

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, 2011, through May 31, 2012, 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:

- Summons enforcement (IRC §§ 7602(a), 7604(a), and 7609(a));
- Accuracy-related penalty (IRC § 6662(b)(1) and (2));
- Collection due process (CDP) hearings (IRC §§ 6320 and 6330);
- Trade or business expenses (IRC § 162(a) and related Code sections);
- Gross income (IRC § 61 and related Code sections);
- Failure to file penalty (IRC § 6651(a)(1)), failure to pay penalty (IRC § 6651(A)(2), and 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);
- Relief from joint and several liability for spouses (IRC § 6015); and
- Limitations on assessment (IRC § 6501).

The majority of these issues were identified as Most Litigated Issues last year, with the exception of the limitations on assessment.³ Notably, taxpayers litigating this issue succeeded in full or part in the greatest percentage of all Most Litigated Issues, with a 42 percent success rate. Summons enforcement remained the top issue this year. The number of CDP cases increased significantly after falling for two years in a row — from 89 in 2011 to 116 in 2012.⁴ Cases with accuracy-related penalty issues rose from 55 in 2011 to 117 in 2012, a 113 percent increase.⁵

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

² 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. See *Study of Tax Court Cases in which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)*, *infra*.

³ See National Taxpayer Advocate 2011 Annual Report to Congress 587.

⁴ See *id.* at 589, Table 3.0.1; National Taxpayer Advocate 2010 Annual Report to Congress 416, Table 3.0.1.

⁵ See *id.*

Once TAS identified the Most Litigated Issues, it analyzed each one in four sections: summary of findings, description of present law, analysis of the litigated cases, and conclusion. Each case is listed in Appendix III, which categorizes the cases by type of taxpayer (*i.e.*, individual or business).⁶ 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.⁷

We have also included a "Significant Cases" section summarizing decisions that are not among the top ten issues but are relevant to tax administration.⁸ This year, the Significant Cases discussion includes two decisions issued by the Supreme Court that impact tax administration issues.⁹

In Volume 2 of this year's report is a TAS study of Earned Income Tax Credit (EITC) cases where the IRS conceded the EITC issue without trial, but only after the case was already in the United States Tax Court.¹⁰ Settled cases are not included in the count of cases for the Most Litigated Issues; however, this research study is relevant because most Tax Court cases (80 percent in fiscal year 2011) are settled.¹¹ The study's findings demonstrate the burden placed on taxpayers when the IRS examination function does not operate properly. In most cases, taxpayers try to resolve their problems by calling the IRS before they file their Tax Court petitions, calling five times on average, and in most cases, taxpayers submit documentary evidence that an Appeals Officer or Chief Counsel attorney accepts as probative of the claim.¹² Taxpayers often submit their documentation only after petitioning the Tax Court, however, even though they have usually spoken with an IRS examiner beforehand. This suggests that taxpayers are willing to talk with the IRS before they petition the Tax Court and can provide acceptable supporting documentation, but do not obtain the information necessary to enable them to substantiate their claims from their conversations with examiners. Moreover, examiners reject documents that Appeals Officers or Chief Counsel attorneys later accept as substantiation of claimed EITC, and sometimes misapply the law.

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

⁷ "Pro se" means "for oneself; on one's own behalf; without a lawyer." *Black's Law Dictionary* (9th ed. 2009). For purposes of this analysis, we considered the court's decision with respect to the issue analyzed only. A "split" decision is defined as a partial allowance on the specific issue analyzed. The citations also indicate whether decisions were on appeal at the time this report went to print.

⁸ Two of the cases discussed in the "Significant Cases" section of this report were decided outside the June 1, 2011, through May 31, 2012, period used to identify the ten most litigated issues, but we nonetheless have included these cases because of their impact on tax administration.

⁹ *United States v. Home Concrete & Supply, LLC* 132 S. Ct. 1836 (2012) and *National Fed'n of Indep. Businesses et al. v. Sebelius* 132 S. Ct. 2566 (2012).

¹⁰ See Volume II: *Study of Tax Court Cases in which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)*, *infra*.

¹¹ Counsel Automated Tracking System, TL -711.

¹² See Volume II: *Study of Tax Court Cases in which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)*, *infra*.

AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

Initially, taxpayers can generally litigate a tax matter in four different 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 generally a “prepayment” forum. In other words, taxpayers can access the Tax Court without having to pay the disputed tax in advance. The Tax Court has jurisdiction over a variety of issues, including deficiencies, certain declaratory judgment actions, appeals from 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*. Table 3.o.1 lists the Most Litigated Issues for the review period of June 1, 2011, through May 31, 2012, and identifies the number of cases, broken down by issue, in which taxpayers appeared without representation. As the table illustrates, the issues with the highest rates of *pro se* appearance are summons enforcement and the frivolous issues penalty.

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).

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).

TABLE 3.0.1, Pro Se Cases by Issue

Most Litigated Issue	Litigated Cases Reviewed	Pro Se Litigation	Percentage of Pro Se Cases
Summons Enforcement	153	123	80%
Accuracy-Related Penalty	117	53	45%
Collection Due Process	116	81	70%
Trade or Business Expenses	115	71	62%
Gross Income	92	53	58%
Failure to File, Failure to Pay, and Estimated Tax Penalties	74	52	70%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	48	22	46%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	40	37	93%
Joint and Several Liability	40	18	45%
Limits on assessment	33	9	27%
Total	828	519	63%

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

TABLE 3.0.2, Outcomes for Pro Se and Represented Taxpayers

Most Litigated Issue	Pro Se Taxpayers			Represented Taxpayers		
	Total Cases	Taxpayer Prevailed in Whole or in Part	Percent	Total Cases	Taxpayer Prevailed in Whole or in Part	Percent
Summons Enforcement	123	1	1%	29	0	0%
Accuracy-Related Penalty	53	14	26%	64	26	41%
Collection Due Process	81	9	11%	35	6	17%
Trade or Business Expenses	71	23	32%	44	13	30%
Gross Income	53	5	9%	39	11	28%
Failure to File, Failure to Pay, and Estimated Tax Penalties	52	6	12%	22	2	9%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	22	0	0%	26	2	8%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	37	4	11%	3	0	0%
Joint and Several Liability	18	7	39%	22	12	55%
Limits on Assessment	9	1	11%	24	13	54%
Total	519	70	13%	308	85	28%

Most Litigated Issues: Significant Cases

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

In *United States v. Home Concrete & Supply, LLC*, the Supreme Court held that a taxpayer's overstatement of basis, and resulting understatement of gross income, did not trigger the extended six-year limitations period on assessment under IRC § 6501(e).²

The IRS ordinarily must assess a deficiency against a taxpayer within three years after the return is filed.³ This period is extended to six years, under IRC § 6501(e), if a taxpayer “omits from gross income” an amount which exceeds 25 percent of the amount of gross income shown on the return.

More than three years but less than six years after the taxpayer filed a return, the IRS identified an overstated basis of sufficient magnitude to trigger the extended period, and assessed additional tax.⁴ The taxpayer argued that, because an overstatement of basis is not an “omission from gross income,” it did not trigger the extended limitations period, and the assessment was time-barred.

As the case was being litigated, the Treasury Department promulgated regulations interpreting the statute in its favor, so that an overstatement of basis could trigger the extended limitations period.⁵ It has consistently held this position notwithstanding a 1958 loss before the Supreme Court in *Colony*, a case construing a nearly identical provision of the 1939 code, which held that the extended limitations period did not apply to cases involving an overstatement of basis.⁶

The government won at the District Court for the Eastern District of North Carolina, but lost before the Court of Appeals for the Fourth Circuit and the Supreme Court.⁷ The

¹ Tax cases decided by the Supreme Court may be included in this section, however, even if also discussed in connection with one of the ten most litigated issues. When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2011, and ending on May 31, 2012. For purposes of this section of the report, we generally use the same time period.

² 132 S. Ct. 1836 (2012) [hereinafter *Home Concrete*]. For prior discussion of this issue, see National Taxpayer Advocate 2010 Annual Report to Congress 418, 423 (discussing *Intermountain Insurance Service of Vail, LLC v. Comm'r*, 134 T.C. 211 (2010), *rev'd*, 650 F.3d 691 (D.C. Cir. 2011), *vacated* 132 S. Ct. 2120 (2012) [hereinafter *Intermountain*]); National Taxpayer Advocate 2009 Annual Report to Congress 407, 416 (discussing *Bakersfield Energy Partners, LP v. Comm'r*, 568 F.3d 767 (9th Cir. 2009)). For a general discussion of the statute of limitations issues raised in this case and others, see Most Litigated Issue: *Limitations on Assessment Under Internal Revenue Code Section 6501*, *infra*.

³ IRC § 6501(a).

⁴ The tax “basis” for determining the gain or loss from the sale or other disposition of property is generally the taxpayer’s cost, as adjusted. See IRC §§ 1011, 1001. A taxpayer may understate gain on a disposition of property by overstating basis or understating the amount realized.

⁵ See Treas. Reg. § 301.6501(e)-1(a)(iii).

⁶ *The Colony, Inc. v. Comm'r*, 357 U.S. 28 (1958) [hereinafter *Colony*]. Although *Colony* was decided on the basis of the predecessor of current IRC § 6501(e), the Court noted that its decision was “in harmony” with the “unambiguous” language of IRC § 6501, which had recently been enacted as part of the 1954 IRC. *Id.* at 37. The 1939 IRC language is identical to the language at issue in *Home Concrete*, except that “per centum” was replaced by “percent.” *Home Concrete*, 132 S. Ct. at 1840.

⁷ *United States v. Home Concrete & Supply, LLC*, 599 F.Supp.2d 678 (E.D.N.C. 2008), *rev'd*, 634 F.3d 249 (4th Cir. 2011), *aff'd*, 132 S. Ct. 1836 (2012).

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Supreme Court declined to give deference to Treasury regulations it deemed inconsistent with its prior decision in *Colony*.

Under the Court’s analysis in *Chevron*, agency regulations are entitled to deference unless (1) they contradict an unambiguous statute, or (2) adopt an unreasonable construction of it.⁸ In *Colony*, the Court acknowledged that the statute’s language was ambiguous.⁹ For that reason, the IRS argued that its regulations should receive deference. The Court rejected this logic, reasoning that because *Colony* had already interpreted the statute, the language was no longer ambiguous, and the agency could no longer adopt a different interpretation. Justice Scalia broke from the majority, however, writing his own concurring opinion about why the regulations were not entitled to deference, leaving no majority explanation for the holding.¹⁰

Justice Breyer’s plurality opinion, joined by Justices Roberts, Thomas, and Alito, reasoned that unlike post-*Chevron* decisions, the *Colony* Court’s statement that the statute was ambiguous did not embody the normally-implicit conclusion that Congress had delegated gap-filling or clarifying authority to the agency. Rather, after *Colony* employed the traditional tools of statutory construction, it was clear that there was no gap to be filled, or ambiguity to be clarified, by agency regulations.

In a concurring opinion, Justice Scalia stated that if the plurality wanted to stand by its prior decision in *Brand X*, which held that “a court’s judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute,”¹¹ it should have concluded that the regulations were unreasonable. He urged the Court to abandon *Brand X* as overly reliant on the “magic words ‘ambiguous’ and ‘unambiguous.’”¹²

This case settles the controversy about whether an extended period of limitations applies to cases where an understatement of income is the result of an overstatement of basis.¹³ It also suggests that an agency’s regulations may not be entitled to deference if they are inconsistent with a court’s interpretation of a statute — especially the Supreme Court’s

⁸ *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

⁹ In *Colony*, the Court stated that the 1939 code provision at issue was ambiguous, but also stated that the same provision of the 1954 code was unambiguous.

¹⁰ Justice Scalia indicated that he had joined the majority because taxpayers justifiably relied on *Colony*. *Home Concrete*, 132 S. Ct. at 1846.

¹¹ *Id.* at 1846 (quoting *Nat’l Cable & Telecomms. Ass’n. v. Brand X Internet Serv.*, 545 U.S. 967, 982 (2005)).

¹² *Id.*

¹³ The Supreme Court vacated and remanded five circuit court decisions, which held that an overstatement of basis produces an omission from gross income that triggers the extended assessment limitations period under IRC § 6501(e)(1)(A). See *Beard v. Comm’r*, 633 F.3d 616 (7th Cir. 2011), *vacated*, 132 S.Ct. 2099 (2012); *Grapevine Imports Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011), *vacated*, 132 S.Ct. 2099 (2012); *Salman Ranch Ltd. v. Comm’r*, 647 F.3d 929 (10th Cir. 2011), *vacated*, 132 S.Ct. 2100 (2012); *Intermountain Ins. Servs. of Vail LLC v. Comm’r*, 650 F.3d 691 (D.C. Cir. 2011), *vacated*, 132 S.Ct. 2120 (2012); *UTAM Ltd. v. Comm’r*, 645 F.3d 415 (D.C. Cir. 2011), *vacated*, 132 S.Ct. 2100 (2012). The Supreme Court also denied certiorari in four cases in which a circuit court held that a basis overstatement did not constitute an omission from gross income for purposes of triggering the extended limitations period for assessment. *United States v. Burks*, 633 F.3d 347 (5th Cir. 2011), *cert. denied*, 132 S.Ct. 2099 (2012); *Comm’r v. DSDBL Ltd.*, 436 Fed.Appx. 384 (5th Cir. 2011), *cert. denied*, 132 S.Ct. 2099 (2012); *Comm’r v. Equip. Holding Co.*, 439 Fed.Appx. 368 (5th Cir. 2011), *cert. denied*, 132 S.Ct. 2122 (2012); and *Comm’r v. R & J Partners*, 441 Fed.Appx. 271 (5th Cir. 2011), *cert. denied*, 132 S.Ct. 2100 (2012).

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interpretation — that is set forth in a pre-*Chevron* decision, even if the decision acknowledges that the statute is ambiguous.¹⁴

In *National Federation of Independent Businesses et al. v. Sebelius*, the Supreme Court held that (1) the “penalty” under IRC § 5000A for failure to purchase health insurance was a constitutional exercise of Congress’s power to tax; (2) the tax did not have to be apportioned among the states under the Direct Tax Clause; and (3) the Anti-Injunction Act did not bar the suit challenging its constitutionality.¹⁵

Twenty-six states, private individuals, and an organization of independent businesses challenged the constitutionality of the Patient Protection and Affordable Care Act of 2010 (PPACA). The PPACA includes an “individual mandate,” codified at IRC § 5000A, which provides that an individual taxpayer who fails to maintain adequate health insurance coverage must include a “shared responsibility payment” on his or her federal income tax return.¹⁶

The shared responsibility payment has many characteristics of a tax: it does not apply to those whose household incomes are below the IRS’s filing threshold; factors such as taxable income, number of dependents, and joint filing status determine the amount of the payment; the statute itself is codified in the IRC; and the IRS enforces and collects it, even though the IRS is prohibited from using certain tools to do so.¹⁷

First, the Supreme Court addressed the Anti-Injunction Act (AIA), which ordinarily bars suits “for the purpose of restraining the assessment or collection of any tax,” so that those seeking judicial review generally must pay the tax and then sue for a refund.¹⁸ It concluded the AIA did not bar the suit because Congress labeled the shared responsibility payment a “penalty,” not a “tax.” The Court would not apply the AIA to a payment labeled as a penalty, even if the label was inaccurate, unless Congress explicitly provided that the penalty in question would be treated as a tax for purposes of the AIA, as it has done for certain penalties. IRC § 6671(a) provides that penalties in Title 26, subchapter 68B, are treated as taxes

¹⁴ See William J. Wilkins, IRS Chief Counsel, Prepared remarks to ABA Tax Section (May 12, 2012), in *IRS Chief Counsel Speech Examines Government Loss In Home Concrete*, 2012 TNT 94-25 (May 15, 2012) (“[A]lthough maybe some exceptions exist, I think we will find that pretty much all pre-*Chevron* Supreme Court [decisions] should be read as final determinations that cannot be changed through regulations. For post-*Chevron* cases, we will have to look for whether the word ‘ambiguous’ is used, because, as Justice Scalia points out, everyone now knows that is the magic word that signals that there is room to adopt a different statutory interpretation through regulations.”).

¹⁵ 132 S. Ct. 2566 (2012) [hereinafter *NFIB*].

¹⁶ Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1501, 124 Stat. 119, 244 (2010) (effective for tax years ending after Dec. 31, 2013).

¹⁷ *NFIB*, 132 S.Ct. at 2594.

¹⁸ IRC § 7421(a).

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under Title 26, which includes the AIA. The individual mandate is not in subchapter 68B. Thus, it is not treated as a tax for purposes of the AIA.¹⁹

Next, the Court held that although Congress does not have the authority to require individuals to buy insurance under the Commerce Clause or Necessary and Proper Clause, the individual mandate and shared responsibility payments are authorized under its power to lay and collect taxes. It explained that the shared responsibility payment is a tax for Constitutional purposes because (1) for most people, “the payment is far less than the price of insurance,” thus, people may rationally chose not to purchase insurance; (2) the payment is not limited to willful violations, as penalties for unlawful acts often are; and (3) the IRS collects the payment through “the normal means of taxation,” but not those means “most suggestive of a punitive sanction, such as criminal prosecution.”²⁰

Finally, although the Direct Tax Clause of the U.S. Constitution requires that a capitation or other direct tax be apportioned so that each state pays it in proportion to its population, the Court concluded the shared responsibility payment was not a capitation or other direct tax.²¹ This Constitutional limit may apply to certain direct taxes on property or capitations paid by every person “without regard to property, profession, or any other circumstance.”²² Because the shared responsibility payment is not a tax on property and only those who fail to purchase health insurance pay it, it is Constitutional even though not apportioned.²³

In *Massachusetts v. U.S. Department of Health and Human Services*, the U.S. Court of Appeals for the First Circuit held unconstitutional the Defense of Marriage Act’s (DOMA) prohibition against the filing of joint federal income tax returns by same-sex couples.²⁴

For purposes of federal law, section three of the Defense of Marriage Act (DOMA) defines “marriage” as a legal union between one man and one woman as husband and wife, and

¹⁹ The Court did not specifically address whether the suit was barred under the Declaratory Judgment Act (DJA), even though the DJA overlaps with the AIA in barring suits to contest unpaid taxes and is not found in Title 26. See, e.g., *Cohen v. United States*, 650 F.3d 717, 722 (D.C. Cir. 2011) (indicating that the limitations imposed by the DJA are generally interpreted as being “coterminous” with the limitations imposed by the AIA). The U.S. Court of Appeals for the Sixth Circuit acknowledged the potential applicability of the DJA to the PPACA suit, but did not specifically address it either. See *Thomas More Law Center v. Obama*, 651 F.3d 529, 539 (6th Cir. 2011) (acknowledging that, “[I]n language at least as broad as the Anti-Injunction Act, the Declaratory Judgment Act forbids declaratory judgment action with respect to Federal taxes.” (Internal citations omitted)).

²⁰ *NFIB*, 132 S. Ct. at 2595-2596.

²¹ U.S. Const. Art. I, § 9, cl. 4.

²² *NFIB*, 132 S. Ct. at 2599 (citing *Hylton v. United States*, 3 Dall. 171, 174 (1796) (opinion of Chase, J.)).

²³ To the extent this suggests that the Constitutional limit on direct taxes should be interpreted narrowly, it weakens the argument that various consumption taxes would be unconstitutional. Compare Erik Jensen, *The Apportionment of “Direct Taxes”: Are Consumption Taxes Constitutional?*, 97 Colum. L. Rev. 2334 (Dec. 1997) with Bruce Ackerman, *Taxation and the Constitution*, 99 Colum. L. Rev. 1 (Jan. 1999) (arguing that the direct tax limitations should be interpreted narrowly).

²⁴ 682 F.3d 1 (1st Cir. 2012), *petition for cert. filed* (U.S. July 3, 2012) (No. 12-15). For a discussion of unanswered federal tax questions posed by state laws governing domestic partnerships, see National Taxpayer Advocate 2010 Annual Report to Congress 211 (Most Serious Problem: *State Domestic Partnership Laws Present Unanswered Federal Tax Questions*) and Status Update: *Federal Tax Questions Continue to Trouble Domestic Partners and Same-Sex Spouses*, *supra*. For prior coverage of this case, see National Taxpayer Advocate 2010 Annual Report to Congress 418, 426-427 (discussing *Gill v. Office of Pers. Mgmt.*, 699 F. Supp. 2d 374, 375 (D. Mass. 2010), *aff’d sub. nom. Massachusetts v. U.S. Dep’t. of Health & Human Servs.*, 682 F.3d 1 (1st Cir. 2012) [hereinafter *Gill*], which is the lower court’s decision in this case).

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“spouse” as a person of the opposite sex who is a husband or a wife.²⁵ DOMA does not invalidate same-sex marriages that certain states recognize as legal. However, by prohibiting the federal government from recognizing them, it deprives same-sex married couples of many of the benefits enjoyed by opposite-sex married couples. For example, same-sex couples are not entitled to the tax benefits associated with filing a joint federal income tax return.²⁶

In *Gill*, taxpayers brought suit to enjoin federal agencies from enforcing DOMA to deprive them of federal marriage-based benefits in violation of the equal protection principles embodied in the Due Process Clause of the Fifth Amendment.²⁷ Laws involving classifications that discriminate against certain “suspect” classes, such as race, are subject to “strict scrutiny,” which requires that the government have a compelling interest for the policy and that the policy be narrowly tailored to achieve the governmental interest by the least restrictive means.²⁸ Gender-based classifications are subject to “intermediate scrutiny,” requiring the law or policy to be substantially related to furthering an important government objective.²⁹ Laws discriminating against certain other classes of individuals are generally constitutional if they pass a “rational basis” test,³⁰ which simply requires the government policy to be rationally related to a legitimate governmental interest.³¹ The district court did not need to decide if strict (or intermediate) scrutiny applied because it concluded, “there exists no fairly conceivable set of facts that could ground a rational relationship’ between DOMA and a legitimate government objective.”³² Thus, it held that DOMA failed a rational-basis inquiry and violated the equal protection principles embodied in the Fifth Amendment.

In a consolidated appeal, the U.S. Court of Appeals for the First Circuit agreed that DOMA is unconstitutional. While the court concluded that it could not extend “strict” scrutiny by adding a new suspect class, it applied “intensified” scrutiny, which the Supreme Court has applied in cases where “minorities are subject to discrepant treatment,” and requires that the government interest be shown with “special clarity” when it intervenes in areas where state regulation has traditionally governed.³³ The court recognized that this case was not just about same-sex marriage, but also about a federal law intruding into a realm

²⁵ Defense of Marriage Act (DOMA), Pub. L. No. 104-199, § 3(a), 110 Stat. 2419 (1996) (codified at 1 U.S.C. § 7).

²⁶ A 2004 study by the Government Accountability Office (GAO) found that 1,138 federal statutory provisions tied benefits, protections, rights, or responsibilities to marital status. See GAO, GAO-04-353R, *Defense of Marriage Act: Update to Prior Report* (2004).

²⁷ *Gill*, 682 F.3d at 376.

²⁸ See, e.g., *Adarand Constructors, Inc. v. Peña*, 515 U.S. 200 (1995).

²⁹ See *Craig v. Boren*, 429 U.S. 190 (1976).

³⁰ Rational basis review usually leads to a ruling favorable to the government, as courts normally show deference to any legitimate governmental interest. See Gayle L. Pettinga, *Rational Basis with Bite: Intermediate Scrutiny by Any Other Name*, 62 Ind. L.J. 779 (1987).

³¹ See, e.g., *FCC v. Beach Commc’ns*, 508 U.S. 307 (1993).

³² *Gill*, 682 F.3d at 387. Prior to the enactment of DOMA, federal law incorporated each state’s marital status determinations. The government asserted that Congress enacted DOMA to preserve the *status quo* definitions of “marriage” and “spouse” during a time of debate when the status of same-sex marriage and related definitions were changing in individual states.

³³ *Massachusetts*, 682 F.3d at 10.

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traditionally controlled by the states — domestic relations and the regulation of marriage. Therefore, DOMA required more than the most deferential rational basis review.

Ultimately, the court concluded that the rationales offered by Congress for the enactment of DOMA — encouraging responsible procreation; defending heterosexual marriage and traditional notions of morality; protecting state sovereignty and democratic self-governance; and preserving scarce government resources — did not withstand intensified scrutiny or show the government's interest with special clarity. Thus, it held DOMA unconstitutional, but stayed implementation of its decision pending a likely appeal to the Supreme Court.³⁴

In *Windsor v. United States*, the U.S. Court of Appeals for the Second Circuit held unconstitutional DOMA's denial of a spousal deduction to a same-sex couple in computing the federal estate tax, and the United States Supreme Court has granted *certiorari*.³⁵

Edie Windsor and her late spouse, Thea Spyer, long-time New York residents, were married in Canada in 2007. Spyer died in 2009. Because of section three of DOMA, Windsor did not qualify for the unlimited marital deduction, under IRC § 2056(a), and was required to pay federal estate tax on Spyer's estate. Windsor paid the tax in her capacity as executor of the estate and filed suit, seeking a refund of the federal estate tax levied on Spyer's estate and a declaration that section three of DOMA violates the Equal Protection Clause of the Fifth Amendment.

After concluding that Windsor and Spyer's marriage would be recognized under New York state law, the United States District Court for the Southern District of New York held DOMA violated the Equal Protection Clause of the U.S. Constitution because it lacked a rational basis.

The U.S. Court of Appeals for the Second Circuit affirmed the district court. First, it distinguished *Baker v. Nelson*, in which the Supreme Court summarily dismissed a challenge to Minnesota law prohibiting same-sex marriage "for want of a substantial federal question."³⁶ It distinguished *Baker* as involving the constitutionality of a *state* law and cited significant developments since *Baker* was decided in 1971.³⁷ It noted that marriage is an area that has long been regarded as a virtually exclusive province of the States, but that DOMA is a federal law.

³⁴ See *Petition for Writ of Certiorari, Bipartisan Legal Advisory Grp. of the U.S. House of Representatives v. Gill*, No. 12-15 (U.S. July 3, 2012).

³⁵ 699 F.3d 169 (2nd Cir. 2012), *cert. granted* (Dec. 7, 2012) (No. 12-307) [hereinafter *Windsor*]. Although the 2nd Circuit's opinion was not decided within the reporting period, the lower court's decision, which was affirmed by the 2nd Circuit, was issued on June 2, 2011 (within the reporting period). See *Windsor v. United States*, 797 F. Supp. 2d 320 (S.D.N.Y. 2011).

³⁶ 409 U.S. 810 (1972).

³⁷ Intermediate level scrutiny had not been established in 1971. The Supreme Court had not yet ruled that a classification of homosexuals for its own sake lacked a rational basis. See *Romer v. Evans*, 517 U.S. 620 (1996). Nor had it yet ruled that the government could not make private homosexual conduct a crime. See *Lawrence v. Texas*, 539 U.S. 558 (2003).

Next, it recognized same-sex married couples as a “quasi-suspect” class and applied “intermediate scrutiny.” It reasoned (1) homosexuals have endured historic discrimination, (2) homosexuality has no relation to aptitude or ability to contribute to society, (3) homosexuals are a discernable group, and (4) the class remains a politically weak minority. To withstand intermediate scrutiny, a law must be substantially related to an important government interest. The court concluded that the rationales offered by Congress for the enactment of DOMA (described in *Gill*, summarized above) did not withstand intermediate scrutiny because they were not substantially related to an important government interest. Thus, it held DOMA unconstitutional. This case is particularly important because the Supreme Court has granted certiorari.

In *Estate of Petter v. Commissioner*, the U.S. Court of Appeals for the Ninth Circuit upheld a “reallocation clause” that allowed a taxpayer to avoid gift tax even after an IRS audit determined that a gift had been undervalued.³⁸

After inheriting a large amount of United Parcel Service (UPS) stock, Ms. Petter’s advisors designed a complex trust arrangement allowing her to maximize the stock she could give to her two children without having to pay gift tax. She transferred her UPS stock to a family-owned limited-liability company (LLC). She gave a specified number of LLC units to trusts controlled by her children, and gave the remaining units to two charities. The specified number of LLC units transferred to the trusts was the number worth a specified dollar amount – the amount that Ms. Petter could transfer tax-free to her children. A “reallocation clause” in the transfer documents required the trusts to transfer additional units to the charities if the value of the units initially received was “finally determined for federal gift tax purposes” to exceed the specified dollar amount that Ms. Petter could transfer tax-free.³⁹

On her gift tax return, Ms. Petter claimed that interests in the LLC were worth 59.3 percent less than the stock because LLC interests are less marketable than stock and because the LLC operating agreement restricted sales of the LLC interests. The IRS challenged the value of the transfers, and the parties ultimately settled on a 36 percent discount. Thus, the settlement triggered a transfer of additional LLC units from the trusts to the charities pursuant to the reallocation clauses.

The IRS viewed the reallocation clauses as requiring a second transfer of value to the charities that was contingent upon the outcome of the IRS’s audit. Thus, it argued they were either invalid as against public policy, or constituted a “condition precedent” that made the transfers nondeductible under Treas. Reg. § 25.2522(c)-3(b)(1).⁴⁰ Citing the general public

³⁸ 653 F.3d 1012 (9th Cir. 2011).

³⁹ Coupling the transfers of LLC units to the trusts with simultaneous transfers to charities created a “charitable freeze,” an “estate planning technique that seeks to ensure that if the IRS successfully challenges a taxpayer’s valuation of a gift, the amount by which the gift was undervalued does not go to the IRS as estate or gift tax, but rather to one or more charities named by the donor.” *Estate of Petter*, 653 F.3d at 1015 n.2.

⁴⁰ Treas. Reg. § 25.2522(c)-3(b)(1) reads in relevant part, “[I]f, as of the date of the gift, a transfer for charitable purposes is dependent upon the performance of some act or of the happening of a precedent event in order that it might become effective, no deduction is allowable.”

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policy in favor of encouraging gifts to charities and similar formulaic clauses that the IRS and the courts have endorsed, the Tax Court sided with Ms. Petter.⁴¹

The U.S. Court of Appeals for the Ninth Circuit agreed, reasoning that under the terms of the original transfer, the charities had the right to receive a pre-defined number of LLC units, even though that number would be determined by a formula.⁴² Thus, the IRS's determination that the LLC units had a greater fair market value than originally believed did not grant the charities the right to receive additional units. It merely ensured that they received the units they were originally entitled to receive. Accordingly, Treas. Reg. § 25.2522(c)-3(b)(1), did not bar Ms. Petter from claiming a charitable deduction equal to the value of the additional units received by the charities after the IRS audit determined the units had been undervalued. The court invited Treasury to “amend its regulations if troubled by the consequences of our resolution of this case.”⁴³

This case demonstrates how a donor can make wealth transfer tax valuations “essentially audit proof,” at least according to some commentators.⁴⁴ The IRS has no incentive to audit a donor's valuation if a successful audit is likely to increase the amount transferred to charity, rather than to increase the tax due to the IRS. In cases where charities have a practical and legal ability and incentive to prevent undervaluation of gifts they receive, IRS enforcement may not be necessary. The rationale of this case, however, may extend to situations where donee charities either have no ability or incentive to enforce their rights.⁴⁵

In Fort Properties, Inc. v. American Master Lease LLC, the U.S. Court of Appeals for the Federal Circuit held that a method for applying the tax-deferred property exchange rules under IRC § 1031 to “deed-shares” was not a patentable subject matter, even though some claims would be implemented using a computer.⁴⁶

American Master Lease LLC (AML) patented a method by which the property interests in a real estate portfolio are divided into shares (called “deed-shares”) and sold to investors like stock. Each deed-share could be encumbered by its own mortgage debt and exchanged tax-free for other “like-kind” property under IRC § 1031. Fort Properties, Inc., a real estate company, brought action against AML, seeking a declaration that it was not infringing AML's patent.⁴⁷

The district court concluded that the patent was invalid because it sought to cover an abstract idea.⁴⁸ It applied the *Bilski* Court's “machine or transformation” test which limits

⁴¹ *Estate of Petter v. Comm'r*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

⁴² The IRS did not pursue its public policy argument on appeal.

⁴³ *Estate of Petter*, 653 F.3d at 1023.

⁴⁴ See, e.g., John A. Bogdanski, *Defined Value Clauses Keep Trumping IRS Revaluations*, 39 *Est. Plan.* 37, 43 (Jan. 2012).

⁴⁵ *Id.*

⁴⁶ 671 F.3d 1317 (Fed. Cir. 2012), *aff'g* 609 F.Supp. 2d 1052 (C.D. Cal. 2009), *reh'g denied* (May 29, 2012).

⁴⁷ *Fort Props. Inc. v. Am. Master Lease, LLC*, 609 F.Supp.2d 1052 (C.D. Cal. 2009), *aff'd*, 671 F.3d 1317 (Fed. Cir. 2012).

⁴⁸ *Id.* at 1056.

