

Most Litigated Issues: Introduction

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to include in her Annual Report to Congress (ARC) the ten tax issues most litigated in federal courts, classified by the types of taxpayers affected. From the analysis of these issues, the National Taxpayer Advocate may develop recommendations for mitigating disputes that result in litigation.

The Taxpayer Advocate Service (TAS) used commercial legal research databases to identify the ten most litigated issues (Most Litigated Issues) in federal courts from June 1, 2009, through May 31, 2010.¹ For the purposes of this section of the ARC, the term “litigated” means cases in which the court issued an opinion.² This year’s ten Most Litigated Issues, in order of magnitude, are:

- Summons enforcement (IRC §§ 7602(a), 7604(a), and § 7609(a));
- Collection due process hearings (IRC §§ 6320 and 6330);
- Accuracy-related penalties (IRC § 6662(b)(1) and (2));
- Trade or business expenses (IRC § 162(a) and related Code sections);
- Gross income (IRC § 61 and related Code sections);
- Failure to file penalty (IRC § 6651(a)(1)) and estimated tax penalty (IRC § 6654);
- Frivolous issues penalty and related appellate-level sanctions (IRC § 6673);
- Civil actions to enforce federal tax liens or to subject property to payment of tax (IRC § 7403);
- Family status issues (IRC §§ 2, 24, 32, and 151); and
- Relief from joint and several liability for spouses (IRC § 6015).

These are the same issues identified in 2009, but in a slightly different order.³ Summons enforcement outpaced collection due process hearings to become the number one most litigated issue.⁴ Other notable changes included an increase of almost 24 percent in accuracy-related penalty cases, as well as significant decreases in frivolous penalty cases and civil actions to enforce federal tax liens.⁵

Once TAS identified the ten issues, it analyzed each one in four sections: summary of findings, description of present law, analysis of the litigated cases, and conclusion. Each case

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

² We recognize that many cases are resolved before the court issues an opinion. Some taxpayers reach a settlement with the IRS before trial, while the courts dismiss other taxpayers’ cases for a variety of reasons, including lack of jurisdiction and lack of prosecution. Additionally, courts can issue less formal “bench opinions,” which are not published or precedential.

³ See National Taxpayer Advocate 2009 Annual Report to Congress 403-498.

⁴ Collection due process cases fell from 170 in 2009 to 131 in 2010. See National Taxpayer Advocate 2009 Annual Report to Congress 405, Table 3.0.1.

⁵ Accuracy-related penalty cases rose from 101 to 125 in 2010. Frivolous issues penalty cases dropped from 62 to 46 in 2010. Civil actions to enforce federal tax liens decreased from 61 to 46 in 2010. See *id.*

is listed in Appendix III, and categorized 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*, and lists the court's decision.⁷

Beginning in 2007, TAS expanded the Most Litigated Issues section of the ARC by adding a new "Significant Cases" discussion. This discussion summarizes important judicial decisions that were not included in the top ten issues but that the National Taxpayer Advocate deemed relevant to tax administration.⁸

AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

Initially, taxpayers generally have access to four different tribunals in which to litigate a tax matter: the United States Tax Court, United States District Courts, the United States Court of Federal Claims, and United States Bankruptcy Courts. With limited exceptions, taxpayers have an automatic right to appeal decisions of any of these courts.⁹

The Tax Court is generally a "prepayment" forum. In other words, taxpayers can access the 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, and relief from joint and several liability.¹⁰

The federal district courts and United States Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,¹¹ and (2) the taxpayer has filed an administrative claim for refund.¹² The federal district courts, along with the bankruptcy courts in very limited circumstances, provide the only forums in which a taxpayer can receive a jury trial.¹³ Bankruptcy courts can adjudicate tax matters that were not adjudicated prior to the initiation of a bankruptcy case.¹⁴

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 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 One or more of the cases discussed in the Significant Cases section of this report were decided outside the June 1, 2009, through May 31, 2010, period used to identify the ten most litigated issues, but we nonetheless have included them because of their impact on tax administration.

⁹ See IRC § 7482, which provides that United States Courts of Appeals have jurisdiction to review the decisions of the Tax Court; 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). 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.

¹⁰ IRC §§ 6214; 7476-7479; 6330(d); 6015(e).

¹¹ 28 U.S.C. § 1346(a)(1). See *Flora v. United States*, 362 U.S. 145 (1960), *reh'g denied*, 362 U.S. 972 (1960).

¹² IRC § 7422(a).

¹³ The bankruptcy courts 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).

¹⁴ See 11 U.S.C.A. §§ 505(a)(1) and (a)(2)(A).

ANALYSIS OF PRO SE LITIGATION

As in previous years, our analysis indicates that many taxpayers appeared before the courts *pro se*.¹⁵ Table 3.o.1 lists the most litigated issues for the period June 1, 2009, through May 31, 2010, and identifies the number of cases, broken down by issue, in which taxpayers appeared without counsel. As illustrated in the table below, the areas with the highest rates of *pro se* taxpayers are the frivolous issues penalty, family status issues, and summons enforcement. The high percentages of *pro se* taxpayers litigating these issues suggest that there may be an unwillingness on the part of representatives to take these cases, or that the issues affect many low and middle income taxpayers who cannot afford representation. These data may suggest a need for more Low Income Taxpayer Clinics and volunteer clinics to provide free or low cost representation.

TABLE 3.0.1, Pro Se Cases By Issue

Most Litigated Issue	Total Number of Litigated Cases Reviewed	Pro Se Litigation	Percentage of Pro Se Cases
Summons Enforcement	146	115	79%
Collection Due Process	131	84	64%
Accuracy-Related Penalties	125	78	62%
Trade or Business Expenses	119	86	72%
Gross Income	103	74	72%
Failure to File and Estimated Tax Penalties	71	50	70%
Frivolous Issues Penalty (and Analogous Appellate-Level Sanctions)	46	45	98%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	46	29	63%
Family Status Issues	45	39	87%
Joint and Several Liability	36	20	56%
Total	868	620	71%

Table 3.o.2 shows that, in general, taxpayers have a higher chance of prevailing in litigation if they are represented. However, *pro se* taxpayers actually experienced a substantially higher rate of success than represented taxpayers in litigation over family status issues and failure to file and estimated tax penalties. This higher success rate is noteworthy and indicates possible communication barriers between taxpayers and the IRS in the administrative process.

¹⁵ *Pro se* means “for oneself; on one’s own behalf; without a lawyer.” *Black’s Law Dictionary* (9th ed. 2009).

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	115	5	4%	31	6	19%
Collection Due Process	84	10	12%	47	5	11%
Accuracy-Related Penalties	78	22	28%	47	17	36%
Trade or Business Expenses	86	30	35%	33	13	39%
Gross Income	74	8	11%	29	11	38%
Failure to File and Estimated Tax Penalties	50	9	18%	21	2	10%
Frivolous Issues Penalty (and Analogous Appellate-Level Sanctions)	45	9	20%	1	1	24%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	29	2	7%	17	4	24%
Family Status Issues	39	10	26%	6	1	17%
Joint and Several Liability	20	6	30%	16	8	50%
Total	620	111	18%	248	68	27%

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The purpose of this section is to describe certain judicial decisions 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 *Bilski v. Kappos*, the Supreme Court held that while a commodity hedging process was too abstract to be patented, other business methods may be eligible for patent protection even if they fail the Federal Circuit’s “machine or transformation” test.²

One of the requirements to obtain a patent from the United States Patent and Trademark Office (USPTO) is that the invention or discovery must be a “new and useful process, machine, manufacture, or composition of matter” under 35 U.S.C. § 101. Mr. Bilski submitted a patent application for a process to manage the risk of commodity price fluctuations in energy markets (*i.e.*, hedging). The USPTO rejected his application because the process was not a patentable subject matter under 35 U.S.C. § 101. After the Board of Patent Appeals and Interferences upheld the USPTO’s determination, Mr. Bilski appealed to the Court of Appeals for the Federal Circuit. In affirming the Board of Patent Appeals and Interferences, the Federal Circuit explained that a process may constitute a patentable subject matter only if it either (1) is tied to a particular machine or (2) transforms an article into a different state or thing (“machine or transformation” test). The Federal Circuit adopted this machine-or-transformation analysis as the sole test for identifying a patentable “process.”³

The Supreme Court unanimously held that Mr. Bilski’s claims were ineligible for patent protection because they covered an abstract idea. As to what constitutes a patentable “process,” however, the Court provided little guidance. While acknowledging the “machine-or-transformation test is a useful and important clue,” the Court rejected it as the sole test. The Court reasoned that the statutory language does not so restrict the meaning of “process.”

A concurring opinion joined by four justices would have barred patents on business methods, which were not generally thought to be patentable before the 1999 *State Street* decision.⁴ According to the concurrence, Congress responded to this unexpected development by establishing “prior use” as a defense against business method patent infringement

¹ When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2009, and ending on May 31, 2010. For purposes of this section of the report, we generally use the same time period.

² 130 S. Ct. 3218 (2010), *aff’d sub nom. In re Bilski*, 545 F.3d 943 (Fed. Cir. 2008). For recent press coverage, see, e.g., Jeremiah Coder, *Supreme Court Affirms Bilski, Limits Federal Circuit’s Reasoning*, 2010 TNT 124-1 (June 29, 2010).

³ *In re Bilski*, 545 F.3d 943, 959-60 (Fed. Cir. 2008), *aff’d sub nom. Bilski v. Kappos*, 130 S. Ct. 3218 (2010). The Federal Circuit rejected its prior test, *i.e.*, whether it produced a “useful, concrete, and tangible result.” See *State Street Bank & Trust Co. v. Signature Fin. Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998), *cert. denied*, 525 U.S. 1093 (1999).

⁴ *Bilski*, 130 S. Ct. at 3251 (Stevens, J., concurring) (citing legislative history noting “business methods and processes . . . until recently were thought not to be patentable.”) (citation omitted). The case in question was *State Street Bank & Trust Co. v. Signature Fin. Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998), *cert. denied*, 525 U.S. 1093 (1999).

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claims.⁵ The majority concluded that holding business method patents unpatentable, as suggested by the concurrence, would render superfluous the “prior use” defense enacted by Congress in 1999. However, the majority explained that nothing in its opinion should be read as endorsing the analysis in *State Street*.⁶

Although this case did not involve a tax issue, it is nonetheless significant because it affects the extent to which tax strategies may be patented. On the one hand, the decision suggests that patenting a tax strategy, which is not tied to a computer or other machine, may be possible. On the other hand, the court pointedly disavowed the *State Street* case and encouraged the Federal Circuit to develop other limiting criteria. Because the Supreme Court decision does not ban tax strategy patents, however, legislation is still needed.⁷

In *Astrue v. Ratliff*, the Supreme Court held that an attorney fee award pursuant to the Equal Access to Justice Act (EAJA) was subject to offset against the litigant’s federal debts pursuant to the Treasury Department’s Offset Program (TOP).⁸

Ruby Ree, represented by Catherine Ratliff, prevailed on a claim against the United States for Social Security benefits. The District Court granted Ree’s motion for attorney fees pursuant to the EAJA.⁹ However, the government notified Ree that it would offset the attorney fee award to satisfy Ree’s preexisting nontax debt, pursuant to the Treasury Offset Program (TOP).¹⁰ Ratliff intervened to challenge the offset on the basis that EAJA fee awards belong to the litigant’s attorney, and thus may not be used to offset a litigant’s debts. The District Court held that because EAJA provides for a court to award fees to “a prevailing party,” Ratliff, as the litigant’s attorney, lacked standing to challenge the proposed offset.¹¹ The Eighth Circuit reversed, relying on case law to hold that EAJA attorneys’ fees are awarded to attorneys, not litigants. The Supreme Court, relying on statutory construction, reversed the Eighth Circuit.

A concurring opinion states, however, that while technically correct, the majority’s opinion undermines the purpose of EAJA to eliminate the financial disincentive to challenge unreasonable government actions. Justice Sotomayor argues the majority’s holding increases the risk that an attorney will not receive a fee award, inevitably decreasing the willingness of attorneys to undertake representation of low income litigants. She also suggests that

⁵ *Bilski*, 130 S. Ct. at 3251-52 (Stevens, J., concurring).

⁶ *Id.* at 3231.

⁷ For the National Taxpayer Advocate’s proposal, see National Taxpayer Advocate 2007 Annual Report to Congress 512 (Key Legislative Recommendation: *Eliminate Tax Strategy Patents*).

⁸ 130 S. Ct. 2521 (2010), *rev’g and remanding* 540 F.3d 800 (8th Cir. 2008).

⁹ 28 U.S.C. § 2412.

¹⁰ 31 U.S.C. §§ 3711, 3716 (2010); 31 C.F.R. §§ 285.5, 901.3. The Court did not decide if a 2005 amendment to applicable regulations (31 C.F.R. § 285.5(e)(5)) (relating to payments made to representative payees) exempted the payment from offset. *Ratliff*, 130 S. Ct. at 2525 n. 2. The TOP is a centralized offset program, administered by the Financial Management Service’s (FMS) Debt Management Services (DMS), to collect delinquent debts owed to federal agencies and states. Pursuant to TOP, FMS offsets such debts against certain federal payments. See, e.g., IRC § 6402(d); 31 U.S.C. § 3720A.

¹¹ 28 U.S.C. § 2412(d)(1)(A).

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litigants would be better able to repay the government if they could find attorneys to represent them to pursue claims against the government.

This case may be significant for tax attorneys because the tax fee shifting statute under IRC § 7430 is similar to EAJA in providing for an award of fees to “a prevailing party.” Moreover, it may call into doubt existing case law that suggests the government cannot offset an award of fees to a taxpayer’s attorney under IRC § 7430 against the taxpayer’s debts¹²

In *Fisher v. United States*, the Court of Appeals for the Federal Circuit affirmed the Court of Federal Claims, holding that when a policyholder of a mutual life insurance company received cash upon the company’s demutualization, the policyholder could recover tax basis before recognizing gain.¹³

Prior to March of 2000, Sun Life Assurance Company (Sun Life) was a mutual life insurance company owned by its policyholders. In addition to typical insurance contract rights to payment on death of an insured, policies conferred the rights to vote, dividends, and liquidating distributions, if any. In March of 2000, when Sun Life demutualized, it distributed shares of stock in exchange for the ownership rights of the policyholders, who could elect to immediately sell the stock (*i.e.*, receive cash in lieu of stock).

The IRS argued that pursuant to Treasury Regulation § 1.61-6(a), policyholders were required to allocate basis in the policy among the ownership and contract rights in accordance with their relative values when acquired. Thus, a policyholder could only allocate basis to the ownership rights by establishing that they were worth more than zero when acquired.

One policyholder, a trust, argued that, pursuant to the common law “open transaction” doctrine, it should instead be entitled to recover its entire basis in the policy first because the ownership rights were impractical or impossible to value.¹⁴ The United States Court of Federal Claims agreed, holding that the “open transaction” doctrine applied. The Court of Appeals for the Federal Circuit affirmed this decision in an unpublished opinion.¹⁵ The opinion is significant because the Court of Appeals for the Federal Circuit is a court of national jurisdiction, which has reaffirmed the continuing relevance of the “open

¹² One court explained:

That the statute [IRC § 7430] provides that attorneys’ fees are to be awarded to the prevailing party is not controlling...the prevailing party is only nominally the person who receives the award; the real party in interest vis-à-vis attorneys’ fees awarded under the statute are the attorneys themselves. . . . For the same reasons, the fact that the district court awarded the attorneys’ fees to Marre, and not his attorneys, does not affect our conclusion that, in this particular case, ‘the fee once awarded becomes in effect an asset of the attorney, not the client.’

Marre v. United States, 117 F.3d 297, 304 (5th Cir. 1997) (citations omitted), *aff’d in part, rev’d in part* 70 A.F.T.R.2d (RIA) 5,159 (S.D. Tex. 1992).

¹³ 333 Fed. App’x. 572 (Fed. Cir. 2009), *aff’d* 82 Fed. Cl. 780 (2008).

¹⁴ The “open transaction doctrine” is a theory pursuant to which the tax consequences of a transaction remain “open” until a contingency is resolved. See, e.g., *Burnet v. Logan*, 283 U.S. 404 (1931), *aff’d sub nom. Logan v. Comm’r*, 42 F.2d 193 (2d Cir. 1930), *rev’d* 12 B.T.A. 586 (1928). See also *Pierce v. United States*, 49 F. Supp. 324 (Ct. Cl. 1943). Taxpayers sometimes rely on this doctrine to defer gains, and the IRS has sometimes relied on it to conclude that losses should be deferred. See *id.*

¹⁵ *Fisher v. United States*, 333 Fed. App’x. 572 (Fed. Cir. 2009), *aff’d* 82 Fed. Cl. 780 (2008).

transaction” doctrine. The opinion is also significant because of the impact of the lower court’s decision on the tax treatment of demutualization transactions.

In *O’Donnabhain v. Commissioner*, the Tax Court held sex reassignment surgery and hormone therapy incurred by an individual with gender identity disorder were deductible as medical expenses, but costs associated with breast augmentation were not.¹⁶

O’Donnabhain was diagnosed with gender identity disorder (GID), a condition listed in the Diagnostic and Statistical Manual of Mental Disorders published by the American Psychiatric Association. According to this manual, an individual with GID exhibits a strong desire to be, or belief that he or she is, the opposite sex and has a persistent preoccupation with getting rid of his or her sex characteristics. This condition produces clinically significant distress or impairment in social, occupational, or other important areas of human functioning. According to the World Professional Association for Transgender Health, an association of health professionals specializing in GID, treatments for GID include hormonal sex reassignment and surgical sex reassignment, including genital and breast surgery. O’Donnabhain’s doctors treated the condition with hormone therapy, sex reassignment surgery, and breast augmentation surgery. O’Donnabhain deducted the related expenses, and the IRS disallowed them.

IRC § 213(a) allows a deduction for unreimbursed expenses for “medical care” to the extent they exceed 7.5 percent of adjusted gross income. Medical care is defined as amounts paid for the “treatment . . . of disease, or for the purpose of affecting any structure or function of the body.”¹⁷ For purposes of this definition, a “disease” can be a “physical or mental defect or illness.”¹⁸ However, the term “medical care” generally does not include “cosmetic surgery or other similar procedures.”¹⁹ Cosmetic surgery is any procedure “which is directed at improving the patient’s appearance and does not meaningfully promote the proper function of the body or prevent or **treat illness or disease.**”²⁰

The IRS argued that (1) O’Donnabhain did not have GID, and (2) the expenditures were for cosmetic surgery, did not treat a disease, and were not medically necessary.²¹ Based on expert testimony, Judge Gale, writing for the majority in a fully reviewed opinion, first concluded O’Donnabhain had GID. The majority also held that GID is a disease, basing this conclusion on substantial medical authority, including expert testimony, which suggested that mental conditions without known organic causes can be diseases, particularly

¹⁶ 134 T.C. No. 4 (2010).

¹⁷ IRC § 213(d)(1)(A).

¹⁸ Treas. Reg. § 1.213-1(e)(1)(ii).

¹⁹ IRC § 213(d)(9)(A).

²⁰ IRC § 213(d)(9)(B) (emphasis added).

²¹ IRS Chief Counsel attorneys previously concluded that this type of surgery was not deductible. CCA 200603025 (Oct. 14, 2005).

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if they either significantly impair normal function or are listed in a medical text.²² In addition, the court held that the expenditures for hormone therapy and sex reassignment surgery were to “treat” GID. The court found, however, that breast augmentation did not “treat” O’Donnabhain’s GID because she failed to establish that hormone therapy had an insufficient impact on her breasts and that breast augmentation surgery was necessary. Accordingly, the court held that O’Donnabhain’s expenditures for hormone therapy and sex reassignment surgery were deductible, but those for breast augmentation were not.²³

In *Petaluma FX Partners, LLC v. Commissioner*, the Court of Appeals for the District of Columbia Circuit held that the Tax Court lacked jurisdiction to determine the partners’ outside bases and accuracy-related penalties in a partnership-level proceeding.²⁴

Taxpayers formed Petaluma FX Partners, LLC (Petaluma) to implement a so-called Son of Boss tax shelter. The shelter was intended to allow the partners to inflate their outside basis in Petaluma and claim tax losses. The IRS issued a Notice of Final Partnership Administrative Adjustment (FPAA) to Petaluma, reducing each line item on Petaluma’s return to zero. However, the FPAA also explained that (1) the partnership was disregarded, (2) the partners’ outside partnership bases were zero, and (3) the valuation misstatement penalty applied to the partners.

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.²⁵ Thus, Petaluma argued the Tax Court (and presumably the IRS) had no jurisdiction to make these determinations in partnership-level proceedings, but the Tax Court disagreed.²⁶

Petaluma appealed, and the D.C. Circuit agreed with Petaluma. While the court acknowledged the Tax Court had jurisdiction to determine that Petaluma was not a partnership, it held that the Tax Court had no jurisdiction to make a determination with respect to the partners’ outside bases. It 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. For the same reasons, the court vacated and remanded the Tax Court’s decision with respect to partner-level accuracy-related penalties.

²² In concluding GID is a disease, the court also relied on nontax case law, which held that GID constitutes a medical condition of sufficient seriousness that it triggers the Eighth Amendment requirement that prison officials not ignore or disregard it.

²³ Several of the judges dissented on the issue of whether the expenditures for breast augmentation were deductible.

²⁴ 591 F.3d 649 (D.C. Cir. 2010), *rev’d in part, aff’d in part, vacating and remanding in part* 131 T.C. 84 (2008). The Court of Appeals for the Federal Circuit recently followed *Petaluma* in this regard. See *Jade Trading, LLC v. United States*, 598 F.3d 1372 (Fed. Cir. 2010), *aff’d in part, vacating and remanding in part* 80 Fed. Cl. 11 (2007).

²⁵ IRC § 6226(f).

²⁶ *Petaluma FX Partners, LLC v. Comm’r*, 131 T.C. 84 (2008).

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In *Intermountain Insurance Service of Vail, LLC v. Commissioner*, the Tax Court held that a temporary regulation, purporting to retroactively apply the six-year statute of limitations on assessment in IRC § 6501(e), was inapplicable and invalid.²⁷

More than three years but less than six years after an LLC filed a partnership return, the IRS determined the return reflected an overstated basis and assessed additional tax.²⁸ The taxpayer moved for summary judgment, arguing before the Tax Court that the IRS's assessment was time-barred because the three-year statute of limitations period for assessment applied instead of the six-year period applicable to substantial omissions of gross income under IRC § 6501(e). Relying on Ninth Circuit and Supreme Court precedent, the Tax Court held that an overstatement of basis is not an omission of gross income for purposes of IRC § 6501(e) and granted the taxpayer's motion.²⁹ As a result, the overstatement of basis did not trigger the longer six-year limitations period.

After entry of the Tax Court's order and decision, the IRS issued temporary and proposed regulations stating that an overstatement of basis can constitute a substantial omission.³⁰ These regulations purport to "apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009."³¹

The government filed a motion to vacate and reconsider the decision based on the retroactivity of the temporary regulations. The IRS argued the court should apply the temporary regulations to determine if the statutory period would have lapsed before September 24, 2009. If not, according to the IRS, the temporary regulations applied.

Judge Wherry, writing for the majority in a fully reviewed opinion in which none of the judges dissented, responded that the IRS's argument was "irreparably marred by circular, result-driven logic and the wishful notion that the temporary regulations should apply to this case because Intermountain was involved in what he believes was an abusive tax transaction."³² The majority reasoned that because the applicable period for assessing the tax expired before September 24, 2009, the temporary regulations did not apply.

The court went on to hold that even if the regulations did apply, they were invalid. It applied the test set forth in *Chevron*, which entitles agency regulations to deference unless (1) they contradict an unambiguous statute, or (2) set forth an unreasonable construction of

²⁷ 134 T.C. No. 11 (2010), supplementing T.C. Memo. 2009-195, appeal docketed, No. 25868-06 (DC Cir. Jul. 27, 2010) (hereinafter *Intermountain*). For additional discussion, see Jeremiah Coder, *News Analysis: IRS Undeterred After Tax Court's Intermountain Decision*, 2010 TNT 94-6 (May 17, 2010).

²⁸ 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 in connection with the disposition.

²⁹ *Intermountain Ins. Serv. of Vail, LLC v. Comm'r*, T.C. Memo. 2009-195. For prior coverage of this issue, see 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), *aff'g* 128 T.C. 207 (2007)).

³⁰ Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii), T.D. 9466, 74 Fed. Reg. 49,321 (Sept. 28, 2009); 74 Fed. Reg. 49,354 (Sept. 28, 2009).

³¹ Temp. Treas. Reg. § 301.6501(e)-1T(b), T.D. 9466, 74 Fed. Reg. 49,321, 49,323 (Sept. 28, 2009).

³² *Intermountain*, 134 T.C. No. 11 (2010).

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it.³³ The court did not reach the second prong of the test because it determined the statute was unambiguous in light of operative Supreme Court precedent.

In a concurring opinion, several of the Tax Court judges indicated they would have reached the same result on the basis that the regulations were procedurally invalid under the Administrative Procedure Act (APA).³⁴ The APA requires an agency to publish a regulation not less than 30 days before its effective date unless an exception applies.³⁵ According to the concurring opinion, the temporary regulations were invalid because the Secretary of the Treasury published them without the requisite 30-day period, and no exception applied.³⁶

In *Smith v. Commissioner*, the Tax Court held that it lacked jurisdiction in a deficiency proceeding to redetermine penalties for failure to report involvement in a listed transaction.³⁷

The IRS issued a notice of deficiency to the taxpayers (husband and wife) for tax years 2003-2006, reflecting a \$133,974 tax deficiency and \$37,774 in accuracy-related penalties. The IRS also assessed \$300,000 in section 6707A penalties for the 2004-2006 periods (\$100,000 per year) for failure to disclose participation in a listed transaction.³⁸ The taxpayers timely filed a petition challenging the deficiency notice and the notice of assessment.

If a taxpayer files a timely petition after receiving a statutory notice of deficiency, the Tax Court has so-called “deficiency jurisdiction” pursuant to which it is empowered to make a “redetermination of the deficiency.”³⁹ However, the IRS is authorized to assess certain penalties, generally called “assessable” penalties, without issuing a notice of deficiency.⁴⁰ The IRS argued the court had no jurisdiction to redetermine the section 6707A penalty because it is an assessable penalty.⁴¹

The court agreed that it had no jurisdiction but found that the label “assessable penalty” was not dispositive. It reasoned, instead, that the Tax Court lacks deficiency jurisdiction because the section 6707A penalty does not fall within the statutory definition of a deficiency,

³³ *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

³⁴ 5 U.S.C. §§ 551-559.

³⁵ 5 U.S.C. § 553(d).

³⁶ While the IRS argued the regulations were exempt from this requirement (under 5 U.S.C. § 553(b)) because they were “interpretive rules,” the court concluded that no such exception applied because they were “legislative rules.”

³⁷ 133 T.C. No. 18 (2009). For a discussion of the section 6707A penalty, see National Taxpayer Advocate 2008 Annual Report to Congress 419-422 (Legislative Proposal: *Modify Internal Revenue Code Section 6707A to Ameliorate Unconscionable Impact*) and National Taxpayer Advocate 2008 Annual Report to Congress vol. II 1, 21 (*A Framework for Reforming the Penalty Regime*).

³⁸ According to IRC § 6707A(c)(2), a “listed transaction” is “a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.”

³⁹ IRC § 6213(a).

⁴⁰ Such penalties are located in subchapter B of chapter 68 of the IRC, which is entitled “Assessable Penalties.”

