

INTRODUCTION: Most Litigated Issues

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

TAS identified the Most Litigated Issues from June 1, 2015, through May 31, 2016, by using commercial legal research databases. For purposes of this section of the Annual Report, the term “litigated” means cases in which the court issued an opinion.² This year’s Most Litigated Issues are:

- Accuracy-Related Penalty (IRC § 6662(b)(1) and (2));³
- Appeals From Collection Due Process (CDP) hearings (IRC §§ 6320 and 6330);
- Summons Enforcement (IRC §§ 7602(a), 7604(a), and 7609(a));
- Gross Income (IRC § 61 and related Code sections);
- Trade or Business Expenses (IRC § 162(a) and related Code sections);
- Failure to File Penalty (IRC § 6651(a)(1)), Failure to Pay Penalty (IRC § 6651(a)(2)), and Failure to Pay Estimated Tax Penalty (IRC § 6654);
- Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax (IRC § 7403);
- Charitable Deductions (IRC § 170);
- Frivolous Issues Penalty (IRC § 6673 and related appellate-level sanctions); and
- Trust Fund Recovery Penalty (IRC § 6672).⁴

All of these issues were identified as Most Litigated Issues last year, with the exception of the trust fund recovery penalty, which replaced relief from joint and several liability for spouses as the tenth most litigated issue.⁵ This issue last appeared in a Most Litigated Issues section in 2005.⁶ Accuracy-related penalties remained the top litigated issue this year, and we identified 122 cases, nine more than the 113 cases we identified last year.⁷ This works out to an eight percent increase, the second largest increase in any category of cases. CDP cases experienced the largest percentage increase, as we identified 99 cases this year compared with 79 cases last year, a 25 percent increase.⁸ We also observed declines from last year of more than 25 percent in three categories of cases. The number of failure to file, failure to pay, and failure

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

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

3 Internal Revenue Code (IRC) § 6662 also includes (b)(3), (b)(4), (5), (6), (7), and (8), but because those types of accuracy-related penalties were not heavily litigated, we have only analyzed (b)(1), and (2).

4 In addition to the cases we identified in the ten Most Litigated Issues, we identified 42 cases under IRC §§ 7407 and 7408, which involve United States District Court actions to enjoin tax return preparers, and actions to enjoin specified conduct related to tax shelters and reportable transactions, respectively. However, because the majority of these cases did not involve substantive decisions on the merits, we did not include this category of cases in our Most Litigated Issues section.

5 See National Taxpayer Advocate 2015 Annual Report to Congress 426.

6 *Id.* at 543.

7 *Id.* at 429.

8 *Id.* at 481.

to pay estimated tax penalty cases dropped from 63 to 45, a 29 percent decrease, the largest percentage drop in any category.⁹ Cases involving civil actions to enforce federal tax liens decreased from 44 to 32, a 27 percent decrease.¹⁰ Finally, the number of trade or business expense cases dropped from 99 to 73, a 26 percent decrease.¹¹

Overall, the total number of cases identified in the Most Litigated Issues section dropped from 640 in 2015 to 609 this year, a five percent decrease from last year,¹² and continuing the downward trend in the number of cases over the last few years.¹³ We also noticed a slight dip from last year in the percentage of cases involving *pro se* taxpayers, as 60 percent of cases involved *pro se* taxpayers as compared to 62 percent in 2015.¹⁴

Once TAS identified the Most Litigated Issues, we analyzed each one in five sections: summary of findings, taxpayer rights impacted, description of present law, analysis of the litigated cases, and conclusion.¹⁵ Each case is listed in Appendix 3, which categorizes the cases by type of taxpayer (*i.e.*, individual or business).¹⁶ Appendix 3 also provides the citation for each case, indicates whether the taxpayer was represented at trial or argued the case *pro se* (*i.e.*, without representation), and lists the court's decision.¹⁷

We have also included a “Significant Cases” section summarizing decisions that are not among the top ten issues but are relevant to tax administration. In this section, we used the same reporting period, beginning on June 1, 2015, and ending on May 31, 2016, that we used for the ten Most Litigated Issues.

9 See National Taxpayer Advocate 2015 Annual Report to Congress 499.

10 *Id.* at 509.

11 *Id.* at 459.

12 *Id.* at 427.

13 We identified 731 cases in 2014 and 877 cases in 2013. See National Taxpayer Advocate 2014 Annual Report to Congress 425; National Taxpayer Advocate 2013 Annual Report to Congress 324.

14 See National Taxpayer Advocate 2015 Annual Report to Congress 429.

15 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR that was adopted by the IRS are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

16 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.

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

AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

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

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

With limited exceptions, taxpayers have an automatic right of appeal from the decisions of any of these courts.¹⁸

The Tax Court is a “prepayment” forum. In other words, taxpayers can access the Tax Court without having to pay the disputed tax in advance. The Tax Court has jurisdiction over a variety of issues, including deficiencies, certain declaratory judgment actions, appeals from CDP hearings, relief from joint and several liability, and determination of employment status.¹⁹

The United States District Courts and the United States Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,²⁰ and (2) the taxpayer has filed an administrative claim for refund.²¹ The United States District Courts, along with the bankruptcy courts in very limited circumstances, provide the only fora in which a taxpayer can receive a jury trial.²² Bankruptcy courts can adjudicate tax matters that were not adjudicated prior to the initiation of a bankruptcy case.²³

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

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

20 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).

21 IRC § 7422(a).

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

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

ANALYSIS OF PRO SE LITIGATION

As in previous years, many taxpayers appeared before the courts *pro se*. Figure 3.0.1 lists the Most Litigated Issues for the review period June 1, 2015, through May 31, 2016, and identifies the number of cases, categorized by issue, in which taxpayers appeared without representation. As the figure illustrates, the issues with the highest rates of *pro se* appearance are CDP and the frivolous issues penalty.

FIGURE 3.0.1, Pro Se Cases by Issue

Most Litigated Issue	Litigated Cases Reviewed	Pro Se Litigation	% of Cases Involving Pro Se Taxpayers
Accuracy-Related Penalty	122	70	57%
Collection Due Process	99	66	67%
Summons Enforcement	87	49	56%
Gross Income	81	49	60%
Trade or Business Expenses	73	45	62%
Failure to File, Failure to Pay, and Estimated Tax Penalties	45	28	62%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	32	18	56%
Charitable Deductions	26	10	38%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	23	22	96%
Trust Fund Recovery Penalty	21	6	29%
Total	609	363	60%

Figure 3.0.2 affirms our contention that taxpayers are more likely to prevail if they are represented. However, the disparity in the success rate between *pro se* and represented taxpayers decreased for the second consecutive year.²⁴ *Pro se* taxpayers prevailed in 17 percent of cases this year as compared to 19 percent last year, an 11 percent decrease in success rate. Notably, represented taxpayers fared worse than last year, achieving a 22 percent success rate as compared to 28 percent last year, a 21 percent decrease in success rate. Thus, for this year, the success rate for represented taxpayers was only five percent greater than that of *pro se* taxpayers.

FIGURE 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
Accuracy-Related Penalty	70	22	31%	52	14	27%
Collection Due Process	66	8	12%	33	8	24%
Summons Enforcement	49	1	2%	38	7	18%
Gross Income	49	3	6%	32	5	16%
Trade or Business Expenses	45	15	33%	28	8	29%
Failure to File, Failure to Pay, and Estimated Tax Penalties	28	2	7%	17	3	18%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	18	1	6%	14	1	7%
Charitable Deductions	10	3	30%	16	4	25%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	22	6	27%	1	1	100%
Trust Fund Recovery Penalty	6	2	33%	15	2	13%
Total	363	63	17%	246	53	22%

²⁴ See National Taxpayer Advocate 2015 Annual Report to Congress 430.

Significant Cases

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

In *Altera Corp. & Subs. v. Commissioner*, the Tax Court held Treasury regulations were invalid because the government failed to engage in “reasoned decisionmaking” by articulating a rational connection between the facts and the “arms-length” standard it adopted.²

In 1997, Altera Corp. (Altera), a Delaware corporation, and its foreign subsidiary agreed to share the cost of a research and development project. However, they did not share the cost of the stock-based compensation (*e.g.*, options to purchase Altera stock) that Altera paid to employees who worked on the project. On audit, the IRS exercised its authority under Internal Revenue Code (IRC) § 482³ to increase Altera’s U.S. taxable income for 2004-2007 by the amount it believed the subsidiary would have reimbursed Altera for the employees’ stock-based compensation if the agreement had been negotiated at “arm’s length.”⁴

The IRS has taken the position in court and in regulations proposed in 2002 that related parties must share stock-based compensation costs because that is what unrelated parties would do if dealing at arm’s length.⁵ In response to the IRS’s proposed rule, stakeholders submitted information showing that unrelated parties do not share the cost of stock-based compensation because its value is speculative, potentially large, and outside their control. Commentators also suggested that stock option grants do not change a company’s operating expenses and do not factor into its pricing decisions.

Nonetheless, in 2003, the government issued final regulations requiring that “stockbased compensation must be taken into account ... [to satisfy the] arm’s length standard.”⁶ The government restated its belief that parties dealing at arm’s length “generally would not distinguish between stock-based compensation and other forms of compensation.”⁷ It distinguished the transactions cited by commentators on the basis that they did not involve the “development of high-profit intangibles,”⁸ asserting that “there is little, if any, public data regarding transactions involving high-profit intangibles.”⁹ However, the regulations did not distinguish between transactions involving high- and low-profit intangibles.

1 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2015, and ending on May 31, 2016. For purposes of this section, TAS used the same period.

2 *Altera Corp. & Subs. v. Comm’r*, 145 T.C. 91 (2015), *appeal docketed*, No. 16-70496 (9th Cir. Feb. 19, 2016).

3 IRC § 482 authorizes the Secretary to allocate income and expenses among related entities if the allocation is necessary to prevent evasion of taxes or clearly reflect the income of the entities.

4 *Altera*, 145 T.C. at 95. See also Treas. Reg. § 1.482-1(b)(1) (“the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer.”). The IRS could have adopted a different standard based on legislation authorizing it to use the “commensurate with income” standard, particularly in light of legislative history citing the difficulty of finding comparable transfers of high-profit potential intangibles at arm’s length between unrelated parties, but it did not. *Altera*, 145 T.C. at 96-98.

5 Prop. Treas. Reg. § 1.482-7(d)(2), 67 Fed. Reg. 48997, 49002 (July 29, 2002); Action on Decision (AOD), 2010-33 I.R.B. 240 (acq. in result in *Xilinx, Inc. & Subs. v. Comm’r*, 598 F.3d 1191 (9th Cir. 2010), *aff’g*, 125 T.C. 37 (2005), which rejected the IRS’s reallocation of the value of employee stock options under IRC § 482 because “the significance of the Ninth Circuit’s opinion was mooted by the 2003 amendments” to Treas. Reg. §§ 1.482-1(b)(1) and 1.482-7(d)).

6 T.D. 9088, 68 Fed. Reg. 51171, 51173 (Aug. 26, 2003).

7 *Id.*

8 *Id.* The term “high-profit” refers to the “subsequent success of the product.” *Altera*, 145 T.C. at 96. (internal citation omitted).

9 T.D. 9088, 68 Fed. Reg. 51171, 51173 (Aug. 26, 2003) (citation to legislative history omitted).

Following the IRS's proposed tax assessment, Altera filed suit in the Tax Court. It argued the 2003 regulations were arbitrary and capricious, and therefore, invalid under § 553(b) of the Administrative Procedure Act (APA) because the government did not explain why it rejected the comments and analysis it received from stakeholders.¹⁰ Thus, the regulations were not the product of “reasoned decisionmaking,” as required under *State Farm*.¹¹ The IRS countered that the court should give deference to the regulations under *Chevron*,¹² that APA § 553(b) did not apply because they were interpretive (not legislative) rules, and that they were the product of reasoned decisionmaking in any event.¹³

The Tax Court held that the regulations were invalid. APA § 553(b) requires an agency to promulgate “legislative” rules, such as these, using the formal notice and comment rulemaking process.¹⁴ Under this process, agencies must provide the public with notice of the proposed rule (regulation), consider any comments, and provide a concise statement explaining the basis for and purpose of the final rule.¹⁵ Even if a court gives so-called *Chevron* deference to the regulations, they may be deemed arbitrary and capricious, and thus invalid, if an agency does not respond to significant comments and articulate a reasoned explanation for its final rule as required under *State Farm*.¹⁶ An agency meets the reasoned decisionmaking test under *State Farm*, only if it examines the relevant data and contemporaneously articulates a satisfactory explanation for its action including a rational connection between the facts found and the choice made.¹⁷

In this case, the regulations were not a product of reasoned decision-making because the Treasury Department did not: (1) establish a connection between the facts found and the choice made, (2) provide a reasoned explanation for why it clung to the assumption that unrelated parties would share the cost of stock-based compensation after commentators presented evidence to the contrary, or (3) adopt an alternative rationale for the rules.¹⁸ The government did not contemporaneously explain why it did not

10 5 U.S.C. § 706(2)(A) (establishing an “arbitrary, capricious, an[d] abuse of discretion” standard of review); 5 U.S.C. § 553(c) (requiring an agency to consider comments and provide a concise statement explaining the basis and purpose for a final rule when promulgating legislative rules).

11 *Motor Vehicle Mfrs. Ass’n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983) (requiring rules to be the product of reasoned decisionmaking).

12 Under the framework set forth in *Chevron*, agency regulations are entitled to deference unless they (1) contradict an unambiguous statute, or (2) adopt an unreasonable construction of it. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). If a court determines that a statute is ambiguous under *Chevron* step-one, it generally gives “*Chevron* deference” to agency regulations under *Chevron* step-two unless they are arbitrary and capricious.

13 The Tax Court acknowledged that its past practice of referring “to regulations issued pursuant to specific grants of rulemaking authority as legislative regulations and regulations issued pursuant to Treasury’s general rulemaking authority, under sec. 7805(a), as interpretive regulations” was inconsistent with general administrative law use of the legislative and interpretive labels. *Altera*, 145 T.C. at 111, n.10. In the future it will refer to regulations issued pursuant to specific grants of rulemaking authority as specific authority regulations and regulations issued pursuant to Treasury’s general rulemaking authority, under IRC § 7805(a), as general authority regulations. *Id.* Under the reasoning of this decision, both specific authority and general authority regulations may be legislative regulations for purposes of the APA if they have the force of law, as discussed below.

14 5 U.S.C. §§ 553(b) and (c). An exception applies when the agency for “good cause” finds that the notice and comment process would be impracticable, unnecessary, or contrary to the public interest. 5 U.S.C. § 553(b). The government did not identify any such good cause in this instance.

15 *Id.*

16 *Altera*, 145 T.C. at 112-13 (citing *Motor Vehicle Mfrs. Ass’n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)).

17 *Id.*

18 The government argued that its regulations were based, in part, on the “commensurate-with-income” standard. Some have argued that they should have been upheld on that basis. See *Law Professors Urge Ninth Circuit to Uphold Cost-Sharing Reg.*, 2016 TNT 130-12 (July 7, 2016). However, the court did not sustain the regulations on that basis because the preamble to the regulations indicated that the standard it adopted was consistent with the arm’s-length standard. Under the arm’s-length standard the government was required to consider information about the costs that unrelated parties actually share, according to the court.

distinguish between high- and low-profit intangibles.¹⁹ When the IRS later cited the administrative burden of such a distinction, the court discounted this as a speculative *post hoc* argument.²⁰ In other words, the government's conclusions had no basis in fact because it failed to engage in any fact finding.

The government's errors were not harmless. It was unclear that the government would have adopted the same rule if it had determined the inclusion of stock-based compensation was inconsistent with the arm's length standard. Moreover, the agency's failure to respond to comments frustrated the court's review and was prejudicial to affected entities.

The Tax Court also rejected the government's argument that the regulations were not subject to APA § 553(b). The APA does not require agencies to use the formal notice and comment process to promulgate "interpretative" rules, which include general statements of policy, or rules of agency organization, procedure, or practice.²¹ However, "interpretive rules merely explain preexisting substantive law" and do not, themselves, have the force of law.²² A rule is legislative if "Congress has delegated legislative power to the agency and if the agency intended to exercise that power in promulgating the rule."²³ Congress has expressly delegated such legislative power to Treasury pursuant to IRC § 7805(a).²⁴ Although the preamble to the 2003 regulation states that APA "section 553(b) ... does not apply to these regulations,"²⁵ the court inferred that the agency nonetheless intended to exercise its legislative power because (1) the regulation was necessary to sustain an adjustment to the taxpayer's income (*i.e.*, it had the force of law), and (2) Treasury expressly invoked general rulemaking authority under IRC § 7805(a) in promulgating it.²⁶

This case is significant because it contradicts the IRS's assumption that most of its regulations are interpretive.²⁷ Rather, it suggests that most are legislative regulations that could be overturned if the government did not connect the facts to the final rule and provide a reasoned response to any comments under *State Farm's* reasoned decisionmaking standard. Other Treasury regulations are likely to be challenged on this basis, particularly in light of the fact that until 2014, the IRS's Chief Counsel Directives Manual (CCDM) stated that "[I]t is not necessary to justify the rules that are being proposed

19 *Altera*, 145 T.C. at 125.

20 *Id.* at 126. This analysis may suggest the court would have upheld the regulations if they had (1) required related parties to take stock-based compensation into account only with respect to high-profit intangibles, (2) had explained (and cited data to show) that it would be administratively difficult to distinguish between high- and low-profit intangibles, or (3) clearly explained that the government relied, *in the alternative*, on the "commensurate with income" standard with respect to the rule governing stock-based compensation.

21 5 U.S.C. § 553(b).

22 *Altera*, 145 T.C. at 111 (quotation omitted). While the IRS declined to brief this issue, it has taken the position that interpretive rules carry the force of law. *Altera*, 145 T.C. at 116. See also CCDM 32.1.5.4.7.5.1(10) (Sept. 30, 2011).

23 *Altera*, 145 T.C. at 111 (2015) (*quoting Am. Mining Cong. v. Mine Safety & Health Admin.*, 995 F.2d 1106, 1109 (D.C. Cir. 1993)).

24 *Altera*, 145 T.C. at 116. IRC § 7805(a) provides that "... the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."

25 68 Fed. Reg. 51171, 51177 (Aug. 26, 2003).

26 *Altera*, 145 T.C. at 115 (internal citations omitted).