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patentable subject matter to methods that (1) are tied to a particular machine or (2) transform an article into a different state or thing.⁴⁹ According to the patent, a computer would be used to generate the deed-shares, but AML admitted in its patent application that the method “need not be performed by a computer.”⁵⁰ Thus, the district court concluded the process was not tied to a machine. Because the court also concluded that the creation or transfer of a deed-share did not transform an article or thing (only legal ownership), it held the patent invalid.

The U.S. Court of Appeals for the Federal Circuit agreed.⁵¹ It analyzed other cases involving abstract business methods and concluded that the abstract concepts covered by the deed-share investment tool patent could not be transformed into a patentable subject matter merely because of connections to the physical world through deeds, contracts, and real property. It also concluded that claims covering the use of a computer were not sufficient to render the subject matter patentable because they did not impose meaningful limits on the claim’s scope.

In 2011, following recommendations from the American Institute of CPAs (AICPA), the National Taxpayer Advocate, and others, Congress barred the issuance of tax strategy patents.⁵² But the law applied prospectively, meaning that the roughly 160 tax strategy patents already issued by the U.S. Patent and Trademark Office remain on the books.⁵³ Accordingly, this case is significant because it provides guidance for determining the extent to which these tax strategy patents are valid.

In *Sarmiento v. United States*, the U.S. Court of Appeals for the Second Circuit held that the IRS’s contractual right to retain a taxpayer’s “overpayment of tax” under the terms of an offer-in-compromise included the right to retain refundable credits.⁵⁴

On November 14, 2007, married taxpayers entered into separate offer-in-compromise (OIC) agreements to settle unpaid tax liabilities. The taxpayers signed the standard IRS Form 656, *Offer in Compromise*, which requires that the taxpayer must agree to offer, as

⁴⁹ *In re Bilski*, 545 F.3d 943 (Fed. Cir. 2008), *aff’d sub nom. Bilski v. Kappos*, 130 S. Ct. 3218 (2010) [hereinafter *Bilski*]. For prior discussion of *Bilski*, see National Taxpayer Advocate 2009 Annual Report to Congress 403, 407; National Taxpayer Advocate 2010 Annual Report to Congress 414, 418.

⁵⁰ *Fort Props., Inc.*, 609 F. Supp. 2d at 1056.

⁵¹ The federal circuit acknowledged that the Supreme Court had subsequently indicated that that the “machine-or-transformation” test is simply “a useful and important clue, an investigative tool” and is not “the sole test for deciding whether an invention is a patent-eligible ‘process.’” *Bilski*, 130 S. Ct. at 3227. Accordingly, the federal circuit’s analysis focused more on precedent than on the machine-or-transformation test applied by the district court.

⁵² See, e.g., AICPA Position on Patents for Tax Planning Methods (2011), http://www.aicpa.org/Advocacy/Issues/DownloadableDocuments/TaxStrategyPatents/TSP_Overview_112th_Congress.pdf; National Taxpayer Advocate 2007 Annual Report to Congress 512 (Key Legislative Recommendation: *Eliminate Tax Strategy Patents*). The Leahy-Smith America Invents Act prevents a person from patenting a tax strategy that could subject taxpayers to royalties for using the strategy when filing their tax returns, except in connection with their use of software for financial services management, or return preparation or filing. Pub. L. No. 112-29, § 14, 125 Stat. 284, 327-28 (2011) (codified as 35 U.S.C. § 102 (note)).

⁵³ See AICPA, *List of 161 Issued Tax Strategy Patents as of 9/16/11 Date of Enactment that Remain in Existence* (Sept. 16, 2011), http://www.aicpa.org/InterestAreas/Tax/Resources/TaxPatents/DownloadableDocuments/InterestingPatents/Existing_Issued_Tax_Strategy_Patents_as_of_9_16_11_date_of_enactment.doc. For further analysis, see Jeremiah Coder, *Tax Patents Face Higher Bar After Federal Circuit Ruling*, 2012 TNT 41-3 (Feb. 29, 2012).

⁵⁴ 678 F.3d 147 (2d Cir. 2012).

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“additional consideration” to the IRS “overpayment of any tax or other liability, for tax periods extending through the calendar year in which the IRS accepts the offer.” The taxpayers paid the amounts required under their offers in 2008.

In early 2008, the taxpayers filed a joint return for 2007, claiming refundable credits, including the Earned Income Tax Credit, the Additional Child Tax Credit, and the Economic Stimulus Payment. The IRS retained these amounts, concluding that they constituted “additional consideration” under the terms of the OIC agreements and denied the taxpayer’s administrative claim to recover them.

The IRS reasoned that its interpretation of Form 656 was consistent with IRC § 6401(b) (1), which provides that if certain refundable credits exceed a taxpayer’s tax liability, “the amount of such excess *shall be considered* an overpayment.” In addition, IRC § 6428(g) treats the economic stimulus payments as a constructive overpayment of taxes, and “deems the stimulus credit to be a refund of this constructive overpayment.” Thus, the IRS concluded the credits were properly offset as “overpayments” for 2007.

The U.S. Court of Appeals for the Second Circuit found for the IRS. While the taxpayers acknowledged that the amounts in question were treated as “overpayments” under the IRC, their primary argument was that the terms “refund” and “overpayment,” as used in the OIC agreements, should be afforded their “ordinary ‘plain English’” meaning. The court rejected this argument, reasoning that, like Form 1040, *U.S. Individual Income Tax Return*, Form 656 is a specialized tax document and its terms must take their meaning from the IRC. Any other conclusion could inject unnecessary uncertainty into the interpretation of standard tax forms.

Second, the taxpayers argued that the stimulus payment related to 2008 – beyond the tax period covered by the overpayment offset provision. The court disagreed, concluding that the “advance refunds” provided by the stimulus payments under IRC § 6428(g) granted eligible taxpayers “a refund applicable to the 2007 tax year.” Thus, even though the credits would be applied in 2008, they were actually a “refund” of 2007 taxes, and therefore were properly retained by the IRS as additional consideration under the OIC agreements executed in 2007.

Finally, the taxpayers argued that they could not have agreed to allow the IRS to retain the stimulus payment because Congress had not enacted stimulus payments when they signed the Form 656. The court concluded that, because the language of Form 656 is unambiguous, by agreeing to the overpayment provision, the taxpayers assumed the risk that they would become eligible for unanticipated tax credits that they would have to forfeit. This

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case is significant because it clarifies how to interpret Form 656 and may provide insight into how the IRS and the courts will interpret other closing agreements.⁵⁵

In *Bemont Investments, LLC v. United States*, the U.S. Court of Appeals for the Fifth Circuit Court held that the 40 percent gross valuation misstatement penalty did not apply because the IRS totally disallowed the loss.⁵⁶

On his 2001 return, Mr. Beal claimed losses attributable to a tax shelter designated as a “listed transaction.” The IRS disallowed the losses because it disregarded the entities and transactions that purported to generate them as shams, lacking economic substance. The IRS sought various penalties including the 40 percent gross valuation misstatement penalty.

The district court found that because the IRS totally disallowed the losses, the overstatement was not “attributable to” a “valuation misstatement.” Thus, it applied the 20 percent negligence penalty, rather than the 40 percent gross valuation misstatement penalty. Relying on the *Todd* and *Heasley* cases, the Fifth Circuit Court of Appeals affirmed the district court’s holding on this point.⁵⁷

In a concurring opinion, Circuit Court Judge Prado, joined by Judges Reavley and Davis, criticized *Todd* and *Heasley*, arguing they had misinterpreted the Joint Committee on Taxation’s General Explanation (called the Blue Book) of the how to apply the gross valuation misstatement penalty. The Blue Book explains that the penalty is computed after taking unrelated adjustments to other items into account, but sheds no light on how to apply the penalty when a single item is disallowed on more than one basis (*e.g.*, both a gross valuation misstatement and a lack of economic substance), according to Judge Prado.⁵⁸

The IRS will continue to argue that the gross valuation misstatement penalty applies if an overvaluation is an integral part of a transaction, regardless of the grounds for disallowance

⁵⁵ This case may also highlight the continuing need for legislation to protect the EITC from being fully offset by the IRS. See National Taxpayer Advocate 2009 Annual Report to Congress 366-370. Under certain hardship circumstances, the IRS, using refund offset bypass procedures (OBR), may deviate from its normal procedures and give the taxpayer his or her refund rather than offset the refund to an outstanding tax liability under IRC § 6402. See IRM 21.4.6.5.12.1 (Aug. 31, 2012). The National Taxpayer Advocate will explore whether a taxpayer who is suffering a hardship and has entered an OIC might be able to use the OBR procedures to bypass the offset of a refund for the calendar year in which the IRS accepts the offer without defaulting on the agreement.

⁵⁶ 679 F.3d 339 (5th Cir. 2012).

⁵⁷ See *Todd v. Comm’r*, 862 F.2d 540 (5th Cir. 1988); *Heasley v. Comm’r*, 902 F.2d 380 (5th Cir. 1990). The court also discounted the IRS’s argument that Treas. Reg. § 1.6662-5(g), which explains that a value or basis of zero may be considered a gross valuation misstatement, negated the holdings of these cases. *Bemont*, 679 F.3d at 348 n.5.

⁵⁸ Judge Prado’s reasoning was cited with approval by the Federal Circuit Court of Appeals in June 2012. See *Alpha I, L.P. ex rel. Sands v. United States*, 682 F.3d 1009, 1029-30 (Fed. Cir. 2012).

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of the related deduction or credit.⁵⁹ This case is significant because it highlights a split of authority concerning the applicability of the gross valuation misstatement penalty.⁶⁰

In *Tigers Eye Trading, LLC v. Commissioner*, 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.⁶¹

The tax matters partner of *Tigers Eye Trading, LLC* (*Tigers Eye*), an entity that had engaged in a tax shelter, entered a stipulated decision, which the Tax Court approved in 2009. Pursuant to the decision, *Tigers Eye* was disregarded for Federal income tax purposes, its outside basis was reduced to zero, and partner-level accuracy-related penalties were applicable. Thus, the 40 percent gross valuation misstatement penalty applied to the partners' overstatement of outside bases.⁶²

In 2010, the Court of Appeals for the D.C. Circuit, the court to which *Tigers Eye* would be appealable, issued its decision in *Petaluma FX Partners, LLC v. Commissioner*.⁶³ *Petaluma* held that the Tax Court lacked jurisdiction to determine the partners' outside bases and accuracy-related penalties in a partnership-level proceeding.⁶⁴ In partnership-level proceedings, the Tax Court generally has jurisdiction only with respect to "partnership items," the allocation of such items, and penalties or additional amounts which relate to an adjustment to a partnership item.⁶⁵ The D.C. Circuit reasoned that outside basis was an "affected item" and not a "partnership item." Thus, the IRS would need to adjust the partners' outside bases by issuing a notice of deficiency to them (rather than by making a direct computational adjustment), which they could then dispute in the Tax Court.

After the *Petaluma* decision, *Tigers Eye* filed a motion for the Tax Court to revise its stipulated decision to remove the penalties applicable to the partners' outside bases. *Tigers Eye* argued that under the "Golsen rule," the Tax Court did not have jurisdiction to approve a

⁵⁹ *Keller v. Comm'r*, 556 F.3d 1056, 1061 (9th Cir. 2009), *aff'g in part, rev'g in part and remanding* T.C. Memo. 2006-131, *action on dec.* 2011-02, I.R.B. 2011-44 (Oct. 31, 2011) (nonacq.). The IRS may also oppose a taxpayer's concession in cases involving abusive tax shelter transactions if the application of valuation misstatement penalties is at issue. See CC-Notice 2012-001 (Oct. 5, 2011).

⁶⁰ As the Judge Prado observed, "[E]xcept for the Ninth Circuit, every sister circuit that has considered the issue has concluded that the valuation misstatement penalty may apply even if the deduction is totally disallowed because the underlying transaction lacked economic substance." *Bemont*, 679 F.3d at 354. However, a 40 percent penalty now 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 (Mar. 30, 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). See also, IRC § 6664(d)(2) (no reasonable cause exception for transactions lacking economic substance).

⁶¹ 138 T.C. No. 6 (2012), *appeal docketed sub nom. Logan Trust v. Comm'r*, No. 12-1148 (D.C. Cir. Mar. 16, 2012) [hereinafter *Tigers Eye*].

⁶² The Tax Court had previously denied the participating partners' right to interpose the partner-level reasonable cause defenses to accuracy-related penalties. *Id.* at 17, n.10.

⁶³ 591 F.3d 649 (U.S. App. D.C. 2010), *aff'd*, T.C. Memo. 2012-142 [hereinafter *Petaluma*].

⁶⁴ Other courts have followed *Petaluma* in this regard. See, e.g., *Jade Trading, LLC v. United States*, 598 F.3d 1372 (Fed. Cir. 2010), *aff'g in part, vacating and remanding in part* 80 Fed. Cl. 11 (2007). For a discussion of *Petaluma*, see National Taxpayer Advocate 2010 Annual Report to Congress 422.

⁶⁵ IRC § 6226(f).

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stipulated decision covering outside basis and partner-level penalties given the circuit court decision in *Petaluma*.⁶⁶

The Tax Court denied *Tigers Eye*'s motion, holding that it had jurisdiction. It noted that in *Petaluma* the government had conceded that outside basis was an affected item, arguing instead that the Tax Court had jurisdiction because the elements of an affected item (partner-level penalties) consisted entirely of partnership items.⁶⁷ Because *Petaluma* did not consider precisely the same issue, the Tax Court concluded that *Golsen* did not apply and characterized some of its analysis as "dicta." The Tax Court also cited the recent decisions of the Supreme Court and D.C. Circuit in *Mayo* and *Intermountain* for the proposition that federal courts must defer to regulations, rather than follow earlier case law.⁶⁸ The Tax Court went on to conclude that, because the partnership was disregarded for tax purposes, the disallowance of outside bases was a partnership item over which it had jurisdiction, and that it also had jurisdiction to determine partner-level accuracy-related penalties that flowed from the disallowance.

This decision addresses important questions about the scope of the Tax Court's jurisdiction in partnership-level proceedings. However, it may also be significant because the court's rationale for not applying the so-called *Golsen* rule suggests that the Tax Court will not always follow decisions of a circuit court to which a case is appealable.⁶⁹

⁶⁶ See *Golsen v. Comm'r*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971) (holding that the Tax Court would follow the case law of the Circuit to which a case was appealable).

⁶⁷ In a status report filed May 19, 2010, the government made the same concession in *Tigers Eye*. See *Tigers Eye*, 138 T.C. No. 6 *160 (J. Wherry, concurring, and characterizing the statement as a concession of fact). According to press accounts, a contrary position "could easily prejudice the government in other ongoing litigation." Shamik Trivedi, *Tax Court Thumbs its Nose at D.C. Circuit's Ruling on TEFRA Jurisdiction*, 2012 TNT 31-2 (Feb. 15, 2012) (quoting Thomas A. Cullinan).

⁶⁸ *Mayo Found. for Medical Educ. & Research v. U.S.*, 131 S. Ct. 704 (2011), *aff'g* 568 F.3d 675 (8th Cir. 2009), *rev'g* 503 F. Supp. 2d 1164 (D. Minn. 2007) [hereinafter *Mayo*]; *Intermountain*, *supra*. For summaries of these cases, see National Taxpayer Advocate 2011 Annual Report to Congress 593, 594 (discussing *Mayo*) and National Taxpayer Advocate 2010 Annual Report to Congress 418, 423 (discussing *Intermountain*). As J. Holmes observes in dissent, however, the D.C. Circuit cited the regulations in *Petaluma* and no one had challenged their validity. *Tigers Eye*, 138 T.C. No. 6 *200-02.

⁶⁹ J. Holmes, in dissent, characterizes the majority opinion as a brazen challenge to the D.C. Circuit's precedent — a "reverse benchslap." *Tiger's Eye*, 138 T.C. No. 6 *211.

MLI
#1**Summons Enforcement Under IRC §§ 7602, 7604, and 7609****SUMMARY**

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

A person who has a summons served upon him or her may contest its legality if the government petitions to enforce it.³ 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.⁴ Generally, the burden on the taxpayer to establish the illegality of the summons is heavy.⁵ We identified 153 federal cases decided between June 1, 2011 and May 31, 2012 that included issues of IRS summons enforcement. The parties contesting the summonses did not fully prevail in any of these cases, but one case resulted in a split decision, and the IRS prevailed in the remaining 152 cases. Of 13 cases with docketed appeals, five have since been dismissed.

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.⁶ 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.⁷ However, the IRS may not issue a summons *after* referring the matter to the Department of Justice (DOJ).⁸ If the recipient fails to comply with a summons, the United States may commence an action under IRC § 7604 in the appropriate United States District Court to compel production or testimony.⁹ If the United States files a petition to enforce the summons, the taxpayer may contest the validity of the summons in that proceeding.¹⁰ Also,

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

² IRC § 7602(a).

³ *U.S. v. Powell*, 379 U.S. 48, 58 (1964).

⁴ IRC § 7609(b).

⁵ *Hill v. U.S.*, 2012 U.S. Dist. LEXIS 73696 (W.D. Mo. 2012), *adopting* 2012 U.S. Dist. LEXIS 73699 (W.D. Mo. 2012).

⁶ IRC § 7602(a). See also *LaMura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985) (citing *U.S. v. Bisceglia*, 420 U.S. 141, 145-146 (1975)).

⁷ 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).

⁸ 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).

⁹ IRC § 7604.

¹⁰ *U.S. v. Powell*, 379 U.S. 48, 58 (1964).

if the summons is served upon a third party, any person entitled to notice may initiate a petition to quash the summons in an appropriate U.S. District Court, or intervene in any proceeding regarding the enforceability of the summons.¹¹

A taxpayer or other person named in a third-party summons is generally entitled to notice,¹² but there are exceptions. 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.”¹³ This exception reflects congressional recognition of a difference between a summons issued in an attempt to compute the taxpayer’s taxable income, and a summons issued after the IRS has made an assessment or obtained a judgment. For example, notice would not be necessary where the IRS has made the assessment and is attempting to determine whether the taxpayer has an account in a certain bank with sufficient funds to pay the tax. Giving taxpayers notice in such a situation would seriously impede the IRS’s ability to collect the tax.¹⁴ The courts have interpreted this “aid of collection” exception to apply only where the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned.¹⁵ Another situation where no notice is necessary is when an IRS criminal investigator serves a summons, in connection with a criminal investigation, on any person who is not the third-party recordkeeper.¹⁶

Regardless of whether the taxpayer contests the summons in a motion to quash or a response to an IRS petition to enforce, the legal standard is the same.¹⁷ In *United States v. Powell*, the Supreme Court set forth four threshold 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.¹⁸

¹¹ 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).

¹² IRC § 7609(a)(1); *Jordan v. U.S.*, 108 A.F.T.R.2d (RIA) 6821 (S.D. Ohio 2011), *adopted by* 108 A.F.T.R.2d (RIA) 6824 (S.D. Ohio 2011).

¹³ IRC § 7609(c)(2)(D)(i). The exception also applies to the collection of a liability of “any transferee of any person referred to in clause (i).” IRC § 7609(c)(2)(D)(ii).

¹⁴ H.R. Rep. No. 94-658 at 310, reprinted in 1976 U.S.C.C.A.N. at 3206. See also S. Rep. No. 94-938, pt. 1, at 371-371, reprinted in 1976 U.S.C.C.A.N. at 3800-01 (containing essentially the same language).

¹⁵ *Ip v. U.S.*, 205 F.3d 1168, 1172-76 (9th Cir. 2000).

¹⁶ 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).

¹⁷ *Phillips v. IRS*, 99 A.F.T.R.2d (RIA) 3487 (D. Ariz. 2007).

¹⁸ *U.S. v. Powell*, 379 U.S. 48, 57-58 (1964).

The IRS bears the initial burden of establishing that these requirements have been satisfied.¹⁹ However, this burden is minimal, as the government need only introduce a sworn affidavit of the agent who issued the summons declaring that each of the Powell requirements has been satisfied.²⁰ 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.²¹

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

- Attorney-client privilege;²²
- Tax practitioner privilege;²³ or
- Work-product privilege.²⁴

However, these privileges are limited. For example, they extend to “tax advice,” but not to tax return preparation materials.²⁵ Another limitation is the “tax shelter” exception, which permits discovery of communications between a tax practitioner and client that promote participation in any tax shelter.²⁶ Under the tax shelter exception, 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.”²⁷ 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.”²⁸

¹⁹ *Fortney v. U.S.*, 59 F.3d 117, 119-20 (9th Cir. 1995).

²⁰ *U.S. v. Dynavac, Inc.*, 6 F.3d 1407, 1414 (9th Cir. 1993).

²¹ *Id.*

²² The attorney-client privilege provides protection from discovery of information where:

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

²³ IRC § 7525 extends the protection of the common law attorney-client privilege to federally authorized tax practitioners in federal tax matters. Criminal tax matters and communications regarding tax shelters are exceptions to the privilege. IRC § 7525(a)(2), (b). The tax practitioner privilege is interpreted based on the common law rules of the attorney-client privilege. *U.S. v. BDO Seidman, LLP*, 337 F.3d 802, 810-812 (7th Cir. 2003), *cert. denied*, *Roes v. U.S.*, 540 U.S. 1178 (2004).

²⁴ 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).

²⁵ *U.S. v. Frederick*, 182 F.3d 496, 500 (7th Cir. 1999), *cert. denied*, 528 U.S. 1154 (2000).

²⁶ IRC § 7525(b); *Valero Energy Corp. v. U.S.*, 569 F.3d 626 (7th Cir. 2009).

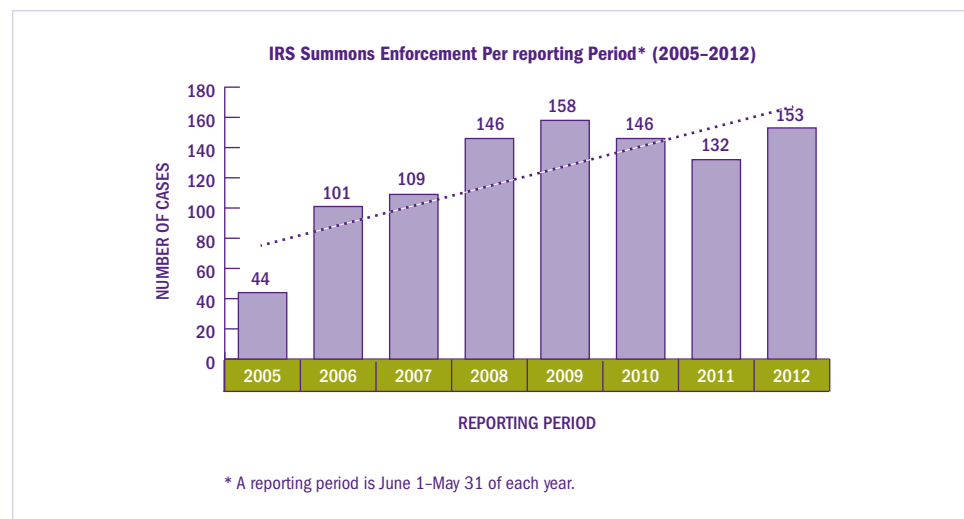
²⁷ IRC § 7525(b).

²⁸ IRC § 6662(d)(2)(C)(ii).

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. At that time, we identified only 44 cases but predicted the number would rise as the IRS became more aggressive in its enforcement initiatives. The volume of identified cases has risen from 101 during the reporting period ending on May 31, 2006 to 153 during this year's reporting period as shown in Figure 3.1.1 below. A detailed list of these cases appears in Table 1 of Appendix III.

FIGURE 3.1.1, Summons Enforcement Cases, 2005-2012



The IRS prevailed in full in 152 cases, and one resulted in a split decision. Taxpayers did not prevail in full in any case. Attorneys represented taxpayers in 29 cases, while taxpayers appeared *pro se* (i.e., without counsel) in 123 cases.²⁹ One-hundred and fifteen cases involved individual taxpayers, while the remaining 38 involved business taxpayers, including sole proprietorships (16 of whom had representation). The arguments the litigants raised against IRS summonses generally fell into the following categories:

Powell Requirements: Taxpayers frequently argued that the IRS did not meet one or more of the *Powell* requirements, but such arguments met with little success. This outcome is due in large part to the substantial burden placed upon the taxpayer to rebut the IRS's *prima facie*³⁰ showing that the summons should be enforced. The United States Court of

²⁹ In the remaining case, *In re Does*, 108 A.F.T.R.2d (RIA) 7499 (E.D. Cal. 2011), the United States commenced an *ex parte* proceeding seeking court approval of a "John Doe" summons.

³⁰ "*Prima facie*" means "at first sight, on first appearance but subject to further review or evidence." *Black's Law Dictionary* (9th ed. 2009).

Appeals for the Eighth Circuit has described the IRS's burden here to be slight, and the taxpayer's burden to be great.³¹

Criminal Referral: The IRS may issue summonses for the purpose of investigating a possible criminal offense, so long as the matter has not yet been referred to the DOJ.³² Many taxpayers argued that because the IRS issued the summons pursuant to a possible criminal investigation, it violated the IRC § 7602(d) restriction on issuing a summons after referring the matter to the DOJ. However, the courts were careful to distinguish between a *referral* to the DOJ, which prevents the IRS from issuing a summons, and a *criminal investigation* by the IRS, which does not.³³

Constitutional Arguments: Taxpayers asserted several constitutional arguments, without success. For example, courts have long stated that taxpayers cannot use the Fourth Amendment as a defense against a third-party summons.³⁴ Although the courts also rejected blanket assertions of Fifth Amendment protection,³⁵ taxpayers may have valid Fifth Amendment claims regarding specific documents or testimony.³⁶ Even though a taxpayer may assert the claim on behalf of himself or herself, he or she may not assert it on behalf of a business entity.³⁷ Courts have also rejected First Amendment arguments against summons enforcement. In one case, the court rejected a taxpayer's claim that his First Amendment rights were violated by IRS agents who were attempting to "deter or chill respondent's speaking out against harassing agent conduct."³⁸ Courts also rejected taxpayers' arguments that summons enforcement violated their rights under federal privacy laws.³⁹ Some taxpayers argued, without success, that the summonses issued were unconstitutionally overbroad.⁴⁰

In limited circumstances, the IRS can issue a summons even if the name of the taxpayer under investigation is unknown,⁴¹ *i.e.*, a "John Doe" summons.⁴² In *In re: Does*,⁴³ the court

³¹ *U.S. v. Claes*, 747 F.2d 491, 494 (8th Cir. 1984).

³² See, e.g., *Peterson v. U.S.*, 109 A.F.T.R.2d (RIA) 1099 (D. Neb. 2012).

³³ See, e.g., *Gonzalez v. U.S.*, 108 A.F.T.R.2d (RIA) 6652 (N.D. Ill. 2011).

³⁴ *Lewis v. U.S.*, 109 A.F.T.R.2d (RIA) 1756 (E.D. Cal. 2012) (citing *Donaldson v. U.S.*, 400 U.S. 517, 522 (1971)).

³⁵ *U.S. v. Sakai*, 107 A.F.T.R.2d (RIA) 2757 (D. Haw. 2011), *adopted by* 107 A.F.T.R.2d (RIA) 2765 (D. Haw. 2011).

³⁶ *U.S. v. Schlewis*, 108 A.F.T.R.2d (RIA) 5297 (D. Colo. 2011), *appeal docketed*, No. 11-1329 (10th Cir. July 20, 2011).

³⁷ *Id.*

³⁸ *Canatella v. U.S.*, 108 A.F.T.R.2d (RIA) 5256 (N.D. Cal. 2011), *appeal docketed*, No. 11-2175 (9th Cir. Aug. 5, 2011).

³⁹ See, e.g., *Talbot v. U.S.*, 108 A.F.T.R.2d (RIA) 5309 (D. Ariz. 2011), *appeal docketed*, No. 11-17166 (9th Cir. Sept. 13, 2011); *Jordan v. U.S.*, 108 A.F.T.R.2d (RIA) 6821 (S.D. Ohio 2011), *adopted by* 108 A.F.T.R.2d (RIA) 6824 (S.D. Ohio 2011).

⁴⁰ See, e.g., *U.S. v. Lyons*, 107 A.F.T.R.2d (RIA) 2733 (E.D. Tex. 2011), *adopting* 107 A.F.T.R.2d (RIA) 2732 (E.D. Tex. 2011); *U.S. v. Lano Equip., Inc.*, 2012 U.S. Dist. LEXIS 77900 (D. Minn. 2012), *adopted by* 2012 U.S. Dist. LEXIS 77392 (D. Minn. 2012).

⁴¹ IRC § 7609(f).

⁴² 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).

⁴³ 108 A.F.T.R.2d (RIA) 7499 (E.D. Cal. 2011).

granted the IRS's revised *ex parte* petition to serve a "John Doe" summons on the California Board of Equalization, which it previously denied without prejudice.⁴⁴ The IRS summons sought to identify, from California state records, a class of taxpayers who had made non-spousal transfers of real property to related parties for little or no consideration.⁴⁵ The court concluded that the IRS met all three elements of IRC § 7609(f) and held that the Tenth and Eleventh Amendments to the Constitution did not prohibit the issuance of a "John Doe" summons on a state.⁴⁶ The court reasoned that because the Tenth Amendment does not prevent a federal grand jury from subpoenaing a state, it cannot bar an IRS summons. The court also concluded that the Eleventh Amendment only provides states sovereign immunity when the state is being sued by private individuals, not when the state is sued by the United States.⁴⁷

In *Miccosukee Tribe of Indians of Florida v. United States*, the taxpayer, the Miccosukee Tribe of Indians (the Tribe), argued that tribal sovereign immunity barred the United States from issuing summonses to financial institutions to obtain the Tribe's financial records.⁴⁸ In that case, the IRS issued summonses to several financial institutions seeking the Tribe's records to determine whether the Tribe had properly complied with its federal tax reporting and withholding obligations. The Tribe argued that tribal sovereign immunity barred the United States from issuing the summonses. The court rejected the claim, holding that tribal sovereign immunity does not bar suits by the United States and cannot be invoked to "prevent the federal government from exercising its superior sovereign power."⁴⁹

Privilege: Courts generally rejected claims of attorney-client privilege. In *Dougan v. United States*,⁵⁰ the court rejected the taxpayer's argument that the attorney-client privilege protected his bank records from being summoned. The taxpayer, a personal injury attorney, argued that to examine his bank records would be tantamount to violating his clients' confidences.⁵¹ The court concluded that the bank records did not constitute confidential communications between an attorney and his clients, and thus were not subject to the attorney-client privilege.⁵² In a few cases, taxpayers asserted blanket claims of attorney-client

⁴⁴ See *In re: Does*, 107 A.F.T.R.2d (RIA) 2318 (E.D. Cal. 2011). The earlier proceeding in this case was included in the case table in the National Taxpayer Advocate's 2011 Annual Report to Congress at 701.

⁴⁵ Most gifts above a certain value must be reported on a Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*. IRC § 6019. Two legal commentators believe that this litigation reveals a major ongoing IRS compliance initiative in the area of unfiled gift tax returns. See Scott D. Michel and Beth Shapiro Kaufman, *Unreported Gifts of Real Property: Time for a Voluntary Disclosure?*, 132 Tax Notes 513 (2011).

⁴⁶ *In re: Does*, 108 A.F.T.R.2d (RIA) 7499 (E.D. Cal. 2011).

⁴⁷ *Id.*

⁴⁸ 108 A.F.T.R.2d (RIA) 5572 (S.D. Fla. 2011), *appeal docketed*, No. 11-14825 (11th Cir. Oct. 17, 2011), *motion to stay pending appeal denied* by 108 A.F.T.R.2d (RIA) 7072 (S.D. Fla. 2011).

⁴⁹ 108 A.F.T.R.2d (RIA) 5572 (S.D. Fla. 2011), (citing *Fla. Paraplegic Assoc'n v. Miccosukee Tribe of Indians*, 166 F.3d 1126, 1127 (11th Cir. 1999)), *appeal docketed*, No. 11-14825 (11th Cir. Oct. 17, 2011), *motion to stay pending appeal denied* by 108 A.F.T.R.2d (RIA) 7072 (S.D. Fla. 2011).

⁵⁰ 108 A.F.T.R.2d (RIA) 5847 (E.D. Cal. 2011), *adopted* by 108 A.F.T.R.2d (RIA) 6663 (E.D. Cal. 2011).

