents or employees.").

69 IRC § 1402(a)(1).

70 Rev. Rul. 60-32, 1960–1 C.B. 23. *See also* Rev. Rul. 65-149, 1965-1 C.B. 434 (1965) ("if this income is received by a farm operator, or a landlord who materially participates, it should be treated as self-employment income. If it is received by a landlord who does not materially participate, it should be treated as rental income and excluded from net earnings from self-employment.").

71 *Wuebker v. Comm'r*, 205 F.3d 897 (6th Cir. 2000).

72 Notice 2006-108, 2006-2 C.B. 1118.

Following the logic of Notice 2006-108, the Tax Court agreed with the IRS. It reasoned that because Mr. Morehouse's receipt of CRP payments depended on his continued maintenance of his land in accordance with the CRP contracts, his participation in the CRP was a trade or business (and not a passive investment) with the requisite nexus to the CRP payments. It also concluded the CRP payments were not rents from real estate.[73]

The United States Court of Appeals for the Eighth Circuit reversed. It distinguished this case from *Wuebker* on the basis that Mr. Morehouse was not a farmer, characterizing the IRS's extension of *Wuebker*'s rationale to non-farmers in Notice 2006-108 as "problematic."[74] It went on to observe that Notice 2006-108 contained "little analysis" and deferred to the IRS's "reasonable" and "longstanding" judgment expressed in Revenue Ruling 60-32, concluding that CRP payments made to non-farmers, such as Mr. Morehouse, constitute rentals from real estate, which are excluded from SECA tax.[75]

This case is significant because it clarifies that CRP payments received by non-farmer investors can qualify for the "rentals from real estate" exclusion from SECA tax. Also notable is that the IRS made, and both the Tax Court and the Eighth Circuit Court of Appeals allowed, arguments inconsistent with the IRS's official published position, as reflected in Revenue Ruling 60-32.[76]

In *BASR Partnership v. United States*, the Court of Federal Claims held that a preparer's fraud could not extend the normal three-year statute of limitations for the IRS to assess a tax.[77]

The BASR partnership entered into a tax shelter that it and its partners reported on returns filed in 2000. In 2010, the IRS issued a Notice of Final Partnership Administrative Adjustment (FPAA) to BASR and assessed additional tax against the partners. The promoter of the tax shelter had the intent to evade tax, but BASR and its partners did not. BASR argued that the FPAA was time-barred because the promoter's "intent to evade" did not extend the assessment statute of limitations for the partners.

Under IRC § 6501, the IRS generally must assess any additional tax within three years after a return is filed,[78] except "in the case of a false or fraudulent return with the intent to evade tax."[79] Some

73 The Tax Court also reasoned that Congress had expressed its intent not to exclude all CRP payments when it enacted legislation in 2008 that specifically excluded CRP payments from the calculation of net earnings from self-employment in certain limited circumstances. Legislation enacted in 2008 specifically excluded CRP payments from the calculation of net earnings from self-employment where the taxpayer is receiving Social Security retirement or disability payments, seemingly based on the assumption that they might otherwise be subject to SECA tax. Food, Conservation, and Energy Act of 2008, Pub. L. No. 110–246, § 15301(a), 122 Stat. 1651, 2263 (codified at IRC § 1402(a)(1)).

74 *Morehouse v. Comm'r*, 769 F.3d at 621.

75 *Id*.

76 The IRS is generally bound by its published positions. *See Rauenhorst v. Comm'r*, 119 T.C. 157, 172-83 (2002) ("Respondent's counsel may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law … we treat the Commissioner's position in …[the revenue ruling at issue], as a concession…. [internal citations omitted]"); CCDM 35.7.2.1.8(8) (Aug. 11, 2004) ("Respondent may not argue against his published position"). However, the public was on notice that the IRS was reconsidering its position because of Notice 2006-108.

77 113 Fed. Cl. 181 (2013), *appeal docketed*, No. 14-5037 (Fed. Cir. Jan. 7, 2014).

78 IRC § 6501(a).

79 IRC § 6501(c)(1). A similar exception applies to "a willful attempt in any manner to defeat or evade tax." IRC § 6501(c)(2).

authority suggests that even a preparer's "intent to evade" may trigger this exception for fraud.[80] Under IRC § 6229(a), however, the IRS generally must assess any additional tax attributable to any partnership item (or affected item) within three years after the partnership return is filed.[81] The period is extended if "any partner has, with the intent to evade tax, signed or participated directly or indirectly in the preparation of a partnership return which includes a false or fraudulent item."[82]

First, BASR argued that IRC § 6229(c), which specifically applies to partnership items, displaces IRC § 6501(c) with respect to them, and any other interpretation would render IRC § 6229(c) superfluous. Under this theory, the FPAA was time-barred because the partners did not have the requisite intent to extend the assessment period. The government countered that IRC § 6229 could extend, but not shorten, the limitations period provided by IRC § 6501. The court agreed with the government on this point.

Next, the government argued that the assessment was authorized under IRC § 6501(c). It reasoned that the promoter's intent to evade tax (or status as an agent of the taxpayer) was sufficient to extend the limitations period. It cited the maxim that statutes of limitations are strictly construed in favor of the government.[83] The government also advanced public policy arguments that the taxpayer's willful ignorance in failing to verify the accuracy of the returns should not be rewarded, and that fraud, whether perpetrated by the taxpayer or a preparer, is particularly difficult for the IRS to detect within the normal limitations period.

The court disagreed with the government. It reasoned that because the language of IRC § 6501(a) is expressly limited to a return filed by "the taxpayer," the fraudulent intent referenced in IRC § 6501(c) is "by implication limited to fraud by the taxpayer."[84] The court cited the legislative history of IRC § 6501(c)(1) and similar statutory language contained in a predecessor statute (*i.e.*, language used to both extend the limitations period and trigger a fraud penalty) as supporting this interpretation. Thus, it held the FPAA was time-barred under IRC § 6501(a).

This case is significant because it suggests that innocent victims of preparer fraud may not lose the benefit of the three-year assessment statute of limitations.

In *Kaplan v. United States*, the Court of Federal Claims held it had jurisdiction to prevent "manifest injustice," even though the plaintiff could not establish he had paid enough to trigger jurisdiction under 28 U.S.C. § 1491(a)(1).[85]

Merchants Restaurant failed to pay its employment taxes for three quarters. Under IRC § 6672, "[a]ny person required to collect, truthfully account for, and pay over" employment taxes (*i.e.*, a "responsible person") who willfully fails to do so is personally liable for a trust fund recovery penalty. The IRS assessed $86,902.76 in trust fund recovery penalties against Mr. Kaplan. He claimed that he was merely an

80 *See, e.g.*, *Allen v. Comm'r*, 128 T.C. 37 (2007) (holding that even where a taxpayer had no intent to evade tax, his preparer's intent to evade tax kept the assessment period open). Some have argued that a preparer's intent does not trigger the fraud exception. *See, e.g.*, Bryan Camp, *Tax Return Preparer Fraud and the Assessment Limitations Period*, 116 Tax Notes 687 (2007); Bryan Camp, *Presumptions and Tax Return Preparer Fraud*, 120 Tax Notes 167 (2008). *See also* Jeremiah Coder, *The IRS's Misguided Fraud Whodunit*, 2012 TNT 190-1 (2012).

81 If filed early, however, the period begins on the last day for filing the partnership return for that year (without regard to extensions). IRC § 6229(a).

82 IRC § 6229(c). The extended period is unlimited for signing or "participating" partners and six years for others. *Id.*

83 *BASR*, 113 Fed. Cl. at 191 (quoting *Badaracco v. Comm'r*, 464 U.S. 386 (1984)).

84 *Id.*

85 *Kaplan v. United States*, 115 Fed. Cl. 491 (2014), *vacating* 113 Fed. Cl. 84 (2013).

investor, not a responsible person. Mr. Kaplan made three $100 payments toward the penalties associated with each of the quarters and filed a claim for refund in order to establish jurisdiction to contest the assessment in court. When the IRS denied his claim, Mr. Kaplan petitioned the Court of Federal Claims, seeking a determination that he was not liable for the penalties.

In general, under the *Flora* rule, neither federal district courts nor the Court of Federal Claims have authority (under 28 U.S.C. § 1346(a)(1) or 28 U.S.C. § 1491(a)(1), respectively) to decide the merits of a tax refund suit, unless the taxpayer-plaintiff has paid the tax in full.[86] Because a trust fund recovery penalty is "divisible" (*i.e.*, relating to separate transactions or events), the *Flora* rule only requires the plaintiff to pay the penalty as to the wages of a single employee for one quarter.[87]

In this case, the government filed a motion to dismiss Mr. Kaplan's complaint because he could not show that his payments satisfied the entire assessment for at least one employee per quarter.[88] Mr. Kaplan argued his payments were sufficient based on estimates from one week's worth of payroll records. The court initially disagreed and dismissed the case.[89]

On reconsideration, the court determined that Mr. Kaplan was caught in a "catch-22" because in order to prove that he was not a responsible person he would first have to produce evidence (*i.e.*, the records required to ascertain the amount needed to satisfy the jurisdictional requirement), which he could only obtain if he were a responsible person. The inequity of his situation was magnified by the government's inability to state what minimum payment would be sufficient. Therefore, to prevent a "manifest injustice," the court accepted his payments as sufficient to establish jurisdiction.

This case is significant to the extent it signals that other courts may relax the *Flora* rule with respect to others caught in a similar catch-22. However, the case may be somewhat unique due to Mr. Kaplan's diligent, but unsuccessful attempts to obtain the payroll information needed to establish that his payments were sufficient and also the IRS's own inability to estimate what payments would have been sufficient.

In *Florida Bankers Assoc. v. United States Department of Treasury*, the District Court for the District of Columbia upheld regulations requiring banks to report interest paid to certain non-resident aliens.[90]

In 2012, the Treasury Department issued final regulations requiring banks to report interest they paid on deposits maintained at U.S. offices to residents of any of the 70 countries that had entered into information exchange agreements with the United States.[91] The preamble to the regulations stated that the IRS needed this information so that it could provide reciprocal information to foreign countries pursuant to information exchange agreements.

The IRS had received comments on the proposed regulations raising concerns that the reporting requirement would negatively affect U.S. banks because customers would close accounts due to confidentiality

86 *See Flora v. United States*, 362 U.S. 145 (1960); *Shore v. United States*, 9 F.3d 1524 (Fed. Cir. 1993).

87 *See, e.g., Psaty v. United States*, 442 F.2d 1154 (3d Cir. 1971); *Steele v. United States*, 280 F.2d 89 (8th Cir. 1960).

88 The IRS could have accepted a "representative amount," but the IRS may have concluded that Mr. Kaplan's payment was not sufficiently representative. *See* IRM 8.25.1.7.4.2 (Oct. 14, 2014) ("[I]f the amount required cannot be accurately determined, the Service may accept a representative amount.").

89 *Kaplan*, 113 Fed. Cl. at 84.

90 *Florida Bankers Assoc. v. United States Department of Treasury*, 113 A.F.T.R.2d (RIA) 498 (D.D.C. 2014), *appeal docketed*, No. 14-5036 (D.C. Cir. Feb. 11, 2014).

91 T.D. 9584, 77 Fed. Reg. 23,391 (Apr. 19, 2012) (codified, in relevant part, at Treas. Reg. § 1.6049-4(b)(5)(i)).

concerns.[92] In the preamble to the final regulations, the IRS discussed existing legal and procedural safeguards, such as provisions in its exchange agreements requiring foreign governments to treat the information as secret. The IRS concluded that because of these safeguards, the regulations "should not significantly impact the investment and savings decisions of the vast majority of nonresidents who are aware of and understand these safeguards and existing law and practice."[93]

The Florida and Texas Bankers Associations challenged the regulations as violating the Administrative Procedure Act (APA) and the Regulatory Flexibility Act (RFA).[94] First, the government argued that the plaintiffs had no standing, and if they did, the Anti-Injunction Act (AIA) or the Declaratory Judgment Act (DJA) barred the court from hearing the case.[95] The court concluded, however, that the association-plaintiffs had standing.[96] Next, the court found that the AIA and the DJA were inapplicable because they only bar suits that would restrain the assessment or collection of any tax. The court acknowledged that a violation of the regulations could trigger a penalty that would be treated as a tax, but it reasoned that this suit was to bar implementation of reporting requirements before any tax (or penalty) had been incurred.[97]

However, the court upheld the regulations. Under the APA, a court will set aside agency actions that are arbitrary and capricious.[98] According to the court, "[t]he agency must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made" in order to satisfy the APA's arbitrary and capricious standard.[99] Under the RFA, the agency must either analyze the proposed rule's impact on small businesses or certify that the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities.[100] The banking associations argued that the regulations would cause more harm to banks (including small banks) than the IRS anticipated, and that the final regulations did not articulate a satisfactory explanation for not taking additional steps to address the risk of capital flight.

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92 77 Fed. Reg. 23,391, 23,392 (Apr. 19, 2012).

93 77 Fed. Reg. 23,391, 23,393 (Apr. 19, 2012). One commentator countered that: (a) the preamble does not conclude that the vast majority of nonresident aliens would not withdraw their funds from U.S. banks, but rather that funds would not be withdrawn by "the vast majority of nonresidents *who are aware of and understand these safeguards and existing law and practice*," (b) most people would probably not take the time to learn about the safeguards, and (c) residents of some treaty partners such as China, Egypt, Indonesia, Mexico, Pakistan, Panama, the Russian Federation, and Venezuela, might reasonably fear their governments would not respect the confidentiality provisions of a treaty. *See* Patrick J. Smith, *District Court Misapplies APA in Florida Bankers Association*, 142 Tax Notes 745 (2014).

94 Administrative Procedure Act (APA), 5 U.S.C. ch. 5 and ch. 7; and Regulatory Flexibility Act (RFA), 5 U.S.C. ch. 6.

95 IRC § 7421(a) (AIA); 28 U.S.C. § 2201 (DJA). As the DJA is generally interpreted as baring the same suits as the AIA, the court did not analyze them separately.

96 The government argued the associations lacked standing because they did not submit an affidavit identifying a specific member who was injured by the regulation. *Florida Bankers Assoc.*, 113 A.F.T.R.2d (RIA) 498 at *5. The court reasoned that an affidavit is only required when the association's interest is not self-evident. *Id*. at *6. It found the association's interest self-evident, explaining,

> [P]laintiffs' member banks are directly regulated by the regulations being challenged. They are currently suffering from additional, allegedly unlawful reporting requirements, causing them injury. That injury would undoubtedly be redressed by abrogation of the regulations. Because such a lawsuit 'is germane to the organization[s'] purpose,' which involves policy advocacy on behalf of financial institutions, the Bankers Associations have standing … *Id*.

97 According to the court, "[T]he D.C. Circuit has confirmed that reporting requirements related to Chapter 61A of the Internal Revenue Code—as opposed to the associated penalties found in Chapter 68B—are not subject to the AIA or DJA." *Florida Bankers Assoc.*, 2014 U.S. Dist. LEXIS 3521 at *21 (citing *Foodservice and Lodging Inst., Inc. v. Regan*, 809 F.2d 842 (D.C. Cir. 1987)).

98 5 U.S.C. § 706(2)(A). The association-plaintiffs also argued the regulations failed under 5 U.S.C. § 706(2)(E) for lack of "substantial evidence" to support their conclusions, but the court concluded the "substantial evidence" standard inapplicable and that the challenge would have failed under that standard as well. *Florida Bankers Assoc.*, 2014 U.S. Dist. LEXIS 3521 at *24.

99 *Florida Bankers Assoc.*, 2014 U.S. Dist. LEXIS 3521 at *14 (quoting *Motor Vehicle Mfrs. Ass'n of United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983)).

100 5 U.S.C. §§ 603-605.

The court upheld the regulations under the APA because the IRS reasonably concluded that they would improve U.S. tax compliance, impose a minimal reporting burden on banks, and not cause any rational actor—other than a tax evader—to withdraw his funds from U.S. accounts. The regulations also withstood challenge under the RFA because the IRS reasonably concluded that they would not have a "significant" economic impact on a significant number of small entities. The court discounted the economic impact of capital flight as a speculative indirect economic effect that the government did not need to consider under the RFA.[101]

This case is significant to the extent it suggests that agencies do not need to consider secondary effects, such as capital flight, when promulgating rules under the RFA. In addition, this case confirms the viability of the APA and RFA as vehicles for challenging Treasury regulations and illustrates that the AIA and DIA do not shield regulations that do not directly impose a tax.

In *Corbalis v. Commissioner*, the U.S. Tax Court held that it had jurisdiction to review the IRS's denial of interest suspension under IRC § 6404(g), notwithstanding an IRS Revenue Procedure to the contrary.[102]

After the IRS made an audit adjustment to Mr. Corbalis' returns, he requested interest suspension under IRC § 6404(g). IRC § 6404(g) generally provides that if a taxpayer files a timely return and the IRS does not give the taxpayer timely notice of an additional liability and the basis for the additional liability, then the IRS "shall suspend" interest, provided certain other requirements are satisfied.

In certain circumstances, IRC § 6404(h) authorizes the Tax Court to review the IRS's "failure to abate interest under this section… if such action is brought within 180 days after… [the IRS's] final determination not to abate such interest." On October 11, 2012, the IRS issued Mr. Corbalis Letter 3477, *IRC 6404(g) Interest Suspension*, denying his request for interest suspension.[103] The letter stated that "[t]he judicial review provisions of IRC section 6404(h) do not apply to IRC section 6404(g). Therefore, you do not have appeal rights, nor may you petition the Tax Court for judicial review regarding this letter."[104] On November 9, 2012, Mr. Corbalis filed a protest, asserting the letter constituted a final determination which the Tax Court could review pursuant to its authority to review denials of requests for abatement under IRC § 6404(h).

The IRS filed a motion to dismiss, arguing that the Tax Court had no jurisdiction because IRC § 6404(h) only authorizes it to review a denial of interest "abatement" under IRC § 6404(e), not interest "suspension," under IRC § 6404(g). It cited Revenue Procedure 2005-38, which provides that no judicial review is available under IRC § 6404(h) where the IRS has failed to suspend interest under IRC § 6404(g), with one limited exception.[105] The exception may apply if the IRS's failure to suspend interest was the result of an unreasonable IRS error or delay in performing a ministerial or managerial act, the taxpayer filed a claim for abatement of the interest, and the claim was denied.[106] The exception did not apply in this case.

101 *Florida Bankers Assoc.*, 2014 U.S. Dist. LEXIS 3521 at *35-36 ("RFA calls for agencies to scrutinize only the regulations' direct impact, such as 'reporting, recordkeeping and other compliance requirements'—not indirect impacts caused by the actions of third parties like capital flight.").

102 *Corbalis v. Comm'r*, 142 T.C. No. 2 (2014).

103 Although the IRS also denied Mr. Corbalis' request for interest abatement, the parties agreed that the denial was not a final determination.

104 *Corbalis*, 142 T.C. No. 2, *3.

105 Rev. Proc. 2005-38 § 2.05, 2005-28 I.R.B. 81.

106 *Id.*

In addition, the IRS argued, in the alternative, that Letter 3477 was not a "final determination," which could trigger jurisdiction under IRC § 6404(h).

The Tax Court held it had jurisdiction to review the IRS's denial of interest suspension. It concluded that interest suspension is a category of abatement. It reasoned there is a strong presumption that administrative actions are subject to judicial review,[107] and the requirement in IRC § 6404(g) that the IRS "shall" suspend interest in appropriate circumstances weighed in favor of judicial review. The Tax Court gave Revenue Procedure 2005-38 no deference because it contained "no reasoning" to support its conclusion that with one limited exception, no judicial review of the failure to suspend interest is available to taxpayers. The court also found that Letter 3477 was a final determination for jurisdictional purposes under IRC § 6404(h). It reasoned that if the taxpayer had delayed filing a petition in the Tax Court, the IRS might have argued that the 180-day period for doing so had lapsed.

This case is significant because it confirms the Tax Court has jurisdiction to review denials of interest suspension under IRC § 6404(g). It is also significant because it suggests that revenue procedures and statements in IRS letters are not entitled to deference, particularly when they do not include any reasoning.

107 *Corbalis*, 142 T.C. No. 2, *8 ("…respondent's position ignores a strong presumption that the actions of an administrative agency are subject to judicial review." [Internal citations omitted.]).

MLI #1

Accuracy-Related Penalty Under IRC §§ 6662(b)(1), (2), and (3)

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. This year, we also analyzed accuracy-related penalties under IRC § 6662(b)(3) (substantial valuation misstatement) and the increased penalty amount under IRC § 6662(h) for a gross valuation misstatement because during our review period of June 1, 2013, through May 31, 2014, taxpayers litigated these penalties more frequently than in past years.[1] Specifically, we reviewed 12 cases involving IRC § 6662(b)(3), and 14 cases involving IRC § 6662(h). IRC § 6662(b) also authorizes the IRS to impose four other accuracy-related 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] Underpayment is the amount by which any tax imposed by the Internal Revenue Code exceeds the excess of

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

Refundable credits cannot reduce the amount shown as tax, by the taxpayer on a return, below zero.[5]

The IRS may assess penalties under IRC § 6662(b)(1), IRC § 6662(b)(2), and IRC § 6662(b)(3), but the total penalty rate generally cannot exceed 20 percent (*i.e.*, the penalties are not "stackable").[6] Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith.[7] 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

1 The United States Supreme Court has recently interpreted IRC § 6662(h) in the context of a partner claiming outside basis in a sham partnership. *See United States v. Woods*, 134 S. Ct. 557 (2013), *rev'g* 471 F. App'x 320 (5th Cir. 2012), *aff'g per curiam* 794 F. Supp. 2d 714 (W.D. Tex. 2011). For a more detailed discussion of *Woods*, see Significant Cases, *infra*.

2 IRC § 6662(b)(4) authorizes a penalty for any substantial overstatement of pension liabilities; IRC § 6662(b)(5) authorizes a penalty for any substantial 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.

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

4 I.R.C. § 6664(a).

5 *Rand v. Comm'r*, 141 T.C. 376 (2013). Following *Rand*, there has been a proposal to calculate negative tax in computing the amount of underpayment for accuracy-related penalty purposes. *See* Joint Committee on Taxation, *Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title VI- Tax Administration and Compliance* (JCX-17-14), (Feb. 26, 2014), at 42-43.

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

7 IRC § 6664(c)(1).

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

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.[13] 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.[14] 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.[15] 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.[16]

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.

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8 IRC § 6662(c).

9 Treas. Reg. § 1.6662-3(b)(1).

10 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).

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

12 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).

13 IRC § 6662(d)(2)(A)(i)-(ii).

14 IRC § 6662(d)(2)(B)(i)-(ii). No reduction is permitted, however, for any item attributable to a tax shelter. *See* IRC § 6662(d)(2)(C)(i). If a return position is reasonably based on one or more of the authorities set forth in Treas. Reg. § 1.6662-4(d)(3)(iii), the return position will generally satisfy the reasonable basis standard. This may be true even if the return position does not satisfy the substantial authority standard found in Treas. Reg. § 1.6662-4(d)(2). *See* Treas. Reg. § 1.6662-3(b)(3). Types of authority found in Treas. Reg. § 6662-4(d)(3)(iii) include (among others): applicable provisions of the Internal Revenue Code, proposed, temporary and final regulations construing such statutes, revenue rulings and revenue procedures, and tax treaties and regulations thereunder. A taxpayer may qualify for relief under the reasonable cause and good faith exception even if a return does not satisfy the reasonable basis standard. *See* Treas. Reg. § 1.6662-3(b)(3).

15 IRC § 6662(d)(1)(A)(i)-(ii).

16 IRC § 6662(d)(1)(B)(i)-(ii).

Substantial Valuation Misstatement/Gross Valuation Misstatement

IRC § 6662(b)(3) imposes a 20 percent penalty on any portion of an underpayment shown to be due to a substantial valuation misstatement. This occurs when the value of any property (or adjusted basis of any property) claimed on an income tax return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis.[17] The penalty does not apply, however, unless the portion of the underpayment attributable to substantial valuation misstatements exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company).[18]

If any part of the underpayment is attributable to a gross valuation misstatement, the penalty increases from 20 percent to 40 percent.[19] A gross valuation misstatement occurs if the value or adjusted basis of the property claimed on any return is 200 percent or more of the correct amount of such valuation or adjusted basis.[20]

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.[21] A reasonable cause determination takes into account all of the pertinent facts and circumstances.[22] Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.[23] In the context of a substantial (or gross) valuation misstatement of charitable deduction property,[24] there can be no reasonable cause unless: (i) the claimed value of property was based on a qualified appraisal by a qualified appraiser, and (ii) the taxpayer made a good faith investigation of the value of the contributed property.[25]

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process[26] and through its Automated Underreporter (AUR) computer system.[27] Before a taxpayer receives a notice of deficiency,

17 IRC § 6662(e)(1)(A).

18 IRC § 6662(e)(2).

19 IRC § 6662(h)(1).

20 IRC § 6662(h)(2)(A)(i).

21 IRC § 6664(c)(1).

22 Treas. Reg. § 1.6664-4(b)(1).

23 *Id*.

24 *See* Treas. Reg. §1.6664-4(h)(2) for the definition of charitable deduction property.

25 Treas. Reg. § 1.6664-4(h)(1)(i)-(ii).

26 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).

27 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.").

he or she generally has an opportunity to engage the IRS on the merits of the penalty.[28] Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC § 6211-6213).[29] 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.[30] Alternatively, taxpayers may seek judicial review through refund litigation.[31] 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.[32]

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.[33] 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.[34]

ANALYSIS OF LITIGATED CASES

We identified 153 opinions issued between June 1, 2013 and May 31, 2014 where taxpayers litigated the negligence/disregard of rules or regulations, substantial understatement, or substantial (or gross) valuation misstatement components of the accuracy-related penalty. The IRS prevailed in full in 119 cases (78 percent), the taxpayers prevailed in full in 24 cases (16 percent) and 10 cases (seven percent) resulted in split decisions. Table 1 in Appendix III provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 81 of the 153 cases (53 percent) and convinced the court to dismiss or reduce the penalty in 11 (14 percent) of those cases. Represented taxpayers fared significantly better, achieving full or partial relief from the penalty in 23 of their 72 cases (32 percent).

In some cases, the court found taxpayers liable for the accuracy-related penalty but failed to clarify whether it was for negligence under IRC § 6662(b)(1), a substantial understatement of tax under § 6662(b)(2),

28 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).

29 IRC § 6665(a)(1).

30 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.