27 See, e.g., CCDM 32.1.1.2.6 (Sept. 23, 2011); CCDM 32.1.5.4.7.5.1(2) (Sept. 30, 2011). For additional commentary on *Altera's* significance, see, e.g., Jerald August, *Altera: Why the Government Can't Count on Chevron Step Two*, 2016 TNT 109-9 (June 7, 2016). In addition, two groups of tax and administrative law professors filed amicus briefs in support of the government, which discuss significant policy concerns. See *Brief of Amici Curiae Anne Alstott et al.*, Dkt. Nos. 16-70496, 16-70497 (July 5, 2016), <http://ssrn.com/abstract=2805432>; *Brief of Amici Curiae J. Richard Harvey et al.*, Dkt. Nos. 16-70496, 16-70497 (July 1, 2016), <http://ssrn.com/abstract=2805663>.

or adopted or alternatives that were considered.”²⁸ The IRS and Treasury are reportedly making more effort to build the regulation file, explain decisions, respond to significant comments, and limit the issuance of temporary regulations.²⁹ These changes are consistent with the taxpayer *right to be informed*, illustrating how taxpayer rights reinforce what the APA requires.³⁰

In *Florida Bankers Assoc. v. United States Department of Treasury, the United States Court of Appeals for the District of Columbia Circuit held the Anti-Injunction Act (AIA) barred a challenge to information reporting regulations.*³¹

In 2012, the Treasury Department issued final regulations (the 2012 Rule) requiring banks to report interest paid to certain nonresident aliens, even if the aliens were not subject to tax on the income in the U.S.³² If a bank fails to report the interest, it is subject to a “penalty” under IRC § 6721(a). The Florida and Texas Bankers Associations challenged the 2012 Rule. The government argued, in part, that the AIA barred the court from hearing the case.³³

By way of background, the Court of Appeals for the District of Columbia held in *Seven-Sky* that the AIA did not bar a pre-enforcement suit challenging the Affordable Care Act’s requirement that individuals obtain insurance (the “individual mandate”).³⁴ In *NFIB*, the Supreme Court agreed.³⁵ The D.C. Circuit also held in *Foodservice* that the AIA did not bar a pre-enforcement suit challenging regulations requiring food and beverage establishments to report amounts that their employees earned in tips.³⁶ Similarly, after oral argument in this case, the Supreme Court held in *Direct Marketing* that the Tax Injunction Act (TIA), a state analogue to the AIA, did not bar a pre-enforcement challenge to a Colorado law which required out-of-state retailers to report purchases by Colorado customers.³⁷

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- 28 CCDM 32.1.5.4.7.3(1) (Sept. 30, 2011); CCDM 32.1.5.4.7.3(1) (Aug. 11, 2004) (same). See also Richard W. Skillman, *The Problems With Altera*, 2016 TNT 11-11 (Jan. 16, 2016) (“If a regulation can be invalidated because of a flaw or gap in its preamble explanation, it will be open season, and in some cases easy pickings, to challenge the validity of many tax regulations that have gone unchallenged for years.”). However, the IRS has recently removed the direction that regulation writers do not have to “justify the rules” (as quoted above). See CCDM 32.1.5.4.7.3(1) (Oct. 20, 2014). In addition, the IRS has long directed its attorneys to respond to comments received in response to proposed regulations. See, e.g., CCDM 32.1.5.4.7.3(3) (Oct. 20, 2014) (“The drafting team should explain why the agency found some comments persuasive, and others not, in issuing the final regulations.”); CCDM 32.1.5.4.7.3(2) (Sept. 30, 2011) (same); CCDM 32.1.5.4.7.3(2) (Aug. 11, 2004) (same).
- 29 Andrew Velarde, *Reg Process Could Get Slower and Less Stable, Wilkins Warns*, 2016 TNT 123-7 (June 27, 2016).
- 30 IRC § 780.
- 31 *Florida Bankers Assoc. v. U.S. Dep’t of Treasury*, 799 F.3d 1065 (D.C. Cir., 2015), *vacating and remanding* 19 F. Supp. 3d 111 (D.D.C. 2014), *reh’g en banc denied*, 116 A.F.T.R.2d (RIA) 6704 (D.C. Cir. 2015), *cert. denied*, No.15-969 (June 6, 2016).
- 32 T.D. 9584, 77 Fed. Reg. 23391 (Apr. 19, 2012) (promulgating Treas. Reg. § 1.6049-4(b)(5)(i)). The preamble to the regulations explained that the IRS needed this information so that it could provide reciprocal information to foreign countries pursuant to information exchange agreements.
- 33 IRC § 7421(a) (AIA) (taxpayers are precluded from filing suit for the purpose of restraining assessment or collection of any tax). As the Declaratory Judgment Act (28 U.S.C. § 2201) is generally interpreted as barring the same suits as the AIA (i.e., the statutes are “coterminous”), the courts did not analyze them separately and the Court of Appeals for the District of Columbia referred to both statutes as the AIA. This summary will use the same practice.
- 34 *Seven-Sky v. Holder*, 661 F.3d 1 (D.C. Cir. 2011), *cert. denied*, 133 S. Ct. 63 (2012), *abrogated on other grounds by Nat’l Fed’n of Indep. Bus. (NFIB) v. Sebelius*, 132 S. Ct. 2566 (2012).
- 35 *NFIB*, 132 S. Ct. at 2566.
- 36 *Foodservice & Lodging Inst, Inc. v. Regan*, 809 F.2d 842 (D.C. Cir. 1987).
- 37 *Direct Mktg. Ass’n v. Brohl*, 135 S. Ct. 1124 (2015). While *Direct Marketing* involved the Tax Injunction Act (TIA), 28 U.S.C. § 1341, which provides that federal district courts “shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law,” the Supreme Court interpreted it as applying the AIA to state taxes, explaining that “[I]n defining the terms of the TIA, we have looked to federal tax law as a guide. Although the TIA does not concern federal taxes, it was modeled on the Anti-Injunction Act (AIA), which does.” *Direct Mktg.*, 135 S. Ct. at 1129 (citations omitted).

The district court found the AIA inapplicable to the 2012 Rule because it only bars suits that would restrain the “assessment or collection of any tax.”³⁸ The court reasoned that this suit was to prevent implementation of reporting requirements before any tax (or penalty) had been incurred. Accordingly, the suit would not restrain the IRS from making an assessment because facts did not yet exist that would trigger a valid assessment.³⁹

A three-judge panel of the D.C. Circuit reversed and remanded, holding the AIA barred the suit. The majority opinion by Circuit Judge Kavanaugh explained that while the AIA does not apply to suits involving tax-related regulatory requirements that are enforced by penalties, it does apply if the penalties are treated as taxes for purposes of the AIA. IRC § 6671(a) provides that the penalty under IRC § 6721(a) for a bank’s failure to comply with the reporting requirement is treated as a tax because it is located in Chapter 68, Subchapter B of the Tax Code. The D.C. Circuit focused on the Supreme Court’s explanation that, “[P]enalties in subchapter 68B” are “treated as taxes under Title 26, which includes the Anti-Injunction Act.”⁴⁰ The opinion distinguished *NFIB*, *Seven-Sky*, *Direct Marketing*, and *Foodservice* on the basis that the penalties in those cases were not treated as taxes for purposes of the AIA.⁴¹

The opinion also cited Supreme Court precedent indicating that an artfully drafted pleading, which challenges the regulatory aspects of a tax (*e.g.*, in the context of tax-exempt entities or child labor taxes) cannot avoid the AIA if, as a result of the suit, the government would be restrained from collecting the tax.⁴² If the AIA were inapplicable to the regulatory component of a tax, a taxpayer could characterize a challenge to a tax as a challenge to its regulatory components, reducing the AIA “to dust in the context of challenges to regulatory taxes,” according to the court.⁴³

A strongly-worded dissent by Circuit Judge Henderson countered that the AIA does not bar a pre-enforcement challenge to regulatory requirements such as the 2012 Rule. First, the dissent argued that the literal language of the AIA does not bar suits just because they involve taxes; rather, they must also seek to “restrain the assessment or collection” thereof.⁴⁴ Suits that merely *inhibit* the assessment or collection of tax are not covered, as the Supreme Court noted in *Direct Marketing*.⁴⁵

Second, an alternative basis for the holding that the AIA did not apply in *Seven-Sky* was that the plaintiff challenged the regulatory requirement and not the associated penalty.⁴⁶ Third, like the penalty for failure to purchase insurance in *Seven-Sky*, the penalty for failure to report payments to nonresident aliens does not implicate the purpose of the AIA to protect the government’s ability to “collect a consistent stream of revenue,” because a penalty is meant to deter violations of the underlying regulatory requirement

38 IRC § 7421(a). The district court went on to uphold the regulations. For prior discussion of this case, see National Taxpayer Advocate 2014 Annual Report to Congress 427, 439 (*Significant Cases*).

39 According to the district court, “[T]he D.C. Circuit has confirmed that [information] reporting requirements related to Chapter 61A of the Internal Revenue Code — as opposed to the associated penalties found in Chapter 68B — are not subject to the AIA....” *Florida Bankers*, 19 F. Supp.3d at 121 (citing *Foodservice and Lodging Inst., Inc.*, 809 F.2d at 842).

40 *Florida Bankers*, 799 F.3d at 1068 (quoting *NFIB*, 132 S. Ct. at 2583).

41 It indicated the penalty at issue in *Foodservice* was under IRC § 6652, which is in Subchapter A.

42 See, *e.g.*, *Bailey v. George*, 259 U.S. 16 (1922) (child labor tax); *Alexander v. “Americans United” Inc.*, 416 U.S. 752 (1974) (tax exemption); *Bob Jones University v. Simon*, 416 U.S. 725 (1974) (tax exemption).

43 *Florida Bankers*, 799 F.3d at 1071.

44 See *id.* at 1075 n.26.

45 See *id.* at 1076 n.33.

46 Circuit Judge Randolph’s concurring opinion disagrees with the dissent’s characterization of *Seven-Sky*, asserting that the AIA would have applied in *Seven-Sky* if the penalty at issue was a tax within the meaning of the AIA. *Florida Bankers*, 799 F.3d at 1072.

rather than raise revenue.⁴⁷ Fourth, the penalty at issue in *Foodservice* was the same one at issue in this case (IRC § 6721), though Congress attached the tax penalty to the tip-reporting requirement after oral argument in *Foodservice* (but three months before the decision). Finally, if a bank cannot obtain preenforcement review of the 2012 Rule then it may only obtain review by incurring a penalty and initiating a refund suit, while risking penalties and imprisonment for willful failure to file under IRC § 7203.⁴⁸ Such a precondition would present constitutional concerns, according to the dissent.

This case is significant because it illustrates the continuing confusion about the scope of the AIA as applied to penalties for failure to comply with regulatory requirements.⁴⁹ Clarity in this area is increasingly important, as Congress has turned to the IRS to administer social programs and regulatory requirements.

In *Z Street, Inc. v Koskinen*, the United States District Court of Appeals for the District of Columbia Circuit held the AIA did not bar a suit alleging the IRS improperly scrutinized and delayed applications for tax exemption from organizations with certain political views.⁵⁰

About eight months after *Z Street* applied for tax-exempt status under IRC § 501(c)(3), it filed suit under the Declaratory Judgment Act, 28 U.S.C. § 2201, alleging the IRS had delayed processing its application due to the special scrutiny it was applying to organizations holding certain political views (the “Israel Special Policy”), in violation of the First Amendment. The IRS moved to dismiss, arguing that the action was barred by the AIA, which prohibits suits to “restrain the assessment or collection of any tax,” and that *Z Street* had adequate remedies at law. For example, if the IRS did not act on the application within 270 days (only 32 more days), *Z Street* could sue for a declaratory judgment under IRC § 7428, or it could obtain judicial review by waiting for the IRS to issue a statutory notice of deficiency (SNOD) and then file a petition with the U.S. Tax Court (under IRC § 6213), or it could pay the tax and file a refund suit in a U.S. district court or the U.S. Court of Federal Claims (under IRC § 7422).

The district court denied the IRS’s motion and the United States District Court of Appeals for the District of Columbia Circuit affirmed.⁵¹ For purposes of the motion, the D.C. Circuit assumed *Z Street*’s allegation of improper discrimination was true. The court explained that the AIA does not apply in situations where the plaintiff has no alternative means to challenge the IRS’s actions. It reasoned that although *Z Street* could potentially obtain judicial review of its exemption status under IRC §§ 7428, 6213, or 7422, a review under those provisions would not address *Z Street*’s alleged injury — special scrutiny and delay resulting from the Israel Special Policy. Because application of the AIA would leave *Z Street* with no alternative means to challenge the Israel Special Policy, it did not bar the suit.

47 *Florida Bankers*, 799 F.3d at 1078 (internal citations omitted).

48 *Florida Bankers* elaborated in its petition to the Supreme Court that banks do not have the option of violating the rule in order to challenge it because many of them could lose their Federal Deposit Insurance Act coverage and, thus, their ability to do business if they incurred a criminal penalty like the one imposed for violation of the reporting regulation. *Florida Bankers*, 2016 WL 369508, No. 15-969 (Jan. 29, 2016) (petition for writ of cert.). The Supreme Court denied certiorari. *Florida Bankers Assoc. v. U.S. Dep’t of Treasury*, 136 S. Ct. 2429 (2016).

49 The Chief Counsel for the IRS has reportedly expressed concern, that “arguments are seriously being put forth in support of the proposition that the Anti-Injunction Act is toothless to forestall out-of-box regulation challenges by interest groups that do not have an actual controversy.” Andrew Velarde, *Reg Process Could Get Slower and Less Stable, Wilkins Warns*, 2016 TNT 123-7 (June 27, 2016).

50 *Z Street, Inc. v Koskinen*, 791 F.3d 24 (D.C. Cir. 2015).

51 *Id.* at 32, *aff’g* 44 F. Supp.3d 48 (D.D.C. 2014).

This case is significant because it suggests that judicial review is more likely to be available to plaintiffs who allege that an IRS process has systemic flaws that would not otherwise be subject to judicial review. If so, it may increase judicial oversight of the IRS's procedures.

In *Dorrance v. United States*, the United States Court of Appeals for the Ninth Circuit held taxpayers had no basis in stock received upon demutualization of their insurance carrier.⁵²

Mr. and Mrs. Dorrance purchased life insurance policies from mutual insurance companies. Mutual insurance companies are owned by policyholders, not stockholders. They return any surplus (profits) to policyholders in the form of dividends. Policyholders also have certain mutual rights normally held by stockholders, such as the right to vote and the right to receive the mutual company's surplus if it liquidates.

In transactions qualifying as tax-free re-organizations, each of the insurance companies demutualized, distributing shares of stock to policyholders in exchange for their mutual rights. When the Dorrances sold their stock, they reported the proceeds as gain, paid the resulting tax, and then filed for a refund, claiming the sale produced no gain. They argued the sale did not generate gain because the stock represented a return of previously-paid policy premiums. In the alternative, they argued their membership rights were not capable of valuation, and therefore, their premium payments should have been counted toward their basis in the stock under the open transaction doctrine.⁵³ This was the approach adopted in 2008 by the Court of Federal Claims in *Fisher*.⁵⁴ The IRS denied the claim, arguing that the Dorrances had no basis in the stock because they did not prove they had paid anything for the membership rights (and thus the stock).

The district court rejected both parties' positions and, after a bench trial, held that the stock had a basis equal to its value minus the amount of the Dorrances' projected future contributions to surplus under the policies.⁵⁵ Both parties appealed. The United States Court of Appeals for the Ninth Circuit agreed with the IRS. It determined the Dorrances acquired the membership rights at no cost. Accordingly, the Dorrances' stock basis was zero.

This case is significant because the IRS is likely to deny claims it had suspended. Following the *Fisher* decision, taxpayers made protective claims for refunds of taxes paid on the sale of stock received in connection with demutualizations. The IRS sometimes responded by indicating it would hold those claims in abeyance pending resolution of *Dorrance*.⁵⁶ As a result of this case, the IRS will reject the claims, potentially generating additional litigation in this area.

52 *Dorrance v. United States*, 809 F.3d 479 (9th Cir. 2015). For prior coverage of the issues in this case, see National Taxpayer Advocate 2013 Annual Report to Congress 326, 336 (discussing the district court opinion); National Taxpayer Advocate 2008 Annual Report to Congress 468-469 (discussing *Fisher v. United States*, 82 Fed. Cl. 780 (2008), *aff'd without opinion*, 333 F. App'x 572 (Fed. Cir. 2009), which held the open transaction doctrine applied to the sale of stock received in connection with a demutualization).

53 Under this doctrine the transaction would remain open (*i.e.*, basis may be adjusted, but gain or loss is deferred) until the Dorrances dispose of the stock. See *Fisher v. United States*, 82 Fed. Cl. 780 (2008), *aff'd without opinion*, 333 F. App'x 572 (Fed. Cir. 2009).

54 *Id.* Although the IRS has not issued an AOD, it disagrees with *Fisher*. See *Cadreja v. United States*, 104 Fed. Cl. 296 (2012); *Reuben v. United States*, 111 A.F.T.R.2d (RIA) 620 (D. Cal. 2013), *rev'd*, 628 F. App'x 509 (9th Cir. 2016); Letter from IRS Associate Chief Counsel (Income Tax & Accounting) to Senator Harkin (May 23, 2011), *reprinted as, IRS Will Not Refund Tax Paid on Sale of Life Insurance Company Stock*, 2011 TNT 180-28 (Sept. 16, 2011).

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

56 Memorandum for Technical Services Territory Managers, from Director, Technical Services, *Guidance for Demutualization Claims* (Aug. 24, 2009).

In *Ibrahim v. Commissioner*, the United States Court of Appeals for the Eighth Circuit held that a taxpayer could file jointly even after filing as head of household and timely petitioning the Tax Court.⁵⁷

Mr. Ibrahim and his wife, both immigrants who spoke little English, filed their 2011 tax returns with assistance from Oday Tax Service. Mr. Ibrahim claimed head of household (HOH) filing status, which was improper because he was married and living with his wife. The IRS sent a timely SNOD to Mr. Ibrahim, asserting he should be taxed at the higher rate applicable to those who are married filing separately (MFS). After filing a petition with the Tax Court to challenge the deficiency, Mr. Ibrahim and his wife sought to amend their returns by electing married filing jointly (MFJ) status and claiming the earned income tax credit (EITC) along with other tax benefits.⁵⁸ The IRS argued that after filing his petition, Mr. Ibrahim was no longer eligible for MFJ status.

IRC § 6013(b)(2)(B) specifically bars a taxpayer from electing MFJ status after filing a “separate return” if either spouse has received a SNOD and filed a timely petition with the Tax Court. In *Glaze*, the Fifth Circuit Court of Appeals held that the term “separate return” in IRC § 6013(b) means only a return electing MFS status, and not any other filing status, including HOH.⁵⁹ The Court of Appeals for the Eleventh Circuit follows the reasoning in *Glaze*.⁶⁰ The Tax Court, however, interprets the term “separate return” to mean any return except for a MFJ return.⁶¹ Although the IRS follows *Glaze* in cases appealable to the Fifth and Eleventh Circuits under the *Golsen* rule, it does not do so in other cases.⁶² Because this case was appealable to the Eighth Circuit, the Tax Court held that IRC § 6013(b)(2) barred Mr. Ibrahim and his wife from amending their returns to elect MFJ filing status.⁶³

The United States Court of Appeals for the Eighth Circuit reversed.⁶⁴ It concluded that the term “separate return” as used in IRC § 6013(b) applies only to a MFS return and not an HOH return. Thus, Mr. Ibrahim was permitted amend his return to file as MFJ.