⁵¹ *Id.*

⁵² *Id.*

privilege but failed to identify specific communications the privilege covered.⁵³ The courts required the taxpayers to produce logs describing which documents they believed were protected.⁵⁴

In addition to the attorney-client privilege, taxpayers may use the tax practitioner privilege under IRC § 7525 or the work-product privilege as defenses to summons enforcement. The tax practitioner privilege exists to the extent the communication would be considered privileged if it took place between a taxpayer and an attorney and its purpose was obtaining tax advice from a federally authorized tax practitioner.⁵⁵

In *United States v. PricewaterhouseCoopers, LLP*, the court considered the applicability of the tax practitioner privilege.⁵⁶ In that case, a husband and wife had their returns prepared by PricewaterhouseCoopers (PWC). The IRS issued a summons to PWC seeking the documents used to prepare the returns. Upon learning about the summons, the taxpayers retained an attorney, who wrote to PWC stating that the firm should not disclose the information because it was privileged under IRC § 7525. PWC sent the taxpayers copies of all documents in its possession and requested that they identify any privileged ones. However, the taxpayers did not identify purportedly confidential documents, nor did they intervene or move to quash the summonses in the enforcement proceeding. While PWC did not object to enforcement of the summonses based on privilege or otherwise, it requested the protection of a court order requiring production in light of the letter it had received from the taxpayers' attorney.⁵⁷ The court held that the taxpayers had waived any privilege by failing to intervene or file a move to quash in the proceeding. The court noted further that even had the taxpayers properly asserted a privilege, it would not have been upheld in this case, as there was no indication that the documents contained "confidential tax advice or other communications."⁵⁸

Finally, in one case, a court rejected a taxpayer's work-product objection to summons enforcement. In *United States v. Sakai*,⁵⁹ the court concluded that under a totality of the circumstances, the taxpayers' amended returns were not prepared "because of" litigation, since the IRS had not yet begun its audit when they were prepared, and so the taxpayer's accountant could not invoke the privilege to avoid testifying about the returns.

⁵³ *U.S. v. Sakai*, 107 A.F.T.R.2d (RIA) 2757 (D. Haw. 2011), adopted by 107 A.F.T.R.2d (RIA) 2765 (D. Haw. 2011); *Amabile*, U.S. v., 2011 U.S. Dist. LEXIS 146350 (E.D. Pa. 2011).

⁵⁴ *Id.*

⁵⁵ IRC § 7525(a)(1).

⁵⁶ 2012 U.S. Dist. LEXIS 64517 (D. Minn. 2012), adopting 2012 U.S. Dist. LEXIS 63808 (D. Minn. 2012).

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ 107 A.F.T.R.2d (RIA) 2757 (D. Haw. 2011), adopted by 107 A.F.T.R.2d (RIA) 2765 (D. Haw. 2011).

The IRS prevailed in all 39 of the cases involving motions to quash summonses, in part because the courts lacked jurisdiction to hear the cases. The courts dismissed these cases for lack of jurisdiction for the following reasons:

Lack of Jurisdiction Due to Procedural Requirements: The United States is immune from suit unless Congress has expressly waived its sovereign immunity.⁶⁰ Since a motion to quash service of an IRS summons is a suit against the United States, a court has jurisdiction only when Congress has expressly waived sovereign immunity.⁶¹ When a taxpayer wishes to challenge an IRS summons issued to a third party, federal law sets forth the exclusive method by which a taxpayer may proceed.⁶² A taxpayer may initiate a proceeding in the U.S. District Court for the district in which the third party resides, no later than 20 days from the date the notice of summons was given.⁶³ Accordingly, courts have strictly construed IRC § 7609 when determining whether sovereign immunity has been waived.⁶⁴ For example, a court dismissed a *pro se* taxpayer's motion to quash for lack of jurisdiction, because the taxpayer filed the motion 11 days after the 20-day limit had expired.⁶⁵ Another court held that it lacked subject matter jurisdiction over a petition to quash a third-party tax summons, where the third parties neither resided nor were found within the jurisdiction of the District Court.⁶⁶

In *Day v. United States*,⁶⁷ the government served summonses upon two banks to investigate a taxpayer who asserted that he was a *bona fide* resident of the United States Virgin Islands (USVI) and was not required to file a U.S. tax return. The taxpayer moved to quash the summons, arguing that the IRS acted in bad faith, because it essentially eliminated the statute of limitations for USVI residents with gross income exceeding \$75,000 for taxable years ending before December 31, 2006.⁶⁸ The court rejected this argument and held that substantive challenges to the statutory period of limitation on assessments do not constitute a defense to an IRS summons.⁶⁹

Lack of Jurisdiction Due to Notice Requirements: Courts denied several 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

⁶⁰ *U.S. v. Dalm*, 494 U.S. 596, 608 (1990).

⁶¹ *Grant v. U.S.*, 2012 U.S. Dist. LEXIS 2972 (C.D. Cal. 2012).

⁶² IRC § 7609(b)(2)(A). See *Lewis v. U.S.*, 109 A.F.T.R.2d (RIA) 1756 (E.D. Cal. 2012).

⁶³ IRC § 7609(b)(2)(A); *Mayberry v. U.S.*, 108 A.F.T.R.2d (RIA) 5497 (E.D.N.C. 2011).

⁶⁴ *Dunich-Kolb v. U.S.*, 108 A.F.T.R.2d (RIA) 5165 (D.N.J. 2011).

⁶⁵ *Mayberry v. U.S.*, 108 A.F.T.R.2d (RIA) 5497 (E.D.N.C. 2011).

⁶⁶ *Williams v. U.S.*, 453 Fed. Appx. 532 (5th Cir. 2011) (per curiam), *aff'g* 107 A.F.T.R.2d (RIA) 1453 (N.D. Tex. 2011).

⁶⁷ 108 A.F.T.R.2d (RIA) 6266 (D. Colo. 2011).

⁶⁸ For a detailed discussion of the statutory period of limitations issue pertaining to USVI residents, see National Taxpayer Advocate 2009 Annual Report to Congress 391-399 (Legislative Recommendation: *Provide a Fixed Statute of Limitations for U.S. Virgin Islands Taxpayers*). The taxpayer also cited the 2009 Annual Report to Congress for the proposition that, in his opinion, the IRS had acted in bad faith.

⁶⁹ 108 A.F.T.R.2d (RIA) 6266 (D. Colo. 2011). The court also concluded that its reasoning would not change even if the taxpayer were to challenge the statutory period for assessment on constitutional grounds.

validity.⁷⁰ In *Viewtech, Inc. v. United States*,⁷¹ the court concluded that neither an individual taxpayer, nor a corporation in which he had a sufficient interest, was entitled to notice, so neither had standing to quash the summons.

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.⁷² Accordingly, the IRS may request documents and testimony from taxpayers who have failed to provide that information voluntarily. Taxpayers and third parties rarely succeed in contesting IRS summonses due to the significant burden of proof and strict procedural requirements. Thus, taxpayers seldom challenge summons enforcement at the appellate level.⁷³ It appears that as the IRS employs a more aggressive enforcement policy, it will continue to rely heavily on the summons enforcement tool, and the courts will continue to see these cases.

⁷⁰ IRC § 7609(c)(2)(D)(i); *Viewtech, Inc. v. U.S.*, 653 F.3d 1102 (9th Cir. 2011), *aff'g* 104 A.F.T.R.2d (RIA) 7101 (S.D. Cal. 2009).

⁷¹ *Id.*

⁷² IRC § 7602(a).

⁷³ Appeals were docketed in only 13 of the 153 cases reviewed herein, and five have since been dismissed.

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

Internal Revenue Code (IRC) §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if an underpayment exceeded a computational threshold called a substantial understatement. IRC § 6662(b) also authorizes the IRS to impose five other accuracy-related penalties.¹ We did not analyze these other accuracy-related penalties because during our review period of June 1, 2011, through May 31, 2012, taxpayers litigated these penalties less frequently than the negligence and substantial understatement penalties.

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.² The IRS may assess penalties under both IRC § 6662(b)(1) and IRC § 6662(b)(2), but the total penalty rate cannot exceed 20 percent (*i.e.*, the penalties are not "stackable").³ 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.⁴ In addition, a taxpayer will be subject to the negligence component of the penalty only on the portion of the underpayment attributable to negligence. For example, if a taxpayer wrongly reports multiple items of income, 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 as "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."⁵ Negligence includes a failure to keep adequate books and records or to

¹ IRC § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement for income taxes; IRC § 6662(b)(4) authorizes a penalty for any substantial overstatement of pension liabilities; IRC § 6662(b)(5) authorizes a penalty for any substantial valuation understatement of estate or gift taxes; IRC § 6662(b)(6) authorizes a penalty when the IRS disallows the tax benefits claimed by the taxpayer when the transaction lacks economic substance; and IRC § 6662(b)(7) authorizes a penalty for any undisclosed foreign financial asset understatement. Note, however, that there has been some significant litigation involving IRC § 6662(h) (the increased penalty in the case of a gross valuation misstatement). For additional discussion of that litigation, see *Significant Cases, supra*.

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

³ Treas. Reg. § 1.6662-2(c). The penalty rises to 40 percent if any portion of the underpayment is due to a "gross valuation misstatement." See IRC § 6662(h)(1).

⁴ IRC § 6664(c)(1).

⁵ IRC § 6662(c).

substantiate items that gave rise to the underpayment.⁶ 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),⁷ or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.⁸ The IRS can also consider various other factors in determining whether the taxpayer's actions were negligent.⁹

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.¹⁰ 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.¹¹ 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.¹² 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 \$10,000,000.¹³

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

Reasonable Cause

The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.¹⁴ A reasonable cause

⁶ Treas. Reg. § 1.6662-3(b)(1).

⁷ IRC § 6724(d)(1) defines an information return by cross-referencing various other sections of the Code that define information returns (e.g., IRC § 6724(d)(1)(A)(ii) cross-references IRC § 6042(a)(1) for reporting of dividend payments).

⁸ Treas. Reg. § 1.6662-3(b)(1)(i)-(ii).

⁹ 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 (May 14, 1999).

¹⁰ IRC § 6662(d)(2)(A)(i)-(ii).

¹¹ 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).

¹² IRC § 6662(d)(1)(A)(i)-(ii).

¹³ IRC § 6662(d)(1)(B)(i)-(ii).

¹⁴ IRC § 6664(c)(1).

determination takes into account all of the pertinent facts and circumstances.¹⁵ Generally, the most important factor is the extent of the taxpayer's effort to determine the proper tax liability.¹⁶

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process¹⁷ and through its Automated Underreporter (AUR) computer system.¹⁸ Before a taxpayer receives a notice of deficiency, he or she has opportunities to engage the IRS on the merits of the penalty.¹⁹ Once the IRS concludes an accuracy-related penalty is warranted, it must follow the same deficiency procedures it uses with other assessments (*i.e.*, IRC §§ 6211-6213).²⁰ Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to petition the United States Tax Court to challenge the assessment.²¹ Alternatively, taxpayers may seek judicial review through refund litigation.²² Under certain circumstances, a taxpayer can request an administrative appeal of IRS collection procedures (and the underlying liability) through a Collection Due Process (CDP) hearing.²³

¹⁵ Treas. Reg. § 1.6664-4(b)(1).

¹⁶ *Id.*

¹⁷ IRM 4.10.6.2(1) (May 14, 1999) ("assessment of penalties should be considered throughout the audit"). See also IRM 20.1.5.3(1)-(2) (Jan. 24, 2012).

¹⁸ 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 (July 31, 2012). 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.")

¹⁹ For example, when the IRS proposes to adjust a taxpayer's liability, including additions to tax such as the accuracy-related penalty, it typically sends a notice ("30-day letter") of proposed adjustments to the taxpayer. A taxpayer has 30 days to contest the proposed adjustments to 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).

²⁰ IRC § 6665(a)(1).

²¹ 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.

²² Taxpayers may litigate an accuracy-related penalty by paying the tax liability (including the penalty) in full, filing a timely claim for refund, and then instituting a refund suit in the appropriate United States District Court or the Court of Federal Claims. 28 U.S.C. § 1346(a)(1); IRC § 7422(a); *Flora v. United States*, 362 U.S. 145 (1960) (requiring full payment of tax liabilities as a prerequisite for jurisdiction over refund litigation).

²³ IRC §§ 6320 and 6330 provide for due process hearings in which a taxpayer may raise a variety of issues including the underlying liability, provided the taxpayer did not receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute such liability. IRC §§ 6320(c), 6330(c)(2).

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.²⁴ 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.²⁵

ANALYSIS OF LITIGATED CASES

We identified 117 opinions issued between June 1, 2011 and May 31, 2012 where taxpayers litigated the negligence/disregard of rules or regulations or substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 77 cases (66 percent), the taxpayers prevailed in full in 29 cases (25 percent), and 11 cases (nine percent) resulted in split decisions. Table 2 in Appendix III provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 53 of the 117 cases (45 percent) and convinced the court to dismiss or reduce the penalty in 14 (26 percent) of those cases. Represented taxpayers fared much better, achieving full or partial relief from the penalty in 26 of their 64 cases (41 percent).

In some cases, the court found taxpayers liable for the accuracy-related penalty but failed to clarify whether it was for negligence under § 6662(b)(1), or a substantial understatement of tax under § 6662(b)(2), or both.²⁶ Regardless of the subsection at issue, the analysis of reasonable cause is the same. Therefore, we have combined our analyses of reasonable cause for the negligence and substantial understatement cases.

Reasonable Cause

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.²⁷ 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 the law. For example, in *Miller v. Commissioner*,²⁸ the taxpayers engaged in rental real estate activities and sought to deduct losses associated with those activities. The IRS disallowed the losses,

²⁴ IRC § 7491(c) provides that “the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.”

²⁵ IRC § 7491(a). See also Tax Court Rule 142(a).

²⁶ See e.g., *Crane v. Comm’r*, T.C. Memo. 2011-256 (IRS assessed accuracy-related penalties against taxpayers for both § 6662(b)(1) understatement of tax and (b)(2) negligence, but the Tax Court ultimately held them liable for “the accuracy-related penalty under section 6662(a),” (without identifying which subsection applied); compare with *Woodsum v. Comm’r*, 136 T.C. 585, 590 (2011) (IRS assessed accuracy-related penalties under both § 6662(b)(1) and (b)(2); however, once the IRS established that the taxpayers had substantially understated their income under § 6662(b)(2), the court declined to consider the negligence claim).

²⁷ IRC § 6001; Treas. Reg. § 1.6001-1(a).

²⁸ T.C. Memo. 2011-219.

believing the taxpayers' rental activities were passive activities.²⁹ While rental activity is generally treated as a passive activity, the taxpayers adequately established through contemporaneous records and credible testimony that the husband qualified as a real estate professional and that he and his wife materially participated in renting two of their six properties, so the deductions attributable to those activities were not subject to the passive activity limitation of IRC § 469. In contrast, the court found that the taxpayers' participation in the remaining four properties was passive, and therefore sustained the IRS's disallowance of losses with respect to the real estate activities at those properties. The court did not, however, impose the accuracy-related penalty for a substantial understatement of income tax because the taxpayers acted with reasonable cause and in good faith. The taxpayers met their burden of proof by establishing that the husband qualified as a real estate professional and by providing extensive records of their rental real estate activities, including contemporaneous timesheets showing active participation with respect to two of their properties.³⁰

Other taxpayers did not present sufficient evidence to indicate they acted with reasonable cause or in good faith, so their accuracy-related penalties were sustained. For example, in *Esrig v. Commissioner*,³¹ the Tax Court found a husband and wife liable for all accuracy-related penalties because they kept generally inadequate books and records and failed to adequately substantiate various items, including net operating loss carryovers, office expenses and certain itemized business deductions. Similarly, in *Linzy v. Commissioner*,³² a professional tax return preparer owned an apartment building, part of which was used to operate her business. The Tax Court found that the taxpayer failed to substantiate deductions for contract labor, medical expenses, and most of her charitable contributions. In addition, she improperly deducted numerous payments that should have been depreciated as required by law. Therefore, the Tax Court found no reasonable cause or good faith for the underpayments and upheld the accuracy-related penalty.

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.³³ 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

²⁹ IRC § 469(a)(1) provides that passive activity losses shall be disallowed.

³⁰ *Miller*, T.C. Memo. 2011-219.

³¹ T.C. Memo. 2012-38.

³² T.C. Memo. 2011-264.

³³ Treas. Reg. § 1.6664-4(c)(1). See also IRM 20.1.5.6.1(6) (Jan. 24, 2012).

3. The taxpayer actually relied in good faith on the adviser's judgment.³⁴

In *Butler v. Commissioner*,³⁵ the IRS imposed accuracy-related penalties on taxpayers due to income tax deficiencies for two years related to the donation of conservation easements. The taxpayers presented credible evidence that, throughout the process of donating the easements and preparing their tax returns, they relied upon their longtime attorney and accountant, and engaged a real estate firm specializing in conservation conveyances, which helped them select qualified and experienced appraisers of conservation easements. The court agreed that the taxpayers had reasonable cause and acted in good faith with respect to their underpayments and held them not liable for accuracy-related penalties.

Several cases were decided against the taxpayer, however, where the taxpayer failed to establish that the tax professional met all of the three above-mentioned criteria. In *Kirman v. Commissioner*,³⁶ the taxpayer failed to establish that his tax preparer was a “competent professional who had sufficient expertise to justify reliance.”³⁷ While the preparer had an accounting degree, he was not a CPA and only prepared tax returns “on the side.”³⁸ Second, the taxpayer failed to establish that he provided all relevant and necessary information to his return preparer. Finally, “unconditional reliance on a preparer or adviser does not always constitute reasonable reliance.”³⁹ The taxpayer relied entirely on his return preparer and did not examine or sign the original return. For all these reasons, the Tax Court found taxpayer's reliance on his tax preparer unreasonable and sustained the accuracy-related penalty.

Reasonable cause was also found lacking when the tax professional had an inherent conflict of interest. In *Hristov v. Commissioner*,⁴⁰ the taxpayers (a husband and wife) met with a promoter who told them they could reduce their tax liability by using an IRC § 419 welfare benefit plan⁴¹ and a defined benefit plan. The taxpayers claimed deductions for their IRC § 419 plan contributions and defined benefit contributions, which the IRS disallowed during an audit. Before entering into the transaction, the taxpayers met with their tax return preparer, who informed them she had never worked with an IRC § 419 welfare benefit plans or defined benefit plans before. The Tax Court rejected the taxpayers' reasonable reliance argument because the taxpayers knew their return preparer lacked the necessary knowledge and experience in the relevant areas of federal tax law; they failed to show that they provided her with all the necessary and accurate information to prepare the returns;

³⁴ *Neonatology Associates, PA v. Comm'r*, 115 T.C. 43, 99 (2000) (citations omitted), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

³⁵ T.C. Memo. 2012-72.

³⁶ T.C. Memo. 2011-128.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ T.C. Memo. 2012-147.

⁴¹ IRC §§ 419 and 419A allow employers to make tax deductible contributions to welfare benefit plans in order to provide medical and life insurance benefits to their employees or their beneficiaries.

and their reliance on the promoter of the tax shelter was not reasonable due to his conflict of interest. The taxpayers knew, or should have known, that any advice received from the promoter was not independent because the promoter benefited financially from their use of his services. It was also unreasonable for the taxpayers to rely on advice that would seem to a reasonable person to be “too good to be true.”⁴²

Another case where reliance on professional advice was found insufficient to constitute reasonable cause involved taxpayers who failed to examine the prepared return adequately to ensure its accuracy. In *Woodsum v. Commissioner*,⁴³ married taxpayers retained a firm to prepare their joint federal return. The taxpayers gave the firm over 160 information returns they had received from third-party payors, including a Form 1099-MISC, *Miscellaneous Income*, reporting a long-term capital gain of \$3.4 million.⁴⁴ The firm prepared a 115-page return that reported \$29.2 million of adjusted gross income but omitted the \$3.4 million. While the cause of the omission was never determined, the taxpayers contend it was a simple clerical error or oversight by the return preparers, and argued that they should not be held liable for an accuracy-related penalty because they were relying on professional advice. The Tax Court disagreed. The third prong of the *Neonatology* test described above is that “the taxpayer actually relied in good faith on the adviser’s *judgment*.”⁴⁵ The Court explained that, to rely on an advisor’s judgment, the advisor must communicate some “analysis or conclusion” that would be characterized as “substantive advice.”⁴⁶ There was no evidence that the return preparers used any “analysis” or “judgment” or that they were conveying a professional opinion to omit the \$3.4 million. In signing the erroneously prepared return, the taxpayers were not following “substantive professional advice; they were instead unwittingly (they contend) perpetuating a clerical mistake.”⁴⁷ Therefore, there was no merit to the defense of reliance on professional advice. “Even if all data is furnished to the preparer, the taxpayer still has a duty to read the return and make sure all income items are included.”⁴⁸ The \$3.4 million gain reported on the Form 1099-MISC should have appeared as a clear entry on Schedule D. Taxpayers showed insufficient evidence that they made a reasonable review of their return or that they put forth reasonable “effort to assess the . . . proper tax liability.”⁴⁹

⁴² *Hristov*, T.C. Memo. 2012-147.

⁴³ 136 T.C. 585 (2011).

⁴⁴ *Id.* at 589. Although not the largest amount reported on the taxpayers’ information returns, had it been included on the taxpayers’ tax return, “it would have been the third largest long-term capital gain amount reported as a line item on Schedule D, Capital Gains and Losses.” 136 T.C. 585 (2011) at 588.

⁴⁵ *Neonatology Associates, P.A. v. Comm’r*, 115 T.C. 43, 99 (2000) at 344 (emphasis added) (citations omitted), *aff’d*, 299 F.3d 221 (3d Cir. 2002).

⁴⁶ *Woodsum*, 136 T.C. at 593 (quotations omitted). See also Treas. Reg. § 1.6664-4(c)(2).

⁴⁷ *Woodsum*, 136 T.C. at 594.

⁴⁸ *Id.* at 595 (quoting *Magill v. Comm’r*, 70 T.C. 465, 479-80 (1978), *aff’d*, 651 F.2d 1233 (6th Cir. 1981)).

⁴⁹ *Id.* at 596 (quoting Treas. Reg. § 1.6664-4(b)(1)).

Characterization of Settlement Income

We reviewed multiple cases decided this past year where accuracy-related penalties were imposed on taxpayers for not reporting income received from settlements.⁵⁰ IRC § 104(a) (2) excludes from gross income “the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal *physical* injuries or *physical* sickness.”⁵¹ In each of the cases, the courts determined that no portion of any of the settlements was attributable to physical injuries or physical sickness, so the entire amount of each settlement was properly includible in gross income. However, the courts did not impose accuracy-related penalties in all of the cases. For example, in *Neri v. Commissioner*,⁵² Mr. Neri was awarded \$210,000 from an arbitrator in a proceeding involving claims he made against his former employer based on disability discrimination. Mr. Neri and his wife excluded the award from their gross income after consulting a tax attorney. After taking into account all the facts and circumstances, the Tax Court concluded that the taxpayers were not liable for the accuracy-related penalty.

In *McGowan v. Commissioner*,⁵³ the taxpayer filed a sexual harassment complaint against her employer and entered into a settlement agreement whereby the employer paid her three separate payments—one for attorneys’ fees, one for lost income, and one for “physical injury caused by emotional distress.”⁵⁴ The Tax Court upheld the IRS’s determination that there was no evidence of a physical injury, and that “pursuant to the settlement agreement, [the taxpayer] received damages on account of her emotional distress and not as a result of a physical injury or physical sickness.”⁵⁵ Therefore, the entire settlement amount was properly includible in gross income. The Tax Court declined to impose the accuracy-related penalty, however, because the taxpayer, who lacked knowledge and experience in tax law, reasonably believed that a portion of her settlement payment was due to “physical injury.” Therefore, she acted in good faith in not reporting that amount on her income tax return.

In contrast, the court did sustain the IRS’s imposition of the penalty in *Campbell v. Commissioner*.⁵⁶ In that case, the taxpayer was awarded \$5.25 million in settlement of two whistleblower lawsuits against his former employer, a government contractor. The taxpayer did not include any of the settlement award in his gross income. In concluding that the imposition of the accuracy-related penalty was proper, the court noted that the taxpayer was a sophisticated taxpayer with a business degree in accounting “who chose not to consult a professional tax consultant in preparing his return.”⁵⁷

⁵⁰ See, e.g., *Campbell v. Comm’r*, 658 F.3d 1255 (11th Cir. 2011), *aff’d* 134 T.C. 20 (2010); *Healthpoint, Ltd. v. Comm’r*, T.C. Memo. 2011-246.

⁵¹ IRC § 104(a)(2) (emphasis added).

⁵² T.C. Memo. 2012-71.

⁵³ T.C. Memo. 2011-186.

⁵⁴ *Id.* at 3.

⁵⁵ *Id.* at 6.

⁵⁶ 658 F.3d 1255 (11th Cir. 2011), *aff’d* 134 T.C. 20 (2010).

⁵⁷ *Id.* at 1260, *aff’d* 134 T.C. 20 (2010).

Improper Stacking

IRC § 6662(b) provides that the underpayment penalty will not apply to any portion of an underpayment on which a penalty is imposed under IRC § 6663.⁵⁸ We reviewed two cases that interpreted this anti-stacking provision. In both *Garavaglia v. Commissioner*⁵⁹ and *Garcia v. Commissioner*,⁶⁰ married couples filed joint tax returns, upon which the IRS imposed deficiencies and penalties. In both cases, the Tax Court found the husbands liable for fraud penalties under § 6663 for underpayments in connection with their respective businesses. Therefore, imposing the § 6662(b) accuracy-related penalty on the wives for the same underpayments would have resulted in “impermissible stacking,”⁶¹ so the Tax Court found both wives not liable for the underpayment penalty.

CONCLUSION

Of the 117 cases we reviewed, the courts upheld the underlying tax deficiency, or portions of the deficiency, determined by the IRS in all cases. Nonetheless, in over one-third 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 most common bases for finding reasonable cause were maintenance of adequate records and reliance on competent and disinterested tax professionals. The courts also took into account the education, knowledge of tax law, and business experience of the taxpayers when determining the reasonableness of a given position. The IRS should take a closer look at the court’s rationale in the cases where the taxpayer prevailed on the penalty issue. While the existence of reasonable cause is very fact-specific, the IRS may find lessons to be gained from those cases and incorporated into the Internal Revenue Manual and training materials, so that it does not unnecessarily impose on taxpayers the burden of having to litigate their positions in order to obtain penalty relief.

⁵⁸ IRC § 6663 is referred to as the civil fraud penalty and provides as follows: “If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.”

⁵⁹ T.C. Memo. 2011-228, *appeal docketed*, No. 12-1444 (6th Cir. Apr. 13, 2012).

⁶⁰ T.C. Memo. 2012-155.

⁶¹ *Garcia*, T.C. Memo. 2012-155 at 34-35; *Garavaglia*, T.C. Memo. 2011-228 at 84, *appeal docketed*, No. 12-1444 (6th Cir. Apr. 13, 2012) (citing *Foxworthy, Inc. v. Comm’r*, T.C. Memo. 2009-203).

MLI
#3**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 lien with respect to a particular tax liability. At the hearing, the taxpayer has the statutory right to raise any relevant issues related to the unpaid tax, the lien, or the proposed levy, including the appropriateness of the collection action, collection alternatives, spousal defenses, and under certain circumstances, the underlying tax liability.²

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

Since 2003, CDP has been one of the federal tax issues most frequently litigated in the federal courts and analyzed for the National Taxpayer Advocate's Annual Report to Congress. The trend continues this year, with our review locating 116 opinions during the review period of June 1, 2011, through May 31, 2012.⁵ Taxpayers prevailed in full in eight of these cases⁶ (approximately seven percent) and in part in seven others (approximately six

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

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

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

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

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

⁶ *Dingman v. Comm'r*, T.C. Memo. 2011-116; *Fatehi v. Comm'r*, T.C. Summ. Op. 2012-26; *Rosenbloom v. Comm'r*, T.C. Memo. 2011-140; *Salahuddin v. Comm'r*, T.C. Memo. 2012-141; *Beeler v. Comm'r*, 434 Fed.Appx. 41 (2nd Cir. 2011), *vacating and remanding* T.C. Memo. 2009-266; *City Wide Transit, Inc. v. Comm'r*, T.C. Memo. 2011-279, *appeal docketed*, No. 12-1040 (2nd Cir. Mar. 14, 2012); *Custom Stairs & Trim, Ltd, Inc. v. Comm'r*, T.C. Memo. 2011-155; *Leago v. Comm'r*, T.C. Memo. 2012-39.

percent).⁷ Of the 15 taxpayers who prevailed in whole or in part, nine appeared *pro se*⁸ and the six others were represented.⁹

The cases discussed below demonstrate that CDP serves 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 process in eight of the 116 cases reviewed.

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of an NFTL filed by the IRS, or of a proposed levy action.¹⁰ 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.¹¹ The hearing allows taxpayers to raise issues relating to collection of the liability, including:

- Appropriateness of collection actions;¹²
- Collection alternatives such as an installment agreement (IA), offer in compromise (OIC), posting a bond, or substitution of other assets;¹³
- Appropriate spousal defenses;¹⁴
- The existence or amount of the underlying tax liability, but only if the taxpayer did not receive a notice of deficiency or otherwise have an opportunity to dispute the liability;¹⁵ and
- Any other relevant issue relating to the unpaid tax, the NFTL, or the proposed levy.¹⁶

A taxpayer cannot raise an issue considered at a prior administrative or judicial hearing if the individual participated meaningfully in that hearing or proceeding.¹⁷

⁷ *Conway v. Comm’r*, 137 T.C. 209 (2011); *Karakaedos v. Comm’r*, T.C. Memo. 2012-53; *Lewis v. Comm’r*, T.C. Memo. 2012-138; *Semen v. Comm’r*, T.C. Memo. 2011-120; *Everett Assocs., Inc. v. Comm’r*, T.C. Memo. 2012-143; *Moreira v. Comm’r*, T.C. Memo. 2011-93; *Pacific West Fin. & Ins. Co. v. Comm’r*, T.C. Memo. 2011-143.

⁸ *Dingman v. Comm’r*, T.C. Memo. 2011-116; *Fatehi v. Comm’r*, T.C. Summ. Op. 2012-26; *Karakaedos v. Comm’r*, T.C. Memo. 2012-53; *Lewis v. Comm’r*, T.C. Memo. 2012-138; *Salahuddin v. Comm’r*, T.C. Memo. 2012-141; *Semen v. Comm’r*, T.C. Memo. 2011-120; *Custom Stairs & Trim, Ltd, Inc. v. Comm’r*, T.C. Memo. 2011-155; *Everett Assocs., Inc. v. Comm’r*, T.C. Memo. 2012-143; *Leago v. Comm’r*, T.C. Memo. 2012-39.

⁹ *Conway v. Comm’r*, 137 T.C. 209 (2011); *Rosenbloom v. Comm’r*, T.C. Memo. 2011-140; *Beeler v. Comm’r*, 434 Fed.Appx. 41 (2nd Cir. 2011), *vacating and remanding* T.C. Memo. 2009-266; *City Wide Transit, Inc. v. Comm’r*, T.C. Memo. 2011-279, *appeal docketed*, No. 12-1040 (2nd Cir. Mar. 14, 2012); *Moreira v. Comm’r*, T.C. Memo. 2011-93; *Pacific West Fin. & Ins. Co. v. Comm’r*, T.C. Memo. 2011-143.

¹⁰ IRC §§ 6320 and 6330. See RRA 98, Pub. L. No. 105-206, § 1001(a), 112 Stat. 685 (1998).

¹¹ 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 *United States v. National Bank of Commerce*, 472 U.S. 713, 719-722 (1985); *Phillips v. Comm’r*, 283 U.S. 589, 595-601 (1931).

¹² IRC § 6330(c)(2)(A)(ii).

¹³ IRC § 6330(c)(2)(A)(iii).

¹⁴ IRC § 6330(c)(2)(A)(i).

¹⁵ IRC § 6330(c)(2)(B).

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

¹⁷ IRC § 6330(c)(4).

Procedural Collection Due Process Requirements

The IRS must provide a CDP notice to the taxpayer after it has filed the first NFTL or generally before its first intended levy for the particular tax and tax period.¹⁸ The IRS must provide the notice not more than five business days after the day of filing the lien notice, or at least 30 days before the day of the proposed levy.¹⁹ In a lien filing, the notice must inform the taxpayer of his or her right to request a CDP hearing within a 30-day period, which begins on the day after the end of the five-business-day period after the filing of the NFTL.²⁰ In the case of a levy, the notice must inform the taxpayer of his or her right to request a hearing within the 30-day period beginning on the day after the date on the CDP notice.²¹

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.²² Taxpayers who fail to timely request a hearing will be afforded an “equivalent hearing,” which is similar to a CDP hearing, but without judicial review.²³ The Code and regulations require taxpayers to provide their reasons for requesting a hearing. The regulations ask taxpayers to use Form 12153, *Request for a Collection Due Process or Equivalent Hearing*. Failure to provide the basis may result in denial of a face-to-face hearing.²⁴ 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.²⁵

Conduct of a CDP Hearing

The IRS generally will suspend levy action throughout a CDP hearing involving 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; or

¹⁸ IRC § 6330(f) permits the IRS to levy without first giving a taxpayer a CDP notice in the following situations: the collection of tax is in jeopardy, a levy was served on a state to collect on 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).