⁴¹ According to IRC § 6671, assessable penalties are paid upon notice and demand by the Secretary, and are assessed and collected in the same manner as taxes.

is not determined on a notice of deficiency, and does not depend upon the existence of a deficiency (*i.e.*, it may be assessed even if there is an overpayment of tax).⁴²

In *Tucker v. Commissioner*, the Tax Court held that IRS Appeals employees charged with conducting collection due process hearings are not “officers” within the meaning of the Appointments Clause of the U.S. Constitution, and thus, do not need to be appointed by the President or the Secretary of the Treasury.⁴³

Mr. Tucker filed tax returns reporting tax liabilities, which he did not pay. Before issuing a levy to collect delinquencies, the IRS must offer taxpayers a collection due process (CDP) hearing by an “officer or employee” of the IRS Office of Appeals.⁴⁴ Mr. Tucker requested and received a CDP hearing pursuant to which his offer to compromise the tax liability was rejected. As part of his appeal to the Tax Court, Mr. Tucker filed a motion for remand, contending that the persons who conduct CDP hearings – generally appeals officers, settlement officers, and team managers – are appointed in violation of the Appointments Clause of Article II, Section 2 of the U.S. Constitution.

The Appointments Clause provides:

[The President] shall nominate, and by and with the Advice and Consent of the Senate, shall appoint ... all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.⁴⁵

If appeals officers, settlement officers, or team managers are “inferior officers” within the meaning of the Appointments Clause, as Mr. Tucker asserts, they are appointed in violation of it because none are appointed by the President or the Secretary of the Treasury. Instead, they are hired by the IRS Commissioner’s delegate pursuant to IRC § 7804(a).

According to the court, to be an inferior officer, rather than an employee who is not an officer (called a “lesser functionary”), an appointee must exercise significant authority pursuant to an office established by law. Because an “officer or an employee” (emphasis added) may conduct a CDP hearing, the court reasoned that no particular position was “established by law.”⁴⁶ Even if a position was established by law, the court concluded that employees who conduct CDP hearings do not have the level of “significant authority,” required to qualify as inferior officers. After reviewing the many ways that the outcome of a CDP hearing may

⁴² IRC § 6211 (defining deficiency). The court noted that it “would presumably have jurisdiction to redetermine a liability challenge asserted by petitioners in a collection due process hearing.” *Smith v. Comm’r*, 133 T.C. No. 18 n.6 (2009).

⁴³ 135 T.C. No. 6 (2010).

⁴⁴ See IRC § 6330(b)(3) (“The hearing under this subsection shall be conducted by an officer or employee who has had no prior involvement with respect to the unpaid tax”); IRC § 6320(b)(3) (same with respect to CDP hearings resulting from lien notices).

⁴⁵ U.S. Const. art. II, § 2.

⁴⁶ IRC § 6330(b)(3); IRC § 6320(b)(3).

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be revisited, modified, or reversed by various officials, it analogized appeals employees to administrative law judges for the Federal Deposit Insurance Corporation, who are lesser functionaries (not inferior officers) even though they take testimony, conduct trials, rule on the admissibility of evidence, enforce discovery orders, and recommend a decision to a board.⁴⁷ As a result, the court held that appeals employees who conduct CDP hearings are not inferior officers for purposes of the Appointments Clause, and are not required to be appointed by the Secretary of the Treasury or the President.

In *Gill v. Office of Personnel Management*, the United States District Court for the District of Massachusetts held unconstitutional the application of the Defense of Marriage Act (DOMA) in denying married same-sex couples the benefit of filing joint federal income tax returns.⁴⁸

Seven married same-sex couples and three survivors of same-sex spouses (the plaintiffs), all married in Massachusetts, sought federal benefits commonly available to married persons, including tax benefits associated with filing a joint federal income tax return.⁴⁹ A husband and wife are generally entitled to file a joint federal income tax return.⁵⁰ DOMA provides, however, that only a man and a woman can be considered married, spouses, or a husband and wife for purposes of federal law.⁵¹ Three of the same-sex couples filed amended tax returns for multiple years, claiming joint filing status, which would produce refunds. The IRS disallowed their refund claims, citing DOMA.

The plaintiffs asserted that DOMA denied them federal marriage-based benefits in violation of the equal protection principles embodied in the Due Process Clause of the Fifth Amendment.⁵² Laws involving classifications that discriminate against certain “suspect” classes of similarly situated individuals are subject to “strict scrutiny,” the highest level of judicial review.⁵³ Laws discriminating among other classes of individuals are constitutional if they pass a “rational basis” test.⁵⁴ Pursuant to this test, the government need only

⁴⁷ The court cited *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000).

⁴⁸ 699 F. Supp. 2d 374 (D. Mass. 2010), *appeal docketed*, No. 10-2207 (1st. Cir. Oct. 13, 2010). For a discussion of unanswered federal tax questions posed by state laws governing domestic partnerships, see Most Serious Problem, *State Domestic Partnership Laws Present Unanswered Federal Tax Questions*, *supra*.

⁴⁹ 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).

⁵⁰ IRC § 6013(a).

⁵¹ Section three of DOMA provides that:

In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word ‘marriage’ means only a legal union between one man and one woman as husband and wife, and the word ‘spouse’ refers only to a person of the opposite sex who is a husband or a wife. DOMA, Pub. L. No. 104-199, § 3, 110 Stat. 2419 (1996) (codified at 1 U.S.C. § 7).

⁵² *Gill*, 699 F. Supp. 2d at 375.

⁵³ See, e.g., *Adarand Constructors, Inc. v. Peña*, 515 U.S. 200 (1995), *vacating and remanding* 16 F.3d 1537 (10th Cir. 1994), *aff’g* 790 F. Supp. 240 (D. Colo. 1992).

⁵⁴ 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 (Summer 1987).

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show that the challenged classification is rationally related to a legitimate governmental interest.⁵⁵

The court did not need to decide if discrimination between same and different-sex married persons was a type of discrimination that would be subject to strict scrutiny because it concluded “there exists no fairly conceivable set of facts that could ground a rational relationship between DOMA and a legitimate government objective.”⁵⁶ Thus, it held that DOMA failed a rational-basis inquiry and violated the equal protection principles embodied in the Fifth Amendment.⁵⁷

⁵⁵ See, e.g., *FCC v. Beach Comm'ns*, 508 U.S. 307 (1993), *vacating and remanding* 16 F.3d 1537 (10th Cir. 1994), *aff'g* 790 F. Supp. 240 (D. Colo. 1992).

⁵⁶ Prior to the enactment of DOMA, federal law incorporated each state's marital status determinations. *Gill*, 699 F. Supp. 2d at 384. The government asserted that Congress enacted DOMA to preserve the *status quo* definitions of “marriage” and “spouse” in time of debate when the status of same-sex marriage and related definitions in individual states were changing. *Id.* The court determined that DOMA does not advance the congressional objectives intended at its enactment to encourage responsible procreation, defend heterosexual marriage and traditional notions of morality, and conserve scarce resources. *Id.*

⁵⁷ In a companion case, the district court held that DOMA was unconstitutional under the Tenth Amendment (reserving unenumerated powers to the states) and the Spending Clause. See *Commonwealth of Mass. v. Dep't of Health & Human Services (HHS)*, 698 F. Supp. 2d 234 (D. Mass. 2010).

MLI
#1**Summons Enforcement Under Internal Revenue Code Sections 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 individual who is 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 the legality of the summons if the government petitions a court to enforce it.³ If the IRS serves a summons upon 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 formidable.⁵ We reviewed 146 cases in federal court that included issues of IRS summons enforcement and were litigated between June 1, 2009, and May 31, 2010. The parties contesting the summonses prevailed in full in only four of these cases, with seven cases resulting in split decisions, one resulting in no decision, and the IRS prevailing in the remaining 134 cases.

PRESENT LAW

The IRS has broad authority under IRC § 7602 to issue a summons to examine a taxpayer's books and records or demand testimony under oath.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 those 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 IRS may commence an action under IRC § 7604 in the appropriate United States District Court to compel production or testimony.⁹ If the IRS files a petition to enforce the summons, the taxpayer may contest the validity of the summons in that proceeding.¹⁰ Also, if the summons is served upon a third party, any

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 *Bodensee Fund, LLC v. U.S. Dept. of Treasury-IRS*, 101 A.F.T.R.2d (RIA) 2092 (E.D. Pa. 2008).

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, 145-46 (1975)).

⁷ IRC § 7602(a). 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).

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

A person named in a third-party summons is generally entitled to notice,¹² but several exceptions may apply. First, 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 (and is attempting to determine, for example, whether the taxpayer has an account in a certain bank and whether the account has sufficient funds to pay the tax). Giving taxpayers notice in the latter case would seriously impede the IRS’s ability to collect the tax.¹⁴ The courts have interpreted the “aid of collection” exception to apply only where the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned.¹⁵ Second, also to facilitate tax collection, a summons issued by an IRS criminal investigator in connection with a criminal investigation is exempt from IRC § 7609 notice procedures if the summons is served on any person who is not a third-party record keeper.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 notice was served. IRC § 7609(b)(2)(A).

¹² IRC § 7609(a)(1).

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

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 371-72, *reprinted in* 1976 U.S.C.C.A.N. at 3800-3801 (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 data to which the source relates.” IRC § 7603(b)(2).

¹⁷ *Phillips v. Comm’r*, 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 met.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
- Work-product privilege;²³ or
- Tax practitioner privilege.²⁴

However, these privileges are limited. For example, they extend to “tax advice” but not 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

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. Our prediction was accurate, as the volume of cases grew to 101 in 2006, 109 in 2007, 146 in 2008, and 158 in 2009 before declining to 146 in 2010.²⁷ A detailed list of this year’s cases appears in Table 1 in Appendix III.

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 generally provides protection from discovery of information where:

(1) legal advice of any kind is sought, (2) from a professional legal advisor in his or her capacity as such, (3) the communication is related to this purpose, (4) made in confidence, (5) by the client, (6) and at the client’s insistence protected, (7) from disclosure by the client or the legal advisor, (8) except where the privilege is waived. *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 The work product doctrine 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).

²⁴ 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, 810-12 (7th Cir. 2003), *petition for cert. denied*, *Roes v. U.S.*, 540 U.S. 1178 (2004).

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

²⁶ IRC § 7525(b); *Valero Energy Corp. v. U.S.*, 569 F.3d 626 (7th Cir. 2009), *aff’d* 2008 U.S. Dist. LEXIS 105609 (N.D. Ill. 2008).

²⁷ National Taxpayer Advocate 2009 Annual Report to Congress 430-437; National Taxpayer Advocate 2008 Annual Report to Congress 488-494; National Taxpayer Advocate 2007 Annual Report to Congress 588-593; National Taxpayer Advocate 2006 Annual Report to Congress 582-588.

The IRS prevailed in full in 134 cases. Taxpayers prevailed in only four cases, seven ended in split decisions, and one case resulted in no decision. Attorneys represented taxpayers in 31 cases, while taxpayers appeared *pro se* (i.e., without counsel) in the other 115. One hundred twenty-six cases involved individual taxpayers, while the remaining 20 involved business taxpayers (17 of which had representation). The arguments the litigants raised against IRS summonses generally fell into the following categories:

Powell Requirements: Although we identified no cases in which the taxpayer successfully challenged the government's *prima facie* showing, taxpayers frequently argued that one or more of the *Powell* requirements had not been met. For example, a court found the IRS had authority to investigate U.S. Virgin Islands residents under IRC §§ 932(c)(4) and 7651(1) to determine whether the taxpayers were *bona fide* Virgin Islands residents and whether the U.S. Virgin Islands was a source of their income.²⁸ However, in *Nero Trading*, despite the IRS's broad investigative authority, the Eleventh Circuit found that the district court's failure to explain its reasons for denying the taxpayer's request for an evidentiary hearing resulted in the taxpayer not being afforded a meaningful opportunity to question the IRS about its reasons for issuing the summonses.²⁹ Because the Eleventh Circuit could not ascertain from the record whether the summonses were issued for a proper purpose, it remanded the case to the district court for further proceedings consistent with the opinion.³⁰

As long as a matter has not been referred to the DOJ, the IRS can issue a summons for the purpose of determining criminal liability.³¹ Taxpayers in some cases argued the summonses were overly broad, but failed to support their claims with evidence that the information sought was irrelevant.³² Taxpayers also claimed the IRS already possessed the requested documents, but courts found that the IRS could seek documents directly from the summoned party even if other sources may provide similar information.³³ For example, in *Twin Palms Resort*, the district court held that the IRS was entitled to obtain records from third parties to establish the accuracy of records that the taxpayer had already provided.³⁴ Courts found that all necessary administrative steps were completed where a delegation

²⁸ *Twin Palms Resort, LLC v. U.S.*, 676 F. Supp. 2d 1350 (S.D. Fla. 2009) (the IRS derives its investigative powers from its authority to enforce U.S. tax law in the Virgin Islands under IRC § 7651(1), and from the requirement of IRC § 932(c)(4) that Virgin Islands residents file U.S. tax returns if they have not fully reported their income and fully paid their taxes to the U.S. Virgin Islands Bureau of Internal Revenue); see also *St. Claire v. U.S.*, 105 A.F.T.R.2d (RIA) 1569 (S.D. Cal. 2010) (finding a summons was issued for a proper purpose even though the IRS Revenue Agent did not immediately return the taxpayer's phone calls). For a discussion of tax issues pertaining to the U.S. Virgin Islands, see the National Taxpayer Advocate 2009 Annual Report to Congress 391-399.

²⁹ *Nero Trading, LLC v. U.S.*, 570 F.3d 1244 (11th Cir. 2009), *reversing and remanding* 104 A.F.T.R.2d (RIA) 5205 (N.D. Ga. 2007).

³⁰ *Id.*

³¹ *Seay v. U.S.*, 105 A.F.T.R.2d (RIA) 1103 (W.D.N.C. 2010); *U.S. v. Little*, 104 A.F.T.R.2d 7473 (E.D. Ky. 2009).

³² *Twin Palms Resort, LLC v. U.S.*, 676 F. Supp. 2d 1350 (S.D. Fla. 2009); *Sugarloaf Funding v. U.S. Dep't of Treasury*, 584 F.3d 340 (1st Cir. 2009).

³³ *Marcon, Inc. v. U.S.*, 105 A.F.T.R.2d (RIA) 460 (D. Idaho 2009) (IRS may verify existence of bank account by use of summons instead of relying on witness's report that the account exists); *U.S. v. Elmes*, 104 A.F.T.R.2d (RIA) 7676 (S.D. Fla. 2009), *reconsideration denied by* 105 A.F.T.R.2d (RIA) 322 (S.D. Fla. 2009), *sanctions denied by* 105 A.F.T.R.2d (RIA) 666 (S.D. Fla. 2010), *petition dismissed by* 2010 U.S. Dist. LEXIS 10234 (S.D. Fla. 2010).

³⁴ *Twin Palms Resort, LLC v. U.S.*, 676 F. Supp. 2d 1350 (S.D. Fla. 2009).

order authorized IRS Special Agents to issue summonses without the separate approval or signature of a supervisory official.³⁵

Criminal Referral: 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.³⁶ Additionally, the IRC § 7602(d) restriction on issuing a summons after DOJ referral applies only when the IRS has referred a taxpayer whose tax liabilities are under investigation to the DOJ.³⁷

Constitutional Arguments: Taxpayers asserted several unsuccessful constitutional arguments. For example, courts have long stated that taxpayers cannot use the Fourth Amendment as a defense against a third-party summons.³⁸ Furthermore, although taxpayers may have a valid Fifth Amendment claim regarding specific documents or testimony, the courts routinely rejected blanket assertions of a Fifth Amendment privilege.³⁹ A court acknowledged that no Fifth Amendment rights exist in respect to documents prepared in a representative capacity as a taxpayer's agent or employee, unless related testimony could personally incriminate the preparer.⁴⁰ Fifth Amendment rights are not applicable to subpoenaed documents that are not of the type created by the taxpayer, such as bank statements, checkbooks, deeds, vehicle registrations, and insurance policies. However, the Ninth Circuit found the Fifth Amendment privilege applied to documents related to offshore credit card accounts where the government failed to show knowledge, at the time it issued the summonses, that the taxpayers controlled these accounts.⁴¹ Courts have rejected arguments asserting violation of taxpayers' privacy rights,⁴² and protections by the Eleventh

³⁵ *Bohall v. U.S.*, 339 Fed. App'x. 661 (8th Cir. 2009); *Neilson v. U.S.*, 674 F. Supp. 2d 248 (D.D.C. 2009).

³⁶ *Sanders v. U.S.*, 105 A.F.T.R.2d (RIA) 2013 (D. Ariz. 2010); *Kern v. U.S.*, 105 A.F.T.R.2d (RIA) 1526 (E.D. Mich. 2010), *adopting* 105 A.F.T.R.2d (RIA) 1520 (E.D. Mich. 2010); *Seay v. U.S.*, 105 A.F.T.R.2d (RIA) 1103 (W.D.N.C. 2010); *U.S. v. Allen*, 105 A.F.T.R.2d (RIA) 887 (S.D. Ohio 2009); *U.S. v. Little*, 104 A.F.T.R.2d 7473 (E.D. Ky. 2009).

³⁷ *Seay v. U.S.*, 105 A.F.T.R.2d (RIA) 1103 (W.D.N.C. 2010).

³⁸ *Hibben v. U.S.*, 104 A.F.T.R.2d (RIA) 6623 (S.D. Ohio 2009) *adopting* 104 A.F.T.R.2d (RIA) 6621 (S.D. Ohio 2009) (citing *Donaldson v. U.S.*, 400 U.S. 517, 522 (1971)).

³⁹ *U.S. v. Lanoie*, 105 A.F.T.R.2d (RIA) 844 (10th Cir. 2010); *U.S. v. Elmes*, 104 A.F.T.R.2d (RIA) 7676 (S.D. Fla. 2009), *reconsideration denied by* 105 A.F.T.R.2d (RIA) 322 (S.D. Fla. 2009), *sanctions denied by* 105 A.F.T.R.2d (RIA) 666 (S.D. Fla. 2010), *petition dismissed by* 2010 U.S. Dist. LEXIS 10234 (S.D. Fla. 2010); *U.S. v. Griggs*, 103 A.F.T.R.2d (RIA) 922 (D. Ariz. 2009), *magistrate's recommendation* 2009-2 T.C. (CCH) ¶ 50768 (D. Ariz. 2009), *accepted by* 104 A.F.T.R.2d (RIA) 7695 (D. Ariz. 2009), *reconsideration denied by* 105 A.F.T.R.2d (RIA) 744 (D. Ariz. 2009), *stay denied by* 105 A.F.T.R.2d (RIA) 859 (D. Ariz. 2009), *motion granted by* 105 A.F.T.R.2d (RIA) 1525 (D. Ariz. 2010) (Fifth Amendment privilege abandoned where taxpayer asserted the privilege in response to specific questions but refused to explain basis for the objections and to submit relevant documents for *in camera* review).

⁴⁰ *U.S. v. Little*, 104 A.F.T.R.2d 7473 (E.D. Ky. 2009); *Collins v. Provost* (Andre), 104 A.F.T.R.2d (RIA) 7382 (E.D. Cal. 2009), *adopted by* 104 A.F.T.R.2d (RIA) 7778 (E.D. Cal. 2009).

⁴¹ *U.S. v. Bright*, 596 F.3d 683 (9th Cir. 2010), *aff'g in part* 102 A.F.T.R.2d (RIA) 6183 (D. Haw. 2008).

⁴² *Metz v. U.S.*, 104 A.F.T.R.2d (RIA) 7228 (M.D. Fla. 2009) (finding no invasion of privacy where taxpayer makes no effort to show how his right of privacy is violated); *Neilson v. U.S.*, 674 F. Supp. 2d 248 (D.D.C. 2009) (The Right to Financial Privacy Act does not apply to summonses issued pursuant to IRC § 7609 and did not preclude the IRS from issuing third-party summons to financial institutions in connection with taxpayer.).

Amendment⁴³ and First Amendment,⁴⁴ emphasizing that the First Amendment does not protect false commercial speech.⁴⁵ Finally, the courts held that where the taxpayer received notice and was given an opportunity to respond, no due process violation occurred.⁴⁶

Privilege: Courts generally rejected blanket claims of attorney-client privilege.⁴⁷ Despite a circuit split on the work-product privilege,⁴⁸ the Supreme Court denied certiorari in *United States v. Textron, Inc.*⁴⁹ The Court left intact a 3-2 *en banc* ruling by the First Circuit that the work product doctrine did not protect tax accrual work papers prepared by in-house lawyers and accountants to support Textron's calculation of tax reserves for its audited financial statements. The First Circuit concluded that the work product privilege extends only to documents prepared for use in actual or anticipated litigation, not documents created to comply with financial reporting rules. The dissenting opinion argued that the court had quietly abandoned the "because of" standard, which was the standard previously adopted by this circuit,⁵⁰ to create a new "prepared for" test and pointed out that the majority failed to acknowledge that the documents were protected under the "because of" standard in their opinion.

In addition to the work-product privilege, taxpayers may use the attorney-client or taxpayer-client privileges as defenses to summons enforcement.⁵¹ Nonetheless, bank records of a client's trust account are not the type of documents protected by attorney-client privilege unless a limited exception, "the last link doctrine," applies.⁵² The last link doctrine excludes from disclosure a person's identity if it would also reveal the client's motive for seeking

⁴³ *U.S. v. Allen*, 105 A.F.T.R.2d (RIA) 887 (S.D. Ohio 2009) (the Eleventh Amendment confers immunity on states, not on individuals).

⁴⁴ *U.S. v. Worley*, 104 A.F.T.R.2d (RIA) 5974 (M.D. Pa. 2009), *reconsideration denied* by 2009 U.S. Dist. LEXIS 79208 (M.D. Pa. 2009), *mandamus denied* by 331 Fed. App'x. 948 (3d Cir 2009), *appeal dismissed* by 347 Fed. App'x. 744 (3d Cir. 2009) (necessity of orderly collection of tax revenues required a taxpayer to comply with a summons and list his assets even if compliance may have conflicted with the taxpayer's religious beliefs not to boast of his wealth and material possessions).

⁴⁵ *U.S. v. Allen*, 105 A.F.T.R.2d (RIA) 887 (affirming that the First Amendment does not confer immunity from operation of the federal tax law); *Pragovich v. I.R.S.*, 104 A.F.T.R.2d (RIA) 7625 (E.D. Mich. 2009), *accepted* by 676 F. Supp. 2d 557 (E.D. Mich. 2009) (6th Cir. 2009) (communication, which facilitates frivolous lawsuits against the IRS, is false or misleading speech not protected by the First Amendment).

⁴⁶ *Bohall v. U.S.*, 339 Fed. App'x. 661 (8th Cir. 2009) (no denial of due process found where taxpayer had opportunity to respond to motions to dismiss); *Kern v. U.S.*, 105 A.F.T.R.2d (RIA) 1520 (E.D. Mich. 2010), *adopted* by 105 A.F.T.R.2d (RIA) 1526 (E.D. Mich. 2010) (no due process violation resulting from lack of notice where taxpayer not entitled to notice under IRC § 7609).

⁴⁷ *U.S. v. Bernhoft*, 104 A.F.T.R.2d (RIA) 7059 (E.D. Wis. 2009) (blanket claim of attorney-client privilege failed where taxpayer did not provide privilege log or affidavits specifying how privilege applies to each document).

⁴⁸ Courts have diverged on the appropriate standard for assessing whether a document was prepared in anticipation of litigation. Some courts have followed the Fifth Circuit's "primary purpose" test, which provides that if the "primary motivating purpose behind the creation of the document was to aid in possible future litigation", the documents are privileged. *U.S. v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982). Other courts have adopted the "because of" standard, where the "relevant inquiry is whether the document was prepared or obtained 'because of the prospect of litigation.'" *U.S. v. Adlman*, 134 F.3d 1194, 1205 (2d Cir. 1998); see also *U.S. v. Deloitte, LLP*, 2010-1 U.S.T.C. (CCH) ¶ 50487 (D.C. Cir. 2010), *affirming in part, vacating in part, remanding* 623 F. Supp. 2d 39 (D.D.C. 2009); *In re Grand Jury Subpoena*, 357 F.3d 900, 907-08 (9th Cir. 2004); *PepsiCo, Inc. v. Baird, Kurtz & Dobson LLP*, 305 F.3d 813, 817 (8th Cir. 2002); *Logan v. Commercial Union Ins. Co.*, 96 F.3d 971, 976-77 (7th Cir. 1996).

⁴⁹ 577 F.3d 21 (1st Cir. 2009) (*en banc*), *cert. denied*, 176 L. Ed. 2d 1219 (2010).

⁵⁰ *Maine v. United States Dep't of the Interior*, 298 F.3d 60 (1st Cir. 2002) (citing *U.S. v. Adlman*, 134 F.3d 1194 (2d Cir. 1998)).

⁵¹ *U.S. v. Textron, Inc. and Subsidiaries*, 577 F.3d 21 (1st Cir. 2009) (*en banc*), *cert. denied*, 176 L. Ed. 2d 1219 (2010); *Valero Energy Corp. v. U.S.*, 569 F.3d 626 (7th Cir. 2009), *aff'g* 2008 U.S. Dist. LEXIS 105609 (N.D. Ill. 2008).

⁵² *In re Grand Jury (Lipnack)*, 831 F.2d 225 (11th Cir. 1987).

legal advice.⁵³ The taxpayer-client privilege exists to the extent the communication would be considered a privileged communication if it took place between a taxpayer and an attorney and was for the purpose of obtaining tax advice from a federally authorized tax practitioner.⁵⁴ The privilege does not, however, apply to communications in connection with the promotion of the direct or indirect participation of a taxpayer in any tax shelter.⁵⁵ 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” and “in connection with the promotion of the direct or indirect participation of the person in any tax shelter.”⁵⁶ A tax shelter is defined as “a partnership or 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.”⁵⁷

The IRS prevailed in 27 of the 30 cases initiated by filing 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.⁵⁸ 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.⁵⁹ 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.⁶⁰ A taxpayer may initiate a proceeding in the U.S. District Court in which the third party resides, no later than 20 days from the date the notice of summons was given.⁶¹ For example, a court dismissed a *pro se* taxpayer’s motion to quash for lack of jurisdiction because the taxpayer filed the motion 18 days after the 20-day limitation period had expired.⁶²

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

⁵³ *Sunshine Behavioral Health Svcs. v. U.S.*, 104 A.F.T.R.2d (RIA) 5104 (M.D. Fla. 2009) (finding that the taxpayers had not demonstrated that the information fell within this limited exception).

⁵⁴ IRC § 7525(a)(1). See *Valero Energy Corp. v. U.S.*, 569 F.3d 626 (7th Cir. 2009), *aff’d* 2008 U.S. Dist. LEXIS 105609 (N.D. Ill. 2008).

⁵⁵ IRC § 7525(b). See *Valero Energy Corp. v. U.S.*, 569 F.3d 626 (7th Cir. 2009), *aff’d* 2008 U.S. Dist. LEXIS 105609 (N.D. Ill. 2008).

⁵⁶ IRC § 7525(b).

⁵⁷ IRC § 6662(d)(2)(C)(ii).

⁵⁸ *U.S. v. Dalm*, 494 U.S. 596, 608 (1990).

⁵⁹ *Navarro v. I.R.S.*, 105 A.F.T.R.2d (RIA) 2587 (2d Cir. 2010); *Hollywood Svcs., Inc. v. I.R.S.*, 105 A.F.T.R.2d (RIA) 1883 (D. Colo. 2010).

⁶⁰ IRC § 7609(b)(2)(A). See *Hollywood Svcs., Inc. v. I.R.S.*, 105 A.F.T.R.2d 1883 (D. Colo. 2010); *Atl. Ave. D.B. Fin./Legal Support Group v. U.S.*, 104 A.F.T.R.2d (RIA) 5586 (S.D. Fla. 2009).

⁶¹ IRC § 7609(b)(2)(A); *Andrikopoulos v. U.S.*, 105 A.F.T.R.2d (RIA) 1085 (D. Colo. 2010), *adopted by* 105 A.F.T.R.2d (RIA) 1087 (D. Colo. 2010); *Neilson v. U.S.*, 674 F. Supp. 2d 248 (D.D.C. 2009).