This case is significant because it highlights the inconsistent interpretation of IRC § 6013(b)(2)(B) by the courts. The National Taxpayer Advocate has recommended legislation that would allow all taxpayers to change their filing status, regardless of which circuit court would hear their appeal.⁶⁵

In *Voss v. Comm’r*, the United States Court of Appeals for the Ninth Circuit held that the mortgage interest deduction limits apply on a per-taxpayer (not per-residence) basis.⁶⁶

Bruce Voss and Charles Sophy, unmarried joint owners of two homes, each claimed a home mortgage interest deduction in excess of the statutory limit. For taxpayers other than married individuals filing

57 *Ibrahim v. Comm’r*, 788 F.3d 834 (8th Cir. 2015).

58 To be considered eligible for the EITC, a married taxpayer must file a joint return. IRC § 32(d).

59 *Glaze v. United States*, 641 F.2d 339 (5th Cir. 1981).

60 *Bonner v. City of Prichard*, 661 F.2d 1206 (11th Cir. 1981) (adopting all prior decisions of the Court of Appeals for the Fifth Circuit).

61 See, e.g., *Currie v. Comm’r*, T.C. Memo. 1986–71; *Blumenthal v. Comm’r*, T.C. Memo. 1983–737; *Saniewski v. Comm’r*, T.C. Memo. 1979–337.

62 See *Golsen v. Comm’r*, 54 T.C. 742, 757 (1970), *aff’d*, 445 F.2d 985 (10th Cir. 1971). See also *Glaze*, 641 F.2d at 339, *action on dec.*, 1981-140 (June 2, 1981); Chief Counsel Notice CC-2006-010 (Mar. 2, 2006).

63 *Ibrahim v. Comm’r*, T.C. Memo. 2014-8.

64 *Ibrahim*, 788 F.3d at 841.

65 See National Taxpayer Advocate 2014, Annual Report to Congress 346-350 (Legislative Recommendation: *Clarify the Definition of “Separate Return” in IRC § 6013 and Allow Taxpayers Who Petition the Tax Court to Change Their Filing Status to Married Filing Jointly in Accordance with the Tax Court’s Rules of Practice and Procedure*).

66 *Voss v. Comm’r*, 796 F.3d 1051 (9th Cir. 2015), *rev’g* 138 T.C. 204 (2012).

a separate return, IRC § 163(h)(3) limits the deduction for interest to \$1 million of home acquisition debt and \$100,000 of home equity debt on a qualified residence. If the limits apply to each taxpayer, then two unmarried taxpayers could deduct interest on up to \$2.2 million of debt. If the limits apply to a qualifying residence, two co-owners could only deduct interest on up to \$1.1 million of debt (assuming they do not own other qualifying residences). After an audit, the IRS disallowed a portion of their mortgage interest deductions, arguing that the limits apply on a per-residence basis. The taxpayers challenged the IRS's assessment in the Tax Court, arguing that the statute's limits apply on a per-taxpayer basis. The Tax Court agreed with the IRS, but a majority of the United States Court of Appeals for the Ninth Circuit agreed with the taxpayers.

The United States Court of Appeals for the Ninth Circuit focused on the parentheticals in IRC § 163(h)(3)(B)(ii) and (C)(ii) that halve the debt ceilings (*i.e.*, reduce them to \$550,000) “in the case” of a married individual filing a separate return. It explained that by doing so, “Congress implied that unmarried co-owners filing separate returns are entitled to deduct interest on up to \$1.1 million of home debt each.”⁶⁷ While this created a marriage penalty, the court observed that was Congress's decision.⁶⁸ It also pointed out that applying a per-residence ceiling would be unworkable in situations where two or more unmarried taxpayers each had an individual primary residence and also co-owned a secondary residence, which were in each case, qualified residences.⁶⁹

This case is significant because unless the IRS acquiesces in the result, unmarried taxpayers in different circuits may be subject to different mortgage interest deduction limits. Specifically, the Tax Court may continue to apply the limits on mortgage interest deductions on a per-residence basis under the *Golsen* rule (discussed above),⁷⁰ but apply it on a per-taxpayer basis for cases appealable to the Ninth Circuit.

In *United States v. Norcal Tea Party Patriots*, the United States Court of Appeals for the Sixth Circuit held the names, addresses, and taxpayer identification numbers of applicants for tax-exempt status do not constitute “return information” under IRC § 6103(b)(2)(A).⁷¹

The Norcal Tea Party Patriots filed suit seeking to certify a class of organizations whose applications for tax exemption were allegedly targeted by the IRS for special scrutiny. They sought to discover fellow members of the putative class that were on the IRS's “Be on the Lookout” (BOLO) list.⁷² The IRS argued that any information contained in an application for tax-exempt status, including the applicant's name, is confidential “return information” that is barred from disclosure under IRC § 6103.

67 Voss, 796 F.3d at 1068.

68 *Id.* at 1065. The court was unpersuaded by the analysis of CCA 200911007 (Mar. 13, 2009), which concluded that unmarried co-owners are limited to \$1,000,000 of total, aggregate acquisition indebtedness.

69 Voss, 796 F.3d at 1064 (“For example, two individuals might each have a separate primary residence but go in together on a vacation home in Maui. For such co-owners, filing tax returns under the Tax Court's per-residence approach would be like running a three-legged race. The co-owners are tied together for one home but not the other. This would mean that the two (or it could be three or four) co-owners would have to coordinate their tax returns to ensure that the aggregate amount of acquisition debt for each taxpayer's ‘qualified residence’ does not exceed \$1 million. It would also mean that one co-owner's deduction might depend on the size of another co-owner's mortgage on a home in which the first co-owner has no interest.”).

70 See *Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

71 *United States v. NorCal Tea Party Patriots*, 817 F.3d 953 (6th Cir. 2016).

72 For more information about the BOLO list, see *National Taxpayer Advocate Special Report to Congress: Political Activity and the Rights of Applicants for Tax-Exempt Status* and Treasury Inspector General for Tax Administration (TIIGTA), Ref. No. 2013-10-053, *Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review* (May 14, 2013).

The district court agreed that the plaintiffs' requests encompassed "return information," but held that the IRS could disclose the documents under IRC § 6103(h)(4)(B), which permits disclosure where "the treatment of an item reflected on such return is directly related to the resolution of an issue" in a judicial proceeding.⁷³ The district court ordered the IRS to produce the documents, but permitted the IRS to redact employer identification numbers. The IRS filed a petition for a *writ of mandamus*, arguing that IRC § 6103(h)(4)(B) did not apply.⁷⁴ According to the IRS, IRC § 6103(h)(4)(B) authorizes disclosure only of information reflected on a return. It argued that because names on a BOLO list are return *information*, which is not reflected on a return, they may not be disclosed pursuant to IRC § 6103(h)(4)(B).

The United States Court of Appeals for the Sixth Circuit agreed with the IRS that IRC § 6103(h)(4)(B) only authorizes disclosure of information reflected on a return and not all return information. However, it ordered the IRS to disclose the names on the BOLO list because it concluded they are neither information on returns nor return information. The court reasoned that "return information" as defined by IRC § 6103(b)(2)(A) includes "a taxpayer's identity," which means the name of a person with respect to whom a return is filed. Because an application for exemption is not a return, the name of an applicant for tax-exemption is not a "taxpayer's identity" as that term is defined in IRC § 6103(b)(6) and used in IRC § 6103(b)(2)(A).⁷⁵

The court also rejected the IRS's argument that the names of applicants for tax-exempt status are return information under IRC § 6103(b)(2)(A) because the names are "other data ... with respect to the determination of the existence, or possible existence, of liability" for a tax. The court reasoned that if "data collected" includes the name of an applicant for tax-exempt status, then it also includes the name of a taxpayer who files a return. But, if that were true, then Congress was wasting its time when it included "taxpayer identity" as a type of return information under IRC § 6103(b)(2)(A), because a taxpayer's name would already be "data collected" (and thus return information) under the IRS's interpretation of that term.

This case is significant because it holds that "the names, addresses, and taxpayer-identification numbers of applicants for tax-exempt status are not 'return information' under IRC § 6103(b)(2)(A)."⁷⁶ As a result, it appears that such information may be disclosed to the public, even if tax-exempt status is not granted.⁷⁷

In *Peterson v. Commissioner*, the United States Court of Appeals for the Eleventh Circuit held that a payee was bound to report payments as provided by a contract that was unilaterally amended by the payor.⁷⁸

Mrs. Peterson was an independent contractor for Mary Kay who reached the highest level of its sales network to become a National Sales Director (NSD). She earned commissions on wholesale purchases of

73 *NorCal Tea Party Patriots v. I.R.S.*, 114 A.F.T.R.2d (RIA) 5358 (S.D. Ohio 2014).

74 A *writ of mandamus* is an extraordinary remedy whereby a court may order an inferior court or government official to fulfill their official duties or correct an abuse of discretion. See, e.g., *Cheney v. United States Dist. Court*, 542 U.S. 367, 380 (2004) (explaining a *writ of mandamus* is only appropriate in "exceptional circumstances amounting to a judicial usurpation of power, or a clear abuse of discretion...") (internal citations omitted).

75 The court did not discuss the broad interpretation applied to the term "taxpayer" in other circumstances. See, e.g., *U.S. v. Williams*, 514 U.S. 527, 529 (1995) (concluding that a "taxpayer" includes someone who pays the tax of another).

76 *NorCal Tea Party Patriots*, 817 F.3d at 965.

77 See, e.g., *Lloyd Hitoshi Mayer, NorCal Tea Party Patriots Opens a Crack in Taxpayer Privacy Protections* (June 2016), http://www.americanbar.org/content/dam/aba/publishing/aba_tax_times/16jun/att-16jun-005-at-court-norcal-tea-party-patriots-mayer.authcheckdam.pdf (concluding the decision appears to "open the door for interested parties to seek disclosure, both in litigation and through FOIA requests, of documents listing applicants for recognition of exemption").

78 *Peterson v. Comm'r*, 117 A.F.T.R.2d (RIA) 1815 (11th Cir. 2016).

Mary Kay products by her network of independent beauty consultants, sales directors, and other NSDs. As an NSD, Mrs. Peterson became eligible for two non-employee retirement programs, the Family Security Program (FSP) and the Great (or Global) Futures Program (GFP). Payments under the FSP and GFP were based on her pre-retirement commissions in the United States and the post-retirement wholesale purchases by her international network, respectively. In exchange for payments under the programs, Mrs. Peterson agreed to retire (*i.e.*, sever her NSD agreement and cease earning regular commissions) at a certain age and not to compete with Mary Kay.

The FSP and GFP agreements, which Mrs. Peterson signed in 1992 and 2005, respectively, did not address the character of the program payments. However, Mary Kay retained the right to terminate or modify them at any time. In 2008, immediately before Mrs. Peterson retired, Mary Kay unilaterally modified them to clarify that the payments were deferred compensation. According to Mary Kay, it modified the agreements to ensure the programs complied with the requirements of IRC § 409A.⁷⁹ When Mrs. Peterson retired and received payments under the FSP and GFP, she took the position that they were for the sale of her business and her covenant not to compete. She argued they were not deferred compensation, which would be subject to self-employment tax. Self-employment tax is only due on income “derived by an individual from any trade or business carried on by such individual.”⁸⁰ It is not due on the sale of a business.

The IRS determined the FSP and GFP payments were subject to self-employment tax. Both the Tax Court and the U.S. Court of Appeals for the Eleventh Circuit agreed. According to the Tax Court, the FSP and GFP payments were “derived” from Mrs. Peterson’s prior labor. The payments would only be made after a minimum number of years of service and were based on her pre-retirement commissions and the post-retirement wholesale volume of her network (*i.e.*, how well the network performed based on her prior services), respectively.⁸¹ The Tax Court also noted that the FSP and the GFP agreements, as amended, expressly provided that the distributions were deferred compensation (*i.e.*, related to Mrs. Peterson’s prior labor) and Mrs. Peterson had not shown they were unenforceable. It cited *Comm’r v. Danielson*, which established the so-called *Danielson* rule that unless a contract is unenforceable, a taxpayer generally cannot use substance-over-form principles to disavow the form of a transaction that he or she agreed to.⁸²

Relying on the *Danielson* rule, a majority of an Eleventh Circuit panel affirmed. The majority was not concerned that Mary Kay had unilaterally amended the program agreements to characterize the payments solely for tax purposes, or that it did so immediately before Mrs. Peterson retired.⁸³ It reasoned that when Mrs. Peterson agreed to allow Mary Kay to make unilateral modifications to the agreements, she implicitly agreed to Mary Kay’s characterization of the payments under them. A dissenting opinion

79 IRC § 409A generally provides that participants in a nonqualified deferred compensation plan that fails to satisfy certain requirements are immediately subject to current taxation, plus interest, on all compensation deferred under the plan. It also imposes an additional 20 percent tax on certain non-complying compensation. Mary Kay claimed it had always viewed the payments under the plans as deferred compensation (deductible by Mary Kay) and made the amendments to protect participating NSDs from the consequences of not complying with IRC § 409A.

80 IRC § 1402(a).

81 *Peterson v. Comm’r*, T.C. Memo. 2013-271.

82 *Id.* (citing *Plante v. Comm’r*, 168 F.3d 1279, 1280-1281 (11th Cir. 1999), and *Comm’r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967)).

83 In some circumstances, however, the timing of a unilateral contract modification can support a finding of bad faith, which can make the modification unenforceable. See, e.g., Earle K. Shawe and Mark J. Swerdlin, *You Promised! - May an Employer Cancel or Modify Employee Severance Pay Arrangements?*, 44 *Mb. L. Rev.* 903 (1985), <http://digitalcommons.law.umaryland.edu/mlr/vol44/iss3/6>.

by Judge Rosenbaum (concurring in part) observed that the agreements Mrs. Peterson signed did not characterize the payments as deferred compensation. The dissenting opinion takes “issue with the Majority’s second-order conclusion that Peterson’s consent to unilateral amendments *to the Programs* somehow permitted Mary Kay to bind Peterson to its post-hoc characterization of the Program payments for purposes of applying the judicially crafted *Danielson* rule.”⁸⁴ One rationale for the *Danielson* rule is to prevent a party from unjustly enriching itself by unilaterally altering the intended tax consequences of a transaction after consummation.⁸⁵ The dissent argues that applying the *Danielson* rule in circumstances like these — where the contract was unilaterally modified by one party after execution by the other — actually incentivizes parties to engage in the very post-hoc tax liability shifting that the rule is meant to guard against.⁸⁶

While another rationale for the rule is to prevent the IRS from having to pursue a taxpayer’s counterparty in whipsaw litigation in a particular set of cases, the dissent argues this is not one of those cases. Because no prior court has applied the *Danielson* rule in situations where one party unilaterally modified the contract after execution by the other, the majority’s conclusion does not prevent unnecessary whipsaw litigation. Rather, it prevents necessary whipsaw litigation, according to the dissent.

After concluding that the payments were not deferred compensation, the dissent agreed with the majority’s conclusion that the FSP payments were subject to self-employment tax. They had sufficient nexus to the quality of Ms. Peterson’s prior work for Mary Kay. However, the dissent concluded that the GFP payments were not subject to self-employment tax. It reasoned they were based on the quality of work subsequently performed by members of Mrs. Peterson’s network, and thus, lacked sufficient nexus to the quality of her work.

This case is significant to the extent it expands the scope of the *Danielson* rule.⁸⁷ It may suggest that one party to a contract may require another party to characterize a transaction in a way not contemplated at the outset, provided he or she has enough bargaining power and foresight to obtain the right to make unilateral modifications.⁸⁸ Although the unilateral modification of a contract can render it unenforceable, such provisions are not uncommon in the context of employment contracts.⁸⁹ As workers are increasingly

84 *Peterson v. Comm’r*, 117 A.F.T.R.2d (RIA) 1815 (11th Cir. 2016).

85 The majority observes that Mary Kay was not enriched because its amendment was to clarify the characterization of the programs, as it had always intended to deduct payments under them. If the transaction were properly characterized as Mary Kay’s purchase of Mrs. Peterson’s business or her goodwill under the non-compete, however, the dissent points out that its payments would not have been fully deductible.

86 A related function of the *Danielson* rule is to promote certainty. However, permitting one party to bind the other to a new tax treatment of a transaction after execution of the agreement could result in less certainty, according to the dissent.

87 Litigation over application of the *Danielson* rule may have abated in recent years due to its partial codification. See IRC §1060(a)(flush) (“If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate.”).

88 The majority’s holding could possibly be distinguished from other cases on the basis that Mrs. Peterson implicitly ratified the unilateral modification through her actions because she did not object when informed of the modification. She may have thought that protesting would be fruitless, however, because Mary Kay did not negotiate and tailor the program terms for her. *Peterson*, 117 A.F.T.R.2d (RIA) at n.29 (“Neither standard Program agreement was personalized for Peterson...”).

89 See, e.g., *Michael L. DeMichele and Richard A. Bales, Unilateral-Modification Provisions in Employment Arbitration Agreements*, 24 HOFSTRA LAB. & EMP. L.J. 63 (Fall 2006).

hired as independent contractors rather than employees,⁹⁰ unilateral modification provisions may find their way into more contracts with non-employees.

In *May v. United States*, the United States District Court for the District of Arizona held the IRS’s receipt of “information” triggered the limitations period for assessing the penalty under IRC § 6707A for failure to report a listed transaction, even though the taxpayer did not file the proper form.⁹¹

More than a year after Mr. May disclosed information about a listed transaction to the IRS, it assessed a penalty against him under IRC § 6707A for failing to disclose the transaction on Form 8886, *Reportable Transaction Disclosure Statement*. Mr. May had executed two timely Forms 872, *Consent to Extend the Time to Assess Tax*. One extended the limitations period for income and excise taxes for tax years (TYs) 2003 and 2004. Another extended the limitations period for IRC § 6707A penalties for TYs 2005 and 2006, but not 2004. Mr. May paid the penalty, submitted a claim for refund, and filed suit on the basis that the penalty was time barred as to 2004.