31 Taxpayers may litigate an accuracy-related penalty by paying the tax liability (including the penalty) in full, filing a timely claim for refund, and then timely instituting a refund suit in the appropriate United States District Court or the Court of Federal Claims. 28 U.S.C. § 1346(a)(1); 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).

32 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).

33 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."

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

or both.[35] Regardless of the subsection at issue, the analysis of reasonable cause is generally the same.[36] As such, we have combined our analyses of reasonable cause for the negligence, substantial understatement, and substantial (or gross) misstatement 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.[37] 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 *Rodriguez v. Commissioner*,[38] the taxpayers sought to deduct losses from their horse breeding activities. Although a deduction is allowed for ordinary and necessary expenses paid or incurred by a taxpayer in carrying on a trade or business,[39] the IRS disallowed the reported losses in this case for failure to substantiate that the activity was conducted in "a businesslike manner."[40] In *Rodriguez*, the taxpayers kept electronic records of their farm's finances; however, the court did not find these records credible or adequate to substantiate the losses taken on Schedule F.[41] The court did not uphold the accuracy-related penalty asserted against the taxpayers because their records demonstrated that they made a good faith effort to maintain a record of their horse breeding activities even though their attempt at recordkeeping fell short for substantiation purposes.[42]

While the Tax Court has been sympathetic to honest misunderstandings of a complex tax code,[43] it will still impose an accuracy-related penalty on taxpayers not demonstrating a good faith effort to comply with the law. For example, in *Adeyemo v. Commissioner*,[44] the taxpayers (a husband and wife) maintained a logbook of time spent on rental activities. Although the court acknowledged the husband put in a certain amount of effort, it found that taxpayers' actions did not amount to good faith because they did not maintain records for all of their business expenses and did not rely on the logbook when filing their returns.[45]

In contrast, in *Goralski v. Commissioner*,[46] the taxpayers (a husband and wife) sought to obtain the First-Time Homebuyer Credit (FTHBC) pursuant to IRC § 36. The husband's mother had passed away

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35 *See, e.g., Douglas v. Comm'r*, T.C. Memo. 2014-104 (IRS assessed 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 Sampson v. Comm'r*, T.C. Memo. 2013-212 (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).

36 As discussed earlier, the reasonable cause exception is narrower in the context of a substantial (or gross) valuation misstatement of charitable deduction property.

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

38 T.C. Memo. 2013-221.

39 IRC § 162(a).

40 *See also* Treas. Reg. § 1.183-2(b)(1).

41 *Rodriguez*, T.C. Memo. 2013-221.

42 *Id*.

43 *See, e.g., Faylor v. Comm'r*, T.C. Memo. 2013-143 (relieving from the accuracy-related penalty a taxpayer who improperly deducted a payment to his ex-spouse as alimony because of his inexperience and honest misunderstanding).

44 T.C. Memo. 2014-1.

45 *Id*. The court also did not find that the taxpayers had established reasonable cause.

46 T.C. Memo. 2014-87.

during the taxable year in question, and his sister was experiencing difficulty with their mother's loss.[47] During this time, the husband shared his late mother's house, which he had inherited, with his sister. The husband and wife subsequently bought their own house and the IRS disallowed their FTHBC claim for failure to substantiate that the house the husband inherited from his mother was *not* his principal residence. The IRS assessed an accuracy-related penalty. However, the court found that the taxpayers had reasonable cause for believing that they were entitled to the FTHBC as a result of "honest misunderstanding of law that was reasonable in the light of all the facts and circumstances, including [the husband's] experience, knowledge, and education." The court sympathized with the family's circumstances and, among other factors, relied on the fact that the taxpayers acted in good faith by researching the relevant law before claiming the credit.

While expectations for compliance with the tax code are high, taxpayers avoided an accuracy-related penalty attributable to negligence or disregard of rules and regulations by showing that their tax position had a reasonable basis.[48] In *TIFD III-E, Inc. v. United States*,[49] the taxpayer treated banks that held its preferred shares as equity partners. The Second Circuit denied the taxpayer's equity characterization, upheld the IRS's assessment of a 20 percent penalty for substantial understatement, and reversed the district court's holding without remand.[50] However, the government later realized that the substantial understatement penalty could not be assessed because the ten percent substantial understatement threshold had not been satisfied. The parties jointly moved to alter the judgment, and then the district court evaluated whether to impose the penalty. The district court concluded that the uncertain state of the law and the uncertain outcome of litigation were factors to support a finding of reasonable basis to the taxpayer's tax position, and therefore the court found that the negligence penalty was not applicable.[51]

In *Chandler v. Commissioner*,[52] the taxpayers were found liable for gross valuation misstatement when they deducted the value of easements as a charitable deduction, which was improperly substantiated. The IRS imposed accuracy-related penalties on the understatement that arose from the unsubstantiated basis increase. However, the correct method of valuing conservation easements was unsettled at the time the taxpayers filed their returns. The court focused the penalty application in this case on whether the deduction had been properly substantiated through appraisals as a sign of a good faith effort to comply with the tax code.[53] The court found that even though Mr. Chandler had a law degree and was an experienced businessman, he reasonably relied on a professional appraiser and his accountant. Further, the court found that the valuation of easements is not an issue that most taxpayers encounter.

Definition of Underpayment

We also reviewed several cases in which taxpayers contested an accuracy-related penalty assessed by the IRS after it challenged their claim to refundable tax credits. In computing their penalties, the IRS reduced the amount of tax shown by taxpayers on their return by the amount of refundable tax credits they claimed. Until recently, the Tax Court has not addressed, in a precedential opinion, whether the amount

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47 T.C. Memo. 2014-87.

48 IRC § 6662(a), (b)(1), and (c). A return position that has a reasonable basis is not attributable to negligence. Treas. Reg. §§ 1.6662–3(b)(1).

49 113 A.F.T.R.2d (R.I.A.) 1557 (D. Conn. 2014), *appeal docketed*, No. 14-1952 (2d Cir. June 9, 2014).

50 *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006).

51 *TIFD III-E, Inc*. 113 A.F.T.R.2d (R.I.A.) 1557 (D.Conn. 2014).

52 142 T.C. No. 16 (2014).

53 *Id*.

of tax shown by a taxpayer on his or her return could be reduced below zero by refundable credits, including the Earned Income Tax Credit.[54]

In *Rand v. Commissioner*,[55] the taxpayers were able to reduce their liability for accuracy-related penalties from about $1,494 to about $29. The taxpayers had claimed the earned income tax credit, the child tax credit, and the recovery rebate credit. However, the IRS determined that the taxpayers were not entitled to any of these credits and assessed an accuracy-related penalty against them. On their return, the taxpayers had shown a tax liability of $144 and claimed credits worth $7,471. In computing the penalty amount, the IRS reduced the amount of tax shown by the taxpayers on their return below zero, to -$7,327, by subtracting the amount of credits they had claimed.

The taxpayers challenged the IRS's method of computing underpayment. The case centered on the meaning of "the amount shown as tax," a component to determining underpayment. First, the taxpayers argued that the amount shown on their tax return is limited to the amount actually reported on the return (without reducing that amount for refundable credits). Second, they asserted that refundable credits cannot reduce the amount shown on the return below zero. The Tax Court agreed with the taxpayers' second argument. Relying on the definition of "deficiency,"[56] and on the legislative history of links between the definitions of "deficiency" and "underpayment," the court's majority held that rebates—such as refundable credits—*can* reduce the amount of tax shown on the return, but *not* below zero. Consequently, the amount of tax shown on the taxpayers' return was not -$7,327 but $0, the amount of underpayment was $144, and the penalty amount $29. The Tax Court had reached similar conclusions on the computation of amount of tax shown on the return in earlier cases, but *Rand* is the first precedential opinion of the court to reach this conclusion.[57]

The Office of Chief Counsel recently issued litigating guidelines for handling Tax Court cases involving the accuracy-related penalty determined with respect to disallowed refundable credits in light of the *Rand* decision.[58] Chief Counsel has ceded to the Tax Court's position. Attorneys are instructed to not treat claims for refund or credit based on erroneous refundable credits as a negative amount of tax shown on the return when determining the amount of an underpayment subject to a penalty under IRC § 6662. It should be noted that this guidance is provided "pending any future guidance" and is effective until further notice, perhaps suggesting that the issue is not settled.[59]

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.[60] 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

54 *See* IRC § 32.
55 141 T.C. 376 (2013).
56 *See* I.R.C. § 6211(b)(4).
57 *See, e.g., Solomon v. Comm'r*, T.C. Summ.Op. 2008-95.
58 *See* Chief Counsel Notice CC-2014-007 (July 31, 2014).
59 *Id*.
60 *See* Treas. Reg. § 1.6664-4(c)(1). *See also* IRM 20.1.5.6.1(6), *Reasonable Cause* (Jan. 24, 2012).

3. The taxpayer actually relied in good faith on the adviser's judgment.[61]

Taxpayers argued their good faith reliance on a competent tax professional in several cases this year,[62] including *Moore v. Commissioner*.[63] In *Moore*, the IRS imposed an accuracy-related penalty for a substantial understatement of income tax resulting from transactions in which the taxpayers' cost basis in stock was overstated. The taxpayers hired a professional tax advisory firm to help them prepare their returns and provided the advisors with all facts concerning the transactions in good faith to properly report their basis in stock. The Tax Court declined to uphold the accuracy-related penalty because the taxpayers established good faith reliance on a competent tax professional.

In *Palmer Ranch Holdings Ltd. v. Commissioner*,[64] the IRS imposed a 40 percent accuracy-related penalty on the taxpayer (a partnership) for a gross valuation misstatement.[65] Alternatively, the IRS argued that the taxpayer was liable for a 20 percent accuracy-related penalty for negligence or disregard of rules or regulations, a substantial understatement of income tax, or a substantial valuation misstatement.[66] The taxpayer had donated a conservation easement and claimed its appraised value as a charitable deduction. The Tax Court found that the actual value of the easement was less than what the taxpayer had claimed, and therefore disallowed a portion of its deduction.[67] However, because the amount of overstatement was about 20 percent, it was not a gross valuation misstatement and the 40 percent penalty was inapplicable. The taxpayer presented credible evidence of good faith reliance on competent professionals, including a tax attorney, a licensed appraiser, and a land planning and engineering firm. The partnership was unsophisticated in the field of tax and relied on a tax attorney to "advise it on how to donate the easement in compliance with the Internal Revenue Code."[68] The partnership was able to establish the three criteria above, and the court held it was not liable for any accuracy-related penalties.

In several cases, the taxpayer could not establish all three of the above-mentioned criteria had been satisfied. For example, in *Ames-Mechelke v. Commissioner*,[69] the taxpayer hired a tax return preparer to determine the tax consequences of her income and expenses. The taxpayer participated in an abusive trust arrangement, the promoter of which had introduced the taxpayer to her return preparer. As her participation in the abusive transaction escalated, the taxpayer became aware of the tax avoidance aspect of the trust arrangement. Eventually, she engaged in a more aggressive trust arrangement organized by the same promoter. The Tax Court concluded that the taxpayer could not have relied on her return preparer in good faith once she gained knowledge of the tax avoidance aspect of the trust arrangement. As the taxpayer was not able to establish actual reliance in good faith, she failed to meet the third prong of the *Neonatology* test described above and was liable for an accuracy-related penalty.[70]

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

62 *See, e.g., Azimzadeh v. Comm'r*, T.C. Memo. 2013-169 (finding the taxpayer reasonably relied on his CPA's judgment in claiming a real-estate loss and home mortgage interest deductions to which he was not entitled; but finding that the taxpayer failed to show that he had provided adequate documentation to his CPA for unreported wages and was, therefore, liable for an accuracy-related penalty for that portion of the underpayment of tax).

63 T.C. Memo. 2013-249.

64 T.C. Memo. 2014-79.

65 *See* IRC § 6662(h)(2).

66 *See* IRC §§ 6662(a) and (b)(1), (2), and (3).

67 Generally, the charitable contribution amount is the contributed property's fair market value at the time it is contributed. *See* Treas. Reg. §§ 1.170A-1(a), (c)(1).

68 *Palmer Ranch Holdings Ltd.*, T.C. Memo. 2014-79.

69 T.C. Memo. 2013-176.

70 *Neonatology*, 115 T.C. at 99.

There are many more examples of taxpayers' failure to establish the competence of their tax return preparers.[71] While some taxpayers choose to use tax software to prepare their tax returns, the Tax Court may not find reliance on tax return preparation software justifiable to avoid an accuracy-related penalty. In this regard, the Tax Court has observed "[a] mistake in entering the amount into the tax preparation software, albeit accidental, is not a defense to the imposition of the section 6662(a) penalty."[72] In particular, relying on tax preparation software without doing any independent research or consulting a tax expert may not provide a defense of reasonable cause.[73] Prior year cases indicate that the Tax Court may be open to allowing a reasonable cause defense if there is a tax preparation software programming error.[74]

No Affirmative Defense Offered by the Taxpayer

Many taxpayers 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 *Schlievert v. Commissioner*,[75] the taxpayers substantially understated income tax by deducting losses associated with investments in record label activities. The court found that the taxpayers were not allowed to deduct expenses in excess of gross income because they were not engaged in the record label for profit, as defined in IRC § 183.

The taxpayers did not address the penalty issue in their brief, and they presented no evidence on reasonable cause for their underpayment. Consequently, the court held that the taxpayers were liable for the accuracy-related penalty. The taxpayers appeared *pro se* in this case. It may be that some *pro se* taxpayers are unaware that they bear the burden of proving reasonable cause.

CONCLUSION

In approximately one 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.

Our review of cases this year shows that taxpayers with representation fared significantly better than their unrepresented counterparts. Represented taxpayers were successful in dismissing or reducing their penalties in 32 percent of the cases with representation versus 14 percent of unrepresented taxpayers.[76]

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71 *See, e.g., Curtis v. Comm'r*, T.C. Memo. 2014-19 (finding taxpayer liable for an accuracy-related penalty because he failed to show any credible evidence that he had hired a competent tax return preparer). Taxpayers may have a difficult time demonstrating the competency of many tax return preparers if the government is barred from regulating unenrolled return preparers. *See Loving v. Internal Revenue Service*, 742 F.3d 1013 (D.C. Cir. 2014), *aff'g* 917 F.Supp.2d 67 (D.D.C. 2013); Written Statement of Nina E. Olson, National Taxpayer Advocate, Hearing on Protecting Taxpayers From Incompetent and Unethical Return Preparers Before the Committee on Finance, U.S. Senate, at 9 (Apr. 8, 2014) (citing Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 2013 TNT 92-31 (May 13, 2013)).

72 *See Brooks v. Comm'r*, T.C. Memo. 2013-141, 2013 Tax Ct. Memo. LEXIS 142 at *50-*51 (citation omitted).

73 *See Bigdeli v. Comm'r*, T.C. Memo 2013-148 (June 11, 2013); *Estate of Limberea v. Comm'r*, T.C. Summ. Op. 2013-50 (June 24, 2013).

74 *See Langley v. Comm'r*, T.C. Memo 2013-22, 10 (Jan. 17, 2013) ("Although they have not shown exactly the manner in which they relied on TurboTax or its instructions, we find it unlikely that TurboTax was responsible for the items giving rise to the Petitioners' deficiency."); *Morales v. Comm'r*, T.C. Memo 2012-341, 6 (Dec. 6, 2012) ("Moreover, Petitioners failed to introduce other evidence that demonstrates their improperly claiming the first-time homebuyer credit was the result of a TurboTax programming flaw or instructional error.")

75 T.C. Memo. 2013-239.

76 *See* Analysis of Litigated Cases discussion, *supra*.

Represented taxpayers fared better than they did over the same period last year, while unrepresented taxpayers fared worse over the same period.[77]

Taxpayers should be aware that they must raise an affirmative defense to the penalty in order to have a chance at avoiding liability for the penalty, because taxpayers are deemed to have conceded those issues that they do not raise.[78]

77 *Compare* National Taxpayer Advocate 2013 Annual Report to Congress 342 (Most Litigated Issue: *Accuracy-Related Penalty Under IRC §§ 6662(b)(1) and (2)*) (the court dismissed or reduced penalties in 20 percent of the cases for *pro se* taxpayers and 24 percent of the cases for represented taxpayers).

78 *See* Tax Ct. R. 34(b)(4).

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

SUMMARY

The deductibility of trade or business expenses has long been among the ten Most Litigated Issues since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.[1] We identified 115 cases involving a trade or business expense issue that were litigated between June 1, 2013, and May 31, 2014. The courts affirmed the IRS position in 87 of these cases (76 percent), while taxpayers fully prevailed in only three cases (three percent). The remaining 25 cases (22 percent) resulted in split decisions.

PRESENT LAW

Internal Revenue Code § 162 allows deductions for ordinary and necessary trade or business expenses paid or incurred during the course of a taxable year.[2] 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 involve the analysis of facts and circumstances particular to each case. When a taxpayer seeks judicial review of the IRS's determination of a tax liability relating to the deductibility of a particular expense, the courts must often address a series of questions, including those discussed below.

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

Although "trade or business" is one of the most widely used terms in the IRC, neither the Code nor Treasury Regulations provide a definition.[3] The definition of a "trade or business" comes from common law, where the concepts have been developed and refined by the courts.[4] The Supreme Court has interpreted "trade or business" for purposes of IRC § 162 to mean an activity conducted with "continuity and regularity" and with the primary purpose of earning income or making profit.[5]

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.[6] The Supreme Court describes an "ordinary" expense

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1 *See* National Taxpayer Advocate 1998-2013 Annual Reports to Congress.

2 Hereafter, the Internal Revenue Code will be referred to as the "IRC" or the "Code."

3 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).

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

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

6 290 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.[7] The Court describes a "necessary" expense as one that is appropriate and helpful for development of the business.[8]

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

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

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

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

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

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

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*.[15] The court held that the taxpayer's business expense deductions were not

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

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

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

10 IRC § 162(a).

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

12 IRC § 167.

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

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

15 39 F.2d 540 (2d Cir. 1930). George M. Cohan was an actor, playwright, and producer who spent large sums travelling and entertaining actors, employees, and critics. Although Cohan did not keep a record of his spending on travel and entertainment, he estimated that he incurred $55,000 in expenses over several years. The Board of Tax Appeals, now the Tax Court, disallowed these deductions in full based on Cohan's lack of supporting documentation. Nevertheless, on appeal, the 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.

adequately substantiated, but stated that "the [Tax Court] should make as close an approximation as it can, bearing heavily, if it chooses, upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent."[16]

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."[17]

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.[18]

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.[19] 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.

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.[20] This year, we reviewed 115 cases involving trade or business expenses that were litigated in federal courts from June 1, 2013, through May 31, 2014. Table 2 in Appendix III contains a list of the main issues in those cases. Figure 3.2.1 (below) categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

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

17 "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).

18 Treas. Reg. § 1.274-5T(b).

19 *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).

20 *See* National Taxpayer Advocate 1998–2013 Annual Reports to Congress.

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[a]	16	54
Profit objective[b]	0	12
Ordinary and necessary trade or business expenses[c]	2	9
Personal vs. business expenses[d]	9	17
Business expenses vs. capital expenditures[e]	1	2
Did the taxpayer establish the carrying on of a trade or business?	3	9
Gambling expenses[f]	0	4

a 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.

b 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. reas. Reg. § 1.183-2(b) provides the following nonexhaustive list of nine factors to consider in determining whether an activity is conducted for profit: ( ) 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 taxp yer; and (9) elements of personal pleasure or recreation.

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

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

e Under IRC § 263(a), generally no deduction is allowed for capital expenditures, where capital expenditures include any amount paid for permanent improvements made to increase the value of any property. 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) and (B). (These amounts are increased to $10,000 and $60,000 for taxable years beginning in 2010. *See* IRC § 195(b)(3).

f IRC § 165(d) provides that "losses from wagering transactions shall be allowed only to the extent of the gains from such transactions."

Approximately 64 percent of the cases (74 of 115) involved taxpayers representing themselves (*pro se*). The 36 percent (41 of 115) of cases with taxpayers represented by counsel fared slightly better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in approximately 27 percent of cases (11 of 41). By contrast, *pro se* taxpayers received full or partial relief in 23 percent of cases (17 of 74).

Individual Taxpayers

None of the 23 decisions involving individual taxpayers (where the term "individual" excludes a sole proprietorship) was issued as a regular opinion of the Tax Court.[21] Seventeen of the 23 individual taxpayers

21 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 Rules of Practice and Procedure, Rules 170-175. More than half of the cases reviewed this year involving individual taxpayers (excluding sole proprietorships) were "S" cases.

appeared *pro se*. No individual taxpayers received full relief, while only seven earned split decisions. The court upheld the IRS position in 16 of 23 cases (70 percent).

The most prevalent issue was the substantiation of claimed trade or business expense deductions. For example, in *Humphrey v. Commissioner*, the Tax Court denied several claimed business expense deductions for failure to substantiate.[22] The taxpayer, a Customs and Border Protection agent, was unable to substantiate travel and vehicle expenses for trips related to his work because he only gave the Court a rough estimate of his miles rather than a contemporaneous log. He similarly failed to provide any records for other travel expenses. Further, the Tax Court denied expense deductions for meals and entertainment because the taxpayer did not provide any substantiation. Deductions for gifts and cell phone expenses were also denied as there was no evidence proving a business purpose. Finally, the Court denied a deduction for legal fees for failure to provide adequate substantiation.[23]

Business Taxpayers

We reviewed 92 cases involving business taxpayers. As it turned out, business taxpayers had a slightly lower success rate compared to individual taxpayers. Individual taxpayers did not win a single case in full; however, individuals received partial relief from split decisions in 30 percent of cases (seven of 23). Meanwhile, business taxpayers received full or partial relief in approximately 23 percent of cases (21 of 92).

Business taxpayers were represented by counsel in 38 percent (eight of 21) of favorably decided cases, including all three of the cases in which the taxpayer received full relief. Business taxpayers were represented by counsel in 37 percent (26 of 71) of the cases the IRS won. The success of *pro se* taxpayers in court stemmed mostly from their ability to provide records substantiating deductions in cases where such substantiation was in controversy.

As it was for the individual taxpayers, substantiation of expenses was by far the most prevalent issue, and in most instances, the courts denied the business taxpayers' deductions for failure to substantiate.[24] Courts did, however, allow some of these deductions when the taxpayer produced sufficient evidence.[25] 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. As previously mentioned, however, IRC § 274(d) makes the *Cohan* rule unavailable in certain circumstances in which the taxpayer must substantiate the deductions.

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22 T.C. Memo. 2013-198.

23 The taxpayer provided carbon copies of checks without anything more, which is not adequate substantiation. *Id*. (citing *Miller v. Comm'r*, T.C. Memo. 1996-402). Another example is *Golit v. Comm'r*, T.C. Memo. 2013-191, where the Tax Court disallowed deductions for books and stethoscopes, among other items, due to the taxpayer's failure to substantiate claimed business expenses.

24 *See Alexander v. Comm'r*, T.C. Memo. 2013-203 (deduction denied for grain farming expenses for failure to substantiate; court did not reach question of profit motive); *Edem v. Comm'r*, T.C. Memo. 2013-238 (taxpayers introduced no evidence to substantiate business expenses; deductions were denied); *Gorokhovsky v. Comm'r*, 549 F. App'x 527 (7th Cir. 2013), *aff'g* T.C. Memo. 2012-206 (deduction denied for business expenses for failure to substantiate; self-generated, handwritten notes were not credible evidence of deductions); *Van Velzor v. Comm'r*, T.C. Memo. 2014-71 (deduction for labor expenses for failure to substantiate when only evidence was self-serving testimony and unreliable hearsay).

25 *See Azimzadeh v. Comm'r*, T.C. Memo. 2013-169 (deductions for business expenses allowed to the extent substantiated; deduction denied for travel expenses for failure to meet IRC § 274 substantiation requirements); *Karch v. Comm'r*, T.C. Memo. 2013-237, *appeal docketed*, No. 14-3179 (3d Cir. July 3, 2014) (deduction for wage, mortgage, and contract service expenses allowed to the extent substantiated; deductions denied for other business expenses for failure to substantiate).

Taxpayers had particular difficulty validating their home office deductions, losing cases where business use of a personal residence was at issue.[26] One example of this issue was *Thunstedt v. Commissioner*, where the taxpayer, an art dealer, sought to deduct over 60 percent of his home as an office.[27] In his testimony, the taxpayer listed business activities he conducted out of his home, asserting, "everything I do is business."[28] However, he failed to provide evidence that any part of the house was exclusively used for business and also attested that his children frequently stayed in the house. The Tax Court denied the deduction in full because the taxpayer did not give evidence that any specific part of the house was used exclusively for business, which meant the Court could not even make a rough estimate of the proper deduction using *Cohan*.

Another common theme was the difficulty in proving that expenses were ordinary and necessary to the taxpayer's business.[29] The taxpayer in *Bagley v. Commissioner*, however, scored a victory after he sought to deduct litigation expenses from a *qui tam* lawsuit.[30] Laid off and failing to find other work, the taxpayer initiated a *qui tam* lawsuit against his old employer, a federal contractor, under the False Claims Act. The government eventually intervened in the suit, and at the case's conclusion, the government paid the taxpayer over $36 million as the combination of an award, plus statutory attorneys' fees. The taxpayer in turn paid over $18 million to the attorneys he had hired to assist with the suit. The IRS disputed the categorization of the $18 million of legal fees as a business expense.

After determining the litigation activities did indeed constitute a trade or business, the court proceeded to examine whether the litigation expenses were ordinary and necessary. Because the trade or business in question was litigation, the court agreed with the taxpayer that legal fees constituted ordinary and necessary business expenses and allowed the claimed deduction.[31]

Taxpayers were also denied business expense deductions under IRC § 262(a) when the courts found the expenses were related to personal, rather than business activities.[32] In *Dargie v. United States*, Dr. Dargie

26 IRC § 280(A)(c)(1) allows the deduction of "a portion of the dwelling unit which is exclusively used on a regular basis … as the principal place of business for any trade or business of the taxpayer." If the taxpayer is an employee, the home office deduction is only allowable if the exclusive use is for the convenience of the employer. *Id*. Examples of cases examined in which the court denied deductions for home office expenses are *Dupre v. Comm'r*, T.C. Memo. 2013-287 (home office deduction denied for failure to show exclusive use or convenience of employer) and *Scully v. Comm'r*, T.C. Memo. 2013-229 (deduction denied for failure to provide any evidence of exclusive use).

27 T.C. Memo. 2013-280.

28 *Id*.