⁶² *Andrikopoulos v. U.S.*, 105 A.F.T.R.2d 1085 (D. Colo. 2010).

summons due to one of the IRC § 7609(c) exceptions, and therefore lacked standing to contest the validity of the summons.⁶³ In *Fisher v. United States*,⁶⁴ the taxpayers asserted that a third-party summons delivered by fax to PayPal was not properly served. The court acknowledged that although taxpayers can generally raise issues relevant to their interest in nondisclosure of information, IRC § 7609 does not give them standing to assert issues of meaningful concern only to third parties. The court held that it lacked subject matter jurisdiction over a petition to quash the summons, concluding that service of summons on PayPal affected only PayPal's interests, and not the taxpayers' interests. In *Sunshine Behavioral Health Services v. United States*,⁶⁵ however, the court did not agree with a broad interpretation of IRC § 7609,⁶⁶ finding that if the summons seeks documents belonging to a third party, the third party had standing to contest the validity of the summons. In this case, the IRS issued a collection summons to a bank, seeking bank statements for an attorney's trust account where the attorney had represented the taxpayer in a bankruptcy proceeding. The court held that the taxpayer's attorney had standing to challenge the summons because the IRC § 7609(c)(2)(D) exception-to-notice provision did not apply. On the other hand, in *Viewtech, Inc. v. United States*,⁶⁷ the court found the IRC § 7609(c)(2)(D) exception applied because the government introduced sufficient evidence that the taxpayer had a recognizable legal interest in the third-party company whose bank account records were summoned. The court held that the taxpayer was not entitled to notice of a summons to the company because he received company funds to his personal bank account and was sole and majority shareholder for two consecutive years.

CONCLUSION

The IRS may issue a summons to obtain information needed to determine the correctness of a tax return, determine if a return should have been filed, determine a taxpayer's tax liability, or collect a liability.⁶⁸ Accordingly, the IRS may request documents and testimony from taxpayers who have failed to provide that information to the IRS voluntarily. Taxpayers and third parties continue to contest IRS summonses, but rarely succeed due to the significant burden of proof and strict procedural requirements. It appears that as the IRS employs a more aggressive enforcement policy, it will continue to rely heavily on the summons enforcement tool. We expect the courts will continue to see these cases litigated.

⁶³ IRC § 7609(c)(2)(D)(i); *Hollywood Svcs., Inc. v. I.R.S.*, 105 A.F.T.R.2d 1883 (D. Colo. 2010); *Kern v. U.S.*, 105 A.F.T.R.2d (RIA) 1520 (E.D. Mich. 2010), *ad-opted by* 105 A.F.T.R.2d (RIA) 1526 (E.D. Mich. 2010); *Viewtech, Inc. v. U.S.*, 104 A.F.T.R.2d (RIA) 7101 (S.D. Cal. 2009); *Atl. Ave. D.B. Fin./Legal Support Group v. U.S.*, 104 A.F.T.R.2d (RIA) 5586 (S.D. Fla. 2009).

⁶⁴ 676 F. Supp. 2d 1165 (W.D. Wash. 2009).

⁶⁵ 104 A.F.T.R.2d (RIA) 5104 (M.D. Fla. 2009).

⁶⁶ Several circuit courts have interpreted broadly the IRC § 7609(c)(2)(D) exception to notice to find that "as long as the third-party summons is issued to aid in the collection of any assessed tax liability the notice exception applies." *Huffman v. U.S.*, 100 A.F.T.R.2d 7089 (S.D. Fla. 2007) (citing *Barnes v. U.S.*, 199 F.3d 386 (7th Cir. 1999); *U.S. v. First Bank*, 737 F.2d 269 (2d Cir. 1984)).

⁶⁷ 104 A.F.T.R.2d (RIA) 7101 (S.D. Cal. 2009).

⁶⁸ IRC § 7602(a).

MLI
#2**Appeals From Collection Due Process Hearings
Under Internal Revenue Code Sections 6320 and 6330****SUMMARY**

Collection Due Process (CDP) hearings were created by the IRS Restructuring and Reform Act of 1998 (RRA 98).¹ CDP hearings provide taxpayers with an independent review by the 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 CDP hearing, the taxpayer has the statutory right to raise any relevant issues related to the unpaid tax, the lien, or the proposed levy, including the appropriateness of collection action, collection alternatives, spousal defenses, and under certain circumstances, the underlying tax liability.²

Taxpayers have the right to judicial review of Appeals' determinations provided that they timely request the CDP hearing and timely petition the 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 the courts issuing 131 opinions during the review period of June 1, 2009, through May 31, 2010.⁵ The cases discussed below demonstrate 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. Where taxpayers attempted to use the process inappropriately, courts imposed sanctions or warned taxpayers about the possibility of sanctions being imposed in the future.

¹ Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, § 3401, 112 Stat. 685 (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 and the review requirements.

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 Appendix III, Table 2, *infra*.

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of an NFTL filed by the IRS, or of a proposed levy action.⁶ 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.⁷ The hearing allows taxpayers an opportunity to raise issues relating to the collection of the subject tax, including:

- Appropriateness of collection actions;⁸
- Collection alternatives such as an installment agreement (IA), offer in compromise (OIC), posting a bond, or substitution of other assets;⁹
- Appropriate spousal defenses;¹⁰
- The existence or amount of the underlying tax liability, but only if the taxpayer did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the tax liability;¹¹ and
- Any other relevant issue relating to the unpaid tax, the NFTL, or the proposed levy.¹²

A taxpayer may not raise an issue considered at a prior administrative or judicial hearing if the individual participated meaningfully in that hearing or proceeding.¹³

Procedural Collection Due Process Requirements

The IRS must provide a CDP notice to the taxpayer after it has filed the first NFTL or before its first intended levy for the particular tax and tax period. The notice must be provided 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.¹⁴ In a lien filing, the notice must inform the taxpayer of his or her right to request a CDP hearing within the 30-day period that begins on the day after the end of the five-business-day period after the filing of the NFTL.¹⁵ 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.¹⁶

⁶ IRC §§ 6320 and 6330. See RRA 98, Pub. L. No. 105-206, § 1001(a), 112 Stat. 685 (1998).

⁷ Prior to the enactment of RRA 98, the U.S. Supreme Court had held that a post-deprivation hearing was sufficient to satisfy due process concerns in the tax collection arena. See *U.S. v. National Bank of Commerce*, 472 U.S. 713, 719-722 (1985); *Phillips v. Comm'r*, 283 U.S. 589, 595-601 (1931).

⁸ IRC § 6330(c)(2)(A)(ii).

⁹ IRC § 6330(c)(2)(A)(iii).

¹⁰ IRC § 6330(c)(2)(A)(i).

¹¹ IRC § 6330(c)(2)(B).

¹² IRC § 6330(c)(2)(A); Treas. Reg. §§ 301.6320-1(e) and 301.6330-1(e).

¹³ IRC § 6330(c)(4).

¹⁴ 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.

¹⁵ IRC § 6320(a)(3)(B); Treas. Reg. § 301.6320-1(b)(1).

¹⁶ IRC § 6330(a)(3)(B); Treas. Reg. § 301.6330-1(b)(1).

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.¹⁷ Taxpayers who fail to timely request a CDP hearing will be afforded an “equivalent hearing,” which is similar to a CDP hearing, but without judicial review.¹⁸ The regulations require taxpayers to provide their reasons for requesting a hearing (preferably using Form 12153, *Request for a Collection Due Process or Equivalent Hearing*). Failure to provide the basis for the hearing may result in a denial of a face-to-face hearing.¹⁹ The regulations provide that 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 with respect to a levy, within the one-year period beginning the day after the date of the CDP notice.²⁰

Conduct of a CDP Hearing

The IRS generally will suspend levy action throughout a CDP hearing involving an intent to levy, unless it determines the collection of tax is in jeopardy, the collection resulted from a levy on a state tax refund, or the IRS has served a disqualified employment tax levy.²¹ 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 to the court good cause to resume collection activity.²²

CDP hearings are informal. When a taxpayer requests a CDP hearing with respect to both a lien and a proposed levy, Appeals will attempt to conduct one hearing.²³ Courts have determined that a CDP hearing need not be face-to-face but can take place by telephone or correspondence.²⁴ The Office of Appeals presumptively establishes telephonic CDP hearings, so it is incumbent on the taxpayer to request a face-to-face session.²⁵ The CDP regulations state that taxpayers who provide non-frivolous reasons for opposing the IRS

¹⁷ 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).

¹⁸ Treas. Reg. §§ 301.6320-1(i)(2) Q&A-116 and 301.6330-1(i)(2) Q&A-116; *Orum v. Comm’r*, 123 T.C. 1 (2004); *Moorhous v. Comm’r*, 116 T.C. 263 (2001).

¹⁹ 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. In conjunction with issuing regulations, the IRS revised Form 12153 to include space for the taxpayer to identify collection alternatives that he or she wants Appeals to consider. The current form also includes a description of common alternatives so taxpayers can apply them to the specific facts of their cases. See IRS Form 12153, *Request for a Collection Due Process or Equivalent Hearing* (Rev. 11-2006).

²⁰ Treas. Reg. §§ 301.6320-1(i)(2) A-17 and 301.6330-1(i)(2) A-17.

²¹ IRC § 6330(e)(1) provides the general rule for suspending collection activity. IRC § 6330(f) provides that if collection of the tax is deemed in jeopardy, the collection resulted from a levy on a state tax refund, or the IRS served a disqualified employment tax levy, IRC § 6330 does not apply, except to provide the opportunity for a CDP hearing within a reasonable time after the levy. See *Clark v. Comm’r*, 125 T.C. 108, 110 (2005) (citing *Dora v. Comm’r*, 119 T.C. 356 (2002)). 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).

²² IRC §§ 6330(e)(1) and (e)(2).

²³ IRC § 6320(b)(4).

²⁴ *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)).

²⁵ Treas. Reg. §§ 301.6320-1(d)(2) A-D6, A-D8 and 301.6330-1(d)(2) A-D6, A-D8. See, e.g., Appeals Letter 4141 (rev. Sept. 2009) acknowledges the taxpayer’s request for a CDP hearing, and provides information on the availability of a face-to-face conference.

collection action will generally be offered, but not guaranteed, a face-to-face conference. Taxpayers making frivolous arguments are not entitled to a face-to-face conference.²⁶ A taxpayer will not be granted a face-to-face conference concerning a collection alternative, such as an installment agreement or OIC, unless other taxpayers would be eligible for the alternative under similar circumstances.²⁷ For example, a taxpayer who proposes an offer in compromise as the only issue to be addressed at the hearing, but who has failed to file all required returns and is therefore ineligible for an offer, will not be granted a face-to-face conference. Appeals may, however, in its discretion, grant a face-to-face conference where it determines it is appropriate to explain the requirements to become eligible for a collection alternative.²⁸

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 regarding the substance of the case and who has had “no prior involvement” in the case.²⁹ In addition to 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.³⁰ 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.³¹

On December 6, 2006, Congress passed the Tax Relief and Health Care Act of 2006 (TRHCA).³² Section 407 of the TRHCA changed the CDP process by providing that the IRS may disregard any portion of a hearing request that is based on a position identified as frivolous by the IRS or reflects a desire to delay or impede the administration of federal tax laws.³³ Section 407 also amended IRC § 6702 to create a frivolous submission penalty

²⁶ 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.

²⁷ Treas. Reg. §§ 301.6320-1(d)(2) A-D8 and 301.6330-1(d)(2) A-D8.

²⁸ Treas. Reg. §§ 301.6320-1(d)(2) A-D8 and 301.6330-1(d)(2) A-D8. See also Appeals Interim Guidance, *Face-to-Face Collection Due Process Conferences in the Absence of a Collection Information Statement*, (Oct. 12, 2010), available at <http://www.irs.gov/pub/irs-utl/ap-08-1010-06.pdf>. The guidance 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, the guidance states Appeals should “[g]rant a face-to-face request if it is necessary to explain the requirements for becoming eligible for a collection alternative. Taxpayers may be better able to understand the requirements for becoming eligible for a collection alternative if they are able to meet with an Appeals employee face-to-face. Examples include a taxpayer with a hearing impairment, who speaks little or no English, or who lacks sophistication.”

²⁹ IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1) and 6330(b)(3). See also Rev. Proc. 2000-43, 2000-2 C.B. 404. See, e.g., *Industrial Investors v. Comm’r*, T.C. Memo. 2007-93; *Moore v. Comm’r*, T.C. Memo. 2006-93, *action on dec.*, 2007-2 (Feb. 27, 2007); *Cox v. Comm’r*, 514 F.3d 1119, 1124-1128 (10th Cir. 2008).

³⁰ IRC § 6330(c)(1); *Hoyle v. Comm’r*, 131 T.C. No. 13 (2008).

³¹ IRC § 6330(c)(3)(C).

³² Pub. L. No. 109-432, 120 Stat. 2922 (2006). The provisions set forth in section 407 are effective for submissions made and issues raised after the date on which the IRS first prescribed a list of frivolous positions. Notice 2007-30, 2007-1 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 I.R.B. 609, provides the current list of frivolous positions.

³³ IRC § 6330(g).

for such requests.³⁴ A CDP hearing request is subject to the penalty if any portion of the request “(i) is based on a position which the Secretary has identified as frivolous...or (ii) reflects a desire to delay or impede the administration of the Federal tax laws.”³⁵

Section 407 also amended IRC §§ 6320(b)(1) and 6330(b)(1) to require taxpayers to include the grounds for requesting the hearing in writing in their CDP hearing requests. Section 6330(c)(4) was amended to provide that an issue may not be raised at a hearing if the issue is based on a position identified as frivolous by the IRS or reflects a desire to delay or impede the administration of federal tax laws.

On May 25, 2007, Congress again modified CDP procedures for employment tax liabilities by amending IRC § 6330(f) to permit a levy to collect employment taxes without first giving a taxpayer a pre-levy CDP notice if the levy is a “disqualified employment tax levy.”³⁶ A disqualified employment tax levy is

[A]ny levy in connection with the collection of employment taxes for any taxable period if the person subject to the levy (or any predecessor thereof) requested a hearing under this section with respect to the unpaid employment taxes arising in the most recent 2-year period before the beginning of the taxable period with respect to which the levy is served.³⁷

Judicial Review of CDP Determination

Within 30 days of Appeals’ determination, the taxpayer may petition the United States Tax Court for judicial review.³⁸ Where the validity of the underlying tax liability is properly at issue in the CDP hearing, the court will review the amount of the tax liability on a *de novo* basis.³⁹ Where the appropriateness of the collection action is at issue, the court will review the IRS’s administrative determination for abuse of discretion.⁴⁰

ANALYSIS OF LITIGATED CASES

CDP was the second-most frequently litigated tax issue in the federal court system between June 1, 2009, and May 31, 2010. We reviewed 131 CDP court opinions, a 23 percent decrease from the 170 cases in last year’s analysis. However, these 131 opinions do not

³⁴ The frivolous submission penalty applies to the following submissions: CDP hearing request, offer in compromise, installment agreement request, and application for a taxpayer assistance order.

³⁵ IRC § 6702(b)(2)(a). Before assertion of the penalty, the IRS must notify the taxpayer that it has determined that the taxpayer filed a frivolous hearing request. The taxpayer then has 30 days to withdraw the submission in order to avoid assertion of the penalty. IRC § 6702(b)(3).

³⁶ Pub. L. No. 110-28, § 8243(a), (b), 121 Stat. 112, 200 (2007). This amendment is effective for such levies served on or after September 22, 2007.

³⁷ IRC § 6330(h).

³⁸ 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).

³⁹ The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing the 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).

⁴⁰ See, e.g., *Murphy v. Comm’r*, 469 F.3d 27 (1st Cir. 2006).

reflect the full number of CDP cases filed because the court does not issue an opinion in all cases. Some are resolved through settlements, and in other cases taxpayers do not pursue litigation after filing a petition with the court, resulting in dismissal of the action prior to the court issuing an opinion. Additionally, the Tax Court disposes of some cases by issuing unpublished orders. Table 2 in Appendix III provides a detailed list of the CDP opinions reviewed, 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 13 of the 131 cases reviewed (approximately ten percent), and prevailed in part in two cases.⁴¹ Taxpayers with representation received full relief in four cases and partial relief in one case,⁴² while *pro se* taxpayers prevailed in nine cases and partial relief in one case.⁴³

Table 3.2.1 below compares litigation success rates in CDP cases reported in the 2003 through 2010 Annual Reports to Congress.⁴⁴

TABLE 3.2.1, SUCCESS RATES IN CDP CASES⁴⁵

Court Decision	2003	2004	2005	2006	2007	2008	2009	2010
Decided for IRS	96%	95%	89%	90%	92%	90%	92%	89%
Decided for Taxpayer	1%	4%	8%	8%	5%	8%	4%	10%
Split Decision ⁴⁶	3%	1%	3%	2%	3%	2%	4%	2%
Neither ⁴⁷	N/A	N/A	N/A	N/A	Less than 1%	N/A	N/A	N/A

Issues Litigated

The cases discussed below are those that the National Taxpayer Advocate believes are significant or noteworthy. The outcomes of these cases can provide important information to Congress, the IRS, and taxpayers about the rules and operation of CDP hearings. Equally important, all of the cases reviewed offer the opportunity to look for ways to improve the collection process, in both application and execution.

⁴¹ See, e.g., *Barnes v. Comm'r*, T.C. Memo. 2010-30; *Blair v. Comm'r*, T.C. Memo. 2009-232; *Blank v. Comm'r*, T.C. Summ. Op. 2010-10; *Selph v. Comm'r*, T.C. Summ. Op. 2010-20.

⁴² See, e.g., *Fairlamb v. Comm'r*, T.C. Memo. 2010-22; *Judge v. Comm'r*, T.C. Memo. 2009-135; *Ken Ryan, Inc. v. Comm'r*, T.C. Summ. Op. 2010-18; *Michael v. Comm'r*, 133 T.C. No. 10 (2009).

⁴³ See, e.g., *Medical Practice Solutions LLC v. Comm'r*, T.C. Memo. 2009-214; *Selph v. Comm'r*, T.C. Summ. Op. 2010-20; *Vinatieri v. Comm'r*, 133 T.C. No. 16 (2009).

⁴⁴ See National Taxpayer Advocate 2008 Annual Report to Congress 482, Table 3.2.1, for 2003, 2004, 2005, 2006, 2007, and 2008 statistics.

⁴⁵ Numbers have been rounded to nearest percentage.

⁴⁶ A "split" decision refers to a case with multiple issues where both the IRS and the taxpayer prevail on one or more substantive issues.

⁴⁷ A "neither" decision refers to a case where the court's decision was not in favor of either party.

Procedural Rulings

IRS practices and actions, such as assessing taxes, are governed by procedural rules set out in statutes and regulations. The IRS's failure to follow these procedural rules can result in unreasonable actions. The Tax Court may review CDP hearings to make sure that Appeals Officers have properly reviewed IRS procedural actions or have themselves correctly followed all required procedures.

Vinatieri v. Commissioner

In *Vinatieri v Commissioner*,⁴⁸ the IRS sent the taxpayer a Final Notice of Intent to Levy and Notice of Your Right to a Hearing on September 13, 2007, with respect to the taxpayer's tax liability for 2002. The taxpayer timely requested a hearing on September 24, 2007, which was conducted through correspondence and by telephone with the settlement officer. The settlement officer asked the taxpayer whether she wanted to enter into an installment agreement, and the taxpayer stated, "she has nothing." The taxpayer was a single mother who could only work part time because she had pulmonary fibrosis.

During the review of the taxpayer's case, the settlement officer discovered the taxpayer had not filed a return for 2005. The taxpayer explained to the settlement officer that the payroll company responsible for completing her 2005 Form W-2, *Wage and Tax Statement*, was no longer in business, and that she had attempted to get the tax information from the IRS, but the IRS had no information regarding her 2005 income.

The settlement officer told the petitioner that she might be able to have her account placed in currently not collectible (CNC) status, but would need her to submit a Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, and a diagnosis regarding her current health condition. The taxpayer submitted a completed Form 433-A, indicating she had monthly income of \$800 and expenses of \$800, had \$14 cash on hand, and owned a 1996 Toyota Corolla four-door sedan with 243,000 miles that was valued at \$300. The taxpayer was unable to obtain a written diagnosis of her medical condition from her physician because her physician would only provide the documentation in a claim for workers' compensation.

In light of the taxpayer's financial information, which showed that she relied on her car to get to work and would not be able to pay her basic living expenses if her wages were levied upon, the settlement officer concluded in her log that the levy would create an economic hardship. However, the settlement officer issued a notice of determination, which was approved by the Appeals team manager, finding that it was appropriate to proceed with the levy, because collection alternatives such as an installment agreement, an OIC, or reporting the account as CNC, were not available because the petitioner had not filed her 2005 and 2007 returns. The taxpayer appealed to the Tax Court.

⁴⁸ 133 T.C. No. 16 (2009).

The Tax Court ruled that upholding the levy was “unreasonable because IRC § 6343 would require its immediate release, and the determination to do so was arbitrary.” The court observed that pursuant to IRC § 6343(a)(1)(D),⁴⁹ a levy that creates an economic hardship for a taxpayer must be released. Because the settlement officer had determined that the taxpayer met these hardship requirements with respect to CNC status, the taxpayer must have similarly met the economic hardship requirements of IRC § 6343(a)(1)(D). Thus, proceeding with the levy was unreasonable because IRC § 6343(a)(1)(D) would have required its immediate release. The Court denied the IRS’s motion for summary judgment.

In response to this case, the National Taxpayer Advocate in March 2010 issued guidance to TAS employees discussing the *Vinatieri* decision and the Internal Revenue Manual (IRM) provisions that could lead to levies required to be immediately released.⁵⁰ In addition, TAS submitted draft language to the IRS recommending changes to the misleading IRM provisions, and is actively engaging the IRS in discussion.⁵¹ As of October 1, 2010, the IRS had not implemented any of the suggested changes.⁵² Thus, taxpayers continue to encounter the same situation as Mrs. Vinatieri and some of them have come to TAS for help.⁵³

Szulczewski v. Commissioner

In *Szulczewski v. Commissioner*,⁵⁴ the IRS failed to meet its burden of proving that it properly mailed a statutory notice of deficiency to the taxpayer’s last known address. The IRS bears the burden of proof in this case because it could not produce a notice of deficiency. When the IRS cannot produce a notice of deficiency it must provide evidence that shows that the notice was delivered to the Postal Service for mailing. In this case, the IRS was unable to provide a copy of the notice of deficiency at trial or a PS Form 3877, which shows the name and address of taxpayers who have been sent a notice of deficiency for a particular day. The IRS relied on the stipulation of facts and the testimony of a paralegal

⁴⁹ IRC § 6343(a)(1)(D) requires the release of a levy if the levy is creating an economic hardship for the taxpayer. Treasury Regulation § 301.6343-1(b)(4) (i) provides that economic hardship is present if “satisfaction of the levy in whole or in part will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses.”

⁵⁰ TAS Interim Guidance Memorandum (IGM), *Interim Guidance on Handling Collection Cases Where Economic Hardship Is Present but the Taxpayer Has Not Filed All Required Returns* (Mar. 23, 2010), available at http://www.irs.gov/pub/foia/ig/tas/tas-13_1-0110-01.pdf.

⁵¹ E-mail from Special Counsel to the National Taxpayer Advocate, Office of Chief Counsel, to Director, Collection Policy (Mar. 24, 2010); E-mail from TAS Collection Technical Liaison to Supervisory Revenue Officer, Small Business/Self Employed (SB/SE) Collection Policy (Sept. 16, 2010).

⁵² According to the Wage & Investment (W&I) division, “there is not a need to make additional changes to the IRM guidance or training material as it relates to addressing economic hardship situations.” W&I response to TAS research request (July 9, 2010) (response to question 3). However, on Aug. 20, 2010, W&I issued a Servicewide Electronic Research Program (SERP) Alert 100440, *Vinatieri Decision: Guidance When a Taxpayer Who Has Been Levied Indicates that the Levy Is Creating a Hardship* (Aug. 20, 2010), reminding its employees of two circumstances in which accounts can be closed without securing an unfiled return, and that accounts can be referred for Substitute for Return (SFR) processing or the delinquent return module can be sent to the queue. According to SB/SE, “Since the *Vinatieri* decision...analysts have been working on an IRM revision CNC procedures for the IRM 5.19.1. Any changes will be incorporated in the IRM rewrite.” SB/SE response to TAS research request (July 13, 2010) (response to question 2).

⁵³ As of Sept. 9, 2010, TAS had issued 62 Operations Assistance Requests to the IRS operating divisions, advocating for taxpayers suffering from economic hardship when the IRS has issued a notice of levy or a Final Notice of Intent to Levy but will not place the account in CNC status or release a levy because of unfiled returns. While often the required returns are ultimately secured, TAS successfully advocated for placing the taxpayer’s account in CNC status in five cases despite unfiled returns and successfully advocated for a levy release in 11 cases (one of these cases is included in the five CNC cases), despite unfiled returns. This issue was also raised in the National Taxpayer Advocate’s FY 2011 Objectives Report to Congress.

⁵⁴ *Szulczewski v. Comm’r*, T.C. Summ. Op. 2009-136.

to support its assertion that that the notice was sent. Regarding the stipulation of facts, the parties stipulated that the IRS mailed the notice of deficiency, by certified mailed, to petitioner's last known address on August 31, 2004. However, in the next sentence the parties stipulated that "Petitioner claims he did not receive the Statutory Notice dated August 31, 2004." After weighing the testimony offered during trial and the stipulation of facts, the Court concluded that the IRS had not met its burden of proving that the notice of deficiency was properly mailed.

Judge v. Commissioner

In *Judge v. Commissioner*,⁵⁵ the court held that the settlement officer's denial of a short extension of time was an abuse of discretion. The taxpayer timely requested a CDP hearing and stated he would pursue a collection alternative. Appeals requested a completed Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, which the taxpayer submitted on July 2, 2007. When the settlement officer received the case file, he could not find the Form 433-A. In an October 11, 2007, letter, the settlement officer requested that the taxpayer submit Form 433-A, a signed 2006 return, and proof of 2007 estimated tax payments, within 14 days. The settlement officer did not tell the taxpayer that he could not find the Form 433-A previously submitted. The taxpayer's representative told the settlement officer that he believed the taxpayer's income was overstated on the Form 433-A and requested a short extension of time to prepare a revised form. The settlement officer denied the request. On November 19, 2007, the respondent issued a notice of determination sustaining the levy for the years at issue. The Tax Court held that it was unreasonable of the settlement officer to deny the taxpayer's request for a brief extension to file the Form 433-A. The matter was remanded back to Appeals for the Appeals Officer to consider an OIC or another collection alternative.

Fairlamb v. Commissioner

In *Fairlamb v. Commissioner*,⁵⁶ the Court held that Appeals' determination rejecting the taxpayer's OIC was insufficient to determine if the rejection was an abuse of discretion. The taxpayer failed to timely file federal tax returns for taxable years 1998 through 2004. The IRS filed substitutes for returns for these years, and after assessment of tax, it sent the taxpayer a Letter 1058, *Final Notice-Notice of Intent to Levy and Notice of Your Right to a Hearing*, regarding the 2002, 2003, and 2004 liabilities. The taxpayer then submitted a timely Form 12153, *Request for a CDP Hearing*, on which he stated that enforcement action would create a hardship and he intended to submit an OIC. The taxpayer submitted two offers that the IRS rejected, followed by a third one when he was 65 years old. This time, the settlement officer initially recommended acceptance, but the officer's manager rejected the offer because the amount did not appear to equal or exceed the taxpayer's reasonable collection potential (RCP). The manager's RCP calculation was based on the general rule of

⁵⁵ T.C. Memo. 2009-135.

⁵⁶ T.C. Memo. 2010-22.

adding the value of the taxpayer's assets to the taxpayer's future income for the number of months remaining on the statutory period for collection, rather than the taxpayer's future income over the next five years until retirement. However, the Court questioned why Appeals did not consider IRM 5.8.5.5(3), which instructs Appeals to consider the taxpayer's overall situation, mental status, number and age of dependents, education level, and work experience. The Court further questioned why Appeals did not consider IRM 5.8.5.5(5), which provides for flexibility in special circumstances where future income may differ from current or past income, especially when "a taxpayer is elderly, in poor health, or both and the ability to continue working is questionable." The Court remanded the case and directed Appeals to clarify its decision and to allow the taxpayer to propose a new collection alternative.