¹⁹ IRC § 6320(a)(2) or § 6330(a)(2). The CDP notice can be provided to the taxpayer in person, left at the taxpayer’s residence or dwelling, or sent by certified or registered mail (return receipt requested) to the taxpayer’s last known address.

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

²¹ IRC § 6330(a)(3)(B); Treas. Reg. § 301.6330-1(b)(1).

²² 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).

²³ Treas. Reg. §§ 301.6320-1(i)(2) Q&A-I16 and 301.6330-1(i)(2) Q&A-I16; *Orum v. Comm’r*, 123 T.C. 1 (2004); *Moorhous v. Comm’r*, 116 T.C. 263 (2001).

²⁴ 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, *Request for Collection Due Process or Equivalent Hearing* (Mar. 2011).

²⁵ Treas. Reg. §§ 301.6320-1(i)(2) A-17 and 301.6330-1(i)(2) A-17.

- The IRS has served a disqualified employment tax levy or a federal contractor levy.²⁶

The IRS also suspends collection activity throughout any judicial review of Appeals' determination, unless the underlying tax liability is not at issue and the IRS can demonstrate good cause to resume collection activity.²⁷

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

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

²⁷ IRC §§ 6330(e)(1) and (e)(2).

²⁸ IRC § 6320(b)(4).

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

³⁰ See, e.g., Appeals Letter 4141 (rev. Aug. 2012) acknowledges the taxpayer's request for a CDP hearing and provides information on the availability of a face-to-face conference. The National Taxpayer Advocate has repeatedly raised concerns regarding the inadequacy of Appeals' discussion on how to request a face-to-face hearing and the location of this discussion 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*); and National Taxpayer Advocate 2010 Annual Report to Congress 128 (Most Serious Problem: *The IRS's Failure To Provide Timely and Adequate Collection Due Process Hearings May Deprive Taxpayers of an Opportunity To Have Their Cases Fully Considered*). In response to taxpayers' and their representatives' dissatisfaction with the Appeals' CDP hearings, including the difficulty of receiving a face-to-face hearing, TAS worked with Appeals to test the use of "telepresence" or "virtual" face-to-face hearings. This test began in 2011 between two Low Income Taxpayer Clinics and two campus Appeals units and is ongoing. For a further discussion, see Status Update: *The IRS Has Made Significant Progress in Delivering Virtual Face-To-Face Service and Should Expand Its Initiatives to Meet Taxpayer Needs and Improve Compliance*, *supra*.

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

³² Treas. Reg. §§ 301.6320-1(d)(2) A-D7 and 301.6330-1(d)(2) A-D7. Appeals Letter 3846 (rev. July 2008) provides that to be allowed a face-to-face conference about collection alternatives the taxpayer must have filed all required returns.

³³ Treas. Reg. §§ 301.6320-1(d)(2) A-D8 and 301.6330-1(d)(2) A-D8.

³⁴ *Id.* See also National Office Program Manager Technical Advice, PMTA-2010-0153 (March 23, 2010). Internal Revenue Manual (IRM) 8.22.5.6.1 (Mar. 29, 2012) addresses how Appeals should handle a request for a face-to-face conference when the taxpayer has not produced the collection information necessary to evaluate the collection alternative. Consistent with the regulations, IRM 8.22.5.6.1(13) states: "Grant a face-to-face request if it is necessary to explain the requirements for becoming eligible for a collection alternative. See Policy Statement P-5-100, which is also IRM 1.2.14.1.17. Examples include a taxpayer with a hearing impairment, who speaks little or no English, or who lacks sophistication. Under these or similar circumstances, grant a face-to-face conference."

The CDP hearing is to be held by an impartial officer from Appeals, who is barred from engaging in *ex parte* communication with IRS employees about the substance of the case and who has had “no prior involvement” in the case.³⁵ In addition to addressing the issues raised by the taxpayer, the Appeals Officer must verify that the IRS has met the requirements of all applicable laws and administrative procedures.³⁶ In its determination, Appeals must weigh the issues raised by the taxpayer and decide whether the proposed collection action balances the need for efficient collection of taxes with the legitimate concern of the taxpayer that any collection be no more intrusive than necessary.³⁷

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.³⁸ Similarly, IRC § 6330(c)(4) provides that a taxpayer cannot raise an issue at a hearing 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.³⁹ 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.”⁴⁰ In *Thornberry v. Comm’r*, 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 Tax Court found that 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.⁴¹

³⁵ IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1) and 6330(b)(3). See also Rev. Proc. 2012-18, 2012-1 C.B. 455. See, e.g., *Industrial Investors v. Comm’r*, T.C. Memo. 2007-93; *Moore v. Comm’r*, T.C. Memo 2006-93, *action on dec.*, 2007-2 (Feb. 27, 2007); *Cox v. Comm’r*, 514 F3d 1119, 1124-1128 (10th Cir. 2008), *action on dec.*, 2009-22 (June 1, 2009).

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

³⁷ IRC § 6330(c)(3)(C).

³⁸ 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.

³⁹ The frivolous submission penalty applies to the following submissions: CDP hearing request, OIC, IA, and application for a taxpayer assistance order.

⁴⁰ IRC § 6702(b)(2)(a). Before asserting the penalty, the IRS must notify the taxpayer that it has determined that the taxpayer filed a frivolous hearing request. The taxpayer then has 30 days to withdraw the submission to avoid the penalty. IRC § 6702(b)(3).

⁴¹ *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 CC-Notice 2012-003 (Dec. 2, 2011).

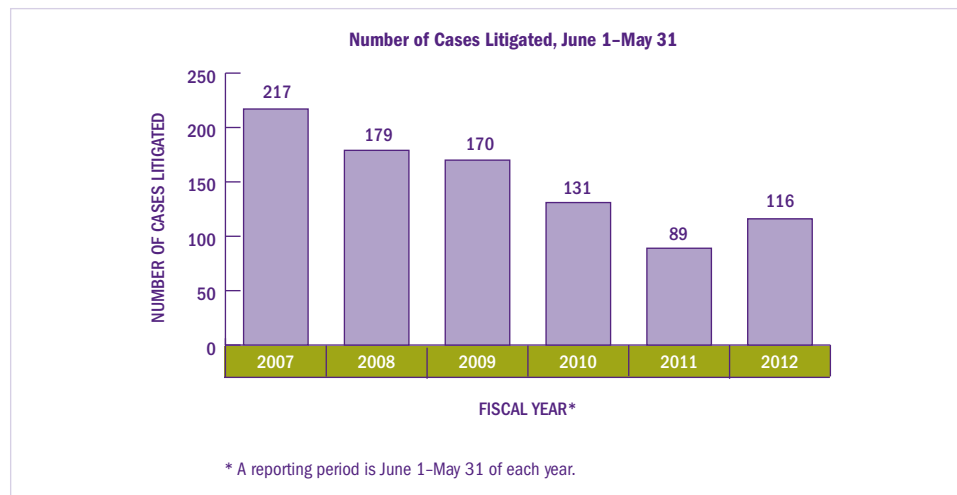
Judicial Review of CDP Determination

Within 30 days of Appeals' determination, the taxpayer may petition the Tax Court for judicial review.⁴² 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.⁴³ Where the appropriateness of the collection action is at issue, the court will review the IRS's administrative determination for abuse of discretion.⁴⁴

ANALYSIS OF LITIGATED CASES

We identified and reviewed 116 CDP court opinions, a 30 percent increase from the 89 cases in last year's report. As shown in the chart below, litigation of CDP cases had declined considerably over the past several years; however, the number now appears to be ticking back up slightly.

FIGURE 3.3.1, CDP Cases Litigated Between 2007 and 2012⁴⁵



The 116 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,

⁴² IRC § 6330(d)(1). Prior to October 17, 2006, the taxpayer could also petition the federal district court if the Tax Court did not have jurisdiction over the underlying tax liability (e.g., if the matter involved an employment tax liability).

⁴³ The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing Appeals' CDP determinations. H.R. Rep. No. 105-99, at 266 (Conf. Rep.). The term *de novo* means anew. *Black's Law Dictionary*, 447 (7th ed. 1999).

⁴⁴ See, e.g., *Murphy v. Comm'r*, 469 F.3d 27 (1st Cir. 2006).

⁴⁵ National Taxpayer Advocate 2007 Annual Report to Congress 569 (Most Litigated Issue: *Appeals from Collection Due Process Hearings Under Internal Revenue Code Section 6320 and 6330*), National Taxpayer Advocate 2008 Annual Report to Congress 476 (Most Litigated Issue: *Appeals from Collection Due Process Hearings Under Internal Revenue Code Section 6320 and 6330*), National Taxpayer Advocate 2009 Annual Report to Congress 418 (Most Litigated Issue: *Appeals from Collection Due Process Hearings Under Internal Revenue Code Section 6320 and 6330*), National Taxpayer Advocate 2010 Annual Report to Congress 436 (Most Litigated Issue: *Appeals from Collection Due Process Hearings Under Internal Revenue Code Section 6320 and 6330*), and National Taxpayer Advocate 2011 Annual Report to Congress 619 (Most Litigated Issue: *Appeals from Collection Due Process Hearings Under Internal Revenue Code Section 6320 and 6330*).

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 3 in Appendix III provides a detailed list of the CDP opinions, including specific information about the issues, the types of taxpayers involved, and the outcomes of the cases.

Litigation Success Rate

Taxpayers prevailed in full in eight of the 116 cases (approximately seven percent).⁴⁶ Of the cases in which the courts found for the taxpayer in whole or in part, the taxpayers appeared *pro se* in nine cases⁴⁷ and were represented in the six others.⁴⁸ This was the IRS's lowest success rate in litigating CDP cases over the past ten years. Table 3.3.2 below compares litigation success rates in CDP cases reported in the 2003 through 2012 Annual Reports to Congress.

TABLE 3.3.2, Success Rates in CDP Cases⁴⁹

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

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 opportunity to improve the CDP process, in both application and execution.

⁴⁶ *Dingman v. Comm'r*, T.C. Memo. 2011-116; *Fatehi v. Comm'r*, T.C. Summ. Op. 2012-26; *Rosenbloom v. Comm'r*, T.C. Memo. 2011-140; *Salahuddin v. Comm'r*, T.C. Memo. 2012-141; *Beeler v. Comm'r*, 434 Fed.Appx. 41 (2nd Cir. 2011), *vacating and remanding* T.C. Memo. 2009-266; *City Wide Transit, Inc. v. Comm'r*, T.C. Memo. 2011-279, *appeal docketed*, No. 12-1040 (2nd Cir. Mar. 14, 2012); *Custom Stairs & Trim, Ltd, Inc. v. Comm'r*, T.C. Memo. 2011-155; *Leago v. Comm'r*, T.C. Memo. 2012-39.

⁴⁷ *Dingman v. Comm'r*, T.C. Memo. 2011-116; *Fatehi v. Comm'r*, T.C. Summ. Op. 2012-26; *Karakaedos v. Comm'r*, T.C. Memo. 2012-53; *Lewis v. Comm'r*, T.C. Memo. 2012-138; *Salahuddin v. Comm'r*, T.C. Memo. 2012-141; *Semen v. Comm'r*, T.C. Memo. 2011-120; *Custom Stairs & Trim, Ltd, Inc. v. Comm'r*, T.C. Memo. 2011-155; *Everett Assocs., Inc. v. Comm'r*, T.C. Memo. 2012-143; *Leago v. Comm'r*, T.C. Memo. 2012-39.

⁴⁸ *Conway v. Comm'r*, 137 T.C. 209 (2011); *Rosenbloom v. Comm'r*, T.C. Memo. 2011-140; *Beeler v. Comm'r*, 434 Fed.Appx. 41 (2nd Cir. 2011), *vacating and remanding* T.C. Memo. 2009-266; *City Wide Transit, Inc. v. Comm'r*, T.C. Memo. 2011-279, *appeal docketed*, No. 12-1040 (2nd Cir. Mar. 14, 2012); *Moreira v. Comm'r*, T.C. Memo. 2011-93; *Pacific West Fin. & Ins. Co. v. Comm'r*, T.C. Memo. 2011-143.

⁴⁹ Numbers have been rounded to nearest percentage. 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.

Procedural Rulings

Churchill v. Commissioner

In *Churchill v. Commissioner*,⁵⁰ the IRS sent the taxpayer an NFTL and a right to a hearing (a CDP lien notice) for debts associated with tax years 1992 through 2004. Two months later, the IRS sent the taxpayer a final notice of intent to levy and the right to a hearing (a CDP levy notice) for tax years 1998 through 2004. Upon receiving these notices, the taxpayer requested a CDP hearing, asked to discuss the possibility of an OIC, and during these discussions proposed an offer amount. The Appeals Officer informed the taxpayer that the IRS would reject the offer because the Appeals Officer determined that the taxpayer could pay more. Since the taxpayer lived in a community property state, the Appeals Officer included his wife's income, which the taxpayer had omitted, when calculating his collection potential. The Appeals Officer recommended that the taxpayer increase his offer, but the taxpayer did not respond, so the IRS rejected the OIC and sent the taxpayer a notice of determination sustaining the NFTL filing and proposed levy. The taxpayer and his wife divorced before the IRS mailed the notice of determination, but after the CDP hearing.

The Tax Court held that the Settlement Officer did not abuse her discretion in including the community property assets in determining the taxpayer's ability to pay or in upholding the IRS's collection activities. The court also held it has the authority to remand a CDP case for consideration of a material change in the taxpayer's circumstances occurring in the period between the CDP hearing and the Tax Court trial. The court found remand is appropriate whenever it would be "helpful, necessary, or productive." Therefore, the court remanded the case back to Appeals so Appeals could evaluate the taxpayer's OIC in light of the change in the taxpayer's financial circumstances following the divorce (*i.e.*, that his wife's income or assets were no longer available for collection).

Lewis v. Commissioner

In *Lewis v. Commissioner*,⁵¹ the taxpayer voluntarily filed for Chapter 11 bankruptcy. In the bankruptcy proceeding, the IRS filed a proof of claim, and later an amended proof of claim, for tax liabilities for tax years 1999, 2000, 2001, and 2003 and Trust Fund Recovery Penalties (TFRP) for the first and second quarters of 2001. After the bankruptcy proceeding, the examination of tax years 1999, 2000, and 2001 continued. As a result of the examination, the taxpayer signed Form 4549, *Income Tax Examination Changes*, agreeing to partial abatement of tax and additions to tax for 1999 and to additional assessments of tax and additions to tax for tax years 2000 and 2001. The IRS sent the taxpayer a CDP levy notice on April 10, 2008, and the taxpayer asked for a CDP hearing. In the hearing request, the taxpayer stated he was willing to offer collection alternatives, that the amount the IRS sought was inaccurate because it did not reflect amounts paid during bankruptcy, and that the taxpayer was under the protection of his confirmed chapter 11 bankruptcy plan.

⁵⁰ T.C. Memo. 2011-182.

⁵¹ T.C. Memo. 2012-138.

Upon receipt of an IRS letter dated August 21, 2009, identifying the Settlement Officer assigned to his case, the taxpayer called and left a phone message requesting a face-to-face hearing. On September 9, 2009, the Settlement Officer returned the call, and the taxpayer once again expressed his desire for a face-to-face hearing and a collection alternative. The Settlement Officer explained that the taxpayer would need to submit Form 433-A, *Collection Information Statement*, in order for a collection alternative to be considered. The taxpayer agreed to provide the documentation and asked if he could have until September 14, 2009, to send it; the Settlement Officer agreed. The taxpayer claimed the documentation was sent before that date, but the Settlement Officer said it was never received. After the phone call, the taxpayer and Settlement Officer had no further contact until December 21, 2009, when the Settlement Officer issued the notice of determination sustaining the proposed levy. The determination was based solely on the taxpayer's failure to provide the documents necessary to consider a collection alternative.

The Tax Court held that the Settlement Officer abused his discretion because the taxpayer was not afforded a face-to-face CDP hearing as requested, or even a telephone CDP hearing. Nothing indicated that the phone call on September 9, 2009, constituted a CDP hearing. The court further held that the Settlement Officer's determination to sustain the proposed levy, based solely on the grounds that he did not receive documentation, was an abuse of discretion because the Settlement Officer did not attempt to notify the taxpayer that the documentation had not yet been received, and failed to address the issues raised by the taxpayer with respect to the chapter 11 bankruptcy plan.

Weber v. Commissioner

In *Weber v. Commissioner*,⁵² the taxpayer appealed an IRS determination to proceed with a levy, arguing that his 2008 income tax had been paid by overpayments for previous years. The taxpayer had filed a return for 2006 claiming an overpayment and electing to have it applied toward his estimated liability for 2007. Shortly thereafter, the IRS made a TFRP assessment against the taxpayer that exceeded the overpayment. Thus, the IRS did not apply the 2006 overpayment to the 2007 estimated tax liability but instead applied it to the TFRP liability.

By August 2008, the TFRP liability had been satisfied from payments by the taxpayer and other responsible persons. The taxpayer proceeded to file his 2007 return, carrying forward the 2006 overpayment per his previous election. The IRS promptly disallowed the carryforward attempt on the 2007 return, but the taxpayer attempted to use the 2006 overpayment credit once again on his 2008 return.

In October 2009, the IRS advised the taxpayer it had adjusted his 2008 estimated tax payments (*i.e.*, reducing them by the claimed 2007 overpayment), that he had a balance due on his 2008 income tax account, and also owed penalties and interest. The taxpayer contended

⁵² *Weber v. Comm'r*, 138 T.C. No. 18 (2012).

that his overpayments should have been applied in the manner he specified (*i.e.*, 2006 refund applied to 2007 and 2007 refund applied to 2008), satisfying the 2008 liability.

The Tax Court considered whether it had jurisdiction to determine an overpayment with respect to an unrelated liability in a CDP case. For the court to apply overpayments in the manner the taxpayer specified, the court would have to adjudicate his right to an overpayment with respect to the TFRP assessment. The Tax Court held that it did not have jurisdiction over this inquiry because the court lacked jurisdiction to determine the availability of a credit from a non-CDP period that has not been previously determined to be available by a court or the IRS. A taxpayer may only obtain consideration of these claims through the administrative and judicial refund claim process.⁵³ The Tax Court acknowledged, however, that an overpayment of a TFRP (or any liability) that has been determined by the IRS or a court, but has not yet been refunded or applied to another liability, may be considered in a CDP hearing when determining if the liability remains unpaid.

Leago v. Commissioner

In *Leago v. Commissioner*,⁵⁴ a taxpayer who had owned a video rental store failed to file Form 941, *Employer's Quarterly Federal Tax Return*, for all four quarters of 1995 and the fourth quarter of 1996 and Form 940, *Federal Unemployment Tax Return*, for tax year 1996. As a result, the IRS sent a CDP levy notice and, upon receipt of this notice, the taxpayer requested a hearing. During the hearing, the taxpayer requested to be placed in currently not collectible (CNC) status, because he had a brain tumor and was experiencing economic hardship because of his medical problems. At the conclusion of the hearing, the Settlement Officer requested that petitioner submit various information, including a current doctor's statement and Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*. In response, the taxpayer provided letters from doctors regarding his condition and the Form 433-A. Despite these circumstances, the Settlement Officer sustained the proposed levy on the basis that the taxpayer had failed to file federal income tax returns and make tax payments for recent tax years. The taxpayer challenged this determination in Tax Court, which remanded the case for further consideration of whether the taxpayer qualified for any collection alternative. On remand, the taxpayer submitted an OIC, but the Settlement Officer rejected it on the grounds that it failed to adequately reflect the taxpayer's reasonable collection potential (RCP). A significant point of disagreement was what allowance, if any, should have been made for taxpayer's brain surgery.

Generally, for an OIC based on doubt as to collectibility to be accepted, the offer amount must equal or exceed the taxpayer's RCP. Where the taxpayer would, however, suffer economic hardship if the IRS collected an amount equal to the RCP, the IRS may accept a lesser amount if special factors are present.⁵⁵ In this context, factors indicating economic

⁵³ In *Weber*, the taxpayer had, in fact, availed himself of the judicial remedy and had filed a refund suit in the District Court with respect to the TFRP.

⁵⁴ T.C. Memo. 2012-39.

⁵⁵ Rev. Proc. 2003-71, § 4.02(3), 2003 C.B. 517.

hardship include a long-term illness, medical condition, or disability that renders a taxpayer incapable of earning a living, where it is “reasonably foreseeable that taxpayer’s financial resources will be exhausted providing for care and support during the course of the condition.”⁵⁶

The Court determined that the Settlement Officer did not appear to have considered the special circumstances related to the economic hardship that were not in dispute (*e.g.*, diagnosis of a brain tumor, need for surgery, the taxpayer’s lack of health insurance or significant assets, and continuous health problems that had limited his ability to earn income) when deciding to reject the offer. Therefore, the court remanded the case, ordering Appeals to fully consider the taxpayer’s special circumstances when making a final determination of whether to accept the proposed OIC.⁵⁷

Custom Stairs & Trim v. Commissioner

In *Custom Stairs & Trim v. Commissioner*,⁵⁸ a small construction business had a long history of timely filing its employment tax returns and making timely tax deposits. In early 2005, however, because of Hurricane Ivan, the taxpayer fell behind in its employment tax obligations and continued to have trouble making these payments until 2009. For most of these tax quarters, the taxpayer actually paid the IRS more than enough to fully satisfy its current tax obligations, but the IRS applied the payments to prior arrearages, which are generally paid first unless the taxpayer specifies otherwise, so the later tax periods had an outstanding balance due.⁵⁹ Because of the way the IRS applied the payments, the taxpayer owed employment taxes and associated failure to deposit and failure to pay penalties for the second quarter of 2008.

In late 2008, the IRS sent the taxpayer a CDP lien notice and a CDP levy notice with respect to the employment tax liability for the second quarter of 2008. The taxpayer requested a CDP hearing seeking the abatement of the penalties. The Settlement Officer declined, advising the taxpayer it had not shown reasonable cause for the failure to pay. The Settlement Officer then issued a notice of determination sustaining the NFTL filing and the Notice of Intent to Levy, and the taxpayer appealed the determination to the Tax Court.

After reviewing the Settlement Officer’s conclusion that reasonable cause was not present, the court found the taxpayer’s failure to make deposits as penalties were accumulating “was due in significant part to Hurricane Ivan, the 2008 economic collapse, and practical fact of the cascading penalties themselves. Quarter after quarter, funds were used to pay then-assessed penalties for the prior quarter at the cost of not making all timely deposits for the

⁵⁶ Treas. Reg. § 301.7122-1(c)(3)(A).

⁵⁷ In the Court’s decision entered on September 2, 2012, the parties stipulated that collection of taxpayer’s outstanding liabilities would be settled in the amount of \$4,000 pursuant to an amended OIC.

⁵⁸ T.C. Memo. 2011-155.

⁵⁹ See *Davis v. United States*, 961 F.2d 867 (9th Cir. 1992), *Concert Staging Services, Inc., v. Comm’r*, T.C. Memo. 1011-231, and Rev. Proc. 2002-26, 2002-15 I.R.B. 746 (Apr. 15, 2002).

current quarter.”⁶⁰ The court found reasonable cause was present in these circumstances and that the penalties should be abated. Further, the court found the taxpayer had acted with business care by taking significant steps to reduce expenses in an effort to keep up with its tax obligations and keep the business alive (*e.g.*, laying off employees, eliminating vacations and paid holidays, and curtailing benefits). The court noted that a memorandum in the administrative file, written by the Taxpayer Advocate Service, provided elaborate details of the good faith efforts the taxpayer had made to resolve its tax problem. The court, in rejecting the IRS’s argument that Custom Stairs should go out of business if it could not afford to make its tax payment timely, emphasized that this approach hurts the country’s economy and the federal fisc.

Conway v. Commissioner

In *Conway v. Commissioner*,⁶¹ the IRS assessed TFRPs under IRC § 6672 against Michael Conway (Conway) and Raymond Nakano (Nakano), the chief executive officer (CEO) and chief financial officer (CFO), respectively, of National Airlines, Inc. (National), for National’s failure to pay excise taxes.⁶² The IRS then issued a CDP lien notice to Conway and a CDP levy notice to Nakano in an attempt to collect the TFRP assessments. Both taxpayers requested a CDP hearing in response to the notices, and at the taxpayers’ requests, they received a joint hearing. In their hearing requests, the taxpayers claimed the IRS had failed to issue notice and demand for payment within 60 days of the assessment, thereby precluding the IRS from collecting the TFRP assessments by lien or levy.⁶³ Appeals sustained the filing of the NFTL and proposed levy action, and both Conway and Nakano filed Tax Court petitions challenging the Appeals determinations. The two cases were consolidated by the Tax Court.

Nakano claimed the IRS did not give him notice and demand within 60 days of any assessment or properly assess the TFRPs against him, thereby making the proposed levy an abuse of discretion. However, the Tax Court determined the CDP levy notice also served as a notice and demand for payment, because it went beyond the usual proposed levy notice and specifically identified the type and amount of unpaid tax for each tax period, explicitly demanded payment, and was sent within 60 days of the assessments, thereby meeting the applicable statutory requirements. Nakano also argued the TFRP assessments were invalid as untimely. However, the Court found no evidence suggesting the IRS did not timely assess the TFRPs.

⁶⁰ T.C. Memo. 2011-115.

⁶¹ 137 T.C. 209 (2011).

⁶² National operated from 1999 to 2001. When it ceased operating, it had reported but unpaid transportation excise taxes. IRC § 9502 establishes the Airport and Airway Trust Fund, which includes, in part, excise taxes collected by airlines under IRC § 4261. Because the airline failed to pay over the trust fund taxes, the IRS may pursue collection by making assessments under IRC § 6672.

⁶³ In their hearing request, the taxpayers had also argued they were not liable for the TFRP assessments. However, during the hearing, they conceded that they could not contest the underlying liability as part of the CDP process. Both Conway and Nakano filed refund suits to contest the assessments, and both were found liable for the assessments. See *Conway v. United States*, 103 A.F.T.R.2d 2009-2523 (E.D. Tex. 2009); *Nakano v. United States*, 104 A.F.T.R.2d 2009-5421 (D. Ariz. 2009).

Conway also argued the IRS failed to provide him notice and demand within 60 days of the assessment. The IRS argued that Letter 3164B, the CDP lien Notice and Form 3552, *Notice of Tax Due* (hereafter referred to as Notice of Tax Due) all constituted notice and demand. Alternatively, the IRS argued that it did not need to issue notice and demand to Conway because he was already aware of the unpaid tax and demand for payment as a result of his role as National's CEO.

The Tax Court determined the Letter 3164B did not constitute valid notice and demand for payment under IRC § 6303 because it did not state the amounts, types, or periods of the unpaid taxes. Moreover, it was also defective because the letter was not sent after the assessment was made nor was it sent to the taxpayer's "dwelling or usual place of business" or mailed to his last known address as required by § 6303.

Next, the court considered whether the CDP lien notice could serve as both a notice and demand under § 6303 and a CDP lien notice under § 6320. The court found that the IRS can only issue a CDP lien notice after notice and demand have been made and the taxpayer refuses to pay. Thus, a CDP lien notice cannot serve as both notice and demand for payment and a CDP lien notice. Last, the court found that the Notice of Tax Due did not constitute notice and demand because it was sent after the NFTL was filed.

Finally, the court held that any notice Conway may have had as a result of his role as CEO did not eliminate the need for the IRS to issue notice and demand for payment prior to filing the NFTL.

For these reasons, the court found the IRS had failed to give notice and demand for payment before filing the NFTL. Thus, the NFTL filing was premature and should have been withdrawn under IRC § 6323(j)(1)(A), and Appeals' determination to sustain the NFTL filing against Conway was an abuse of discretion.

Gillum v. Commissioner

In *Gillum v. Commissioner*,⁶⁴ the taxpayer appealed the Tax Court's decision to uphold the filing of the NFTL and the proposed levy, arguing that he was not afforded a fair CDP hearing. The taxpayer alleged that the Settlement Officer relied on information that was not part of the administrative record when the proposed OIC was evaluated. According to the taxpayer, the Settlement Officer admitted during the Tax Court trial to providing an incomplete administrative record to the Tax Court.

The Appeals Court upheld the Tax Court's decision that the taxpayer was afforded a fair CDP hearing. First, the Appeals Court determined that the Settlement Officer never admitted during the Tax Court trial to providing an incomplete administrative record as the taxpayer suggested. In fact, the trial transcript revealed that the Settlement Officer confirmed

⁶⁴ 676 F.3d 633 (8th Cir. 2012), *aff'g* T.C. Memo. 2010-280.

that the administrative record was complete and the facts relied upon in making a determination were a part of the administrative record. Second, the court found that even if the Settlement Officer did rely on documents outside of the administrative record, the error was harmless. The Appeals Court agreed with the Tax Court that the Settlement Officer did not improperly rely on information outside the record when making the determination to reject the proposed OIC; it therefore, affirmed the decision.

Imposition of Sanctions

IRC § 6673(a)(1) authorizes the Tax Court to impose sanctions when it appears that proceedings have been instituted or maintained primarily for delay or when the taxpayer's position is frivolous or groundless.⁶⁵ These penalties are meant to deter the filing of frivolous CDP hearing requests. As we found in last year's analysis, the court imposed these penalties in only a few CDP cases. Of the 116 CDP cases reviewed this year, the court imposed sanctions in only eight, or approximately seven percent.⁶⁶ Last year, with 89 CDP cases decided, the court imposed sanctions in four cases, or four percent.⁶⁷ 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 benefit of counsel) litigated 81 (or 70 percent) of the 116 CDP cases brought before the Tax Court, an increase from 63 percent in the previous year. Table 3.3.3 shows the breakdown of *pro se* and represented cases and the decisions rendered by the court, indicating that 15 taxpayers, represented or unrepresented (or about 13 percent of the 116 cases), received some relief on judicial review.

TABLE 3.3.3, Pro Se and Represented Taxpayer Cases and Decisions

Court Decisions	Pro Se Taxpayers		Represented Taxpayers	
	Volume	Percentage of Total	Volume	Percentage of Total
Decided for IRS	71	88%	29	83%
Decided for Taxpayer	5	6%	3	9%
Split Decisions	4	5%	3	9%
Neither ⁶⁸	1	1%		
Totals:⁶⁹	81		35	

⁶⁵ For a more detailed discussion of IRC § 6673, see Most Litigated Issue: *Frivolous Issues Penalty Under IRC § 6673 and Related Appellate Level Sanctions*, *infra*.

⁶⁶ See, *Alexander v. Comm'r*, T.C. Memo. 2012-75; *Byrd v. Comm'r*, T.C. Memo. 2011-146; *Jackson v. Comm'r*, T.C. Memo. 2012-58; *Lee v. Comm'r*, 463 Fed. Appx. 236 (5th Cir. 2012); *McNeil v. Comm'r*, T.C. Memo. 2011-150, *aff'd*, 451 Fed.Appx. 622 (8th Cir. 2012); *Tinnerman v. Comm'r*, 448 Fed.Appx. 73 (D.C. Cir. 2012), *aff'g* T.C. Memo. 2010-150; *Umoren v. Comm'r*, T.C. Memo. 2012-117; *Weybrew v. Comm'r*, 451 Fed.Appx. 257 (4th Cir. 2011).

⁶⁷ National Taxpayer Advocate 2011 Annual Report to Congress 629.

⁶⁸ *Campbell v. Comm'r*, T.C. Memo. 2012-82.

⁶⁹ Due to rounding, the percents may not add up to exactly 100 percent.

CONCLUSION

CDP hearings continue to provide an invaluable opportunity for taxpayers to meaningfully address the appropriateness of IRS collection actions. Given the important protection that CDP hearings offer, it should be of little surprise that CDP remains one of the most frequently litigated tax issues in the federal courts — a trend unlikely to change anytime soon. In fact, the number of CDP cases litigated increased this year by about 30 percent when compared to last year. Further, this year the IRS had the lowest success rate for litigating CDP cases when compared to all years since 2003. The cases this year illustrate the discretion of the Settlement Officer to consider special circumstances surrounding cases and impacting taxpayers, such as health conditions and the impact of natural disasters and economic conditions on businesses. The IRS should review the cases in which the taxpayer prevailed, particularly those involving special circumstances, so it can improve its processes and not unnecessarily burden taxpayers who are experiencing such difficulties.

The Tax Court also grappled with whether it had jurisdiction to determine an overpayment of an unrelated liability in a CDP case. Finally, the Eighth Circuit Court of Appeals considered whether a Settlement Officer reviewed information outside the administrative record when making a final determination, and if so, whether it was harmful to the fairness of the hearing. Because of the important role of CDP hearings in protecting taxpayer rights, taxpayers and their representatives will likely continue to pursue their CDP rights in court, and CDP will most likely continue to be a heavily litigated issue in years to come.