29 *See* IRC § 162(a) ("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 ... (3) 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 examples of cases examined in which the court denied deductions for failure to prove the expense was ordinary and necessary in business, *see*, *e.g*., *Chaganti v. Comm'r*, T.C. Memo. 2013-285 (deduction for court-ordered fines denied because they were not ordinary and necessary to the taxpayer's business); *Elick v. Comm'r*, T.C. Memo. 2013-139, *appeal docketed*, No. 13-73837 (9th Cir. Oct. 31, 2013) (deduction denied for management fees for failure to prove ordinary and necessary in business).

30 963 F. Supp. 2d 982 (C.D. Cal. 2013). The False Claims Act (FCA) establishes liability for any person who knowingly presents, or causes to be presented, to an officer or employee of the United States Government a false or fraudulent claim for payment or approval. 31 U.S.C. § 3729(a). The FCA authorizes both the Attorney General and private persons to bring civil actions to enforce the Act. 31 U.S.C. § 3730. An action brought by a private person under § 3730(b) of the FCA is termed a *qui tam* suit. *Qui tam* is a writ whereby a private individual who assists a prosecution can receive all or part of any penalty imposed. Its name is an abbreviation of the Latin phrase *qui tam pro domino rege quam pro se ipso in hac parte sequitur*, meaning "[he] who sues in this matter for the king as well as for himself."

31 963 F. Supp. 2d at 1002.

32 IRC § 262(a) provides that personal, living and family expenses are generally not deductible. *See*, *e.g.*, *Bigdeli v. Comm'r*, T.C. Memo. 2013-148 (deduction denied for vehicle and travel expenses because expenses were of a personal nature); Austin Otology *Assocs. v. Comm'r*, T.C. Memo. 2013-293 (deduction denied for hunting trips and security expenses because expenses were of a personal nature).

signed a "conditional award agreement" with his medical school saying that he would either spend four years working in an underserved community in exchange for payment of his educational expenses or pay back his award—up to double the amount being awarded.[33] After graduating, he chose not to work in the specified location and instead repaid the amount of his initial award, plus interest.

The taxpayers (husband and wife) then sought to deduct that expense, claiming it was a payment of damages attributable to Dr. Dargie's breach of the agreement and thus an ordinary and necessary expense of opening his medical practice in the chosen location. The Court of Appeals for the Sixth Circuit rejected that characterization, upholding the lower court's determination that the payments were personal expenses incurred to enable Dr. Dargie to meet the minimum requirements for his occupation.[34]

Courts likewise generally sustained IRS determinations that business expense deductions were not attributable to an activity engaged in for profit within the meaning of IRC § 183.[35] In *United States v. Hart*, the taxpayer sought to deduct expenses related to a book he had written.[36] The court proceeded to examine the taxpayer's deductions using the nine-factor test of Treas. Reg. § 1.183-2(b).[37] The taxpayer self-published the book, entitled *Constitutional Income: Do You Have Any?*, but failed to realize any profit from the publication. Hart testified the first and second editions of the book sold out, but he also gave away hundreds of copies.

The court held that he did not engage in his book writing activity for profit, stating that "Mr. Hart's testimony concerning how he managed his book-writing activity simply does not support a finding that the book writing was engaged in for purposes of generating a profit."[38] The court noted that Hart had never written a book before, worked as an engineer during the writing process, never put together a business plan for his writing activities, and admitted that he had personal reasons for writing the book.

Similarly, the taxpayers in *Schlievert v. Commissioner* sought to deduct expenses related to their music label activity under IRC § 162(a), but the Tax Court denied the deduction because the activity was not engaged in for profit pursuant to IRC § 183.[39] In *Schlievert*, the taxpayers, a husband and wife, held themselves out as a record label and sought to deduct a variety of expenses related to band activities.

The taxpayers started their label at the behest of their daughter, who was trying to break into the music industry as a band manager. They financed a band their daughter had recruited by reimbursing her for expenses and claimed those reimbursements as deductions. Examining those expenses with the nine factors of Treas. Reg. § 1.183-2(b), the Tax Court denied the deductions because the activity was not engaged in for profit. It cited the lack of previous experience in the music industry, the lack of profits, the absence of a business plan, and a personal desire to help their daughter succeed as weighing against

33 742 F.3d 243 (6th Cir. 2014), *aff'g* 113 A.F.T.R.2d (RIA) 817 (W.D. Tenn. 2013).

34 *Id*.

35 *See, e.g., Hoelscher v. Comm'r*, T.C. Memo. 2013-236 (deduction denied for ranching activities because not engaged in for profit under IRC § 183).

36 111 A.F.T.R.2d (RIA) 2235 (D. Idaho 2013).

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

38 111 A.F.T.R.2d 2235 (D. Idaho 2013).

39 T.C. Memo. 2013-239.

a profit motive. The Tax Court declared the record label expenses were investments in the career of the taxpayers' daughter, which, "though laudable," were not deductible.[40]

Another issue addressed by the courts this year deals with the question of whether a transaction has economic substance, which is a prerequisite for deductibility.[41] For example, in *John Hancock Life Insurance Company v. Commissioner*, the Tax Court denied rent, depreciation, interest, and transaction expense deductions because they were derived from transactions that lacked economic substance.[42] The transactions in question were a series of lease-in-lease-out (LILO) and sales-in-lease-out (SILO) transactions whereby John Hancock would lease (LILO) or buy (SILO) from a tax-exempt entity, then lease the property back to the original entity, garnering favorable tax treatment. The Tax Court found that the transactions lacked economic substance because they were structured so that John Hancock never incurred any real risk and thus were similar in substance to a loan rather than a lease or sale.

CONCLUSION

The definition of an allowable business expense remains open to interpretation and is highly fact-specific. This circumstance continues to generate substantial controversy between the IRS and taxpayers regarding the scope of properly claimed business deductions. This year, as in prior years, the IRS actively scrutinized and challenged many such deductions, while taxpayers were often willing to resort to litigation where the disallowance could not be resolved administratively within the IRS. From June 1, 2013, through May 31, 2014, courts generally favored the IRS's denial of business expense deductions, but specific facts and circumstances yielded some victories for taxpayers.

Many taxpayers remain confused over the Code's requirements. This confusion is particularly apparent with respect to the IRC § 280(A) limitations on the home office deduction.[43] Taxpayers lost on this issue and routinely argued for deductions while admitting that the space was used for personal activities or that their employer did not ask them to work from home. The fact that taxpayers claim home office deductions, while then effectively conceding their inapplicability through their testimony, indicates a general lack of understanding about the requirements. This confusion regarding the rules surrounding IRC § 280(A) underscores the need for a home office standard deduction or similar safe harbor as previously recommended by the National Taxpayer Advocate.[44]

Given the relative frequency of home office litigation, we recommend that the IRS highlight the available home office guidance on its website and improve the landing page taxpayers see when they access the home office section.[45] While the page provides an accurate overview of the deduction, it may not adequately emphasize or define the requirement of "exclusive use" or define the phrase "for the convenience

40 T.C. Memo. 2013-239.

41 Taxpayers lost all three cases litigated on the economic substance issue. *See John Hancock Life Ins. Co. v. Comm'r*, 141 T.C. 1 (2013); *UnionBanCal & Subsidiaries v. U.S.*, 113 Fed. Cl. 117 (Fed. Cl. 2013) (denying deduction for rent expenses because transactions did not have economic substance); *Humboldt Shelby Holding Corp. v. Comm'r*, T.C. Memo. 2014-47, *appeal docketed*, No. 14-3428 (2d Cir. Sept. 12, 2014) (denying deduction for legal expenses because the associated transactions did not have economic substance).

42 141 T.C. 1 (2013).

43 This longstanding confusion likely is why the IRS issued guidance to simplify calculation and reporting of this deduction in Revenue Procedure 2013-13. As part of a taxpayer burden reduction effort, the IRS concurrently began a marketing campaign to further educate taxpayers regarding this deduction.

44 National Taxpayer Advocate 2007 Annual Report to Congress 503-511 (Key Legislative Recommendation: *Home Office Business Deduction*).

45 *See* IRS, Home Office Deduction, *available at* http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Home-Office-Deduction (last visited on Sept. 5, 2014).

of your employer." Taxpayers may access more detailed explanations by following the link to Publication 587, *Business Use of Your Home*, but would be better served if the initial page elaborated on these two vital and frequently misunderstood requirements. Through education, outreach, and collaboration with stakeholders, the IRS can help taxpayers understand the requirements and limitations of the home office and other business expense deductions.

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

SUMMARY

Pursuant to Internal Revenue Code (IRC) § 7602, the IRS may examine any books, records, or other data relevant to an investigation of a civil or criminal tax liability.[1] To obtain this information, the IRS may serve a summons directly on the subject of the investigation or any third party who may possess relevant information.[2] If a person summoned under § 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] When challenging the summons's validity, the taxpayer generally must provide "some credible evidence" supporting an allegation of bad faith or improper purpose.[7] The taxpayer is entitled to a hearing to examine an IRS agent about his or her purpose for issuing a summons only when the taxpayer can point to specific facts or circumstances that plausibly raise an inference of bad faith.[8] Naked allegations of improper purpose are not enough, but because direct evidence of IRS's bad faith "is rarely if ever available," circumstantial evidence can suffice to meet that burden.[9]

We identified 102 federal cases decided between June 1, 2013, and May 31, 2014, that included issues of IRS summons enforcement. In 49 cases, the government filed a petition to enforce the summons. In 51 cases, the taxpayer or a third party initiated the litigation by filing a motion to quash the summons. In two cases, the IRS was allowed to issue "John Doe" summonses.[10]

Of the 102 cases, the parties contesting the summonses prevailed fully in two cases, with three other cases resulting in split decisions. The IRS prevailed in full in the remaining 97 decisions.

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

2 IRC § 7602(a).

3 IRC § 7604(b).

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

5 IRC § 7609(b).

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

7 *United States v. Clarke*, 189 L. Ed. 2d 330, 337 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S. Tax Cas. (CCH) ¶ 50,732 (S.D. Fla. 2012). For a more detailed discussion of this important Supreme Court case, see *Significant Cases*, *supra*.

8 *Id.* (stating that "[t]he taxpayer need only make a showing of facts that give rise to a plausible inference of improper motive.").

9 *Id.*

10 *In re Tax Liabilities of John Does*, 112 A.F.T.R.2d (RIA) 5982 (N.D. Cal. 2013); *In re Does*, 112 A.F.T.R.2d (RIA) 5466 (N.D. Pa. 2013). A John Doe summons identifies a particular group or class of people instead of a specific person. For the requirements for issuing a John Doe summons, see note 13, *infra*.

PRESENT LAW

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

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

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

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

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

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

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

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

15 IRC § 7604.

16 *Powell*, 379 U.S. at 58.

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

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

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

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

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

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.[22]

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

- 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.[24]

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

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

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

- Attorney-client privilege;[31]

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

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

24 *Powell*, 379 U.S. at 57-58.

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

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

27 *Id.*

28 *Powell*, 379 U.S. at 58.

29 *United States v. Clarke*, 189 L. Ed. 2d 330, 337 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S. Tax Cas. (CCH) ¶ 50,732 (S.D. Fla. 2012). For a more detailed discussion of this important Supreme Court case, see *Significant Cases*, *supra*.

30 *Id.*

31 The attorney-client privilege provides protection from discovery of information where:

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

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

However, these privileges are limited. For example, attorney-client privilege protects "tax advice," but not tax return preparation materials.[34] 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.[35] Thus, the tax practitioner privilege does not apply to any written communication between a federally authorized tax practitioner and "any person, any director, officer, employee, agent, or representative of the person, or any other person holding a capital or profits interest in the person" which is "in connection with the promotion of the direct or indirect participation of the person in any tax shelter."[36] 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."[37]

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. That year, we identified only 44 cases but predicted the number would rise as the IRS became more aggressive in its enforcement initiatives. The volume of cases rose to 101 during the reporting period ending on May 31, 2006, peaked at 158 for the reporting period ending on May 31, 2009, and stands at 102 during this year's period as shown in Figure 3.3.1 below. A detailed list of these cases appears in Table 3 of Appendix III.

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

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

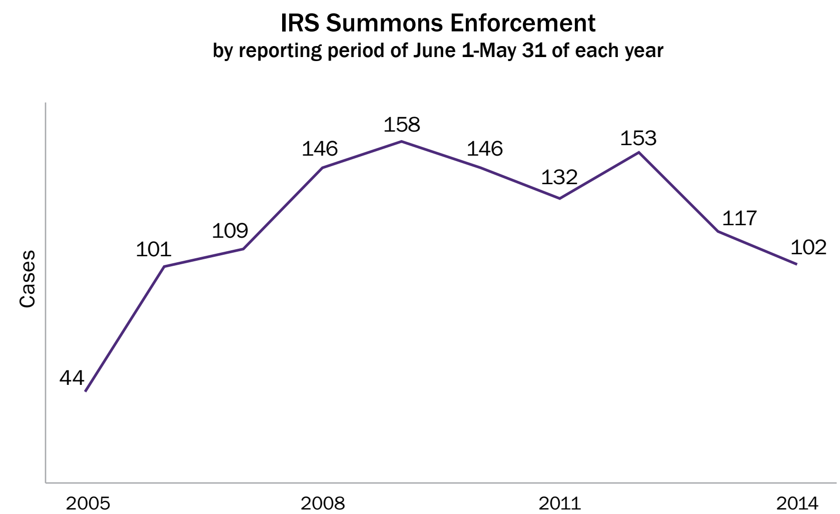
34 *United States v. Frederick*, 182 F.3d 496, 500 (7th Cir. 1999).

35 IRC § 7525(b); *Valero Energy Corp. v. United States*. 569 F.3d 626 (7th Cir. 2009).

36 IRC § 7525(b).

37 IRC § 6662(d)(2)(C)(ii).

FIGURE 3.3.1



In November of 2013, the Large Business and International Division (LB&I) of the IRS issued guidance to examiners on how to handle cases where the taxpayer does not provide a complete response to an Information Document Request (IDR) by the response date. The guidance requires that the examiner issue a delinquency notice and then a pre-summons letter prior to issuing a summons.[38] LB&I created these new procedures, which focus on enhanced pre-summons communications, because it believes the new process will improve the IRS's "ability to gather information timely and reduce the need to enforce IDRs through summonses." If effective, these new procedures could reduce the number of summonses issued, and as a consequence, we may see less litigation in this area in the future.

Of the 102 cases we reviewed this year, the IRS prevailed in full in 97, a success rate of 95 percent. Taxpayers were represented in 32 cases and appeared *pro se* (*i.e.*, on their own behalf) in the remaining 70. Seventy-nine cases involved individual taxpayers, while the remaining 23 involved business taxpayers, including sole proprietorships.[39] The arguments the litigants raised against IRS summonses generally fell into one of seven categories:

***Powell* Requirements:** Taxpayers frequently but unsuccessfully argued that the IRS did not meet one or more of the *Powell* requirements. Taxpayers often were unable to meet the substantial burden to rebut the IRS's *prima facie*[40] showing that the summons should be enforced. The U.S. Court of Appeals for the Eighth Circuit described the taxpayer's burden as heavy since the taxpayer must disprove one of the *Powell* requirements or show that enforcement of the summons would otherwise be an abuse of process.[41]

38 Memorandum for LB&I Employees From Heather C. Maloy, Commissioner, Large Business and International Division, *Large Business and International Directive on Information Document Requests Enforcement Process*, Control No. LB&I-04-1113-009, 2013 TNT 214-19 (Nov. 4, 2013).

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

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

41 *United States v. Claes*, 747 F.2d 491, 494 (8th Cir. 1984).

When taxpayers challenge the IRS's compliance with the *Powell* requirements, they often allege that the IRS failed to take one of the required administrative steps.[42] One recurring argument was that the person who issued the summons did not have the authority to do so.[43] Taxpayers were unsuccessful in making that argument because the Commissioner of Internal Revenue delegated his power to serve summonses to certain employees.[44]

However, one taxpayer was able to prove that the IRS did not meet one of the *Powell* requirement—namely, failing to complete all of the required administrative steps. In *Jewell v. United States*,[45] the United States Court of Appeals for the Tenth Circuit determined that the IRS could not establish a *prima facie* case for summons enforcement under *Powell* because it failed to comply with the 23-day notice of a third party summons required by statute.[46] The Tenth Circuit felt obliged to quash the summons to comply with Supreme Court precedent that requires *all* administrative requirements of the IRC be met even if its ruling might be viewed as "inequitable" or "form over substance."[47] In choosing to quash the summons for failure to meet the notice requirement, the Court of Appeals for the Tenth Circuit created a circuit split because the five other circuits to consider this issue all held that the failure to comply with the statutory notice requirement did not prevent enforcement of the summons.[48]

Criminal Referral: The IRS can issue summonses for the purpose of investigating a possible criminal offense, unless the matter has already been referred to the DOJ.[49] Some taxpayers argued that because the IRS issued a summons pursuant to a possible criminal investigation, it violated IRC § 7602(d).[50] However, the courts clearly state that a criminal investigation is not sufficient to show a referral to the DOJ.[51]

Constitutional Arguments: At least one court reiterated the longstanding rule that taxpayers cannot use the Fourth Amendment as a defense against a third-party summons.[52] Courts also continued to reject blanket assertions of the Fifth Amendment,[53] but noted that taxpayers may have valid Fifth Amendment

42 *See*, *e.g.*, *United States v. Soong*, 113 A.F.T.R.2d (RIA) 1589 (N.D. Cal. 2014), *appeal docketed*, No. 14-15987 (9th Cir. May 20, 2014); *Gangi v. United States*, 113 A.F.T.R.2d (RIA) 1175 (D. Mass. 2014).

43 *See, e.g.*, *Mahmood v. United States*, 2013 U.S. Dist. LEXIS 184841, at *6 (S.D. Cal. Dec. 10, 2013).

44 *See* Delegation Order No. 25-1, IRM 1.2.52.2 (Apr. 30, 2009).

45 *Jewell v. United States*, 749 F.3d 1295 (10th Cir. 2014), *aff'g* 111 A.F.T.R.2d (RIA) 1129 (E.D. Okla. 2013) and *rev'g* 111 A.F.T.R.2d (RIA) 1005 (W.D. Okla. 2013), *reh'g denied en banc*, No. 13-7038 (10th Cir. June 16, 2014).

46 "[N]otice shall be given to any person so identified [in the summons] within 3 days of the day on which such service is made but no later than the 23rd day before the day fixed in the summons as the day upon which such records are to be examined." IRC § 7609(a)(1).

47 *Jewell*, 749 F.3d at 1301.

48 Four circuit courts declined to hold that the 23-day notice period was mandatory. *See Sylvestre v. United States*, 978 F.2d 25, 26, 28 (1st Cir. 1992) (per curiam) (acknowledges that *Powell* requires the IRS to comply with all administrative requirements but ignores the 23-day notice requirement found in the Code); *see also Cook v. United States*, 104 F.3d 886, 889- 90 (6th Cir. 1997), *Azis v. United States* IRS, 522 Fed. Appx. 770, 777 (11th Cir. 2013) (per curiam), *Adamowicz v. United States*, 531 F.3d 151, 161 (2d Cir. 2008) (*per curiam*) (all assume equitable power to excuse notice defect if taxpayer not prejudiced). One other circuit court allowed enforcement of the summons to avoid elevating "form over substance" and rejected the suggestion that every infringement of a statutory requirement absolutely precludes enforcement of an IRS summons. *United States v. Bank of Moulton*, 614 F.2d 1063, 1066 (5th Cir. 1980) (per curiam).

49 IRC § 7602(d);

50 *See*, *e.g.*, *Bone v. United States*, 2013 U.S. Dist. LEXIS 127631 (D. Idaho Sept. 5, 2013), *adopting* 2013 U.S. Dist. LEXIS 127748 (D. Idaho Aug. 12, 2013); *Hunkler v. United States*, 113 A.F.T.R.2d (RIA) 1788 (S.D. Oh. 2014).

51 *Worsham v. Dep't of the Treasury*, 112 A.F.T.R.2d (RIA) 6315 (D. Md. 2013) (D. Md. Sept. 17, 2013).

52 *See, e.g.*, *Nevius v. Tomlinson*, 113 A.F.T.R.2d (RIA) 1872 (W.D. Mo. 2014).

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

claims regarding specific documents or testimony.[54] However, even if a taxpayer may assert the Fifth Amendment on behalf of himself, he cannot assert it on behalf of a business entity.[55]

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

- The documents' existence;
- The documents' authenticity; and
- The possession or control of the documents by the person to whom the summons was issued.[56]

In *United States v. Lawrence*, the court analyzed the applicability of the foregone conclusion exception, specifically, the government's ability to meet the authenticity requirement of the exception.[57] The IRS wanted the taxpayer to produce "cheat sheets" that the taxpayer allegedly withheld. The IRS contended that because one of its agents saw the cheat sheets, their existence was a foregone conclusion, precluding the taxpayer from asserting his Fifth Amendment privilege. The court disagreed, finding that "[e]ven if the IRS may have knowledge of the documents' existence, the Government has made no showing that the documents' authenticity can be independently verified."[58] Because compelling the taxpayer to produce the "cheat sheets" would implicitly affirm the authenticity of the documents, producing the documents would be sufficiently testimonial so that the Fifth Amendment privilege should apply.[59]

When the IRS issues a summons for oral testimony, the process for claiming the Fifth Amendment is similar to that involving an IRS request for documents. In *United States v. Tagle*,[60] the IRS wanted the court to enforce a summons for oral testimony,[61] and the taxpayers argued the order to enforce the summons would violate their Fifth Amendment rights. When the IRS is seeking to enforce summons by way of oral testimony, the taxpayer is required to show that he or she has a reasonable fear that answering the IRS's questions could be incriminating.[62] The court granted the enforcement of summons because it could not assess the hazards of self-incrimination before particular questions had been posed. However, the court noted that the taxpayers may invoke their Fifth Amendment privilege in response to specific questions asked at the interview.

Abuse of Process:[63] Taxpayers consistently tried to make the argument that it would be an abuse of the court's process to enforce the summons.[64] Taxpayers most frequently tried to show that the summons was

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

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

56 *United States v. Bright*, 596 F.3d 683, 692 (9th Cir. 2010).

57 113 A.F.T.R.2d (RIA) 1933 (S.D. Fla. 2014).

58 *Id*.

59 *Id*.

60 113 A.F.T.R.2d (RIA) 1818 (N.D. Cal. 2014).

61 The summons also requested documents but that issue is omitted.

62 *Tagle*, 113 A.F.T.R.2d (RIA) 1818 (N.D. Cal. 2014) (citing *United States v. Neff*, 615 F.2d 1235, 1239 (9th Cir. 1980) (internal quotation and citation omitted).

63 "[A] court may not permit its process to be abused. Such an abuse would take place if the summons had been issued for an improper purpose …" *Powell*, 379 U.S. at 58.

64 *See, e.g., Gangi*, 113 A.F.T.R.2d (RIA) 1175; *Ryder v. United States*, 113 A.F.T.R.2d (RIA) 706 (C.D. Cal. 2014).

issued in bad faith. However, taxpayers were generally unsuccessful in proving bad faith or improper motive based on mere allegations, without any facts and circumstances that can plausibly infer bad faith.[65]

Privilege: In *Wells Fargo and Co. v. United States*, the court analyzed whether certain taxpayer documents summoned by the IRS were protected by the work product doctrine and attorney-client privilege.[66] As part of the IRS's examination of Wells Fargo's federal tax returns for 2007 and 2008, the IRS issued summonses to KPMG, Wells Fargo's independent auditor, and to Wells Fargo seeking its tax accrual work papers (TAWs) and other information. Wells Fargo moved to quash the summonses claiming, among other things, that some of the TAWs, including those related to Wells Fargo's Uncertain Tax Positions (UTPs),[67] were protected by the work product doctrine.

The IRS was partially successful in enforcing the summons. First, the court found that Wells Fargo's identification of UTPs and factual information related to those UTPs contained in the TAWs was not protected by the work product privilege because it was "created in the ordinary course of business and not in anticipation of litigation."[68] Moreover, Wells Fargo could not have anticipated litigation with the IRS because it would not enter into transactions related to a UTP unless there was at least a 70 percent probability of success in litigation. With such a high probability of success, it was unlikely that the IRS would challenge the taxpayer.

Second, the Court determined that "the recognition and measurement analysis [in TAWs] sought by the summonses is work product because it involves legal analysis prepared in anticipation of litigation."[69] Even though Wells Fargo provided the IRS with documents that referenced these analyses, they did not cease to be work product because if the IRS had access to that information, it would give the government "a window into the legal thinking of Wells Fargo's attorneys."[70]

The IRS tried to overcome the work product doctrine by arguing that Wells Fargo waived privilege by disclosing the information to a potential adversary, its auditor, KPMG. The court found that KPMG's TAWs and testimony were protected to the same extent as Wells Fargo's TAWs and testimony because the likelihood of an adversarial relationship between KPMG and Wells Fargo was insufficient to support a finding of waiver.[71] Alternatively, the IRS argued that even if KPMG was not an adversary, Wells Fargo waived the privilege because KPMG was a conduit to an adversary. The IRS based this argument on the theory that KMPG may be required to disclose the TAWs to the Securities and Exchange Commission or the Public Company Accounting Oversight Board.[72] However, the IRS failed to show that there was "more than a remote possibility of disclosure" and that there was an intention that the documents be

65 *Clarke*, 189 L. Ed. 2d 330 (2014). For a more detailed discussion of this important Supreme Court case, see *Significant Cases, supra*. *See also*, *e.g.*, *Worsham*, 112 A.F.T.R.2d (RIA) 6315.

66 *Wells Fargo and Co. v. United States*, 112 A.F.T.R.2d (RIA) 5380 (D. Minn. 2013).

67 UTPs are tax positions taken by the taxpayer in which it has reordered a reserve on its audited financial statements or expects to litigate the position. Wells Fargo would have to disclose its UTPs on Schedule UTP, which is filed with its tax return. *See* IRS Schedule UTP (Form 1120), *Uncertain Tax Position Statement* (2013).

68 *Wells Fargo*, 112 A.F.T.R.2d (RIA) 5380 (D. Minn. 2013) at *35.

69 *Id*. at *100. These TAWs were developed by both KPMG and Wells Fargo's attorneys. Several emails discussed potential challenges by the IRS and developments in possible litigation. These emails also contained analysis of cases and assessments of outcomes in potential litigation. *Id*.

70 *Wells Fargo*, 112 A.F.T.R.2d (RIA) 5380 (D. Minn. 2013) at 114.

71 Specifically, the court noted that KPMG and Wells Fargo have had a "cooperative and professional" relationship for 20 years and that litigation between a client and its auditor is rare. *Id* at 70.