Appeals Impartiality

IRC §§ 6320(b)(3) and 6330(b)(3) require CDP hearings to be conducted by an "impartial" Appeals officer or employee – one "who has had no prior involvement with respect to the unpaid tax" before the first CDP lien or levy hearing. The National Taxpayer Advocate is concerned about a lack of independence of the Office of Appeals from other IRS functions.⁵⁷ In this year's and previous reports, the National Taxpayer Advocate has focused on cases where employees engage in *ex parte* communications that can compromise Appeals' independence.⁵⁸ The case below, however, clarifies what independence means in the context of reviewing collection alternatives in a CDP hearing.

Hartmann v. Commissioner

In *Hartmann v. Commissioner*,⁵⁹ the taxpayer appealed the Tax Court's decision, arguing that it was improper to have the same appeals officer review and make a determination on the taxpayer's OIC as well as conduct the CDP hearing. The Court of Appeals for the Third Circuit affirmed the Tax Court stating that it was not improper for the same IRS agent to conduct both the CDP hearing and review the taxpayer's OIC, which the taxpayer submitted during the CDP hearing as a collection alternative. The Court pointed out that IRC § 6330(b)(3) provides that a CDP hearing "shall be conducted by an officer or employee who has had no prior involvement with respect to the unpaid tax specified." The Court determined that the IRS agent had no "prior involvement" with the case and reviewing the OIC did not fall within this provision.

⁵⁷ See Legislative Recommendation: *Require the IRS Office of Appeals to Maintain Its Independence and Have at Least One Appeals Officer in Each State, supra*; National Taxpayer Advocate 2006 Annual Report to Congress 266 (Most Serious Problem: *Concerns with the IRS Office of Appeals*); National Taxpayer Advocate 2005 Annual Report to Congress 136 (Most Serious Problem: *Appeals Campus Centralization*); National Taxpayer Advocate 2004 Annual Report to Congress 264 (Most Serious Problem: *Independence of the Office of Appeals*).

⁵⁸ See Most Serious Problem: *Appeals' Failure to Adequately Document Prohibited Ex Parte Communications Inadvertently Violate Taxpayer Rights and Damage the Public's Perception of its Independence, supra*.

⁵⁹ 351 Fed. Appx. 624 (3d Cir. 2009).

The Administrative Record

When reviewing the appropriateness of a CDP hearing determination, the Tax Court limits its review to the administrative record, except in cases where the Court considers the underlying tax liability on a *de novo* basis. The administrative record includes the case file, written communication by the taxpayer, or his representative, the Appeals Officer's notes, any notation of oral communication between the taxpayer and Appeals Officer, and any other materials relied upon by the Appeals Officer in making his or her determination.⁶⁰ The administrative record is significant, because, except for limited exceptions, the Tax Court will not review evidence outside the record.⁶¹ On occasion, the Tax Court has found that Appeals Officers have failed to consider or analyze all material facts in the administrative record appropriately. Below is an example of this type of error.

Marlow v. Commissioner

In *Marlow v. Commissioner*,⁶² a husband and wife timely filed a joint return for 2004 and 2005. The IRS sent the taxpayers a Final Notice of Intent to Levy and Your Right to a Hearing and the taxpayers requested a CDP hearing. The IRS stated it did not send a notice of deficiency for the subject tax years because the taxpayers signed Forms 4549, *Income Tax Examination Changes*, and 870, *Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment*, agreeing to the additional tax and waiving the notice of deficiency. During the CDP hearing, the taxpayers testified they did not recall signing these forms. Further, there were no entries in the IRS history indicating (1) the revenue agent received Forms 4549 from the taxpayers, signed or unsigned; (2) the taxpayers ever signed Forms 4549 agreeing that additional taxes were owed for 2004 and 2005; or (3) the taxpayers agreed on Forms 4549 and Forms 870 or in any other writing to waive the restrictions on assessment of the deficiencies.

At the hearing, the taxpayers were told they could not challenge the underlying tax liability, because they had signed Forms 4549 and 870 agreeing to it. The settlement officer, relying on the certificate of assessment and payments (Form 4340) of the taxpayers' account, determined that the IRS followed all requirements of applicable law and administrative procedure and that the petitioners had agreed to the assessments of additional tax. However, when the taxpayers requested the administrative file after the hearing to see the signed forms, the IRS was unable to locate the file. The Court held that the settlement officer did not obtain proper verification that all requirements of applicable law and administrative

⁶⁰ Treas. Reg. §§ 301.6320-1(f)(2).

⁶¹ *Murphy v. Comm'r*, 469 F.3d 27 (1st Cir. 2006) (evidence outside administrative record is permissible if the a failure to explain administrative action frustrates effective judicial review); *Robinette v. Comm'r*, 439 F.3d 455, 461 (8th Cir. 2004) ("Of course, where a record created in informal proceedings does not adequately disclose the basis for the agency's decision, then it may be appropriate for the reviewing court to receive evidence concerning what happened during the agency proceedings.") (citations omitted). See also *James Madison Ltd. By Hecht v. Ludwig*, 82 F.2d 1085, 1096 (D.C. Cir. 1996) (courts may "need to resolve factual issues regarding the process the agency used in reaching its decision.... Although these facts are usually established by the administrative record or are otherwise undisputed, parties may occasionally raise an issue requiring district courts to engage in independent fact-finding").

⁶² T.C. Memo. 2010-113. The taxpayer in Marlow was represented by a low income taxpayer clinic (LITC). The LITC program serves individuals who have a problem with the IRS and whose income is below a certain level. LITCs are independent from the IRS.

procedure had been met. Although reliance on a Form 4340 generally is sufficient for verification, if a taxpayer disputes the accuracy of the Form 4340, further verification may be necessary, and in this instance, the IRS could not produce evidence sufficient to establish that the taxpayers signed the waiver forms. The court held that remand was not necessary and would not be productive, because the IRS was unable to locate the forms even for trial. Thus, the Court affirmatively held that the tax assessments were invalid, because the IRS had made them without first issuing notices of deficiency.

Imposition of Sanctions

Over the past few years, one notable issue that began emerging from the review of CDP decisions was the extent to which the courts imposed sanctions on taxpayers for frivolous positions. Section 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.⁶³ These penalties are used to deter the filing of frivolous CDP hearing requests. However, penalties to deter frivolous requests were imposed significantly less often this year than last. Of the 131 cases decided during the review period, the courts imposed sanctions in only five cases, or four percent.⁶⁴ Last year, with 170 cases decided, the courts imposed sanctions in 22 cases, or 13 percent.⁶⁵ This significant decline in CDP cases in which the IRC § 6673 penalty was applied may be attributable to recently enacted IRC § 6330(g),⁶⁶ which allows the IRS to disregard a frivolous hearing request and precludes judicial review of such requests. The National Taxpayer Advocate will continue to analyze this issue in future reports and is interested to learn whether this is a one-time decrease in sanctions, or a new trend.

Pro Se Analysis

Pro se taxpayers, those without benefit of counsel, litigated 84 (or 64 percent) of the 131 cases brought before the courts, a decrease from 72 percent in the previous year, but still up compared to 58 percent in 2008.⁶⁷ Table 3.2.2 shows the breakdown of *pro se* and represented cases and the decisions rendered by the court, indicating that approximately 12 percent of *pro se* taxpayers received some relief on judicial review while approximately 11 percent of represented taxpayers received full or partial relief.

⁶³ For a more detailed discussion of IRC § 6673, see Most Litigated Issue: *Frivolous Issues Penalty and Related Appellate Level Sanctions Under Internal Revenue Code Section 6673*, *infra*.

⁶⁴ See e.g., *Kay v. Comm'r*, T.C. Memo. 2010-59.

⁶⁵ See e.g., *Maga v. Comm'r*, T.C. Memo. 2008-162; *Taylor v. Comm'r*, T.C. Memo. 2008-151; *Williams v. Comm'r*, T.C. Memo. 2008-173.

⁶⁶ Pub. L. No. 109-432, 120 Stat. 2922 (2006).

⁶⁷ National Taxpayer Advocate 2008 Annual Report to Congress 486.

TABLE 3.2.2, 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	74	88%	42	89%
Decided for Taxpayer	9	11%	4	9%
Split Decisions	1	1%	1	2%
Totals:	84		47	

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. The cases reviewed illustrate the critical importance of the IRS’s rigorous compliance with the fundamental CDP requirements, such as verification under IRC § 6330(c)(1) and balancing of harm to the taxpayer, and of taxpayers being both timely and forthright with respect to their CDP requirements. 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
#3**Accuracy-Related Penalties Under Internal Revenue Code Sections 6662(b)(1) and (2)****SUMMARY**

Internal Revenue Code (IRC) §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if under § (b)(1) a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if under § (b)(2) an underpayment of tax exceeded a computational threshold called a substantial understatement. IRC § 6662(b) also authorizes the IRS to impose three other accuracy-related penalties.¹ However, during our review period of June 1, 2009, through May 31, 2010, taxpayers litigated these penalties less frequently than the negligence and substantial understatement penalties; therefore our analysis does not address the three other accuracy-related 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 a substantial understatement.²

The IRS may assess penalties under both subsections of the accuracy-related statute. The total penalty rate, however, may not exceed 20 percent (*i.e.*, the penalties are not "stackable").³ Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith.⁴ In addition, a taxpayer will only be subject to the negligence component of the penalty on the portion of the underpayment attributable to negligence. For example, if a taxpayer erroneously reports multiple items of income, some items may be justifiable mistakes while others might be the result of negligence, and the penalty would only apply to the latter.

Negligence

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

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; and IRC § 6662(b)(5) authorizes a penalty for any substantial valuation understatement of estate or gift taxes.

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) defines negligence 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."

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 a taxpayer 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

In general, an “understatement” is the difference between (1) the correct amount of tax and (2) the amount reported on the return, reduced by any rebate.¹⁰ Understatements are generally reduced by the portion of an understatement attributable to (1) an item for which the taxpayer had substantial authority; or (2) any item if the taxpayer adequately disclosed the relevant facts affecting the item's tax treatment in the return or in an attached statement, and the taxpayer had a reasonable basis for the tax treatment of the item.¹¹ For individuals, the understatement of tax is substantial if it exceeds the greater of \$5,000 or ten percent of the correct amount of tax required to 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 \$10,000,000.¹³

For example, if the correct amount of tax should have been \$10,000 and the 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 the ten percent test (\$1,000 is ten percent of \$10,000), it is less than the fixed \$5,000 threshold. Conversely, if the same individual taxpayer reported a tax of \$4,000, the substantial understatement penalty would apply because the \$6,000 shortfall is more than \$1,000 (ten percent of \$10,000), and is also greater than \$5,000.

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) references IRC § 6042(a)(1) for reporting of dividend payments).

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

¹¹ IRC § 6662(d)(2)(B). 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) and (ii).

¹³ IRC § 6662(d)(1)(B)(i) and (ii).

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 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.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, including the imposition of the IRC § 6662 penalties) through a Collection Due Process (CDP) hearing.²³

¹⁴ IRC § 6664(c)(1).

¹⁵ Treas. Reg. § 1.6664-4(b)(1). For a discussion of problems related to the IRS's administration of the reasonable cause penalty, see Most Serious Problem: *Over-Reliance on the Reasonable Cause Assistant Leads to Inaccurate Penalty Abatement Determinations, supra*.

¹⁶ Treas. Reg. § 1.6664-4(b)(1).

¹⁷ IRM 20.1.5.3(1) and (2) (July 1, 2008).

¹⁸ The AUR is an automated program that identifies discrepancies between amounts that taxpayers reported on a tax return and amounts that payors reported via Form W-2, Form 1099, and other information returns. See IRM 4.19.2 (Sept. 1, 2009). 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, then at that point the IRS first involves its employees to determine whether the penalty is appropriate. If the taxpayer does not respond timely to the notice, the computers then automatically convert the proposed penalty to an assessment. 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. The taxpayer has 30 days to contest the proposed adjustments to IRS Appeals, during which time he or she may raise issues related to the deficiency, including the reasonable cause exception. If the issue is not resolved after the 30-day letter, the IRS sends a statutory notice of deficiency ("90-day letter") to the taxpayer. See IRS 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). Note that a taxpayer has 150 days instead of 90 to petition the Tax Court if the IRS sent the notice of deficiency to an address 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. U.S.*, 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 § 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

For the period from June 1, 2009, through May 31, 2010, we identified 125 cases 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 86 cases (69 percent), taxpayers prevailed in full in 30 cases (24 percent), and nine cases (seven percent) resulted in split decisions. Thus, taxpayers prevailed partially or fully in 31 percent of the penalty disputes.

Taxpayers appeared *pro se* (without representation) in 78 of the 125 cases (62 percent). *Pro se* taxpayers convinced the court to dismiss or reduce the penalty in 22 cases (28 percent of *pro se* cases).²⁶ Taxpayers appeared with representation in 47 of the 125 cases (38 percent). Represented taxpayers achieved full or partial relief from the penalty in 17 cases (36 percent of represented cases).

In some cases, the court was unclear on which subsection, (b)(1) or (b)(2), of the accuracy-related penalty applied. Where possible, in Table 3 of Appendix III, we indicate which subsection was at issue. Regardless of the subsection, 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 for Reasonable Cause and as Proof of Taxpayer's Good Faith

Taxpayers were most successful in establishing a defense for an underpayment when they produced adequate records. Taxpayers are required to maintain records sufficient to establish the amount of gross income, deductions, and credits claimed on a return.²⁷ For example, in *Manning v. Commissioner*,²⁸ the court found that although the taxpayers (a husband and wife) mistakenly claimed two deductions in 2003 for items not paid until the following year, the taxpayers kept accurate records and were otherwise thorough. Therefore,

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 *Id.* See also Tax Court Rule 142(a).

²⁶ In determining the taxpayer success rates, we included those cases that were split between the taxpayer and the IRS because the taxpayer achieved a reduction in penalties.

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

²⁸ T.C. Memo. 2009-157.

the taxpayers had shown that they acted with reasonable cause and good faith, and were not liable for the penalty.

In other cases, the court found the taxpayer did not show good faith in attempting to comply with tax laws, and had no reasonable cause when presenting inadequate records or insufficient substantiation. For example, in *Ramirez v. Commissioner*,²⁹ the U.S. Tax Court sustained the IRS in denying deductions and imposing accuracy-related penalties, because the taxpayer failed to keep adequate records to substantiate deductions. The taxpayer failed to comply with record-keeping requirements for deductions and did not provide requested information.

Reliance on Advice of Tax Professional for Reasonable Cause

Reliance on a tax professional was the second most commonly litigated example of reasonable cause. To qualify for reliance on a tax professional under the reasonable cause exception for accuracy-related penalties, the taxpayers must establish that: (1) they provided all necessary information to the tax professional; (2) the tax professional was competent with sufficient expertise; and (3) the taxpayers relied in good faith on the tax professional's opinion or tax return preparation.³⁰

Cases in which the taxpayer was successful in claiming reliance on a tax professional include:

- A taxpayer who was a recreational gambler failed to substantiate the gambling wins and losses she claimed on her return. The court found that although she could not claim the deductions without sufficient substantiation, her reliance on the attorney who prepared her return was reasonable and in good faith.³¹
- The taxpayer, a partnership that was a shareholder in a corporation, attempted to claim a deduction for business expenses of the corporation that were capital investments. Although the court found against the taxpayer on the issue of the deductions, the court held that the taxpayer's reliance on the advice of a CPA, who was also an attorney, was reasonable and in good faith.³²
- The taxpayer, a company, was found to have attempted to comply with the law because it sought advice from accountants and attorneys, and had hired tax professionals to write opinions on an issue that was a matter of first impression. Therefore, the reliance on a tax professional was reasonable cause and in good faith.³³

²⁹ T.C. Memo. 2010-108.

³⁰ *Neufeld v. Comm'r*, T.C. Memo. 2008-79; *Neonatology Associates, P.A. v. Comm'r*, 115 T.C. 43, 99 (2000) (citations omitted), *aff'd*, 299 F.3d 221 (3d Cir. 2002); Treas. Reg. § 1.6664-4(c)(1).

³¹ *Laplante v. Comm'r*, T.C. Memo. 2009-226.

³² *Canterbury Holdings LLC v. Comm'r*, T.C. Memo. 2009-175.

³³ *Southgate Master Fund v. U.S.*, 104 A.F.T.R.2d (RIA) 6053 (N.D. Tex. 2009).

Examples of cases where the taxpayers were unsuccessful in claiming reliance on a tax professional include:

- The taxpayer's estate failed to report income from Social Security, dividends, and interest on a return. The court found the estate's reliance on a tax professional was not reasonable because the executor neither provided his preparer with necessary documentation nor examined the return before filing it.³⁴
- The taxpayers, a husband and wife, claimed deductions for noncash charitable contributions which the IRS disallowed for failure to substantiate. The court found that the couple had failed to show that their reliance on their CPA's advice was reasonable cause or in good faith because they did not show that he was a tax expert and they failed to provide him with necessary information.³⁵
- The taxpayers, a husband and wife, argued that they relied on their preparer to correctly prepare personal and corporate returns. The Tax Court held that the taxpayers failed to show that they reasonably or in good faith relied on the preparer because the husband lacked the records to substantiate deductions.³⁶

Although reliance on a tax professional may be evidence of acting reasonably and in good faith, it does not necessarily entitle the taxpayer to escape liability for accuracy-related penalties. The taxpayer must also exercise diligence and prudence. In *Prudhomme v. Commissioner*,³⁷ the court found taxpayers' reliance on their accountants' expertise was not reasonable because one of the accountants was a last-minute replacement for their regular accountant and the taxpayers had failed to disclose to either accountant that they had previously sold their business.

Other Circumstances for Reasonable Cause

Tax Sophistication of the Taxpayer

A taxpayer's education and sophistication in business and tax issues are taken into account when determining whether a taxpayer acted with reasonable cause and in good faith.³⁸ For taxpayers with special knowledge or experience in tax law, courts often sustained the penalty because the taxpayers should have known better. For example, the Tax Court held that taxpayers sophisticated in business or tax matters lacked reasonable cause and did not act in good faith in the following instances:

- A tax attorney with 35 years of experience liquidated his partnership interest and attempted to classify it as long-term capital gain instead of ordinary income. He also failed to use the proper mechanism to report the income, doing so inconsistently with

³⁴ *Estate of Stiel v. Comm'r*, T.C. Memo. 2009-278.

³⁵ *Friedman v. Comm'r*, T.C. Memo. 2010-45.

³⁶ *Rosser v. Comm'r*, T.C. Memo. 2010-6.

³⁷ 345 Fed. Appx. 6 (5th Cir. 2009), *aff'g* T.C. Memo. 2008-83.

³⁸ Treas. Reg. § 1.6664-4(b)(1).

the manner in which the partnership reported the liquidation on the partnership return. The Tax Court held that a tax attorney of his standing should have known how to report the inconsistency and therefore, he did not act reasonably or in good faith.³⁹

- The taxpayer, a former IRS employee, attempted to take several deductions that the IRS disallowed, including a net operating loss carryforward and a long-term capital loss for amounts from an uncollected judgment that were discharged in a bankruptcy. The court held that as a tax service representative with the IRS for more than ten years, the taxpayer “had a wider range of knowledge of tax matters than do members of the general public.”⁴⁰ Consequently, in light of the taxpayer’s experience and knowledge, the taxpayer and his wife were liable for the penalty.⁴¹
- A CPA who had a master’s degree in accounting and majored in tax claimed unsubstantiated deductions on his return, filed as single while he was married, and attempted to deduct amounts paid in a personal lawsuit as a business expense. The Tax Court found that, considering his training and experience, he failed to act with reasonable cause or in good faith.⁴²
- Several taxpayers attempted to take business deductions for dog breeding and raising horses. They failed to show that their reliance on advice of a tax professional was reasonable because they were sophisticated business persons who failed to keep adequate records of their expenses. In addition, the tax professional had warned at least one of the taxpayers of the possible repercussions if the activities were found to be hobbies.⁴³

In contrast, taxpayers fared better when they lacked specialized tax knowledge. For example, the Tax Court in *Derby v. Commissioner* held that although the taxpayer was not eligible for the deductions, given his lack of experience and knowledge of tax law, reliance on his bookkeeper to prepare his return was reasonable and he acted in good faith.⁴⁴

Taxpayers Facing Complex Issues or Circumstances

The court found reasonable cause to dismiss a penalty when taxpayers litigated a complex issue or circumstances created a misunderstanding of law. For example, in *Anderson v. Comm’r*,⁴⁵ a fisherman who was part of a crew of fewer than ten members failed to report self-employment tax for work done on a boat because he believed he was not self-employed.⁴⁶ The court held that although the taxpayer was self-employed, he was not liable for the accuracy-related penalty because he had received compensation for additional boat

³⁹ *Wallis v. Comm’r*, T.C. Memo. 2009-243.

⁴⁰ *Green v. Comm’r*, T.C. Memo. 2010-109 (citation omitted).

⁴¹ *Green v. Comm’r*, T.C. Memo. 2010-109.

⁴² *Argyle v. Comm’r*, T.C. Memo. 2009-218.

⁴³ *Smith v. Comm’r*, 104 A.F.T.R.2d (RIA) 7830 (9th Cir. 2009), *aff’g* T.C. Memo. 2007-368.

⁴⁴ T.C. Memo. 2010-66.

⁴⁵ T.C. Memo. 2010-1.

⁴⁶ See IRC § 3121(b)(20). An individual working on a boat for catching fish or other aquatic animals, and whose pay is determined by the amount of the catch, is not considered an employee if the boat normally has less than ten persons working on it.

repairs and had been required to pay lobbying fees, and under those circumstances, his belief that he was not self-employed was reasonable. Therefore, the taxpayer acted in good faith and with reasonable cause.

Penalties in Settlement Cases

Several taxpayers attempted to exclude settlement payments from gross income under IRC §104(a)(2).⁴⁷ In cases where the court found the amount of the settlement payment should be included in gross income, the accuracy-related penalty often was not upheld. For example, in *Espinoza v. Commissioner*,⁴⁸ the Tax Court found the taxpayer's reliance on the advice of her personal injury attorney, that the amount of the settlement was not includible in gross income, was reasonable and the taxpayer acted in good faith. Similarly, in *Longoria v. Commissioner*,⁴⁹ the Tax Court held that, although the taxpayer failed to show that the settlement award was for personal injuries, he was not liable for an accuracy-related penalty because he acted in good faith and reasonably relied on his CPA's advice that the award payment was not includible.

On the other hand, courts have found other taxpayers liable for the accuracy-related penalty for not including settlement payments in gross income. For example, in *Campbell v. Commissioner*,⁵⁰ the taxpayer received a "qui tam" settlement payment as a result of two lawsuits he brought under the False Claims Act.⁵¹ The taxpayer included the net proceeds of the settlement payment, less attorney's fees, on his return as "other income" but failed to include any of the proceeds when computing taxable income. In sustaining the IRS's determination to impose the substantial understatement component of the accuracy-related penalty, the court concluded that the taxpayer did not have substantial authority or reasonable basis for excluding the settlement payment from gross income, and did not adequately disclose the net proceeds. The court held that because the taxpayer was sophisticated in accounting and business, his failure to seek a tax professional's advice was not reasonable.

Tax Shelter Penalty Litigation

In the majority of cases where accuracy-related penalties were assessed for tax shelters, they were upheld.⁵² When an underpayment is related to an item reflected on the return of a pass-through entity, to discern whether the taxpayer acted with reasonable case or good faith, one may look at all circumstances, including the actions of the taxpayer and

⁴⁷ IRC § 104(a)(2) excludes from gross income damage awards received "on account of personal physical injuries or physical sickness." Damage awards received for other injuries or reasons must generally be included in gross income.

⁴⁸ T.C. Memo. 2010-53.

⁴⁹ T.C. Memo. 2009-162.

⁵⁰ 134 T.C. No. 3 (2010).

⁵¹ The False Claims Act allows a private citizen to bring a *qui tam* action on behalf of the United States. See 31 U.S.C. §§ 3729-3733. *Qui tam* is "[a]n action brought under a statute that allows a private person to sue for a penalty, part of which the government or some specified public institution will receive." Black's Law Dictionary 1282 (8th ed. 2004).

⁵² IRC § 6662(d)(2)(C). A tax shelter is an entity or arrangement whose "significant purpose...is the avoidance or evasion of Federal income tax."

the entity.⁵³ For example, in *Enbridge Energy Company Inc. v. United States*,⁵⁴ the taxpayer created a corporation solely to purchase another company for the purpose of acquiring the other company's assets. The court found that the conduit transaction⁵⁵ was a tax shelter because its only purpose was to avoid tax liability. Thus, neither the substantial authority nor the adequate disclosure/reasonable basis exceptions to reduce the amount of the understatement were applicable.

Where taxpayers attempt to assert a defense of reliance on the advice of a tax professional in the tax shelter context, the courts have sometimes held this defense to be unreasonable. For example, in *Nevada Partners Fund LLC v. United States*,⁵⁶ the court sustained the accuracy-related penalties because it found that the taxpayers' reliance on the advice of a tax professional was not reasonable or in good faith. There was substantial authority that instructed the taxpayers against entering into the transaction. In addition, the court looked at the sophistication of the parties, and concluded that their reliance on their tax advisor was not reasonable, given that the parties knew that the advisor was under investigation for such transactions.

CONCLUSION

In the cases reviewed for this report, deficiency determinations or a portion of the deficiency determined by the IRS were generally upheld. However, the court at times overruled the IRS, in full or in part, in regard to the accuracy-related penalties. In 31 percent of the cases, the court reduced or dismissed the penalty. The success rate was greater for taxpayers who were represented by counsel than for those who appeared *pro se*.

The cases indicate that when the taxpayers were incorrect on the underlying tax issue, they often escaped liability for the penalty if they made a legitimate attempt to ascertain the correct amount of tax. Adequacy of records and reliance on tax professionals were the pre-eminent bases for a finding of reasonable cause. The courts also considered factors such as the knowledge or sophistication of the taxpayer and the complexity of the circumstances. The IRS should review the cases where the court found against the IRS's determinations to impose a penalty and incorporate the courts' rationale into employee training, the Internal Revenue Manual, and the Reasonable Cause Assistant (RCA).⁵⁷

⁵³ Treas. Reg. § 1.6664-4(e).

⁵⁴ 354 Fed. Appx. 15 (5th Cir. 2009), *aff'd* 553 F. Supp. 2d 716 (S.D. Tex. 2008).

⁵⁵ A conduit transaction is "[a] sale by one person ... transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title." See *Comm'r v. Court Holding Corp.*, 324 U.S. 331 (1945).

⁵⁶ 105 A.F.T.R.2d (RIA) 2133 (S.D. Miss. 2010).

⁵⁷ For a full discussion of problems with the RCA, see Most Serious Problem, *Over-Reliance on the Reasonable Cause Assistant Leads to Inaccurate Penalty Abatement Decisions*, *supra*.

MLI
#4**Trade or Business Expenses Under Internal Revenue Code
Section 162 and Related Sections****SUMMARY**

The deductibility of trade or business expenses is perennially among the ten most litigated tax issues in the federal courts. We identified 119 cases that included a trade or business expense issue and were litigated between June 1, 2009, and May 31, 2010. The courts affirmed the IRS position in the majority (approximately 64 percent) of cases, while taxpayers prevailed about seven 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 a taxpayer’s taxable year. Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance. The IRS, the Department of the Treasury, Congress, and the courts continue to provide legal guidelines about whether a taxpayer is entitled to certain trade or business expense deductions. The 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 trade or business expense, the courts must often address a series of questions, including those discussed below.

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

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

What is an ordinary and necessary expense?

IRC § 162(a) requires a trade or business expense to be both “ordinary and necessary” in relation to the taxpayer’s trade or business in order to be deductible. In *Welch v. Helvering*, the Supreme Court stated that the words “ordinary” and “necessary” have different

¹ The IRS prevailed in full in 74 of the 119 cases, while taxpayers prevailed in full in only nine cases.