MLI
#4**Trade or Business Expenses Under IRC § 162 and Related Sections****SUMMARY**

The deductibility of trade or business expenses is perennially among the ten Most Litigated Issues. We identified 115 cases involving a trade or business expense issue that were litigated between June 1, 2011, and May 31, 2012. The courts affirmed the IRS position in the majority (approximately 69 percent) of cases, while taxpayers prevailed about five percent of the time.¹ The remaining cases resulted in split decisions.

PRESENT LAW

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

What is a trade or business expense under § 162?

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

What is an ordinary and necessary expense?

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

¹ The IRS prevailed in full in 79 out of the 115 cases, while taxpayers prevailed in full in only six cases.

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

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

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

⁵ 290 U.S. 111, 113 (1933).

frequent occurrence in the taxpayer's trade or business.⁶ The Court describes a “necessary” expense as one that is appropriate and helpful for development of the business.⁷

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

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

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

Whether an expenditure is deductible under IRC § 162(a) or is a capital expenditure under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach to applying principles of capitalization and deductibility.¹²

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

IRC § 162(a) requires an expense to be “paid or incurred during the taxable year” to be deductible. The Code also requires a taxpayer to maintain books and records that substantiate income, deductions, and credits—including adequate records to substantiate deductions claimed as trade or business expenses.¹³ If a taxpayer cannot substantiate 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 is one of “indulgence” established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.¹⁴ The court held that the taxpayer's business expense deductions were not adequately substantiated, but stated that “the [Tax Court]

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

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

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

⁹ IRC § 162(a).

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

¹¹ IRC § 167.

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

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

¹⁴ 39 F.2d 540 (2d Cir. 1930).

should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent.”¹⁵

The *Cohan* rule may not be 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; or
4. Certain “listed property.”¹⁶

A taxpayer must substantiate a claimed IRC § 274(d) expense with adequate records or sufficient evidence to establish the amount, time, place, and business purpose.¹⁷

Who has the burden of proof in a substantiation case?

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

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

ANALYSIS OF LITIGATED CASES

Trade or business expenses have 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 expense issues that were litigated in federal courts from June 1, 2011, through May 31, 2012. Table 4 in Appendix III

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

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

¹⁷ Treas. Reg. § 1.274-5T(b).

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

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

²⁰ See National Taxpayer Advocate 1998-2011 Annual Reports to Congress.

contains a list of the main issues in those cases. Table 3.4.1 (below) categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

TABLE 3.4.1, Trade or Business Expense Issues in Cases Reviewed

Issue	Type of Taxpayer	
	Individual	Business (including sole proprietorships)
Substantiation of expenses, including application of the <i>Cohan</i> rule ²¹	13	59
Profit objective ²²	2	10
Ordinary and necessary trade or business expenses ²³	6	8
Personal vs. business expenses ²⁴	6	11
Business expenses vs. capital expenditures ²⁵	0	3
Education expenses ²⁶	2	1
Did the taxpayer establish the carrying on of a trade or business?	3	12
Gambling expenses ²⁷	0	1

Approximately 62 percent of the taxpayers litigating trade or business deduction issues represented themselves (*pro se*). Taxpayers represented by counsel actually fared slightly worse than their *pro se* counterparts. Taxpayers with representation received full or partial relief in approximately 30 percent of litigated cases (13 of 44), while *pro se* taxpayers received full or partial relief in about 32 percent of litigated cases (23 of 71).

²¹ 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 v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930).

²² IRC § 183(a) provides the general rule that no deduction attributable to an activity engaged in by an individual or an S corporation shall be allowed if such activity is not engaged in for profit. Treas. Reg. § 1.183-2(b) provides the following nonexhaustive list of nine factors to consider in determining whether an activity is conducted for profit: (1) manner in which the taxpayer carries on the activity; (2) expertise of the taxpayer or his advisors; (3) time and effort expended by the taxpayer in carrying on the activity; (4) expectation that assets used in the activity may appreciate in value; (5) success of the taxpayer in carrying on similar or dissimilar activities; (6) taxpayer's history of income or losses with respect to the activity; (7) amount of occasional profits, if any, which are earned; (8) financial status of the taxpayer; and (9) elements of personal pleasure or recreation.

²³ IRC § 162(a) allows deductions for ordinary and necessary trade or business expenses paid or incurred during the taxable year.

²⁴ IRC § 262(a) provides that personal, living, and family expenses are generally not deductible.

²⁵ 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), (B). (These amounts are increased to \$10,000 and \$60,000 for taxable years beginning in 2010. See IRC § 195(b)(3).)

²⁶ Treas. Reg. § 1.162-5(a) provides that a taxpayer may deduct educational expenses under IRC § 162(a) if the education maintains or improves skills required by the individual in his or her employment or other trade or business, or meets the express requirements of the individual's employer.

²⁷ IRC § 165(d) provides that "[l]osses from wagering transactions shall be allowed only to the extent of the gains from such transactions."

Individual Taxpayers

Not one of the 19 decisions involving individual taxpayers (where the term “individual” excludes a sole proprietorship) was issued as a regular opinion of the Tax Court.²⁸ Of the 19 cases litigated by individual taxpayers, all but three appeared *pro se*. One individual taxpayer received full relief, and five of the individual cases resulted in split decisions.

The most prevalent issue was the substantiation of claimed trade or business expense deductions, which appeared in 13 cases. For example, in *Lyseng v. Commissioner*,²⁹ the Tax Court denied several deductions for lack of substantiation, including depreciation on a travel trailer, laundry services, vehicle permit costs, and towing expenses. The taxpayer provided no evidence to substantiate the laundry, vehicle, and towing expenses, and therefore the court disallowed the deductions. In regard to the depreciation deduction, the taxpayer provided no evidence substantiating the trailer’s cost basis — no bill of sale, canceled check, or third-party corroborating testimony. The Tax Court did find that the taxpayer substantiated the deductions for unreimbursed automobile expenses and some union dues. The taxpayer kept a mileage record with the dates of travel and provided credible testimony regarding the business purpose of each trip he took for his employer. A pay stub from an employer, combined with credible taxpayer testimony, also convinced the court to partially allow some of the union dues.

Even when the individual taxpayer maintains records to substantiate a deduction, he or she still has to prove the expense is ordinary and necessary to a trade or business. In *Farias v. Commissioner*,³⁰ the taxpayer was a teacher who claimed deductions for unreimbursed employee expenses for the purchase of a specialty chair, an adjustable headrest, a pillow, and ice/heat pads. The taxpayer claimed she purchased the items because she suffered a back injury when she moved her classroom. The taxpayer also taught fitness classes and claimed deductions for fitness items, including clothing. The Tax Court upheld the IRS’s denial of the deductions because the purchases were not ordinary and necessary to her teaching position. The Tax Court also disallowed the taxpayer’s deductions for fitness expenses because she failed to clearly describe the items purchased and to prove the clothing was ordinary and necessary in her trade or business. The court further determined the clothing deduction was not allowable because the clothing was suitable for general use.

Another case involving an individual taxpayer required an analysis of whether typical living and leisure activities could be viewed as “business” activities conducted in pursuit of a profit under IRC § 183(a). The taxpayer in *Faust v. Commissioner*, a retired minister, created

²⁸ 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. All but seven of the cases involving individual taxpayers (excluding sole proprietorships) were “S” cases.

²⁹ T.C. Memo. 2011-226.

³⁰ T.C. Memo. 2011-248.

an enterprise called “MacLeisure Creations,” which essentially encompassed all of his daily activities.³¹ He claimed income from the enterprise on his Forms 1040, for both 2005 and 2006. The taxpayer also took business deductions for those years for, among other expenses, books, comedy shows, boating equipment, washing machine repairs, utility and phone bills, and dinner outings with his spouse. In upholding the IRS’s disallowance of the deductions, the court ultimately determined the enterprise was not conducted for profit under the nine factors of Treasury Regulation § 1.183-2(b).³² The Tax Court decided the activities were not for profit primarily because the taxpayer had never earned a profit,³³ relied on other income to subsidize his activities, showed no expertise, did not seek business advice, kept no separate bank accounts or books, and experienced much personal pleasure in pursuing the activities under the guise of his enterprise.

Business Taxpayers

Ninety-six cases involved business taxpayers, who had similar success to individual taxpayers in obtaining a favorable outcome. Business and individual taxpayers received full or partial relief in about 31 percent of cases (30 of 96 and six of 19, respectively). Business taxpayers were represented by counsel in 11 of the favorably decided cases.

As with individual taxpayers, substantiation of expenses was by far the most prevalent issue,³⁴ and in some instances the court denied business taxpayers’ deductions for failure to substantiate.³⁵ Courts were willing to uphold a taxpayer’s deductions when there was enough evidence for proper substantiation.³⁶ 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.³⁷

Another common difficulty was failure to prove that expenses were ordinary and necessary to the taxpayer’s business. In *Fuhrman v. Commissioner*, the taxpayer husband owned a trucking business consisting of five wholly-owned corporations and an LLC that owned 30 trucks.³⁸ The LLC leased its trucks solely to related businesses, but principally to one of the wholly-owned corporations. The same wholly-owned corporation provided safety, sales

³¹ T.C. Memo. 2011-158.

³² See footnote 22, *supra*, for the nine factors. The IRS allowed the taxpayer itemized deductions for expenses up to the amount of gross income reported from the activities under IRC § 183(b)(2), consisting of \$235 for 2005 and \$210 for 2006. The court stated that this limitation was proper because the enterprise was not conducted for profit. However, the court did not reach the issue of substantiation of expenses, or specify which activities generated the gross income. T.C. Memo. 2011-158.

³³ MacLeisure Creations had large net losses for eight consecutive years. T.C. Memo. 2011-158.

³⁴ Substantiation of expenses was at issue in 56 out of 97 cases (58 percent) involving business taxpayers.

³⁵ See, e.g., *Colvin v. Comm’r*, T.C. Memo. 2012-26 (deductions denied for failure to substantiate when taxpayer records were destroyed by a flood and oral testimony was too general).

³⁶ *Mali v. Comm’r*, T.C. Memo. 2011-121 (deductions allowed for various substantiated graphic design production expenses, but others denied for failure to show business purpose of payments, failure to substantiate, or inability to prove that the amount of the deduction was not already allowed).

³⁷ *West v. Comm’r*, T.C. Memo. 2011-272 (deductions allowed under *Cohan* for taxpayer’s average bricklaying and farming expenses even though exact amounts unknown).

³⁸ T.C. Memo. 2011-236.

management, and driver relations services to the LLC for the taxable years under review, and the latter deducted the costs of these expenses. In upholding the IRS's denial of the deductions, the Tax Court noted that the LLC had no employees or owners other than the taxpayer and had no customers other than the corporation and related entities. The court also noted that the services the corporation provided to the LLC were the type of services that the former normally performed for itself and its customers. The court concluded the taxpayer failed to show how the expenses were necessary for the LLC's leasing activities, and also failed to show that the expenses were ordinary.

Another common question for business taxpayers was whether claimed deductions were attributable to an active trade or business. In *Broz v. Commissioner*,³⁹ the taxpayer organized an S corporation ("First S Corporation") to conduct a cellular phone business and decided to expand it into new license areas. The taxpayer then formed another S corporation ("Lessee") that would bid on Federal Communications Commission (FCC) licenses, transfer them to its newly-formed subsidiaries, lease them back, and then build and run new digital networks to use the licenses. These subsidiaries ("Lessors") were organized as single-member LLC license-holding companies. They claimed amortization deductions for the licenses under IRC § 197. The Tax Court noted that the question of whether a cell phone business begins upon the grant of FCC licenses or when contracts for wireless service are sold was a question of first impression. The court scrutinized each entity separately to determine whether it conducted an active trade or business, and ultimately denied the Lessors the deductions because neither the Lessors nor the Lessee were actively engaged in a trade or business. The evidence indicated that the First S Corporation, not the Lessee, ran the on-air networks and used the licenses while assigning the income from such activities to the Lessee or Lessors. The court reasoned that the mere transfer of the cellular licenses to the Lessors was not enough to establish an active trade or business under § 162, and the Lessors were thus not entitled to claim the amortization deductions under IRC § 197.

Courts often upheld the IRS's determination that business expense deductions were not attributable to a "for profit" activity that constituted an actual trade or business under § 183. The taxpayer in *Zenzen v. Commissioner* began drag racing as a hobby in his spare time, but eventually bought his own transporter and cars, started a racing team with his children, and deducted various racing costs as business expenses on his Schedule C.⁴⁰ The taxpayer did not create a business plan or keep dedicated ledgers or books for racing but did keep receipts and spent a significant amount of time on the activities. The Tax Court referenced the nine factors of Treas. Reg. § 1.183-2(b) in its analysis, and concluded the drag racing was not "for profit." Among the dispositive factors were the facts that the taxpayer spent over 54 times what he made racing, was well-off financially with a full-time job, had no good faith belief that he would make a profit, and gained a great deal of personal pleasure from running the team with his children.

³⁹ 137 T.C. 46 (2011), *appeal docketed*, No. 12-1403 (6th Cir. Apr. 6, 2012).

⁴⁰ T.C. Memo. 2011-167.

Among the other business cases of interest is *Lua v. Commissioner*,⁴¹ where the taxpayer (a sole proprietor) proved that cash received by his satellite installers from end-consumers for “additional services” provided during an installation is deductible compensation even though the money never came directly to the taxpayer’s business. *F.W. Services, Inc. & Subsidiaries v. Commissioner* involved deductions for amounts paid under insurance policies.⁴² The taxpayer, a temporary service agency, obtained two insurance policies from one company to cover worker’s compensation and employer liability. Both policies contained a \$500,000 loss reimbursement endorsement, so the taxpayer obtained a third policy with a second insurance company establishing a reserve fund to cover the potential reimbursements. The taxpayer deducted the amounts paid under the first insurer’s policies as well as those paid to the second insurer, including amounts remaining in the reserve fund, as insurance premiums. The IRS denied the deduction for the amount remaining in the reserve fund, but the taxpayer argued that if the three contracts were viewed as one policy, that amount should be treated as an insurance premium. The Fifth Circuit affirmed the Tax Court, concluding that the amount remaining in the reserve fund was not a premium under § 162(a)⁴³ even if the three contracts were read together. The court upheld the IRS’s denial of the insurance deduction for amounts remaining in the reserve fund because the substance of the transactions indicated that the second insurer’s contract created a deposit account and did not shift risk.

CONCLUSION

Taxpayers continue to challenge the IRS’s denials of trade or business deductions. From June 1, 2011, through May 31, 2012, those who were represented did not fare better than those who represented themselves — in fact, *pro se* taxpayers fared slightly better, prevailing 32 percent of the time compared to 30 percent for represented taxpayers. Though the IRS generally prevailed, the courts did not always favor the IRS’s application of the law to the taxpayers’ facts and circumstances. Thus, the definition of an allowable business expense remains open to interpretation and is highly fact-specific.

Many of the cases involving individual taxpayers demonstrate persistent taxpayer confusion over the Code’s requirements, especially those in IRC § 274(d) relating to strict substantiation of listed items. The IRS can minimize litigation by providing clear guidance on the deductibility of trade or business expenses. Through education, outreach, and collaboration with stakeholders, the IRS can help taxpayers understand what trade or business deductions are allowable and how to substantiate them.

In several cases involving business taxpayers, the courts sided with the IRS in denying certain deductions when related entities or hobby loss rules were involved. Even when

⁴¹ T.C. Memo. 2011-192.

⁴² 459 Fed. Appx. 389 (5th Cir. 2012), *aff’g* T.C. Memo. 2010-128.

⁴³ Treas. Reg. § 1.162-1(a) provides that insurance premiums may be deducted as business expenses.

taxpayers were careful to establish complex business structures and document transactions conducted between related entities, the courts were not convinced that the entity claiming deductions was an active trade or business. Without assurances that their sophisticated business structures will yield the anticipated deductions, business taxpayers may be less willing to engage in such transactions. The IRS may find it useful to reach out to business tax advisors to ensure that they are aware of the IRS's willingness to litigate such cases.

MLI
#5

Gross Income Under IRC § 61 and Related Sections

SUMMARY

When preparing tax returns, taxpayers must report gross income for the taxable year to determine the tax they must pay. The reporting of gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.¹ For this report, we reviewed 92 cases decided between June 1, 2011, and May 31, 2012. The majority of gross income cases this year involved taxpayers failing to report items of income, including some specifically mentioned in Internal Revenue Code (IRC) § 61 such as wages,² interest,³ dividends,⁴ and annuities.⁵

PRESENT LAW

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

ANALYSIS OF LITIGATED CASES

In the 92 opinions issued by the federal courts involving gross income 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 all cases analyzed appears in Table 5 of Appendix III.

In 39 cases (about 42 percent), taxpayers were represented, while the rest were *pro se* (without counsel). Eleven of the 39 represented taxpayers (about 28 percent) prevailed in full or in part in their cases. Five of the 53 *pro se* taxpayers (about nine percent) prevailed in full or in part. Overall, taxpayers prevailed in full or in part in 16 of 92 cases (about 17 percent).

Drawing on the full list in Table 5 of Appendix III, we here discuss cases involving damage awards, loan proceeds, and discharge of indebtedness, because they present significant

¹ See, e.g., National Taxpayer Advocate 2010 Annual Report to Congress 467-471; National Taxpayer Advocate 2011 Annual Report to Congress 637-642.

² Internal Revenue Code (IRC) § 61(a)(1). See, e.g., *Caton v. Comm’r*, T.C. Memo. 2012-92.

³ IRC § 61(a)(4). See, e.g., *Megibow v. Comm’r*, T.C. Memo. 2011-211.

⁴ IRC § 61(a)(7). See, e.g., *Juha v. Comm’r*, T.C. Memo. 2012-68.

⁵ IRC § 61(a)(9). See, e.g., *McNeil v. Comm’r*, 467 Fed.Appx. 778 (10th Cir. 2012).

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).

issues litigated in multiple cases. We also discuss individual cases of first impression decided in the federal appeals courts, concerning parsonage income for a second home and a change of accounting method.

Damage Awards

The taxation of damage awards continues to generate litigation. This year, at least ten taxpayers challenged the inclusion of settlement proceeds or arbitration awards in gross income, and the IRS won every case. IRC § 104(a)(2) specifies that damage awards and settlement proceeds⁹ are taxable as gross income unless the award was received “on account of personal physical injury or physical sickness.”¹⁰ Congress added the “physical injury or physical sickness” requirement in 1996;¹¹ until then, the word “physical” did not appear in the statute. The legislative history of the 1996 amendments to IRC § 104(a)(2) states 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.¹²

Thus, a court cannot consider damage awards for emotional distress to be excludible from income, even if the emotional distress has resulted in “insomnia, headaches, [or] stomach disorders.”¹³ To justify exclusion from income under IRC § 104, the taxpayer must show that settlement proceeds are in lieu of damages for physical injury or sickness.¹⁴

Six taxpayers argued that their settlement awards compensated, in whole or in part, for personal physical injuries or physical sickness. For example, in *Ahmed v. Commissioner*,¹⁵ the taxpayer alleged that harassment he suffered while employed contributed to his heart attack shortly after his employer terminated him.¹⁶ The taxpayer was rehired, and on his first day back on the job, “he was exposed to chemicals that made him nauseated and dizzy and that required him to visit the emergency room on the same day.”¹⁷ Under the settlement agreement, the taxpayer agreed to retire and release his employer from all claims, including “personal injuries.” The taxpayer argued the employer intended the settlement to compensate him for physical injuries. The Tax Court found the settlement payment

⁹ See Treas. Reg. § 1.104-1(c)(1) (damages received, for purposes of IRC § 104(a)(2), “means an amount received (other than workers’ compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution”).

¹⁰ IRC § 104(a)(2).

¹¹ Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (1996).

¹² H.R. Conf. Rep. No. 104-586, at 143-44 (1996).

¹³ H.R. Conf. Rep. No. 104-737, at 301 (1996). The exclusion does apply to damages received as reimbursement for amounts paid for medical care attributable to emotional distress for which deductions are allowed under IRC § 213. IRC § 104(a)(2).

¹⁴ See, e.g., *Green v. Comm’r*, 507 F.3d 857 (5th Cir. 2007), *aff’d* T.C. Memo. 2005-250.

¹⁵ T.C. Memo. 2011-295, *appeal docketed*, No. 12-11337 (11th Cir. Mar. 5, 2012).

¹⁶ *Id.*

¹⁷ *Id.*

was severance pay, and not attributable to physical injuries, because the taxpayer agreed to retire from that job.¹⁸

The courts place the burden on the taxpayer to prove settlements were for personal physical injuries or sickness. In *Reesink v. Commissioner*,¹⁹ the taxpayer filed suit accusing his brother “of attacking and strangling him on several occasions as well as poisoning him by pouring cleaning fluid into his drinking water.”²⁰ The brothers each owned one-half of an apartment building, where the alleged acts occurred. The taxpayer settled by agreeing to cooperate in the joint sale of the apartment building and for “\$60,000 as payment in full for his claims arising from the events described in his complaint.”²¹ The complaint did not allege physical injuries. The Tax Court found that the claims could be for emotional distress, and because the taxpayer failed to meet his burden of proof, he must treat the settlement income as taxable.²²

Loan Proceeds

Loan proceeds are excludable from the borrower’s gross income.²³ Courts consider several factors to determine whether the parties intended to make a bona fide loan (*i.e.*, money has been advanced and must be repaid); no single factor is dispositive.²⁴ Some of the factors include whether the parties document the loan, the lender charges interest, and the borrower repays the loan on a fixed payment schedule.²⁵

Two taxpayers convinced the Tax Court that they received nontaxable loan proceeds. In *Bailey v. Commissioner*,²⁶ the taxpayer received stock from a client. He agreed to hold the stock in trust for the benefit of his client, but used some of it as collateral for \$3 million in loans, which he guaranteed and repaid one year later.²⁷ Mr. Bailey argued his use of the stock was not taxable, because he eventually transferred the stock and its proceeds to the federal government in forfeiture of his client’s assets.²⁸ The Tax Court rejected the IRS’s argument that the use of stock as collateral constitutes income in an amount equal to the value of the stock or, alternatively, the value of the loan proceeds.²⁹

¹⁸ T.C. Memo. 2011-295.

¹⁹ *Reesink v. Comm’r*, T.C. Memo. 2012-118.

²⁰ *Id.*

²¹ *Id.*

²² *Id.* For a discussion on the law treating taxpayers differently according to illness, see National Taxpayer Advocate 2009 Annual Report to Congress 351-356 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*).

²³ *Comm’r v. Indianapolis Power & Light Co.*, 493 U.S. 203, 207-208 (1990) (quotation omitted).

²⁴ *Welch v. Comm’r*, 204 F.3d 1228, 1230 (9th Cir. 2000); *Friedrich v. Comm’r*, 925 F.2d 180, 182 (7th Cir. 1991).

²⁵ *Moore v. United States*, 412 F.2d 974, 978 (5th Cir. 1969).

²⁶ T.C. Memo. 2012-96.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

In *Kaider v. Commissioner*,³⁰ the taxpayer received four checks totaling \$21,500 as loan proceeds in 2006 from a company that he assisted. The Tax Court analyzed several factors and found that each check constituted a loan. The factors included whether:

- The taxpayer entered a loan agreement for each loan;
- The company had not deducted the payments as compensation;
- The taxpayer's services were insignificant compared to the loan amounts; and
- The company owner's testimony was not credible when compared to the taxpayer's testimony.³¹

The Tax Court agreed with the taxpayer and held that the checks were bona fide loans excludable from the taxpayer's gross income.³²

Discharge of Indebtedness

We reviewed six cases in which taxpayers disputed the IRS's determination that a discharge of indebtedness was taxable income, and in two of the cases prevailed in full. A taxpayer must include income from discharge of indebtedness when calculating gross income,³³ but can exclude it in certain circumstances. In this regard, IRC § 108(a) provides, subject to limitations, that a taxpayer may exclude income from the discharge of indebtedness if the discharge occurs in bankruptcy, or when the taxpayer is insolvent, or if the indebtedness is qualified farm or business real estate debt or qualified principal residence indebtedness.³⁴ The creditor issues a Form 1099-C, *Cancellation of Debt*, to the taxpayer for cancelled debts of \$600 or more.³⁵

The issuance of a Form 1099-C is not dispositive of whether or when a debt is discharged.³⁶ A debt is "deemed" to have been discharged, and a Form 1099-C is required, if (and only if) an "identifiable event" has occurred.³⁷ For example, in *Kleber v. Commissioner*, the Tax Court held that the taxpayers (a husband and wife) were not liable for cancellation of indebtedness income (COI) reported by a third party on Form 1099-C in 2006 because the "identifiable event" occurred in an earlier year for which a Form 1099-C had not been issued.³⁸ Ms. Kleber had agreed to lease land from the Navy from 1997 to 2001 but in 1998 informed the Navy that she could not comply with the lease, and did not make any subsequent payments. In 1999, the government sent her several letters demanding past-due rent

³⁰ T.C. Memo. 2011-174.

³¹ *Id.*

³² *Id.*

³³ IRC § 61(a)(12).

³⁴ IRC § 108(a)(1)(A)-(E).

³⁵ IRS, Instruction 1099-A & C, *Instructions for Forms 1099-A and 1099-C 2* (2012).

³⁶ T.C. Memo. 2011-233.

³⁷ Treas. Reg. § 1.6050P-1(a). The only exception is that a creditor may, at its discretion, report an actual discharge of indebtedness that occurs before an identifiable event occurs. Treas. Reg. § 1.6050P-1(b)(3).

³⁸ *Kleber v. Comm'r*, T.C. Memo. 2011-233.

and interest. For the next seven years, responsibility for collecting the debt shifted among different government departments, but none took any visible collection action.³⁹

In 2006, the government issued Ms. Kleber a Form 1099-C reflecting COI, which she did not report on her 2006 return. After an examination, the IRS asserted a deficiency and a penalty. Ms. Kleber petitioned the Tax Court, arguing that the amount of COI income for 2006, if there was any, was incorrect and the debt should have been discharged in an earlier year.

There is a rebuttable presumption that an “identifiable event,” requiring a creditor to issue Form 1099-C, occurred during a calendar year if a creditor has not received a payment on an indebtedness at any time during a preceding “testing period.”⁴⁰ The testing period is 36 months, plus the number of months during which the creditor was precluded from engaging in collection activity under local law.⁴¹ The creditor can rebut the presumption that an identifiable event took place, triggering its obligation to issue a Form 1099-C, by showing it engaged in significant collection activity (more than just automated mailing or other nominal acts) during the last 12 months of the testing period.⁴² According to the Tax Court, the government failed to produce any evidence that active collection activity occurred after 1999. As a result, the IRS did not rebut the presumption that a Form 1099-C for this debt was required in 2002, at the end of the 36-month testing period, rather than in 2006. Thus, the Tax Court held that there was no COI in 2006, and the taxpayers had no obligation to report the income on their 2006 return.⁴³

Parsonage Income

The Eleventh Circuit Court of Appeals reversed a decision by a divided Tax Court that held parsonage income for a second home was excludable from gross income.⁴⁴ IRC § 107 provides an exclusion from income for the rental value of parsonages. A minister of the gospel may exclude from gross income compensation for the rental value of a home provided to him or her, or the rental allowance, to the extent the payment does not exceed the

³⁹ T.C. Memo. 2011-233.

⁴⁰ Treas. Reg. § 1.6050P-1(b)(2)(iv).

⁴¹ *Id.*

⁴² *Id.*

⁴³ Because the 36-month testing period allows a creditor to issue (or threaten to issue) a Form 1099-C even though it is not actually discharging a debt, a creditor can collect the debt even as the IRS proposes additional tax due to the reported cancellation of the same debt. The National Taxpayer Advocate has recommended removing the 36-month testing period as an “identifiable event.” See National Taxpayer Advocate 2010 Annual Report to Congress 383 (Legislative Recommendation: *Remove the 36-Month “Testing Period” that May Trigger Cancellation of Debt Reporting*). The recommendation would not harm taxpayers like the Klebers who can point to another “identifiable event” that occurred in a year before the Form 1099-C was issued, such as “discharge pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge the debt.” Treas. Reg. § 1.6050P-1(b)(2)(i)(G). Moreover, the recommendation would not affect the availability of exclusions under IRC § 108(a)(1)(A)-(E), such as for insolvency and for qualified farm indebtedness.

⁴⁴ *Comm’r v. Driscoll*, 669 F.3d 1309 (11th Cir. 2012), *rev’g and remanding Driscoll v. Comm’r*, 135 T.C. 557 (2010). See National Taxpayer Advocate 2011 Annual Report to Congress 640-641.

fair rental value of the home, including furnishings and components such as a garage, plus utilities.⁴⁵

In *Commissioner v. Driscoll*,⁴⁶ the taxpayer-husband was a minister who received a parsonage allowance as part of his compensation from his employer, a tax-exempt organization under IRC § 501(c)(3). Mr. Driscoll excluded the allowance from his income under IRC § 107 and used the allowance to provide a primary residence and a second lakefront home for his family. The IRS determined a deficiency in income for the portion of the parsonage allowance used for the lakefront home in each of the tax years at issue.⁴⁷ The taxpayers petitioned the Tax Court, and the IRS took the position that the plain language of IRC § 107 permits the exclusion of the allowance up to the amount used to provide “a home,” indicating a singular residence.⁴⁸

The Tax Court majority relied on the Dictionary Act, 1 U.S.C. § 1, for the proposition that singular terms (here, “a home”) in the Internal Revenue Code also include plural forms (“homes”).⁴⁹ However, the Dictionary Act does not apply if the context indicates otherwise.⁵⁰ The Eleventh Circuit found that “home” has a singular connotation as “one’s principal place of residence.”⁵¹ The legislative history is consistent with this narrow reading.⁵² Finally, the Court explained that income exclusions should be narrowly construed and any ambiguity in § 107 should be resolved in favor of the IRS.⁵³

Change of Accounting Method

If the IRS determines that a method of accounting does not clearly reflect income, the computation of taxable income shall be made under a method that, in the opinion of the Secretary, does clearly reflect income.⁵⁴ The IRS can impute a change in accounting method to assess additional taxes in the current tax year to disallow deductions taken in prior closed tax years when taxpayers have failed to adopt an accounting method required under the law.⁵⁵ The IRC disallows deductions to a person who transacts business with a related party, who because of its accounting method does not include the amount of the transaction in its gross income. Related parties must match their income and deductions in the same taxable year.⁵⁶

⁴⁵ IRC § 107.

⁴⁶ 669 F.3d 1309.

⁴⁷ *Id.* at 1310.

⁴⁸ *Driscoll v. Comm’r*, 135 T.C. 557, 563-64 (2010).

⁴⁹ *Id.* at 566.

⁵⁰ 669 F.3d at 1311.

⁵¹ *Id.* at 1311-1312.

⁵² *Id.* at 1312 (quoting S. Rep. No. 83-1622, at 186 (1954); H.R. Rep. No. 83-1337, at A35 (1954)).

⁵³ *Id.* at 1312-1313.

⁵⁴ IRC § 446(b).

⁵⁵ IRC § 481.

⁵⁶ IRC § 267(a)(2).

In *Bosamia v. Commissioner*,⁵⁷ the Bosamias owned two related S corporations: an importer and a music seller. The music seller purchased cassettes from the importer on credit, creating an account payable. The music seller deducted from its taxable income the cost of goods sold, equal to the annual increase in the account payable under the accrual method of accounting. However, the importer did not report the corresponding account receivable as income because the importer accounted for income on the cash basis.⁵⁸ The IRS issued a notice of deficiency, disallowing the music seller's deductions from 1998 through 2004, because the importer did not include the receivable in gross income. The IRS argued that the adjustment to the deductions over several tax years should be treated as an adjustment under IRC § 481 for a change in accounting method in the tax year before the court, effectively reopening the expired assessment statute of limitations for the earlier tax years.⁵⁹ The Fifth Circuit Court of Appeals agreed with the IRS and affirmed the Tax Court's decision.

CONCLUSION

Taxpayers litigate many of the same gross income issues year after year. The courts broadly define gross income, and narrowly construe exceptions. Most cases considering the inclusion of income under IRC § 61 were decided for the IRS. A major source of litigation was the inclusion of damage awards. 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.⁶⁰ One exception to decisions favoring the IRS was in the area of cancellation of debt income, where taxpayers successfully relied on a presumption in a Treasury Regulation that required their creditor to report cancellation of debt income in an year earlier than the year at issue. Because the presumption harms taxpayers by allowing a creditor to continue to collect a debt that has been reported to the IRS as discharged, giving rise to cancellation of debt income, the National Taxpayer Advocate has recommended removing the presumption from the regulation. The recommendation leaves undisturbed other bases for excluding or contesting the reported cancellation of debt income.

⁵⁷ *Bosamia v. Comm'r*, 661 F.3d 250 (5th Cir. 2011), *aff'g* T.C. Memo. 2010-218.

⁵⁸ 661 F.2d at 252.

⁵⁹ *Id.* at 256-258.