72 *Id*. at 123 (citing *United States v. Johnson*, 378 F. Supp. 2d 1041, 1046 (N.D. Iowa 2005) *and Gundacker v. Unisys Corp.*, 151 F.3d 842, 848 (8th Cir. 1998)).

disclosed to the adversary.[73] The Court concluded that certain TAWs were protected by the work product doctrine and eight of the documents sought by the United States were protected by attorney-client privilege. The court ordered Wells Fargo and KPMG to disclose specific documents not protected by privilege.

The IRS prevailed in 14 cases involving motions to quash summonses based solely on the court lacking subject matter jurisdiction. 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.[74] Therefore, 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. The taxpayer must initiate the 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.[75] 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 three days after the 20-day limit expired.[76] 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.[77]

Lack of Jurisdiction Due to Notice Requirements:[78] 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.[79] In *Beakley v. United States*, the government served third-party summonses requesting information related to the taxpayer's tax liability or the collection of the liability involving the potential settlement of a case in which the taxpayer was a party.[80] 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 issued in aid of collection of tax assessment, which is a statutory exception to the notice requirement.[81] Therefore, the court held that sovereign immunity had not been waived and the court lacked subject matter jurisdiction.

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.[82] Accordingly, the IRS may request documents and testimony from taxpayers who have failed to provide

73 *Id*. at 128.

74 *United States v. Dalm*, 494 U.S. 596, 608 (1990).

75 IRC § 7609(b)(2)(A).

76 *Fisher v. United States*, 112 A.F.T.R.2d (RIA) 6971 (E. Wis. 2013).

77 *Abusch v. United States*, 112 A.F.T.R.2d (RIA) 7089 (E.D. La. 2013), *adopting* 112 A.F.T.R.2d (RIA) 7088 (E.D. La. 2013).

78 There is a jurisdictional split as to whether the failure to comply with the statutory notice requirement is an absolute bar to enforcement of the summons. *Cf. Jewell v. United States*, 749 F.3d 1295 (10th Cir. 2014) with *Sylvestre v. United States*, 978 F.2d 25, 26, 28 (1st Cir. 1992) (per curiam); *Cook v. United States*, 104 F.3d 886, 889 (6th Cir. 1997), *Azis v. United States IRS*, 522 Fed. App'x. 770, 777 (11th Cir. 2013) (per curiam); *Adamowicz v. United States*, 531 F.3d 151, 161 (2d Cir. 2008) (per curiam); *United States v. Bank of Moulton*, 614 F.2d 1063, 1066 (5th Cir. 1980) (per curiam).

79 IRC § 7609(c)(2).

80 *Beakley v. United States*, 113 A.F.T.R.2d (RIA) 1848 (N.D. Tex. 2014), *adopting* 113 A.F.T.R.2d (RIA) 1846 (N.D. Tex. 2014).

81 IRC § 7609(c)(2)(D)(i).

82 IRC § 7602(a).

that information voluntarily. Taxpayers and third parties rarely succeed in contesting IRS summonses due to the significant burden of proof and strict procedural requirements.

After a spike in 2012, the number of summons enforcement cases returned to pre-2007 levels. Because the IRS in November 2013 developed new procedures that provide for better pre-summons communications, we expect even less litigation in this area in the future. The Supreme Court's recent decision in *Clarke* may reduce the number of cases as well. The Supreme Court clarified that during a summons enforcement proceeding, a taxpayer is entitled to examine an IRS agent about the purpose of the summons only if the taxpayer presents credible evidence of bad faith or an improper motive.[83] Thus, taxpayers can no longer challenge the summons based on an unsupported claim of improper purpose, which may reduce future litigation in this area.

83 *United States v. Clarke*, 189 L. Ed. 2d 330, 337 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S. Tax Cas. (CCH) ¶ 50,732 (S.D. Fla. 2012).

MLI #4

Gross Income Under IRC § 61 and Related Sections

SUMMARY

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.[1] For this report, we reviewed 89 cases decided between June 1, 2013, and May 31, 2014. The majority of cases involved taxpayers failing to report items of income, including some specifically mentioned in Internal Revenue Code (IRC) § 61 such as wages,[2] interest,[3] dividends,[4] and annuities.[5]

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 and exclusions from this broad definition of gross income, 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 89 opinions involving gross income issued by the federal courts and reviewed for this report, gross income issues most often fall into two categories: (1) what is included in gross income under IRC § 61, and (2) what can be excluded under other statutory provisions. A detailed list of the cases appears in Table 4 of Appendix III.

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1 *See*, *e.g.*, National Taxpayer Advocate 2013 Annual Report to Congress 355-61; National Taxpayer Advocate 2012 Annual Report to Congress 637-42.

2 IRC § 61(a)(1). *See*, *e.g.*, *Aldrich v. Comm'r*, T.C. Memo. 2013-201.

3 IRC § 61(a)(4). *See*, *e.g.*, *Duggan v. Comm'r*, T.C. Memo. 2014-17.

4 IRC § 61(a)(7). *See*, *e.g.*, *Edem v. Comm'r*, T.C. Memo. 2013-238.

5 IRC § 61(a)(9). *See*, *e.g.*, *Craighead v. Comm'r*, T.C. Memo. 2013-246.

6 IRC § 61(a).

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

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 IRC § 6212. *See also* 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 34 cases (about 38 percent), taxpayers were represented, while the rest were *pro se* (without counsel). Eight of the 34 represented taxpayers (about 24 percent) prevailed in full in their cases and four prevailed in part, whereas *pro se* taxpayers prevailed in full in just two cases and in part in two others. Overall, taxpayers prevailed in full or in part in 16 of 89 cases (about 18 percent).

Drawing on the full list in Table 4 of Appendix III, we have chosen to discuss cases involving damage awards and IRA distributions, which were among the most common issues. In addition, we discuss a case of first impression involving the characterization of payments to a parent to care for her disabled adult son as foster care payments.

Damage Awards

Taxation of damage awards continues to generate litigation. This year, taxpayers in at least five cases (about six percent of those reviewed) challenged the inclusion of damage awards in their gross income, but just one taxpayer prevailed, and only in part, on the issue.[12]

IRC § 104(a)(2) specifies that damage awards and settlement proceeds[13] are taxable as gross income unless the award was received "on account of personal physical injuries or physical sickness."[14] Congress added the "physical injuries or physical sickness" requirement in 1996;[15] until then, the word "physical" did not appear in the statute. The legislative history of the 1996 amendments to IRC § 104(a)(2) provides that "[i]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness…[but] emotional distress is not considered a physical injury or physical sickness."[16] Thus, damage awards for emotional distress are not considered as received on account of physical injury or physical sickness, even if the emotional distress results in "insomnia, headaches, [or] stomach disorders."[17]

To justify exclusion from income under IRC § 104, the taxpayer must show settlement proceeds are in lieu of damages for physical injury or sickness.[18] In *Molina v. Commissioner*, the taxpayer petitioned the U.S. Tax Court to exclude from his income a settlement award from his former employer for alleged discrimination, alleged creation of a hostile work environment, and alleged retaliation for reporting the alleged discrimination.[19]

The parties entered into mediation and negotiated a settlement after Mr. Molina filed suit in the Superior Court of New Jersey. Mr. Molina's complaint only alleged serious and significant emotional and physical distress, and made no mention of any physical injuries or sickness suffered as a result of the alleged discrimination and retaliation. He settled with his former employer, and in 2007 received an installment payment under the agreement and a payment for attorneys' fees. While he reported the installment

12 *See, e.g.*, *Simpson v. Comm'r*, 141 T.C. 331 (2013), *appeal docketed*, No. 14-72372 (9th Cir. Aug. 4, 1014).

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

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). Note, however, that IRC § 104(a)(2) excludes from income damages, up to the cost of medical treatment for which a deduction under IRC § 213 was allowed for any prior taxable year, for mental or emotional distress causing physical injury.

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

19 T.C. Memo. 2013-226.

payment on his tax return, he argued that it was excludible from gross income and did not include it in his total gross income.[20]

The court looked to the employer's intent in making the payments.[21] The settlement agreement characterized the payments as wages and attorney fees.[22] The Tax Court then looked to the contents of the taxpayer's complaint for insight into what the settlement payment was for, and determined it made no claims of physical injuries or illness, nor was there any evidence that Mr. Molina ever informed his former employer of any injuries or illness. This led the court to conclude that the employer intended the payments to be solely for wages and attorney fees.[23] This case serves as a caution to taxpayers that failure to carefully consider how the settlement agreement specifies the reasons and characterization for the payments can lead to significant tax consequences down the road.

As illustrated by continuing litigation of the characterization of settlement damages, the question of when damage awards can be excluded from gross income continues to confuse taxpayers. Even when taxpayers seek legal advice before filing a complaint for damages or accepting settlement proceeds, they may not understand how to characterize the damages in the complaint to be able to exclude them under IRC § 104(a)(2), or they may be uncertain about the proper tax treatment of the proceeds. For example, in *Simpson v. Commissioner*, the taxpayer's attorney informed the taxpayer and her family that her settlement proceeds would not be taxed.[24] The taxpayer relied on her attorney (who was not her tax advisor) and failed to include the settlement proceeds in her gross income.[25]

As these cases illustrate, the issue of including damages awarded on account of mental illness in gross income continues to plague the courts, and taxpayers continue to disagree with the IRS's and courts' interpretation that mental illness equates to emotional distress, opposed to physical sickness or injury. As discussed in the National Taxpayer Advocate's 2009 Annual Report to Congress, this assessment seems particularly outdated when considering the medical communities' advancements in understanding the physical cause and symptoms of mental illness.[26]

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."[27] IRC § 408(d)(1) governs the tax treatment of distributions from individual retirement accounts (IRAs), and provides that they are generally included in gross income as amounts received as an annuity under IRC § 72.

20 *Molina v. Comm'r*, T.C. Memo. 2013-226.

21 *Id*.

22 *Id*.

23 *Id*.

24 141 T.C. 331 (2013).

25 *Simpson v. Comm'r*, 141 T.C. 331 (2013).

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

27 IRC § 61(a).

Taxpayers in at least ten cases argued that portions of their IRA distributions were excluded from gross income, prevailing in full in two cases and in part in one case.[28] Taxpayers in at least three cases challenged the taxability of the distributions, arguing the "rollover provision" under § 408(d) applied.[29] The "rollover provision" generally excludes from gross income IRA distributions that are transferred into an eligible retirement account within 60 days of receipt.[30] Taxpayers are limited, however, under IRC § 408(d)(3)(B) to one nontaxable rollover per year.[31]

For example, in *Bobrow v. Commissioner* the taxpayers (husband and wife) received distributions from three separate IRAs, and attempted to complete two nontaxable rollovers for the husband in one tax year.[32] The court found that distributions from two of the accounts were includible in gross income, while the distribution from the third account was excludible. In addition, the court found Mr. Bobrow's second rollover for the tax year was properly characterized as a taxable distribution and includible in gross income.

Foster Care Payments

One court this year decided a case of first impression regarding the characterization of payments from the state as foster care payments.[33] Qualified foster care payments, received by a foster care provider, are excludible from gross income under IRC § 131(a).

In *Ray v. Commissioner*, Mrs. Ray provided certified care to her severely disabled adult son Tony. Tony's Individualized Service Plan (ISP), developed by the Franklin County (Ohio) Board of Developmental Disabilities after he turned 18, requires that he receive this care from a certified provider, and further dictates that he reside in the Rays' home.[34] Additionally, upon Tony turning 18, Mrs. Ray was appointed his legal guardian, as his disabilities are such that he is unable to talk, walk, or provide for any of his own needs.[35] She receives compensation for the care she provides to Tony from the state of Ohio, through a Medicaid program called Individual Options Waiver, which permits a person with disabilities to live at home.[36]

The Rays filed amended returns for tax years 2005–2007 to exclude the payments Mrs. Ray received from the state for her care of Tony as foster care payments.[37] The issue before the court was whether the payments were excludible as qualified foster care payments. The decision turned on the meaning of "foster," and whether the IRC § 131 exclusion is applicable if the taxpayer providing the care is the biological parent of a recipient older than 18. The word "foster" appears throughout IRC § 131, but Congress did not define the term.

28 *See Roberts v. Comm'r*, 141 T.C. No. 19 (2013) (taxpayer prevailed in full); *Haury v. Comm'r*, 751 F.3d 867 (8th Cir. 2014) (taxpayer prevailed in full); *Bobrow v. Comm'r*, T.C. Memo. 2014-21 (taxpayers prevailed in part).

29 *See Alexander v. Comm'r*, T.C. Summ. Op. 2014-18; *Bobrow v. Comm'r*, T.C. Memo. 2014-21; *Haury v. Comm'r*, 751 F.3d 867 (8th Cir. 2014).

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

31 IRC § 408(d)(3)(B).

32 T.C. Memo. 2014-21.

33 *See Ray v. U.S.*, 113 A.F.T.R.2d (RIA) 382 (S.D. Ohio 2014).

34 *Id*.

35 *Id*.

36 *Id*.

37 *Id*.

Where a word is not defined statutorily, the court must use its "ordinary meaning."[38] The court determined that a foster care situation exists when one voluntarily provides care for a minor or other qualified foster individual in absence of a legal obligation.[39] Because Mrs. Ray is Tony's legal guardian, she was under a legal obligation to either obtain or provide care to him. As a result, payments made to her for personally providing that care cannot be construed as foster care payments.[40] Thus, the payments Mrs. Ray received from the state were not excludible.

CONCLUSION

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

While the number of cases involving the tax treatment of settlements and awards continued to decrease, from six in 2013 to five this year, it remains a perennial area of confusion for taxpayers. The National Taxpayer Advocate has previously recommended a legislative change that would clarify the tax treatment of court awards and settlements by permitting taxpayers to exclude any payments received as a settlement or judgment for mental anguish, emotional distress, or pain and suffering.[41] Additionally, the National Taxpayer Advocate plans to provide for inclusion in the IRS 2015-2016 Priority Guidance Plan her recommendations for published guidance regarding facts and circumstances under which damages awarded on account of mental illness should be considered a physical injury, and thereby excluded from gross income under IRC § 104(a)(2).

Cases involving the tax treatment of distributions from IRAs continued to rise this year, with ten cases compared to eight last year. Taxpayers litigated this issue with some success, prevailing in full or in part in three cases.

38 *Ray v. U.S.*, 113 A.F.T.R.2d (RIA) 382 (S.D. Ohio 2014) (quotations omitted).

39 *Id.*

40 *Id.*

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

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

SUMMARY

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 2001, CDP has been one of the federal tax issues most frequently litigated in the federal courts and analyzed in the National Taxpayer Advocate's Annual Reports to Congress. The trend continues this year, with our review of litigated issues finding 76 opinions on CDP cases during the review period of June 1, 2013, through May 31, 2014.[5] Taxpayers prevailed in full in five of these cases (nearly seven percent) and in part in three others (nearly four percent). Of the eight opinions where taxpayers prevailed in whole or in part, two taxpayers appeared *pro se* and six 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 some of the 76 cases reviewed.

CDP hearings are particularly valuable because they provide taxpayers with an enforceable remedy with respect to several rights articulated in the Taxpayer Bill of Rights recently adopted by the IRS in response to National Taxpayer Advocate recommendations.[6] In particular, by providing an opportunity for a taxpayer to challenge the underlying liability and raise alternatives to the collection action, the CDP hearing enforces the taxpayer's *right to challenge the IRS position and be heard*. If the taxpayer does not agree with the Appeals determination, he may file a petition in Tax Court, which furthers the taxpayer's *right to*

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 5 in Appendix III, *infra*.

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

appeal an IRS decision in an independent forum. Lastly, since the Appeals Officer must consider whether the IRS's proposed collection action balances the overall need for efficient collection of taxes with the legitimate concern that the IRS's collection actions are no more intrusive than necessary, the CDP hearing protects a taxpayer's *right to privacy*.

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 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 filing 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

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

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) or § 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.

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 hearing.[20] Taxpayers who fail to timely request a CDP hearing will be afforded an "equivalent hearing," which is similar to a CDP hearing but lacks judicial review.[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

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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).

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).

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 regulations state that taxpayers who provide non-frivolous reasons for opposing the IRS collection action will generally be offered but not guaranteed face-to-face conferences.[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. However, Appeals may, 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."[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] 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]

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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*). For information regarding the availability of Virtual Service Delivery (VSD) teleconferencing, which provides virtual face-to-face meeting in remote locations, see National Taxpayer Advocate 2012 Annual Report to Congress 462 (Status Update: *The IRS Has Made Significant Progress in Delivering Virtual Face-to-Face Service and Should Expand Its Initiatives to Meet Taxpayer Needs and Improve Compliance*). *See also* Director, Policy, Quality and Case Support, *Implementation of Virtual Service Delivery (VSD)*, Memorandum AP-08-0714-0007 (July 24, 2014).

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 *Id*.

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.

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 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 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 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 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]

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

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.

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

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

44 *Wadleigh v. Comm'r*, 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).

ANALYSIS OF LITIGATED CASES

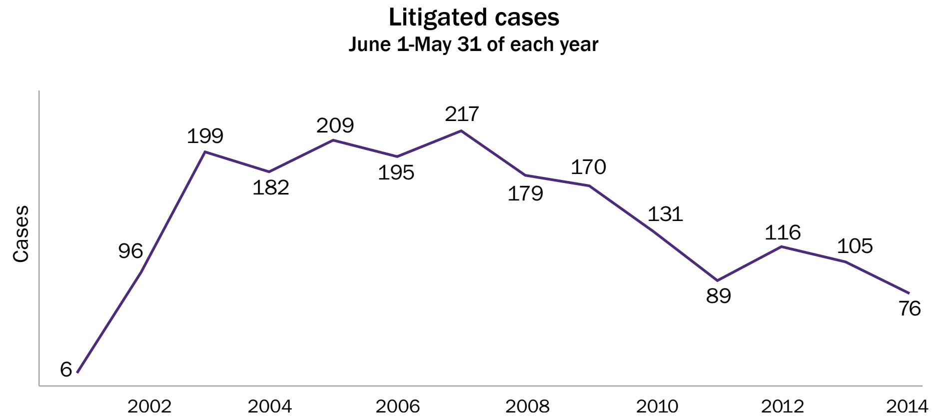
We identified and reviewed 76 CDP court opinions, a 28 percent decrease from the 105 cases in last year's report. As shown in the chart below, litigation of CDP cases considered by the court has been averaging about 141 cases per year since 2001.

This decline in the number of litigated cases may be associated with a series of significant operational changes in lien-filing policies and collection payment options (including offers in compromise and "streamlined" installment agreements) the IRS implemented in fiscal years (FYs) 2011 and 2012. These changes were in response to concerns from the National Taxpayer Advocate and the Internal Revenue Service Advisory Council (IRSAC), and are collectively known as the "Fresh Start" initiative.[47] The "Fresh Start" initiative has resulted in fewer NFTL filings and more accepted offers in compromise in the past few years, and had a positive impact on many taxpayers and revenue collection.[48]

47 *See* IRS, IR-2011-20, *IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes Made to Lien Process* (Feb. 24, 2011); IR-2012-31, *IRS Offers New Penalty Relief and Expanded Installment Agreements to Taxpayers under Expanded Fresh Start Initiative* (Mar. 7, 2012); IR-2012-53, *IRS Announces More Flexible Offer-in-Compromise Terms to Help a Greater Number of Struggling Taxpayers Make a Fresh Start* (May 21, 2012). *See also* National Taxpayer Advocate 2012 Annual Report to Congress 348-351; National Taxpayer Advocate Fiscal Year 2013 Objectives Report to Congress 32-35.

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

FIGURE 3.5.1[49]



The 76 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 published CDP opinions, including specific information about the issues, the types of taxpayers involved, and the outcomes of the cases.

Litigation Success Rate

Taxpayers prevailed in full in five of the 76 cases brought during the year ending May 31, 2014 (nearly seven percent).[50] Taxpayers prevailed in part in three other cases (nearly four percent). Of the cases in which the courts found for the taxpayer in whole or in part, the taxpayers appeared *pro se* in two cases and were represented in six others. The IRS prevailed fully in 89 percent of cases, an increase from the lowest recorded success rate of 84 percent last year.

49 *See* National Taxpayer Advocate 2013 Annual Report to Congress 371; National Taxpayer Advocate 2012 Annual Report to Congress 595; National Taxpayer Advocate 2011 Annual Report to Congress 619; National Taxpayer Advocate 2010 Annual Report to Congress 436; National Taxpayer Advocate 2009 Annual Report to Congress 418; National Taxpayer Advocate 2008 Annual Report to Congress 476; National Taxpayer Advocate 2007 Annual Report to Congress 569; National Taxpayer Advocate 2006 Annual Report to Congress 556; National Taxpayer Advocate 2005 Annual Report to Congress 477-478; National Taxpayer Advocate 2004 Annual Report to Congress 500; National Taxpayer Advocate 2003 Annual Report to Congress 318; National Taxpayer Advocate 2002 Annual Report to Congress 273; *See* National Taxpayer Advocate 2001 Annual Report to Congress 263. CDP cases did not appear as a most litigated issue in the National Taxpayer Advocate 2000 Annual Report to Congress.

50 *Bogart v. Comm'r*, T.C. Memo. 2014-46; *Dixon v. Comm'r*, 141 T.C. 173 (2013); *Dixon v. Comm'r*, T.C. Memo. 2013-207; *Moosally v. Comm'r*, 142 T.C. No. 10 (2014); *Szekely v. Comm'r*, T.C. Memo. 2013-227.

FIGURE 3.5.2, Success Rates in CDP Cases[51]

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

Issues Litigated

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

Isley v. Commissioner

In *Isley v. Commissioner*,[52] the IRS issued four CDP notices (two involving the filing of an NFTL and two involving a proposed levy) to the taxpayer, Ronald Isley (Isley), a founding member of the Isley Brothers singing group. The CDP notices were for unpaid income taxes covering the years 1997–2004, and 2006. Isley had repeatedly failed to pay income taxes for over 30 years, filed for bankruptcy twice, and was convicted of tax evasion for the years 1997–2002 (conviction years). He was sentenced to 37 months in prison followed by a three-year probationary period. The terms of his probation required that he make full payment of taxes owed for his conviction years during his probationary period. While the court did not include exact dates in its decision, Isley entered prison around December 1, 2006 and was released in late 2009 or early 2010. The court noted that the probationary period would not have ended until December 2010 at the earliest.

Isley received the CDP notices while serving his sentence, and in response, he requested a CDP hearing in 2007 for each of the NFTLs and levy notices. During the CDP hearing, Isley submitted an OIC covering both his conviction years and non-conviction years, proposing to pay $1,047,216 and providing the required 20 percent down payment.[53] The Appeals Officer (AO) assigned to the case recommended acceptance and the OIC was sent to attorney Ronald Chun (Chun) in the Office of Chief Counsel for review as required under IRC § 7122(b).[54]

51 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.

52 141 T.C. 349 (2013).

53 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).

54 If an OIC is submitted in a case where the unpaid amount of the tax assessed is $50,000 or more, the IRS Office of Counsel is required to review the OIC for legal sufficiency so as to ensure that all legal requirements for compromise have been met. *See also* IRM 5.8.8.12, (Aug. 8, 2014). Following the conclusion of the CDP hearing, Isley owed over $9 million in tax liability, including penalties.

Chun, who had been involved with Isley's second bankruptcy, recommended that the IRS reject the OIC because he determined that the IRS lacked settlement authority. Isley's case had already been referred to the Department of Justice (DOJ) for criminal prosecution and therefore was subject to IRC § 7122(a) (discussed below). On a related note, Chun found that the OIC was inconsistent with Isley's terms of probation. Lastly, Chun recommended rejecting the offer on the alternative grounds that Isley's collection potential exceeded the offer, that he provided incomplete or inaccurate information, and that he was not in current compliance with his tax obligations. Based on Mr. Chun's recommendation and his own further examination, the AO issued a determination rejecting the OIC and sustaining the proposed levies and NFTL filings. Isley appealed the AO's determination to the Tax Court.

The Commissioner argued that IRC § 7122(a) prohibits the IRS from compromising Isley's liabilities.[55] Since the DOJ prosecuted Isley for criminal tax evasion, the Commissioner reasoned that the IRS had no authority to accept or even process the OIC. Isley countered that IRC § 6330 gave him the right to raise all relevant issues during his CDP hearing. Additionally, he argued that IRC § 7122(a) only applied to pending criminal prosecutions and that his criminal case was complete as of his sentencing in September of 2006.

Neither party's arguments persuaded the court. Instead, the Tax Court ruled that IRC § 7122(a) did not bar the AO from negotiating the OIC, but that the AO could not unilaterally approve the OIC—he would need to seek approval from DOJ. The court came to this determination for several reasons. First, the court found that IRC § 6330(c) does not supersede IRC § 7122(a). Second, the court found that DOJ's approval continued to be necessary until the terms of the settlement in his criminal case had been met. In particular, the court found that an OIC in this instance would have violated Isley's terms of probation. However, the court did note that Isley (either on his own or along with the AO) could have requested that the terms of his probation be modified. No such request had been made. Lastly, since Isley was behind on his current tax obligations, the Tax Court held the AO had not abused his discretion in rejecting the offer.

Isley contended that Chun's involvement in reviewing the OIC effectively made him a "*de facto*" AO and because of Chun's involvement in Isley's bankruptcy case, Chun's involvement in the CDP hearing violated the impartial officer requirement of IRC § 6330(b)(3). However, the court rejected that argument because Chun was involved in the case as an IRS Office of Chief Counsel attorney pursuant to IRC § 7122(b), and thus the impartial officer requirement did not apply to him. Additionally, the Tax Court noted that the bankruptcy proceedings concerned different tax years so Chun's actions in the bankruptcy proceeding could not have constituted prior involvement.

Isley also alleged that Chun's participation violated the prohibition against *ex parte* communication between AOs and other IRS employees.[56] The Tax Court disagreed, finding that the *ex parte* prohibition

55 IRC § 7122(a) provides: "The Secretary may compromise any civil or criminal case arising under the internal revenue laws prior to reference to the Department of Justice for prosecution or defense; and the Attorney General or his delegate may compromise any such case after reference to the Department of Justice for prosecution or defense." The regulations provide further guidance by prohibiting the IRS from accepting "for processing any offer to compromise a liability following reference of a case involving such liability to the Department of Justice for prosecution or defense." Treas. Reg. 301.7122-1(d)(2).

56 Section 1001(a)(4) of RRA 98 directed the Commissioner to "ensure an independent appeals function within the Internal Revenue Service, including the prohibition … 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." In accordance with that directive, the IRS initially issued guidance in Rev. Proc. 2000-43, 2000-2 C.B. 404 which was then superseded by Rev. Proc. 2012-18, 2012-1 C.B. 455.

rules only apply to IRS employees working in the Office of Appeals. Since Chun was an employee of the IRS Office of Chief Counsel, this rule did not apply.