² In 1986, the term “trade or business” appeared in at least 492 subsections of the Code and 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).

meanings, and both must be satisfied for a taxpayer to benefit from the deduction.⁵ The Supreme Court describes an “ordinary” expense as customary or usual and of common or frequent occurrence in the taxpayer’s trade or business,⁶ and a “necessary” expense as appropriate and helpful for the development of the business.⁷

Common law also requires that the amount of the expense be reasonable for an ordinary and necessary business expense to be deductible. In *Commissioner v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held that “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 one that is ordinary and necessary, and 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, such capital expenditures may be subject to amortization, depletion, or depreciation over the useful life of the property.¹¹

Whether to deduct expenditures under IRC § 162(a) or to capitalize them under IRC § 263 is a question of fact. Thus, 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?

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 deductions by documentary evidence (*e.g.*, an invoice, paid bill, or canceled check) but can establish that he or she had some deductible business expenses, the courts may opt to employ the *Cohan* rule to grant deductions of reasonable amounts.

⁵ 290 U.S. 111, 113 (1933).

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) (citation omitted), *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).

The *Cohan* rule is a rule of “indulgence” established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.¹⁴ The court held that the taxpayer’s business expense deductions were not adequately substantiated, but “the [Tax Court] should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent.”¹⁵

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

1. Travel expenses (including meals and lodging while away from home);
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 corroborate the taxpayer’s statement that establishes the amount, time, place, and business purpose of the expense.¹⁷

Who has the burden of proof in a substantiation case?

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

¹⁴ 39 F.2d 540 (2d Cir. 1930).

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

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

¹⁷ Treas. Reg. § 1.274-5T(b).

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

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

ANALYSIS OF LITIGATED CASES

Trade or business expenses have been one of the ten most litigated tax issues in the federal courts since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998. For this year's report, we reviewed 119 cases involving various trade or business expense issues litigated in federal courts from June 1, 2009, through May 31, 2010. Table 4 in Appendix III lists those cases and the issues involved. 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. In *Wolfgang v. Commissioner*,²⁰ for example, the taxpayer raised four distinct trade or business expense issues, so *Wolfgang* appears in four categories in Table 3.4.1.

TABLE 3.4.1. TRADE OR BUSINESS EXPENSE ISSUES IN CASES REVIEWED

Issue	Type of Taxpayer	
	Individual	Business (including sole proprietors)
Substantiation of expenses, including application of the Cohan rule ²¹	24	43
Profit objective ²²	0	14
Ordinary and necessary trade or business expenses ²³	1	11
Personal vs. business expenses ²⁴	19	31
Business expenses vs. capital expenditures ²⁵	0	6
Education expenses ²⁶	4	0
Did the taxpayer establish the carrying on of a trade or business?	0	23

²⁰ T.C. Memo. 2010-69.

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). IRC § 274(d) and Treas. Reg. § 1.274-5T(b) set strict substantiation rules for business expenses for travel, entertainment, gifts, and certain listed property as defined in IRC § 280F(d)(4).

²² IRC § 183(a) provides 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. The nine-factor test to determine whether an activity is engaged in for profit includes: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned from the activity; (8) the financial status of the taxpayer; and (9) the elements of personal pleasure or recreation. See Treas. Reg. § 1.183-2(b)(1)-(9). All facts and circumstances are to be taken into account and no single factor or set of factors is determinative. Treas. Reg. § 1.183-2(b).

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), startup 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 startup expenditures in the tax year in which an active trade or business begins and amortize any excess expenditures 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).

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.

Approximately 72 percent of the taxpayers litigating trade or business deduction issues represented themselves (*pro se*). In terms of percentage, taxpayers represented by counsel were about as successful as their *pro se* counterparts in obtaining relief. Taxpayers with representation received full or partial relief in approximately 39 percent of litigated cases (13 of 33), while *pro se* taxpayers received full or partial relief in approximately 35 percent of litigated cases (30 of 86).

Individual Taxpayers

None of the 30 decisions involving individual taxpayers was issued as a regular opinion of the Tax Court.²⁷ All but four of these taxpayers appeared *pro se*, and one individual taxpayer received full relief, although 11 of the 30 cases resulted in split decisions. The most prevalent issue for individual taxpayers was the substantiation of the claimed trade or business expense deductions, which appeared in 24 cases.

For example, in *Freeman v. Commissioner*,²⁸ a split decision, the Tax Court allowed a courier for an auto parts delivery company to deduct travel expenses for his 234-mile daily route based on the taxpayer's credible testimony. The taxpayer's mileage log was lost in a fire confirmed by state authority. Despite the strict substantiation requirements of IRC § 274(d), the court allowed the taxpayer to substantiate his deductions by reasonable reconstruction because the taxpayer's records were lost in circumstances beyond his control. Yet, the court denied business mileage expenses to the taxpayer's wife, whose only evidence that she delivered for the same company was her husband's unsupported testimony. In *Tarpo v. Commissioner*,²⁹ another split decision, the taxpayers (a husband and wife) claimed a number of deductions related to an elaborate scheme to route ordinary income into an offshore trust. The Tax Court acknowledged it could estimate some expenses under the *Cohan* rule. Nevertheless, the court refused to apply the *Cohan* rule because it found the taxpayers' unsupported self-serving affidavits were an insufficient basis for a reasonable estimate. The Tax Court allowed only a licensing fee deduction because it was convinced the fee was actually paid and necessary to the wife's beauty consultant business.

²⁷ Tax Court reported decisions fall into three categories: regular decisions, memorandum decisions, and small tax case ("S") decisions. The regular decisions of the Tax Court include cases which have some new or novel point of law, or in which there may not be general agreement, and therefore have the most legal significance. In contrast, memorandum decisions generally involve fact patterns within previously settled legal principles and therefore are not as legally 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. Seventy percent of the cases involving individual taxpayers were "S" cases (21 of 30).

²⁸ T.C. Memo. 2009-213.

²⁹ T.C. Memo. 2009-222.

In several cases, the IRS disallowed significant deductions because of taxpayers' employment status, regardless of adequate substantiation.³⁰ In *Rosemann v. Commissioner*,³¹ for example, the Tax Court classified a traveling salesman as a common-law employee and precluded him from deducting business expenses on Schedule C. Consequently, the taxpayer's expenses were subject to the two percent adjusted gross income limitation of IRC § 67(a). In *Martin v. Commissioner*,³² a taxpayer incorporated his real estate sales business and sought to fully deduct expenses that the corporation paid on his behalf. The Tax Court recharacterized the deductions as wage expenses. The court explained that classifying the taxpayer as an employee was proper because the corporation's income was generated from the substantial services he performed, and the taxpayer was the corporation's officer and only employee.³³

Courts denied travel expense deductions to taxpayers who traveled for work extensively but were not "away from home."³⁴ For example, in *Minick v. Commissioner*,³⁵ a field engineer who traveled out of state while working at assigned construction sites failed to establish any business relationship with the state of his personal residence, and that his residence was not his tax home for purposes of IRC § 162. The Tax Court held that the taxpayer's camper and motel expenses were dictated by a choice to maintain his personal residence rather than the exigencies of his engineering trade.

Business Taxpayers

Eighty-nine of the 119 litigated trade or business expense cases involved business taxpayers. These taxpayers were slightly more successful than individual taxpayers in obtaining a favorable outcome, receiving full or partial relief in approximately 35 percent of cases (31 of 89) compared to 40 percent for individuals (12 of 30). Notably, however, seven business taxpayers obtained full relief, while one individual taxpayer (*Singleton*) prevailed in full. In ten favorably decided cases, business taxpayers were represented by counsel.

³⁰ The significance of employee classification arises from the amount of business expenses a taxpayer may deduct. Common-law employees must report their deductions on Form 2106, *Employee Business Expenses*, and Schedule A of Form 1040. They may deduct only business expenses unreimbursed by the taxpayer's employer subject to a two percent limitation for miscellaneous itemized deductions. See IRC §§ 67(a), (b). Independent contractors, business owners, and statutory employees may deduct reasonable business expenses in full on Schedule C of Form 1040. See IRC § 3121(d) for the definition of an "employee."

³¹ T.C. Memo. 2009-185.

³² T.C. Memo. 2009-234.

³³ Employee classification affects business taxpayers as well as individual taxpayers. In *Stahl*, a district court found that a § 501(d) religious organization was not entitled to deduct as business expenses the value of meals and medical care provided to a member. See *Stahl v. United States*, 673 F. Supp. 2d 1233 (E.D. Wash. 2009). The court concluded that the organization's founding member was not an employee because his relationship with the organization was based not on job performance but on shared religious commitments.

³⁴ See IRC § 162(a); Treas. Reg. § 1.162-2. Generally, a taxpayer's tax home is the taxpayer's principal place of employment. The place of a taxpayer's personal residence may become the taxpayer's tax home, in exception to the rule, when the taxpayer accepts temporary, and not indefinite, employment away from the taxpayer's personal residence. This exception applies only if exigencies of the taxpayer's trade or business rather than the taxpayer's personal choice drive the taxpayer's decision to maintain the same place of personal residence while traveling.

³⁵ T.C. Memo. 2010-12.

As with individual taxpayers, substantiation of expenses was the most prevalent issue,³⁶ and in some instances the courts denied business taxpayers' deductions for failure to substantiate.³⁷ On the other hand, courts allowed business taxpayers' deductions when they were properly substantiated.³⁸ For example, in *Foster v. Commissioner*,³⁹ the Tax Court estimated deductible wage expenses based on a taxpayer's credible testimony that two project managers were the taxpayer's employees and he paid them weekly wages. The court also approximated deductions for rental expenses for a joint lease based on the taxpayer's testimony and a worksheet that detailed reimbursements.

Another common issue litigated by business taxpayers was the question of whether the business expense deductions were attributable to a legitimate "for profit" activity constituting a trade or business. In *Helmick v. Commissioner*,⁴⁰ the Tax Court held that the taxpayers' horse-breeding and boarding operation, though unprofitable, was an activity engaged in with intent of making a profit. Despite their shoebox record keeping, the taxpayers conducted the operation in a businesslike manner, had a business strategy, and invested in the construction of an indoor riding arena and additions to their barn. The taxpayers' middle-class status meant that they could not afford to maintain the horse-breeding activity without prospects for profit.⁴¹ The court found it unlikely and even absurd that the taxpayers would spend a substantial amount of time performing dawn-to-dusk strenuous labor and lose thousands of dollars simply for pleasure.

In *Chow v. Commissioner*,⁴² the Tax Court acknowledged that an expectation of profit is a product of subjective intent that need not be reasonable, and took an uncommon position in finding that taxpayers pursued gambling activity with a profit objective.⁴³ The court reasoned that the taxpayers could not sustain indefinitely the losses they had incurred and distinguished them from casual gamblers who rely on other sources of income and have no expectation of profit. Yet, the Tax Court cautioned that this was a close case, and the taxpayers would be prudent to abandon gambling as a potential source of income.

The Court of Appeals for the Second Circuit faced an issue of first impression in *Robinson Knife*⁴⁴ and reversed the Tax Court to allow current deduction of a trademark licensee's royalty payments. The taxpayer incurred third-party trademark royalties only upon sale of inventory and thus calculated them as a percentage of net sales revenue from inventory.

³⁶ Substantiation of expenses issue appeared in 24 of 89 cases involving business taxpayers.

³⁷ See, e.g., *Bennett v. Comm'r*, T.C. Memo. 2010-114; *Willcock v. Comm'r*, T.C. Memo. 2010-75.

³⁸ See, e.g., *Houston v. Comm'r*, T.C. Memo. 2009-286; *Derby v. Comm'r*, T.C. Memo. 2010-66.

³⁹ T.C. Memo. 2009-274.

⁴⁰ T.C. Memo. 2009-220.

⁴¹ The Tax Court expressly distinguished the taxpayers' operation from the stereotypical abusive scenario involving horse breeding where a wealthy businessman owns a "gentleman's farm" as a weekend retreat for the recreation of family and friends. *Helmick*, T.C. Memo. 2009-220.

⁴² T.C. Memo. 2010-48.

⁴³ IRC § 165(d) trumps the general language of IRC § 162(a) to limit a deduction for gambling losses to the amount of gambling winnings. See IRC §§ 162(a); 165(d).

⁴⁴ *Robinson Knife Mfg. Co. v. Comm'r*, 600 F.3d 121 (2d Cir. 2010), *rev'g* T.C. Memo. 2009-9.

The Second Circuit determined that these sales-based royalties did not require capitalization because they were not incurred “by reason of” production activities and were not properly allocable to the property produced by the taxpayer.⁴⁵

Courts scrutinized at length acquisition of property interests to determine whether ownership was genuine so that related business expenses would qualify as deductible.⁴⁶ The Eighth Circuit affirmed the Tax Court’s holdings to disallow depreciation and other deductions in a series of cases where the taxpayers did not acquire genuine tax ownership of ATM and payphone equipment.⁴⁷ The relevant purchase and service agreements indicated that the benefits and burdens of owning the equipment had not passed to the taxpayers because their contractual counterparties retained a high degree of control over the equipment, including choosing the locations for installation; performing the installation, maintenance, and repairs; paying insurance and other expenses; and retaining the majority of the profits. Thus, the Tax Court held that the taxpayers did not engage in a trade or business related to handling ATM and payphone equipment and were not eligible to deduct professional and legal expenses.

In *Consolidated Edison of New York v. United States*,⁴⁸ the Court of Federal Claims subjected the taxpayer’s LILO (Lease-In-Lease-Out) transaction⁴⁹ to a rigorous conjunctive test and allowed the taxpayer’s business expense deductions.⁵⁰ The test required that the transaction have both economic substance and a legitimate business purpose independent of tax benefits. The court found the LILO transaction was motivated by a legitimate business purpose because it helped the company reach its strategic goals. In addition, the transaction demonstrated the attributes of a genuine lease and even exceeded the Supreme Court’s standard for true ownership.⁵¹ The Court of Federal Claims recognized that risk of investment loss and reasonable opportunity to profit are among the benefits and burdens requisite for ownership of a leveraged leasehold interest, and the company’s management deliberately evaluated the many benefits and risks of entering the transaction when reviewing potential investment opportunities. The transaction’s potential for a realistic residual value created a true possibility to obtain a significant profit, and the taxpayer’s investment remained subject to market risk and currency fluctuation throughout the life of

⁴⁵ Treas. Reg. § 1.263A-1(e)(3)(i); *Robinson Knife Mfg. Co. v. Comm’r*, 600 F.3d 121, 131 (2d Cir. 2010), *rev’g* T.C. Memo. 2009-9.

⁴⁶ A taxpayer is entitled to depreciation and other business expense deductions only if the benefits and burdens of owning the property have passed to the taxpayer. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). Mere transfer of legal title does not create property ownership where the transferor retains significant control over the property. *Frank Lyon Co. v. United States*, 435 U.S. 561, 572-73 (1978).

⁴⁷ *Doherty v. Comm’r*, 105 A.F.T.R.2d (RIA) 2181 (8th Cir. 2010), *aff’g* T.C. Memo. 2009-99; *Loveland v. Comm’r*, 105 A.F.T.R.2d (RIA) 2182 (8th Cir. 2010), *aff’g* T.C. Memo. 2009-98; *Snyder v. Comm’r*, 105 A.F.T.R.2d (RIA) 2180 (8th Cir. 2010), *aff’g* T.C. Memo. 2009-97.

⁴⁸ 90 Fed. Cl. 228 (2009).

⁴⁹ The taxpayer invested in a state of the art electricity-generating plant located in The Netherlands and sought to deduct related rent and interest expenses.

⁵⁰ A taxpayer must qualify as a true owner of a leasehold interest in property to realize tax benefits of ownership and be eligible for deductions related to a leveraged lease, such as a LILO or SILO (Sale-In-Lease-Out) transaction provided that the transaction is a genuine lease. See *Consolidated Edison of New York v. United States*, 90 Fed. Cl. 228, at *126-27 (2009) (citing *Frank Lyon Co. v. United States*, 435 U.S. 561, 584 (1978); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1355-57 (Fed. Cir. 2006)).

⁵¹ See *Frank Lyon Co. v. United States*, 435 U.S. 561, 572-73 (1978) (noting that the Supreme Court is “not so much concerned with the refinements of title as it is with actual command over the property taxed – the actual benefit for which the tax is paid”).

the lease. The opportunity to reach company goals through the LILO transaction created an additional positive cash flow benefit of not having to incur alternate costs. Moreover, the company would realize millions of dollars in pre-tax and after-tax cash profits if the sublease purchase options were exercised. Ultimately, the court acknowledged that each leasing transaction must be evaluated on its own merits.

By contrast, in *Altria Group, Inc. v. United States*,⁵² a jury returned a verdict denying deductions related to a taxpayer's LILO and SILO transactions⁵³ because it concluded that the transactions failed to transfer ownership. When the taxpayer challenged the jury instructions and sought a new trial, the court held that the jury's finding – that the transaction lacked legitimate business purpose – was sufficient to support the verdict of lack of economic substance. In addition, the court pointed out that the transactions were motivated not by a reasonable opportunity to profit, but by tax avoidance, because the present value of the investments' pre-tax returns was negative, and the present value of after-tax returns was barely positive. Significant to the denial of the deductions was the conjunctive test the court applied where lack of either legitimate business purpose or reasonable opportunity to profit indicated the transaction lacked economic substance.

CONCLUSION

Taxpayers continued to challenge the IRS's denials of trade or business expense deductions. Surprisingly, represented taxpayers did not fare significantly better than others who litigated *pro se*. While the IRS generally prevailed, the courts did not always favor the IRS's application of the law to the taxpayers' facts and circumstances. Thus, the definition of an allowable trade or business expense remains open to interpretation and is highly fact-specific.

Many of these cases demonstrate taxpayer confusion over the legal requirements. The IRS can encourage compliance and minimize litigation by helping self-employed and small business taxpayers understand these requirements. Through education, outreach, and collaboration with stakeholders, the IRS can help taxpayers understand what trade or business expense deductions are allowable and how to substantiate them. By providing clear guidance on the deductibility of trade or business expenses, the IRS can minimize litigation.

⁵² 2009 U.S. Dist. LEXIS 27463 (S.D.N.Y. 2009), *motion for new trial denied by* 2010 U.S. Dist. LEXIS 25160 (S.D.N.Y. 2010).

⁵³ The taxpayer leased a Dutch wastewater treatment plant, two domestic power plants, and a domestic railroad maintenance facility from tax indifferent parties. The deductions in question were for depreciation, amortization, interest, and transaction expenses.

MLI
#5**Gross Income Under Internal Revenue Code Section 61 and Related Sections****SUMMARY**

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.¹ For this report, we reviewed 103 cases decided between June 1, 2009, and May 31, 2010. Some gross income issues in these cases include:

- Damage awards;
- Foreign earned income; and
- Discharge of indebtedness.

PRESENT LAW

Internal Revenue Code (IRC) § 61 broadly defines gross income as “all income from whatever source derived.”² The U.S. Supreme Court has defined gross income as any accession to wealth.³ However, over time, Congress has carved out numerous exceptions and exclusions from this broad definition of gross income, and has based other elements of tax law on the definition.⁴

ANALYSIS OF LITIGATED CASES

In the 103 opinions involving gross income issued by the federal courts and reviewed for this report, gross income issues most often fall into two categories: (1) what is included in gross income under IRC § 61, and (2) what can be excluded under other statutory provisions. A detailed list of all cases analyzed appears in Table 5 of Appendix III.

In 29 cases (28 percent), taxpayers were represented, while the rest were *pro se* (without counsel). Eleven of the 29 represented taxpayers (about 31 percent) prevailed in full or in part in their cases whereas *pro se* taxpayers prevailed in full in just three cases, and in part in five others. Overall, taxpayers prevailed in full or in part in 19 of 103 cases (less than 18 percent). The vast majority of gross income cases this year involved taxpayers failing to report items of income, including some specifically mentioned in IRC § 61 such as wages,⁵

¹ See, e.g., National Taxpayer Advocate 2008 Annual Report to Congress 470-475; National Taxpayer Advocate 2009 Annual Report to Congress 445-450.

² IRC § 61(a).

³ *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 431 (1955) (interpreting § 22 of the Internal Revenue Code of 1939, the predecessor to IRC § 61).

⁴ See, e.g., IRC §§ 104 (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).

⁵ IRC § 61(a)(1). See, e.g., *Nino v. Comm'r*, T.C. Memo. 2009-293.

interest,⁶ and pensions.⁷ In the context of items that can be excluded from gross income, the cases raised the following issues.

Damage Awards

Taxation of damage awards continues to generate litigation. This year, at least 11 taxpayers (about 11 percent of the cases reviewed) challenged the inclusion of damage awards in their gross income, and only one taxpayer prevailed on the issue. IRC § 104(a)(2) specifies that damage awards and settlement proceeds⁸ are taxable as gross income unless the award was received “on account of personal physical injury or physical sickness.”⁹ Congress added the “physical injury or physical sickness” requirement in 1996;¹⁰ until then, the word “physical” did not appear in the statute. The legislative history of the 1996 amendments to IRC § 104(a)(2) provides that “[i]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness...[but] emotional distress is not considered a physical injury or physical sickness.”¹¹ Thus, damage awards for emotional distress are not considered as received on account of physical injury or physical sickness, even if the injury is emotional distress resulting in “insomnia, headaches, [or] stomach disorders.”¹²

To justify exclusion from income under IRC § 104, the taxpayer must show settlement proceeds are in lieu of damages for physical injury or sickness.¹³ In *Domeny v. Commissioner*, the taxpayer petitioned the U.S. Tax Court to exclude from her income a settlement award from a hostile work environment suit.¹⁴ Prior to her employment and the subsequent suit, the taxpayer was diagnosed with multiple sclerosis (MS), and she chose her new employer with the understanding that the promised work environment would mitigate her symptoms. Following a change in management that led to a contentious and stressful work environment, the taxpayer’s MS symptoms began to worsen. Her doctor recommended that she take leave from work, explaining that the taxpayer was experiencing “shooting pain up her legs, fatigue, burning eyes, spinning head, vertigo, and lightheadedness.”¹⁵ She was subsequently fired for failing to timely return to work. The taxpayer eventually settled her suit and received several payments, with no express statement of their purpose, including

⁶ IRC § 61(a)(4). See, e.g., *Evans v. Comm’r*, T.C. Memo. 2010-62.

⁷ IRC § 61(a)(11). See, e.g., *Green v. Comm’r*, T.C. Memo. 2010-109.

⁸ See Treas. Reg. § 1.104-1(c) (damages received, for purposes of IRC § 104(a)(2), means amounts received “through prosecution of a legal suit or action based upon tort or tort type rights or through a settlement agreement entered into in lieu of such prosecution”).

⁹ IRC § 104(a)(2).

¹⁰ Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (1996).

¹¹ H.R. Rep. No. 104-586, at 143-44 (1996).

¹² H.R. Conf. Rep. No. 104-737, at 301 (1996). Note, however, that IRC § 104(a)(2) excludes from income damages, up to the cost of medical treatment under IRC § 213, for mental or emotional distress causing physical injury.

¹³ See, e.g., *Green v. Comm’r*, 507 F.3d 857 (5th Cir. 2007), *aff’d* T.C. Memo. 2005-250.

¹⁴ T.C. Memo. 2010-9.

¹⁵ *Domeny v. Comm’r*, T.C. Memo. 2010-9.

a sum documented by a Form W-2, *Wage and Tax Statement*, a sum documented by a Form 1099-MISC, *Miscellaneous Income*, and one undocumented sum.

Because the settlement agreement was ambiguous, the court looked to the payor's intent, as evidenced by the facts and circumstances surrounding the litigation.¹⁶ Even though the settlement agreement contained a blanket release and "had no specific or express statement of the payor's intent," the court determined that intent can be inferred from the manner of payment; here the payor divided the settlement into three payments with varying tax treatments.¹⁷ This inference, combined with the payor's knowledge of the taxpayer's medical condition prior to terminating her employment, led the Tax Court to hold that the payor was aware that at least part of the recovery may not be subject to tax as compensation for exacerbating her acute illness. Thus, the taxpayer was able to show that a portion of the settlement proceeds was in lieu of damages for physical injury. Consequently, the portion of the payment evidenced by the Form 1099-MISC, was excluded from her gross income.¹⁸

In another case, *Save v. Commissioner*, the taxpayer argued that her settlement payments were received on account of a physiological illness caused by her emotional distress, thus satisfying the "physical illness" requirements of IRC § 104(a)(2).¹⁹ The Tax Court rejected the taxpayer's claim because she provided neither a clear allocation in the settlement agreement between taxable payments and nontaxable payments tied to the personal injury claims, nor any evidence that the payor intended to compensate her for a physical injury.²⁰ The court refused outright to determine what amount of the settlement was paid as a personal injury claim, "absent proof of a specific payment for tortlike personal physical injuries or physical sickness."²¹

As illustrated by these cases, the question of when damage awards can be excluded from taxable income continues to confuse taxpayers. Even when taxpayers seek legal advice before filing a complaint for damages or accepting settlement proceeds, they may not understand how to characterize the damages in the complaint in order for them to be excludible under IRC § 104(a)(2), or may be confused about the proper tax treatment of the proceeds. For example, in *Espinoza v. Commissioner*, the taxpayer's attorney informed the taxpayer and her family that her settlement proceeds would not be taxed.²² Even though the taxpayer received Form 1099-MISC from the payor, she did not realize she would be taxed on the settlement award until she received a notice of deficiency.²³ To reduce

¹⁶ *Domeny v. Comm'r*, T.C. Memo. 2010-9 (citing *Kurowski v. Comm'r*, 917 F.2d 1033, 1036 (7th Cir. 1990), *aff'g* T.C. Memo. 1989-149).

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ T.C. Memo. 2009-209.

²⁰ *Save v. Comm'r*, T.C. Memo. 2009-209.

²¹ *Id.* See also *Hellesen v. Comm'r*, T.C. Memo. 2009-143 (holding that without an allocation of a specific amount of the settlement as compensation for physical injuries or physical sickness, no amount of the settlement could be excluded from gross income under IRC § 104(a)(2)).

²² T.C. Memo. 2010-53.

²³ *Espinoza v. Comm'r*, T.C. Memo. 2010-53.

litigation in this area, the National Taxpayer Advocate has proposed that Congress amend IRC §104(a)(2) to exclude from gross income any payments received as a settlement or judgment for mental anguish, emotional distress, or pain and suffering.²⁴

Foreign Earned Income

In the 2008 Annual Report to Congress, we highlighted 96 cases in which taxpayers raised the issue of excluding income earned in Antarctica under IRC § 911.²⁵ IRC § 911 permits taxpayers to exclude, within statutory limits, income they earned while residing in a foreign country.²⁶ Only a territory under the sovereignty of a foreign nation is considered a “foreign country.”²⁷ The Tax Court determined that Antarctica does not qualify as a foreign country under IRC § 911, and the IRS prevailed in all 96 cases.

These Antarctica cases significantly inflated the number of gross income cases in the 2008 Annual Report. In the 2009 report, we located only three cases where taxpayers argued income should be excluded from gross income under IRC § 911; this year, we identified only one case containing an IRC § 911 argument (and this was not an “Antarctica” case).²⁸ While taxpayers did not litigate a significant number of cases over foreign earned income this year, IRC § 911 may continue to raise questions from Americans working abroad.

Discharge of Indebtedness

We reviewed ten cases in which taxpayers disputed the IRS’s determination that a discharge of indebtedness was taxable income. Taxpayers prevailed in full in only two of these cases. Generally, a taxpayer must include discharges of indebtedness in gross income.²⁹ However, in certain circumstances, cancellation of indebtedness income may be excluded. IRC § 108(a) provides that a taxpayer may exclude, subject to limitations, income from the discharge of indebtedness if the discharge occurs in a bankruptcy case, when the taxpayer is insolvent, or if the indebtedness is qualified farm or business real estate debt or qualified principal residence indebtedness.³⁰

The burden of proof is on the taxpayer to show that any of the exceptions in IRC § 108(a) apply.³¹ For example, in *Felt v. Commissioner*, the taxpayer had discharge of debt income from an unrepaid loan from both a bank and his (now defunct) fully-owned corporate entity, which was used to purchase a savings and loan company in 1983.³² The taxpayer did not dispute the amount of the debt, but argued he qualified for the insolvency exception in

²⁴ See National Taxpayer Advocate 2009 Annual Report to Congress 351-356.