⁶⁰ National Taxpayer Advocate Annual 2009 Annual Report to Congress 351-356 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*).

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 74 decisions issued by federal courts from June 1, 2011, to May 31, 2012, 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. Seventeen cases involved the imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties, three cases involved only the estimated tax penalty, five cases involved only the failure to pay penalty, and 34 cases involved only the failure to file penalty.

The failure to file and failure to pay penalties shall be imposed unless the taxpayer can demonstrate that the failure is due to reasonable cause and not willful neglect.² The estimated tax penalty is imposed unless the taxpayer can meet one of the statutory exceptions.³ Most taxpayers in the cases we analyzed were unable to avoid the penalty.

PRESENT LAW

Under IRC § 6651(a)(1), a taxpayer who fails to file a return on or before its due date (including extensions) will be subject to a five percent penalty for each month or partial month the return is late, up to a maximum of 25 percent, unless the failure is due to reasonable cause and not willful neglect.⁴ The penalty is based on the amount of tax due, minus any credit the taxpayer is entitled to receive and any payment made by the due date.⁵ The failure to file penalty applies to income, estate, gift, employment and self-employment, and certain excise tax returns.⁶ 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.⁷

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

² IRC § 6651(a)(1), (a)(2).

³ IRC § 6654(e).

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

⁵ IRC § 6651(b)(1).

⁶ IRC § 6651(a)(1).

⁷ Treas. Reg. § 301.6651-1(c)(1).

IRC § 6651(a)(2) applies to a taxpayer who fails to pay an amount shown as tax on his or her return. 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.⁸ Unless the taxpayer can show that the failure to pay was due to reasonable cause and not willful neglect, the failure to pay penalty accrues at a rate of 0.5 percent per month on the unpaid balance for as long as the balance due remains unpaid, up to a maximum of 25 percent of the amount due.⁹ The failure to pay penalty applies to income, estate, gift, employment and self-employment, and certain excise tax returns.¹⁰ To establish reasonable cause, the taxpayer must show that he or she exercised ordinary business care and prudence but was still unable to pay by the due date, or that payment on the due date would cause undue hardship.¹¹ Courts will consider “all facts and circumstances of the taxpayer’s financial situation” to determine whether the taxpayer exercised ordinary business care and prudence.¹²

IRC § 6654 imposes a penalty on any underpayment of estimated tax by an individual.¹³ The law requires four installments per taxable year, each generally 25 percent of the annual payment.¹⁴ The required annual payment is generally the lesser of 90 percent of the tax shown on the return for the current taxable year or 100 percent of the tax shown on the return for the previous year.¹⁵ The IRS will determine the amount of the penalty by applying the underpayment rate according to IRC § 6621 to the amount of the underpayment for the period of the underpayment.¹⁶

The estimated tax penalty applies to returns of individuals and certain estates and trusts.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

⁸ IRC § 6651(c)(1).

⁹ If 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).

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 F3d 499, 507 (3d Cir. 1999).

¹³ IRC § 6654(a).

¹⁴ IRC § 6654(c)(1), (d)(1)(A).

¹⁵ IRC § 6654(d)(1)(B).

¹⁶ IRC § 6654(a).

¹⁷ IRC § 6654(a), (l).

¹⁸ IRC § 6654(e)(1).

¹⁹ IRC § 6654(e)(2).

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

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

ANALYSIS OF LITIGATED CASES

We analyzed 74 opinions issued between June 1, 2011, and May 31, 2012, where the failure to file penalty, failure to pay penalty, or estimated tax penalty (or all three) were in dispute. All but six of these cases were litigated in the United States Tax Court. A detailed list appears in Table 6 in Appendix III. Forty-three cases involved individual taxpayers and 31 involved businesses (including individuals engaged in self-employment or partnerships). Of the 52 cases in which taxpayers appeared *pro se* (without counsel), taxpayers prevailed in full in two cases, and four resulted in split decisions. Of the 22 cases in which taxpayers appeared with representation, taxpayers prevailed in full in only one case, and one was resolved as a split decision.

Failure to File Penalty

A common basis for the courts' rulings against taxpayers on the failure to file penalty was the lack of evidence that the failure was due to reasonable cause. In fact, in 67 of the 74 cases (91 percent), the taxpayers did not present any evidence of reasonable cause. When taxpayers did present evidence in defense of their failures to file by the due date (or at all), the arguments included the following.

Medical Illness

Depending on the facts and circumstances, a medical illness may establish reasonable cause for failing to file, if the taxpayer can show incapacitation to such a degree that he or she could not file a return on time.²³ The taxpayer in *In re Williams* did not establish reasonable cause when the Bankruptcy Court found that his knee surgeries had not debilitated him so much that he had reasonable cause for filing his return late.²⁴

²⁰ IRC § 6654(e)(3)(A).

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, such as where the taxpayer only makes frivolous arguments. *Funk v. Comm'r*, 123 T.C. 213 (2004).

²³ *Williams v. Comm'r*, 16 T.C. 893, 905-06 (1951) (interpreting § 291 of the 1939 Code, a predecessor to IRC § 6651), *acq.*, 1951-2 C.B. 1. See, e.g., *Harbour v. Comm'r*, T.C. Memo. 1991-532 (finding reasonable cause for failing to timely file because the taxpayer was in a coma the month before the due date of his tax return).

²⁴ 109 A.F.T.R.2d (RIA) 2365 (Bankr. D. Neb. 2012).

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A court also may find reasonable cause where a taxpayer cannot file on time because he or she is caring for another person.²⁵ For example, in *Bailey v. Commissioner*, the Tax Court determined a taxpayer had reasonable cause for missing a filing deadline during the year in which his wife lost her struggle with a terminal illness.²⁶ The taxpayer filed his 1998 return 50 days after his wife died in October 1999, and filed his 1999 and 2000 returns a few months late. The court found that the taxpayer had reasonable cause for the late filing of the 1998 return because he spent most of his time at his wife's bedside.

Reliance on Agent

The United States Supreme Court, in *United States v. Boyle*,²⁷ held that taxpayers have a nondelegable duty to file a return on time, and a taxpayer's reliance on an agent does not excuse a failure to comply with a known filing requirement. In *Greenwald v. Commissioner*,²⁸ the taxpayer argued that he reasonably relied on an accounting firm to request an extension of time to file his 2005 return. The firm told the taxpayer that its policy was to request extensions for its customers without being prompted, but he later discovered the extension had not been filed, and he filed his own return on January 12, 2007. The Tax Court determined there was not enough evidence to show reasonable cause for the late filing because the taxpayer knew he would need an extension and did not file one, and under *Boyle* the duty to file could not be delegated to an attorney or accountant.²⁹ The court also noted that the taxpayer failed to present evidence proving the date when he gave his tax return information to the accounting firm, and the witness from the firm could not recall the contents of the taxpayer's file.

A taxpayer may establish reasonable cause if he or she can prove reasonable reliance on a professional tax advisor, or that the taxpayer made a good-faith effort to ascertain return filing requirements.³⁰ In order to reasonably rely on the advice of a tax professional, the taxpayer must present evidence of the professional's expertise and show that the taxpayer provided him or her with all necessary and accurate information.³¹ In *Cahill v. Commissioner*, the taxpayer was unable to establish reasonable cause for her failure to file when she claimed reliance on an attorney and a stockbroker.³² She claimed the attorney and the broker told her she did not have to file, but she did not provide any written opinion from either of them, and failed to establish they were competent tax advisors.

²⁵ *Tabbi v. Comm'r*, T.C. Memo. 1995-463 (determining reasonable cause existed for the late filing of a joint return where the taxpayers' son had heart surgery and the taxpayers were continuously at the hospital for four months surrounding the due date of the return).

²⁶ T.C. Memo. 2012-96.

²⁷ 469 U.S. 241 (1985).

²⁸ T.C. Memo. 2011-239.

²⁹ *Greenwald*, T.C. Memo. 2011-239.

³⁰ *Estate of La Meres v. Comm'r*, 98 T.C. 294, 315-17 (1992) (citations omitted).

³¹ *Id.*

³² T.C. Memo. 2011-203.

“Zero Return” Filers and Other Frivolous Arguments

Under the longstanding four-part test articulated in *Beard v. Commissioner*,³³ a valid return must:

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

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-2.³⁴ A “zero” return does not constitute a tax return under the *Beard* test because it is devoid of financial data and does not provide sufficient information to calculate the tax liability.³⁵ Thus, when the taxpayer in *Richmond v. Commissioner* filed a return containing all zeros, the Tax Court sustained the failure to file penalty.³⁶

In six cases where the IRS had asserted the failure to file penalty, the courts also imposed the IRC § 6673 penalty for making frivolous arguments.³⁷ Among the frivolous argument cases is one where the taxpayer argued that as a resident of the United States, he *may* choose to file a return, or he *may* choose not to do so, and he chose the latter.³⁸ The Tax Court held him liable for the failure to file penalty, and also imposed a \$1,000 penalty under IRC § 6673.

Failure to Pay an Amount Shown Penalty

A taxpayer can file his or her return by the applicable due date and still be liable for a penalty if the amount shown on the return is not paid. In cases where taxpayers disputed that they were subject to the failure to pay penalty, many of the justifications were similar to those used for the failure to file penalty under IRC § 6651(a)(1). To refute the failure to pay penalty, individual taxpayers unsuccessfully argued medical illness³⁹ or reliance on an agent.⁴⁰

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

³⁴ See, e.g., *Parker v. Comm’r*, T.C. Memo. 2012-66 (concluding that there was no evidence of reasonable cause presented when the taxpayer reported all “zeros” on his return and offered only frivolous arguments).

³⁵ See *Turner v. Comm’r*, T.C. Memo. 2004-251, and the numerous cases cited therein.

³⁶ T.C. Memo. 2011-251, *aff’d*, 2012 U.S. App. LEXIS 17059 (10th Cir. Aug. 15, 2012).

³⁷ See Most Litigated Issue: *Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions, infra*.

³⁸ *Garber v. Comm’r*, T.C. Memo. 2012-47, 2 (emphasis added).

³⁹ *Nasir v. Comm’r*, T.C. Memo. 2011-283.

⁴⁰ *Cahill v. Comm’r*, T.C. Memo. 2011-203.

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Some business taxpayers successfully argued they had reasonable cause for their failure to pay because they exercised ordinary business care and prudence.⁴¹ For example, the taxpayer in *Custom Stairs & Trim, Ltd. v. Commissioner*, a small construction business in Florida, was assessed the IRC § 6651(a)(2) penalty when it failed to pay the required employment tax for the second quarter of 2008.⁴² This case came to the Tax Court for judicial review of the IRS Office of Appeals determination after a Collection Due Process (CDP) hearing under IRC §§ 6320 and 6330.⁴³ The IRS argued that the mere inability to pay, combined with the business's payment of other creditors instead of the IRS, can *never* constitute reasonable cause for abatement of employment tax penalties. The court disagreed, stating that “a majority of the Courts of Appeals that have decided this issue determined ‘that financial hardship can, under certain circumstances, justify failure to pay . . . employment taxes,’”⁴⁴ and criticized the IRS for “essentially argu[ing] that if Custom Stairs cannot afford to make its tax payment timely it should go out of business.”⁴⁵ The court expressly rejected the IRS's position, stating: “Both the economy and the federal fisc are negatively impacted by such an approach — the amount of money flowing into the economy and the fisc is reduced as a result of increased unemployment, idle buildings and plants, and decreased sales of goods and services.”⁴⁶

To determine whether the taxpayer had reasonable cause, the Tax Court referenced Treasury Regulation § 301.6651-1(c)(1), which states that a taxpayer can show reasonable cause if it proves that it “exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship . . . if he paid on the due date.”⁴⁷ The primary factors showing whether the business exercised ordinary care include (1) the taxpayer's favoring creditors other than the government, (2) the taxpayer's financial decisions, and (3) the taxpayer's willingness to decrease its costs and staff.⁴⁸ The court found Custom Stairs' failure to make the quarterly payment was due to Hurricane Ivan, the 2008 economic collapse, and the practical fact of the cascading penalties themselves.⁴⁹ It determined that Custom Stairs had exercised ordinary business care and prudence in cutting benefits and payroll, selectively

⁴¹ *Custom Stairs & Trim, Ltd., v. Comm'r*, T.C. Memo. 2011-155.

⁴² *Id.*

⁴³ For a detailed discussion of CDP, see Most Litigated Issue: *Appeals From Collection Due Process Hearings Under IRC §§ 6320 and 6330*, *supra*.

⁴⁴ *Custom Stairs & Trim, Ltd.*, T.C. Memo. 2011-155, 7 (quotation omitted).

⁴⁵ *Id.* at 8.

⁴⁶ *Id.* (quoting *East Wind Indus., Inc. v. U.S.*, 196 F.3d 499, 509 (3d Cir. 1999)).

⁴⁷ Treas. Reg. § 301.6651-1(c)(1).

⁴⁸ *Custom Stairs & Trim, Ltd.*, T.C. Memo. 2011-155 (citing, *inter alia*, *Staff It, Inc. v. U.S.*, 482 F.3d 792 (5th Cir. 2007) (additional citations omitted)).

⁴⁹ The taxpayer paid over to the IRS amounts greater than the employment taxes it owed for that period. However, because the taxpayer did not designate the payments, the IRS characterized the payments as pertaining to a prior quarter. Although failure to pay penalties were assessed for multiple quarters, quarter after quarter funds were applied to the penalties assessed for the prior quarter, and only the second quarter of 2008 remained unpaid at the time of the litigation. *Custom Stairs & Trim, Ltd.*, T.C. Memo. 2011-155.

paying business expenses, and even attempting to sell real property to pay the penalties, and thus had reasonable cause.⁵⁰

Estimated Tax Penalty

Courts routinely found taxpayers liable for the IRC § 6654 estimated tax penalty when the IRS proved the taxpayer had a tax liability, had no withholding credits, and made no estimated tax payments for that year, and the taxpayer offered no evidence to refute the IRS's evidence.⁵¹

The IRS has the burden of production under IRC § 7491(c) to produce evidence that a taxpayer was required to make an annual payment under IRC § 6654(d)(1)(B). We found only two cases where the taxpayer prevailed regarding the estimated tax penalty because of the IRS's failure to put forth evidence that the penalty was appropriate. In *Gleason v. Commissioner*, the Tax Court concluded the taxpayer was not liable for the § 6654 penalty because the IRS failed to introduce evidence necessary for the court to calculate her estimated tax for the 2000 taxable year.⁵² The IRS failed to offer evidence that the taxpayer filed a return for the 2000 taxable year or that she owed any tax. The court reasoned that because the taxpayer's 2001 and 2003 returns reported that she owed no tax, assessment of the § 6654 penalty resulted in a penalty equal to 90 percent of zero estimated tax.⁵³ Therefore, the taxpayer was not liable for a § 6654 penalty for either the 2001 or 2003 taxable years. Similarly, the IRS failed its burden of production for one of the six tax years at issue in *West v. Commissioner*.⁵⁴

CONCLUSION

The United States tax system relies on taxpayers voluntarily filing accurate returns and paying their taxes. Penalties attempt to establish fairness by imposing an additional cost on the noncompliant taxpayer. The penalties for failure to file, failure to pay an amount shown as tax, and failure to pay estimated tax were designed to encourage voluntary compliance and deter noncompliance.⁵⁵

The IRS should determine whether these penalties positively influence compliance as intended, particularly in the case of taxpayers who comply with their filing obligations, although in an untimely manner. If compliance is not significantly improved, then the penalties fail to serve their primary function. Although revenue is generated by the penalties,

⁵⁰ The court relied on the elaboration of facts provided in the National Taxpayer Advocate's memorandum accompanying a Form 9102, *Taxpayer Assistance Order* issued earlier. *Custom Stairs & Trim, Ltd.*, T.C. Memo. 2011-155.

⁵¹ See, e.g., *Caton v. Comm'r*, T.C. Memo. 2012-92; *Plotkin v. Comm'r*, T.C. Memo. 2011-260, *appeal docketed*, No. 12-10620 (11th Cir. Feb. 6, 2012).

⁵² T.C. Memo. 2011-154.

⁵³ *Gleason v. Comm'r*, T.C. Memo. 2011-154 (citing *Mendes v. Comm'r*, 121 T.C. 308, 324 (2003) (holding that a taxpayer's estimated liability is based on the original return filed rather than the taxpayer's ultimate tax liability or a notice of deficiency)).

⁵⁴ T.C. Memo. 2011-272.

⁵⁵ See Policy Statement 20-1 (formerly P-1-18), IRM 1.2.20.1.1 (June 29, 2004). See also *U.S. v. Boyle*, 469 U.S. 241, 245 (1985) ("Congress' purpose in the prescribed civil penalty was to ensure timely filing of tax returns to the end that tax liability will be ascertained and paid promptly").

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

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the allowance of a one-time abatement for taxpayers who comply with filing obligations in an untimely manner might reduce litigation without significantly affecting compliance. The National Taxpayer Advocate reiterates her recommendation to implement a one-time abatement of the failure to file penalty for taxpayers who comply with their filing obligations, but in an untimely manner.⁵⁶ More broadly, she notes the significance of cases such as *Custom Stairs*, discussed above, which abated the failure to pay penalty where it served no compliance purpose for a taxpayer exercising ordinary business care for payment of its tax liability. Further, she urges a repeal of the failure to pay penalty, which could be replaced by a market rate of interest equal to the rate on an unsecured loan.⁵⁷

⁵⁶ 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. 29, 2011), the National Taxpayer Advocate continues to recommend a statutory waiver similar to IRC § 6656(c).

⁵⁷ 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 a 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 the tax. We identified 48 opinions issued between June 1, 2011, and May 31, 2012 that involved civil actions to enforce liens under IRC § 7403. The courts affirmed the position of the United States in all but two cases; taxpayers prevailed in one case; and one other resulted in a split opinion. Over the four years that this issue has appeared as a Most Litigated Issue, the number of cases identified has remained consistent, with the exception of 2009 when 61 cases were identified.¹

PRESENT LAW

IRC § 7403 specifically 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 the property of the delinquent taxpayer to the payment of a liability, by initiating a civil action against the taxpayer in the appropriate U.S. District Court.² All persons holding liens or claiming any interest in the taxpayer's property should be named as parties to the action.³ The nature of a taxpayer's legal interest in the property subject to a lien is determined by the law of the state where the property is located.⁴ However, once it is determined that a delinquent taxpayer has an interest in the property, federal law controls whether the property is exempt from attachment.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, the court is not required to authorize a forced sale under all circumstances and may exercise limited equitable discretion.⁷ In cases

¹ See National Taxpayer Advocate 2011 Annual Report to Congress 650-654 (Most Litigated Issue: *Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payments of Tax Under IRC Section 7403*); National Taxpayer Advocate 2010 Annual Report to Congress 483-486 (Most Litigated Issue: *Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payments of Tax Under IRC Section 7403*); National Taxpayer Advocate 2009 Annual Report to Congress 465-470 (Most Litigated Issue: *Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payments of Tax Under IRC Section 7403*).

² IRC § 7403(a); Treas. Reg. § 301.7403-1(a). Such action may be initiated regardless of whether a levy has been made.

³ IRC § 7403(b).

⁴ *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985).

⁵ *United States v. Rodgers*, 461 U.S. 677 (1983). Similarly, federal tax liens can attach to property exempt from the reach of creditors under state law, including property held by a delinquent taxpayer as a tenant by the entirety. *United States v. Craft*, 535 U.S. 274 (2002).

⁶ IRC § 7403(c).

⁷ *Rodgers*, 461 U.S. at 711.

where the forced sale involves the interests of non-delinquent third parties, a U.S. District Court should consider four factors when determining whether the property should be sold:

1. The extent to which the government's financial interests would be prejudiced if they were relegated to a forced sale of the partial interests of the delinquent taxpayer;
2. Whether the innocent third party with a separate legal 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 the 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

The United States may bid at the sale of the property when it holds a first lien,⁹ but the amount of the bid is limited to the amount of the lien, plus selling expenses.¹⁰ If any of the taxpayer's other creditors institute a foreclosure action on property subject to a federal tax lien and the United States is not a party, the United States may intervene as if it had originally been joined as a party,¹¹ and may move the case to the U.S. District Court if it was instituted in a state court.¹² However, junior federal tax liens may be effectively extinguished in a foreclosure and sale under state law, even if the United States is not a party to the proceeding.¹³ The IRC also specifically authorizes the court to appoint a receiver to enforce the lien, and upon the government's certification that it is in the public interest, the court may appoint a receiver with all powers of a receiver in equity to preserve and operate the property prior to sale.¹⁴

ANALYSIS OF LITIGATED CASES

We reviewed 48 opinions entered between June 1, 2011, and May 31, 2012, in civil actions to enforce federal tax liens. Table 7 in Appendix III contains a detailed list of those cases. In 22 cases, taxpayers represented themselves (*pro se*), while 26 taxpayers were represented by counsel. Taxpayers with representation received full relief in one case and partial relief in another, while *pro se* taxpayers did not receive relief in any case.

⁸ *Rodgers*, 461 U.S. at 709–11.

⁹ IRC § 7403(c).

¹⁰ *Id.*

¹¹ IRC § 7424; 28 U.S.C. § 2410.

¹² 28 U.S.C. § 1444. However, if the application of the United States to intervene is denied, the adjudication will have no effect upon the federal tax lien on the property. IRC § 7424.

¹³ *United States v. Brosnan*, 363 U.S. 237 (1960).

¹⁴ IRC §§ 7403(d) and 7402(a).

The courts ruled on the appropriateness of foreclosure in all 48 cases, with the government prevailing fully in 46.¹⁵ For example, in *United States v. Rivetts*,¹⁶ the court considered whether it was appropriate to order the foreclosure of the taxpayers' residence. First, because the taxpayers alleged they had never received a notice of deficiency as required by the IRC, the court considered whether the government sent the taxpayer a notice for each assessment and found that it had.¹⁷ Next, the court considered whether the suit began prior to the period of collection expiring and found this requirement had also been met.¹⁸ The court then determined the taxpayers had failed to show that tax liabilities assessed against them were incorrect and had not paid the liabilities.¹⁹ Finally, the court considered whether it should exercise its equitable discretion and prohibit the foreclosure sale because of the hardship it would cause to the extended family living with the taxpayers. The court concluded that the sale of the residence was appropriate even though it might result in dislocation costs and inconvenience to the family.

Tax liens can attach not only to proceeds of the sale of encumbered property but also to new property purchased with the proceeds. In *United States v. McCullough*,²⁰ the court allowed the government to foreclose upon real property purchased with the proceeds from the sale of the original encumbered property. In that case, the taxpayer transferred her residence to her daughter in exchange for \$1.00 and "natural love and affection." At the time, federal tax liens attached to the property as the taxpayer had outstanding liabilities, but no notice of federal tax lien (NFTL) had been filed. The daughter later transferred the property to herself and her husband, eventually selling it and using the proceeds to buy a new home. The court found the original transfer to the daughter was made without adequate consideration. Thus, the daughter was not considered a *bona fide* purchaser, so the transfer to her did not extinguish the tax liens.²¹ Because the liens encumbered the residence, they would follow any property substituted for the residence provided the chain of substitution could be traced. Thus, the court ordered foreclosure of the new property, noting that tax

¹⁵ In seven cases, United States Courts of Appeals affirmed the trial courts' decisions in favor of the government. See *United States v. Barczyk*, 434 Fed. Appx. 488 (6th Cir. 2011) (per curiam), *aff'g* 697 F. Supp. 2d 789 (E.D. Mich. 2010), *cert. denied*, 132 S. Ct. 1118 (2012); *United States v. Burnett*, 452 Fed. Appx. 569 (5th Cir. 2011), *aff'g* 106 A.F.T.R.2d (RIA) 6699 (S.D. Tex. 2010); *United States v. Howard*, 442 Fed. Appx. 262 (9th Cir. 2011), *aff'g* 102 A.F.T.R.2d (RIA) 5601 (D. Ariz. 2008); *United States v. Springer*, 427 Fed. Appx. 650 (10th Cir. 2011), *aff'g* 105 A.F.T.R.2d (RIA) 1192 (N.D. Okla. 2010); *Ansel Capital Inv., LLC v. United States*, 448 Fed. Appx. 709 (9th Cir. 2011), *aff'g* 2010 U.S. Dist. LEXIS 41977 (D. Mont. 2010); *United States v. Black*, 109 A.F.T.R.2d (RIA) 2282 (9th Cir. 2012), *aff'g* 106 A.F.T.R.2d (RIA) 5320 (E.D. Wash. 2010) and 725 F. Supp. 1279 (E. D. Wash. 2010); *Eckhardt v. United States*, 109 A.F.T.R.2d (RIA) 1414 (11th Cir. 2012) (per curiam), *aff'g* 2010 U.S. Dist. LEXIS 142176 (S.D. Fla. 2010).

¹⁶ 109 A.F.T.R.2d (RIA) 2127 (D. Minn. 2012).

¹⁷ IRC § 6213.

¹⁸ IRC § 6502.

¹⁹ In *Rivetts*, the court held that the taxpayers' self-serving affidavits were not sufficient to rebut the presumption of correctness. 109 A.F.T.R.2d (RIA) 2127 (D. Minn. 2012).

²⁰ 108 A.F.T.R.2d (RIA) 6732 (W.D. Pa. 2011).

²¹ If a taxpayer transfers property subject to a federal tax lien to a purchaser before the government files an NFTL, the lien no longer attaches and the purchaser acquires the property free of the lien. IRC § 6323(a). A purchaser is defined in the Code as a person who for adequate consideration acquires an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice. IRC § 6323(h)(6).

liens “follow the property through subsequent transfers until satisfied or barred by the statute of limitations.”²²

In *United States v. Ford*,²³ the court concluded it was appropriate to foreclose upon property held by a third-party purchaser. The case involved a delinquent taxpayer whose real property was sold to another individual by the mortgage company after the taxpayer defaulted on his mortgage. The third party had been informed of the NFTL filing before she bought the property. Although it was the previous owner who owed the debt to the government, the court reasoned that the new owner was not innocent merely because she purchased the home for value and paid for its taxes and insurance. Rather, since she purchased the home with actual and constructive knowledge of the tax lien, the court held that equity did not preclude foreclosure.

In *United States v. Corry Communications*,²⁴ however, the court determined it was inappropriate to foreclose the tax liens that attached to an active FCC broadcast license. The court reasoned that while there is a private right to receive proceeds from a transfer of the license, the right to operate an FCC-approved broadcast license is a public right and is not property subject to foreclosure under § 7403.

In a number of cases involving property in which non-delinquent third parties held interests, the courts considered the equitable factors set forth by the Supreme Court in *United States v. Rodgers*.²⁵ For example, in *United States v. Smith*,²⁶ the court applied the *Rodgers* factors and granted the government’s motion for foreclosure of federal tax liens against the taxpayers’ home. The court determined that each factor weighed in favor of foreclosure even though the taxpayer’s spouse, who did not owe any taxes, was a co-owner of the properties. The court found that the second *Rodgers* factor did not favor relief, as the non-liable spouse had no legally recognized expectation that the property would not be subject to a forced sale, because property held in a tenancy by the entirety²⁷ can be subjected to a forced sale due to the debts of one spouse. In *United States v. Buaiz*,²⁸ the court found that all four *Rodgers* factors weighed in favor of the United States and ordered the foreclosure of the property even though the taxpayer’s children had an interest in it.

The limited nature of a judge’s discretion to deny foreclosure under *Rodgers* is illustrated by *United States v. Winsper*.²⁹ In that case, the district court reduced the tax assessment against the taxpayer to judgment, but decided not to order the foreclosure of the liens

²² 108 A.F.T.R.2d (RIA) 6732 (W.D. Pa. 2011).

²³ 109 A.F.T.R.2d (RIA) 1201 (E.D. Mich. 2012).

²⁴ 108 A.F.T.R.2d (RIA) 6521 (W.D. Pa. 2011), *rejecting* 2011 U.S. Dist. LEXIS 116783 (W.D. Pa. 2011).

²⁵ 461 U.S. 677, 710-11 (1983).

²⁶ 109 A.F.T.R.2d (RIA) 772 (W.D. Ky. 2012).

²⁷ An “estate by entirety” is a common-law estate in which each spouse is seized of the whole of the property. An estate by entirety is based on the legal fiction that a husband and wife are a single unit. *Black’s Law Dictionary* (9th ed. 2009).

²⁸ 108 A.F.T.R.2d (RIA) 5856 (E.D. Tenn. 2011).

²⁹ 680 F.3d 482 (6th Cir. 2012), *rev’g* 106 A.F.T.R.2d (RIA) 5130 (W.D. Ky. 2010).

attached to the home owned by the taxpayer and his wife. On appeal, the United States Court of Appeals for the Sixth Circuit reviewed the decision for abuse of discretion, and concluded by reversing and remanding the case back to the district court, so that it could reconsider whether to exercise its limited discretion not to order foreclosure of the entire property. The Sixth Circuit held that the district court misapplied two of the four *Rodgers* factors and improperly placed the burden on the government to justify foreclosure. The court explained that the factors do not impose a burden of proof that the government must satisfy before the district court can order a sale, but rather are to be used when a court determines whether to exercise its limited discretion not to order a sale.

Several opinions we reviewed involved foreclosure of federal tax liens against taxpayer property titled in the name of a nominee.³⁰ The term “nominee” refers to parties that hold legal title to a property while a different party retains all or some of the benefits of the property.³¹ In *United States v. Brice*,³² the IRS assessed taxes against the taxpayer and recorded NFTLs against his properties, of which the most notable were a residence and an airplane hangar, both owned by the taxpayer and his wife. The couple conveyed the properties to themselves as trustees of a family trust, then as trustees conveyed the properties to another trust without consideration, for which the taxpayer served as trustee and chairman. That trust then transferred the properties to yet another trust, for which the taxpayer also served as trustee and chairman. He also paid his personal living expenses out of the trust’s bank account. The court held that the taxpayer was the true owner of the residence and the hangar and the trust was simply holding the property as his nominee, since no other person was involved. Accordingly, the liens remained attached to the properties, and the court ordered foreclosure.

Similarly, in *United States v. Sanchez-Martinez*,³³ the government filed an action to foreclose its tax liens against real property held by the taxpayer’s sister and the taxpayer’s single-member LLC. The court set forth several factors to use in determining whether property was held by a nominee. The court concluded that those holding title to the property were nominees, since the taxpayer declared to a revenue officer that he owned the property, the taxpayer paid taxes on the property, the titleholders were closely related to the taxpayer, and there was no evidence that the titleholders interfered with the taxpayer’s use of the property. The court accordingly granted the government’s motion for summary judgment and ordered foreclosure.

³⁰ See, e.g., *United States v. Ippolito*, 109 A.F.T.R.2d (RIA) 1083 (M.D. Fla. 2012); *United States v. Ledford*, 109 A.F.T.R.2d (RIA) 1643 (D. Colo. 2012); *United States v. Sanchez-Martinez*, 109 A.F.T.R.2d (RIA) 2183 (E.D.N.C. 2012).

³¹ See *United States v. Ledford*, 109 A.F.T.R.2d (RIA) 1643 (D. Colo. 2012).

³² 109 A.F.T.R.2d (RIA) 1613 (W.D. Mo. 2012).

³³ 109 A.F.T.R.2d (RIA) 2183 (E.D.N.C. 2012).

CONCLUSION

While the trend in NFTL filings had been generally rising since fiscal year (FY) 2002, in 2011 the IRS announced its “Fresh Start” initiative.³⁴ The Fresh Start initiative was designed to assist taxpayers with financial burdens by making changes in how the IRS files and withdraws NFTLs.³⁵ As a result, in FY 2012 NFTL filings decreased to just over 700,000.³⁶ However, although NFTL filings have decreased, IRS referrals to the Department of Justice of lien foreclosure suits have increased by 26 percent since FY 2010.³⁷ Due to the increase in referrals to Justice, we anticipate an increase in court opinions on enforcement of IRC § 7403.³⁸

³⁴ IRS, Media Relations Office, *IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes to Lien Process*, IR-2011-20 (Feb. 24, 2011). See Statistics of Income Data Books, Table 16b, Delinquent Collection Activities, 2002-2010 and Statistics of Income Data Books, Table 16, Delinquent Collection Activities, 2010-2011.

³⁵ For a full discussion of the National Taxpayer Advocate’s concerns about liens see Most Serious Problem: *Although the IRS “Fresh Start” Initiative has Reduced the Number of Lien Notices Filed, the IRS has Failed to Determine if its Lien Policies are Clearly Supported by Either Increased Taxpayer Compliance or Revenue*, *supra*.

³⁶ IRS, Collection Report NO-5000-25 (Oct. 1, 2012).