Under IRC § 6501(c)(10), the IRS must assess the IRC § 6707A penalty within one year after the earlier of “(A) the date on which the Secretary is furnished the information so required, or (B) the date that a material advisor” provides the same information. The government argued that only the filing of Form 8886, and not the mere delivery of “information,” triggers the running of the statute of limitations period.⁹² Even if the period would normally have expired, the government argued that Mr. May extended it by signing Form 872, which covered all “income and excise taxes” for 2004. According to the government, the word “tax” on Form 872 included additions to tax and penalties, such as the IRC § 6707A penalty.

The court first concluded that under the plain language of the statute, it is the furnishing of information, and not the submission of a particular form, that starts the limitations period. Next, the court concluded that the Form 872 covering 2004 extended the period for assessing tax, but not the IRC § 6707A penalty. Based on the parties’ conduct and testimony, the court found they only intended the Forms 872 to extend the period for assessing the IRC § 6707A penalty when they specifically referenced that penalty. The only Form 872 applicable to 2004 did not specifically cover the IRC § 6707A penalty. Thus, the IRS’s assessment was time barred.

This case is significant because it suggests the one-year limitations period for assessing a penalty for failure to report a listed transaction begins when someone provides information about the transaction to the IRS, even if someone other than the taxpayer does so and even if the information is not provided on Form 8886. The case is also significant to the extent it suggests that Forms 872 covering “taxes” do not automatically cover penalties, particularly if the IRS’s practice is to address penalties by specifically referencing them on separate Forms 872.

90 See, e.g., *The Sharing Economy: A Taxing Experience for New Entrepreneurs: Hearing Before the H. Comm. on Small Business, 114th Cong.* (2016) (statement of Nina E. Olson, National Taxpayer Advocate), https://www.irs.gov/pub/tas/nta_written_testimony_the_sharing_economy_5_26_2016.pdf.

91 *May v. United States*, 115 A.F.T.R.2d (RIA) 2155 (D. Ariz. 2015).

92 See, e.g., Treas. Reg. § 1.6011-4(d) (“If the form is not completed in accordance with the provisions in this paragraph (d) and the instructions to the form, the taxpayer will not be considered to have complied with the disclosure requirements of this section.”).

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

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

TAXPAYER RIGHTS IMPACTED²

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

PRESENT LAW

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

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

In computing the amount of underpayment for accuracy-related penalty purposes, Congress changed the law in 2015 to provide that the excess of refundable credits over the tax is taken into account as a negative

1 Internal Revenue Code (IRC) § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement under chapter 1 (IRC §§ 1-1400U-3); IRC § 6662(b)(4) authorizes a penalty for any substantial overstatement of pension liabilities; IRC § 6662(b)(5) authorizes a penalty for any substantial valuation understatement of estate or gift tax; IRC § 6662(b)(6) authorizes a penalty when the IRS disallows the tax benefits claimed by the taxpayer when the transaction lacks economic substance; IRC § 6662(b)(7) authorizes a penalty for any undisclosed foreign financial asset understatement; and IRC § 6662(b)(8) authorizes a penalty for any inconsistent estate basis. IRC § 6662(b)(8) was added by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, § 2004(c), 129 Stat. 443, 456 (2015). We have chosen not to cover the IRC §§ 6662(b)(3)-(8) penalties in this report, as these penalties were not litigated nearly as much as IRC §§ 6662(b)(1) and 6662(b)(2) during the period we reviewed.

2 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the IRC. See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

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

4 IRC § 6664(a).

amount.⁵ Therefore, for returns filed after December 18, 2015, or for returns filed on or before that date for which the period of limitations on assessment under IRC § 6501 has not expired, a taxpayer can be subject to an IRC § 6662 underpayment penalty based on a refundable credit which reduces tax below zero.

The IRS may assess penalties under IRC § 6662(b)(1) and 6662(b)(2), but the total penalty rate generally cannot exceed 20 percent (*i.e.*, the penalties are not “stackable”).⁶ Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith.⁷ In addition, a taxpayer will be subject to the negligence component of the penalty only on the portion of the underpayment attributable to negligence. If a taxpayer wrongly reports multiple sources of income, for example, some errors may be justifiable mistakes, while others might be the result of negligence; the penalty applies only to the latter.

Negligence

The IRS may impose the IRC § 6662(b)(1) negligence penalty if it concludes that a taxpayer’s negligence or disregard of the rules or regulations caused the underpayment. Negligence is defined to include “any failure to make a reasonable attempt to comply with the provisions of this title, and the term ‘disregard’ includes any careless, reckless, or intentional disregard.”⁸ Negligence includes a failure to keep adequate books and records or to substantiate items that give rise to the underpayment.⁹ Strong indicators of negligence include instances where a taxpayer failed to report income on a tax return that a payor reported on an information return,¹⁰ as defined in IRC § 6724(d)(1),¹¹ or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.¹² The IRS can also consider various other factors in determining whether the taxpayer’s actions were negligent.¹³

Substantial Understatement

Generally, an “understatement” is the difference between (1) the correct amount of tax and (2) the tax reported on the return, reduced by any rebate.¹⁴ Understatements are reduced by the portion attributable to (1) an item for which the taxpayer had substantial authority or (2) any item for which the taxpayer, in the return or an attached statement, adequately disclosed the relevant facts affecting the

5 IRC § 6664(a). Prior to December 18, 2015, refundable credits could not reduce below zero the amount shown as tax by the taxpayer on a return. See *Rand v. Comm’r*, 141 T.C. 376 (2013). On December 18, 2015, Congress enacted a law that reversed the Tax Court’s decision in *Rand* and amended IRC § 6664(a) to be consistent with the rule of IRC § 6211(b)(4). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title II, § 209, 129 Stat. 2242, 3084 (2015).

6 Treas. Reg. § 1.6662-2(c). The penalty rises to 40 percent if any portion of the underpayment is due to a “gross valuation misstatement.” IRC § 6662(h)(1); Treas. Reg. § 1.6662-5(a).

7 IRC § 6664(c)(1).

8 IRC § 6662(c).

9 Treas. Reg. § 1.6662-3(b)(1).

10 Treas. Reg. § 1.6662-3(b)(1)(i).

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

12 Treas. Reg. § 1.6662-3(b)(1)(ii).

13 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 under-reported income. Internal Revenue Manual (IRM) 4.10.6.2.1, *Negligence* (May 14, 1999). See also IRM 20.1.5.2, *Common Features of Accuracy-Related and Civil Fraud Penalties* (Jan. 24, 2012).

14 IRC § 6662(d)(2)(A)(i)-(ii).

item's tax treatment and the taxpayer had a reasonable basis for the tax treatment.¹⁵ For individuals, the understatement of tax is substantial if it exceeds the greater of \$5,000 or ten percent of the tax that must be shown on the return for the taxable year.¹⁶ 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 for the taxable year (or, if greater, \$10,000), or \$10,000,000.¹⁷

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

Reasonable Cause

The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.¹⁸ A reasonable cause determination takes into account all of the pertinent facts and circumstances.¹⁹ Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.²⁰

Reasonable Basis

An understatement of tax may be reduced by any portion of the understatement attributable to an item for which the tax treatment is adequately disclosed and supported by a reasonable basis.²¹ This standard is met if the taxpayer's position reasonably relies on one or more authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii).²² Applicable authority could include information such as sections of the IRC; proposed, temporary, or final regulations; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties, court cases, and congressional intent as reflected in committee reports.²³

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

16 IRC § 6662(d)(1)(A)(i)-(ii).

17 IRC § 6662(d)(1)(B)(i)-(ii).

18 IRC § 6664(c)(1).

19 Treas. Reg. § 1.6664-4(b)(1).

20 *Id.*

21 IRC § 6662(d)(2)(B)(ii)(I), (II).

22 Treas. Reg. § 1.6662-3(b)(3).

23 Treas. Reg. § 1.6662-4(d)(3)(iii).

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process²⁴ and through its Automated Underreporter (AUR) computer system.²⁵ Before a taxpayer receives a notice of deficiency, he or she generally has an opportunity to engage the IRS on the merits of the penalty.²⁶ Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC §§ 6211-6213).²⁷ Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to petition the United States Tax Court to challenge the assessment.²⁸ Alternatively, taxpayers may seek judicial review through refund litigation.²⁹ Under certain circumstances, a taxpayer can request an administrative review of IRS collection procedures (and the underlying liability) through a Collection Due Process (CDP) hearing.³⁰

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.³¹ The IRS must first present sufficient evidence to establish that the penalty was warranted.³² The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.³³ Because the reasonable basis standard is a higher standard to meet, it is possible that

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

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

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

27 IRC § 6665(a)(1).

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

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

30 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 actually receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute such liability. IRC §§ 6320(c), 6330(c)(2)(B).

31 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.”

32 *Higbee v. Comm’r*, 116 T.C. 438, 446 (2001); IRC § 7491(c).

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

a taxpayer may obtain relief from a penalty assessment by successfully arguing a reasonable cause defense, even if that defense does not satisfy the reasonable basis standard.³⁴

ANALYSIS OF LITIGATED CASES

We identified 122 opinions issued between June 1, 2015 and May 31, 2016, where taxpayers litigated the negligence or disregard of rules or regulations or substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 86 cases (70 percent), taxpayers prevailed in full in 20 cases (16 percent), and 16 cases (13 percent) resulted in split decisions. Table 1 in Appendix 3 provides a detailed list of these cases.

During the period covered by this report, we noticed a nearly threefold uptick in the number of split decisions in the accuracy-related penalty category. For the period covered by the 2015 Annual Report to Congress, only six out of the 113 total accuracy-related penalty cases (five percent) resulted in split decisions.³⁵ However, in our review for this year's report, we identified 16 out of the 122 total cases (13 percent) as split decisions.

Taxpayers appeared *pro se* (without representation) in 70 of the 122 cases (57 percent) and convinced the court to dismiss or reduce the penalty in 22 (31 percent) of those cases. Surprisingly, represented taxpayers fared slightly worse, achieving full or partial relief from the penalty in 14 of their 52 cases (27 percent). In contrast, during the same period last year, *pro se* taxpayers did not fare as well, having achieved full or partial penalty relief in 21 percent of cases while represented taxpayers achieved full or partial penalty relief in a similar percentage of cases as this year (27 percent).³⁶

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

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

Taxpayers are required to maintain records sufficient to establish the amount of gross income, deductions, and credits claimed on a return.³⁷ The failure to “keep adequate books and records or to substantiate items properly” was stated as a primary factor in 55 percent of cases (31 out of 56) where the court found a taxpayer liable for an underpayment penalty due to negligence.³⁸

For example, in *Avery v. Commissioner*,³⁹ married taxpayers operated an information technology company where the wife was the sole shareholder and president of the company and the husband was the executive vice president and sole technician. Mr. Avery worked out of the basement of the couple's home and would make daily automobile trips to the company's clients to provide onsite technical support services

34 Treas. Reg. § 1.6662-3(b)(3).

35 See National Taxpayer Advocate 2015 Annual Report to Congress 450.

36 *Id.*

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

38 See, e.g., *Boneparte v. Comm'r*, T.C. Memo. 2015-128; *Holden v. Comm'r*, T.C. Memo. 2015-131.

39 T.C. Memo. 2016-50.

as well as to stores to purchase materials. He was not reimbursed by the company for his automobile expenses.

The couple engaged a tax return preparer, who was referred to them by acquaintances, to prepare their 2011 Form 1040, *U.S. Individual Income Tax Return*. Their return reflected an automobile expense of \$39,991, an amount that would indicate that Mr. Avery drove approximately 75,000 miles for business according to the IRS's standard mileage rate for 2011. The IRS selected the couple's return for examination and the agent conducting the exam requested substantiation of the claimed automobile expenses. Mr. Avery claimed he maintained a mileage log where he would record the dates, number, and mileage of the trips he made in the automobile but stated that he lost this log. The IRS issued a notice of deficiency, which disallowed the claimed automobile expenses and asserted an accuracy-related penalty for negligence.⁴⁰

The couple challenged the notice of deficiency in the Tax Court. At trial, Mr. Avery was the taxpayers' only witness but he did not produce his mileage log. Instead, he provided three items:

1. A list of names of the company's clients and related invoices;
2. Receipts for the servicing and repair of Mr. Avery's automobile that he used for business travel; and
3. A list reflecting his estimated business mileage from January through April 2011.

The court noted that IRC § 162 allows a deduction from income for all ordinary and necessary expenses for carrying on a trade or business and that, under IRC § 6001, taxpayers are generally required to keep records substantiating amounts reported on a tax return.⁴¹ The court also pointed out that automobile expense deductions are subject to the strict substantiation requirements of IRC § 274(d), which provides, among other things, that no deduction may be allowed with respect to any property listed in § 280F(d)(4) unless the taxpayer establishes:

- (A) The amount of the expense or other item;
- (B) The time and place of the use of the property;
- (C) The business purpose of the expense; and
- (D) The business relationship to the taxpayer of the person using the property.

The court further noted that deductions arising from property subject to the strict substantiation requirements set forth in § 274(d) are disallowed in full unless that taxpayer meets each element of these requirements and also discussed the related regulations.⁴²

Turning to the evidence introduced by Mr. Avery, the court first highlighted the fact that he failed to produce his mileage log at trial. The court then found that each of the three pieces of evidence that he provided failed to meet the § 274(d) substantiation requirements. Mr. Avery had failed to explain how he calculated his mileage driven, receipts he provided did not explain business use of the automobile, and he

40 Because the taxpayers' automobile expenses were incorrectly claimed on a Schedule C, *Profit or Loss From Business (Sole Proprietor)*, the IRS mistakenly believed that Mr. Avery operated a sole proprietorship and was therefore also liable for self-employment tax. The IRS later conceded that Mr. Avery did not operate a sole proprietorship and was not liable for the self-employment tax.

41 For a more detailed discussion of whether or not a taxpayer is considered to be in a trade or business and entitled to certain deductions, see Most Litigated Issue: *Trade or Business Expenses Under IRC § 162 and Related Sections*, *infra*.

42 See Treas. Reg. § 1.274-5T(c).

acknowledged that his recollection of trips made to client sites was not reliable and that he did not keep records regarding daily visits to clients who had ongoing maintenance contracts with the company.

The court stated that it had no doubt that Mr. Avery drove to the worksites of the company's clients. However, because he did not meet the strict substantiation requirements of § 274(d), the court disallowed the taxpayers' claimed automobile expense deductions. The court also imposed the § 6662(b)(1) accuracy-related penalty for negligence, as it found the taxpayers failed to keep adequate books and records. Finally, the court dismissed the taxpayers' defense to the penalty by claiming reasonable cause and good faith reliance on a tax professional, an area that will be discussed in more detail below.

Inadequate record keeping was also an important factor in many determinations of whether the reasonable cause and good faith exception applied to a taxpayer's conduct. Some courts examined the issues of negligent record keeping and reasonable cause concurrently.

For example, in *Boneparte v. Commissioner*,⁴³ the taxpayer petitioned the Tax Court to challenge a notice of deficiency stemming from claimed deductions relating to gambling losses, medical transportation expenses, nonbusiness bad debts, an IRC § 72(t) ten percent additional tax on an early retirement plan distribution, and an accuracy-related penalty under IRC § 6662(b)(1). The court found, among other things, that the taxpayer did not maintain appropriate records of his gambling activity, medical transportation expenses, and nonbusiness bad debts. It therefore did not allow any of these deductions. The court also imposed an IRC § 6662(b)(1) accuracy-related penalty for negligence, noting the taxpayer's failure to keep accurate records for his claimed deductions and that he did not show reasonable cause for this failure. Thus, the court rejected reasonable cause based on the same evidence that established negligence.

Reliance on the Advice of a Tax Professional As Reasonable Cause

Another commonly litigated question was whether reliance on a tax professional established reasonable cause. The taxpayer's education, sophistication, and business experience are relevant in determining whether his or her reliance on tax advice was reasonable.⁴⁴ To prevail, a taxpayer must establish that:

1. The advisor was a competent professional who had sufficient expertise to justify reliance;
2. The taxpayer provided necessary and accurate information to the advisor; and
3. The taxpayer actually relied in good faith on the adviser's judgment.⁴⁵

Taxpayers argued their good faith reliance on a competent tax professional in several cases this year, including *Espaillet v. Commissioner*.⁴⁶ In *Espaillet*, a married couple filed joint Federal income tax returns for 2008 and 2009 claiming losses that stemmed from a scrap metal business operated by Mr. Espaillet's brother. The couple primarily ran a successful landscaping business but Mr. Espaillet and other family members also spent a significant amount of time assisting his brother with the scrap metal business, which was not successful. Under the advice of their certified public accountant (CPA), the Espaillets claimed the losses as "other expenses" deductions on their Schedule C. The IRS later audited the couple's tax returns for these years and disallowed the "other expenses" deductions. Due to the disallowed deductions, the IRS also assessed an accuracy-related penalty under IRC § 6662(b)(1) or, in the alternative, § 6662(b)(2).

43 T.C. Memo. 2015-128.

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

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

46 T.C. Memo. 2015-202. See also *Lamas-Richie v. Comm'r*, T.C. Memo. 2016-63; *Vandenbosch v. Comm'r*, T.C. Memo. 2016-29.

Although it found various reasons why the taxpayers were not entitled to their claimed loss deductions for 2008 and 2009, the court ruled that the couple was not liable for accuracy-related penalties because they acted with reasonable cause and relied in good faith on their CPA. In examining this defense, the court noted that the couple ran a successful landscaping business and that Mr. Espaillat was familiar with running a business and keeping appropriate records but was unfamiliar with the tax code. It also highlighted the fact that the taxpayers had sought the help of a CPA, who had assisted them for over a decade, to prepare their returns for the years in issue. The CPA had the taxpayers each fill out a questionnaire each year before preparing their returns, which they thoroughly completed. The CPA also testified that the taxpayers provided all requisite information and that he discussed the taxpayers' situation with them and thought the Schedule C reporting of the scrap metal loss deduction was appropriate. Finally, the court mentioned that the CPA had over 30 years of experience and that because the taxpayers had always used a Schedule C for their landscaping business, they acted in good faith in relying on their CPA's advice to report their scrap metal financial dealings on a Schedule C. Because they acted with reasonable cause and in good faith reliance on their CPA, they were not liable for accuracy-related penalties under IRC § 6662(b)(1) or (b)(2).⁴⁷

In contrast, married taxpayers in *Ogden v. Commissioner*⁴⁸ were held liable for an accuracy-related penalty because the couple had neither reasonably, nor in good faith relied on their CPA's advice in preparation of their Federal income tax return.