²⁵ See, e.g., *Booth v. Comm’r*, T.C. Memo. 2007-253; *Charpentier v. Comm’r*, T.C. Memo. 2007-314.

²⁶ IRC § 911.

²⁷ Treas. Reg. § 1.911-2(h).

²⁸ *Musshafen v. Comm’r*, T.C. Summ. Op. 2009-115.

²⁹ IRC § 61(a)(12).

³⁰ IRC § 108(a).

³¹ U.S. Tax Court Rules of Practice and Procedure, Rule 142(a).

³² T.C. Memo. 2009-245.

IRC § 108.³³ The court attempted to assess the taxpayer's finances, but was unable to do so due to the taxpayer's inability to provide relevant evidence; consequently, the taxpayer was required to include the discharge of indebtedness income in his gross income.³⁴

CONCLUSION

Taxpayers litigate many of the same gross income issues year after year due to the complex nature of what constitutes gross income. This report has highlighted some of the main areas of confusion under IRC § 61, though these issues are not discrete. Many of the Most Litigated Issues touch tangentially or directly on the problem of delineating gross income, for example, Accuracy Related Penalty and Frivolous Issues litigation. Those issues are discussed in their respective sections.

³³ *Felt v. Comm'r*, T.C. Memo. 2009-245.

³⁴ *Id.*

MLI
#6**Failure to File Penalty Under Internal Revenue Code
Section 6651(A)(1) and Estimated Tax Penalty Under Internal
Revenue Code Section 6654****SUMMARY**

We reviewed 71 decisions issued by the federal courts from June 1, 2009, to May 31, 2010, regarding the addition to tax under Internal Revenue Code (IRC) § 6651(a)(1) for failure to timely file an income tax return, or the addition to tax under IRC § 6654 for failure to pay estimated tax.¹ The phrase “addition to tax” is commonly referred to as a penalty, so we will refer to these two additions to tax as the failure to file penalty and the estimated tax penalty. Thirty-four cases involved imposition of the estimated tax penalty in conjunction with the failure to file penalty, two cases involved only the estimated tax penalty, and the remaining 35 cases involved only the failure to file penalty.

The failure to file penalty is mandatory unless the taxpayer can demonstrate the failure is due to reasonable cause and not willful neglect.² Similarly, the estimated tax penalty is mandatory unless the taxpayer can meet one of the statutory exceptions.³ In the cases analyzed, taxpayers were largely unsuccessful in their attempts to avoid these penalties.

PRESENT LAW

Under IRC § 6651(a)(1), a taxpayer that fails to file a tax 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 such failure is due to reasonable cause and not willful neglect.⁴ The penalty is based on the tax due, minus any credit the taxpayer is entitled to receive or payment made by the due date.⁵ The failure to file penalty applies to income, estate, gift, and certain excise tax returns.⁶ 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

IRC § 6654 imposes a penalty on any underpayment of a required installment of estimated tax by an individual,⁸ and by certain estates and trusts.⁹ Four installments are required per taxable year, and each amount is generally 25 percent of the taxpayer’s total annual

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

² IRC § 6651(a)(1).

³ IRC § 6654(e).

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

⁵ IRC § 6651(b)(1).

⁶ IRC § 6651(a)(1).

⁷ Treas. Reg. § 301.6651-1(c)(1).

⁸ IRC § 6654(a) and (b).

⁹ IRC § 6654(a) and (l).

payment.¹⁰ The required annual payment is the lesser of 90 percent of the tax for the current taxable year or 100 percent of the tax shown on the taxpayer's return for the previous taxable year.¹¹ The IRS will determine the amount of the penalty by applying the underpayment rate according to IRC § 6621¹² to the amount of the underpayment for the period of the underpayment.¹³ To avoid the estimated tax penalty, the taxpayer has the burden of proving one of the following exceptions applies:

- The tax due is less than \$1,000;¹⁴
- The preceding taxable year was a taxable year of 12 months, the taxpayer has no tax liability for the preceding taxable year, and the taxpayer was a citizen or resident of the United States throughout that year;¹⁵
- The IRS determines that by reason of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;¹⁶ 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 such year, and the underpayment was due to reasonable cause and not willful neglect.¹⁷

In any court proceeding, the IRS has the initial burden of production to provide sufficient evidence regarding the appropriateness of the failure to file and the estimated tax penalties.¹⁸ If the IRS meets this burden, the taxpayer may produce evidence to establish any exception to the penalty.¹⁹

ANALYSIS OF LITIGATED CASES

We analyzed 71 opinions issued between June 1, 2009, and May 31, 2010, where the failure to file penalty or the estimated tax penalty was in dispute. All but ten of these cases were litigated in the United States Tax Court. A detailed list of cases appears in Table 6 in Appendix III. Fifty-three cases involved individual taxpayers and 18 involved businesses (including individuals engaged in self-employment or partnerships). Of the 50 cases in which taxpayers appeared *pro se*, or without counsel, taxpayers prevailed in full in only one case, and eight cases resulted in split decisions. Of the 21 cases in which taxpayers

¹⁰ IRC § 6654(c)(1) and (d)(1).

¹¹ IRC § 6654(d)(1)(B).

¹² IRC § 6621(a)(2). The interest rate for an underpayment is the sum of the federal short-term rate plus three percentage points.

¹³ IRC § 6654(a)(1) - (3).

¹⁴ IRC § 6654(e)(1).

¹⁵ IRC § 6654(e)(2).

¹⁶ IRC § 6654(e)(3)(A).

¹⁷ IRC § 6654(e)(3)(B).

¹⁸ IRC § 7491(c). See also *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001). An exception to this rule alleviates the IRS from this initial burden where the taxpayer's petition fails to state a claim for relief from the penalty, such as where the taxpayer only makes frivolous arguments. *Funk v. Comm'r*, 123 T.C. 213, 217-18 (2004) (citations omitted).

¹⁹ *Higbee v. Comm'r*, 116 T.C. 438, 447 (2001). See also U.S. Tax Court Rules of Practice and Procedure, Rule 142(a).

appeared with representation, only one was resolved in the taxpayer's favor in full and one resulted in a split decision.

Failure to File Penalty

A common basis for the courts ruling against taxpayers was lack of evidence that the failure to file was due to reasonable cause. In fact, in 41 of the 71 cases, the taxpayers did not present any evidence of reasonable cause. In cases where evidence of reasonable cause was presented, the taxpayers' arguments included:

Medical Illness: Depending on the facts and circumstances, an illness may establish reasonable cause for failure to file.²⁰ For illness or incapacity to constitute reasonable cause, the taxpayer must show incapacitation to such a degree that he or she could not file a return on time.²¹ A court also may allow a taxpayer who is caring for another person to establish reasonable cause if providing the care prevents the taxpayer from filing on time.²²

While a court may be sympathetic to a taxpayer's medical condition, the court will not find reasonable cause when the condition was not present at the time the return was due. One court determined reasonable cause did not exist where a taxpayer claimed his illness prevented him from filing a return, but he continued his business and other affairs during his period of illness.²³

Courts have held that illness of a taxpayer's agent is not reasonable cause because it does not discharge the taxpayer's responsibility to timely file a return.²⁴ For example, in *Benton Workshop, Inc. v. United States*,²⁵ the president of a corporation experienced physical and mental impairment that required her to give up her duties, one of which was filing the company's employment tax returns. In holding that the president's illness was not reasonable cause, the court noted that the vice president knew the returns needed to be filed and he could have made arrangements to file them, as he arranged to pay the corporation's creditors.

Mistaken Belief as to Filing Obligation: Often, taxpayers mistakenly believe they are not required to file returns. If a taxpayer's mistaken belief about the filing requirement is based on an incomplete or flawed reading of the law, the taxpayer does not have reasonable cause. For example, in *Trask v. Commissioner*,²⁶ the taxpayer believed he was

²⁰ See, e.g., *Harbour v. Comm'r*, T.C. Memo. 1991-532 (the taxpayer was in a coma the month before the due date of his tax return and therefore had reasonable cause for failing to timely file).

²¹ *Williams v. Comm'r*, 16 T.C. 893, 905-06 (1951), acq., 1951-2 C.B. 1.

²² *Tabbi v. Comm'r*, T.C. Memo. 1995-463 (reasonable cause existed for late filing a joint return when taxpayers' son had heart surgery and taxpayers were continuously at hospital for four months surrounding due date of return).

²³ *Kelso v. Comm'r*, T.C. Memo. 2009-125.

²⁴ See, e.g., *Donald's Electric & Refrigeration Serv., Inc. v. U.S.*, 95 A.F.T.R.2d (RIA) 1398 (W.D. Va. 2005).

²⁵ 104 A.F.T.R.2d (RIA) 6034 (E.D. Ark. 2009).

²⁶ T.C. Memo. 2010-78.

not required to file a timely return because he thought his tax liability was zero due to net operating losses. The court held that the taxpayer's belief was not reasonable cause for failing to file. Similarly, in *Soltan v. Commissioner*,²⁷ the taxpayers' belief that they were both exempt from paying withholding tax and filing income tax returns because their net operating loss would reduce their tax liability to zero was not reasonable cause.

Reliance on Agent: The Supreme Court, in *United States v. Boyle*, held that taxpayers have a nondelegable duty to file a return on time, and a taxpayer's reliance on an agent does not excuse failure to file.²⁸ A taxpayer may, however, succeed with a reasonable cause argument where the taxpayer is effectively disabled from fulfilling its obligations because of circumstances beyond its control.²⁹ Examples of cases where the taxpayers were unsuccessful in claiming reliance on an agent included:

- Consistent with the *Boyle* line of reasoning, where the taxpayer relied on an attorney to request an extension and meet the filing deadline, the court held this was not reliance on tax advice, but a delegation of the taxpayer's duty to file, which is not reliance for reasonable cause.³⁰
- Where the taxpayer argued that a bookkeeper who was responsible for filing employment tax returns had suffered a personal crisis, reliance on the bookkeeper was not reasonable cause because it takes no special training to ascertain when returns are due.³¹
- The court found there was no reasonable cause for failing to timely file employment tax returns where the taxpayer stated it had relied on its CPA to file the returns. Although filing the returns was part of the CPA's employee responsibilities, the taxpayer failed to verify that the CPA had actually done so. Additionally, the court noted that the taxpayer had a history of failing to timely file returns and the failure to oversee the CPA's performance was, in light of that history, an indication of a lack of ordinary business care and prudence.³²

"Zero Return" Filers and Other Frivolous Arguments: Under the longstanding four-part test articulated in *Beard v. Commissioner*, for a document to be a valid return it 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.³³ A return subject to the frivolous

²⁷ T.C. Memo. 2010-91.

²⁸ 469 U.S. 241, 252 (1985).

²⁹ *United States v. Boyle*, 469 U.S. 241, 248 n.6 (1985).

³⁰ *Estate of Furtres v. U.S.*, 104 A.F.T.R.2d (RIA) 6527 (N.D. Tex. 2009).

³¹ *Nicholas Acoustics & Specialty Co. v. U.S.*, 2010 WL 2505472 (S.D. Miss. 2010) (quoting *United States v. Boyle*, 469 U.S. 241, 251 (1985)).

³² *McNair Eye Ctr., Inc. v. Comm'r*, T.C. Memo. 2010-81.

³³ *Beard v. Comm'r*, 82 T.C. 766, 777 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986).

tax submission penalty under IRC § 6702³⁴ does not constitute a return for purposes of the failure to file penalty.³⁵

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, *Wage and Tax Statement*. A “zero return” does not constitute a tax return for purposes of the failure to file penalty of IRC § 6651(a)(1).³⁶

In *Hamilton v. Commissioner*,³⁷ the Tax Court held that a purported return containing only zeros was not valid and the taxpayer failed to show reasonable cause for failing to file a return. In a similar case where the taxpayer had not filed for several years and later filed returns containing all zeros, the court held that the taxpayer did not have reasonable cause.³⁸ Further, a taxpayer who argued that he had no taxable income, because he did not recognize gain in the sale of his labor, later submitted Forms 1040, *U.S. Individual Income Tax Return*, and 1099, *U.S. Information Return*, showing only zeros. The court held this was not reasonable cause for failing to file.³⁹

A taxpayer attempted to argue that the wages and other income he received was income of a trust and he was therefore exempt from paying withholding taxes.⁴⁰ The court found this argument did not constitute reasonable cause for failing to file.

One taxpayer, who had brought multiple separate actions before the Tax Court asserting frivolous arguments, argued that he was not subject to the income tax laws because he did not consent to being a taxpayer.⁴¹ The Tax Court held he failed to show reasonable cause.

Miscellaneous Arguments: One taxpayer argued that she had reasonable cause for failing to file because her husband had advised her that they were not required to file and threatened to leave her if she did, which would have injured her financially.⁴² The court, in rejecting the taxpayer’s arguments, held that courts have never found threats from a spouse as reasonable cause for failing to file and because there was no evidence the husband had any income or assets, the court could not find how his threat would cause financial injury. In addition, the court stated that the taxpayer’s reliance on her husband’s advice did not constitute reliance on a tax professional and she had not shown reasonable cause.

³⁴ IRC § 6702 imposes a penalty of \$5,000 for filing a frivolous return.

³⁵ IRM 20.1.2.1.6.2 (Sept. 4, 2009) (citing Rev. Rul. 2007-19, 2007-1 C.B. 843).

³⁶ See *Turner v. Comm’r*, T.C. Memo. 2004-251, and the numerous cases cited therein.

³⁷ T.C. Memo. 2009-271.

³⁸ *Ulloa v. Comm’r*, T.C. Memo. 2010-68.

³⁹ *Hodges v. Comm’r*, T.C. Memo. 2009-179.

⁴⁰ *Lizalek v. Comm’r*, T.C. Memo. 2009-122.

⁴¹ *Florance v. Comm’r*, T.C. Memo. 2009-155. See also *Florance v. Comm’r*, T.C. Memo. 2009-154.

⁴² *Wolffgram v. Comm’r*, T.C. Memo. 2010-69.

In *New York Guangdong Finance, Inc. v. Commissioner*,⁴³ a foreign company failed to file tax returns, arguing that it believed that the company was exempt from paying taxes under a treaty. The court found the company was liable for taxes. Moreover, reliance on a statement of the company's president that the firm was exempt was not reasonable. The court noted that even if the company had been exempt from paying the tax, it was not exempt from filing a return.

A few taxpayers argued that the assessment of penalties violated the Paperwork Reduction Act. In upholding the failure to file penalty, the court in *Springer v. Commissioner*⁴⁴ stated the Act was not applicable to the failure to file penalty because it does not affect a taxpayer's obligation to file federal income tax returns.

A constant theme throughout the cases we reviewed is that the existence of reasonable cause in any given case depends on all the facts and circumstances of the case.⁴⁵ In addition, in eight of the 69 cases where the IRS had asserted the failure to file penalty, the courts also imposed a penalty under IRC § 6673 for taking a frivolous position.⁴⁶

Estimated Tax Penalty

Courts routinely found taxpayers liable for the IRC § 6654 estimated tax penalty when the Commissioner proved the taxpayers had a tax liability, had no withholding credits, and did not make any estimated tax payments for that year, and the taxpayers offered no evidence to refute the Commissioner's evidence.⁴⁷

The IRS has the burden of production under IRC § 7491(c) to produce evidence that a taxpayer was required to make four required installments under IRC § 6654(c)(1). In six of the eight cases where taxpayers prevailed on the estimated tax penalty for some or all of the years at issue, their success was a result of the IRS failing to meet its burden of production regarding the appropriateness of the penalty. For example, in *Davenport v. Commissioner*, the Tax Court held that the Commissioner failed to introduce evidence showing whether a taxpayer filed a return for the preceding year and the amount of tax shown on that return. The IRS did not satisfy the burden of production because it was impossible to determine whether the taxpayer had a required annual payment that was payable in four installments.⁴⁸

⁴³ 588 F.3d 889 (5th Cir. 2009), *aff'd* T.C. Memo. 2008-62.

⁴⁴ 508 F.3d 1142 (10th Cir. 2009), *aff'd* 231 Fed. Appx. 793 (10th Cir. 2007), *petition for cert. denied*, 130 S. Ct. 1907 (2010).

⁴⁵ IRM 20.1.1.3.2 (Dec. 11, 2009).

⁴⁶ Under IRC § 6673, the Tax Court is authorized to impose a penalty against a taxpayer if the taxpayer takes a frivolous position in a proceeding. The maximum penalty is \$25,000. See Most Litigated Issue: *Frivolous Issues Penalty and Related Appellate-Level Sanctions Under Internal Revenue Code Section 6673*, *infra*.

⁴⁷ See, e.g., *Evans v. Comm'r*, T.C. Memo. 2010-62; *Houston v. Comm'r*, T.C. Memo. 2009-286.

⁴⁸ T.C. Memo. 2009-248.

CONCLUSION

The U.S. tax system relies on taxpayers voluntarily filing accurate returns and paying their taxes. Penalties attempt to establish fairness in the system by imposing an additional cost on the noncompliant taxpayer. The penalties for failure to file and failure to pay estimated tax were implemented to encourage voluntary compliance.⁴⁹

The IRS should determine whether imposing these penalties positively influences compliance as intended. Congress should again consider the National Taxpayer Advocate's recommendation of a one-time abatement of the failure to file penalty for taxpayers who comply with their filing obligations, but in an untimely manner.⁵⁰ This proposal would broaden the definition of reasonable cause by providing the IRS the authority to abate a late filing penalty for inadvertent taxpayer mistakes, while still encouraging the IRS's goal of voluntary compliance.

⁴⁹ See Policy Statement 20-1 (Formerly P-1-18), IRM 1.2.20.1.1 (June 29, 2004). See also *United States 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."). For an in-depth discussion of IRS penalty administration, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 2 (*A Framework for Reforming the Penalty Regime*).

⁵⁰ 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(Dec. 11, 2009), the National Taxpayer Advocate continues to recommend a statutory waiver similar to IRC § 6656(c).

MLI
#7**Frivolous Issues Penalty and Related Appellate-Level Sanctions
Under Internal Revenue Code Section 6673****SUMMARY**

During the 12 months between June 1, 2009, and May 31, 2010, the federal courts issued decisions in at least 39 cases involving the Internal Revenue Code (IRC) § 6673 “frivolous issues” penalty, and at least nine 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 The United States Tax Court or a United States District Court raised IRC § 6673 *sua sponte*³ in a number of cases.⁴ In many of these cases, taxpayers escaped liability for the penalty but were warned that they could face sanctions for similar conduct in the future.⁵ Similarly, we identified two cases at the appellate level where the court did not impose a sanction under IRC § 7482(c)(4) or any other authority, but did warn the taxpayer that similar future conduct will result in a sanction.⁶ 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.⁷ The maximum penalty is \$25,000.⁸ In some cases, the IRS requests that the Tax Court impose the penalty;⁹ in other cases, the Tax Court exercises its discretion, *sua sponte*, to impose the penalty.

¹ In two cases, the U.S. Courts of Appeals both affirmed the imposition of the Internal Revenue Code (IRC) § 6673 penalty and addressed the issue of an additional sanction against the taxpayer for filing a frivolous appeal. Thus, the total number of cases we identified as involving frivolous claims is 46.

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 “*Sua sponte*” means without prompting or suggestion. Black’s Law Dictionary 1424 (6th ed. 1990). 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.

⁴ See, e.g., *Hamilton v. Comm’r*, T.C. Memo. 2009-271.

⁵ See, e.g., *Carney v. Comm’r*, T.C. Memo. 2009-310. Note, however, that in at least one case where the Tax Court *sua sponte* imposed the penalty, the taxpayer was held liable for a \$25,000 penalty. See *Davenport v. Comm’r*, T.C. Memo. 2009-248.

⁶ *Landess v. Comm’r*, 357 Fed. Appx. 167 (10th Cir. 2009); *Landess v. Comm’r*, 357 Fed. Appx. 171 (10th Cir. 2009).

⁷ IRC § 6673(a)(1)(A), (B), and (C).

⁸ IRC § 6673(a)(1).

⁹ The standards for the IRS’s decision to seek sanctions under IRC § 6673(a)(1) are found in the Chief Counsel Directives Manual. See CCDM 35.10.2 (Aug. 11, 2004). For sanctions of opposing parties, under IRC § 6673(a)(2), all requests for sanctions are reviewed by the designated agency sanctions officer under Executive Order 12988 on Civil Justice Reform. This review ensures uniformity on a national basis. See, e.g., CCDM 35.10.2.2.3 (Aug. 11, 2004).

Taxpayers who institute an action pursuant to IRC § 7433¹⁰ in a U.S. District Court for damages against the United States could be subject to a maximum penalty of \$10,000 if the court determines the taxpayer's position in the proceedings is frivolous or groundless.¹¹ In addition, IRC § 7482(c)(4),¹² § 1927 of Title 28 of the U.S. Code,¹³ and Rule 38 of the Federal Rules of Appellate Procedure¹⁴ (among other laws and rules of procedure) authorize federal courts to impose penalties against taxpayers or attorneys for raising frivolous arguments or using litigation tactics primarily to delay the collection process. Because the sources of authority for imposing appellate-level sanctions are numerous and some of these sanctions may be imposed in non-tax cases, this report focuses primarily on the IRC § 6673 penalty. However, the table of cases presented in Table 7 of Appendix III lists nine tax cases in which U.S. Courts of Appeals considered sanctions under other authorities.

ANALYSIS OF LITIGATED CASES

We analyzed 39 opinions issued between June 1, 2009, and May 31, 2010, that addressed the IRC § 6673 penalty. Thirty-four of these opinions were issued by the Tax Court, one by a U.S. District Court, and four were issued by U.S. Courts of Appeals on appeals brought by taxpayers who sought review of the Tax Court's imposition of the penalty. Notably, the Courts of Appeals sustained the Tax Court's position in all four cases. A detailed list of all cases appears in Table 7 of Appendix III.

In 21 cases, the Tax Court imposed penalties under IRC § 6673, with the amounts ranging from \$500 to the maximum of \$25,000. One taxpayer in the 46 cases we examined was represented by an attorney; all others appeared *pro se*. The taxpayers in these cases presented a wide variety of arguments that the courts have generally rejected on numerous occasions. Upon encountering these arguments, the courts almost invariably cited the language set forth in *Crain v. Commissioner*:

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

¹⁰ IRC § 7433(a) allows taxpayers a civil cause of action against the United States if an IRS employee intentionally or recklessly disregards any IRC provision or regulation promulgated under the IRC.

¹¹ IRC § 6673(b)(1).

¹² 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.

¹³ 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.

¹⁴ 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.

¹⁵ *Crain v. Comm'r*, 737 F.2d 1417, 1417-18 (5th Cir. 1984).

In the cases we reviewed, taxpayers raised the following issues that the Tax 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 frivolous positions):

- **Citizens of certain states are not subject to income taxes.** At least one taxpayer argued that as a resident of a “sovereign,” “compact,” or “independent” state, he is not subject to income taxes imposed by the United States government.¹⁶ The Tax Court imposed a penalty in the amount of \$10,000.
- **IRS forms and notices violate the Paperwork Reduction Act (PRA) because they do not display a valid Office of Management and Budget (OMB) Control Number.** In at least two cases, taxpayers argued the IRS forms and notices they received violated the PRA.¹⁷ Under the PRA, OMB is given authority to review an agency “collection of information” and to assign a control number to each “collection of information” it approves.¹⁸ If a “collection of information” does not display a current control number or fails to state that the request for information is not subject to the PRA, the PRA provides that a person cannot be subject to a penalty for the failure to maintain or provide information.¹⁹ These taxpayers argued that because certain IRS forms and notices do not contain OMB control numbers, the PRA protects them from any penalties for failure to comply with the IRS’s request for information. Interestingly, although the courts have consistently rejected such arguments,²⁰ in the two cases we reviewed, the Tax Court declined to impose the IRC § 6673 penalty but cautioned the taxpayers that similar arguments in the future would result in a penalty.
- **Only income earned from the United States government is taxable.** Taxpayers in at least three cases presented arguments that only federal government employees, public servants, or those who earn income from the United States government are subject to the income tax.²¹

¹⁶ See *Holmes v. Comm’r*, T.C. Memo. 2010-42.

¹⁷ See, e.g., *Lizalek v. Comm’r*, T.C. Memo. 2009-122; *Turner v. Comm’r*, T.C. Memo. 2010-44.

¹⁸ 44 U.S.C. §§ 3502, 3504, 3507(a).

¹⁹ 44 U.S.C. § 3512.

²⁰ See *U.S. v. Dawes*, 951 F.2d 1189, 1191-93 (10th Cir. 1991) (citations omitted).

²¹ See, e.g., *Bigley v. Comm’r*, T.C. Memo. 2010-29.

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.²² Taxpayers avoided the IRC § 6673 penalty in only eight of the cases where the IRS requested the penalty, demonstrating the willingness of the courts to impose a penalty when the taxpayer makes frivolous arguments or institutes 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.²³ 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, 2009, and May 31, 2010, and will often impose further appellate-level sanctions on taxpayers who assert frivolous arguments.

²² See, e.g., National Taxpayer Advocate 2009 Annual Report to Congress 461-464.

²³ See, e.g., *Hamilton v. Comm’r*, T.C. Memo. 2009-271 (court raised the issue *sua sponte* and found taxpayer liable for \$2,000 penalty for “burdening respondent and this court with frivolous arguments.”).

MLI
#8**Civil Actions to Enforce Federal Tax Liens or to Subject Property
to Payment of Tax Under Internal Revenue Code Section 7403****SUMMARY**

Internal Revenue Code (IRC or “Code”) § 7403 authorizes the United States to file a civil action in a United States District Court against a taxpayer who has refused or neglected to pay any tax, to enforce the federal tax lien, or to subject any of the delinquent taxpayer’s property to the payment of the tax. We identified 46 opinions issued between June 1, 2009, and May 31, 2010, that involved civil actions to enforce federal tax liens under IRC § 7403. The courts affirmed the position of the United States in the majority of cases. Taxpayers prevailed in only five cases and one case resulted in a split decision. This is the second year that this issue has appeared as a Most Litigated Issue in the National Taxpayer Advocate’s Annual Report to Congress.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 tax liability, by initiating a civil action in the appropriate United States District Court against a taxpayer who has refused or neglected to pay any tax.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 U.S. District 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 where the forced sale involves the interests of non-delinquent third parties, a U.S. District Court should consider the following four factors when determining whether the property should be sold:

¹ See 2009 National Taxpayer Advocate Annual Report to Congress 465-470.

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

³ IRC § 7403(b).

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

⁵ *U.S. 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. *U.S. v. Craft*, 535 U.S. 274 (2002).

⁶ IRC § 7403(c).

⁷ *Rodgers*, 461 U.S. at 711.

- 1) The extent to which the government's financial interests would be prejudiced if they were relegated to a forced sale of the partial interest of the delinquent taxpayer;
- 2) Whether the innocent third party with a separate interest in the property, in the normal course of events, has a legally recognized expectation that the property would not be subject to a forced sale by the delinquent taxpayer or his or her 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 IRS may bid at the sale of the property when it holds a first lien.⁹ However, 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 an action to foreclose their lien on the property which is subject to the 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 proper party¹¹ and may remove the case to the U.S. District Court if such action 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 Code 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 46 opinions entered between June 1, 2009, and May 31, 2010, in civil actions to enforce federal tax liens. Table 8 in Appendix III contains a detailed list of those cases. In the majority of cases, taxpayers represented themselves (*pro se*).¹⁵ Taxpayers with representation received full relief in three cases and partial relief in one case, while *pro se* taxpayers prevailed in two cases.

⁸ *Rodgers*, 461 U.S. at 709-11.

⁹ IRC § 7403(c).