³⁷ IRS, Small Business/Self Employed Division (SB/SE) SB/SE, Collection Activity Report NO-5000-24, *Levy and Seizure Report* (Oct. 1, 2012). Department of Justice (DOJ), Tax Division, *Suits to Foreclose Tax Lien - Summary by Fiscal Year of Case Receipt* (Oct. 3, 2012). The IRS conducted 605 seizures and referred 221 lien foreclosure suits to the DOJ in FY 2010, and conducted 733 seizures and referred 278 lien foreclosure suits to the DOJ in FY 2012.

³⁸ For a discussion of the National Taxpayer Advocate’s proposed amendment to IRC § 7403 see Legislative Recommendation: *Amend Code Section 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*, *supra*.

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

From June 1, 2011, through May 31, 2012, the federal courts issued decisions in at least 38 cases involving the Internal Revenue Code (IRC) § 6673 “frivolous issues” penalty and at least six cases involving an analogous penalty at the appellate level.¹ These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal.² In many of the cases we reviewed, taxpayers escaped liability for the penalty but were warned they could face sanctions for similar conduct in the future.³ Nonetheless, we include these cases in our analysis to illustrate what conduct will and will not be tolerated by the courts.

PRESENT LAW

The U.S. Tax Court is authorized to impose a penalty against a taxpayer if the taxpayer institutes or maintains a proceeding primarily for delay, takes a frivolous position in a proceeding, or unreasonably fails to pursue available administrative remedies.⁴ The maximum penalty is \$25,000.⁵ In some cases, the IRS requests that the Tax Court impose the penalty;⁶ in other cases, the Tax Court exercises its discretion, *sua sponte*,⁷ to do so.

Taxpayers who institute actions under IRC § 7433⁸ for certain unauthorized collection actions can be subject to a maximum penalty of \$10,000 if the court determines the taxpayer’s position in the proceedings is frivolous or groundless.⁹ In addition, IRC § 7482(c)(4),¹⁰

¹ Four cases litigated the issue of the IRC § 6673 penalty at the appellate level and involved an analogous appellate level penalty. Thus, we reviewed a total of 40 cases this year.

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

³ See, e.g., *Campbell v. Comm’r*, T.C. Memo. 2012-82.

⁴ IRC § 6673(a)(1)(A), (B), and (C).

⁵ IRC § 6673(a)(1).

⁶ The standards for the IRS’s decision to seek sanctions under IRC § 6673(a)(1) are found in the Chief Counsel Directives Manual (CCDM). See CCDM 35.10.2 (Aug. 11, 2004). For sanctions of opposing parties, under IRC § 6673(a)(2), all requests for sanctions are reviewed by the designated agency sanctions officer (currently the Associate Chief Counsel (Procedure & Administration)). This review ensures uniformity on a national basis. See, e.g., CCDM 35.10.2.2.3 (Aug. 11, 2004).

⁷ “*Sua sponte*” means without prompting or suggestion; on its own motion. Black’s Law Dictionary (9th ed. 2009). 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., *Barry v. Comm’r*, T.C. Memo. 2011-127.

⁸ IRC § 7433(a) allows a taxpayer a civil cause of action against the United States if an IRS employee intentionally or recklessly, or by reason of negligence, disregards any IRC provision or Treasury regulation in connection with collecting the taxpayer’s federal tax liability.

⁹ IRC § 6673(b)(1).

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

§§ 1912 and 1927 of Title 28 of the U.S. Code,¹¹ and Rule 38 of the Federal Rules of Appellate Procedure¹² (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 38 opinions issued between June 1, 2011, and May 31, 2012, that addressed the IRC § 6673 penalty. Twenty-four of these opinions were issued by the Tax Court and 14 were issued by U.S. Courts of Appeals in cases brought by taxpayers who sought review of the Tax Court's imposition of the penalty. Notably, the Courts of Appeals sustained the Tax Court's position in all 14 cases.

In nine cases, the Tax Court imposed penalties under IRC § 6673, with the amounts ranging from \$1,000 to the maximum of \$25,000. In four cases, taxpayers prevailed when the IRS asked the court to impose a penalty, but in each case the court warned the taxpayers not to bring similar arguments in the future.¹³ Three taxpayers were represented by attorneys or other persons admitted to practice before the Tax Court; all 35 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):

¹¹ 28 U.S.C. § 1912 provides that when the Supreme Court or a United States Court of Appeals affirms a judgment, the court has the discretion to award to the prevailing party just damages for the delay, and single or double costs. 28 U.S.C. § 1927 authorizes federal courts to sanction an attorney or any other person admitted to practice before any court of the United States or any territory thereof for unreasonably and vexatiously multiplying proceedings; such person may be required to personally pay the excess costs, expenses, and attorneys' fees reasonably incurred because of his or her conduct.

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

¹³ See, e.g., *Callihan v. Comm'r*, T.C. Memo. 2011-268, *appeal docketed*, No. 12-11586 (11th Cir. Mar. 26, 2012).

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

- **Citizens of certain states are not subject to income taxes:** Taxpayers in at least four cases argued that as residents of “independent” states, they are not subject to income taxes imposed by the United States government.¹⁵ In all four cases the court warned the taxpayers that asserting similar arguments in the future could result in imposition of the § 6673 penalty. Husband and wife taxpayers in another case argued that only residents of “federal zones” or “IRS districts” were responsible for paying income taxes, and the court fined each taxpayer \$20,000.¹⁶
- **Taxpayers who disagree with how the government allocates spending should not be required to pay income taxes:** In at least one case, the taxpayer argued that he did not approve of how the government chose to spend revenue.¹⁷ Specifically, the taxpayer asserted that he disagreed with the wars in Afghanistan and Iraq and requiring him to pay income tax would violate the Nuremberg Principles.¹⁸ The court raised the § 6673 penalty *sua sponte* and declined to impose the penalty, but warned the taxpayer that further similar conduct could result in the imposition of the penalty.
- **Only income earned from the United States government or entities associated with the United States government is taxable:** Taxpayers in at least two cases presented arguments that only federal government employees, public servants, those who earn income from the United States government, or those who earn income from federally licensed corporations are subject to the income tax.¹⁹ The Tax Court imposed the § 6673 penalty in both cases.²⁰

CONCLUSION

Taxpayers in the cases analyzed this year presented the same arguments raised and repeated year after year, which the courts routinely and universally reject.²¹ Taxpayers avoided the IRC § 6673 penalty in only four 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. 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.²² Finally, the U.S. Courts of Appeals have shown their willingness to uphold the penalties imposed by the Tax Court without fail in the cases analyzed for the period between June 1, 2011, and May 31, 2012.

¹⁵ See, e.g., *Callihan v. Comm’r*, T.C. Memo. 2011-268, *appeal docketed*, No. 12-11586 (11th Cir. Mar. 26, 2012) (taxpayer argued that services performed in Florida are not performed in the U.S. and therefore are not taxable); *Carlson v. Comm’r*, T.C. Memo. 2012-76, *appeal docketed*, No. 12-72030 (9th Cir. June 26, 2012) (taxpayer argued that as a resident of Washington or Oregon, she did not live in the U.S. and therefore was not subject to tax).

¹⁶ *Barry v. Comm’r*, T.C. Memo. 2011-127.

¹⁷ *Thompson v. Comm’r*, T.C. Memo. 2011-291.

¹⁸ The Nuremberg Principles were guidelines developed after the trial of certain Nazi war criminals to determine what constitutes a war crime and a crime against humanity.

¹⁹ See *Parker v. Comm’r*, T.C. Memo. 2012-66; *Barry v. Comm’r*, T.C. Memo. 2011-127.

²⁰ See *id.*

²¹ See, e.g., National Taxpayer Advocate 2011 Annual Report to Congress 666-669.

²² See, e.g., *D’Arcy v. Comm’r*, T.C. Memo. 2011-213 (court raised the issue *sua sponte* and warned the taxpayer not to assert similar arguments in the future).

MLI
#9**Relief From Joint and Several Liability Under IRC § 6015****SUMMARY**

Married couples may elect to file their federal income tax returns jointly or separately. Spouses filing joint returns are jointly and severally liable for any deficiency or tax due.¹ Joint and several liability permits the IRS to collect the entire amount due from either taxpayer.²

Internal Revenue Code (IRC) § 6015 provides three avenues for relief from joint and several liability. Section 6015(b) provides “traditional” relief for deficiencies. Section 6015(c) also provides relief for deficiencies for certain spouses who are divorced, separated, widowed, or not living together, by allocating the liability between the spouses. Section 6015(f) provides “equitable” relief from both deficiencies and underpayments, but only applies if a taxpayer is not eligible for relief under IRC § 6015(b) or (c).

We reviewed 39 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2011, and May 31, 2012. The most significant issues the courts addressed this year are the effect of prior proceedings on the Tax Court’s jurisdiction and whether District Courts have jurisdiction to determine innocent spouse claims raised as a defense in a collection suit. The Tax Court also decided a case that illustrates some of the dynamics involved when the IRS agrees that relief is appropriate but the other spouse opposes it.

PRESENT LAW**Traditional Innocent Spouse Relief Under IRC § 6015(b)**

IRC § 6015(b) provides that a requesting spouse shall be partially or fully relieved from joint and several liability, pursuant to procedures established by the Secretary, if the requesting spouse can demonstrate that:

1. A joint return was filed;
2. There was an understatement of tax attributable to erroneous items of the nonrequesting spouse;³
3. Upon signing the return, the requesting spouse did not know or have reason to know of the understatement;

¹ IRC § 6013(d)(3). We use the terms “deficiency” and “understatement” interchangeably for purposes of this discussion and the case table in Appendix III, even though IRC § 6015(b)(1)(D) and (f) expressly use the term “deficiency” and IRC § 6015(b)(1)(B) refers to an “understatement of tax.”

² The National Taxpayer Advocate, in the 2005 Annual Report to Congress, proposed legislation that would eliminate joint and several liability for joint filers. See National Taxpayer Advocate 2005 Annual Report to Congress 407.

³ An erroneous item is any income, deduction, credit, or basis that is omitted from or incorrectly reported on the joint return. See Treas. Reg. § 1.6015-1(h)(4).

4. Taking into account all the facts and circumstances, it is inequitable to hold the requesting spouse liable; and
5. The requesting spouse elected relief within two years after the IRS began collection activities against him or her.⁴

A requesting spouse is eligible for a refund under this subsection so long as the requesting spouse made the payment and the requirements of IRC § 6511 have been met.⁵

Allocation of Liability Under IRC § 6015(c)

IRC § 6015(c) provides that the requesting spouse shall be relieved from liability for deficiencies allocable to the nonrequesting spouse, pursuant to procedures established by the Secretary. To obtain relief under this section, the requesting spouse must demonstrate that:

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

This election allocates to each joint filer the portion of the deficiency attributable to each filer as calculated under the allocation provisions of IRC § 6015(d). A taxpayer is ineligible to make an election under IRC § 6015(c) if the IRS demonstrates that, at the time he or she signed the return, the requesting taxpayer had “actual knowledge” of any item giving rise to the deficiency.⁶ Relief is not available for amounts attributable to fraud, fraudulent schemes, or certain transfers of disqualified assets.⁷ Finally, no credit or refund is allowed as a result of relief granted under IRC § 6015(c).⁸

Equitable Relief Under IRC § 6015(f)

IRC § 6015(f) provides that the Secretary may relieve a taxpayer from liability for both deficiencies and underpayments⁹ where the taxpayer demonstrates that:

1. Relief under IRC § 6015(b) or (c) is unavailable; and

⁴ Not all actions that involve collection will trigger the two-year period of limitations. Under the regulations, only the following four events constitute “collection activity” that will start the two-year period: (1) an IRC § 6330 notice; (2) an offset of an overpayment of the requesting spouse against the joint income tax liability under IRC § 6402; (3) the filing of a suit by the United States against the requesting spouse for the collection of the joint tax liability; and (4) the filing of a claim by the United States to collect the joint tax liability in a court proceeding in which the requesting spouse is a party or which involves property of the requesting spouse. Treas. Reg. § 1.6015-5(b)(2).

⁵ IRC 6015(g)(1). See Footnote 17 for an explanation of the general time period for filing refund claims under IRC § 6511.

⁶ IRC § 6015(c)(3)(C).

⁷ IRC § 6015(c)(4), (d)(3)(C).

⁸ IRC § 6015(g)(3).

⁹ An underpayment of tax occurs when the tax is properly shown on the return but is not paid. *Washington v. Comm’r*, 120 T.C. 137, 158-59 (2003).

2. Taking into account all the facts and circumstances, it would be inequitable to hold the taxpayer liable for the underpayment or deficiency.

Previously, the IRS incorporated the statutory two-year deadline found in IRC § 6015 (b)(1)(E) and (c)(3)(B) into the section 6015 regulations and thereby imposed the two-year rule on requests for equitable relief under IRC § 6015(f).¹⁰ In 2009, the Tax Court, in *Lantz v. Commissioner*, held the regulation imposing the two-year rule invalid.¹¹ The IRS appealed the Tax Court's *Lantz* and similar decisions, and three Courts of Appeal ultimately held that the regulation was valid.¹² In the meantime, the Tax Court continued to hold the regulation invalid, and the issue was appealed to other Courts of Appeal.¹³ The National Taxpayer Advocate consistently advocated for removal of the two-year rule that prevented taxpayers from obtaining equitable relief.¹⁴ As reported last year, on July 25, 2011, the IRS announced that, notwithstanding three appellate court decisions that upheld the validity of the regulation, the regulations issued under IRC § 6015 would be revised to remove the two-year rule for requests for equitable relief.¹⁵ Cases in litigation would be resolved consistently with this decision; pending modification of the regulation to formally remove the two-year rule, taxpayers requesting equitable relief under IRC § 6015(f) after July 25, 2011, may do so without regard to when the first collection activity was taken. Taxpayers must file requests for equitable relief within the period of limitation on collection in IRC § 6502¹⁶ or, for any credit or refund of tax, within the period of limitation in IRC § 6511.¹⁷

¹⁰ Treas. Reg. §1.6015-5(b)(1).

¹¹ 132 T.C. 131 (2009).

¹² *Lantz v. Comm'r*, 607 F.3d 479 (7th Cir. 2010) *rev'g and remanding* 132 T.C. 131 (2009); *Mannella v. Comm'r*, 631 F.3d 115 (3d Cir. 2011) *rev'g and remanding* 132 T.C. 196 (2009); *Jones v. Comm'r*, 642 F.3d 459 (4th Cir. 2011), *rev'g and remanding* T.C. Docket No. 17359-08 (May 28, 2010).

¹³ Adhering to the rule in *Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), that the Tax Court will defer to a Court of Appeals decision which is squarely on point where appeal from the Tax Court decision lies to that Court of Appeal, the Tax Court continued to hold the regulation invalid in cases appealable to other circuits. See, e.g., *Young v. Comm'r*, T.C. Docket No. 12718-09 (May 12, 2011); *Pullins v. Comm'r*, 136 T.C. 432 (2011); *Stephenson v. Comm'r*, T.C. Memo. 2011-16; *Hall v. Comm'r*, 135 T.C. 374, *appeal dismissed* (6th Cir. Aug. 2, 2011); *Buckner v. Comm'r*, T.C. Docket No. 12153-09, *appeal dismissed* (6th Cir. July 27, 2011); *Carlile v. Comm'r*, T.C. Docket No. 11567-09, *appeal dismissed* (9th Cir. Dec. 8, 2010); *Payne v. Comm'r*, T.C. Docket No. 10768-09, *appeal dismissed* (9th Cir. July 25, 2011); *Coulter v. Comm'r*, T.C. Docket No. 1003-09, *appeal dismissed* (2d Cir. Aug. 4, 2011).

¹⁴ National Taxpayer Advocate 2010 Annual Report to Congress 377 (Legislative Recommendation: *Allow Taxpayers to Request Equitable Relief Under Internal Revenue Code Section 6015 (f) or 66(c) at Any Time Before Expiration of the Period of Limitations on Collection and to Raise Innocent Spouse Relief as a Defense in Collection Actions*); vol. 2 at 1-12 (*Unlimit Innocent Spouse Equitable Relief*); National Taxpayer Advocate 2006 Annual Report to Congress 540 (Legislative Recommendation: *Eliminate the Two-Year Limitation Period for Taxpayers Seeking Equitable Relief under IRC § 6015 or 66*).

¹⁵ IR 2011-80 (July 25, 2011), available at <http://www.irs.gov/uac/Two-Year-Limit-No-Longer-Applies-to-Many-Innocent-Spouse-Requests>. Details of the changes to the rule are provided in Notice 2011-70, 2011-2 C.B. 135 (July 25, 2011), available at <http://www.irs.gov/pub/irs-drop/n-11-70.pdf>. The Notice contains transitional rules and provides that pending litigation will be managed consistently with the removal of the two-year rule. See also CC-Notice 2011-017 (July 25, 2011), providing direction for Chief Counsel attorneys handling cases docketed with the Tax Court that involve the two-year deadline.

¹⁶ The statutory period of limitations on collection is generally ten years after the date the tax is assessed. IRC § 6502(a). However, a variety of statutory provisions may extend or suspend the collection period. For example, if a court proceeding to collect the tax is brought, such as a suit to reduce a tax liability to judgment, the period of limitations on collection is extended. Therefore, the period of limitations on collection could exceed ten years and a claim for innocent spouse relief would be valid at any point during that time.

¹⁷ Generally, taxpayers must request a refund within three years from the date their return was filed, or two years from the time the tax was paid, whichever occurs later, or, if no return was filed, within two years from the time the tax was paid. IRC § 6511(a). If taxpayers meet the three-year requirement, they can recover payments made during the three-year period that precedes the date of the refund request, plus the period of any extension of time for filing the return. However, taxpayers who do not meet the three-year requirement can recover only payments made during the two-year period preceding the date of the refund request. IRC § 6511(b)(2).

Revenue Procedure 2003-61 lists some of the factors the IRS has considered in determining whether equitable relief is appropriate.¹⁸ In January 2012, the IRS issued a proposed revenue procedure to supersede Rev. Proc. 2003-61.¹⁹ IRS Chief Counsel attorneys immediately applied the provisions of the proposed revenue procedure in docketed Tax Court cases, as did the court.²⁰ However, taxpayers were advised to notify the IRS in their applications for relief (or supplement existing applications) if they would receive more favorable treatment under one or more of the factors provided in Revenue Procedure 2003-61. The IRS would then apply those factors until the proposed new revenue procedure was finalized.

Factors common to both the old and new guidance include marital status, economic hardship, knowledge or reason to know, legal obligations of the nonrequesting spouse, significant benefit to the requesting spouse, and compliance with income tax laws. Abuse was an additional factor under Revenue Procedure 2003-61; the proposed guidance removed abuse as a separate factor, but clarified the effect abuse has on the analysis generally and on the knowledge factor and significant benefit factors specifically.²¹

Rights of Nonrequesting Spouse

The individual with whom the requesting spouse filed the joint return is generally referred to as a “nonrequesting spouse,” and is granted certain rights by IRC § 6015. The nonrequesting spouse must be notified and given an opportunity to participate in any administrative proceedings concerning a claim under IRC § 6015.²² Further, if during the administrative process full or partial relief is granted to the requesting spouse, the nonrequesting spouse can file a protest and receive an administrative conference in the IRS Appeals function.²³ The nonrequesting spouse does not have the right to petition the Tax Court in response to the IRS’s administrative determination regarding IRC § 6015 relief.²⁴ If the requesting spouse files a Tax Court petition, the nonrequesting spouse must receive notice of the Tax Court proceeding and has an unconditional right to intervene in the proceeding to dispute or support the requesting spouse’s claim for relief.²⁵ However, an intervening spouse has no standing to appeal the Tax Court’s decision to the United States Court of Appeals.²⁶

¹⁸ Rev. Proc. 2003-61, 2003-2 C.B. 296.

¹⁹ Notice 2012-8 (Jan. 5, 2012), 2012-4 I.R.B. 309, available at http://www.irs.gov/irb/2012-04_IRB/ar09.html. The Department of Treasury and the IRS invited public comment on the proposed guidance and on the administration of the IRS’s innocent spouse program by Feb. 21, 2012.

²⁰ CC-Notice 2012-004 (Jan. 5, 2012), available at <http://www.irs.gov/pub/irs-ccdm/cc-2012-004.pdf>. See *Sriram v. Comm’r*, T.C. Memo. 2012-91, in which the Tax Court analyzed the claim under the provisions of Rev. Proc. 2003-61 and Notice 2012-8.

²¹ Notice 2012-8, §§ 4.01(5), (7)(d); 4.02(3); 4.03(2)(c)(iv), (e).

²² IRC § 6015(h)(2).

²³ Rev. Proc. 2003-19, 2003-5 C.B. 371.

²⁴ *Maier v. Comm’r*, 119 T.C. 267 (2002), *aff’d*, 360 F.3d 361 (2d Cir. 2004) (holding that no provisions in IRC § 6015 allow the nonrequesting spouse to petition the Tax Court from a notice of determination).

²⁵ *Van Arsdalen v. Comm’r*, 123 T.C. 135 (2004).

²⁶ *Baranowicz v. Comm’r*, 432 F.3d 972 (9th Cir. 2005).

Judicial Review

Taxpayers seeking relief under IRC § 6015 generally file Form 8857, *Request for Innocent Spouse Relief*.²⁷ After reviewing the request, the IRS issues a final notice of determination granting or denying relief in whole or in part. The taxpayer has 90 days from the date the IRS mails the notice to file a petition with the Tax Court.²⁸ The Tax Relief and Health Care Act of 2006 amended IRC § 6015(e) to expressly provide that the Tax Court has jurisdiction in stand-alone cases to review IRC § 6015(f) determinations, even where no deficiency has been asserted.²⁹

ANALYSIS OF LITIGATED CASES

We analyzed 39 opinions issued between June 1, 2011, and May 31, 2012, including 32 Tax Court opinions, one each from the United States Courts of Appeals for the Third, Fourth, and Ninth Circuits, one from the Court of Federal Claims, and three from U.S. District Courts. In one Tax Court opinion, both spouses sought relief and the court consolidated their cases for trial, briefing, and opinion.³⁰ Because that opinion considered each spouse's claim separately, the total number of cases we analyze is 40. Fifty-three percent of the cases (21 of 40) were decided in favor of the IRS (including one case in which only the intervenor opposed granting relief);³¹ 28 percent (11 of 40) in favor of the requesting spouse (including four cases in which only the intervenor opposed granting relief); and 20 percent (eight of 40) ended in split decisions. In 45 percent (18 of 40) of the cases, the taxpayers were *pro se* (i.e., they represented themselves). Taxpayers prevailed in 17 percent (three of 18) of the cases in which they proceeded *pro se*; four other *pro se* taxpayers obtained split decisions. The nonrequesting spouse intervened in 38 percent of the cases (15 of 40).

Eighty-three percent of the cases (33 of 40) involved an analysis of whether to grant relief. Thirty percent of the cases (12 of 40) involved procedural issues,³² with 83 percent (ten of 12) of these cases decided in favor of the IRS, and 17 percent (two of 12) in favor of the taxpayer.

²⁷ See IRS Form 8857, *Request for Innocent Spouse Relief* (Sept. 2010).

²⁸ IRC § 6015(e)(1)(A)(ii). In 2001, IRC § 6015(e) provided for Tax Court review of determinations under IRC 6015(b) or (c), and it was not clear that taxpayers seeking relief only under IRC § 6015(f) could obtain Tax Court review. The National Taxpayer Advocate recommended amending IRC § 6015(e) to clarify that taxpayers have the right to petition the Tax Court for review of determinations made only under IRC § 6015(f). See National Taxpayer Advocate 2001 Annual Report to Congress 159-65 (Key Legislative Recommendation: *Joint and Several Liability Final Determination Rights*). The statute was so clarified in 2006. See Pub. L. 109-432, Title IV, § 408(a).

²⁹ Pub. L. No. 109-432, Div. C, § 408(a), (c), 120 Stat. 2922, 3061-62 (2006). 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.

³⁰ *Gaitan v. Comm’r*, T.C. Memo 2012-3.

³¹ These percentages add up to more than 100 due to rounding. In *Nunez v. Comm’r*, T.C. Memo. 2012-121, the IRS at trial conceded, taking the position that the requesting spouse was entitled to relief. Only the intervenor opposed granting relief. The Tax Court did not accept the government's concession and agreed with the intervenor, holding that relief was not appropriate. Although the Tax Court did not follow the position taken by the IRS, because the Tax Court's decision allows the IRS to collect the full liability as a result of the decision, it is counted as having been decided in favor of the IRS.

³² The percentages add up to more than 100 and the number of cases adds up to more than 40 because five cases addressed procedural issues and also contained an analysis of whether to grant relief on the merits.

Of the 33 cases decided on the merits, 45 percent (15 of 33) were decided in favor of the IRS, 30 percent (ten of 33) in favor of the taxpayer, and in 24 percent (eight cases) the court split its decision. See Table 9 in Appendix III for a detailed breakdown of the cases.

Procedural Issues

Three Tax Court cases addressed the effect of prior proceedings on the court's jurisdiction. In two of the cases, the taxpayer was prevented by the doctrine of *res judicata* from requesting innocent spouse relief.³³ In one case, the taxpayer was permitted to raise the issue even though he could have requested relief in a prior deficiency proceeding.³⁴ Additionally, two district courts continued the disturbing trend of holding that a taxpayer was not entitled to raise innocent spouse relief as a defense in a collection suit.³⁵

Harbin v. Commissioner, Koprowski v. Commissioner, and Beach v. Commissioner

In *Harbin v. Commissioner*,³⁶ Mr. and Mrs. Harbin petitioned the Tax Court for review of the IRS's determination of tax deficiencies with respect to joint returns they filed for two years. The deficiencies arose in part from Mrs. Harbin's disallowed gambling losses. Mr. Harbin prepared the returns based on documents and gambling records Mrs. Harbin provided, but was unaware of her actual losses and the understatements of tax attributable to her gambling when he signed the returns. It appeared that Mrs. Harbin maintained different records than those she provided Mr. Harbin, which she produced to the IRS during the examination of the returns. Consequently, Mr. Harbin had a viable claim for innocent spouse relief under IRC § 6015(b). His interest in the deficiency case was adverse to Mrs. Harbin's interest in contesting the deficiencies because to qualify for relief under IRC § 6015(b), Mr. Harbin would have to prove the deficiencies were attributable to Mrs. Harbin's erroneous items.³⁷

In their deficiency case, Mr. and Mrs. Harbin were represented by the same attorney. For the attorney, under the circumstances this was a conflict of interest,³⁸ which he evidently did not recognize and did not disclose to the Harbins.³⁹ The same attorney also represented

³³ *Koprowski v. Comm'r*, 138 T.C. 54 (2012); *Beach v. Comm'r*, T.C. Memo. 2011-218.

³⁴ *Harbin v. Comm'r*, 137 T.C. 93 (2011) *appeal dismissed* (7th Cir. June 6, 2012).

³⁵ *United States v. LeBeau*, 109 A.F.T.R.2d (RIA) 1369 (S.D.Cal. 2012); *United States v. Miles*, 109 A.F.T.R.2d (RIA) 1602 (N.D.Cal. 2012).

³⁶ 137 T.C. 93 (2011) *appeal dismissed* (7th Cir. June 6, 2012).

³⁷ *Harbin v. Comm'r*, 137 T.C. 93 n. 2.

³⁸ Rule 1.7 of the American Bar Association (ABA) Model Rules of Professional Conduct, *Conflict Of Interest: Current Clients*, available at http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_7_conflict_of_interest_current_clients.html, provides: "(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if: (1) the representation of one client will be directly adverse to another client." Paragraph (b) of Rule 1.7, which sets forth the conditions under which the representation may be permissible, includes the requirement that "each affected client gives informed consent, confirmed in writing." Rule 24(g), Tax Court Rules of Practice and Procedure, *Conflict of Interest*, provides: "If any counsel of record... (2) represents more than one person with differing interests with respect to any issue in a case... then such counsel must either secure the informed consent of the client...; withdraw from the case; or take whatever other steps are necessary to obviate a conflict of interest or other violation of the ABA Model Rules of Professional Conduct, and particularly Rules 1.7, 1.8, and 3.7 thereof."

³⁹ *Harbin v. Comm'r*, 137 T.C. 93, 96. It appears that the attorney first became aware of his conflict of interest in the deficiency case when informed by IRS Counsel in the course of the innocent spouse case.

both Mr. and Mrs. Harbin in their divorce proceeding, which was finalized shortly before trial in the deficiency case. The deficiency case was settled without trial and without either party requesting innocent spouse relief, and the Tax Court's decision reflecting the stipulated settlement became final.

When the IRS applied Mr. Harbin's overpayment of tax from a later tax year to the liability from one of the years at issue in the prior deficiency proceeding, Mr. Harbin requested innocent spouse relief, which the IRS denied. Mr. Harbin petitioned the Tax Court for review of that determination, and the former Mrs. Harbin intervened in the case. The IRS contended that Mr. Harbin's innocent spouse claim was barred by *res judicata*, which prevents relitigation of a taxpayer's liability for a given tax year both as to matters actually litigated in the prior suit and those that could have been raised.⁴⁰ IRC § 6015(g)(2) provides, however, that a final court decision in a prior proceeding will not be conclusive with respect to the qualification of a taxpayer as an innocent spouse, if that was not at issue in the prior proceeding and the court determines the taxpayer did not meaningfully participate in the prior proceeding. Whether a taxpayer "participated meaningfully" in the prior litigation depends on the facts and circumstances; there is no statutory or judicial definition of the term.⁴¹

Innocent spouse relief was not at issue in the prior deficiency proceeding, so the court examined Mr. Harbin's participation in the prior proceeding to determine whether *res judicata* barred his claim. Considering that Mrs. Harbin's gambling activities gave rise to the deficiency, that only she had personal knowledge of her winnings and losses, and that she maintained and provided the gambling records, the court found Mrs. Harbin effectively had exclusive control over the prior deficiency case. Mr. Harbin's participation in that case was through the attorney who proceeded in spite of a conflict of interest, which limited his ability to represent Mr. Harbin and obstructed Mr. Harbin's opportunity to request innocent spouse relief.⁴² Mr. Harbin was never advised of the possibility of requesting innocent spouse relief in the prior proceeding. Based on the facts and circumstances, the court found Mr. Harbin had not participated meaningfully in the deficiency proceeding and therefore his claim for relief was not barred by the doctrine of *res judicata*.

The parties had stipulated that if Mr. Harbin's claim was not barred, he met several of the requirements for relief under IRC § 6015(b): that a joint return was filed, that the understatement was attributable to the erroneous items of the other joint filer, and that

⁴⁰ As the Supreme Court, in *Comm'r v. Sunnen*, 333 U.S. 591, 597-98, (1948), explained, the doctrine of *res judicata* "rests upon considerations of economy of judicial time and public policy favoring the establishment of certainty in legal relations. The rule provides that when a court of competent jurisdiction has entered a final judgment on the merits of a cause of action, the parties to the suit and their privies are thereafter bound 'not only as to every matter which was offered and received to sustain or defeat the claim or demand, but as to any other admissible matter which might have been offered for that purpose.' *Cromwell v. County of Sac*, 94 U.S. 351, 352, 24 L.Ed. 195." Moreover, "[i]ncome taxes are levied on an annual basis. Each year is the origin of a new liability and of a separate cause of action. Thus if a claim of liability or non-liability relating to a particular tax year is litigated, a judgment on the merits is *res judicata* as to any subsequent proceeding involving the same claim and the same tax year."

⁴¹ *Harbin v. Comm'r*, 137 T.C. 93, 98.

⁴² *Id.* at 99.

the request for relief was timely. The court needed only to address the issue of whether Mr. Harbin knew or should have known of the understatement, and whether, taking into account all the facts and circumstances, it would be inequitable to hold him liable for the deficiencies. The court found it compelling that Mrs. Harbin apparently showed records to the IRS that she had not shown to Mr. Harbin, and found he was entitled to relief under IRC § 6015(b).

Koprowski v. Commissioner

In *Koprowski v. Commissioner*,⁴³ the IRS determined a deficiency in tax with respect to Mr. and Mrs. Koprowski's joint 2006 return. The Koprowskis petitioned the Tax Court for review of the determination, and elected to proceed under the small tax case procedures provided by IRC § 7463.⁴⁴ Both Mr. and Mrs. Koprowski signed the petition and three subsequent court filings. One of the filings stated that Mr. Koprowski was seeking innocent spouse relief and had already requested it from the IRS. When the Koprowskis' case was called from the calendar for trial, both Mr. and Mrs. Koprowski were present, and Mr. Koprowski spoke for the couple in scheduling further proceedings. Later that day, the Koprowskis, who had not been represented by counsel, were assisted by volunteer counsel and ultimately conceded their case in full without further proceedings. The Tax Court entered its decision sustaining the deficiencies in November 2009.