In 2010, Mr. and Mrs. Ogden filed a joint Federal income tax return, with most of the income coming from Mr. Ogden's law practice. The IRS audited the Ogdens' return and determined that they had claimed a contract labor expense of approximately \$500,000 twice and had failed to report \$450,000 of gross receipts. Based on this, the IRS asserted a deficiency of \$255,040 and an accuracy-related penalty of \$51,008. The taxpayers accepted the deficiency but contested the penalty,⁴⁹ arguing that they reasonably relied on advice from their CPA to prepare their return and that the underpayment was the result of an isolated computational error.⁵⁰

The court found that the taxpayers did not reasonably and in good faith rely on the advice of the CPA who prepared their 2010 return. It noted that the taxpayers did not call as a witness the CPA who prepared their return nor did they present any evidence that he provided advice that they could rely on. The court also pointed out that had the taxpayers conducted a reasonable inspection of the return, they would have discovered the duplicated expense deduction and the unreported income. The court believed that Mr. Ogden had sufficient knowledge of the workings of his law firm to detect these errors and that more diligence was necessary to assess the taxpayers' proper tax liability. Therefore, the taxpayers could not claim reasonable cause and good faith reliance on their CPA and were liable for the accuracy-related penalty.

47 Interestingly, the court did not cite the *Neonatology* case in discussing the requirements for good faith reliance on a tax professional. Rather, it cited *Estate of Goldman v. Commissioner*, 112 T.C. 317, 324 (1999) (citing *Metra Chem Corp. v. Commissioner*, 88 T.C. 654, 662 (1987)), *aff'd without published opinion sub nom., Schutter v. Commissioner*, 242 F.3d 390 (10th Cir. 2000). *Estate of Goldman* has a slightly different formulation of the three requirements for good faith reliance on a tax professional but they are substantially the same as the *Neonatology* ones.

48 T.C. Memo. 2015-241.

49 The taxpayers stipulated that they were liable for an accuracy-related penalty for the unreported income so the court only examined whether they were liable for the penalty as it related to the duplicated contract labor expenses.

50 This is a rare case in which only the accuracy-related penalty was at issue before the court. In most cases, taxpayers challenged both the deficiency and the accuracy-related penalty.

Individual Retirement Accounts

As in previous years, we identified several accuracy-related penalty cases under IRC § 6662(b)(1) and (b)(2) that involved individual retirement accounts (IRA) issues.⁵¹

For example, in *Ellis v. Commissioner*,⁵² married taxpayers appealed a Tax Court decision holding that the taxpayers were liable for a deficiency, a ten percent additional tax on an early distribution from a qualified retirement plan, and an IRC § 6662(b)(2) accuracy-related penalty due to Mr. Ellis's engaging in a prohibited transaction with his IRA. In 2005, Mr. Ellis formed a limited liability company (LLC) to engage in the business of used automobile sales. He was also designated to act as the general manager of the LLC and received a salary. In order to fund this venture, Mr. Ellis transferred funds from a 401(k) he had established with a previous employer into a newly formed IRA. He then purchased shares of the LLC with funds from the IRA. Mr. Ellis reported the distributions on his 2005 return but did not report them as taxable.

The IRS examined the Ellis's tax returns for 2005 and 2006 and determined that Mr. Ellis had engaged in prohibited transactions under IRC § 4975(c) by directing his IRA to acquire a membership interest in the LLC with the expectation that the company would employ him and receiving wages from the LLC.⁵³ As a result, the IRS asserted that Mr. Ellis's IRA lost its status as an individual retirement account and, under IRC § 408(e)(2), its entire fair market value was to be treated as taxable income. The IRS also asserted an IRC § 6662 accuracy-related penalty.

The Tax Court agreed with the IRS that Mr. Ellis engaged in a prohibited transaction by causing the LLC to pay him wages in 2005, which violated the rules of IRC § 4975. The Tax Court also sustained the IRC § 6662 accuracy-related penalty, as it found that the taxpayers had a substantial understatement of income under IRC § 6662(b)(2) and had not demonstrated reasonable cause. On appeal, the Eighth Circuit affirmed the Tax Court's decision, agreeing that Mr. Ellis had indeed engaged in a prohibited transaction with the LLC and was therefore liable for the deficiency and accuracy-related penalty.

CONCLUSION

Over this last reporting period, the issue of accuracy-related penalties under IRC § 6662(b)(1) and (b)(2) was decided by the courts in 122 cases. Litigation on the issue climbed by nine cases (from 113) over the last reporting period.⁵⁴ For the current reporting period, the IRS prevailed in full in 70 percent of these cases, which is the lowest percentage reported since 2012.⁵⁵

Also notable is the fact that *pro se* taxpayers fared slightly better than represented ones and an increase in the number of split decisions. In addition, as the National Taxpayer Advocate discussed in a research study in her 2013 Annual Report to Congress, there are circumstances where the IRS's imposition of accuracy-related penalties, and where penalized taxpayers were subject to a default assessment, appealed their assessment, or whose penalty was subsequently abated, may lead to increased future

51 See, e.g., *Dunn v. Comm'r*, T.C. Memo. 2015-208; *Niemann v. Comm'r*, T.C. Memo. 2016-11.

52 *Ellis v. Comm'r*, 787 F.3d 1213 (8th Cir. 2015), *aff'g* T.C. Memo. 2013-245.

53 The IRS asserted deficiencies and penalties in the alternative for either 2005 or 2006.

54 See National Taxpayer Advocate 2015 Annual Report to Congress 450.

55 See National Taxpayer Advocate 2015 Annual Report to Congress 450 (77 percent); National Taxpayer Advocate 2014 Annual Report to Congress 446 (78 percent); National Taxpayer Advocate 2013 Annual Report to Congress 341 (78 percent); National Taxpayer Advocate 2012 Annual Report to Congress 589 (66 percent).

noncompliance.⁵⁶ As noted in the study, this may be due to taxpayer perception of accuracy-related penalties in these circumstances as unfair, thereby undermining the purpose of these penalties, which are supposed to promote voluntary compliance.⁵⁷

Courts most often cited inadequate maintenance of records when imposing an accuracy-related penalty. When accepting a defense for reasonable cause and good faith, courts were most likely to cite reliance on a tax professional and manifestations of taxpayer efforts to comply with the tax code.

It is also important to note that Congress enacted law in 2015 reversing the Tax Court's decision in *Rand v. Commissioner*, in which the Tax Court had held that refundable credits cannot reduce the amount shown as tax by the taxpayer on a return below zero.⁵⁸ Congress amended IRC § 6664(a) to be consistent with the rule of IRC § 6211(b)(4), which allows the IRS to calculate negative tax in computing the amount of underpayment for accuracy-related penalty purposes.⁵⁹ Thus, for returns filed after December 18, 2015, or for returns filed on or before that date for which the period of limitations on assessment under IRC § 6501 has not expired, a taxpayer can be subject to an underpayment penalty in IRC § 6662 based on a refundable credit which reduces tax below zero.

56 See National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, 1-14 (Research Study: *Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?*).

57 *Id.*

58 Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title II, § 209, 129 Stat. 2242, 3084 (2015). See also *Rand v. Comm'r*, 141 T.C. 376 (2013).

59 Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title II, § 209, 129 Stat. 2242, 3084 (2015).

MLI
#2**Appeals From Collection Due Process (CDP) Hearings Under IRC §§ 6320 and 6330****SUMMARY**

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

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

Since 2001, CDP has been one of the federal tax issues most frequently litigated in the federal courts and analyzed in the National Taxpayer Advocate's Annual Reports to Congress. The trend continues this year, with our review of litigated issues finding 99 opinions on CDP cases during the review period of June 1, 2015 through May 31, 2016, which is an increase of 25 percent since last year's report.⁵ Taxpayers prevailed in full in ten of these cases (ten percent) and, in part, in six others (six percent). The 16 percent success rate for the taxpayers is one of the highest success rates since the inception of CDP hearings. Of the 16 opinions where taxpayers prevailed in whole or in part, eight taxpayers appeared *pro se*⁶ and eight were represented.

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

CDP hearings are particularly valuable because they provide taxpayers with an enforceable remedy with respect to several rights articulated in the Taxpayer Bill of Rights (TBOR), which was adopted by the IRS in 2014 and was subsequently incorporated in the Internal Revenue Code (IRC) in response to National Taxpayer Advocate recommendations.⁷ In particular, by providing an opportunity for a taxpayer to

1 IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, § 3401, 112 Stat. 685, 746 (1998).

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

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

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

5 For a list of all cases reviewed, see table 2 in Appendix 3, *infra*.

6 *Pro se* means "[f]or oneself; on one's own behalf; without a lawyer." *Pro Se*, BLACK'S LAW DICTIONARY (10th ed. 2014).

7 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

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

TAXPAYER RIGHTS IMPACTED⁸

- *The Right to Be Informed*
- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of an NFTL filed by the IRS or of a proposed levy action.⁹ As discussed above, the purpose of CDP rights is to give taxpayers adequate notice of IRS collection activity and a meaningful hearing before the IRS deprives the taxpayer of property.¹⁰ The hearing allows taxpayers to raise issues related to collection of the liability, including:

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

⁸ See TBOR, www.irs.gov/advocate/taxpayer-rights.

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

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

¹¹ IRC § 6330(c)(2)(A)(ii).

¹² IRC § 6330(c)(2)(A)(iii).

¹³ IRC § 6330(c)(2)(A)(i).

¹⁴ IRC § 6330(c)(2)(B).

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

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

Procedural Collection Due Process (CDP) Requirements

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

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

Requesting a Collection Due Process (CDP) Hearing

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

¹⁶ IRC § 6330(c)(4).

¹⁷ IRC § 6330(f) permits the IRS to levy without first giving a taxpayer a CDP notice in the following situations: the collection of tax is in jeopardy, a levy was served on a state to collect a state tax refund, the levy is a disqualified employment tax levy, or the levy was served on a federal contractor. A disqualified employment tax levy is any levy to collect employment taxes for any taxable period if the person subject to the levy (or any predecessor thereof) requested a CDP hearing with respect to unpaid employment taxes arising in the most recent two-year period before the beginning of the taxable period with respect to which the levy is served. IRC § 6330(h)(1). A federal contractor levy is any levy if the person whose property is subject to the levy (or any predecessor thereof) is a federal contractor. IRC § 6330(h)(2). Under IRC § 6330(f), the IRS must still provide the opportunity for a CDP hearing “within a reasonable period of time after the levy.”

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

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

²⁰ *Id.*

²¹ IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B); Treas. Reg. §§ 301.6320-1(c)(2), Question and Answer (Q&A) (C)(1)(ii) and 301.6330-1(c)(2), Q&A (C)(1)(ii).

²² Treas. Reg. §§ 301.6320-1(c)(2), Q&A (C)(1)(ii) and 301.6330-1(c)(2), Q&A (C)(1)(ii).

²³ IRC §§ 6320(b)(1) and 6330(b)(1); Treas. Reg. §§ 301.6320-1(c)(2), Q&A (C)(1); 301.6330-1(c)(2), Q&A (C)(1); 301.6320-1(d)(2), Q&A (D)(8); and 301.6330-1(d)(2), Q&A (D)(8). The regulations require the IRS to provide the taxpayer an opportunity to “cure” any defect in a timely filed hearing request, including providing a reason for the hearing. Form 12153 includes space for the taxpayer to identify collection alternatives that he or she wants Appeals to consider, as well as examples of common reasons for requesting a hearing. See IRS Form 12153, *Requests for Collection Due Process or Equivalent Hearing* (Dec. 2013).

²⁴ Treas. Reg. §§ 301.6320-1(i)(2), Q&A (I6) and 301.6330-1(i)(2), Q&A (I6); *Business Integration Servs., Inc. v. Comm’r*, T.C. Memo. 2012-342 at 6-7; *Moorhouse v. Comm’r*, 116 T.C. 263 (2001). A taxpayer can request an Equivalent Hearing by checking a box on Form 12153, *Requests for Collection Due Process or Equivalent Hearing*, by making a written request, or by confirming that he or she wants the untimely CDP hearing request to be treated as an Equivalent Hearing when notified by Collection of an untimely CDP hearing request. Internal Revenue Manual (IRM) 5.19.8.4.3, *Equivalent Hearing (EH) Requests and Timeliness of EH Requests* (Nov. 1, 2007).

filing of the NFTL, or in levy cases, within the one-year period beginning the day after the date of the CDP notice.²⁵

Conduct of a Collection Due Process (CDP) Hearing

The IRS generally will suspend the levy action throughout a CDP hearing involving a notice of intent to levy. However, the requirement to suspend a levy action is inapplicable in certain circumstances where the IRS is not required to provide a CDP hearing prior to the levy and is only required to provide the CDP hearing within a reasonable time after the levy.²⁶ These circumstances occur when the IRS determines that:

- The collection of tax is in jeopardy;
- The collection resulted from a levy on a state tax refund;
- The IRS has served a disqualified employment tax levy; or
- The IRS has served a federal contractor levy.²⁷

The IRS also suspends levy action throughout any judicial review of Appeals' determination, unless the IRS obtains an order from the court permitting levy on the grounds that the underlying tax liability is not at issue, and the IRS can demonstrate good cause to resume collection activity.²⁸

CDP hearings are informal. When a taxpayer requests a hearing with respect to both a lien and a proposed levy, Appeals will attempt to conduct one hearing.²⁹ Courts have determined that a CDP hearing need not be face-to-face but can take place by telephone or correspondence,³⁰ and Appeals will typically conduct the hearing by telephone unless the taxpayer requests a face-to-face conference.³¹ The CDP regulations state that taxpayers who provide non-frivolous reasons for opposing the IRS collection

25 Treas. Reg. §§ 301.6320-1(i)(2), Q&A (I7) and 301.6330-1(i)(2), Q&A (I7).

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

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

28 IRC §§ 6330(e)(1) and (e)(2).

29 IRC § 6320(b)(4).

30 *Katz v. Comm'r*, 115 T.C. 329, 337-38 (2000) (finding that telephone conversations between the taxpayer and the Appeals Officer (AO) constituted a hearing as provided in IRC § 6320(b)). Treas. Reg. §§ 301.6320-1(d)(2), Q&A (D)(6), Q&A (D)(8) and 301.6330-1(d)(2), Q&A (D)(6), Q&A (D)(8).

31 See, e.g., *Appeals Letter 4141* (rev. June 2013) (acknowledging the taxpayer's request for a CDP hearing and providing information on the availability of face-to-face conference). The National Taxpayer Advocate has repeatedly raised concerns regarding the inadequacy of Appeals' communication to taxpayers on how to request a face-to-face hearing and where this information is included in the letter. See National Taxpayer Advocate 2005 Annual Report to Congress 136 (Most Serious Problem: *Appeals Campus Centralization*); National Taxpayer Advocate 2009 Annual Report to Congress 70 (Most Serious Problem: *Appeals' Efficiency Initiatives Have Not Improved Customer Satisfaction or Confidence in Appeals*); National Taxpayer Advocate 2010 Annual Report to Congress 128 (Most Serious Problem: *The IRS's Failure to Provide Timely and Adequate Collection Due Process Hearings May Deprive Taxpayers of an Opportunity to Have Their Cases Fully Considered*). For information regarding the availability of Virtual Service Delivery (VSD) teleconferencing, which provides a virtual face-to-face meeting in remote locations, see National Taxpayer Advocate 2012 Annual Report to Congress 462 (Status Update: *The IRS Has Made Significant Progress in Delivering Face-to-Face Service and Should Expand its Initiatives to Meet Taxpayer Needs and Improve Compliance*). See also Director, Policy, Quality and Case Support, *Implementation of Virtual Service Delivery (VSD)*, Memorandum AP-08-0714-0007 (July 24, 2014). Additionally, the IRS has recently adopted a new IRM, IRM 8.6.1.4.1, *Conference Practice* (Oct. 1, 2016), and the issue of how this new policy will be applied in the case of CDP appeals remains an open and troubling question. For a more detailed discussion of the Appeals policy of generally limiting in-person conferences, see Most Serious Problem: *Appeals: The Office of Appeals' Approach to Case Resolution Is Neither Collaborative Nor Taxpayer Friendly and Its "Future Vision" Should Incorporate Those Values, supra*.

action will generally be offered but not guaranteed face-to-face conferences.³² Taxpayers making frivolous arguments are not entitled to face-to-face conferences.³³ A taxpayer will not be granted a face-to-face conference concerning a collection alternative, such as an IA or OIC, unless other taxpayers would be eligible for the alternative under similar circumstances.³⁴ For example, the IRS will not grant a face-to-face conference to a taxpayer who proposes an OIC as the only issue to be addressed but failed to file all required returns and is therefore ineligible for an offer. Appeals may, however, at its discretion, grant a face-to-face conference to explain the eligibility requirements for a collection alternative.³⁵

The CDP hearing is to be held by an impartial officer from Appeals, who is barred from engaging in *ex parte*³⁶ communication with IRS employees about the substance of the case and who has had “no prior involvement.”³⁷ In addition to addressing the issues raised by the taxpayer, the AO must verify that the IRS has met the requirements of all applicable laws and administrative procedures.³⁸ An integral component of the CDP analysis is the balancing test, which requires the IRS AO to weigh the issues raised by the taxpayer and determine whether the proposed collection action balances the need for efficient collection of taxes with the legitimate concern of the taxpayer that any collection be “no more intrusive than necessary.”³⁹ The balancing test is central to a CDP hearing because it instills a genuine notion of fairness into the process from the perspective of the taxpayer.⁴⁰

Special rules apply to the IRS’s handling of hearing requests that raise frivolous issues. IRC § 6330(g) provides that the IRS may disregard any portion of a hearing request based on a position the IRS has identified as frivolous or that reflects a desire to delay or impede the administration of tax laws.⁴¹ Similarly, IRC § 6330(c)(4) provides that a taxpayer cannot raise an issue if it is based on a position identified as frivolous or reflects a desire to delay or impede tax administration.

32 Treas. Reg. §§ 301.6320-1(d)(2), Q&A (D)(7) and 301.6330-1(d)(2), Q&A (D)(7).

33 Treas. Reg. §§ 301.6320-1(d)(2), Q&A (D)(8) and 301.6330-1(d)(2), Q&A (D)(8).

34 *Id.*

35 *Id.*

36 *Ex parte* means “done or made at the instance and for the benefit of one party only, and without notice to, or argument by, anyone having an adverse interest.” *Ex parte*, BLACK’S LAW DICTIONARY (10th ed. 2014).

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

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

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

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

41 IRC § 6330(g). IRC § 6330(g) is effective for submissions made and issues raised after the date on which the IRS first prescribed a list of frivolous positions. Notice 2007-30, 2007-1 C.B. 833, which was published on or about April 2, 2007, provided the first published list of frivolous positions. Notice 2010-33, 2010-17 C.B. 609, contains the current list.