Isley also argued that his tax liabilities were overstated because the IRS did not properly apply certain payments received after his first bankruptcy proceeding to his tax debt. Isley had previously raised this issue in a refund suit. The Tax Court found that Isley was precluded from raising this issue in the CDP case because Isley had been given a prior opportunity to raise it in his second bankruptcy proceeding and also because it was barred by *res judicata* since Isley had raised this issue in his previous refund suit.

Isley submitted a 20 percent down payment with his OIC, which he argued that the IRS should refund as fraudulently induced because he was told that his offer would be evaluated on collectibility and it was rejected on other grounds. The court concluded that the IRS properly retained the payment since there was no evidence of fraud or false representations and there were in fact collectibility issues raised by the AO in rejecting the OIC.

Finally, the court addressed the AO's decision to sustain the proposed levies (Isley did not challenge the NFTL filings). The court noted that Chun's memo suggested gathering more information related to Isley's assets and future income potential. This indicated to the court that Chun believed continuing negotiations could be productive and that Isley could have submitted another OIC or an installment agreement. As a result, the court concluded that Appeals acted prematurely in sustaining the proposed levies and that such action might be more intrusive than necessary. The court also noted that Isley's tax compliance problems for 2009 and 2010 were inadvertent and curable. Based on that information, the court remanded the case to Appeals for further consideration. The court instructed Appeals to reexamine Isley's financial position to see if submission of another OIC or an installment agreement might be a viable alternative. The Tax Court noted that DOJ would need to approve any OIC or installment agreement before such agreement could be processed or accepted.[57]

Dixon v. Commissioner

In *Dixon v. Commissioner*, James and Sharon Dixon, (the Dixons) were the owners of Tryco Corporation, a temporary employment company that failed to pay its withholding and employment taxes from 1992 to 1995.[58] The Dixons also neglected to pay a substantial part of their individual income tax liabilities during that period. After they were charged with criminal failure to file, they hired an accounting firm that uncovered the tax issues at Tryco. The Dixons reached a plea agreement under which they were to pay restitution for their unpaid taxes in the amount of $61,021.

In order to make those payments and start paying Tryco's withholding liability, the Dixons' tax attorney advised them to give the money to Tryco, which in turn would pay the IRS. In December 1999, Tryco transferred $61,021 to the IRS. A cover letter from the Dixons' attorney accompanied the payment, designating the payment as "'payment of [Form] 941 taxes of the corporation' that was 'to be applied to the withheld income taxes' of [the Dixons] for specified calendar quarters of 1992–95."[59] In early 2000, the Dixons' accountant discovered that the couple actually owed $30,202 more in individual income tax for 1992-1995. In June 2000, Tryco paid this money to the IRS with a cover letter stipulating that this was

57 The Court noted that the probationary period would have ended in late 2012 or early 2013. If Isley had fully complied with the terms of his probation or the liabilities had been discharged by a settlement with DOJ, the OIC issues and IRC § 7122(a) would be considered moot. However, the Court noted that it had not been notified by either party that this occurred and therefore, DOJ approval would be necessary.

58 141 T.C. 173 (2013).

59 *Id*. at 1.

a pre-assessment payment of Form 941 taxes of the corporation, which represented the withheld income taxes for the Dixons for the fourth quarter of 1995.

The IRS initially honored those designations. However, it eventually decided to disregard the designations, applying the restitution funds to Tryco's outstanding general unpaid employment tax liabilities instead. The IRS then issued the Dixons a CDP levy notice seeking to collect the Dixons' unpaid individual income taxes for 1992–1995.

The Dixons requested a CDP hearing. The AO sustained the proposed levy on the basis that the payments were not withheld at the source and that the payments could not be designated to specific employees. The Dixons filed a petition with the Tax Court, arguing on two alternative bases that their payments through Tryco satisfied their individual income tax liabilities.

First, the Dixons argued that the Tryco payments designated for their individual liabilities entitled them to a withholding credit under IRC § 31. Section 31(a)(2) states employees are entitled to a credit against their income taxes equivalent to the amount their employer withholds from their income. However, the regulations governing IRC § 31 state that the taxes must be actually withheld by the employer.[60] To be considered "actually withheld," the withholding must be done contemporaneously in the correct amount or corrected within the prescribed time. The court determined that the restitution payments were not withheld contemporaneously at the source. The payments were also made outside of the window for allowable adjustments under IRC § 31(a). As a result, the court found that the Dixons were not entitled to an IRC § 31 credit.

Alternatively, the Dixons argued that the Commissioner must respect Tryco's designation of the payments to their individual income tax liabilities. IRS policy allows taxpayers to designate where and how voluntary payments should be credited. However, the Commissioner argued that taxpayers are only allowed to designate between a particular tax period or particular type of tax (*i.e.*, trust fund"[61] liabilities versus corporate income tax liabilities), so corporate taxpayers like Tryco could not designate which particular employee within the withholding liabilities would receive credit. The Tax Court rejected this argument, finding that employers are commonly allowed to designate withholding taxes to specific employees for refund suits, which allows employers to do test cases without paying all of the taxes for a class of employees.[62] The court further reasoned that allowing designations was necessary to uphold the policy against double collection of tax. The IRS had already collected the tax from Tryco, and collecting it again from the Dixons would require them to pay the same liability twice.

For these reasons, the Tax Court held that Appeals abused its discretion in failing to honor the Dixons' payment designations. The $91,223 in payments fully discharged the Dixons' individual income tax liabilities for 1992–1995 and therefore, the IRS could not take further levy action for this debt. However, since the court found the payments were valid at the time they were paid through Tryco in 1999 and 2000, and not as IRC § 31 credits, which would have been counted as paid in April 1996, the Dixons owed penalties and interest dating from the original periods the tax was due up to the time when they

60 Treas. Reg. § 1.31-1.

61 Employers are often responsible for collecting and paying employment taxes on behalf of their employees. The employer is to hold the money as a "special fund in trust for the United States." *See* IRC § 7501. Failure to collect, truthfully account for, and pay over any such tax can result in a trust fund recovery penalty under IRC § 6672.

62 Employers are required to withhold and deduct taxes on wages as they are paid to the employee, minus applicable exemptions. *See* IRC § 3402.

paid the liabilities. The court determined that the IRS could collect the penalties and interest through levy action.

Moosally v. Commissioner

In *Moosally v. Commissioner*, the taxpayer had been assessed trust fund recovery penalties for several quarters in 2000 and individual income tax liabilities for 2008.[63] The taxpayer submitted an OIC seeking to compromise these liabilities. The Centralized Offer in Compromise (COIC) unit rejected the offer because the amount was below the reasonable collection potential (RCP). The taxpayer appealed the decision. Appeals informed the taxpayer that Settlement Officer (SO) Smeck would be assigned to the case. Shortly after requesting her OIC Appeal, the IRS sent the taxpayer a CDP NFTL notice concerning the same tax liabilities covered in the OIC.[64] In response, the taxpayer requested a timely CDP hearing, which SO Kane was initially assigned to conduct.

While the CDP hearing was pending, SO Smeck reviewed the OIC rejection. Prior to SO Smeck's final determination regarding the rejection, SO Kane informed the taxpayer that her CDP hearing had been reassigned to SO Smeck. After conducting the CDP hearing, which included reviewing the taxpayer's information, SO Smeck sustained the NFTL filing and the rejection of the OIC. The taxpayer timely petitioned the Tax Court, arguing that Smeck was not an impartial officer because she reviewed the taxpayer's appeal of the rejected offer before she was assigned to the CDP hearing.

IRC § 6320(b)(3) requires that a CDP hearing must be conducted by an impartial AO, which means that the officer has had no prior involvement with the liability in question. The IRS argued that SO Smeck's review of the rejected OIC was current involvement rather than prior, since she had not issued a determination on her review of the OIC. But the Tax Court read the statute and regulations to mean that prior involvement constituted any involvement with the liabilities at issue outside of the CDP hearing context. Therefore, it found that SO Smeck's review of the OIC before the commencement of the CDP hearing constituted prior involvement and remanded the case to give the taxpayer a new CDP hearing with an impartial officer.

Byers v. Commissioner

In *Byers v. Commissioner*, the IRS sent a CDP levy notice to the taxpayer.[65] The taxpayer timely requested a CDP hearing. The proposed levy action was sustained by the AO at the CDP hearing, and the taxpayer appealed to the Tax Court, which granted summary judgment to the Commissioner. The taxpayer appealed the grant of summary judgment to the Court of Appeals for the District of Columbia Circuit (D.C. Circuit).

The first question on appeal was whether the proper venue for the taxpayer's appeal was in the D.C. Circuit. The IRS argued that venue was only proper in the Eighth Circuit, where the taxpayer resided. IRC § 7482(b)(1) states that appeals from the Tax Court are to be reviewed in the D.C. Circuit unless one

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63 142 T.C. No. 10 (2014).

64 The National Taxpayer Advocate has long argued against the practice of filing a lien once an offer has been submitted. Such filings, absent jeopardy or abuse of the system, harm taxpayers at a critical time when they are trying to resolve their tax debts. For instance, a lien could jeopardize a taxpayer's ability to obtain credit or maintain employment. *See* National Taxpayer Advocate 2009 Annual Report to Congress 17-40; National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 1-18. For a discussion of the impact liens have on taxpayer compliance generally, *see* National Taxpayer Advocate 2011 Annual Report to Congress, vol. 2, 91-112; National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2, 105-125.

65 740 F.3d 668 (D.C. 2014), *aff'g* T.C. Memo. 2012-27. The taxpayer filed a petition for *certiorari*, which the Supreme Court denied. *See Byers v. Comm'r*, 740 F. 3d 668 (D.C. 2014), *cert. denied*, 83 U.S.L.W. 3189 (U.S. Oct. 6, 2014) (No. 14-74).

of the specified exceptions applies. IRC § 7482(b)(1)(A) sets forth a general exception which provides that in cases where a petitioner, other than a corporation, seeks redetermination of a tax liability, venue for review by the United States Court of Appeals is based upon the taxpayer's legal residence. The IRS argued that since CDP hearings often include challenges to the underlying liabilities, venue is properly placed in the circuit where the taxpayer resides under IRC § 7482(b)(1)(A). However, the court determined this provision was not applicable since the taxpayer was not challenging the underlying liability. Thus, the proper venue was in the D.C. Circuit. This decision is important because it holds that the D.C. Circuit will not transfer cases to another circuit in non-liability CDP cases unless both parties stipulate to transfer the case.

The *Byers* decision will have several ramifications. For instance, the court does not answer the question of whether another court of appeals could hear an appeal of a non-liability CDP decision without stipulation.[66] This issue will likely be addressed by other circuit courts.[67]

Byers will also create complications for how the Tax Court hears its cases. Under the *Golsen* rule, the Tax Court follows its own precedent unless the court of appeals to which the case would be appealable has ruled to the contrary.[68] How will the Tax Court know where the case is going to be appealed if the taxpayer has a choice in venue? In a Tax Court case subsequent to *Byers*, also involving a non-liability CDP hearing, the Tax Court applied the rules of the appellate court based on the residence of the taxpayer (in this instance the Ninth circuit), stating:

> In light of *Byers*, we are mindful of the uncertainty of appellate venue and the controlling law in this case. We further note, however, that we have not found a case wherein the Court of Appeals for the District of Columbia Circuit has either adopted or rejected the administrative record rule in a collection case under sec. 6320 or sec. 6330.[69]

The changes in practice brought by *Byers* mean that taxpayers and practitioners appealing a non-liability CDP case must now understand the type of case they have and whether it involves redetermination, so that they obtain the appropriate venue. The court in *Byers* was not concerned with taxpayer confusion over types of CDP cases, explaining instead:

> [j]ust as we see in this case, it normally will be obvious from the taxpayer's statement of the issues whether an appeal involves a challenge to a redetermination decision, a CDP decision on a collection method, or both. Therefore, it will not be difficult for this court to distinguish between the two types of cases to determine whether venue is proper in the D.C. Circuit.[70]

66 The court notes "we have no occasion to decide in this case whether a taxpayer who is seeking review of a CDP decision on a collection method may file in a court of appeals other than the D.C. Circuit if the parties have not stipulated to venue in another circuit." *Byers*, 740 F.3d at 677. This language leaves it open for interpretation whether venue would be proper in another circuit court when neither party addresses it, such as the appellate cases decided prior to *Byers*.

67 Legislation has also been proposed to address this issue. Joint Committee On Taxation, *Technical Explanation Of The Senate Committee On Finance Chairman's Staff Discussion Draft Of Provisions To Reform Tax Administration*, JCX-16-13,39-40 (November 20, 2013). The legislation provides that cases under IRC §§ 6015, 6320, and 6330 will be appealable to the circuit in which is located the petitioner's legal residence (in the case of an individual). While this provision has appeared in several bills, it has gained little traction. The National Taxpayer Advocate has also made a legislative recommendation to address this issue. *See* Legislative Recommendation: *APPELLATE VENUE IN NON-LIABILITY CDP CASES: Amend IRC § 7482 to Provide That The Proper Venue to Seek Review of a Tax Court Decision in All Collection Due Process Cases Lies With the Federal Court of Appeals for the Circuit in Which the Taxpayer Resides*, *supra*.

68 *Golsen v. Comm'r*, 54 T.C. 742 (1970).

69 *Boulware v. Commr*, T.C. Memo 2014-80 at 19. On appeal No. 14-1147 (D.C. Cir. Aug. 4, 2014).

70 *Byers*, 740 F.3d at 676.

In practice, making the distinction between liability and non-liability CDP hearings could prove difficult for taxpayers, especially *pro se* taxpayers. This is an area that could benefit from IRS guidance to taxpayers and practitioners, pending judicial or legislative clarification. Taxpayers should also be prepared for litigation over the meaning of "redetermination."

Additionally, "stand alone" innocent spouse cases brought under IRC § 6015(e), may be impacted by *Byers* because the IRS may argue in these cases that they do not involve a redetermination of the underlying liability, but rather seek relief from an existing joint liability.[71] As such, under *Byers*, appeals of these cases from the Tax Court could go to the D.C. Circuit if there is no stipulation otherwise.

Despite these unanswered questions, *Byers* could be beneficial for taxpayers in certain situations. With this ruling, taxpayers may now be able to "forum shop." Taxpayers may consider how their regional circuit would handle their non-liability CDP case in comparison to the D.C. Circuit. For instance, in *Robinette v. Comm'r*, the Tax Court held that it could consider evidence that was not part of the administrative record when it reviews an AO's determination for abuse of discretion.[72] This decision was overturned by the Eighth Circuit, which held that evidence is limited to what is in the administrative record.[73] It is possible that the D.C. Circuit could rule in a way opposite to the Eighth Circuit in regards to evidence at trial. If that happens, taxpayers wishing to submit new evidence during a trial may benefit from having their non-liability CDP appeal heard by the D.C. Circuit. Of course, if the taxpayer is not local to the District of Columbia and chooses not to stipulate to the Court of Appeals based on their residence, they will have to incur the travel costs associated with having their case tried in the D.C. Circuit.

After dealing with the venue issue, the court moved to the substance of the taxpayer's appeal. The taxpayer accused the SO of engaging in improper *ex parte* communications with other IRS employees, but the court denied relief on this issue, finding no credible evidence to support this claim. The court noted that the fact the SO had emailed the Office of Chief Counsel to obtain a copy of the Notice of Deficiency that the SO needed to conduct the hearing was not an improper *ex parte* communication. The taxpayer also argued that Senior Judge Swift was not properly appointed under the Appointments Clause. However, this argument was not raised until Judge Swift had already issued his judgment and was thus deemed untimely. Further, the Court determined that Judge Swift was properly recalled under IRC § 7447(c) and that such a recall is constitutional.[74]

Last, the taxpayer challenged the Tax Court's decision to dismiss as moot the claim relating to the proposed levy on the taxpayer's 2003 tax liability. Previously the IRS abated the liability and indicated that it was no longer pursuing a levy. The taxpayer argued the 2003 issues were still relevant to the case, but the D.C. Circuit affirmed the Tax Court's dismissal of those issues based on the abatement of the 2003 liabilities. The taxpayer then argued that the Tax Court erred in upholding the SO's proposed levy determination after removing the 2003 liability, contending that the SO might not have found that the proposed levy was proper if the 2003 liability had not been at issue when she made her initial determination. The court rejected the argument as untimely since the taxpayer failed to raise the issue in the lower court. The D.C. Circuit therefore upheld the Tax Court's determination sustaining the levy.

71 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.

72 *Robinette v. Comm'r*, 123 T.C. 85 (2004).

73 *Robinette v. Comm'r*, 439 F.3d 459 (8th Cir. 2006).

74 *See Byers v. Comm'r*, 740 F.3d 679 (citing *Shoemaker v. United States*, 147 U.S. 282, 301 (1893)).

Reed v. Commissioner

In *Reed v. Commissioner*, the taxpayer requested a CDP hearing after receiving a CDP levy notice covering tax years 1987–2001.[75] The taxpayer failed to file timely income tax returns in the years at issue, and after eventually filing late returns, he submitted two OICs to settle the resulting liabilities. In the first offer, the taxpayer offered to pay only a fraction of the liability (less than five percent) based on doubt as to collectibility. The IRS rejected the offer, and Appeals sustained the rejection, finding the taxpayer had generated significant income from a real estate sale and subsequently dissipated those funds. Appeals included the dissipated proceeds in its estimate of collection potential.

The taxpayer submitted a second OIC in 2008, where he again sought to settle his outstanding tax liabilities for a small fraction of the outstanding liability, but the SO returned the offer after discovering that the taxpayer was not in compliance with his income tax obligations.[76] The IRS subsequently issued a final notice of intent to levy to the taxpayer. The taxpayer then filed a CDP hearing request.

During the subsequent CDP hearing, the taxpayer contested the manner in which the IRS handled the 2004 and 2008 offers. In particular, he requested that the SO reopen and evaluate the OIC that the taxpayer had submitted in 2008. The SO declined to reopen the 2008 OIC and ultimately issued a notice of determination sustaining the proposed levy. The taxpayer then filed a petition to the Tax Court.

The IRS challenged the Tax Court's jurisdiction over the case, arguing that there was nothing to review since the taxpayer had not offered a new OIC for consideration during the CDP hearing. The IRS also argued that the taxpayer did not have a right to judicial review of the rejected offer in 2004 or the returned offer in 2008. The court rejected this argument since the SO issued a notice of determination and the taxpayer filed a timely petition, the two prerequisites for Tax Court jurisdiction.

Since the taxpayer did not contest the tax liability, the Tax Court reviewed the proposed levy action for abuse of discretion. First, the taxpayer challenged the SO's refusal to reopen the 2008 OIC during the CDP hearing.[77] The SO determined that she did not have authority to reopen the offer, while the taxpayer argued that the IRS could be required to reopen the offer. The Tax Court applied IRC §§ 7122 and 6330 and rejected the taxpayer's argument. Doing otherwise would mean that the Appeals Office in 2011 would be required to consider an offer submitted in 2008, which contained stale financial information. Taxpayers must submit current financial information with offers based on doubt as to collectibility.[78] Requiring Appeals to consider an old offer during the CDP process would expand administrative and judicial review of offers beyond what Congress intended.[79] Thus, the proposed collection action was sustained.

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75 141 T.C. 248 (2013), *opinion supplemented on denial of reconsideration by* T.C. Memo. 2014-41.

76 Under IRC § 7122(e), taxpayers may seek review of *rejected* offers. There is no such right for *returned* offers. The National Taxpayer Advocate has pointed out that the IRS can harm taxpayers by expanding the definition of "returned" offers, which do not provide appeal rights. For a discussion on this, *see* National Taxpayer Advocate 2007 Report to Congress 374-87; National Taxpayer Advocate 2006 Report to Congress 83-109; National Taxpayer Advocate 2004 Annual Report to Congress 311-41; National Taxpayer Advocate 2003 Annual Report to Congress 99-112; National Taxpayer Advocate 2002 Annual Report to Congress 15-24.

77 Following the return of his 2008 offer, the taxpayer exchanged several letters with the offer unit in an attempt to have the offer unit reconsider its decision to return his offer. The taxpayer continued to make payments during the exchange of letters. The Court notes that the taxpayer wanted the 2008 offer reopened on the belief that these payments would be treated as meeting the payment terms of his offer.

78 *See Reed v. Comm'r*, 141 T.C. 248 at 13 (citing *Sullivan v. Comm'r*, T.C. Memo 2009-4; *Goodwin v. Comm'r*, T.C. Memo 2003-289).

79 As noted above, taxpayers may only seek review of rejected offers, and not offers that are returned. IRC § 7122(e).

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.[80] As we found in last year's analysis, the court imposed these penalties in only a few CDP cases. Of the 76 cases reviewed this year, the court imposed sanctions in only two cases, or approximately three percent.[81] Last year, with 105 CDP cases decided, the court imposed sanctions in three cases, or three percent.[82] This low number may be attributable to IRC § 6330(g), which allows the IRS to disregard a frivolous hearing request.

Pro Se Analysis

Pro se taxpayers (those without the benefit of counsel) litigated 48 (or 63 percent) of the 76 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 eight taxpayers, represented or unrepresented (or about 11 percent of the 76 cases), received some relief on judicial review.

FIGURE 3.5.3, *Pro Se* and Represented Taxpayer Cases and Decisions

Court Decisions	*Pro Se* Taxpayers		Represented Taxpayers	
	Volume	% of Total	Volume	% of Total
Decided for IRS	46	96%	22	79%
Decided for Taxpayer	1	2%	4	14%
Split Decisions	1	2%	2	7%
Totals	**48**	**100%**	**28**	**100%**

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. In fact, despite a decline in the number of CDP cases being litigated, there are several important cases that may impact CDP litigation in the future.

As described in the *Moosally* case, the IRS's desire to consolidate work may interfere with taxpayer rights.[83] The recently adopted Taxpayer Bill of Rights increases taxpayers' awareness of their rights, including the right to appeal an IRS decision in an independent forum, under which the Appeals employee conducting the CDP hearing must have had no prior involvement with the taxpayer's case.[84] Similarly, as discussed in *Isley*, in cases involving criminal convictions, taxpayers may need to consider requesting modification of probation terms by the sentencing court with the consent of the Attorney General in order to resolve tax liabilities with the IRS.

80 *See* Most Litigated Issue: *Frivolous Issues Penalty Under Internal Revenue Code Section 6673 and Related Appellate-Level Sanctions*, *infra*.

81 *Best v. Comm'r*, T.C. Memo. 2014-72; *Golub v. Comm'r*, T.C. Memo. 2013-196.

82 National Taxpayer Advocate 2013 Annual Report to Congress 381.

83 *See* IRS, Publication 1, *Your Rights as a Taxpayer* (June 2014).

84 *See, e.g.*, IRC § 6330(b)(3).

The opinions reviewed this year suggest the communication process between the taxpayer and the Appeals Officers occasionally breaks down. For example, in many cases the taxpayer did not provide the requested documentation.[85] Taxpayers also frequently challenged the denial of a face-to-face hearing, an issue that most often resulted from a failure to provide documentation.[86] 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. 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 encourage them to do so.

The Office of Chief Counsel recently reiterated its position that when Appeals makes a determination under IRC § 6330(c)(1) that the IRS has complied with all applicable legal and administrative requirements, this determination should be reviewed using an abuse of discretion standard.[87] The notice also clarified that when assessing whether all legal and administrative requirements have been met, issues related to payments, overpayment credits, validity of the assessment, and the statute of limitations must be addressed as part of that inquiry. These types of issues are not challenges to the underlying liability, which would require the taxpayer to raise them. Because the abuse of discretion standard applies to these verification requirements, if the administrative record supports Appeals' determination, the IRS Office of Chief Counsel will rely on the administrative record and object to the taxpayer submitting additional evidence at trial. If the administrative record is insufficient, Counsel attorneys are instructed that a motion to remand may be appropriate. This notice serves as a reminder to taxpayers to provide complete information and supporting documentation to the AO during the hearing process as it will not only increase the chance of resolution during the CDP hearing but will also provide the court with a more complete record if the taxpayer appeals the AO's determination.

In all cases, the AO must review the case to ensure that all legal and administrative requirements have been met. If the taxpayer believes that this review has been inadequate, the taxpayer should formally challenge the AO's determination that the IRS has complied with all legal and administrative requirements. Taxpayers should make sure that this challenge, as well as any evidence to support it, is properly documented in the administrative record. The taxpayer may be at a disadvantage in this situation because the IRS is the party with the records in its custody. For the above reasons, it is possible that this will be an issue of litigation in the future.

Lastly, the *Byers* decision may impact future litigation of non-liability CDP cases from the perspective of potential forum-shopping. When considering an appeal from a non-liability CDP case, taxpayers may decide to file in either the Circuit Court of Appeals based on their place of residence or in the D.C. Circuit based on what forum's case law is more advantageous. However, *pro se* taxpayers may have difficulty understanding the distinction between issues involving redetermination of liability and non-liability issues raised at a CDP hearing.

85 *See, e.g.*, *Adighibe v. Comm'r*, T.C. Memo 2013-296; *Arede v. Comm'r*, T.C. Memo. 2014-29; *Cheli v. Comm'r*, T.C. Memo. 2013-200; *Lyons v. Comm'r*, T.C. Memo. 2014-32; *Mayhugh v. Comm'r*, T.C. Memo. 2014-98.

86 *See, e.g.*, *LaForge v. Comm'r*, T.C. Memo. 2013-183; *Shirley v. Comm'r*, T.C. Memo. 2014-10 (holding that denial of a face-to-face hearing as part of a supplemental CDP hearing on remand was appropriate when the taxpayer failed to provide amended returns, a completed Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, substantiating documentation, and a reasonable cause explanation).

87 IRS Office of Chief Counsel, Notice CC-2014-002 (May 5, 2014).

In sum, the CDP hearing is a powerful tool for taxpayers. Communication between the IRS and the taxpayer is crucial for this process to work properly. If taxpayers provide 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 56 decisions issued by federal courts from June 1, 2013 to May 31, 2014, 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. Thirteen cases involved the imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties; four 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 30 cases involved only the failure to file penalty.[2]

The IRS imposes the failure to file and failure to pay penalties unless the taxpayer can demonstrate the failure is due to reasonable cause and not willful neglect.[3] The estimated tax penalty is imposed unless the taxpayer can meet one of the statutory exceptions.[4] Taxpayers were unable to avoid a penalty in 49 of the 56 cases.