¹⁰ *Id.*

¹¹ IRC § 7424; 28 U.S.C. § 2410. If the application of the IRS to intervene is denied, the adjudication in such civil action or suit does not have any effect upon the federal tax lien. IRC § 7424.

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

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

¹⁴ IRC §§ 7403(d) and 7402(a).

¹⁵ Seventeen of 46 taxpayers were represented by counsel. Of those 17 cases, the IRS prevailed in 13, three cases resulted in victories for taxpayers, and one case ended in a split decision.

The issue of whether it was appropriate to foreclose the federal tax lien against the taxpayer's real property was the most prevalent issue. It was considered in 38 cases,¹⁶ with the government prevailing fully in 33 of these cases.¹⁷ A typical case is *United States v. Miller*,¹⁸ in which the government filed an action to foreclose its tax liens and sell the taxpayer's real property to which the liens had attached. First, the court determined the taxpayer had failed to show that tax liabilities assessed against her were incorrect.¹⁹ Second, the court determined that she had not paid the assessed liabilities; consequently, the federal tax liens attached to all of the taxpayer's property.²⁰ Next, the court established that the assessments were made within the applicable statute of limitations period and after notice and demand.²¹ Finally, the court ordered foreclosure of the valid federal tax liens against the taxpayer's real property.

However, in *United States v. Anderson*,²² the court denied the government's motion for summary judgment, finding that the taxpayer's spouse should be granted time to answer the complaint to address the equities of displacing her from the home by selling the home in its entirety.²³ Similarly, the court in *United States v. Toler*²⁴ issued a split decision, finding that material issues existed as to ownership of certain parcels of property and whether other parcels had been conveyed fraudulently to avoid foreclosure.

Another common issue litigated by the government was foreclosure of federal tax liens against the taxpayer's property titled in the name of a nominee.²⁵ For example, in *United States v. DeTar*,²⁶ the taxpayers, a husband and wife, owed federal taxes. The husband sought to create a trust for the stated purpose of educating his children. However, at the time the trust was created, the husband admitted to the trust creator that he had not paid his federal income tax for several years and that he wanted to transfer certain real property into the trust in order to avoid tax liens that the government might place upon the

¹⁶ See, e.g., *U.S. v. Brown*, 105 A.F.T.R.2d (RIA) 1450 (D.N.J. 2010); *U.S. v. Dix*, 103 A.F.T.R.2d (RIA) 1448 (E.D. Wis. 2009); *U.S. v. Hockensmith*, 104 A.F.T.R.2d (RIA) 5133 (M.D. Pa. 2009); *U.S. v. Morehouse*, 104 A.F.T.R.2d (RIA) 5001 (D. Or. 2009).

¹⁷ In four cases, the United States Courts of Appeals affirmed the trial court's decision in favor of the government. See *U.S. v. Evans*, 340 Fed.Appx. 990 (5th Cir. 2009); *U.S. v. Filson*, 347 Fed. Appx. 987 (5th Cir. 2009); *U.S. v. Navolio*, 334 Fed. Appx. 204 (11th Cir. 2009); *U.S. v. Offiler*, 336 Fed. Appx. 907 (11th Cir. 2009).

¹⁸ *U.S. v. Miller*, 105 A.F.T.R.2d (RIA) 2636 (S.D. Ala. 2010).

¹⁹ Once the Government introduces into evidence a certificate of assessments and payments (Form 4340), it establishes a presumption of correctness with respect to the tax assessment and constitutes a *prima facie* case of liability on the part of the taxpayer. The burden then shifts to the taxpayer to show that the assessment was not properly made. *United States v. White*, 466 F.3d 1241, 1248 (11th Cir. 2006). In *Miller*, the Government had introduced the Form 4340, and the taxpayer had offered no evidence to refute the presumption of correctness.

²⁰ If a taxpayer, after notice and demand for a payment, refuses or fails to pay, a "secret" lien that attaches to all the taxpayer's property or rights to property arises upon assessment under IRC §§ 6321 and 6322.

²¹ See generally IRC § 6501.

²² 104 A.F.T.R.2d (RIA) 7609 (W.D.N.Y. 2009).

²³ *United States v. Anderson*, 104 A.F.T.R.2d (RIA) 7609 (W.D.N.Y. 2009).

²⁴ *U.S. v. Toler*, 666 F. Supp. 2d 872 (S.D. Ohio 2009).

²⁵ See, e.g., *U.S. v. Springer*, 105 A.F.T.R.2d 1192 (N.D. Okla. 2010); *U.S. v. DeTar, et. al.*, 104 A.F.T.R.2d (RIA) 5572 (W.D. Mich. 2009); *U.S. v. Morgan*, 105 A.F.T.R.2d (RIA) 442 (M.D. Fla. 2010).

²⁶ *U.S. v. DeTar*, 104 A.F.T.R.2d (RIA) 5572 (W.D. Mich. 2009).

property. The United States argued the trust was simply the nominee of the taxpayers and that the true beneficial owners of the property were the taxpayers, not the trust. The court determined the trust was the nominee of the taxpayers²⁷ and the lien properly attached to the property purportedly owned by the trust, and ordered foreclosure of the real property.

CONCLUSION

Enforcement activities by the IRS, including filings of Notices of Federal Tax Lien (NFTLs), continue to increase yearly. In fiscal year (FY) 2002, the IRS filed over 482,000 NFTLs, whereas in FY 2009 the IRS filed over 965,000 NFTLs, an increase of approximately 100 percent in just seven years.²⁸ Between FY 2008 and FY 2009 alone, NFTL filings increased by nearly 200,000.²⁹ This rise in NFTL filings has led more taxpayers to contest the foreclosure actions on these liens in the federal court system. As the IRS continues to increase enforcement activities such as filing NFTLs, we expect the number of court cases involving suits to foreclose liens will also continue to increase.

²⁷ The court applied the *Porta-John* factors to determine nominee status: (1) whether the nominee paid no consideration or inadequate consideration; (2) whether the property was placed in the name of the nominee in anticipation of litigation or liabilities; (3) whether there is a close relationship between the transferor and the nominee; (4) whether the parties to the transfer failed to record the conveyance; (5) whether the transferor retained possession; and (6) whether the transferor continues to enjoy the benefits of the transferred property. *Porta-John of Am., Inc. v. United States*, 4 F. Supp. 2d 688, 701 (E.D. Mich. 1998).

²⁸ The IRS filed approximately 492,000 NFTLs in FY 2002 and 965,618 in FY 2009. Statistics of Income Data Books, Table 16b, Delinquent Collection Activities 2002-2009.)

²⁹ The IRS filed 768,168 NFTLs in FY 2008 and 965,618 in FY 2009. Statistics of Income Data Books, Table 16b, Delinquent Collection Activities 2002-2009.

MLI
#9**Family Status Issues Under Internal Revenue Code
Sections 2, 24, 32, and 151****SUMMARY**

Because family status issues center on interrelated exemptions, credits, and filing statuses claimed on federal tax returns, cases litigated in this area often involve multiple issues with similar factual determinations. This report combines the following issues into a single “family status” category:

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

We reviewed 45 federal court opinions issued between June 1, 2009, and May 31, 2010. Many of these opinions cover multiple family status issues, with the determination of one often affecting others. For example, a denial of the dependency exemption will lead to the summary denial of the child tax credit and may impact eligibility for head of household filing status. In tax year 2009, over 20 million taxpayers filed as head of household, nearly 26 million received the EITC, and more than 55 million sought some form of dependency exemption.⁵

PRESENT LAW**Uniform Definition of Qualifying Child**

Before 2005, the Internal Revenue Code (IRC) contained multiple definitions of a “child” for purposes of filing status, deductions, and tax credits associated with dependent children.⁶ Effective for tax years after December 31, 2004, the Working Families Tax Relief Act (WFTRA) established a uniform definition of a qualifying child (UDOC) with respect to four family status provisions: head of household filing status, the child tax credit, the EITC, and the dependency deduction.⁷ The clear intent of the UDOC legislation was to bring about some uniformity for the vast majority of taxpayers who had to meet multiple tests

¹ Internal Revenue Code (IRC) § 2(b).

² IRC § 24.

³ IRC § 32.

⁴ IRC § 151.

⁵ IRS Compliance Data Warehouse (CDW), Individual Returns Transaction File for Tax Year 2009, updated through cycle 39 (Oct. 8, 2010).

⁶ *E.g.*, IRC § 2(b) (head of household); IRC § 21 (child and dependent care credit); IRC § 24 (child tax credit); IRC § 32 (EITC); IRC § 151 (dependency exemption). IRC § 7703(b) provides an exception to the general determination of whether an individual is married and states that certain married persons who are living apart from their spouses may be treated as unmarried.

⁷ The Working Families Tax Relief Act, Pub. L. No. 108-311, § 201, 118 Stat. 1166, 1169 (2004). Further, UDOC applies to determining whether a taxpayer qualifies for an income inclusion under IRC § 129.

to determine if they were eligible to claim an exemption, credit, or filing status under the basic family status provisions.⁸ Under UDOC eligibility rules, a dependent must be either a “qualifying child” or a “qualifying relative.”⁹ The other family status provisions incorporate UDOC, but retain rules specific to each IRC section (such as age and income restrictions). These family status provisions impact almost 85 million individual taxpayers, with the benefits potentially reaching 82 million children nationwide.¹⁰

Qualifying Child

In general, an individual must meet four tests to be claimed as a qualifying child under UDOC.

- 1. Relationship Test.** The child must be the taxpayer’s child (including an adopted child, stepchild, or eligible foster child), brother, sister, stepbrother, stepsister, or descendant of one of these relatives. An adopted child includes a child lawfully placed with a taxpayer for legal adoption even if the adoption is not final. An eligible foster child is any child placed with a taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.¹¹
- 2. Residency Test.** The child must live with the taxpayer for more than half of the tax year. Exceptions apply for temporary absences for special circumstances: children who were born or died during the year, children of divorced or separated parents, and kidnapped children.¹²
- 3. Age Test.** The child must be under a certain age, depending on the tax benefit claimed, to be a qualifying child.¹³
- 4. Support Test.** The child cannot provide more than half of his or her own support during the year.¹⁴

Qualifying Relative

An individual who does not meet the requirements for a qualifying child may still be claimed as a dependent if he or she meets the requirements for a qualifying relative.¹⁵ Again, four tests must be met to claim someone as a qualifying relative.

⁸ Nina E. Olson, *Uniform Qualifying Child Definition: Uniformity for Most Taxpayers*, 111 Tax Notes 225 (Apr. 10, 2006). See also National Taxpayer Advocate 2006 Annual Report to Congress 463.

⁹ IRC § 152(a).

¹⁰ IRS CDW, Individual Returns Transaction File for Tax Year 2008. These figures are calculated for all taxpayers with at least one qualifying child or dependent, benefiting from at least one of the four “family status” provisions discussed in this Most Litigated Issue.

¹¹ IRC §§ 152(c)(1)(A); 152(c)(2); 152(f)(1).

¹² IRC §§ 152(c)(1)(B); 152(f)(6); Treas. Reg. § 1.152-2(a)(2)(ii).

¹³ IRC § 152(c)(1)(C).

¹⁴ IRC § 152(c)(1)(D).

¹⁵ IRC § 152(a).

Relationship Test. The individual must be:

- A child or a descendant of a child;
- A brother, sister, stepbrother, or stepsister;
- The father, mother, or an ancestor of either;
- A stepfather or stepmother;
- A son or daughter of a brother or sister of the taxpayer;
- A brother or sister of the father or mother of the taxpayer;
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or
- An individual (other than the spouse) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.¹⁶

5. **Gross Income Test.** An individual must have gross income below the amount allowed for a personal exemption for the taxable year.¹⁷

6. **Support Test.** The taxpayer must provide more than one-half of the individual's support for the calendar year in which the taxable year begins.¹⁸

7. **Not a Qualifying Child.** In general, an individual may not be a qualifying child of the taxpayer or any other taxpayer for the taxable year.¹⁹ IRS Notice 2008-5 clarifies when an individual would be considered "not a qualifying child."²⁰

The taxpayer can claim a personal exemption deduction for a dependent who meets the tests of a qualifying relative.²¹

Tie-Breaker Rule

Sometimes a child meets the tests to be a qualifying child for more than one person. However, only one taxpayer can claim that child as a qualifying child. If multiple taxpayers meet the test with respect to the same qualifying child, they may decide among themselves who will claim the child. If they cannot agree, and more than one taxpayer files a return

¹⁶ IRC §§ 152(d)(1)(A); 152(d)(2). However, IRC § 152(f)(3) provides that an individual shall not be treated as a member of the taxpayer's household if at any time during the taxable year the relationship between such individual and the taxpayer is in violation of local law.

¹⁷ IRC § 152(d)(1)(B).

¹⁸ IRC § 152(d)(1)(C).

¹⁹ IRC § 152(d)(1)(D).

²⁰ See Notice 2008-5, 2008-1 C.B. 256. The purpose of this notice is to provide guidance under IRC § 152(d) for determining whether an individual is a qualifying relative for whom the taxpayer may claim a dependency exemption deduction under IRC § 151(c); specifically, that under IRC § 152(d)(1)(D) an individual is not a qualifying relative of the taxpayer if the individual is a qualifying child of any other taxpayer. This notice clarifies that a taxpayer otherwise eligible to claim a dependency exemption deduction for an unrelated child is not prohibited by IRC § 152(d)(1)(D) from claiming the deduction if the child's parent (or other person with respect to whom the child is defined as a qualifying child) is not required by IRC § 6012 to file an income tax return and (i) does not file a return, or (ii) files only to obtain a refund of withheld income taxes.

²¹ IRC §§ 152(d); 151(c).

claiming the child, the IRS will use the tie-breaker rules explained in the table below to determine which taxpayer can claim the child.²² Before 2005, the only family status provision that had a tie-breaker rule was the EITC. With the passage of UDOC, the tie-breaker rules now cover all four family status provisions. Generally, the same taxpayer is entitled to all of the applicable family status benefits with respect to the same qualifying child – or to put it another way, generally taxpayers may not “split the baby” and divide the benefits among themselves.²³ Table 3.9.1 below describes how the tie-breaker rule applies.

TABLE 3.9.1, Tie-Breaker Rule When More Than One Person Files a Return Claiming the Same Qualifying Child

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

Special Rule for Divorced or Separated Parents

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

- The parents are divorced, legally separated, or lived apart at all times during the last six months of the year;
- The child received over half of his or her support for the year from the parents;
- The child is in custody of one or both parents for more than half the year; and
- The custodial parent releases the claim to the dependency exemption in a written declaration that the noncustodial parent attaches to his or her tax return.²⁴

A custodial parent is the parent having custody of the child for the greater part of the calendar year.²⁵ Accordingly, the other parent is the noncustodial parent.²⁶ The special rule for divorced or separated parents allows the noncustodial parent to claim the dependency

²² IRC § 152(c)(4).

²³ See Notice 2006-86, 2006-2 C.B. 680. This notice provides interim guidance to clarify the rule under IRC § 152(c)(4), as amended by WFTRA, for determining which taxpayer may claim a qualifying child when two or more taxpayers claim the same child, and discusses the IRC § 152(e) exception to the prohibition against “splitting the baby,” which is only available for divorced or separated parents.

²⁴ IRC § 152(e); Notice 2006-86, 2006-2 C.B. 680. See also Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents* (used to release the dependency exemption to the noncustodial parent). The custodial parent may, in lieu of Form 8332, use a similar written statement that meets the requirements of the form. Treas. Reg. § 1.152-4(e)(1) requires that the declaration include an unconditional statement that the custodial parent will not claim the child as a dependent for the years covered by the declaration. As required under Treas. Reg. § 1.152-4(e)(1)(ii), noncustodial parent taxpayers divorced after July 2, 2008, may not attach pages of a divorce decree or separation agreement to substantiate a dependency exemption claim, whereas those divorced on or before that date may continue to do so if the pages constitute a statement substantially similar to the form.

²⁵ IRC § 152(e)(4)(A).

²⁶ IRC § 152(e)(4)(B).

exemption and child tax credit. However, the noncustodial parent may not claim head of household filing status, the credit for child and dependent care expenses, or the EITC; these tax benefits may be claimed only by the custodial parent if all other requirements are met.

The statute does not define “custody.” When a child resides with one parent for part of a day and with the other parent for the remainder of that day, it can be difficult to calculate how much time the child spends in the custody of each parent.²⁷ Under regulations published on July 2, 2008, the custodial parent is the one who resides with the child for the greater number of nights during the calendar year.²⁸ The regulations also adopt the rule enunciated by the United States Tax Court in *King v. Commissioner*:²⁹ that the IRC § 152(e) rules for divorced or separated parents also apply to parents who never married.³⁰

ANALYSIS OF LITIGATED CASES

As in previous years, most family status cases litigated during our review period were small Tax Court cases.³¹ Most of the cases address factual disputes and not novel issues of law.³²

Pro Se Analysis

Taxpayers were represented by counsel in only six of the 45 cases litigated this year, even though many cases were highly fact-specific and involved a complicated web of statutory provisions. Out of 45 cases, taxpayers with representation received partial relief in one case, while *pro se* taxpayers received full relief in four cases and partial relief in six cases.³³ It appears that many taxpayers did not understand the complex family status provisions or know what evidence to submit; thus, the assistance of counsel (or lack thereof) might have affected the courts’ rulings. A detailed list of all family status cases analyzed appears in Table 9 in Appendix III.

Cases Decided Where UDOC Applied

As expected, because UDOC has become operative only recently, the number of cases where UDOC applied has greatly increased since 2008. This year, UDOC applied in nearly 87 percent of family status cases (39 of 45). UDOC appears to have made the decision process easier for the courts by simplifying the “qualifying child” analysis with respect to head of household filing status, the child tax credit, the EITC, and the dependency deduction.

²⁷ See, e.g., *Bjelland v. Comm’r*, T.C. Memo 2009-297 (discussing in detail how a child’s time in custody is quantified).

²⁸ Treas. Reg. § 1.152-4(d)(1).

²⁹ 121 T.C. 245 (2003).

³⁰ Treas. Reg. § 1.152-4(b)(2)(C).

³¹ In certain tax disputes involving \$50,000 or less, taxpayers may elect to have their case conducted under the simplified small tax case procedure. Trials in small tax cases are generally less formal and result in a speedier disposition. However, decisions in these cases cannot be appealed or cited as precedent. See IRC § 7463.

³² The cases analyzed in this section often involve multiple family status issues. Therefore a single case might be listed and analyzed in multiple family status categories, though there are only 45 cases discussed.

³³ Out of seven cases with split decisions, six taxpayers were *pro se*. Thus, among taxpayers appearing *pro se* during the relevant period, about 26 percent succeeded in at least one of their family status claims.

Moreover, the UDOC reduces the burden on taxpayers who now need only to establish the existence of a “qualifying child” under one standard, rather than several.

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

We reviewed 18 cases involving head of household status, with six taxpayers prevailing on this issue – although in one case only the mother and not the father prevailed.³⁴ However, taxpayers succeeded in full in a few circumstances. For example, in *Gaitor v. Commissioner*,³⁵ the IRS denied the taxpayer’s entitlement to head of household filing status in the statutory notice of deficiency. Under Tax Court Rule 142(a), the taxpayer had the burden of proving entitlement to head of household status to the court.³⁶ The taxpayer was an unmarried father of four, employed by the Florida state courts. Because the child at issue lived with the taxpayer for most of the year, was seven years old at the time of the assessed deficiency (and thus met the age and self-support requirements of IRC § 152(c)), and was not claimed as a dependent by his mother (or released by his father), the Tax Court was easily persuaded that the taxpayer was eligible for head of household status.³⁷

In many other cases, taxpayers had difficulty proving entitlement to head of household status, usually due to a lack of tax planning or a misunderstanding of the legal requirements. For example, in *Byles v. Commissioner* the taxpayer claimed head of household status under the theory that his nephews were qualifying children and his sister was a qualifying relative.³⁸ The court disallowed the filing status, finding the nephews were not qualifying children because the taxpayer’s sister (their mother) claimed them as dependents (despite living with the taxpayer and receiving most of their support from him), and the sister was not a qualifying relative because she reported slightly more than \$3,300 of income, which was in excess of the personal exemptions amount for that year.³⁹ Because his sister effectively blocked the taxpayer’s ability to claim his nephews as qualifying children and dependents, he was also prevented from claiming the dependency exemption, EITC, and Child Tax Credit, which collectively would have provided the family with greater financial benefit as the taxpayer earned substantially more than his sister. The taxpayer’s frustration in this case is typical of the cases reviewed.

³⁴ *Bjelland v. Comm’r*, T.C. Memo. 2009-297. In this case, the petitioners were parents who lived apart during the year in question. Each parent claimed the son as their dependent. Upon analysis of the facts, the court found that the mother was the custodial parent and entered a decision for her and against the father.

³⁵ T.C. Memo 2010-70.

³⁶ See Tax Court Rule 142(a) (“The burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in the answer, it shall be upon the respondent.”); *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79 (1992).

³⁷ *Gaitor v. Comm’r*, T.C. Memo. 2010-70.

³⁸ T.C. Summ. Op. 2010-25. This case does not have precedential value and is being used for illustration.

³⁹ See IRC § 152(d).

Child Tax Credit

We reviewed 26 cases involving the child tax credit, in which all but one taxpayer appeared *pro se*, and in which taxpayers prevailed in full in four cases (all of which were *pro se*). To receive the child tax credit, the taxpayer must be able to claim the child as a dependent on his or her tax return, and the child must meet the requirements of IRC § 152(c).⁴⁰ In *Sheikh v. Commissioner*, the taxpayer was not eligible for the child tax credit because the dependents claimed by the taxpayer did not meet the relationship test under IRC § 152(c)(2) (*i.e.*, they were not the qualifying children or qualifying relatives of the taxpayer).⁴¹

In *Litton v. Commissioner*, the taxpayer was able to receive the child tax credit for the 2006 tax year.⁴² To receive the credit for a child of divorced parents, the taxpayer must show that the dependents meet the special qualifying children requirements, including the custody test under IRC § 152(e)(1), which was the main issue in this case. The taxpayer testified to the total amount of time she had custody of the claimed dependents (her two children), and provided a detailed annotated calendar to support her claims. The court held that though the children spent “slightly more” time in the taxpayer’s custody during the school year, what “tipped the custody scales” was the taxpayer’s custody of the children over the summer, allowing her to claim them as qualifying children. An interesting aspect of this case was that the taxpayer attempted to exchange summer custody for the husband’s signature on a Form 8832, *Release of Claim to Exemption for Child of Divorced or Separated Parents*, which she believed would ensure a “fair” result for both parties in light of a complex custody agreement. The children’s primary address was listed as the ex-husband’s home, and thus when he did not sign the form and tried to claim the children as his dependents, the IRS sent a notice of deficiency to the taxpayer. The court noted the vagueness of the custody requirement, especially for divorced couples whose children shuttled between them, before agreeing that in this instance the children are the taxpayer’s qualifying children. This case highlights a pattern of confusion regarding the use of Form 8832, discussed in more detail with respect to IRC § 151.

Earned Income Tax Credit

We reviewed 19 cases involving the EITC, with two taxpayers (both of whom were *pro se*) prevailing in full on this issue. Taxpayers appeared *pro se* in 17 of the 19 cases. Several themes appear throughout the EITC cases.

- The taxpayer could not prove the child lived at the taxpayer’s principal place of abode for at least half of the taxable year;
- The taxpayer was married but did not file a joint return during the tax year he or she claimed the EITC; and
- The taxpayer’s income exceeded the adjusted gross income limitation.

⁴⁰ *Sheikh v. Comm’r*, T.C. Memo. 2010-33.

⁴¹ T.C. Memo. 2010-33.

⁴² *Litton v. Comm’r*, T.C. Summ. Op. 2010-16. This case does not have precedential value and is being used for illustration.

In *Reyes v. Commissioner*, the government moved to dismiss the taxpayer's refund claim for EITC because: (1) his claim was not made timely; and (2) his girlfriend's children were not qualifying children as defined in IRC § 32(c)(3)(A).⁴³ The court granted the IRS's motion to dismiss the taxpayer's claim for 2002, but denied the IRS's motion to dismiss the suit for other tax years. The court noted that the taxpayer was granted EITC in 2000 based on one of his girlfriend's children, leading to a "plausible inference" that the taxpayer may qualify, at least partially, for EITC.⁴⁴

In *Scott v. Commissioner*, the taxpayer claimed one of his nieces and one of his nephews as dependents and qualifying children in 2004 and 2006.⁴⁵ The court allowed his EITC claim for 2004, but disallowed it for 2006. The taxpayer could not convince the court he held the same principal place of abode as the children in the latter year, as required under IRC § 152(c)(1)(B), because of inconsistent testimony and evidence relating to an apartment he allegedly rented for a girlfriend.

Dependency Exemption – IRC §151

We reviewed 38 cases involving the dependency exemption, with three taxpayers (all of whom were *pro se*) prevailing in full. Taxpayers appeared *pro se* in all but three of the 38 cases.

Taxpayers continue to experience particular trouble with the requirements for releasing or securing dependency exemption claims through Form 8332, or an equivalent document.⁴⁶ In *Thomas v. Commissioner*, the court denied the exemption because a Form 8832 was not attached to the return and because the taxpayer's divorce decree was not a substantial equivalent of the form and conditioned entitlement to the exemption on payment of child support.⁴⁷ Further, in *Himes v. Commissioner*, the court held that the noncustodial parent could not claim dependency exemptions for his sons without a signed release from their custodial parent, despite the taxpayer's payment of child support and his ex-wife's failure to comply with both the divorce decree and state law.⁴⁸

In *Adler v. Commissioner*, the taxpayer claimed a dependency deduction for his adult daughter for tax years 2001 through 2004 and for his son-in-law for 2002 through 2004.⁴⁹ During those years, the daughter and son-in-law attended college together. The taxpayer

⁴³ *Reyes v. Comm'r*, 105 A.F.T.R.2d (RIA) 830 (E.D. Cal. 2010).

⁴⁴ *Id.*

⁴⁵ *Scott v. Comm'r*, T.C. Memo. 2009-211.

⁴⁶ The final regulations under IRC § 152(e), made effective July 2, 2008, require the release of a claim to the dependency exemption must be on Form 8332 or must be a "document executed for the sole purpose of serving as a written declaration" that the custodial parent is not claiming the dependency exception for a child in a given tax year. See IRC § 152(e)(2).

⁴⁷ *Thomas v. Comm'r*, T.C. Memo. 2010-11.

⁴⁸ *Himes v. Comm'r*, T.C. 2010-97. See *Gessic v. Comm'r*, T.C. Memo. 2010-88 (co-signed page from a separation agreement did not constitute a declaration releasing claim to dependency exemptions because the signatures were undated, the page did not identify the minor children, and the exemptions were conditioned on the taxpayer remaining current on child support payment, and the ex-wife's employment status).

⁴⁹ *Adler v. Comm'r*, T.C. Memo. 2010-47.

testified that he paid for his daughter's expenses, including tuition, textbooks, room and board, and clothes; and later paid for his son-in-law's car and auto insurance, groceries, and other bills. While the court was convinced that the taxpayer paid some of his daughter's expenses, and found it plausible that he paid some of his son-in-law's expenses as well, none of the taxpayer's claims were supported by adequate records or other credible evidence. Because the taxpayer could not meet the support test, the court denied the dependency exemption deductions.

CONCLUSION

Family status provisions still seem to be a confusing area for taxpayers, even though the number of cases we have identified declined significantly in recent years. We reviewed 34 cases in the 2008 Annual Report to Congress,⁵⁰ down from 41 in the 2007 report⁵¹ and 46 in 2006.⁵² However, the number of family status cases rose to 48 in 2009 and is only slightly lower at 45 in 2010.⁵³

The increase in family status cases supports the National Taxpayer Advocate's position that these provisions of the tax code still contain complicated and sometimes conflicting eligibility standards. Because of this complexity, tax return filing can be a difficult and confusing exercise for low and middle income families. Taxpayers who wish to claim the family status credits and deductions often do not understand the qualification requirements or how to properly satisfy them. Further, such taxpayers often lack legal representation when they go before the courts, which may adversely affect the outcomes of their cases. In an effort to build on the improvements made by UDOC and reduce the complexity of these provisions even more, the National Taxpayer Advocate proposed a legislative recommendation in her 2005 Annual Report to Congress on how to restructure the requirements governing these provisions to make them easier for taxpayers to understand, thereby reducing complexity.⁵⁴ The National Taxpayer Advocate updated her 2005 recommendation in the 2008 Annual

⁵⁰ National Taxpayer Advocate 2008 Annual Report to Congress 537.