IRC § 6702(b) allows the IRS to impose a penalty for a specified frivolous submission, including a frivolous CDP hearing request.⁴² A request is subject to a penalty if any part of it “(i) is based on a position which the Secretary has identified as frivolous ... or (ii) reflects a desire to delay or impede the administration of Federal tax laws.”⁴³ A taxpayer can timely petition the Tax Court to review an Appeals decision if Appeals determined that a request for an administrative hearing was based entirely on a frivolous position under IRC § 6702(b)(2)(A) and issued a notice stating that Appeals will disregard the request.⁴⁴ An Appeals letter disregarding a CDP hearing request is a determination that confers jurisdiction under IRC § 6330(d)(1), because it authorizes the IRS to proceed with the disputed collection action.⁴⁵ The IRS Office of Chief Counsel disagreed with the Tax Court precedent in *Thornberry* and is maintaining the position that the Tax Court lacks jurisdiction to review a petition resulting from the denial of a frivolous hearing request under section 6330(g).⁴⁶

Recently, in *Ryskamp v. Commissioner*, the D.C. Circuit upheld the Tax Court’s precedent in *Thornberry* that the IRS’s disregard of a taxpayer’s CDP hearing request as frivolous under IRC § 6330(g) is subject to judicial review, and affirmed the Tax Court’s holding that the IRS abused its discretion in rejecting a taxpayer’s request for a hearing by sending boilerplate rejection letters that do not articulate the grounds of the frivolousness determination.⁴⁷ While the IRS Office of Chief Counsel disagrees with *Ryskamp* on both issues, Counsel has modified its litigating guidelines as follows:

- Counsel will no longer file a motion to dismiss to contest the Tax Court’s threshold jurisdiction to evaluate whether a CDP hearing was properly denied under IRC § 6330(g);
- Counsel will request a remand to Appeals where a hearing was improperly denied;
- Where a hearing was properly denied, instead of filing a motion to remand so Appeals can more fully explain the reasons for rejecting the taxpayer’s arguments as frivolous, Counsel will file an appropriate motion with the court to resolve the case through a dismissal or summary judgment; and
- Counsel will also consider filing a motion to permit levy so that the Service can immediately levy after the Tax Court’s order.⁴⁸

42 The frivolous submission penalty applies to the following submissions: CDP hearing requests under IRC §§ 6320 and 6330, OIC under IRC § 7122, IAs under IRC § 6159, and applications for a TAO under IRC § 7811.

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

44 See *Thornberry v. Comm’r*, 136 T.C. 356, 367 (2011). The D.C. Appeals Court recently upheld *Thornberry* in *Ryskamp v. Comm’r*, 116 A.F.T.R.2d (RIA) 5614 (D.C. Cir. Aug. 14, 2015) cert. denied, 136 U.S. 834 (2016). See also National Taxpayer Advocate 2015 Annual Report to Congress 489 (Most Litigated Issue: *Appeals From Collection Due Process Hearings Under IRC §§ 6320 and 6330*).

45 *Thornberry v. Comm’r*, 136 T.C. 356, 364 (2011).

46 See IRS Chief Counsel Notice CC-2012-003, *Disregarding Frivolous CDP Hearing Requests Under Section 6330(g)* (Dec. 2, 2011).

47 *Ryskamp v. Comm’r*, 797 F.3d 1142 (D.C. Cir. 2015), cert. denied, 136 U.S. 834 (2016). For a further discussion of *Ryskamp*, see *Issues Litigated, infra*.

48 IRS Chief Counsel Notice CC-2016-008, *Disregarding Frivolous CDP Hearing Requests Under Section 6330(g)* (Apr. 4, 2016). In her 2014 Annual Report to Congress, the National Taxpayer Advocate expressed concerns about the Office of Appeals not giving proper attention to the CDP balancing test, especially to legitimate concerns of taxpayers regarding the intrusiveness of the proposed collection action, and often using *pro forma* statements that the balancing test has been conducted. See National Taxpayer Advocate 2014 Annual Report to Congress 185-96 (Most Serious Problem: *Collection Due Process: The IRS Needs Specific Procedures for Performing the Collection Due Process Balancing Test to Enhance Taxpayer Protections*).

Judicial Review of a Collection Due Process (CDP) Hearing

Within 30 days of Appeals' determination, the taxpayer may petition the Tax Court for judicial review.⁴⁹ The court will only consider issues, including challenges to the underlying liability, that were properly raised during the CDP hearing.⁵⁰ An issue is not properly raised if the taxpayer fails to request Appeals' consideration of the issue or requests consideration but fails to present any evidence regarding that issue after being given a reasonable opportunity.⁵¹ The Tax Court, however, may remand a case back to Appeals for more fact finding when the taxpayer's factual circumstances have materially changed between the hearing and the trial.⁵² When the case is remanded, the Tax Court retains jurisdiction.⁵³ The resulting hearing on remand provides the parties with an opportunity to complete the initial hearing while preserving the taxpayer's right to receive judicial review of the ultimate administrative determination.⁵⁴

Where the validity of the underlying tax liability is properly at issue in the hearing, the court will review the amount of the tax liability on a *de novo*⁵⁵ basis.⁵⁶ Where the Tax Court is reviewing the appropriateness of the collection action or subsidiary factual and legal findings, the court will review these determinations under an abuse of discretion standard.⁵⁷

Appellate Venue From Decisions of the Tax Court

Generally, the correct venue for appeals from the Tax Court is the D.C. Circuit unless one of the rules specified in IRC § 7482(b)(1) or exceptions specified in IRC §§ 7482(b)(2) or (b)(3) applies. For instance, IRC § 7482(b)(1)(A) provides that in cases where a petitioner other than a corporation seeks redetermination of a tax liability, venue for review by the United States Court of Appeals lies with the Court of Appeals for the circuit based upon the taxpayer's legal residence.⁵⁸ Pursuant to IRC § 7482(b)(2), the taxpayer and the IRS may stipulate the venue for an appeal in writing.

It has been the longstanding practice of taxpayers and the IRS to appeal CDP, innocent spouse, and interest abatement cases to the circuit of the petitioner's legal residence, principal place of business, or principal office or agency. The Tax Court has also followed this approach. Under the rule established in *Golsen v. Commissioner*,⁵⁹ the Tax Court follows the precedent of the circuit court to which the parties have the right to appeal regardless of whether the taxpayer's tax liability was at issue.

49 IRC § 6330(d)(1).

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

51 Treas. Reg. §§ 301.6320-1(f)(2), Q&A (F)(3); 301.6330-1(f)(2), Q&A (F)(3).

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

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

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

55 *De novo* means "anew." *De Novo*, BLACK'S LAW DICTIONARY (10th ed. 2014).

56 The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing Appeals' CDP determinations. H.R. REP. NO. 1059-99, at 266. See also CC-2014-002 (May 4, 2014).

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

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

59 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

In *Byers v. Commissioner*, the D.C. Circuit held that it will not transfer cases in non-liability CDP cases unless both parties stipulate to the transfer.⁶⁰ The D.C. Circuit did not answer the question of whether another Court of Appeals could hear an appeal of a non-liability CDP decision without stipulation.⁶¹ The Court acknowledged that in some CDP cases involving both challenges to the tax liability and collection issues, the venue presumably would be in the appropriate regional circuit.⁶²

Byers was overruled by the Protecting Americans from Tax Hikes (PATH) Act of 2015, enacted December 18, 2015.⁶³ Section 423 of the PATH Act added new subparagraph IRC § 7482(b)(1)(G), which specifies that CDP cases are appealable to the circuit of the petitioner's legal residence (if the petitioner is an individual) or the petitioner's principal place of business, office, or agency (if the petitioner is not an individual). According to section 423(b) of the PATH Act, the new subparagraph applies only to cases filed after December 18, 2015, but they should not be construed to create any inference regarding cases filed before that date.⁶⁴ In 2014, to address the uncertainty and confusion among taxpayers and practitioners that impact *the right to be informed*, the National Taxpayer Advocate recommended this precise legislative change to Congress.⁶⁵

ANALYSIS OF PUBLISHED OPINIONS

We identified and reviewed 99 CDP court opinions, a 25 percent increase from the 79 published opinions in last year's report. As shown in Figure 3.2.1, we have identified on average over 130 opinions per year since 2001.

From 2003 to 2007, the average number of published opinions was approximately 200. Since 2011, the average number of published opinions has dropped to about 94. This decline may seem to be attributed, in part, to a series of operational changes in fiscal years (FYs) 2011 and 2012, collectively known as the

60 740 F.3d 668 (D.C. Cir. 2014). For a more detailed discussion of the *Byers* case see National Taxpayer Advocate 2014 Annual Report to Congress 477-94 (Most Litigated Issue: *Appeals From Collection Due Process Hearings Under IRC §§ 6320 and 6330*).

61 740 F.3d at 677. The Court noted that it had “no occasion to decide ... whether a taxpayer who is seeking review of a CDP decision on a collection method may file in a court of appeals other than the D.C. Circuit if the parties have not stipulated to venue in another circuit.”

62 *Id.* at 676.

63 Pub. L. No. 114-113, Div. Q, 129 Stat. 2242, 3041-3129 (2015). See IRS Office of Chief Counsel, Notice CC-2016-006, *PATH Act Legislative Amendments: Appellate Venue for CDP and Innocent Spouse Cases, Tax Court Jurisdiction and S-case Status for Interest Abatement Cases, and Applicability of Federal Rules of Evidence to the Tax Court* (Feb. 1, 2016), superseding CC-2015-006, *Venue for Appeals from Decisions of the Tax Court* (June 30, 2015).

64 For cases filed before that date, the guidance in CC-2015-006 applies.

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

“Fresh Start” initiative,⁶⁶ which led to fewer NFTL filings and more accepted OIC.⁶⁷ However, it is not clear that the reduction in CDP published opinions is attributable to the reduced number of lien filings. Furthermore, the annual number of CDP cases petitioned fluctuated inconsistently over this time.⁶⁸

The increase in CDP cases received suggests that the reduced number of CDP opinions identified may not be the result of fewer taxpayers requesting a CDP hearing and then contesting the CDP determination by filing a Tax Court petition. Instead, it could be the result of more taxpayers deciding not to pursue litigation after filing a petition, more settlements, or more non-precedential CDP orders or bench opinions that do not result in a published opinion.⁶⁹ Moreover, the decline in litigated cases may be due to taxpayers litigating many issues of first impression in the years immediately following the enactment of IRC §§ 6320 and 6330, which now have been resolved by the courts.

Thus, the 99 published opinions identified this year do not reflect the full number of CDP cases.⁷⁰ Table 2 in Appendix 3 provides a detailed list of the published CDP opinions, including specific information about the issues, the types of taxpayers involved, and the outcomes of the cases.

Litigation Success Rate

Taxpayers prevailed in full in ten of the 99 published opinions issued during the year ending May 31, 2016 (ten percent). Taxpayers prevailed in part in six other cases (six percent). Of the published opinions in which the courts found for the taxpayer, in whole or in part, the taxpayers appeared *pro se* in eight cases and were represented in eight cases. The IRS prevailed fully in 83 cases (approximately 84 percent) of the published opinions, an increase from the 82 percent last year.⁷¹ The 16 percent success rate⁷² for the taxpayer is one of the highest success rates since the inception of CDP hearings and may be an indication that the IRS is not addressing collection alternatives adequately at the administrative hearing.

66 See IRS, IR-2011-20, *IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes Made to Lien Process* (Feb. 24, 2011); IR-2012-31, *IRS Offers New Penalty Relief and Expanded Installment Agreements to Taxpayers under Expanded Fresh Start Initiative* (Mar. 7, 2012); IR-2012-53, *IRS Announces More Flexible Offer-in-Compromise Terms to Help a Greater Number of Struggling Taxpayers Make a Fresh Start* (May 21, 2012). See also National Taxpayer Advocate 2015 Annual Report to Congress 114, National Taxpayer Advocate 2012 Annual Report to Congress 348-51; National Taxpayer Advocate Fiscal Year (FY) 2013 Objectives Report to Congress 32-35.

67 For instance, in FY 2016, the IRS filed about 55 percent fewer NFTLs than in FY 2011, including a corresponding 58 percent reduction in liens filed by the Automated Collection System (ACS). In FY 2011, the IRS filed 1,042,230 liens. See IRS, Collection Activity Report 5000-23 (Oct. 11, 2011). In FY 2016, the IRS filed 470,602 liens. See IRS, Collection Activity Report 5000-25 (Oct. 4, 2016). Additionally, the dollars collected increased from about \$17 billion in FY 2011 to about \$20.2 billion in 2016. See IRS, Collection Activity Report 5000-2 (Oct. 3, 2011); IRS, Collection Activity Report 5000-6 (Oct. 3, 2011); IRS, Collection Activity Report 5000-108 (Oct. 5, 2011); IRS, Collection Activity Report 5000-2 (Oct. 3, 2016); IRS, Collection Activity Report 5000-6 (Oct. 3, 2016); IRS, Collection Activity Report 5000-108 (Oct. 4, 2016). We also note that the IRS has accepted 36 percent more OICs than during FY 2011, and that the actual number of accepted offers has almost doubled when compared to FY 2010, with FY 2016 having an acceptance rate of 40.4 percent. See IRS, Collection Activity Report 5000-108 (Oct. 5, 2010); IRS, Collection Activity Report 5000-108 (Oct. 5, 2011); IRS, Collection Activity Report 5000-108 (Oct. 4, 2016). During FY 2016, thousands of financially struggling taxpayers have successfully obtained lien withdrawals to help regain their financial viability. See IRS, Collection Activity Report 5000-25 Report (Oct. 4, 2016).

68 IRS Office of Chief Counsel Reports, CDP Cases Received Between June 1, 2000 and May 31, 2015 (on file with TAS).

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

70 See U.S. Tax Court, Orders Search, <https://www.ustaxcourt.gov/InternetOrders/OrdersSearch.aspx>.

71 National Taxpayer Advocate 2015 Annual Report to Congress 489 (Most Litigated Issue: *Appeals From Collection Due Process Hearings Under IRC § 6320 and 6330*).

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

FIGURE 3.2.1, Success Rates in Collection Due Process (CDP) Opinions Identified⁷³

Court Decision	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Decided for IRS	95%	95%	89%	90%	92%	90%	92%	89%	92%	86%	84%	89%	82%	84%
Decided for Taxpayer	1%	3%	8%	8%	5%	8%	4%	10%	3%	7%	8%	7%	14%	10%
Split Decision	4%	2%	3%	2%	3%	2%	4%	2%	3%	6%	9%	4%	4%	6%
Neither	n/a	n/a	n/a	n/a	<1%	n/a	n/a	n/a	1%	<1%	n/a	n/a	n/a	n/a

Issues Litigated

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

Ryskamp v. Commissioner

In *Ryskamp v. Commissioner*, the IRS Office of Appeals sent a letter denying the taxpayer a CDP hearing.⁷⁴ The letter simply stated that the grounds upon which he requested a CDP hearing were frivolous or reflected a desire to delay or impede the administration of the federal tax laws.⁷⁵ In taxable years (TYs) 2003–2009, Mr. Ryskamp incurred tax liabilities because he did not have adequate withholding and failed to make estimated tax payments. In 2011, the IRS notified Mr. Ryskamp that it intended to levy his property in order to collect these delinquent liabilities. Mr. Ryskamp had submitted a CDP hearing request which was later lost by the IRS. The IRS rejected the request pursuant to IRC § 6330(g) stating that Mr. Ryskamp had not offered a legitimate reason for requesting a hearing and asked that he withdraw his frivolous positions and amend his request to provide a legitimate reason. Mr. Ryskamp submitted an amended request and attempted to state legitimate grounds. The AO disregarded Mr. Ryskamp’s request and issued a “boilerplate” letter which did not contain a statement of reasons why the taxpayer’s request was illegitimate.⁷⁶ Instead, the IRS letter recited the various possible reasons a position can be frivolous without specificity.

Having previously decided that the Tax Court had jurisdiction to review the IRS’s frivolousness determination,⁷⁷ the Tax Court found the IRS’s boilerplate letter rejecting Mr. Ryskamp’s arguments as frivolous was inadequate and remanded the case to Appeals.

On remand from the Tax Court, Appeals gave the taxpayer another opportunity to submit a new CDP request. He did so, and raised both frivolous and non-frivolous arguments. Appeals held a hearing by

⁷³ Total percentages may not add to 100 percent, as a result of rounding.

⁷⁴ *Ryskamp v. Comm’r*, 797 F.3d 1142 (D.C. Cir. 2015), cert. denied, 136 U.S. 834 (2016).

⁷⁵ *Id.*

⁷⁶ The IRS’s letter failed to identify any allegedly frivolous positions and lacked any explanation of how and whether the taxpayer’s CDP request showed a desire to delay or impede tax administration. The Appeals letter “merely included a bullet point list of all of the possible reasons the [IRS] could find a request to be frivolous and did not correlate them with any aspects of Ryskamp’s request.” *Ryskamp*, 797 F.3d at 1151.

⁷⁷ See *Thornberry v. Comm’r*, 136 T.C. 356 (2011) (the IRS’s determination that a taxpayer’s entire request for a CDP hearing is frivolous is subject to judicial review to verify the frivolousness determination).

correspondence, at which it rejected Mr. Ryskamp's frivolous positions and substantively considered his non-frivolous positions. Because Mr. Ryskamp refused to provide Appeals with necessary financial information and failed to offer any proof that he was in filing compliance, Appeals issued a notice of determination sustaining the IRS's proposal to levy. After remand, the Tax Court decided that Appeals did not abuse its discretion in concluding the IRS could proceed with collection action.

The taxpayer then appealed to the Court of Appeals for the District of Columbia. The IRS once again argued that the Tax Court lacked jurisdiction over an IRC § 6330(g) denial of a CDP hearing.

The D.C. Circuit reaffirmed the Tax Court's decision in *Thornberry*, concluding that the Tax Court's review is limited to assessing whether the IRS has adequately identified why it deems the taxpayer's CDP request, or portions thereof, to be frivolous, and whether that frivolousness assessment is facially plausible.⁷⁸ The court reasoned that this limited review would provide a safeguard against the IRS misconstruing or inadvertently overlooking a non-frivolous ("plausible or potentially meritorious") CDP request.⁷⁹

The D.C. Circuit also affirmed the Tax Court's holding that the IRS's initial boilerplate determination letter denying the taxpayer's CDP hearing request was inadequate. It also found that the IRS abused its discretion in rejecting Ryskamp's request without first articulating the grounds of its frivolousness determination.⁸⁰

However, the D.C. Circuit agreed with the Tax Court that on remand, Appeals provided the taxpayer with the opportunity to submit a new CDP request and adequately considered taxpayer's frivolous and non-frivolous arguments, concluding that the IRS could proceed with collection.