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.[5] 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.[6] The failure to file penalty applies to income, estate, gift, employment and self-employment, and certain excise tax returns.[7]

1 Internal Revenue Code (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 There were two additional categories of combined case issues: four involved the estimated tax penalty with just the failure to file penalty, and one case involved the estimated tax penalty with just the failure to pay penalty.

3 IRC § 6651(a)(1), (a)(2).

4 IRC § 6654(e).

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

6 Treas. Reg. § 301.6651-1(c)(1).

7 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 it remains unpaid, up to a maximum of 25 percent of the amount due.[8] 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.[9]

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

IRC § 6654 imposes a penalty on any underpayment of estimated tax by an individual or by certain estates or trusts.[14] The law requires four installments per taxable year, each generally 25 percent of the required annual payment.[15] The required annual payment is generally the lesser of 90 percent of the tax shown on the return for the current taxable year or 100 percent of the tax for the previous year.[16] The IRS will determine the amount of the penalty by applying the underpayment rate according to IRC § 6621 to the amount of the underpayment for the applicable period.[17]

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

- The tax due (after taking into account any federal income tax withheld) is less than $1,000;[18]
- The preceding taxable year was a full 12 months, the taxpayer had no liability for the preceding taxable year, and the taxpayer was a U.S. citizen or resident throughout the preceding taxable year;[19]
- The IRS determines that because of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;[20] or

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

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

10 IRC § 6651(a)(2).

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

12 *Id. See, e.g., East Wind Indus., Inc. v. U.S.,* 196 F.3d 499, 507 (3d Cir. 1999).

13 Treas. Reg. § 301.6651-1(c)(2).

14 IRC § 6654(a), (l).

15 IRC § 6654(c)(1), (d)(1)(A).

16 IRC § 6654(d)(1)(B).

17 IRC § 6654(a).

18 IRC § 6654(e)(1).

19 IRC § 6654(e)(2).

20 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.[21]

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

ANALYSIS OF LITIGATED CASES

We analyzed 56 opinions issued between June 1, 2013 and May 31, 2014, where the failure to file penalty, failure to pay penalty, or estimated tax penalty was in dispute. All but five of these cases were litigated in the United States Tax Court. A detailed list appears in Table 6 in Appendix III. Thirty-six cases involved individual taxpayers and 20 involved businesses (including individuals engaged in self-employment or partnerships).

Of the 41 cases in which taxpayers appeared *pro se* (without counsel), taxpayers prevailed in full in one case, and three resulted in split decisions. Of the 15 cases in which taxpayers had representation, taxpayers prevailed in full in three cases, and none were split decisions.

Failure to File Penalty

To be held liable for the failure to file penalty, the taxpayer must have a filing requirement. In *Ungvar v. Commissioner*,[23] a tax-exempt religious corporation petitioned the U.S. Tax Court for redetermination of an employment tax deficiency and additions to tax after the reclassification of an individual as the taxpayer's employee.[24] The IRS issued a notice of determination of worker classification and a notice of deficiency for employment tax deficiencies that arose from this reclassification.[25] The deficiency included a penalty under IRC § 6651(a)(1) for failing to file federal employment tax returns. However, the Tax Court held the taxpayer was not required to file these returns or make any required deposits for the taxable periods at issue, because it was determined the taxpayer did not have any employees at that time. Accordingly, the court held the taxpayer was not liable for the failure to file penalty.[26]

21 IRC § 6654(e)(3)(B).

22 *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).

23 *Ungvar v. Comm'r*, T.C. Memo. 2013-161.

24 IRC § 7436 grants the Tax Court jurisdiction to determine whether the IRS's determination of worker classification is correct and whether the employment taxes, including additions to tax, associated with the worker classification are the proper amount. Originally IRC § 7436 only granted jurisdiction to the Tax Court to review and determine worker classification status and not the proper amount of employment tax associated with the classification. In 2000, Congress amended IRC § 7436 and clarified that the Tax Court does have jurisdiction to determine the proper amount of employment tax under the determination of worker status. *See* The Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 314(f) and (g), 114 Stat. 2763A-587, 2763A-643 (Dec. 21, 2000).

25 The IRS assessed amounts due as a result of the taxpayer's failure to withhold and deposit payments from its employee's wages. Specifically, the taxpayer did not remit amounts required under the Federal Insurance Contributions Act (FICA) and amounts required for income tax withholding (ITW) for the last three quarters of 2004 and all quarters of taxable years 2005, 2006, and 2007. Under IRC §§ 3401 through 3405, employers are required to withhold from employees' wages an amount for payment of tax, such as income tax and employment tax, and are required to remit these withholdings to the IRS.

26 T.C. Memo. 2013-161. The court also held that because the taxpayer did not have any employees during the time period at issue, the taxpayer did not fail to make employment tax deposits and was therefore, not liable for the penalties assessed under IRC § 6656.

More commonly, taxpayers raised reasonable cause arguments in defense to the failure to file penalty. However, in most cases reviewed, taxpayers could not successfully establish that the failures to file were due to reasonable cause. Frequent reasonable cause claims included the following issues.

Medical Illness

Depending on the facts and circumstances, a medical illness may establish reasonable cause for failure to file, if the taxpayer can show incapacitation to such a degree that he or she could not file a return on time.[27] When considering whether the severity of the illness suffices to establish reasonable cause, the court will analyze a taxpayer's management of his or her business affairs during the illness.[28] In *Wolfington v. Commissioner*,[29] the taxpayers (husband and wife) failed to file their 2005 and 2006 federal income tax returns after seeking and receiving filing extensions.[30] In addition to raising other arguments, which the court found unconvincing and misguided, the taxpayers argued that Mrs. Wolfington's illness was "one of the distractions whose cumulative effect prevented [them] from timely filing their return."[31] However, the taxpayers did not provide any evidence, aside from Mr. Wolfington's testimony, that his wife's illness, alone or cumulatively, had a direct impact on their ability to file a return. As the taxpayers' arguments cumulatively did not establish reasonable cause, the Tax Court upheld the penalty as properly assessed. This case highlights the importance of providing additional documentation to establish illness as a reasonable cause.

In *Stevens Tech., Inc. v. Commissioner*,[32] the taxpayer was assessed additions to tax for failure to file quarterly employment tax returns (Forms 941, *Employer's Quarterly Federal Tax Return*) for a number of quarters between 2005 and 2008.[33] After the assessment, the IRS filed a Notice of Federal Tax Lien and sent the taxpayer a *Notice of Federal Tax Lien Filing and Your Right to a Hearing under IRC § 6320*. The taxpayer then requested a Collection Due Process (CDP) hearing requesting abatement of the failure to file penalties on the basis of reasonable cause. After the CDP hearing, and considering the taxpayer's request, the Appeals Officer issued a notice of determination stating that abatement of the failure to file penalties was unwarranted. After receiving this determination, the taxpayer petitioned the U.S. Tax Court under IRC § 6320(a), which grants the Tax Court judicial review of the IRS Appeals Office's CDP determinations.[34] During the trial, the taxpayer argued that its failure to file timely was due to reasonable cause, because one of its officers had significant health and family problems. Despite those difficulties, "the company was able to continue its operations, market its services to clients and potential clients,

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

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

29 T.C. Memo. 2014-45.

30 The taxpayers filed returns only after the IRS issued a statutory notice of deficiency in 2011.

31 T.C. Memo. 2014-45 at 8. The taxpayers also stated they believed it was unnecessary to timely filing the 2005 return because they were not expecting to owe tax, and were unable to timely file the 2006 return because they were still gathering necessary information.

32 T.C. Memo. 2014-13.

33 *Id*. The term "employment taxes," as used in this case, included: (1) employer's share of Federal Insurance Contributions Act (FICA), (2) employee's FICA withholding, and (3) employee's income tax withholding. The term also includes withholding under the Federal Unemployment Tax Act. *See generally*, IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (Federal Insurance Contributions Act); IRC §§ 3201, 3202, 3211, 3221, 3231-3233 and 3241 (Railroad Retirement Tax Act); IRC §§ 3301-3311 (Federal Unemployment Tax Act); IRC §§ 3401-3407 (collection of income at source on wages).

34 Where the validity of the underlying tax liability is properly at issue, the court will review the amount of the tax liability on a *de novo* basis. The legislative history of RRA '98 addresses the standard of review courts should apply in reviewing Appeals' CDP determinations. H.R. Rep. No. 105-599, at 266 (1998) (Conf. Rep.). The term *de novo* means anew. *Black's Law Dictionary*, 447 (7th Ed. 1999).

increase its workforce, and hire an accounting firm to prepare its Forms 941."[35] As a result, the Tax Court held the officer's health and family problems could not be reasonable cause because the failure to file was the result of the company's deliberate choice to focus on business matters rather than on tax compliance.[36]

Reliance on Agent

The U.S. Supreme Court, in *United States v. Boyle*,[37] held taxpayers have a nondelegable duty to file a return on time and a taxpayer's reliance on an agent to file the return does not excuse a failure to comply with a known filing requirement. In *Lamb v. Commissioner*,[38] the taxpayers relied on their attorney to prepare and file their 2008 tax return, but the IRS never received it. The court held, even if the taxpayers' testimony regarding their relationship and interactions with their attorney were credible, their reliance did not excuse their failure to timely file their return.

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.[39] In order to reasonably rely on the advice of a tax professional, the taxpayer must present evidence of the professional's expertise and show he or she provided the professional with all necessary and accurate information.[40]

In *Sean McAlary Ltd., Inc. v. Commissioner*,[41] the taxpayer relied on a preparer to compute and remit employment taxes and file required employment tax returns for tax year 2006 (Form 941, *Employer's Quarterly Federal Tax Return* and 940, *Employer's Annual Federal Unemployment 'FUTA' Tax Return*).[42] However, the returns were not filed and the IRS imposed a failure to file penalty under IRC § 6651(a)(1). The taxpayer argued he was not liable for the penalty, because reliance on advice from the tax professional established reasonable cause. However, the court held reasonable cause did not exist because the taxpayer

35 *Stevens Tech., Inc. v. Comm'r*, T.C. Memo. 2014-13.

36 *Id*. The court also upheld the imposition of the failure to pay penalty under IRC § 6651(a)(2) and failure to make tax deposits under IRC § 6656.

37 469 U.S. 241, 252 (1985).

38 T.C. Memo. 2013-155.

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

40 *Id*. In her Annual Reports to Congress, the National Taxpayer Advocate has emphasized the need for minimum competency standards for paid unenrolled return preparers. *See* National Taxpayer Advocate 2013 Annual Report to Congress 61-74; National Taxpayer Advocate 2009 Annual Report to Congress 41-69; National Taxpayer Advocate 2008 Annual Report to Congress 503-512. In June of 2014, the IRS announced that it would be offering a new voluntary program designed to encourage education and filing season readiness for such preparers. The program will allow unenrolled return preparers to obtain a record of completion when they voluntarily complete a required amount of continuing education, including a course in basic tax filing issues and updates, ethics and other federal tax law courses. Tax return preparers who elect to participate in the program and receive a record of completion from the IRS will be included in a database on IRS.gov that will be available by January 2015 to help taxpayers determine return preparer qualifications. *See* IRS Press Release, *New IRS Filing Season Program Unveiled for Tax Return Preparers*, IR-2014-75 (June 26, 2014). The American Institute of CPAs filed suit, in the District Court for the District of Columbia, alleging that the IRS lacks the authority to implement the voluntary program. The government subsequently filed a motion to dismiss. On October 27, 2014, the District Court for the District of Columbia granted the IRS's motion to dismiss. *AICPA v. IRS*, 2014 WL 5585334 (D.D.C. 2014).

41 T.C. Summ. Op. 2013-62. This is a summary opinion small tax case and pursuant to IRC § 7463(b) cannot be cited as precedent. Normally we do not discuss Tax Court cases that are designated as a "Small Case" under IRC § 7463(b) but we have elected to discuss this case here because it best illustrates the point that reliance on a tax professional is not an absolute defense, but merely a factor to be considered. *See e.g.*, *Freytag v. Comm'r*, 89 T.C. 849, 888 (1987).

42 IRC § 7436(a) vests the Tax Court with jurisdiction to review certain determinations made by the Commissioner regarding employment status (worker classification) and to determine the proper amount of employment tax arising from such determination. In this case, the parties agreed the IRS classification of employee was correct and the remaining issues were the amounts of employment tax and additions to tax.

never investigated the preparer's background or qualifications, or otherwise confirmed that he was a competent professional who had sufficient knowledge and expertise to warrant reliance on his advice.[43]

"Zero Return" Filers and Other Frivolous Arguments

Under the longstanding four-part test articulated in *Beard v. Commissioner*,[44] 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.[45] A "zero" return does not constitute a tax return under the *Beard* test because it is devoid of financial data and lacks sufficient information to calculate the tax liability.[46] Thus, when the taxpayer in *Hill v. Commissioner* filed returns containing zeros for taxable income, the court upheld the failure to file penalty.[47]

Failure to Pay an Amount Shown Penalty

A taxpayer can file a return by the due date and still be liable for a penalty if he or she does not pay the amount shown on the return. In cases where individual taxpayers disputed that they were subject to the failure to pay penalty, many of their justifications were similar to those used for the failure to file penalty under IRC § 6651(a)(1), as the taxpayers often unsuccessfully argued medical illness or reliance on an agent.[48]

However, a taxpayer succeeded in disputing the penalty when the IRS could not meet its burden of production under IRC § 7491(c). Specifically, the IRC § 6651(a)(2) penalty applies only when the return filed by the taxpayer shows the amount due.[49] 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.[50]

For example, in *Close v. Commissioner*,[51] 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. Instead, the IRS relied upon certified Forms 4340, *Certificate of Assessments, Payments, and Other Specified Matters*, that purported to show the IRS filed SFRs for the taxpayers. Still,

43 T.C. Summ. Op. 2013-62.

44 82 T.C. 766, 777 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986).

45 *See*, *e.g.*, *Hill v. Comm'r*, T.C. Memo. 2013-265 (concluding there was no evidence of reasonable cause presented when the taxpayer reported all "zeros" on his return and offered only frivolous arguments).

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

47 *Hill v. Comm'r*, T.C. Memo. 2013-265.

48 *See*, *e.g.*, *U.S. v. Meehan*, 530 F. App'x 155 (3d Cir. 2013), *aff'g* 108 A.F.T.R.2d (RIA) 5619 (illness); *Alexander v. Comm'r*, T.C. Memo. 2013-203 (reliance on agent).

49 IRC § 6651(a)(2), (g)(2).

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

51 T.C. Memo. 2014-25.

the court held the IRS did not meet its burden of production under IRC § 7491(c), because the forms did not adequately prove the SFRs had been created.

Estimated Tax Penalty

Courts routinely found taxpayers liable for the IRC § 6654 estimated tax penalty when the IRS proved the taxpayer

- Had a tax liability;
- Had no withholding credits;
- Made no estimated tax payments for that year; and
- Offered no evidence to refute the IRS.[52]

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). In *Winterroth v. Commissioner*,[53] the IRS did not produce any evidence the taxpayer had a tax liability for 2007. Without the 2007 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 2008, if any. However, the IRS established that the taxpayer was obligated to file a return for 2008 but did not do so and did not make the requisite 2009 payments. Therefore, the IRS did not meet its burden of production of information showing that the taxpayers had a required payment under IRC § 6654 for 2008, but did show that the taxpayer was required to make a payment for 2009.

Penalty for Raising Frivolous Arguments

In four cases where the IRS had asserted either the failure to file penalty, failure to pay penalty, estimated tax penalty, or some combination, the courts also imposed the IRC § 6673 penalty for making frivolous arguments.[54] In one of these cases, the taxpayer failed to file a return because he believed neither compensation nor dividends were taxable income.[55] The Tax Court held the taxpayer liable for fraudulent failure to file, failure to pay tax, and failure to pay estimated income tax, and imposed a $50,000 penalty under IRC § 6673 ($25,000 in each consolidated case).[56]

CONCLUSION

The IRS did not prevail in full in seven of 56 (or 13 percent) of the failure to file penalty, failure to pay penalty, and the estimated tax penalty cases analyzed in this report. This is similar to the prior year, when the IRS did not prevail in 17 percent of cases.[57] Despite a rather high IRS success rate, the litigation represents a significant impact on IRS resources and a burden on taxpayers.

In an effort to reduce the burden on taxpayers and save resources, it is important the IRS clearly explain to taxpayers the requirements of reasonable cause. In a number of cases, it appeared that taxpayers did

52 *See*, *e.g.*, *Duggan v. Comm'r*, T.C. Memo. 2014-17, *appeal docketed*, No. 14-71645 (9th Cir. June 16, 2014).

53 T.C. Memo. 2014-28.

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

55 *Jones v. Comm'r*, T.C. Memo. 2014-101.

56 *Id*.

57 National Taxpayer Advocate 2013 Annual Report to Congress at 384.

not fully understand what type of situations would establish reasonable cause.[58] This disconnect may result in unnecessary litigation, putting the taxpayer at risk for sanctions under IRC § 6673.

Additionally, it is critical that IRS employees look closely and thoroughly at the case facts when assessing reasonable cause claims, rather than solely relying on the Reasonable Cause Assistant (RCA) software,[59] which is designed to help IRS employees make fair and consistent abatement determinations.[60] The RCA program allows IRS employees to override the result in certain circumstances, but employees must understand the definition of reasonable cause in order to apply the override.[61] Thus, a close review by an employee is essential to ensure the penalty is imposed appropriately. To promote voluntary compliance, taxpayers must believe the facts of their individual cases have been carefully considered.

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.[62] She also continues to recommend 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.[63]

58 *See*, *e.g.*, *Wolfington v. Comm'r*, T.C. Memo. 2014-45.

59 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.

60 National Taxpayer Advocate 2010 Annual Report to Congress 198 (Most Serious Problem: *The IRS's Over-Reliance on Its "Reasonable Cause Assistant" Leads to Inaccurate Penalty Abatement Determinations*). *See also* IRS, Reasonable Cause Assistant (RCA) Usability Test Final Report Summary 4 (May 28, 2010). The test showed that employees using the RCA determined penalty abatement requests correctly in only 45 percent of the cases. An even more disturbing finding was that all of the employees in the study believed they were making correct legal determinations based on reasonable cause.

61 IRM 20.1.1.3.6.10(3) (Nov. 25, 2011) ("Fair and consistent application of penalties requires employees to make a final penalty relief determination consistent with the RCA conclusion. Because the individual facts and circumstances vary for each case and that there may be unique facts and circumstances in certain cases that RCA cannot consider, an 'override (abort)' function is available in RCA.").

62 IRM 20.1.1.3.6 (Nov. 25, 2011). The Reasonable Cause Assistant (RCA) will be used when considering penalty relief due to reasonable cause. RCA is to be used after normal case research has been performed, (*i.e.*, applying missing deposits/payments, adjusting tax, researching for missing extensions of time to file, etc.). *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).

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

MLI #7 Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403

SUMMARY

Internal Revenue Code (IRC) § 7403 authorizes the United States to file a civil action in U.S. District Court against a taxpayer who has refused or neglected to pay any tax, to enforce a federal tax lien, or subject any of the delinquent taxpayer's property to the payment of tax. We identified 52 opinions issued between June 1, 2013, and May 31, 2014, that involved civil actions to enforce liens under IRC § 7403. The IRS prevailed in 47 of these cases. The total number of cases represents a 58 percent increase 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]

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1 National Taxpayer Advocate 2013 Annual Report to Congress 403.
2 IRC § 7403(a); Treas. Reg. § 301.7403-1(a).
3 IRC § 7403(b).
4 *United States v. National Bank of Commerce*, 472 U.S. 713, 722 (1985).
5 *United States v. Rodgers*, 461 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] Additionally, the Code specifically authorizes the court to appoint a receiver to enforce the lien and, upon the government's certification that it is in the public interest, to appoint a receiver with all powers of a receiver in equity to preserve and operate the property prior to the sale.[13]

In 2013, 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]

Prior to the issuance of this guidance, the Internal Revenue Manual (IRM) provisions related to referring a case to the DOJ for administrative seizure of a principal residence under IRC § 6334(e)(1) required the IRS to consider who is living in the residence in determining whether referral was appropriate. The IRM provisions regarding referring cases to DOJ, to request the commencement of a foreclosure action of a principal residence, were not as clear about the considerations the IRS should make prior to referring a case.

9 IRC § 7403(c).

10 However, if the application of the United States to intervene is denied, the adjudication will have no effect upon the federal tax lien on the property. IRC § 7424. Under 28 U.S.C. § 2410, the United States may be named a party in any civil action or suit in any district court, or in any state court having jurisdiction of the subject matter. IRC § 7424.

11 28 U.S.C. § 1444.

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

13 IRC §§ 7403(d) and 7402(a).

14 IRS Interim Guidance Memorandum (IGM) SBSE-05-0414-0032 (Apr. 18, 2014) (reissuing IRS Interim Guidance Memorandum SBSE-05-0413-035 (Apr. 30, 2013) (Principal Residence Suit Foreclosure Recommendations)), *available at* http://www.irs.gov/pub/foia/ig/spder/SBSE-05-0414-0032[1].pdf. 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 DOJ. TAS, *Memorandum for Director, Collection Policy* (Aug. 20, 2012). The National Taxpayer Advocate followed this advocacy proposal with a legislative recommendation that Congress amend IRC § 7403 to require that the IRS, before recommending that the Attorney General file a suit to foreclose, first determine that the taxpayer's other property or rights to property, if sold, are insufficient to pay the amount due, and that the foreclosure and sale of the residence will not create an economic hardship due to the financial condition of the taxpayer. National Taxpayer Advocate 2012 Annual Report to Congress 537-43 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*). 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.

The interim guidance clarifies that the procedures for developing suit referral recommendations under IRC § 6334(e) apply to referrals under IRC § 7403 as well.[16] The guidance also emphasizes that the IRS 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 52 opinions issued between June 1, 2013, and May 31, 2014 that involved civil actions to enforce federal tax liens. Table 7 in Appendix III contains a detailed list of those cases. Fifty percent of the taxpayers appeared *pro se* and 50 percent were represented. Taxpayers with representation received full relief in one case and partial relief in two cases. *Pro se* taxpayers received full relief in one case and partial relief in another.

Foreclosure of Tax Liens Against Property that Has Been Transferred to a Third Party

In *Smith v. United States*,[17] a husband and wife bought a residence in 1993. In August 2001, while their divorce proceeding was pending, a *lis pendens*[18] was recorded by the wife on the residence. In March 2003, the IRS assessed income taxes against only the husband for the 2000 and 2001 tax years. In July 2003, the husband and wife were divorced, and the divorce decree stated that the husband's interest in the residence was to be transferred to the wife.

On August 14, 2003, a court order conveying title in the residence to the wife was recorded in the local land records. On September 15, 2003, the IRS filed a Notice of Federal Tax Lien (NFTL) against the husband for his 2000 and 2001 income tax liabilities. In June 2011, another NFTL was recorded against the wife as nominee of her now ex-husband. The nominee NFTL did list the wife's correct address and did not contain language stating that the lien attaches specifically to the residence. In response to the nominee lien filing, the wife filed a quiet title action seeking to remove the liens filed by the United States from the residence. In response, the United States filed a counterclaim seeking to foreclose the liens on the residence.

The wife argued that enforcement of the lien was inappropriate because her due process rights were violated, because she was not given notice of the existence of the lien prior to the entry of the divorce decree. The United States argued that it notified her ex-husband and was not required to give her notice. The Court agreed with the United States finding that the statute only requires the IRS to provide notice to the liable taxpayer.[19] The Court went on to say that the wife cannot also argue that she was denied due process because she was not given sufficient notice of the lien since she received notice of the lien in July 2011, well before any foreclosure proceeding started. The court noted that actual notice of the commencement of a foreclosure proceeding is all that due process requires.

The wife also argued that the NFTL filed in 2003 was not valid because her ex-husband had no interest in the residence at the time the assessments were made, because the residence was conveyed to her before

16 The IGM follows the legislative recommendation made by the National Taxpayer Advocate in 2012. National Taxpayer Advocate 2012 Annual Report to Congress, 537-43 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*).

17 113 A.F.T.R.2d (RIA) 1231 (D. Conn. 2014).

18 A "*lis pendens*" is a "notice, recorded in the chain of title to real property, required or permitted in some jurisdictions to warn all persons that certain property is the subject matter of litigation, and that any interests acquired during the pendency of the suit are subject to its outcome." *Black's Law Dictionary* 9th ed. (2009).

19 IRC § 6303(a).

the tax liens were recorded, and the *lis pendens* filed in 2001 was effective from the date filed. The United States argued that the *lis pendens* was not effective until the judgment was entered in the divorce proceeding, so the ex-husband's interest in the real property was not extinguished until that time.

The court found the ex-husband did have an interest in the property as a lien on the property arose in March 2003 when the taxes were assessed, which was before the divorce judgment was entered. The prior *lis pendens* does not affect the validity of the lien. With respect to the nominee lien filed in 2011, the United States conceded that it did not mean to suggest the wife is a nominee of the husband as the term is defined in law and that the lien was filed purely to provide record notice of the United States' claim to the property. Thus, the court found the 2011 lien invalid.

Because the wife was a non-liable third party, the court then applied the *Rodgers* factors to determine whether foreclosure of the liens on the residence was appropriate.[20] The court found the wife had little expectation of foreclosure—she had sole ownership interest in the property after divorcing her husband in 2003, and a title search conducted in 2005 showed that her interest was unencumbered. The court also found that foreclosure would cause significant prejudice to the wife, as she had lived on the property for over 20 years, and the forced sale of her home could foreseeably cause her to incur significant relocation costs. The court determined that only one of the *Rogers* factors may have weighed slightly in favor of the government—financial prejudice to the government. Thus, the court concluded that it was appropriate to use its limited discretion under *Rodgers* and deny the sale of the property.

In determining the appropriateness of foreclosure, the courts frequently consider whether a transfer of the property to another party extinguished the federal tax lien.[21] For the lien to remain valid after property has been transferred to a subsequent purchaser, an NFTL must have been filed before the transfer. However, if the third party is not a true purchaser under IRC § 6323(h)(6), the lien will be enforceable, even if an NFTL has not been filed.[22]

For example, in *United States v. Chambers*, the taxpayer refused to file an income tax return for tax years 1996 through 2001 and 2003.[23] Based on information returns filed by third parties, the IRS computed the taxpayer's tax liability and sent him 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 for tax years 1997 through 2001 and 2003, the taxpayer transferred real property to his children, who paid ten dollars in consideration. Based on these facts, the court determined the government had demonstrated that it properly assessed the liabilities, that the liabilities remained unpaid after notice and demand for payment, and that a federal tax lien arose upon assessment that attached to all the taxpayer's property, including the property transferred to his children. The court found that because the taxpayer's children did not qualify

20 113 A.F.T.R.2d (RIA) 1231 (D. Conn. 2014). For an explanation of the *Rodgers* factors, see discussion in Present Law section, *supra*.