⁵¹ National Taxpayer Advocate 2007 Annual Report to Congress 634.

⁵² National Taxpayer Advocate 2006 Annual Report to Congress 555.

⁵³ National Taxpayer Advocate 2009 Annual Report to Congress 478. It is not clear what caused the recent increase in family status cases, although one possible explanation could be IRS correspondence examination procedures. See National Taxpayer Advocate 2009 Annual Report to Congress 158; National Taxpayer Advocate 2008 Annual Report to Congress 243. The way the IRS conducts these examinations has affected results. For several years, the IRS has had high levels of "unassociated" correspondence (*i.e.*, taxpayers send in documentation but the IRS does not align it with the case, and sends a statutory notice of deficiency, so the taxpayers must go to court). See National Taxpayer Advocate 2008 Annual Report to Congress 243; National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 94 (IRS Earned Income Credit Audits – A Challenge to Taxpayers).

⁵⁴ National Taxpayer Advocate 2005 Annual Report to Congress 397. This proposal included the following recommendations: (1) combine the exemptions, child tax credit, and part of the EITC into a refundable family credit comprising two components – one for the taxpayer (and his or her spouse) and one for whomever is the "main caregiver" of a child or children based on a per-child amount; (2) separate the child and dependent care credits into two credits; (3) eliminate head-of-household filing status; (4) modify the EITC so that it provides a refundable credit to low income workers based solely on the taxpayer's earned income and is available to workers age 18 and over, regardless of the existence of children in the household; (5) permit married taxpayers who have a legal and binding separation agreement and who live separate and apart as of the last day of the calendar year to be considered "not married" for purposes of filing status; and (6) provide a separate credit for noncustodial parents.

Report to Congress, once again highlighting the importance of creating a less complex tax system.⁵⁵

Since her 2001 Annual Report to Congress, the National Taxpayer Advocate has recommended several times that Congress create an additional credit for noncustodial parents who pay substantially all of a child's support.⁵⁶ The National Taxpayer Advocate believes this credit would reduce litigation and give recognition to the noncustodial parent's ability to pay taxes.

⁵⁵ National Taxpayer Advocate 2008 Annual Report to Congress 363.

⁵⁶ See National Taxpayer Advocate 2008 Annual Report to Congress 368; National Taxpayer Advocate 2005 Annual Report to Congress 397-398; National Taxpayer Advocate 2001 Annual Report to Congress 122.

MLI
#10**Relief From Joint and Several Liability Under Internal Revenue Code Section 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

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 35 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2009, and May 31, 2010, as well as one decision, *Lantz v. Commissioner*,³ issued on June 8, 2010. The most significant issue the courts addressed this year is the period of time within which a taxpayer may request relief under IRC § 6015(f). The Tax Court also explored the doctrine of *res judicata* and its exception under IRC § 6015(g)(2),⁴ and the effect of a family court order that first required a taxpayer to file amended returns electing joint filing status, then allocated liability for the resulting tax.⁵ Finally, one district court decision demonstrates that the issue persists as to whether IRC § 6015 can be raised as a defense in a collection suit.⁶

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;

¹ Internal Revenue Code (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 IRC § 6015(f) expressly use the term “deficiency” and IRC § 6015(b)(1)(B) refers to an “understatement of tax.”

² The National Taxpayer Advocate, in her 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.

³ 607 F.3d 479 (7th Cir. 2010), *rev'g and remanding* 132 T. C. 131 (2009).

⁴ *Diehl v. Comm'r*, 134 T.C. No. 7 (2010). Under the doctrine of *res judicata*, a judgment on the merits in a prior suit bars a second suit involving the same tax year.

⁵ *Bruen v. Comm'r*, T.C. Memo 2000-249.

⁶ 105 A.F.T.R.2d 2827 (S.D. Ohio 2010), *adopted by* 105 A.F.T.R.2d (RIA) 2831 (S.D. Ohio 2010).

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

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.⁹ Relief is not available for amounts attributable to fraud, fraudulent schemes, or certain transfers of disqualified assets.¹⁰ Finally, no credit or refund is allowed as a result of relief granted under IRC § 6015(c).¹¹

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

⁸ Not all actions that involve collection will trigger the two-year limitations period. Under the regulations, only the following four events constitute “collection activity” that will 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).

⁹ IRC § 6015(c)(3)(C).

¹⁰ IRC § 6015(c)(4),(d)(3)(C).

¹¹ IRC § 6015(g)(3).

Equitable Relief Under IRC § 6015(f)

IRC § 6015(f) provides that the Secretary may relieve a taxpayer from liability for both deficiencies and underpayments¹² where the taxpayer demonstrates that:

1. Relief under IRC § 6015(b) or (c) is unavailable; and
2. Taking into account all the facts and circumstances, it would be inequitable to hold the taxpayer liable for the underpayment or deficiency.

One of the regulations under IRC § 6015(f) requires the taxpayer to request relief under IRC § 6015(f) within two years after the IRS initiates collection activity with respect to the taxpayer.¹³ As discussed in last year's report, the U.S. Tax Court, in *Lantz v. Commissioner*, held that this regulation is invalid.¹⁴ This year, the United States Court of Appeals for the Seventh Circuit reversed the Tax Court and held that the two-year rule is a valid interpretation of IRC § 6015(f).¹⁵

Revenue Procedure 2003-61 lists some of the factors the IRS considers in determining whether equitable relief is appropriate.¹⁶ These factors include marital status, economic hardship, knowledge or reason to know, legal obligations of the nonrequesting spouse, significant benefit to the requesting spouse, compliance with income tax laws, and abuse.

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 § 6015.¹⁷ 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.¹⁸ However, 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.¹⁹ 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

¹² 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, 158-159 (2003).

¹³ Treas. Reg. §1.6015-5(b)(1).

¹⁴ 132 T.C. 131 (2009).

¹⁵ *Lantz v. Comm'r*, 607 F.3d 479 (7th Cir. 2010), *rev'g and remanding* 132 T.C. 131 (2009). In *Hall v. Comm'r*, 135 T.C. No. 19 (Sept. 22, 2010), decided after the Seventh Circuit's reversal in *Lantz*, the Tax Court continued to disagree with the Seventh Circuit and held the taxpayer was entitled to relief even though the request was not made within the two-year period.

¹⁶ Rev. Proc. 2003-61, 2003-2 C.B. 296.

¹⁷ IRC § 6015(h)(2).

¹⁸ Rev. Proc. 2003-19, 2003-5 C.B. 371.

¹⁹ IRC § 7442; *Maier v. Comm'r*, 119 T.C. 267 (2002), *aff'd*, 360 F.3d 361 (2d Cir. 2004) (holding that there are no provisions in IRC § 6015 that allow the nonrequesting spouse to petition the Tax Court from a notice of determination).

the proceeding to dispute or support the requesting spouse's claim for relief.²⁰ However, an intervening spouse has no standing to appeal the Tax Court's decision to the United States Court of Appeals.²¹

Judicial Review

Taxpayers seeking relief under IRC § 6015 generally file Form 8857, *Request for Innocent Spouse Relief*.²² 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.²³ The Tax Relief and Health Care Act of 2006 (TRHCA) 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.²⁴

ANALYSIS OF LITIGATED CASES

We analyzed 35 opinions issued between June 1, 2009, and May 31, 2010, including 32 cases in the Tax Court, one each in the United States Courts of Appeals for the Sixth and Ninth Circuits, and one in a U.S. District Court. In addition, we analyzed one opinion issued on June 8, 2010, by the United States Court of Appeals for the Seventh Circuit. Sixty-one percent of the cases (22 of 36) were decided in favor of the IRS, 28 percent (ten of 36) in favor of the taxpayer (including two cases in which only the intervenor opposed granting relief), and 11 percent (four of 36) ended in split decisions. In 56 percent (20 of 36) of the cases, the taxpayers were *pro se* (i.e., they represented themselves). Taxpayers prevailed in 25 percent (five of 20) of the cases in which they proceeded *pro se*; one other *pro se* taxpayer obtained a split decision. The nonrequesting spouse intervened in 28 percent of the cases (ten of 36).

Seventy-two percent of the cases (26 of 36) involved an analysis of whether to grant relief. Thirty-one percent of the cases (11 of 36) involved procedural issues,²⁵ with 55 percent (six of 11) of these cases decided in favor of the IRS, 36 percent (four of 11) in favor of the taxpayer, and one case a split decision.

Of the 26 cases decided on the merits, 62 percent (16 of 26) were decided in favor of the IRS, 27 percent (seven of 26) in favor of the taxpayer, and in 12 percent (three cases) the

²⁰ *Van Arsdalen v. Comm'r*, 123 T.C. 135 (2004).

²¹ *Baranowicz v. Comm'r*, 432 F.3d 972 (9th Cir. 2005).

²² See IRS Form 8857, *Request for Innocent Spouse Relief, Instructions* (Sept. 2010).

²³ IRC § 6015(e)(1)(A)(ii).

²⁴ 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 § 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.

²⁵ The percentages add up to more than 100 and the number of cases adds up to more than 36 because one case that addressed procedural issues also contained an analysis of whether to grant relief.

court split its decision.²⁶ See Table 10 in Appendix III for a detailed breakdown of the cases.

Procedural Issues

The most significant procedural issue courts addressed is the validity of a Treasury regulation that requires a taxpayer to request relief under IRC § 6015(f) within two years after the IRS commences collection activity. Additionally, the Tax Court discussed the doctrine of *res judicata* and its exception under IRC § 6015(g)(2), and one district court continued the disturbing trend of holding that a taxpayer was not entitled to raise innocent spouse relief as a defense in a collection suit.

Lantz v. Commissioner

As reported last year, in *Lantz v. Commissioner*²⁷ the Tax Court considered the validity of Treasury Regulation § 1.6015-5(b)(1), which requires the requesting spouse to make an election for relief under IRC § 6015(f) within two years after the IRS initiates collection activity against the requesting spouse. The court held that the regulation was not entitled to judicial deference because it failed the test articulated by the Supreme Court in *Chevron*,²⁸ noting:

[T]he Supreme Court created a two prong test: (1) If Congress has directly spoken to the precise question at issue, the court is to give effect to the unambiguously expressed intent of Congress. If the statute is ambiguous, then the court is to continue to the second prong: (2) If the statute is ambiguous with respect to the specific issue, the court is to determine whether the regulation is a permissible construction of the statute.²⁹

The Tax Court, applying the first prong, found IRC § 6015 is not ambiguous because while IRC § 6015 (b) and (c) both contain the two-year limitation at issue, IRC § 6015(f) does not; Congress had “spoken” by its “audible silence” in not including the two-year limitation in IRC § 6015(f). Congress’ intent in enacting IRC § 6015(f) was to address inequitable situations not addressed by subsections (b) and (c); adopting the timing rule that Congress had imposed on subsections (b) and (c) but had specifically omitted from subsection (f) ran directly contrary to the nature of the relief provided by Congress, and for that reason was invalid. For argument’s sake, the Tax Court also considered the second prong of the *Chevron* analysis and found the regulation’s one-size-fits-all approach for both traditional and equitable relief was an invalid interpretation of IRC § 6015(f).³⁰ The IRS appealed the

²⁶ These percentages add up to more than 100 due to rounding.

²⁷ *Lantz v. Comm’r*, 132 T.C. 131 (2009) reversed and remanded by 607 F.3d 479 (7th Cir. 2010).

²⁸ *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

²⁹ *Lantz v. Comm’r*, 132 T.C. 131, 137-138 (2009), reversed and remanded by 607 F.3d 479 (7th Cir. 2010).

³⁰ *Lantz v. Comm’r*, 132 T.C. 131 (2009), reversed and remanded by 607 F.3d 479 (7th Cir. 2010).

Tax Court's decision to the United States Court of Appeals for the Seventh Circuit, which reversed and remanded the case to the Tax Court.³¹

The Seventh Circuit rejected the Tax Court's use of "audible silence" as a reliable guide to interpreting the statute. The court noted that where a statute does not impose a time limit for bringing a claim, it does not necessarily follow that there is no deadline. As Congress is aware, courts may "borrow" a deadline from other statutes as a means of preventing stale claims. Administrative agencies also impose deadlines when none is provided by statute; the Treasury was doing nothing unusual in imposing a two-year deadline for claims under IRC § 6015(f).

The Seventh Circuit rejected the argument that IRC § 6015(f) in fact contains a deadline due to the operation of IRC § 6502, which imposes a ten-year statute of limitations on collection.³² Moreover, according to the Seventh Circuit, any deadline (or substitute for a deadline such as the equitable doctrine of laches) for bringing claims under IRC § 6015(f) other than two years would undermine the provisions of IRC § 6015(b) and (c), both of which contain a two-year deadline.³³ This is because a taxpayer who meets the criteria for relief under IRC § 6015(b) also qualifies for relief under IRC § 6015(f). Many taxpayers who qualify for relief under IRC § 6015(f) would be eligible for relief under subsection (c) as well. Without the two-year rule imposed by the regulations under § 6015(f), taxpayers who do not qualify for relief under IRC § 6015(b) or (c) because of the two-year rule would be eligible for relief under IRC § 6015 (f). The two-year deadline in IRC § 6015 (b) and (c) would simply be substituted with the time limit, if any, contained in § 6015(f). Ultimately, keeping in mind that Treasury regulations are entitled to judicial deference, especially when issued pursuant to a specific grant of authority like IRC § 6015(f), the court held that the regulation was a valid interpretation of the statute.³⁴

In addition to appealing the Tax Court's decision in *Lantz*, the IRS has filed an appeal in five other United States Courts of Appeals. The IRS has appealed this issue to the Third Circuit in *Mannella v. Commissioner*,³⁵ the Second Circuit in *Coulter v. Commissioner*,³⁶ the Sixth Circuit in *Buckner v. Commissioner*,³⁷ the Ninth Circuit in *Carlile v. Commissioner*,³⁸ and the Fourth Circuit in *Jones v. Commissioner*.³⁹ Due to the significance of this developing

³¹ *Lantz v. Comm'r*, 607 F.3d 479 (7th Cir. 2010), *rev'g and remanding* 132 T.C. 131 (2009).

³² The court noted that IRC § 6502 is not a constraint on taxpayer action. As long as the IRS attempts to collect the tax within the ten-year period, nothing in IRC § 6502 limits the time within which the taxpayer must make a claim for relief under IRC § 6015(f).

³³ The doctrine of laches operates to bar relief for claims that are brought after unreasonable delay prejudicial to the defendant. See *Lantz v. Comm'r*, 607 F.3d 479, 483 (7th Cir. 2010), *rev'g and remanding* 132 T.C. 131 (2009).

³⁴ IRC § 6015(f) commences with "under procedures prescribed by the Secretary," and IRC § 6015(h) provides that "the Secretary shall prescribe such regulations as are necessary to carry out the provisions of this section [IRC § 6015]."

³⁵ 132 T.C. 196 (2009), *appeal docketed*, No. 07-175310 (3rd Cir. Jan. 25, 2010).

³⁶ Tax Court Docket No. 1003-09, *appeal docketed*, No. 10-680 (2nd Cir. Feb. 24, 2010).

³⁷ Tax Court Docket No. 12153-09, *appeal docketed*, No. 10-2056 (6th Cir. Aug. 18, 2010).

³⁸ Tax Court Docket No. 011567-09, *appeal docketed*, No. 10-72578 (9th Cir. Aug. 23, 2010).

³⁹ Tax Court Docket No. 017359-08, *appeal docketed*, No. 10-1985 (4th Cir. Aug. 30, 2010).

issue, the National Taxpayer Advocate this year reiterates her 2006 legislative recommendation that Congress amend IRC § 6015(f) to clarify that taxpayers may seek relief under IRC § 6015(f) for as long as the period of limitations on collection under IRC § 6502 remains open.⁴⁰ Moreover, in Volume 2 of this year's Annual Report, the National Taxpayer Advocate analyzes the legislative history of IRC § 6015 and its antecedents, concluding that Congress did not intend to impose the two-year time limit on equitable claims for relief.⁴¹ Additionally, a bill introduced in the U.S. House of Representatives on August 10, 2010 would eliminate any time limit for granting relief under IRC § 6015(f).⁴²

At the administrative level, during a nine-month period following the Tax Court's decision in *Lantz*, the IRS referred both docketed and nondocketed cases to the Cincinnati Centralized Innocent Spouse Unit for an evaluation of the merits of the claims.⁴³ However, on March 12, 2010, the IRS Office of Chief Counsel "designated for litigation" the two-year issue, meaning that the IRS will not settle this issue, and no administrative appeal would be available.⁴⁴

On April 5, 2010, the IRS began issuing letters that gave two options to requesting spouses who filed IRC § 6015(f) claims after the two-year period had expired: suspend their claims pending the outcome of litigation "in the courts"; or receive a final notice of determination denying relief.⁴⁵ The notice of determination would not include an evaluation of the merits of the claim. Taxpayers who did not affirmatively choose either of these options within 30 days were issued final notices of determination. Thus, taxpayers continue to receive notices of determination in *Lantz*-type cases and petition the Tax Court on this issue.⁴⁶

Deihl v. Commissioner

In *Deihl v. Commissioner*,⁴⁷ the Tax Court applied the doctrine of *res judicata* and an exception to it under IRC § 6015(g)(2). The doctrine of *res judicata* generally bars subsequent proceedings involving a tax year for which the Tax Court has entered a decision.

⁴⁰ See National Taxpayer Advocate 2006 Annual Report to Congress 540-541; Legislative Recommendation: *Allow Taxpayers to Raise Relief Under Internal Revenue Code Sections 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*, *supra*.

⁴¹ See *Unlimit Innocent Spouse Equitable Relief*, vol. 2, *infra*.

⁴² H.R. 6089, 111 Cong. (2010).

⁴³ See IRS Appeals, Exam Programs - Innocent Spouse, *Actions to Be Taken on Cases Involving the 2-Year Rule in IRC 6015(f) Cases*, issued June 10, 2009, available at http://appeals.web.irs.gov/tech_services/innocentspouse/Documents/Lantz%20guidance%20_06102009.pdf.

⁴⁴ Notice CC-2010-005 (Mar. 12, 2010); IRS Appeals, Exam Programs - Innocent Spouse, *Designation for Litigation: Validity of Two-year Deadline for Section 6015(f) Requests for Relief*, issued Mar. 19, 2010, available at http://appeals.web.irs.gov/tech_services/innocentspouse/default.htm. See also CCDM 33.3.6.1, *Designating a Case for Litigation* (Aug. 11, 2004). The IRS designates cases for litigation when it believes there is a critical need for enforcement activity with respect to recurring, significant legal issues affecting large numbers of taxpayers. The IRS takes the position that designation for litigation is in the interest of sound tax administration to establish judicial precedent, conserve resources, or reduce litigation costs for the IRS and taxpayers.

⁴⁵ See Letter 4581-C available at <http://serp.enterprise.irs.gov/databases/forms-ltrs-pubs.dr/crltrs.dr/c.dr/4581c.htm>.

⁴⁶ As of Aug. 28, 2010, of the 2,693 taxpayers to whom the IRS's Cincinnati Centralized Innocent Spouse Operation sent Letters 4581-C describing these options, 1,383 requested suspension of their claims, 135 opted for a final notice of determination, and 1,175 were issued a final notice of determination because they did not respond to the letter. E-mail from Wage and Investment division (W&I) Compliance (Sept. 1, 2010).

⁴⁷ 134 T.C. No. 7 (2010).

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 if the court determines that the taxpayer did not meaningfully participate in the prior proceeding. In a prior proceeding, the taxpayer in *Deihl* and her spouse litigated their tax liabilities for 1996, 1997, and 1998, and the taxpayer raised the issue of relief under IRC § 6015 with respect to 1996. The taxpayer did not predicate her claim for relief on any specific subsection of IRC § 6015, and was ineligible to make an election under IRC § 6015(c) because she was married and not separated from her husband when she made her claim. The Tax Court, in addressing this issue of first impression, held that the taxpayer had not meaningfully participated in the prior proceeding. Therefore, the doctrine of *res judicata* barred the taxpayer from raising relief from liability under IRC § 6015 with respect to 1996 only under subsections (b) and (f), and not under subsection (c). Because the taxpayer's husband died after the opinion in the prior proceeding had been filed but before final decisions were entered, the taxpayer was entitled to make an election for relief under IRC § 6015(c) for 1996. In addition, the court held that the taxpayer could claim relief under IRC § 6015 (b), (c), and (f) with respect to 1997 and 1998.

United States v. Wallace

In *United States v. Wallace*, the taxpayer raised IRC § 6015 as a defense in an action to reduce joint federal tax assessments to judgment.⁴⁸ Before taking this action, the taxpayer-husband had requested relief from joint and several liability with the IRS with respect to tax years 1995 through 1998. The IRS denied the request as untimely because the husband had submitted it more than two years after the first collection activity. The court noted that because the claim was untimely, “no relief could have been granted under 26 U.S.C. § 6015(b)(1)(E),” and did not consider whether relief under IRC § 6015(f) might be available. Consequently, the court did not explore the Tax Court's opinions in *Lantz* or *Mannella*.

The *Wallace* case also continued the 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 collection suits in district court.⁴⁹ 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 (emphasis added). In recent years, however, the district courts have not been willing to consider the validity of innocent spouse claims in the context of a suit to reduce the assessment to judgment,

⁴⁸ 105 A.F.T.R.2d 2827 (S.D. Ohio), *adopted by* 105 A.F.T.R.2d (RIA) 2831 (S.D. Ohio).

⁴⁹ See 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 twice recommended that legislation clarify that taxpayers may raise relief under IRC §§ 6015 and 66 as a defense in collection actions. See National Taxpayer Advocate 2009 Annual Report to Congress 378; National Taxpayer Advocate 2007 Annual Report to Congress 549.

such as in *Wallace*, or in a foreclosure suit.⁵⁰ In *Wallace*, the court relied on *United States v. Boyton*⁵¹ and held that a district court only has jurisdiction to consider an IRC § 6015 claim in the context of a refund suit and exclusive jurisdiction lies with the Tax Court in all other circumstances. According to the court in *Wallace*, the only way the taxpayer will be permitted to raise his IRC § 6015 claim is to pay the tax and seek a refund in a separate proceeding.⁵² Because taxpayers continue to be harmed by this trend in the district courts, the National Taxpayer Advocate reiterates her recommendation that legislation clarify that taxpayers may raise innocent spouse relief as a defense in collection actions.⁵³

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 of the tax deficiency. All three avenues for relief contain a knowledge element or factor, making it the linchpin in most of the courts' analyses.⁵⁴ Actual or constructive knowledge was a factor in 22 of the 26 decisions 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 required to be shown on the return. One case decided this year illustrates how the Tax Court evaluated a taxpayer's knowledge of an underpayment where the joint return arose as a consequence of divorce proceedings.

In *Bruen v. Commissioner*,⁵⁵ the taxpayer and her spouse filed separate returns for 2002 and 2003. The taxpayer paid the tax shown on her separate returns, but her spouse did not pay the tax shown on his returns. The taxpayer divorced her husband in 2004. In dividing the couple's assets, the family court ordered the couple to file amended returns for 2002 and 2003, using the filing status of married filing jointly. The court's judgment provided that each ex-spouse would be liable for one half of the 2003 tax liability, but was silent as to responsibility for the 2002 liability because it mistakenly assumed the liability had already been paid. The taxpayer and her ex-spouse filed the joint returns as ordered; the returns for both years showed liabilities attributable entirely to the former husband's earnings. Neither the taxpayer nor her ex-husband paid the tax shown on the joint returns, and the

⁵⁰ See *U.S. v. Boyton*, 99 A.F.T.R.2d (RIA) 920 (S.D. Cal. 2007); *U.S. v. Bucy*, 100 A.F.T.R.2d (RIA) 6666 (S.D. W. Va. 2007); *U.S. v. Feda*, 97 A.F.T.R.2d (RIA) 1985, 1989 (N.D. Ill. 2006) (taxpayer could not raise IRC § 6015 as a defense in a suit to reduce assessment to judgment); *U.S. v. Cawog*, 97 A.F.T.R.2d (RIA) 3069 (W.D. Pa. 2006), *appeal dismissed* (3d Cir. July 5, 2007) (taxpayer could not raise IRC § 6015 as a defense in a suit to foreclose tax liens).

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

⁵² The court in *Wallace* erroneously asserted that the refund action based on IRC § 6015 must proceed *simultaneously* with the Tax Court case. If a court were to apply this interpretation, then the taxpayer would have no prepayment forum in which to assert his IRC § 6015 claim. The taxpayer would petition the Tax Court and at the same time have to pay the tax and file a refund claim. IRC § 6015(e)(3) provides that if a suit for refund is commenced, the Tax Court loses jurisdiction over the IRC § 6015 claim to the extent jurisdiction is acquired by the district court.

⁵³ See Legislative Recommendation: *Allow Taxpayers to Raise Relief Under Internal Revenue Code Sections 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*, *supra*.

⁵⁴ 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).

⁵⁵ T.C. Memo. 2009-249.

taxpayer claimed that she should be relieved of liability for the underpayments under IRC § 6015(f). The IRS denied her claim, finding that because the taxpayer knew her former husband would not pay the portion of the liability assigned to her by the family court, she was not entitled to any relief for 2003. The Tax Court agreed that the taxpayer knew that her former husband would not pay the portion of the liability that had been assigned to her, and was therefore not entitled to relief for those amounts. However, the Tax Court found that the taxpayer did not know or have reason to know that her ex-husband would not pay the portion of the liability that had been assigned to him. Noting that “section 6015(f) allows relief ‘for any unpaid tax or any deficiency (*or any portion of either*)’ (emphasis added),” the court held that the taxpayer was entitled to relief from liability for those amounts. The Tax Court applied the same analysis to the 2002 liability, holding that the taxpayer was entitled to relief from liability for the portion the family court had assigned to her former husband, but not from liability for the portion the family court had assigned to her. Finally, the Tax Court analyzed the taxpayer’s claim for relief in the light of all the facts and circumstances, applying the factors found in Revenue Procedure 2003-61.⁵⁶ The court found that while several of the factors weighed in the taxpayer’s favor, her knowledge that her former husband would not pay the portion of the liability that the family court had assigned to her, as well as the family court’s allocation of liability in the context of an overall allocation of the couple’s debts, led to the conclusion that equitable relief beyond half of the tax liability was not appropriate.

The National Taxpayer Advocate has proposed legislation that would eliminate joint and several liability for joint filers and would tax each spouse only on his or her own income.⁵⁷ Adoption of such a proposal would eliminate the need for innocent spouse relief in most instances, as well as the attendant inquiry into a spouse’s knowledge.

CONCLUSION

This year, the courts continued to address the procedural issue of whether the Treasury regulation that imposes a two-year time period within which a requesting spouse must elect relief under IRC § 6015(f) was invalid. The United States Court of Appeals for the Seventh Circuit, reversing the Tax Court, held that the regulation is valid. The issue is before five other United States Courts of Appeals. In addition, the Tax Court clarified that a nonspecific claim for relief under IRC § 6015 does not necessarily mean that all subsections of IRC § 6015 are at issue for purposes of applying the doctrine of *res judicata* and its exception under IRC § 6015(g)(2). With respect to determinations on the merits, issues concerning the requesting spouse’s knowledge continued to predominate. Finally, the issue of whether IRC § 6015 can be raised as a defense in a collection suit continues to create difficulty for taxpayers.

⁵⁶ 2003-2 C.B. 296.

⁵⁷ National Taxpayer Advocate 2005 Annual Report to Congress 407.