Charnas v. Commissioner

In *Charnas v. Commissioner*, the IRS issued a notice of intent to levy to the taxpayer, a lawyer, whose main source of income was contingency fees from representing clients in personal injury actions.⁸¹ The taxpayer timely requested a CDP hearing on Form 12153, *Request for a Collection Due Process or Equivalent Hearing*, and checked boxes for all three collection alternatives.⁸² The Settlement Officer (SO) scheduled a telephone CDP hearing and requested financial documentation for a collection alternative to be considered. Rather than sending in the documents, the taxpayer arrived at the IRS office with the documents in hand. The SO was on sick leave that day and not physically present at the office when the taxpayer arrived. The taxpayer left the financial documents at the IRS office and identified on the documents that his income varied widely from year to year due to the nature of his employment. The SO checked over the documents and denied the taxpayer a collection alternative based on the unexplained fluctuating income and sustained the levy action, without waiting for an explanation from the taxpayer.

78 136 T.C. at 367–69.

79 *Ryskamp*, 797 F.3d at 1149.

80 797 F.3d at 1151.

81 T.C. Memo. 2015-153.

82 Form 12153 lists the following three items as collection alternatives: 1) Installment Agreement, 2) Offer in Compromise, and 3) I Cannot Pay Balance. See IRS Form 12153, *Requests for Collection Due Process or Equivalent Hearing* (Dec. 2013).

Additionally, the SO never afforded the taxpayer a face-to-face conference to explain his situation.⁸³ The taxpayer petitioned the Tax Court to review the SO's determination.

The Tax Court held that the SO acted arbitrarily and capriciously in rendering a determination against the taxpayer and remanded the case to Appeals. The court found that the SO did not weigh the taxpayer's fluctuating income in either the notice of determination or the case activity report when assessing the taxpayer's ability to pay. Additionally, the court found that the taxpayer presented relevant and non-frivolous reasons for disagreement with the proposed action and should have been given a "fair" hearing, providing him the opportunity to explain the significant fluctuations in his income.

The case is important because it reemphasizes the legislative requirement for Appeals to balance the need for efficient collection of taxes with the legitimate concern of the taxpayer that any collection action will be no more intrusive than necessary.⁸⁴ This opinion is in line with the *Budish* case where the court also remanded the case to Appeals for the failure to give proper attention to the balancing test in sustaining a collection action.⁸⁵ The Tax Court consistently views Appeals' failure to meaningfully perform the balancing test as an abuse of discretion.⁸⁶

Abu-Dayeh v. Commissioner

Abu-Dayeh v. Commissioner involves a tax preparer who pled guilty to aiding and assisting in the preparation of materially false and fraudulent tax returns.⁸⁷ In 2008, the taxpayer agreed to terms of a plea agreement to dismiss some of the counts against him, which required him to serve five months in prison and pay the IRS \$79,070 in restitution for the total tax losses due to the taxpayer's conduct.⁸⁸ The taxpayer paid all of the court-order restitution.

Later, in 2010, the IRS assessed multiple \$1,000 penalties under IRC § 6694(b) for understatements due to willful or reckless conduct by the tax return preparer.⁸⁹ The taxpayer protested the assessment by requesting a hearing with Appeals, and a conference was held on March 23, 2011. During the conference with Appeals, the taxpayer raised three defenses to the IRC § 6694(b) penalties:

- (1) He believed he had already paid the penalties as part of his restitution payment;
- (2) He believed the plea agreement covered all issues with respect to his preparation of the 39 fraudulent returns, and as a result it would be unfair for the IRS to assess civil penalties against him; and

83 In prior Annual Reports to Congress, and this report, the National Taxpayer Advocate criticizes Appeals for failing to provide face-to-face hearings to many taxpayers. See, e.g., Most Serious Problem: *Appeals: The Office of Appeals' Approach to Case Resolution Is Neither Collaborative Nor Taxpayer Friendly and Its "Future Vision" Should Incorporate Those Values, supra*; National Taxpayer Advocate 2014 Annual Report to Congress 46-54 (Most Serious Problem: *Appeals: The IRS Lacks a Permanent Appeals Presence in 12 States and Puerto Rico, Thereby Making It Difficult for Some Taxpayers to Obtain Timely and Equitable Face-to-Face Hearings with an Appeals Officer or Settlement Officer in Each State*).

84 IRC § 6330(c)(3)(C). See also National Taxpayer Advocate 2014 Annual Report to Congress 186-96 (Most Serious Problem: *Collection Due Process: The IRS Needs Specific Procedures for Performing the Collection Due Process Balancing Test to Enhance Taxpayer Protections*).

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

86 See National Taxpayer Advocate 2014 Annual Report to Congress 186-96 (Most Serious Problem: *Collection Due Process: The IRS Needs Specific Procedures for Performing the Collection Due Process Balancing Test to Enhance Taxpayer Protections*).

87 T.C. Memo. 2015-136.

88 See *United States v. Husam Abu-Dayeh*, No. 08-cr-00173-SCB-TBM (M.D.Fla., Apr. 22, 2009) (judgment in criminal case).

89 IRC § 6694(b). Taxpayer was assessed 36 separate \$1,000 penalties for returns prepared in taxable years 2003 to 2004.

- (3) His criminal proceedings had been handled by a special criminal investigation agent, and thus the IRS did not independently examine him for preparer penalties.

The AO determined the penalties were properly assessed.⁹⁰ The IRS issued a Letter 1058, *Final Notice of Intent to Levy and Notice of Your Right to a Hearing* on October 18, 2011, to which the taxpayer responded 31 days after the notice was mailed. On May 1, 2012, the IRS mailed to the taxpayer Letter 3172, *Notice of Federal Tax Lien Filing and Notice of Your Right to a Hearing Under IRC 6320*, and filed the NFTL on May 3, 2012. The taxpayer timely requested a CDP hearing. He also requested a withdrawal of the lien and checked the box for “I Cannot Pay Balance.”

The IRS SO held a CDP hearing telephonically, and the taxpayer challenged his underlying liability. The taxpayer also suggested an OIC in the amount of \$5,000, but did not submit an application fee or pay the initial required payment with a completed Form 656.⁹¹ During the CDP process, the taxpayer repeatedly insisted to the SO that he had already paid any applicable penalties by virtue of having paid restitution in his criminal case. The Centralized Offer in Compromise (COIC) office returned the taxpayer’s OIC as not processable due to his failure to submit the application fee or required initial payment.

The SO issued the notice of determination to the taxpayer which sustained the NFTL; concluded that the taxpayer could not raise his underlying liability because he had a prior opportunity to do so; upheld the rejection of the OIC for failure to submit the required payments; and noted that the taxpayer had not proposed any other collection alternatives. The taxpayer petitioned the Tax Court to review the IRS’s determination.

The Tax Court upheld the SO’s determination that the taxpayer could not challenge the underlying liability in the CDP hearing because he had a prior opportunity to do so during his conference with the AO.⁹² Because the validity of the underlying liability was not properly at issue, the Tax Court reviewed the SO’s administrative determination for abuse of discretion.⁹³

In considering whether the IRS abused its discretion, the Tax Court looked at whether the SO considered any relevant issues raised at the hearing, and properly applied the CDP balancing test ensuring that any proposed collection action balanced the need for the efficient collection of taxes with petitioner’s legitimate concern that any collection action be no more intrusive than necessary.⁹⁴ While expressing empathy for the taxpayer, the Tax Court determined that the SO did not abuse her discretion in rejecting the taxpayer’s OIC because the taxpayer failed to pay the application fee, to make a partial payment of his proposed \$5,000 offer, and to submit supporting financial documents as required by IRC § 7122(c) and relevant Treasury Regulations.⁹⁵

90 The AO determined that the taxpayer be properly assessed 36 total penalties of \$1,000 each based on the taxpayer’s admission of guilt as to 39 counts in his plea agreement and the fact that understatements of tax liability existed on only 36 of those counts.

91 See IRM 5.8.2.4.1, *Determining Processability* (July 28, 2015) (stating that an “OIC will be returned as not processable if one or more of the criteria below are present: ... • [t]axpayer did not submit the application fee with the offer[;] ... • [t]axpayer did not submit the required initial payment with the offer”).

92 IRC § 6330(c)(2)(B).

93 *Goza v. Comm’r*, 114 T.C. 176, 181–182 (2000).

94 See IRC §§ 6320(c)(1), 6330(c)(2) and (3)(A), (B), and (C).

95 IRC § 7122(c)(1) and (2)(B); Treas. Reg. § 301.7122–1(d)(1).

The opinion is important because it discusses the issue of contesting the underlying liability at the CDP hearing after the taxpayer has had a prior opportunity to dispute the liability.⁹⁶ It is important to note that the Tax Court verified that the SO properly conducted the CDP balancing test, which is an integral part of the taxpayer's *right to privacy*.

Yasgur v. Commissioner

In *Yasgur v. Commissioner*, the Tax Court was asked to determine if a taxpayer, Mr. Yasgur, was precluded under IRC § 6330(c)(2)(B) from challenging the underlying tax liability because he either “received, was aware of, or deliberately failed to learn of” an April 30, 2005, levy notice issued to him.⁹⁷ This case involves the unique set of facts regarding the mailing location of the notices.

The taxpayer in question was married, but lived separately and had a distant relationship from his wife, despite the fact that they continued to file joint tax returns after establishing separate residences.⁹⁸ For these joint tax returns, including the year 2003 in question, the taxpayers listed the wife's residence, which was their jointly-owned home (“marital home”) 100 miles away from the taxpayer's residence. In addition to living separately, the taxpayers had a “cordial but distant relationship,” in which they would communicate sporadically and often go several months without any communication. The taxpayer stipulated that the marital home address was his “last known address” for purposes of taxes and admitted that the address was primarily used for correspondence related to federal and New York state taxes. The taxpayer's wife would generally forward any unopened mail addressed to Mr. Yasgur individually and would open jointly addressed mail and forward Mr. Yasgur a copy or the original.

In October 2004, the taxpayer filed a joint federal income tax return for 2003 indicating a tax due of \$60,801.⁹⁹ In January 2005, the IRS field office in Holtsville, NY had notified both the taxpayer and his wife of the amount owed in reported unpaid tax. The taxpayer swiftly contacted the collection manager and requested collection actions be stalled until the taxpayers could file an amended return. The collection manager suggested that Mr. Yasgur enter into an IA, a topic he discussed with his distant wife, until, at least, May 23, 2005. However, on April 30, 2005, the IRS Automated Collection System (ACS) Support office mailed, certified, separate notices of intent to levy to Mr. and Mrs. Yasgur, which Mrs. Yasgur picked up at the U.S. Post Office near her home. Mrs. Yasgur neither forwarded this notice to Mr. Yasgur nor requested a CDP hearing within the 30 day time period. Although Mr. Yasgur did not receive the April 30, 2005 notice or have knowledge of it prior to early August 2005, Mr. Yasgur contacted an attorney “regarding one or both of the notices of levy,” and, on August 17, 2005, the attorney requested a hearing with respect to the April 30, 2005 levy notice. The attorney sent a second letter to the IRS requesting another hearing with respect to the notice of lien filing, specifically a Letter 3172, *Notice of*

96 See, e.g., *Our Country Home Enters., Inc. v. Comm'r*, No. 16-1279 (7th Cir. Aug. 25, 2016) (reply brief of appellant) (arguing that the government's contention that the limitations of § 6330(c)(4) prohibited the Tax Court from determining the merits of the penalty assessment is contradictory towards IRS Chief Counsel memos and a prior argument made by Department of Justice, upheld in *Lewis v. Comm'r*, 128 T.C. 48 (2007), that courts should defer to regulation under § 6330(c)(2)(B)); *James v. Comm'r*, No. 16-1154 (4th Cir. Aug. 25, 2016) (reply brief of appellant) (same); and *Keller Tank Serv. v. Comm'r*, No. 16-9001 (10th Cir. Aug. 24, 2016) (reply brief of appellant) (same). These briefs also cite to the National Taxpayer Advocate's 2013, 2014, and 2015 Annual Reports to Congress for a discussion on the issues with “independence” by the Office of Appeals.

97 T.C. Memo. 2016-77.

98 A prior decision by the court had determined that the taxpayer's wife was precluded from challenging the existence or amount of the underlying tax liability for 2003 since she had prior opportunity to do so. *Yasgur v. Comm'r*, T.C. Memo. 2016-77.

99 The taxpayer's liability was primarily attributable to his reporting of passive income from his interest in a law partnership via a Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.*, received before the extended due date of the 2003 return. The taxpayer believes the income was overstated and had a difficult relationship with his law partners so, at the advice of his accountant, they reported the income but intended to file an amended return when they could document Mr. Yasgur's claim of a lesser share of partnership income.

Federal Tax Lien Filing and Your Rights to a Hearing Under IRC § 6320, sent jointly to both Mr. and Mrs. Yasgur on August 16, 2005. In late September 2005, the taxpayers submitted an amended 2003 joint income tax return reflecting a lower tax liability and a refund request for almost \$4,000. Finally, on October 13, 2005, the taxpayer's attorney submitted a Form 12153, *Request for a Collection Due Process or Equivalent Hearing*, requesting a hearing with respect to both the levy and lien notices.

The Appeals SO determined that the husband and wife's requests for a hearing were untimely with respect to both the lien and levy notices but did provide them with an equivalent hearing and issued a decision letter.¹⁰⁰ The decision letter determined that the taxpayers were not entitled to challenge the existence or amount of the underlying tax liability since they had prior opportunity to "discuss" the tax liability. The taxpayer petitioned the Tax Court that the determination made by Appeals to sustain the lien notice was an abuse of discretion since he had no unpaid tax liability for 2003, as shown on the amended return. The Tax Court held that Mr. Yasgur was entitled to challenge the underlying tax liability because he neither received prior notice of the levy nor deliberately refused the delivery of the notice.

The court looked to if Mr. Yasgur either "received, was aware of, or deliberately failed to learn of" the levy notice since, in cases where there is joint and several liability for an unpaid tax, the IRS must send a separate notice to each spouse whose property the IRS intends to levy, and the government has the burden of production to prove the taxpayer received the notice.¹⁰¹ The taxpayer provided significant evidence to rebut the presumption of receipt, including the fact that the taxpayer did not reside at the marital home and his testimony. Specifically, the court did not agree with the government's assertion that since Mrs. Yasgur was aware of the levy, she "would undoubtedly have told him about something so serious and significant affecting their financial circumstances." The court determined that Mrs. Yasgur could have believed that the levy notices addressed the same issues that Mr. Yasgur was working with the Holtsville office on and failed to notify him. Furthermore, the court found evidence of Mr. Yasgur's tendency to be "punctilious and transparent" in his dealings with the IRS and this "pattern of conduct ... is at odds with the contention that [the taxpayer] ... received, or was aware of, the levy notice ... and simply ignored it." Finally, the court found no evidence of the IRS's alleged scheme where the taxpayer arranged to have all his IRS correspondence sent to the marital home while residing elsewhere so that he could disclaim knowledge of any notices. The Tax Court held that the taxpayer did not deliberately refuse delivery nor deliberately failed to learn of the levy notices and thus he did not have the prior opportunity to challenge the underlying tax liability.

The Tax Court opinion reveals the importance of the due process afforded to a taxpayer before a collection action can be sustained. If a taxpayer does not receive notice and does not deliberately thwart an attempt by the IRS to deliver a notice, then the taxpayer must be afforded his or her due process to challenge the underlying tax liabilities. Furthermore, this opinion shows the importance of the IRS's obligation to listen to the taxpayer, as the Tax Court did, instead of assuming the taxpayer is a bad actor. This is at the heart of the taxpayer's *right to challenge the IRS position and be heard*, since there is an obligation on the part of the IRS to listen to the taxpayer, and the *right to a fair and just tax system*, since the IRS failed to consider the specific facts and circumstances of the taxpayers' living situation.

¹⁰⁰ Although the decision letter and SO determination was in respect to both the lien and the levy, the IRS conceded that the lien hearing request was timely and the Tax Court has jurisdiction. This was because the decision letter contained a determination with respect to the lien which may be reviewed by the Tax Court. See *Craig v. Comm'r*, 119 T.C. 252 (2002); cf. *Wilson v. Comm'r*, 113 T.C. 47 (2008) and *MacDonald v. Comm'r*, T.C. Memo. 2009-63.

¹⁰¹ See *Moorhouse v. Comm'r*, 116 T.C. 263, 271 (2001) (discussing the need for separate levy notice to each spouse).

CONCLUSION

CDP hearings provide instrumental protections for taxpayers to meaningfully address the appropriateness of IRS collection actions. Given the important safeguard that CDP hearings offer taxpayers, it is unsurprising that CDP remains one of the most frequently litigated issues. The cases discussed this year were important for a variety of reasons.

The cases affirmed important protections for taxpayers, substantiated the Tax Court's test for abuse of discretion, and addressed procedural issues. The *Ryskamp* opinion confirmed the taxpayer's *right to challenge the IRS's position and be heard*. In *Ryskamp*, the court reaffirmed the Tax Court's holding in *Thornberry* and prevented the IRS from denying a CDP hearing by simply labeling the hearing request as entirely frivolous.¹⁰² The opinion also validated a taxpayer's *right to be informed* because the court held that the IRS could not send standardized letters, but rather, must give some indication as to which issues raised by a taxpayer are frivolous.

Chief Counsel issued a notice changing the guidelines for handling frivolous CDP hearing requests under IRC § 6330(g) in response to *Ryskamp*.¹⁰³ Counsel attorneys will no longer file motions to dismiss, but rather motions to remand cases to Appeals for a substantive hearing to address legitimate issues if Counsel determines that the taxpayer raised at least one legitimate issue and the CDP hearing request should not have been denied in its entirety. The Tax Court in *Ryskamp* held that the IRS cannot send standardized letters and must articulate the bases of its denial under section 6330(g) by explaining why each argument of the taxpayer is not proper.¹⁰⁴ Counsel continues to disagree with the holdings in *Ryskamp* but recognized, in view of the settled Tax Court and D.C. Circuit law, that it would be a waste of Counsel resources to continue to contest Tax Court jurisdiction in those forums.

Charnas illustrates the importance of a taxpayer's *rights to privacy, to challenge the IRS's position and to be heard, and to a fair and just tax system* because the opinion reemphasizes the importance of the CDP balancing test.¹⁰⁵ Similar to the *Budish* case discussed in last year's report,¹⁰⁶ the *Charnas* court found that by failing to perform the proper balancing test, the IRS had abused its discretion in sustaining a levy. The *Charnas* and *Budish* decisions show the Tax Court's consistency in scrutinizing Appeals' determinations lacking elaboration or proper analysis. In *Charnas*, the Tax Court also concluded that a correspondence-only hearing was not sufficient to provide the taxpayer the fair hearing under IRC §§ 6330 and 6320. The *Charnas* decision pushes the IRS to live up to its commitment to provide face-to-face conferences

¹⁰² *Thornberry v. Comm'r*, 136 T.C. 356, 367 (2011).

¹⁰³ Notice CC-2016-008 Subject: *Disregarding Frivolous CDP Hearing Requests Under Section 6330(g)* (Apr. 4, 2016).