21 A federal tax lien arises "If any person liable to pay any tax neglects or refuses to pay the same after demand." IRC § 6321. This lien is called a "secret lien" because it arises upon assessment; nothing is filed publicly. Conversely, an NFTL is filed in the public record (*e.g.*, local courthouse) and provides public notice to creditors.

22 Under IRC § 6323(a), the lien is not valid against a purchaser until notice has been filed that meets the requirements of IRC § 6323(f).

23 113 A.F.T.R.2d (RIA) 2195 (M.D. Fla. 2014).

as a "purchaser" under IRC § 6323(h)(6), the tax lien remained on the property and thus it was subject to foreclosure.[24]

In *United States v. Denneny*,[25] the court considered whether it was appropriate to foreclose on property transferred to a third party after the federal tax lien arose and the IRS filed an NFTL. Since an NFTL was filed at the time the third party purchased the property, the property was purchased subject to the NFTL. It was appropriate for the United States to enforce the liens against the property via a foreclosure action.[26] Applying similar reasoning, the court in *United States v. Woodruff* found that, because the taxpayer transferred properties to his wife after federal tax liens arose and NFTLs were filed, the liens remained on the properties.[27]

Foreclosure of Tax Liens Against Property that Is Held by a Taxpayer's Nominee or Alter Ego

Several 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."[28] 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.[29]

In *United States v. Gilbert*,[30] the court held the trust set up by the taxpayer was the nominee of the taxpayer. The court based this conclusion on the fact that the taxpayer was convicted of tax evasion, in part, for using the trust to evade the payment of his federal income tax liabilities. In particular, the taxpayer was both a transferor of property to the trust and the managing trustee, and the taxpayer turned funds from the trust's bank account to his own personal use.

In *Fourth Investment LP v. United States*,[31] the taxpayers transferred title of their home and a commercial building to two limited partnerships, which the government argued were not functionally partnerships but were simply the taxpayers' nominees. The Ninth Circuit Court of Appeals agreed with the government, noting the transfers were made through a complex series of transactions involving shell entities

24 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 that is valid under local law against subsequent purchasers without actual notice. IRC § 6323(h)(6).

25 112 A.F.T.R.2d (RIA) 7445 (E.D. Pa. 2013).

26 *Id.*

27 113 A.F.T.R.2d (RIA) 1062 (D.N.H. 2014).

28 *United States v. Sabby*, 113 A.F.T.R.2d (RIA) 1335 (D. Minn. 2014) (quoting *Scoville v. United States*, 250 F.3d 1198, 1202 (8th Cir. 2001)).

29 *Id.*

30 113 A.F.T.R.2d (RIA) 620 (W.D. Ky. 2014).

31 720 F.3d 1058 (9th Cir. 2013), *aff'g Leeds LP v. United States*, 807 F. Supp. 2d 946 (S.D. Cal. 2011).

created and controlled by the taxpayers.[32] Specifically, when considering the above-mentioned factors, the court found the entities were nominees because consideration received by the taxpayer for the transfer of real property was inadequate, and the taxpayer retained benefits and possession of the real property.

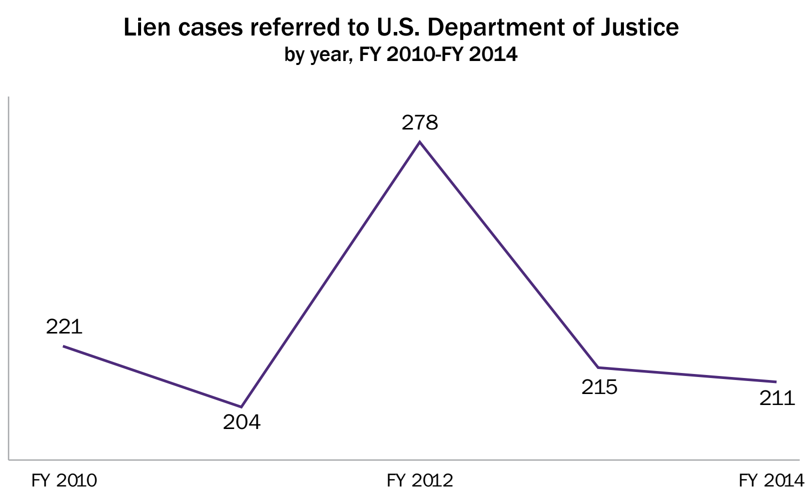
The court in *United States v. Powell*[33] reached a similar decision. The taxpayers formed a corporation with the taxpayer's wife as sole shareholder to hold a residence purchased with the taxpayers' money, and the residence was subject to a federal tax lien. After noting that the taxpayers lived at the residence and paid all the related expenses and taxes, the court held that the corporation was the nominee of the taxpayers and the taxpayer was the true beneficiary and equitable owner of the property. Thus, the court ordered the foreclosure of the tax liens on the properties held by the nominee entities.[34]

CONCLUSION

In the 2012 Annual Report to Congress, we predicted that one might see more court opinions involving lien enforcement in the coming years due to an increase in the number of cases referred to the DOJ by the IRS.[35] While there was a marked increase in lien opinions issued this year, it does not appear this increase was due to a greater number of cases being referred to DOJ. Compared with the FY 2012, the IRS referred fewer lien suits in both FY 2013 and FY 2014. However, because the number of cases referred to DOJ in FYs 2013 and 2014 is similar to years before FY 2012, it may be that FY 2012 was an outlier and the number of lien referrals has remained steady.

Figure 3.7.1, shows the number of cases referred to the DOJ by fiscal year.[36]

FIGURE 3.7.1



32 720 F.3d 1058 (9th Cir. 2013), *aff'g Leeds LP v. United States*, 807 F. Supp. 2d 946 (S.D. Cal. 2011).

33 113 A.F.T.R.2d (RIA) 1382 (2014).

34 *Id*.

35 National Taxpayer Advocate 2012 Annual Report to Congress 639.

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

The overall number of referrals to DOJ has not significantly diminished during this reporting period, notwithstanding the publication of the interim guidance memorandum in 2013. Because the guidance was primarily aimed at ensuring the IRS considers collection alternatives and equitable factors such as hardship prior to requesting the DOJ foreclose the lien on a personal residence, we believe that the number of cases like *Smith v. United States*, involving a personal residence where the *Rogers* factors weighed heavily in favor of the property owner, should diminish. However, the guidance may not impact the overall number of foreclosure referrals as some of the cases being worked by the IRS will not involve situations covered by the guidance.

Taxpayers have the *right to privacy*, which means that any enforcement action should be no more intrusive than necessary.[37] The interim guidance recognizes this right by requiring the IRS to take into account how foreclosure of a taxpayer's home will affect the taxpayer. The National Taxpayer Advocate anticipates the interim guidance will continue to have a positive effect on taxpayer rights in future years, as the IRS refers fewer suits to foreclose tax liens on taxpayers undergoing a hardship or in situations where there are reasonable alternatives. The National Taxpayer Advocate will work with the IRS to formally incorporate the interim guidance into the Internal Revenue Manual. In addition, it would be best for Congress to adopt the National Taxpayer Advocate's previous legislative recommendation to codify the approach used in the interim guidance.[38]

37 *See* IRS, Taxpayer Bill of Rights, http://www.irs.gov/Taxpayer-Bill-of-Rights (last visited Aug. 20, 2014); IRS, Publication 1, *Your Rights as a Taxpayer* (June 2014).

38 The National Taxpayer Advocate recommended Congress amend IRC § 7403 to require that the IRS, before recommending that the Attorney General file a suit to foreclose, first determine that the taxpayer's other property or rights to property, if sold, are insufficient to pay the amount due, and that the foreclosure and sale of the residence will not create an economic hardship due to the financial condition of the taxpayer. National Taxpayer Advocate 2012 Annual Report to Congress 537-43 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*).

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

SUMMARY

From June 1, 2013, through May 31, 2014, the federal courts issued decisions in at least 22 cases involving the Internal Revenue Code (IRC) § 6673 "frivolous issues" penalty, and at least ten cases involving analogous penalties at the appellate level. These penalties may be imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal.[1] In many of the cases we reviewed, taxpayers escaped liability for the penalty but were warned they could face sanctions for similar conduct in the future.[2] Nonetheless, we 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.[3] The maximum penalty is $25,000.[4] In some cases, the IRS requests that the Tax Court impose the penalty;[5] in other cases, the court exercises its discretion, *sua sponte*,[6] to do so.

Taxpayers who institute actions under IRC § 7433[7] for certain unauthorized collection actions can be subject to a maximum penalty of $10,000 if the court determines the taxpayer's position is frivolous or groundless.[8] In addition, IRC § 7482(c)(4),[9] §§ 1912 and 1927 of Title 28 of the U.S. Code,[10] and Rule

1 The Tax Court generally imposes the penalty under IRC § 6673(a)(1). Other courts may impose the penalty under IRC § 6673(b)(1). U.S. Courts of Appeals 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.

2 *See, e.g., Aldrich v. Comm'r*, T.C. Memo. 2013-201.

3 IRC § 6673(a)(1)(A), (B), and (C).

4 IRC § 6673(a)(1).

5 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, e.g.*, CCDM 35.10.2.2.3, *Sanctions Requiring National Office Review* (Aug. 11, 2004).

6 "*Sua sponte*" means without prompting or suggestion; on its own will or motion. *Black's Law Dictionary* (10th ed. 2014), *available at* www.westlaw.com. Thus, for conduct that it finds particularly offensive, the Tax Court can choose to impose a penalty under IRC § 6673 even if the IRS has not requested the penalty. *See, e.g., Toth v. Comm'r*, T.C. Memo. 2013-142.

7 IRC § 7433(a) allows a taxpayer a civil cause of action against the United States if an IRS employee intentionally or recklessly, or by reason of negligence, disregards any IRC provision or Treasury regulation in connection with collecting the taxpayer's federal tax liability.

8 IRC § 6673(b)(1).

9 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.

10 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/her conduct.

38 of the Federal Rules of Appellate Procedure[11] (among other laws and rules of procedure) authorize federal courts to impose penalties against taxpayers or their representatives for raising frivolous arguments or using litigation tactics primarily to delay the collection process. Because the sources of authority for imposing appellate-level sanctions are numerous and some of these sanctions may be imposed in nontax cases, this report focuses primarily on the IRC § 6673 penalty.

ANALYSIS OF LITIGATED CASES

We analyzed twenty-two opinions issued between June 1, 2013, and May 31, 2014 that addressed the IRC § 6673 penalty. Eighteen of these opinions were issued by the Tax Court and four by U.S. Courts of Appeals in cases where taxpayers sought review of the Tax Court's imposition of the penalty. The Courts of Appeals sustained the Tax Court's position in all cases.

In ten cases, the Tax Court imposed penalties under IRC § 6673, with the amounts ranging from $1,500 to $225,000.[12] In three cases, taxpayers prevailed when the IRS asked the court to impose a penalty but in all of these cases, the court warned the taxpayers not to bring similar arguments in the future.[13] Two taxpayers were represented by attorneys or other persons admitted to practice before the Tax Court; all sixteen 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.[14]

In the Tax Court 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 positions):

- **Taxes and procedures to collect taxes are unconstitutional:** Taxpayers in at least four cases argued that taxes, or the actions used by the IRS or the courts to collect them, violate their constitutional rights.[15] Taxpayers generally argued that taxes and the courts' actions were unconstitutional, as well as arguing specifically that taxes and the collection of taxes violated the First, Fourth, Fifth, and Sixteenth Amendments. The IRS prevailed on the issue of sanctions in three of the cases. In

11 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.

12 The maximum penalty is $25,000 in a Tax Court proceeding, but in *Jones v. Comm'r*, T.C. Memo. 2014-101, the Tax Court imposed $225,000 (nine cases consolidated and the penalty was imposed in each of the nine cases).

13 *See*, *Carothers v. Comm'r*, T.C. Memo. 2013-165, *Haag v. Commissioner*, T.C. Memo 2014-11, and *MacDonald v. Comm'r*, T.C. Memo. 2014-42.

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

15 *See*, *e.g.*, *Buckhardt v. Comm'r*, 548 F. App'x 433 (9th Cir. 2013), *aff'g* T.C. Docket. No. 22131-10 (Oct. 13, 2011) (taxpayer argued that the Tax Court violated his First, Fourth, and Fifth Amendment rights).

the fourth case, the court upheld the § 6673 penalty but declined to impose any additional sanctions under 28 U.S.C. § 1912 or the Federal Rules of Appellate Procedure.[16]

- **IRS forms invalidate tax assessments:** In at least two cases, taxpayers argued that various IRS forms invalidated the tax assessments.[17] One taxpayer argued the tax was not properly imposed since it was not validated on a Form 23C, "Assessment Certificate-Summary Record of Assessments" and the other taxpayer argued that IRS forms violate the Paperwork Reduction Act of 1995. Both courts declined to impose any penalties, but warned the taxpayers that further similar conduct could result in penalties.
- **Only income earned from the United States government or entities associated with the United States government is taxable:** Taxpayers in at least six cases argued that only federal government employees, public servants, or those who earn income from the United States government or military are subject to the income tax.[18] The IRS prevailed in four cases and the court raised the issue *sua sponte* in the other two cases, deciding not to impose the penalty in the present cases but warning the taxpayers not to raise similar arguments in the future.

CONCLUSION

Taxpayers in the cases analyzed this year presented the same or similar arguments raised and repeated year after year, which the courts routinely and universally reject.[19] Taxpayers avoided the IRC § 6673 penalty in only three cases where the IRS requested it, demonstrating the willingness of the courts to penalize taxpayers when they offer frivolous arguments or institute a case merely for delay. Whether the taxpayer has a history of making frivolous or groundless arguments may result in a larger penalty being imposed, but that may not always be the case.[20]

Where the IRS has not requested the penalty, the court may nonetheless raise the issue *sua sponte*, and in many cases imposes the penalty or cautions the taxpayer that similar future behavior will result in a penalty.[21] Finally, the U.S. Courts of Appeals have shown their willingness to uphold the IRC § 6673 penalties imposed by the Tax Court without fail in the cases analyzed for the period between June 1, 2013, and May 31, 2014, continuing a trend of upholding all penalties in cases we have analyzed since June 2005.

16 *See Herriman v. Comm'r*, 521 F. App'x 912 (11th Cir. 2013), *aff'g* T.C. Docket. No. 25048-11 (May 8, 2012) (court granted IRS's motion for sanctions pursuant to the Federal Rules of Appellate Procedure); *Golub v. Comm'r*, T.C. Memo. 2013-196 (court, *sua sponte*, imposed sanctions under IRC § 6673); *Young v. Comm'r*, 551 F. App'x 229 (5th Cir. 2014), *aff'g* T.C. Docket No. 4664–12 (Mar. 20, 2013) (court affirmed § 6673 penalty and granted IRS's motion for sanctions pursuant to the Federal Rules of Appellate Procedure); *Buckhardt v. Comm'r*, 548 F. App'x 433 (9th Cir. 2013), *aff'g* T.C. Docket. No. 22131-10 (Oct. 13, 2011) (court affirmed IRC § 6673 penalty but denied IRS's motion for sanctions pursuant to 28 U.S.C. § 1912 and the Federal Rules of Appellate Procedure).

17 *See Pflum, U.S. v.*, 112 A.F.T.R.2d (RIA) 7200 (W.D. Wash. 2013), *aff'g* 112 A.F.T.R.2d (RIA) 7303 (E.D. Wash. 2013); Burt v. Comm'r, T.C. Memo. 2013-140, appeal docketed, No. 13-1946 (6th Cir. Oct. 17, 2013).

18 *See, e.g., Hill v. Comm'r*, T.C. Memo. 2013-265; *Jones v. Comm'r*, T.C. Memo. 2014-101.

19 *See, e.g.*, National Taxpayer Advocate 2013 Annual Report to Congress 399-402.

20 *See, e.g., Golub v. Comm'r*, T.C. Memo. 2013-196 (court imposed $15,000 penalty and had imposed $10,000 penalty in an earlier case). *Compare with Burt v. Comm'r*, T.C. Memo. 2013-140, *appeal docketed*, No. 13-1946 (6th Cir. Oct. 17, 2013) (court declined to impose the IRC § 6673 penalty even though the taxpayer was no stranger to the court and had been penalized $20,000 in an earlier case).

21 *See, e.g., Aldrich v. Comm'r*, T.C. Memo. 2013-201 (court raised the issue *sua sponte* and warned the taxpayer not to assert similar arguments in the future).

MLI #9

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 substantiate contributions of $250 or more. Litigation generally arises over one or more of these four issues:

- Whether the donation is made to a charitable organization;
- Whether contributed property qualifies as a charitable contribution;
- Whether the amount taken as a charitable deduction equals the fair market value of the property contributed; and
- Whether the taxpayer has substantiated the contribution.

We reviewed 30 cases decided between June 1, 2013 and May 31, 2014 with charitable deductions as a contested issue. The IRS prevailed in 25 cases, with taxpayers prevailing in no cases and the remaining five resulting in split decisions. Taxpayers represented themselves (appearing *pro se*) in 13 of the 30 cases (43 percent), with two of these *pro se* cases resulting in split decisions and the IRS prevailing in the remaining 11 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 five years.[8] Corporate charitable deductions are generally limited to ten percent of the taxpayer's taxable

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 insures 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 *See also* Treas. Reg. § 1.170A-1(g) (no deduction for contribution of services).

6 IRC § 170(c).

7 IRC § 170(b)(1)(A), (G).

8 IRC § 170(d)(1).

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 any cash contribution;
- A description (but not the value) of any non-cash contribution;
- A statement that no goods or services were provided by the organization in return for the contribution, if that was the case;
- A description and good faith estimate of the value of goods or services, if any, that an organization provided in return for the contribution; and
- A statement that goods or services, if any, that an organization provided in return for the contribution consisted entirely of intangible religious benefits, if that was the case.[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]

ANALYSIS OF LITIGATED CASES

We reviewed 30 decisions entered between June 1, 2013 and May 31, 2014, involving charitable contribution deductions claimed by taxpayers. Table 9 in Appendix III contains a detailed list of those cases. Of the 30 cases, 13 involved the taxpayers' substantiation (or lack thereof) of the claimed contribution,

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) to (iii).

15 Treas. Reg. § 1.170A-1(c)(1).

16 *Id*.

17 IRC § 170(f)(11)(C). "Qualified appraisal," and "qualified appraiser" are defined in IRC §§ 170(f)(11)(E)(i) and (ii), respectively.

eight cases involved a dispute over the valuation of property contributed,[18] at least eight involved the contribution of an easement, one case involved the issue of whether the recipient was a qualified charitable organization, and one case involved whether the taxpayer actually bore the burden of the contribution.[19]

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.[20] The Tax Court rejected a claimed charitable deduction in one case for the taxpayer's failure to establish that the donee organization qualified as a charitable organization under IRC § 170(c).[21]

In *Golit v. Commissioner*, the taxpayer claimed a deduction for cash contributions to the Church of the Immaculate Conception (Immaculate Conception), a Catholic church in Jos, Nigeria within the Catholic Archdiocese of Jos.[22] Section 170(c) defines "charitable contribution" as a contribution or gift "to or for the use of" an organization "created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States."[23] The taxpayer did not prove that Immaculate Conception was created or organized within the United States or any of its possessions, or under any law of the United States, any State, the District of Columbia, or any possession of the United States. Therefore, the taxpayer failed to show the donee was a qualifying organization within the meaning of section 170(c) and the court sustained the IRS's disallowance of the deduction.[24]

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.[25] Taxpayers generally are not permitted to deduct gifts of property consisting of less than the taxpayers' entire interest in that property.[26] Nevertheless, taxpayers may deduct the value of a contribution of a partial interest in property that constitutes a "qualified conservation contribution,"[27] also known as a conservation easement. A contribution will constitute a qualified conservation contribution only if it is of a "qualified real property interest" made to a "qualified organization" "exclusively for conservation purposes."[28]

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18 In several of the eight valuation cases, the key issue surrounding the valuation of the contribution was the appropriateness of the taxpayer's appraisal on the donated property.

19 Cases addressing more than one described issue are counted for each issue. For example, cases addressing the valuation of easements are counted once as a valuation issue case and again as an easement issue case. As a result, the breakdown of case issues above will not add up to the total number of cases reviewed by TAS.

20 IRC § 170(c).

21 *Golit v. Comm'r*, T.C. Memo. 2013-191.

22 *Id*.

23 IRC § 170(c)(2)(A).

24 *Golit*, T.C. Memo. 2013-191.

25 IRC § 170(f)(3).

26 *Id*.

27 IRC § 170(b)(1)(E).

28 IRC § 170(h)(1)(A)-(C). IRC § 170(h)(4)(B)(i) provides that, in the case of a contribution that consists of a restriction with respect to the exterior of a certified historic structure, the contribution must satisfy two requirements in order to be considered "exclusively for conservation purposes": 1) the interest must include a restriction which preserves the entire exterior of the building; and 2) the interest must prohibit any change to the exterior of the building that is inconsistent with the historic character of the exterior.

In *61 York Acquisition, LLC v. Commissioner*, the taxpayer (a partnership) purchased a partial interest in a property in Chicago, Illinois that has a Chicago landmark designation.[29] The property was used for both office and residential purposes; the taxpayer owned the office portion, but not the residential portion of the building.[30] Further, the property was subject to a declaration of Covenants, Conditions, Restrictions, and Easements agreed to by the prior owner of the office portion of the building and the owner of the residential portion of the property. The declaration set out the rights and responsibilities of each owner. The declaration specified the taxpayer, as owner of the office portion of the property, owned the "Facade" but not the entire exterior of the property; the owner of the office property is responsible for "Maintenance of the Facade and maintenance of other portions of the facade of the building;" and an owner who wishes to make an addition, improvement, or alteration that "materially alters the Facade of the Building" must obtain prior written consent of the other owner.

The partnership granted a "Conservation Deed of Easement" (easement) in the property to the National Architectural Trust, Inc. (NAT). The easement terms required the grantor to obtain prior written consent from the NAT before making any change to the "Protected Facades," which included "the existing facades on the front, sides and rear of the Building and the measured height of the Building."[31]

The court held that the taxpayer could not assign an easement in the entire exterior of the property to the NAT, because its ownership right to the exterior was restricted by the declaration of Covenants, Conditions, Restrictions, and Easements. Specifically, the court held the partnership only had rights to the Facade, as defined by the agreement, and not to the entire exterior. The taxpayer argued that the partnership had an assignable right in the entire exterior because the partnership had an obligation under the declaration to maintain the entire facade of the building. However, the court was unconvinced an obligation created a right.[32]

In sum, the taxpayer's contribution was not a "qualified conservation contribution" under section 170(h)(1) because the easement granted to the NAT did not restrict and preserve the entire exterior of the certified historic structure and therefore did not satisfy the requirement that the contribution be "exclusively for conservation purposes."[33]

Valuation

To receive a deduction for most contributions of property in excess of $5,000, taxpayers must provide a qualified appraisal of the property that is donated.[34] In *Kaufman v. Commissioner*, the taxpayer contributed a facade easement to the NAT and claimed a charitable deduction for the contribution.[35] Since there was no market by which the easement could be valued (*i.e.*, there was no substantial record of sales of easements comparable to the donated easement), the appraisers and the Tax Court determined the value (if any) of the facade easement by applying the before-and-after method. Under this method, the fair market value of the easement "is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property

29 T.C. Memo. 2013-266.
30 *Id.*
31 *Id.*
32 *Id.*
33 *Id.*
34 IRC § 170(f)(11)(C).
35 T.C. Memo. 2014-52, *appeal docketed*, No. 14-1863 (1st Cir. Aug. 20, 2014).

after the granting of the restriction."[36] Both the taxpayer and the IRS relied heavily on expert opinion testimony as to the pre- and post-contribution values of the property. Because the restrictions of the easement were no more burdensome than the local zoning restrictions already applicable to the property, due to its location in a historic district, the court held the value of property was unchanged after the taxpayers granted easement, and therefore the court further held the facade easement had no fair market value when conveyed to the NAT.[37]

When using the before-and-after test to determine the value of an easement placed on property that is later claimed as a charitable contribution, the property's "highest and best use" is used when determining the property's value before an easement. In *Esgar Corp. v. Commissioner*, the taxpayers donated a conservation easement on three parcels of property to the Greenland Reserve, granting them the right to preserve the natural condition of the land and protect its biological, ecological, and environmental characteristics. [38] The grant specifically prohibited the mining of sand, gravel, rock, or any other minerals on the properties. The taxpayers hired an appraiser who determined that had the conservation easements not been granted, the properties would have realized their greatest potential as a gravel mining operation, even though the properties were currently being used for agriculture. The taxpayers claimed a charitable deduction for the contribution based on the property's before easement value, which the taxpayers figured by using gravel mining as the property's best potential use. The IRS disallowed the charitable deduction on the basis that the value of the conservation easement was improper and specifically disputed the property's "before restriction" value determination.[39]

The appellate court upheld the Tax Court's ruling that using gravel mining as the property's best potential use to determine before value was improper.[40] The appellate court further held the properties' current use—agriculture—was its highest and best use. It affirmed the Tax Court's conclusions it was unlikely the properties would have been developed into gravel mines in absence of the easement, because the market in the region would not support another gravel mine nor was an increase in future demand reasonably foreseeable.[41]

Substantiation

Thirteen cases involved the substantiation of deductions for charitable contributions. When determining whether a claimed charitable contribution deduction is adequately substantiated, courts tend to follow a strict interpretation of IRC § 170. Treasury Regulation §1.170A–13(a)(1) requires the taxpayer to maintain a canceled check or a receipt from the donee organization to substantiate a cash contribution. In the absence of a canceled check or a receipt from the donee organization, the taxpayer must maintain other reliable written records showing the name of the donee and the date and the amount of the contribution.

In *Brooks v. Commissioner*,[42] the taxpayer testified to being a Jehovah's Witness and to making cash contributions in 2005 and 2006 to the Jehovah's Witnesses. The taxpayer also testified she contributed $3,000 to a tsunami relief fund in 2006 through the Jehovah's Witnesses.

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36 Treas. Reg. § 1.170A-14(h)(3)(i).

37 T.C. Memo. 2014-52, *appeal docketed*, No. 14-1863 (1st Cir. Aug. 20, 2014).

38 744 F.3d 648, 651 (10th Cir. 2014), *aff'g* T.C. Memo. 2012-35.

39 744 F.3d 648, 651-52 (10th Cir. 2014), *aff'g* T.C. Memo. 2012-35.