In May 2010, the IRS denied Mr. Koprowski's request for innocent spouse relief, and he petitioned the Tax Court for review of that determination. The IRS argued that Mr. Koprowski's claim was barred by the doctrine of *res judicata*. The court agreed, noting that *res judicata* attaches to judgments rendered in small tax cases conducted pursuant to IRC § 7463.⁴⁵ In considering whether the IRC § 6015(g)(2) exception to the doctrine of *res judicata* applied, the court found that innocent spouse relief had been placed in issue in the prior proceeding by one of the Koprowskis' court filings and that Mr. Koprowski meaningfully participated in the prior proceeding. The claim was therefore barred, even though the issue was not actually litigated. The court affirmed the IRS's denial of Mr. Koprowski's innocent spouse claim.

Beach v. Commissioner

In *Beach v. Commissioner*,⁴⁶ Mr. Beach petitioned the Tax Court for review of an asserted deficiency arising from the joint 2004 tax return he filed with his spouse, who was not a

⁴³ 138 T.C. 54 (2012).

⁴⁴ IRC § 7463(a) provides that in deficiency cases where the amount in controversy is \$50,000 or less for any one taxable year, taxpayers may opt to proceed in accordance with Tax Court rules for small tax cases. Title XVII of the Tax Court's Rules of Practice & Procedure set forth rules applicable in small tax cases. Generally, proceedings in small tax cases are less formal and entail a more relaxed approach to admitting evidence than in regular tax cases. However, decisions in small tax cases are not subject to appeal.

⁴⁵ The court explicitly left open the question of whether the related doctrine of collateral estoppel would likewise attach to judgments in small tax cases. A concurring opinion expressed the view that it would. *Koprowski v. Comm'r*, 138 T.C. 54, 66-67 (Holmes, J., concurring).

⁴⁶ T.C. Memo. 2011-218.

party to the deficiency case.⁴⁷ Mr. Beach agreed with the IRS's Appeals Officer to settle the case, and the Tax Court entered its decision in August 2008 based on the parties' stipulation. Mr. Beach did not request innocent spouse relief in that proceeding, but Mrs. Beach did and the IRS granted it.⁴⁸ Mr. Beach then also requested innocent spouse relief, which the IRS denied, and Mr. Beach petitioned the Tax Court for review of that determination. The IRS contended that Mr. Beach's claim was barred by *res judicata*, and the court agreed, noting that it would be "difficult for us to fathom what participating meaningfully would mean [for purposes of IRC § 6015(g)(2)] if petitioner did not do it in the prior proceeding."⁴⁹ Mr. Beach, as the sole party to the deficiency case, exercised exclusive control over it. He alone met with the Appeals Officer, negotiated the settlement, and signed the decision document. The doctrine of *res judicata* barred him from raising the innocent spouse claim he could have raised in the prior proceeding.

United States v. LeBeau and United States v. Miles

The *Le Beau* and *Miles* cases⁵⁰ continued the disturbing trend, identified by the National Taxpayer Advocate in past Annual Reports to Congress, of restricting a taxpayer's ability to raise IRC § 6015 as a defense in district court proceedings.⁵¹ IRC § 6015 (e)(1)(A) provides that an individual who seeks relief from joint liability may, "in addition to any other remedy provided by law," petition the Tax Court to determine the appropriate relief available. Other statutory provisions and judicial precedent make clear that taxpayers may raise IRC § 6015 in a variety of contexts.⁵² This year, one district court, in *U.S. v. Melot*, considered the defense in a suit to reduce joint federal tax assessments to judgment and to foreclose federal tax liens.⁵³ However, in the *LeBeau* and *Miles* cases, two California district courts, relying on *United States v. Boynton*, held that they do not have jurisdiction over IRC § 6015

⁴⁷ Mr. Beach's deficiency case, like the *Koprowskis*', was designated as a small tax case, but Mr. Beach did not argue that the doctrine of *res judicata* does not apply in small tax cases. T.C. Memo. 2011-218.

⁴⁸ The deficiency at issue arose from disputed expenses and losses claimed with respect to rental properties that were Mr. Beach's separate properties. T.C. Memo. 2011-218.

⁴⁹ T.C. Memo. 2011-218, slip. op at 6.

⁵⁰ *United States v. LeBeau*, 109 A.F.T.R.2d (RIA) 1369 (S.D.Cal. 2012); *United States v. Miles*, 109 A.F.T.R.2d (RIA) 1602 (N.D.Cal. 2012).

⁵¹ See National Taxpayer Advocate 2010 Annual Report to Congress 504; National Taxpayer Advocate 2009 Annual Report to Congress 487; National Taxpayer Advocate 2008 Annual Report to Congress 524; National Taxpayer Advocate 2007 Annual Report to Congress 631. Moreover, the National Taxpayer Advocate three times recommended that legislation clarify that taxpayers may raise relief under IRC §§ 6015 and 66 as a defense in collection actions. See National Taxpayer Advocate 2010 Annual Report to Congress 377; National Taxpayer Advocate 2009 Annual Report to Congress 378; National Taxpayer Advocate 2007 Annual Report to Congress 549.

⁵² See IRC §§ 6320(c) and 6330(c)(2)(A)(i) (pertaining to collection due process proceedings); IRC § 6213 and *Corson v. Comm'r*, 114 T.C. 354, 363 (2000) (pertaining to deficiency proceedings); 11 U.S.C.A. § 505(a) (pertaining to bankruptcy proceedings); and IRC § 7422 (pertaining to refund suits).

⁵³ *United States v. Melot*, 109 A.F.T.R.2d (RIA) 1568 (D.N.M. 2012), *appeal dismissed*, (10th Cir. Aug. 1, 2012) (holding that relief under IRC § 6015 was not available because the taxpayer requesting relief had not filed a joint return, and that relief under IRC § 66 was not available because the taxpayer did not establish that she did not know, and had no reason to know, of the item of community income giving rise to the unpaid tax).

claims raised as a defense in an action to reduce joint federal tax assessments to judgment or in a foreclosure suit.⁵⁴

In *LeBeau*, Mrs. LeBeau was denied innocent spouse relief by the IRS⁵⁵ and did not petition the Tax Court for review. When Mrs. LeBeau sought to raise innocent spouse as a defense in a suit to reduce joint tax liabilities to judgment, the court, citing *Boynton*, held, “[t]he district court has jurisdiction to decide an innocent spouse issue only when the taxpayer files a refund suit in the district court while a § 6015 petition is pending with the Tax Court.... Otherwise, the district court has no jurisdiction to decide an innocent spouse claim.”⁵⁶ Mrs. LeBeau was not permitted to raise her innocent spouse claim as a defense.

In *Miles*, Mrs. Miles sought innocent spouse relief for the first time as a defense in a suit to reduce joint tax liabilities to judgment and to foreclose federal tax liens.⁵⁷ The court also relied on *Boynton* for the proposition that “the district court has no jurisdiction to consider the innocent spouse defense when the taxpayer has not first sought such relief with the IRS.”⁵⁸

Relief on the Merits

While the courts considered many factors in determining the appropriateness of relief on the merits under IRC § 6015, the most significant factor was whether the requesting taxpayer had actual or constructive knowledge that there was a deficiency or that the nonrequesting spouse would not pay the tax. All three avenues for relief contain a knowledge element or factor, making it the linchpin in most of the courts’ analyses.⁵⁹ Actual or constructive knowledge was a factor in 28 of the 33 cases decided on the merits. These cases suggest that determining what a taxpayer knew or should have known will continue to generate a significant amount of controversy as long as joint filers are taxed on their combined incomes and remain jointly and severally liable for the tax that must be shown on the return.

In five decisions, the IRS agreed relief would be appropriate for at least one of the years at issue and only the intervening spouse opposed relief. In one such case, the Tax Court

⁵⁴ *United States v. Boynton*, 99 A.F.T.R.2d (RIA) 920 (S.D. Cal. 2007) (holding that the district court has no jurisdiction to consider the innocent spouse defense when the taxpayer has not first sought such relief with the IRS, reasoning that otherwise a district court and the Tax Court would have concurrent jurisdiction over the claim and might be placed in the position of adjudicating the same issues at the same time). District courts in other jurisdictions have also not permitted the defense. See *United States v. Wallace*, 105 A.F.T.R.2d 2827 (S.D. Ohio 2010), adopted by 105 A.F.T.R.2d (RIA) 2831 (S.D. Ohio 2010) (relying on *Boynton*); *United States v. Bucy*, 100 A.F.T.R.2d (RIA) 6666 (S.D. W. Va. 2007); *United States v. Feda*, 97 A.F.T.R.2d (RIA) 1985, 1989 (N.D. Ill. 2006) (taxpayer could not raise IRC § 6015 as a defense in a suit to reduce joint federal tax assessments to judgment); *United States v. Cawog*, 97 A.F.T.R.2d (RIA) 3069 (W.D. Pa. 2006), appeal dismissed (3d Cir. July 5, 2007) (taxpayer could not raise IRC § 6015 as a defense in a suit to foreclose tax liens).

⁵⁵ *United States v. LeBeau*, 109 A.F.T.R.2d (RIA) 1369 (S.D. Cal. 2012).

⁵⁶ *Id.*, slip op. at 7-8.

⁵⁷ *United States v. Miles*, 109 A.F.T.R.2d (RIA) 1602 (N.D. Cal. 2012).

⁵⁸ *Id.*, slip op. at 7.

⁵⁹ See IRC § 6015(b)(1)(C); § 6015(c)(3)(C); Rev. Proc. 2003-61, 2003-2 C.B. 296 §§ 4.02(1)(b) and 4.03(2)(a)(iii); Notice 2012-8, §§ 4.02(3) and 4.03(2)(c), 2012-4 I.R.B. 309.

granted relief and decided the taxpayer could not recover from the IRS the portion of litigation costs that arose after the IRS conceded relief was appropriate.⁶⁰

In *Pounds v. Commissioner*, Mrs. Pounds and her former spouse, Mr. Johnson, filed a joint return for 2004.⁶¹ After they were audited, they consented to the assessment of deficiencies that arose from omitted income and disallowed deductions from Mr. Johnson's business. Mrs. Pounds then requested innocent spouse relief, which the IRS denied. Mrs. Pounds petitioned the Tax Court for review, unaware that the IRS had reversed its position and had issued a revised determination granting innocent spouse relief under IRC § 6015(c). If Mrs. Pounds had known the IRS had changed its mind, she would have had no need to petition the Tax Court. After she filed the petition, if Mrs. Pounds and the IRS had been the only parties to the case, the matter could have been resolved without further proceedings. However, Mr. Johnson, upon being notified of the Tax Court proceeding, exercised his right to intervene as a party to the case, claiming Mrs. Pounds was not entitled to relief under IRC § 6015(c) because she had actual knowledge, at the time she signed the return at issue, of the items giving rise to the deficiency.

The Tax Court noted a difficulty in cases where only the intervening spouse opposes granting relief and actual knowledge is at issue. The IRS, which under IRC § 6015(c) would normally bear the burden of showing that a requesting spouse knew of an item giving rise to a deficiency, may favor granting relief and may therefore no longer be adverse to the requesting spouse. Rather than shifting the burden of proof to the intervening spouse, the court has resolved this difficulty "by determining whether actual knowledge has been established by a preponderance of the evidence as presented by all three parties."⁶² The IRS introduced no evidence at trial other than the stipulated facts. Mrs. Pounds and Mr. Johnson both testified, and Mr. Johnson introduced documentary evidence in support of his position. The Tax Court held that Mrs. Pounds did not have actual knowledge of the understatement and granted relief under IRC § 6015(c). In its order and decision, the Tax Court further decided that pursuant to IRC § 7430 Mrs. Pounds was entitled to recover \$12,779 from the IRS, representing her administrative costs and part of her litigation costs.⁶³ However, the litigation costs incurred after the initial stages of the proceeding, attributable to Mr. Johnson's participation in the case, were not allocable to the IRS and were not recoverable under IRC § 7430.

⁶⁰ The requesting spouse does not always obtain relief when only the intervenor is opposed. In one case, *Nunez v. Comm'r*, T.C. Memo. 2012-121, the Tax Court accepted the intervenor's position and denied relief even though the IRS argued that relief would be appropriate.

⁶¹ *Pounds v. Comm'r*, T.C. Memo. 2011-202.

⁶² *Pounds v. Comm'r*, T.C. Memo. 2011-202, slip op. at 13, citing *Knight v. Comm'r*, T.C. Memo. 2010-242, *McDaniel v. Comm'r*, T.C. Memo. 2009-137, and *Stergios v. Comm'r*, T.C. Memo. 2009-15.

⁶³ Order and Decision in Tax Court docket no. 30363-09 (May 9, 2012). IRC § 7430 provides for the award of reasonable costs for an administrative or court proceeding under certain circumstances when the taxpayer is the prevailing party. Any such costs must be allocable to the United States and not to any other party. IRC § 7430(b)(2). As the court explained in an earlier order (Apr. 5, 2012), the IRS conceded the award of Mrs. Pounds' administrative costs. As for litigation costs, because Mrs. Pounds initiated the court proceeding in response to a notice of determination the IRS then renounced, she could recover litigation costs she incurred in connection with the initial pleadings in the case. The fact that the case progressed beyond that point, however, was due to Mr. Johnson's intervention (rather than to the repudiated IRS notice).

CONCLUSION

This year, in cases decided on the merits, the IRS fully prevailed less than half the time. In order to avoid imposing unnecessary burden on taxpayers, the IRS must analyze the reasons for this outcome and determine what training would help avert it. With respect to procedural developments, the Tax Court applied the *res judicata* provisions of IRC § 6015(g)(2) in three cases. The court held that *res judicata* attaches to judgments in small Tax Court cases, but a taxpayer may be prevented from meaningfully participating in a proceeding by counsel's conflict of interest. The Tax Court also decided a case in which only the intervening spouse opposed granting relief, and held that the requesting spouse who obtained relief could not recover from the IRS that portion of her litigation costs attributable to the former spouse's participation in the suit. Two District Courts continued the disturbing trend of holding that a taxpayer may not raise innocent spouse as a defense in collection suits, a development the National Taxpayer Advocate has sought to rectify since 2007.⁶⁴

⁶⁴ See National Taxpayer Advocate 2010 Annual Report to Congress 377; National Taxpayer Advocate 2009 Annual Report to Congress 378; National Taxpayer Advocate 2007 Annual Report to Congress 549.

MLI
#10**Limitations On Assessment Under IRC § 6501****SUMMARY**

The general statutory period of limitations on assessment of tax, governed by Internal Revenue Code (IRC) § 6501(a), is three years. This limitations period does not apply in certain circumstances, such as when a taxpayer files a false or fraudulent return,¹ willfully attempts to defeat or evade tax,² or fails to file a return altogether.³ In these cases, the IRS may assess the tax or begin a proceeding in court for collection of such tax at any time.⁴ In addition, IRC § 6501(e)(1)(A) extends the period for assessment from three to six years in cases where the taxpayer omits from gross income an amount that is properly includible and is more than 25 percent of the gross income stated in the return.

This is the first year that limitations on assessment has been analyzed as a Most Litigated Issue in the National Taxpayer Advocate's Annual Report to Congress. We reviewed 33 federal court opinions issued between June 1, 2011 and May 31, 2012 involving limitations on assessment. The most significant case was the Supreme Court's decision in *United States v. Home Concrete & Supply, LLC*.⁵ This decision resolved a split among circuits and held that an understatement of income due to an overstatement of basis is not an "omission" from income and does not extend the limitations period under IRC § 6501(e)(1)(A).

PRESENT LAW

IRC § 6501(a) provides the general rule that the IRS must assess any tax within three years after a taxpayer files a return. If the return is filed early, the assessment period generally begins to run on the date the return was due.⁶ If a taxpayer fails to file a return and the IRS prepares a substitute for return (SFR),⁷ the limitations period does not start and the IRS can assess the tax at any time.⁸

¹ IRC § 6501(c)(1).

² IRC § 6501(c)(2).

³ IRC § 6501(c)(3).

⁴ IRC § 6501(c).

⁵ 132 S. Ct. 1836 (2012).

⁶ IRC § 6501(b)(1). Note that for tax imposed by chapter 3 (Withholding of Tax on Nonresident Aliens and Foreign Corporations), chapter 21 (Federal Insurance Contributions Act), or chapter 24 (Collection of Income Tax at Source on Wages), if the return for any period is filed before April 15 of the succeeding calendar year, the return is considered filed on April 15. IRC § 6501(b)(2); Treas. Reg. § 301.6501(b)-1(b).

⁷ See IRC § 6020.

⁸ IRC § 6501(b)(3).

Section 6501(c) provides many other exceptions to the general three-year limitation on assessment. The IRS can assess the tax or begin a court proceeding to collect it at any time in the case of a taxpayer who has:

- Filed a false or fraudulent return with the intent to evade tax;⁹
- Willfully attempted in any manner to defeat or evade tax;¹⁰ or
- Failed to file a return.¹¹

IRC § 6501(c)(4) permits an extension of the limitation on assessment if both the IRS and the taxpayer agree to it, in writing, before the time for assessment has expired. Multiple extensions are permitted, so long as they are agreed to in writing before the expiration of any previous extension.¹² The taxpayer also has the right to refuse an extension, or to limit the extension to particular issues or a particular period.¹³

Another significant exception to the three-year limitation on the assessment period is provided in § 6501(e). If a taxpayer omits from gross income a properly includible amount in excess of 25 percent of the gross income stated in the return, the assessment period is extended to six years.

The general three-year rule in IRC § 6501(a) contains numerous other exceptions, but taxpayers litigated these exceptions less frequently during the period of our review. Therefore, we have focused our analysis on some of the most common issues affecting the statutory limitations period.

The bar of the statutory limitations period is an affirmative defense. A taxpayer raising the limitations period as a defense must specifically plead it and prove it.¹⁴ In the case of an alleged false or fraudulent return, however, the burden is on the IRS to prove the taxpayer filed with an intent to evade tax.¹⁵

ANALYSIS OF LITIGATED CASES

We analyzed 33 opinions issued between June 1, 2011 and May 31, 2012 that addressed the IRC § 6501 limitations period. The IRS prevailed in full in 19 cases (58 percent), the taxpayers prevailed in full in 11 cases (33 percent), and three cases (nine percent) resulted in split decisions. Table 10 in Appendix III provides a detailed list of these cases.

⁹ IRC § 6501(c)(1).

¹⁰ IRC § 6501(c)(2).

¹¹ IRC § 6501(c)(3).

¹² IRC § 6501(c)(4)(A).

¹³ IRC § 6501(c)(4)(B).

¹⁴ Tax Court Rule 142(a)(1).

¹⁵ IRC § 7454(a); Tax Court Rule 142(b).

Taxpayers appeared *pro se* (without representation) in nine of the 33 cases (27 percent) and convinced the court to find in their favor in only one case. Represented taxpayers fared much better, prevailing either partially or in full in 13 of their 24 cases (54 percent).

Substantial Omission of Income

United States v. Home Concrete & Supply, LLC

The most significant development this past year with regard to IRC § 6501 was the Supreme Court decision in *Home Concrete*.¹⁶ Previously, U.S. Courts of Appeals were split on whether an overstatement of basis can result in an “omission of income,” triggering the extended IRC § 6501(e) six-year assessment period instead of the usual three year period.¹⁷ The Supreme Court’s 5-4 plurality decision in *Home Concrete* resolved this uncertainty.

In *Home Concrete*, the taxpayers understated their gross incomes for the year at issue by more than 25 percent because they had overstated their bases in certain property they sold. The IRS assessed a deficiency more than three years but less than six years after the relevant tax returns were filed. After making a deposit, the taxpayers then sued for a refund, claiming the IRS was time-barred from making the assessments under IRC § 6501(a), but the government asserted in response that IRC § 6501(e) was applicable.

The district court found that “where a taxpayer overstates basis and, as a result, leaves an amount out of gross income, the taxpayer ‘omits from gross income an amount properly includible therein’ for purposes of § 6501(e)(1)(A).”¹⁸ Thus, the court concluded the government was entitled to apply the extended six-year limitations period. The taxpayers appealed, and while the case was on appeal, the Treasury Department issued regulations interpreting § 6501(e)(1)(A) in its favor, so an overstatement of basis could trigger the extended limitations period.¹⁹ On appeal, the Fourth Circuit held that *Home Concrete*’s overstated basis in the sale proceeds did not trigger the six-year limitations period.²⁰ The government then appealed, and the Supreme Court granted certiorari.²¹

The government argued before the Supreme Court that the Treasury Regulation²² interpreting the statute’s language in its favor should be granted deference under the *Chevron* stan-

¹⁶ 132 S. Ct. 1836 (2012).

¹⁷ Compare *R & J Partners v. Comm’r*, 441 Fed. Appx. 271 (5th Cir. 2011) and *Bakersfield Energy Partners, LP v. Comm’r*, 568 F.3d 767 (9th Cir. 2009) (both holding that an understatement of income due to an overstatement of basis did not qualify as an “omission from gross income,” and therefore did not trigger the extended limitations period), with *Intermountain Ins. Serv. of Vail, LLC v. Comm’r*, 650 F.3d 691 (D.C. Cir. 2011) (holding that an understatement of income due to an overstatement of basis was an “omission from gross income,” extending the statutory period of limitations on assessment to six years), and *Salman Ranch, Ltd. v. Comm’r*, 647 F.3d 929 (10th Cir. 2011) (holding the same), and *Grapevine Imps., Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011) (holding the same), and *Beard v. Comm’r*, 633 F.3d 616 (7th Cir. 2011) (holding the same).

¹⁸ *Home Concrete & Supply, LLC v. United States*, 599 F.Supp.2d 678, 687 (E.D. N.C. 2008).

¹⁹ See 74 Fed. Reg. 49321 (Sept. 28, 2009) for temporary regulations, and 74 Fed. Reg. 49354 (Sept. 28, 2009) for the notice of proposed rulemaking. Treas. Reg. § 301.6501(e)-1(a)(1)(iii) became effective Dec. 14, 2010 (i.e., the regulation was not applicable to the tax year at issue in *Home Concrete*).

²⁰ *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2011).

²¹ *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 71 (2011).

²² Treas. Reg. § 301.6501(e)-1(a)(1)(iii).

dard.²³ The Supreme Court disagreed, determining that the Court had already interpreted a prior, but “materially indistinguishable”²⁴ version of the statute in its 1958 case, *The Colony, Inc. v. Commissioner*²⁵ and therefore the language was not ambiguous. The Supreme Court concluded that no other permissible construction of § 6501(e)(1)(A) could be adopted by the Treasury Department.

In analyzing *Colony*, the Court in *Home Concrete* acknowledged that an overstatement of basis “wrongly understates the taxpayer’s income.”²⁶ In *Colony*, the Court observed that the definition of the word “omit” is “[t]o leave out or unmentioned; not to insert, include or name.”²⁷ Taken literally, this language limits the statute’s scope “to situations in which specific receipts or accruals of income items are *left out* of the computation of gross income.”²⁸ The *Colony* decision acknowledged that the statute was ambiguous, examined its legislative history, and concluded that Congress intended to extend the limitations period only when a taxpayer failed to report income, not when the taxpayer made an error in reporting an item disclosed on the face of the return.²⁹ *Colony* explained that Congress intended “no broader purpose than to give the Commissioner” extra time to investigate tax returns where, due to an omission, “the Commissioner is at a special disadvantage” because the return itself gives no indication of an omitted item.³⁰ But when an overstatement of basis results in the understatement of income, the error is “disclosed on the face of the return [and] the Commissioner is at no such disadvantage.”³¹

In finding that *Colony* was dispositive of the issue, the Supreme Court in *Home Concrete* concluded as follows: “The provision before us is a 1954 reenactment of the 1939 provision that *Colony* interpreted. The operative language is identical. It would be difficult, perhaps impossible, to give the same language here a different interpretation without effectively overruling *Colony*.” Because *Colony* eliminated any ambiguity in the statute, the *Chevron* standard did not apply.³²

The ruling in *Home Concrete* resolved this much-litigated limitations period issue. On April 30, 2012, the Supreme Court issued a series of orders in pending § 6501(e) cases. In cases where a United States Court of Appeals found for the taxpayer, the Supreme Court simply denied certiorari, upholding the lower courts’ decisions.³³ In cases where a Court of

²³ See *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984) (agency regulations are entitled to deference unless (1) they contradict an unambiguous statute, or (2) set forth an unreasonable construction of it).

²⁴ *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836, 1840 (2012).

²⁵ 357 U.S. 28 (1958) (construing § 275(c) of the 1939 Code, a nearly identical provision).

²⁶ *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836, 1840 (2012).

²⁷ *Colony*, 357 U.S. at 32 (quoting Webster’s New International Dictionary (2d ed. 1939)).

²⁸ *Id.* at 33.

²⁹ *Id.* at 35 (citing S. Rep. No. 73-558, 73d Cong., 2d Sess. 43-44 (1934)).

³⁰ *Id.* at 36.

³¹ *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836, 1841 (2012).

³² *Id.* at 1842-43 (2012).

³³ See, e.g., *Comm’r v. Equip. Holding Co.*, 132 S. Ct. 2122 (2012); *Comm’r v. R & J Partners*, 132 S. Ct. 2100 (2012).

Appeals found for the government, the Supreme Court granted the petitions for certiorari and immediately vacated and remanded the cases for reconsideration.³⁴

Fraudulent Returns and Willful Attempts to Evade Tax

Another commonly litigated issue under IRC § 6501 was whether the taxpayer filed a false or fraudulent return, or willfully attempted to defeat or evade taxes, such that the assessment period was open indefinitely.³⁵ In order to assess tax at any time under § 6501(c)(1) or (2), the government must show “by clear and convincing evidence: (1) [a]n underpayment of tax exists” and (2) the taxpayer “intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes.”³⁶ Fraud is not defined in the IRC or Treasury Regulations. Over the years, however, courts have established certain “badges of fraud”—a nonexclusive list of factors that suggest fraudulent intent.³⁷ The IRS has incorporated those “badges of fraud” into the Internal Revenue Manual (IRM).³⁸ While no single factor is dispositive, a combination of factors is likely to provide sufficient evidence of fraud, taking into account the taxpayer’s “intelligence, education, and tax expertise.”³⁹

For example, in *Scott v. Commissioner*, the Tax Court concluded that the government had successfully established fraud, relying on the following factors: a pattern of consistent underreporting of income; maintenance of inadequate books; failure to cooperate with tax authorities; the taxpayer’s lack of credibility; and the taxpayer’s intelligence, education, and understanding that filing inaccurate returns would frustrate the IRS’s ability to collect the correct tax.⁴⁰

Of the nine cases that addressed the filing of alleged fraudulent returns, the Tax Court found in favor of the taxpayer in only two.⁴¹ In these cases, although the government was able to show fraudulent activity, it was not able to show by clear and convincing evidence that the activity was intended to evade tax. For example, in *City Wide Transit*,

³⁴ See, e.g., *Beard v. Comm’r*, 633 F.3d 616 (7th Cir. 2011), *vacated and remanded by* 132 S. Ct. 2099 (Apr. 30, 2012); *Grapevine Imps., Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011), *vacated and remanded by* 132 S. Ct. 2099 (2012).

³⁵ IRC § 6501(c)(1)-(2). Paragraph (2) applies only to taxes other than income, estate, or gift taxes.

³⁶ *May v. Comm’r*, 137 T.C. 147, 151 (2011), *appeal docketed* No. 12-1829 (6th Cir. June 25, 2012); see also *City Wide Transit, Inc. v. Comm’r*, T.C. Memo. 2011-279, *appeal docketed*, No. 12-1040 (2d Cir. Mar. 14, 2012) (“Although the Court has not expounded on what constitutes a willful attempt to defeat or evade tax under section 6501(c)(2),... there is little ‘meaningful distinction between [a] ‘false or fraudulent return with the intent to evade tax’ and [a] willful attempt in any manner to defeat or evade tax.’” (quoting *Carl v. Comm’r*, T.C. Memo. 1981-202)).

³⁷ See *Spies v. United States*, 317 U.S. 492 (1943). See also *Scott v. Comm’r*, T.C. Memo. 2012-65 (citation omitted). Badges of fraud include: (1) understating income, (2) maintaining inadequate records, (3) failing to file tax returns, (4) implausible or inconsistent explanations of behavior, (5) concealment of income or assets, (6) failing to cooperate with tax authorities, (7) engaging in illegal activities, (8) an intent to mislead which may be inferred from a pattern of conduct, (9) lack of credibility of the taxpayer’s testimony, (10) filing false documents, and (11) dealing in cash. *Id.*

³⁸ See IRM 25.1.2.3 (Jan. 1, 2003).

³⁹ *Browning v. Comm’r*, T.C. Memo. 2011-261 (citations omitted).

⁴⁰ *Scott*, T.C. Memo. 2012-65.

⁴¹ See *Avenell v. Comm’r*, T.C. Memo. 2012-32; *City Wide Transit, Inc. v. Comm’r*, T.C. Memo. 2011-279, *appeal docketed*, No. 12-1040 (2d Cir. Mar. 14, 2012).

Inc. v. Commissioner,⁴² while the record clearly showed that the taxpayer's accountant filed false tax forms on behalf of the taxpayer and altered the taxpayer's checks to the IRS, the taxpayer argued there was no intent to evade tax but instead an attempt to cover up an embezzlement scheme.⁴³ The Tax Court agreed and found the government failed to show "by clear and convincing evidence that [the accountant] filed fraudulent returns *with the intent to evade tax or willfully attempted to defeat or evade tax.*"⁴⁴ Therefore, the statutory limitations period was not extended and the IRS was time-barred from assessing any tax.⁴⁵

Failure to File

If a taxpayer fails to file a return, § 6501(c)(3) allows assessment of the tax at any time. Under § 6501(a), assessment shall occur "within 3 years after the return was filed," (whether or not such return was filed on or after the date prescribed),⁴⁶ so when no return is filed, the limitations period never begins to run and the IRS can assess tax at any time.⁴⁷ However, when a taxpayer files what he or she thinks is a valid return but which contains some defect that makes it invalid,⁴⁸ the IRS treats the return as not being filed at all, thus extending the limitations period indefinitely.

In *Paschall v. Commissioner*,⁴⁹ the taxpayers (a husband and wife) timely filed Forms 1040, *U.S. Individual Income Tax Return* for all years at issue, but failed to file for any year a Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, which was required to compute and disclose excise taxes that arose from excess contributions to Roth IRAs.⁵⁰ The Tax Court rejected the taxpayers' argument that the statutory limitations period started running when they filed the Forms 1040, and the period for assessing the excise tax deficiency had expired. Relying on the Supreme Court's decision in *Commissioner v. Lane-Wells Co.*,⁵¹ the court held that, in the absence of accompanying Forms 5329, filing the Forms 1040 did not include "sufficient information to allow the IRS to compute the taxpayer's liability," and therefore "did not start the statute of limitations running for purposes of the section 4973 excise tax."⁵²

⁴² T.C. Memo. 2011-279.

⁴³ *Id.*

⁴⁴ *Id.* (emphasis added).

⁴⁵ *Id.*

⁴⁶ See, e.g., *United States v. Tyler*, 109 A.F.T.R.2d (RIA) 1383 (E.D.Pa. 2012) (holding that where taxpayer did not file returns for tax years 1992-1998 until 2000-2001, assessment in 2002 was not time-barred).

⁴⁷ *United States v. Melot*, 108 A.F.T.R.2d (RIA) 6884 (D.N.M. 2011).

⁴⁸ In determining what constitutes a "return" sufficient to start the running of the limitations period, most courts apply the four-part test set forth in *Beard v. Commissioner*, 82 T.C. 766, 777-78 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986) (The document must (1) purport to be a return; (2) be signed under penalties of perjury; (3) contain sufficient data to calculate the tax liability; and (4) be completed in an honest and genuine endeavor to satisfy the requirements of the tax law.).

⁴⁹ 137 T.C. 8 (2011).

⁵⁰ See IRC § 4973.

⁵¹ 321 U.S. 219 (1944) (holding that a taxpayer cannot start the running of the period of limitations by filing one return when a different return is required).

⁵² *Paschall*, 137 T.C. at 16-17.

CONCLUSION

The general three-year limitation on assessments provided by § 6501(a) is subject to numerous exceptions. In cases where a taxpayer files a false or fraudulent return, willfully attempts to evade tax, or fails to file altogether, the statutory period of limitations never begins to run and tax may be assessed at any time. In cases involving a false or fraudulent return or a willful attempt to evade tax, the government bears the burden of proving, by clear and convincing evidence, that the taxpayer had the *explicit intent* to defeat or evade tax. The government prevailed in seven out of nine fraud cases we reviewed. In the two cases where the taxpayers prevailed, even though they engaged in fraudulent activity, the government was unable to show that evasion of tax was their primary intent.

In cases where a taxpayer omits from gross income an amount greater than 25 percent of the amount stated in the return, § 6501(e) extends the limitation on assessment from three to six years. The Supreme Court issued a significant opinion this year in *Home Concrete*. It settled a split in the U.S. Courts of Appeals, holding that an understatement of income due to an overstatement of basis was not an “omission of income” and did not trigger an extension of the statutory period of limitations on assessment.