40 *Id*. at 658.

41 *Id*. *See also* Treas. Reg. § 1.170A-14(h)(3)(ii) (discussing fair market value of property before and after restriction).

42 *Brooks v. Comm'r*, T.C. Memo. 2013-141.

To substantiate her $3,000 contribution, the taxpayer provided a photocopy of two receipts. The first receipt showed DaimlerChrysler Corporation made a payment to the taxpayer in the amount of $15,782. The second receipt, a customer receipt from Bank of America, showed a deposit of $12,782 into the taxpayer's account. However, these receipts made no reference to a charitable contribution. The documentation merely established the taxpayer did not deposit into her Bank of America account all of the proceeds from the DaimlerChrysler Corporation payment. The court held the charitable deductions were properly disallowed because the taxpayer provided no other evidence that the $3,000 withheld from the DaimlerChrysler Corporation check was used to make a charitable contribution. Additionally, the taxpayer had failed to provide documentation for other charitable contributions.

Gifts of charitable contributions of $250 or more must be substantiated by a contemporaneous written acknowledgement from the donee organization that must include:

- The amount of cash and a description (but not value) of any property other than cash contributed;
- Whether the donee organization provided any goods or services in consideration, in whole or in part; and
- A description and good faith estimate of the value of any goods or services or, if such goods or services consist solely of intangible religious benefits, a statement to that effect.[43]

In *Wachter v. Commissioner*, the IRS moved for summary judgment, asserting that the taxpayers did not satisfy the requirement of a valid contemporaneous written acknowledgment.[44] The taxpayers provided letters to the IRS for substantiation purposes, but the IRS asserted that the letters did not mention the donee provided goods or services to the taxpayers each year, were not addressed to the taxpayers, and did not mention the value of goods and services. One piece of correspondence predated the contribution check by two days and was unsigned.

The taxpayers asserted that the checks and letters for each year, as well as a 2004 donation agreement,[45] could be taken together to meet the requirements of a contemporaneous written acknowledgment. The court denied the IRS motion for summary judgment because a series of documents may constitute a contemporaneous written acknowledgment and the taxpayers may yet be able to authenticate disputed documents and provide additional documents to supplement those they have included with the stipulation of facts.[46]

CONCLUSION

IRC § 170 and the accompanying Treasury Regulations provide detailed requirements that taxpayers must strictly comply with, 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."[47]

43 IRC § 170(f)(8)(A) and (B).

44 142 T.C. No. 7 (2014).

45 142 T.C. No. 7 at *2. Owners of Wind River signed an agreement dated February 26, 2004 with North Dakota Natural Resource Trust (NRT) agreeing to donate $170,000 by March 1, 2004.

46 The case concluded with a stipulated decision entered on Nov. 6, 2014. Taxpayers were ordered to pay deficiencies in income for the years 2004, 2005 and 2006 in the amounts of $60,381, $47,163 and $33,877, respectively. However, no penalties were due for any of these years. *See*, *Patrick J. Wachter & Louise M. Wachter v. Comm'r*, Tax Court Docket No. 9213-11, (Nov. 6, 2014).

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

A majority of charitable contribution cases reviewed this year addressed either issues regarding substantiation or the rules surrounding the donation of easements. It is critical that taxpayers include every statutorily required item of information in any mandated agreement and ensure the integrity of any necessary valuations of donated property.

When donating a conservation easement, taxpayers should pay particular attention to the valuation of the easement, ensuring the valuation determination can be adequately supported. Additionally, the cases pertaining to a qualified conservation contribution illustrate the importance of paying close attention to the technicalities. Easement deeds should be reviewed for ambiguity, especially as to whether use restrictions have been granted in perpetuity to the donee.

MLI #10

Passive Activity Losses (PAL) Under IRC § 469

SUMMARY

This is the first time the disallowance of the passive activity loss and credit (PAL) under Internal Revenue Code (IRC) § 469 has been among the Most Litigated Issues in the National Taxpayer Advocate's Annual Report to Congress.[1] A possible explanation for this increase in cases may be the IRS having nine Compliance Initiative Programs (CIP) between the tax years of 2007-2012, which specifically addressed compliance issues involving PAL.[2]

We identified and reviewed 28 federal court opinions involving a PAL issue that were issued between June 1, 2013 and May 31, 2014. The 28 opinions do not reflect the full number of PAL cases because the courts do not always publish an opinion. Some cases are resolved through settlements, or taxpayers do not pursue litigation after filing a petition or complaint with the court. The courts also dispose of some cases by issuing unpublished orders. Table 10 in Appendix lll provides a detailed list of the PAL opinions we reviewed. The courts affirmed the IRS position in the vast majority of cases (23 out of 28, approximately 82 percent), while taxpayers fully prevailed only about 14 percent of the time (in four out of 28 cases). The remaining case resulted in a split decision.

PRESENT LAW

Generally, IRC §§ 162 and 212 allow taxpayers to deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business or for the production of income.[3] In 1986, Congress enacted IRC § 469 to address concerns regarding abusive tax shelters.[4] IRC § 469 generally disallows passive activity losses from trade or business activities in which the taxpayer does not materially participate and from rental activities.[5]

- A passive activity loss is the aggregate of losses from all passive activities for the taxable year over the aggregate of income from all passive activities for the year.[6]
- A passive activity credit is the sum of the credits from all passive activities allowable for the taxable year over the regular tax liability of the taxpayer for the taxable year allocable to all passive activities.[7]

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1 *See* National Taxpayer Advocate 1998-2013 Annual Reports to Congress.

2 IRS Compliance Initiative Projects, *National CIP Database* (Sep. 16, 2014). *See* SBSE, Project Code 0031, *PAL Limitations - Rental Real Estate*; SBSE, Project Code 0189, *PAL Limitation - Modified AGI Greater than $100000*; SBSE, Project Code 0553, *High Income/High Wealth with Large Investment Income and Low Earnings*; SBSE, Project Code 0685, *Self-Rented Property - FY 05 & 06*; SBSE, Project Code 0685, *Self Rental Property*; SBSE, Project Code 0688, *Investment Interest Expense - FY 05 & 06*; SBSE, Project Code 0688, *Investment Interest Expense*; SBSE, Project Code 0711, *Real Estate Sales - Principal Residence*; and SBSE, Project Code 0793, *Other Income Deduction PAL*. CIPs are used to identify taxpayer compliance issues. One of the fundamental principles of CIPs is to "[i]dentify trends on non-compliance and improper treatment of tax issues." IRM 4.17.1.2(2), *Compliance Initiative Projects* (Feb. 25, 2010).

3 IRC § 469(c)(6)(A), (B). *See also* Most Litigated Issue: *Trade and Business Expenses*, *supra*.

4 Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2085, 2233 (1986).

5 IRC § 469(c)(1).

6 IRC § 469(d)(1)(A), (B); Temp. Treas. Reg. § 1.469-2T(b)(1).

7 IRC § 469(d)(2)(A), (B).

The PAL limitation applies to individuals, estates, trusts, closely held subchapter C corporations, and personal service corporations.[8] Passive activity loss rules apply at the individual taxpayer level, *i.e.*, at a partner or shareholder level rather than the passthrough entity level.[9] Any loss or credit from passive trade or business activities for the taxable year exceeding passive activity income may not be deducted or credited in that year, but will be carried forward to reduce future passive activity income.[10]

In 1993, Congress created a special rule for taxpayers in real property businesses, permitting them to treat certain rental real estate activities as nonpassive activities. To qualify for this special rule under § 469(c)(7), more than half of a taxpayer's personal services performed during a tax year must be performed in real property trades or businesses in which the taxpayer materially participates, and the taxpayer must perform more than 750 hours in real property trades or businesses in which the taxpayer materially participates during the tax year.[11]

The taxpayer must also materially participate with respect to each rental real estate activity. For this purpose, each interest in rental real estate of the taxpayer is treated as a separate activity unless the taxpayer elects to treat all rental real estate interests as one activity. Judicial interpretation of IRC § 469 and the related regulations is focused on review of specific facts and circumstances.

What is a trade or business?

The Supreme Court has interpreted "trade or business" for purposes of § 162 to mean an activity conducted with "continuity and regularity" for the primary purpose of earning income or making profit.[12] IRC § 469 provides that "trade or business" includes any activity:

- Involving research or experimentation (within the meaning of IRC § 174);[13]
- In connection with a trade or business,[14] or
- With respect to which expenses are allowable as a deduction under IRC § 212.[15]

What is material participation?

Generally, a taxpayer can materially participate in an activity only if the participation is regular, continuous, and substantial.[16] A limited partner in a limited partnership cannot generally meet this requirement except as provided in the regulations.[17] Under the temporary regulations for § 469(h), an individual materially participates if and only if he or she satisfies any one of seven material participation tests:[18]

1. The individual participates in the activity for more than 500 hours during the taxable year;
2. The individual's participation constitutes substantially all of the participation in the activity of all individuals (including non-owners) for the taxable year;

8 IRC § 469(a)(2); Temp. Treas. Reg. § 1.469-1T(b).
9 Temp. Treas. Reg. § 1.469-2T(e)(1).
10 IRC § 469(b).
11 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13143(a) and (b), 107 Stat. 312, 440-41 (1993). The special rule remedied the unfairness of treating real estate professionals as passive investors. *See also* IRC § 469(c)(7).
12 *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987).
13 IRC § 469(c)(5).
14 IRC § 469(c)(6).
15 *Id.*
16 IRC § 469(h).
17 *Id.*; Temp. Treas. Reg. § 1.469-5T(e) (containing exceptions).
18 Temp. Treas. Reg. § 1.469-5T.

3. The individual participates in the activity for more than 100 hours during the taxable year, and his or her participation is not less than that of any other person;
4. The activity is a significant participation activity for the taxable year, and the individual's aggregate participation in all significant participation activities during the taxable year exceeds 500 hours;[19]
5. The individual materially participated in the activity for any five taxable years of the ten tax years immediately preceding the taxable year in question;[20]
6. The activity is personal service activity and the individual materially participated in the activity for any three taxable years preceding the taxable year in question;[21] or
7. Based on all facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the tax year subject to the following requirements:
   - The individual's services in managing the activity will not be taken into account unless no other person receives compensation for performing management services in the activity;
   - No individual performs management services that exceed (by hours) the services performed by the individual; and
   - The individual participates in the activity greater than 100 hours during the taxable year.[22]

However, under IRC § 469 material participation is generally not relevant for rental activities, and is generally not required for working interests in oil and gas properties as long as the taxpayer holds the interest directly or the form of ownership does not limit the liability of the taxpayer.[23]

What are the special rules for taxpayers engaged in real property trades or businesses?

IRC § 469(c)(7) provides a special rule for taxpayers engaged in real property trades or businesses (commonly referred to as the "real estate professional" exception). Under this rule, the rental real estate activities in which the taxpayer materially participates will not be treated as passive activities. For this purpose, each interest in rental real estate of a qualifying taxpayer will be treated as a separate activity unless the taxpayer elects to treat all interests in rental real estate as one activity.[24] A taxpayer will qualify for this exception only if the following two requirements are met: (i) more than half of the personal services performed by the taxpayer in trades or businesses were performed in real property trades or businesses in which the taxpayer materially participated and (ii) the taxpayer performed and materially participated in more than 750 hours of services during the taxable year in real property trades or businesses.[25]

19 A significant participation activity is one in which the individual has more than 100 hours of participation during the tax year but fails to satisfy any other test for material participation. A rental activity may not be included in the significant participation test. If the sum of all the time spent in significant participation activities exceeds 500 hours, such activities are considered nonpassive. Temp. Treas. Reg. § 1.469-5T(c).

20 The five tax years need not be consecutive.

21 A personal service activity is one that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor. Temp. Treas. Reg. § 1.469-5T(d).

22 Temp. Treas. Reg. § 1.469-5T(b)(2).

23 IRC § 469(c)(4), (7)(A), and (3)(A).

24 IRC § 469(c)(7)(A); Treas. Reg. § 1.469-9(e)(1).

25 IRC § 469(c)(7)(B). "Real property trade or business" is defined as "any business that deals in any real property development, construction, redevelopment, reconstruction, acquisition, rental, conversion, operation, leasing, management, or brokerage trade or business." IRC § 469(c)(7)(C).

In the event of a joint return, these requirements are satisfied only if at least one spouse separately satisfies both statutory requirements.[26] This means the spouses' activities cannot be aggregated to satisfy either requirement, *i.e.*, the requirements will not be satisfied if one spouse meets one of the requirements and the other spouse satisfies the other prong.[27] For example, in *Adeyemo v. Commissioner*, discussed below, the court noted that the two requirements for the real-estate professional exception must be independently satisfied by one of the spouses in the case of a joint return.[28] However, in determining whether a taxpayer materially participates in a real property trade or business for this purpose, the work performed by the taxpayer's spouse will count as work performed by the taxpayer.[29]

What is the $25,000 offset for rental real estate activities?

Except as provided in § 469(c)(7), any losses from the taxpayer's rental activities are treated as passive activity losses. However, under § 469(i)(1), the taxpayer may be eligible to annually deduct up to $25,000 of the losses attributable to rental real estate activities in which he or she actively participated during the taxable year.[30] This special allowance begins to phase out when a taxpayer's modified adjusted gross income (MAGI) exceeds $100,000.[31] The $25,000 offset amount is reduced by 50 percent of the amount by which the taxpayer's MAGI exceeds $100,000,[32] and phases out entirely when the MAGI equals or exceeds $150,000.[33]

The deduction is also subject to the phase-out amounts for the rehabilitation credit, commercial revitalization deduction, and low-income housing credit.[34] There are also special rules for estates, surviving spouses, married individuals filing separately, and taxpayers not living apart.[35]

ANALYSIS OF LITIGATED CASES

We reviewed 28 decisions entered between June 1, 2013, and May 31, 2014, involving passive activity loss deductions and credits claimed by taxpayers. Table 10 in Appendix lll contains a list of the cases. The IRS prevailed in full in 23 cases (82 percent), the taxpayers prevailed in full in four cases (14 percent) and one case (four percent) resulted in a split decision.

Taxpayers appeared *pro se* (without representation) in 17 cases (61 percent) and convinced the court to allow their loss deduction in one (six percent) of those cases.[36] Represented taxpayers fared slightly better, achieving full or partial relief in their ability to claim a PAL deduction in four of the 11 cases

26 IRC § 469(c)(7)(B). *See also* Temp. Treas. Reg. § 1.469-5T(f)(3).

27 IRC § 469(c)(7)(B).

28 T.C. Memo. 2014-1.

29 Treas. Reg. § 1.469-9(c)(4).

30 Generally, taxpayers that have less than 10 percent of an interest in rental real estate activity are ot considered as actively participating. IRC § 469(i)(6)(A). Active participation is a lesser standard than material participation in that there is no requirement for "regular, continuous, and substantial participation" and there are no requirements involving rehabilitation and low-income housing credits, or commercial revitalization deductions as a result of real estate activity. IRC § 469(i)(6)(B).

31 IRC § 469(i)(3)(A), (F)(iv). Computed without regard to passive activity losses.

32 IRC § 469(i)(3)(A), (F).

33 IRC § 469(i)(3)(A).

34 IRS § 469(i).

35 *Id*.

36 The taxpayer was *pro se* and won a favorable outcome in *Montgomery v. Comm'r*, T.C. Memo. 2013-151.

(36 percent); business taxpayers represent two of these cases.[37] Figure 3.10.1 shows the breakdown of *pro se* and represented taxpayer cases and the decisions rendered by the courts.

FIGURE 3.10.1, *Pro Se* and Represented Taxpayer Cases and Decisions

Court Decisions	*Pro Se* Taxpayers		Represented Taxpayers	
	Volume	% of Total	Volume	% of Total
Decided for IRS	16	94%	7	64%
Decided for Taxpayer	1	6%	3	27%
Split Decisons	0	0%	1	9%
Totals	**17**	**100%**	**11**	**100%**

All twenty-eight cases addressed whether the taxpayer's activity was a passive activity and 15 of the 28 involved the taxpayers' qualification for the exemption under § 469(i). Twenty-three cases were related to rental real estate, four cases were related to business activity, two of which dealt with breeding animals, and one was related to an aircraft rental.[38] The other issue discussed, which also affected the court's analysis in some cases, was the lack of substantiation or poor recordkeeping to substantiate claimed expenses or hours worked.

Cases Not Involving Real Estate Activities

In cases not involving real estate activities, the most prevalent issue was whether the taxpayer materially participated in the trade or business.[39] Courts generally upheld the IRS's determinations that losses claimed by taxpayers were passive and non-deductible within the meaning of IRC § 469.

For example, in *Bartlett v. Commissioner*,[40] the taxpayers sought to deduct a loss related to bull breeding. The taxpayers claimed to have materially participated in the operation. The Tax Court disagreed and decided the taxpayers did not materially participate and did not allow the claimed losses to be deducted because the taxpayers failed to provide documentary evidence to prove that they met the 500-hour or 100-hour tests.[41] Conversely, the taxpayers in *Tolin v. Commissioner*[42] sought to deduct losses related to their thoroughbred horse breeding activity under IRC § 469. The Tax Court agreed that they materially participated in the business and their activity was not passive, and allowed the loss deduction.

In *Moreno v. United States*,[43] the taxpayer owned an aircraft leasing business and leased out a Lear jet. The U.S. District Court found this activity was not passive and allowed the taxpayer's deductions because the average period of customer use was less than seven days and therefore was a trade or business activity and

37 Two of the cases are designated as business taxpayers, which includes corporations, partnerships, trusts, and sole proprietorships – Schedule C, E, and F filers.

38 In several of the 23 rental real estate cases, the courts did not always use the term "rental real estate," and instead used more generic terms when describing these activities, such as real estate.

39 Temp. Treas. Reg. 1.469-5T(a). An individual taxpayer is considered to have materially participated in an activity if and only if any one of the seven tests that are prescribed in the regulations is met.

40 T.C. Memo. 2013-182.

41 Temp. Reg. 1.469-5T(a).

42 T.C. Memo. 2014-65.

43 *Moreno v. U.S.*, 113 A.F.T.R.2d (RIA) 2149 (W.D. La. 2014). One of the four business taxpayers in our review.

not a rental activity for purposes of § 469. The IRS had conceded that the taxpayers materially participated with respect to the airplane leasing activity.[44]

In *Montgomery v. Commissioner*,[45] married taxpayers were members of a limited liability company that was treated as an S-Corporation for tax purposes and sought to deduct losses from their business activity. The IRS determined the wife did not materially participate in the engineering business and her activity was passive. However, the taxpayers prevailed in Tax Court by showing that the wife materially participated by working more than 500 hours during the tax year.

Activities of Rental Real Estate Businesses or Professionals

Rental real estate activities of real estate professionals may qualify for the exception under § 469(c)(7) but the taxpayers must show that they materially participate in their rental real estate activities in addition to meeting the two qualification tests as real estate professionals. In the majority of these cases, the taxpayers struggled with substantiating that they met the two qualifying tests, and the courts determined their rental real estate activities were passive.[46] However, in some cases the court considered whether the taxpayer qualified for the $25,000 offset for rental real estate activities under IRC § 469(i). As discussed above, the $25,000 offset allows for a deduction of up to $25,000 in rental real estate losses on the taxpayer's tax return, which may be deducted against the taxpayer's non-passive income.

For example, in *Herwig v. Commissioner*,[47] the taxpayers were married business partners who claimed a loss deduction from "suspended" passive losses after Fifth Third Bank foreclosed on their Florida condominium units.[48] The Tax Court disallowed the deduction of the suspended passive losses under § 469(g), ruling that a foreclosure of a rental real estate property is not a disposition of the taxpayers' entire interest in their rental real estate activity.[49] In *Almquist v. Commissioner*,[50] the taxpayer could not substantiate the number of hours he worked. The Tax Court held the taxpayer did not qualify as a real estate professional; therefore, his rental real estate activity was passive and the passive activity loss was disallowed.[51] In *Oderio v. Commissioner*,[52] married taxpayers filed separate returns and claimed a rental loss deduction that the IRS disallowed. The Tax Court held that a married filing separately taxpayer must separately satisfy the requirements of § 469(c)(7)(B) in order to avoid *per se* passive activity loss treatment.[53] The taxpayers, who filed married filing separate, could not combine their efforts under § 469(c)(7)(B)(i) and (ii). The Tax Court stated that the taxpayers could only claim spousal attribution under Temp. Treas. Reg. § 1.469-5T(f)(3) to satisfy the § 469(c)(7)(B) requirements under material participation, however;

44 *Moreno v. U.S.*, 113 A.F.T.R.2d (RIA) 2149 (W.D. La. 2014) (stating that "an activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year – (A) the average period of customer use for such property is seven days or less …" *quoting* IRC § 1.469-1T(e)(3)(i)).

45 T.C. Memo. 2013-151.

46 *See Adeyemo v. Comm'r*, T.C. Memo. 2014-1; *Graffia v. Comm'r*, T.C. Memo. 2013-211; *Merino v. Comm'r*, T.C. Memo. 2013-167; and *Ohana v. Comm'r*, T.C. Memo. 2014-83.

47 T.C. Memo. 2014-95, *appeal docketed*, No. 14-13644, (11th Cir. Aug. 14, 2014). A business taxpayer case.

48 A "suspended" passive activity loss is a loss or credit that was disallowed for a taxable year and treated as a credit or deduction carried forward to and arising in the next taxable year. *See* IRC § 469(b). A taxpayer's suspended losses from an activity may be "freed up" and allowable as a deduction against non-passive income in the taxable year in which the taxpayer disposes of the entire interest in the activity giving rise to the loss in a fully taxable transaction to an unrelated party. *See* IRC § 469(g).

49 T.C. Memo. 2014-95.

50 T.C. Memo. 2014-40.

51 *Id*.

52 T.C. Memo. 2014-39.

53 *Id*., citing IRC § 469(c)(7)(B) and Treas. Reg. § 1.469-9(c)(4).

spousal attribution was not allowed in meeting the other requirements, *i.e.*, that a taxpayer perform more than one half of his or her personal services and more than 750 hours in a real estate trade or business.[54]

However, in *Graffia v. Commissioner*,[55] married taxpayers filed joint returns and were shareholders of an S corporation. The husband materially participated in the business, but the wife did not, and they claimed a business loss deduction. The Tax Court ruled in favor of the taxpayers and held a married shareholder's participation in an activity will be treated as participation of the shareholder's spouse in that activity, regardless of whether the spouses filed a joint return. In *Adeyemo v. Commissioner*,[56] the taxpayers filed a joint return and claimed losses related to rental real estate activity, but the Tax Court determined that their activity was passive, the $25,000 offset was phased out, and the passive activity loss deduction was disallowed.[57] In *Ohana v. Commissioner*,[58] the taxpayers sought to deduct rental and non-rental expenses. The Tax Court found the taxpayers were not involved in a business of real estate development, their rental real estate activities did not amount to a trade or business and therefore were passive activities, and the taxpayers could only deduct their rental expenses to the extent of their rental income.

In *Gragg v. United States*,[59] a married couple filed a joint return and one spouse was a real estate professional. The taxpayers claimed they were not required to show material participation in their rental real estate activities before deducting losses from those activities under IRC § 469(c)(7). The U.S. District Court for the Northern District of California held that in order to deduct losses from a rental real estate activity, the taxpayers were required to establish that they materially participated in each rental real estate activity listed on their return.[60]

Finally, in *Frank Aragona Trust v. Commissioner*,[61] a trust with rental real estate properties claimed loss deductions and the IRS determined the rental real estate activities were passive.[62] The Tax Court found this case to be of first impression. It decided the trust:

- Was capable of performing "personal services" in real-property trades or businesses and qualified as a real estate professional;[63]
- Materially participated in its rental real estate activity through the work performed by its trustees in that activity; and therefore
- Was allowed to deduct its rental real-estate losses.[64]

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54 T.C. Memo. 2014-39.

55 T.C. Memo. 2013-211, *appeal docketed*, No. 13-3757 (7th Cir. Dec. 11, 2013).

56 T.C. Memo. 2014-1.

57 *See also*, *Azimzadeh v. Comm'r*, T.C. Memo. 2013-169 (married taxpayers' rental activity was passive, the $25,000 offset under § 469(i) completely phased out and the Tax Court disallowed their passive activity loss deduction) and *Merino v. Commissioner*, T.C. Memo. 2013-167 (the Tax Court denied the passive activity loss deduction because married taxpayers failed to prove they materially participated in their business activity and the Tax Court ruled that the activity was passive, and they exceeded the $150,000 MAGI amount under § 469(i) and therefore were not eligible for the $25,000 offset for rental real estate activities).

58 T.C. Memo. 2014-83.

59 *Gragg v. United States*, 113 A.F.T.R.2d (RIA) 1647 (N.D. Cal. 2014) (not reported in F.Supp.2d), appeal docketed, No. 14-16053, (9th Cir. May 30, 2014).

60 *Id*.

61 *Frank Aragona Trust v. Comm'r*, 142 T.C. No. 9 (2014).

62 *Id*.

63 IRC § 469(c)(7)(B)(i). The regulations define "personal services" as "work performed by an individual in connection with a trade or business." Treas. Reg. § 1.469-9(b)(4).

64 *Frank Aragona Trust v. Comm'r*, 142 T.C. No. 9 (2014).

CONCLUSION

The courts upheld the IRS's determination regarding passive activity losses in 23 of the 28 cases. Taxpayers appear to be confused by the application of IRC § 469; specifically the substantiation requirements (recordkeeping and consistent documentation of participation) and the Temp. Treas. Reg. § 1.469-5T(a)(4) requirement to log the taxpayer's hours (taxpayers did not keep logs or did not know the required hours needed). The courts largely favored the IRS's disallowance of passive activity loss deductions, relying on IRC § 469; Treas. Reg. § 1.469-1; and Temp. Treas. Reg. §§ 1.469-4T and 1.469-5T (and the seven material participation tests therein). While most taxpayers struggled with the substantiation requirements, the courts' application of the specific facts and circumstances analysis provided positive outcomes for four taxpayers.

Given that this is the first time the disallowance of passive activity loss and credit under IRC § 469 has appeared in this report and the frequency that substantiation appeared in the courts' analysis, we recommend that the IRS highlight the available passive activity loss guidance on its website (with specific attention to rental real estate taxpayers). Due to the complex nature of these laws, the IRS also should undertake additional efforts to educate taxpayers, advisors, and return preparers through webinars, news releases, social media, and similar outreach. By educating taxpayers on the application of IRC § 469 and by suggesting best practices for substantiating real estate activities, the IRS can help taxpayers avoid having their passive loss deductions denied.