¹⁰⁴ *Ryskamp v. Comm'r*, 797 F.3d 1142 (D.C. Cir. 2015), cert. denied, 136 U.S. 834 (2016). Cf. *Lunnon v. Comm'r*, T.C. Memo. 2015-156, *aff'd*, 117 A.F.T.R.2d (RIA) 2094 (10th Cir. 2016). In *Lunnon*, the taxpayer called the revenue officer handling the case the "spawn of Satan himself" and attached a 30-page frivolous document published by Truth Attack entitled "The Real Truth About the IRS's Truth About Frivolous Tax Arguments." Despite making frivolous arguments during the pre-CDP phase of the case, the taxpayer used neutral language in his CDP request disputing the proposed levy, requesting the withdrawal of the NFTL, and stating that he did not owe taxes. During the CDP conference despite the SO's warning Mr. Lunnon about making frivolous arguments, the taxpayer "wanted to discuss only constitutional challenges to his tax liabilities and how he disagreed with [RO's] 'intrusive' investigation." Nonetheless, the SO did not invoke IRC § 6330(g) but instead made a substantive determination on the merits. The Tax Court affirmed the Appeals' determination. The contrast of the handling these two cases shows that administering the frivolous provisions is a challenging task for Appeals employees facing a taxpayer who raises potentially frivolous issues and does not properly articulate legitimate arguments.

¹⁰⁵ IRC § 6330(c)(3)(C).

¹⁰⁶ See *Budish v. Comm'r*, T.C. Memo. 2014-230; see also National Taxpayer Advocate 2015 Annual Report to Congress 481-98 (Most Litigated Issue: *Appeals From Collection Due Process Hearings Under IRC §§ 6320 and 6330*); National Taxpayer Advocate 2014 Annual Report to Congress 186-96.

with Appeals to taxpayers who present relevant, non-frivolous reasons for disagreement.¹⁰⁷ Moving away from *pro forma* statements and boilerplate language (without proper analysis) and encouraging hearing officers to fully consider relevant, non-frivolous issues in a face-to-face setting could go a long way in reducing future litigation. By not giving proper attention to the balancing test and conducting correspondence-only hearings, the IRS is missing opportunities to improve compliance, enhance taxpayer trust and confidence, relieve undue burden on taxpayers, and support the taxpayer's *right to privacy*.¹⁰⁸

Abu-Dayeh is important because it identified the necessity of taxpayers to follow the procedural requirements of offering a collection alternative (*e.g.*, an OIC).¹⁰⁹ Thus taxpayers and the IRS are held accountable to the uniform procedural standards of the taxpayer's *right to a fair and just tax system* is protected.

Yasgur sheds important light on a taxpayer's *right to be informed, right to pay no more than the correct amount of tax, and the right to challenge the IRS's position and be heard*. If a taxpayer does not receive notice of an IRS collection action and does not deliberately prevent an attempt by the IRS to deliver the notice, then the taxpayer must be afforded his or her due process right to challenge the underlying tax liabilities.¹¹⁰ A taxpayer may challenge the existence or amount of the underlying tax liability, but only if he or she did not receive a notice of deficiency with respect to the liability or otherwise have an opportunity to dispute the liability.¹¹¹ The IRS cannot assume taxpayers have had an opportunity to dispute the liability simply because a notice has been sent.

In sum, the CDP hearing is a powerful tool for taxpayers. Genuine two-way communication, rather than boilerplate letters, between the IRS and the taxpayer is crucial for the process to work properly. When taxpayers provide full documentation and develop a complete and comprehensive administrative record, they have a better chance of prevailing on Appeal and during judicial review. To reduce litigation in this area, the IRS Office of Appeals should commit to making substantive determinations in CDP cases properly considering the balancing test and all relevant, nonfrivolous issues, and better take into account all facts and circumstances. The IRS needs to thoroughly address the legitimate issues of a taxpayer disputing a collection action to further the taxpayer's *rights to be informed, to privacy, to pay no more than the correct amount of tax, to challenge the IRS's position and to be heard, to appeal an IRS decision in an independent forum, and to a fair and just tax system*.

107 Treas. Reg. § 301.6330-1(d)(2), Q&A D-7 (stating that “a taxpayer who presents in the CDP hearing request relevant, non-frivolous reasons for disagreement with the proposed levy will ordinarily be offered an opportunity for a face-to-face conference at the Appeals office closest to taxpayer’s residence.”).

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

109 *Abu-Dayeh v. Comm’r*, T.C. Memo. 2015-136.

110 IRC § 6330(c)(2)(B).

111 *Id.*

MLI
#3

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

SUMMARY

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

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

We identified 87 federal cases decided between June 1, 2015, and May 31, 2016 involving IRS summons enforcement issues. The government was the initiating party in 58 cases, while the taxpayer was the initiating party in 29 cases. Overall, taxpayers fully prevailed in three cases, while five cases were split. The IRS prevailed in the remaining 79 cases.

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

2 IRC § 7602(a).

3 IRC § 7604(b).

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

5 IRC § 7609(b).

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

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

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

9 *Id.* at 2367-68.

TAXPAYER RIGHTS IMPACTED¹⁰

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

PRESENT LAW

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

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

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

10 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

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

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

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

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

15 IRC § 7604.

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

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

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

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

For example, the IRS does not have to give notice to the taxpayer or person named in the summons if it is attempting to determine whether the taxpayer has an account in a certain bank with sufficient funds to pay an assessed tax because such notice might seriously impede the IRS's ability to collect the tax.²⁰ Courts have interpreted this "aid in collection" exception to apply only if the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned.²¹ Additionally, the IRS is not required to give notice when, in connection with a criminal investigation, an IRS criminal investigator serves a summons on any person who is not the third-party record-keeper.²²

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

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

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

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

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

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

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

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

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

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

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

27 *Id.*

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

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

30 *Id.* at 2367-68.

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

- Fifth Amendment privilege against self-incrimination;
- Attorney-client privilege;³¹
- Tax practitioner privilege;³² or
- Work product privilege.³³

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

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

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

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

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

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

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

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

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

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

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

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

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

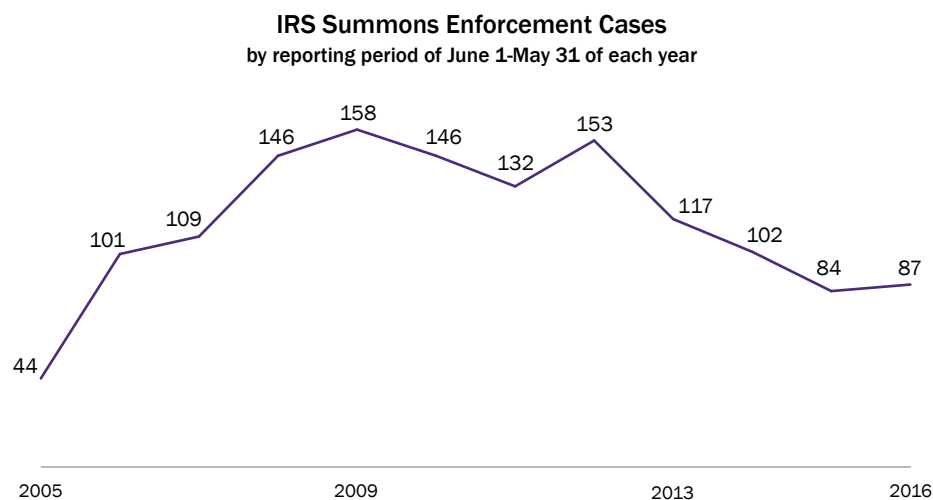
40 *Id.* A tax shelter is defined as “a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.” IRC § 6662(d)(2)(C)(ii).

In July 2016, the IRS issued final regulations providing that outside parties with whom the IRS or the Office of Chief Counsel contracts for services — such as economists, engineers, consultants, or attorneys — may receive books papers, records, or other data summoned by the IRS and, in the presence of an IRS officer or employee, participate fully in the interview of a person who the IRS has summoned as a witness to provide testimony under oath.⁴¹

ANALYSIS OF LITIGATED CASES

Summons enforcement has been a Most Litigated Issue in the National Taxpayer Advocate's Annual Report to Congress every year since 2005, when TAS identified only 44 cases but predicted the number would rise as the IRS became more aggressive in its enforcement initiatives. The number of cases peaked at 158 for the reporting period ending on May 31, 2009, but had steadily declined, except for a one-year increase for the year ending May 31, 2012, as shown in Figure 3.3.1. This year, the number of summons enforcement cases picked up slightly, as we identified 87 cases for the reporting period ending on May 31, 2016, an increase from the 84 cases we identified during last year's reporting period. A detailed list of these cases appears in Table 3 of Appendix 3.

FIGURE 3.3.1



Of the 87 cases TAS reviewed this year, the IRS prevailed in full in 79, a 91 percent success rate, which is a slight decline from the IRS's 96 percent success rate during the 2015 reporting period.⁴² Taxpayers had representation in 38 cases (44 percent) and appeared *pro se* (*i.e.*, on their own behalf) in the remaining 49. This is a notable climb in the number of represented taxpayers as only 27 percent of taxpayers were represented during last year's reporting period.⁴³ Seventy-two cases involved individual taxpayers, while

41 See Treas. Reg. § 301.7602-1(b)(3). As we noted in last year's Annual Report, the IRS issued temporary regulations on this topic in June 2014. See Temp. Treas. Reg. § 301.7602-1T(b)(3); National Taxpayer Advocate 2015 Annual Report to Congress 470-71. These temporary regulations were the subject of summons enforcement litigation involving the IRS's use of an outside law firm in an audit of Microsoft Corporation's transfer pricing arrangements, a case that will be discussed below.

42 See National Taxpayer Advocate 2015 Annual Report to Congress 471.

43 *Id.*

the remaining 15 involved business taxpayers, including sole proprietorships.⁴⁴ Cases generally involved one of the following themes.

Petitions to Enforce and *Powell* Requirements

The United States petitioned to enforce a summons in 58 cases and successfully met its burden under *Powell* in 57 cases.⁴⁵ In only one case, *United States v. Lamotte*, did the IRS fail to satisfy the *Powell* requirements.⁴⁶ In *Lamotte*, the IRS issued two summonses to Mr. Lamotte, who was the treasurer of Northern Tree Service, Inc. (Northern) and director of two captive insurance companies that provided insurance to Northern. One of the summons sought documents and the other testimony relating to Northern's utilization of a captive insurance tax structure.⁴⁷

With respect to the summons requesting documents, Mr. Lamotte argued that the IRS was already in possession of the documents.⁴⁸ The district court agreed, finding that the IRS already had the documents it sought and was therefore not entitled to a summons enforcement order under *Powell*.⁴⁹

Petitions to Quash and Lack of Subject Matter Jurisdiction

Taxpayers petitioned to quash an IRS summons to a third party in 29 instances;⁵⁰ however, in most of these cases, courts dismissed the petitions for lack of jurisdiction on procedural or notice grounds. For example, two United States Courts of Appeals affirmed district court dismissals of a taxpayer's petition to quash a summons issued to the taxpayer's bank because the summons was to aid in the collection of a tax liability, and the taxpayer was therefore not entitled to notice.⁵¹

In *Haber v. United States*, the taxpayer filed a petition to quash an IRS summons served on a bank that sought documents and testimony relating to assets held by the taxpayer's wife, which the district court dismissed for lack of subject matter jurisdiction because the United States has not waived sovereign immunity to allow suits to quash summonses that are issued to aid in the collection of an assessed tax.⁵² On appeal to the Second Circuit, the taxpayer argued that, because he had brought various legal challenges to the assessment which prevented the IRS from beginning actual collection, the summons

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

45 See, e.g., *Davis & Campbell, LLC v. U.S.*, 116 A.F.T.R.2d (RIA) 7124 (S.D.N.Y. 2015); *Neuberger v. U.S.*, 2016 U.S. Dist. LEXIS 59371 (W.D. Pa. 2016); *Wood v. U.S.*, 117 A.F.T.R.2d (RIA) 1919 (D. Md. 2016).

46 *U.S. v. Lamotte*, 117 A.F.T.R.2d (RIA) 1725 (D. Mass. 2016), *adopting* 117 A.F.T.R.2d (RIA) 1718 (D. Mass. 2016), *appeal dismissed*, No. 16-1940 (1st Cir. August 2, 2016).

47 *Id.*, *adopting* 117 A.F.T.R.2d (RIA) 1718 (D. Mass. 2016), *appeal dismissed*, No. 16-1940 (1st Cir. August 2, 2016). A captive insurance structure is where a business sets up an insurance company to protect against certain risks. While this may be structured with legitimate tax benefits, there are situations where it can be abused. See IRS, *Abusive Tax Shelters Again on the IRS "Dirty Dozen" List of Tax Scams for the 2016 Filing Season* (Feb. 16, 2016), https://www.irs.gov/uac/newsroom/abusive-tax-shelters-again-on-the-irs-dirty-dozen-list-of-tax-scams-for-the-2016-filing-season?_ga=1.49174374.1518734088.1474380960.

48 With respect to the summons seeking testimony, the court declined to enforce that summons because, as will be discussed below, Mr. Lamotte had properly invoked the Fifth Amendment privilege.

49 *U.S. v. Lamotte*, 117 A.F.T.R.2d (RIA) 1725 (D. Mass. 2016), *adopting* 117 A.F.T.R.2d (RIA) 1718 (D. Mass. 2016), *appeal dismissed*, No. 16-1940 (1st Cir. August 2, 2016).

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

51 *Haber v. U.S.*, 823 F.3d 746 (2d Cir. 2016), *aff'g* 115 A.F.T.R.2d (RIA) 2221 (S.D.N.Y. 2015); *Maehr v. Comm'r*, 641 F. App'x 813 (10th Cir. 2016), *aff'g* 116 A.F.T.R.2d (RIA) 5398 (D. Colo. 2015). Under IRC § 7609(c)(2)(D)(i), the IRS is not required to provide notice to the taxpayer and the taxpayer therefore has no right to quash the summons if the summons is issued to aid in the collection of the taxpayer's liability.

52 *Haber v. U.S.*, 115 A.F.T.R.2d (RIA) 2221 (S.D.N.Y. 2015), *aff'd* 823 F.3d 746 (2d Cir. 2016).

was not issued to aid in collection, and thus, he should be able to quash the summons.⁵³ The court disagreed, analyzing the language of the statute under IRC § 7609(c)(2)(D), and finding that there was no requirement that IRS have “present authority to collect on the assessment or the actual collection is ‘imminent.’”⁵⁴ The court therefore affirmed the lower court’s dismissal of the taxpayer’s petition to quash.⁵⁵

Similarly, in *Maehr v. Commissioner*, the Tenth Circuit affirmed a district court dismissal of a taxpayer’s petition to quash a summons served on his bank.⁵⁶ The appellate court found that, because the summons was issued to aid in the collection of an assessment under IRC § 7609(c)(2)(D), the IRS was not required to give notice to the taxpayer and he was therefore not permitted to quash the summons.⁵⁷

Privileges

As in past years, taxpayers attempted to invoke various privileges, including Fifth Amendment, attorney-client, or other privileges in response to an IRS summons. For example, two United States Courts of Appeals, in cases of first impression before each circuit, agreed with the unanimous view of the other Courts of Appeals that had considered the issue and held that records required to be kept under the Bank Secrecy Act fell within the required records exception to the Fifth Amendment privilege.⁵⁸

In *United States v. Chabot*, the IRS issued summonses to the taxpayers to give testimony and produce documents relating to their foreign bank accounts for the 2006 through 2009 tax years, which it then amended and narrowed to foreign bank account documents required to be kept under 31 C.F.R. § 1010.420.⁵⁹ The taxpayers did not comply with the summons, claiming that doing so might subject them to prosecution for failing to provide this information in annual Report of Foreign Bank and Financial Account filings. They also claimed that the required records exception to the Fifth Amendment privilege should not apply to their case.⁶⁰ The district court found that the required records exception applied and granted the government’s petition to enforce the summons. On appeal, the court found that the required records exception trumped the taxpayers’ Fifth Amendment privilege claim and affirmed the district court’s granting of the Government’s petition to enforce the summons.⁶¹

In a similar case, *United States v. Chen*, the First Circuit held that foreign banking records required to be kept under the Bank Secrecy Act fell within the required records exception to the Fifth Amendment privilege and thus were subject to the summonses.⁶² However, with respect to other documents for which

53 *Haber v. U.S.*, 823 F.3d 746 (2d Cir. 2016), *aff’g* 115 A.F.T.R.2d (RIA) 2221 (S.D.N.Y. 2015).

54 *Id.*

55 *Id.* The court also dismissed the taxpayer’s contention that the IRS’s issuance of the summons was improper because a Department of Justice referral was in effect under IRC § 7602(d) and that the taxpayer was entitled to jurisdictional discovery.

56 *Maehr v. Comm’r*, 641 F. App’x 813 (10th Cir. 2016), *aff’g* 116 A.F.T.R.2d (RIA) 5398 (D. Colo. 2015).

57 *Id.* The appellate court noted that it was affirming the decision of the district court but for a different reason. The court stated that the district court had found that it lacked subject matter jurisdiction because the taxpayer’s motion to quash was not brought timely under IRC § 7609(b)(2), which requires a taxpayer to bring suit within 20 days after the IRS gives notice. However, the appellate court emphasized that the taxpayer was not entitled to notice in the first place but reached the same result as the district court.

58 *U.S. v. Chabot*, 793 F.3d 338 (3d Cir. 2015), *aff’g* 114 A.F.T.R.2d (RIA) 6235 (D.N.J.), *cert. denied*, 136 S. Ct. 559 (2015); *U.S. v. Chen*, 815 F.3d 72 (1st Cir. 2016), *aff’g in part, vacating in part, and remanding* 952 F.Supp.2d 321 (D.Mass. 2013).

59 *U.S. v. Chabot*, 793 F.3d 338 (3d Cir. 2015), *aff’g* 114 A.F.T.R.2d (RIA) 6235 (D.N.J.), *cert. denied*, 136 S. Ct. 559 (2015).

60 The required records exception to the Fifth Amendment privilege against self-incrimination excludes from the protection of the privilege certain records that an individual is required by law to keep.

61 *Id.*

62 *U.S. v. Chen*, 815 F.3d 72 (1st Cir. 2016), *aff’g in part, vacating in part, and remanding* 952 F.Supp.2d 321 (D.Mass. 2013).

the taxpayer had claimed Fifth Amendment privilege, the court vacated the decision of the district court and remanded the case because the district court had not provided an explanation of why it had denied the taxpayer's privilege claims.⁶³

However, taxpayers were in some cases successful in asserting privileges. For example, as discussed above, in *United States v. Lamotte*, the IRS issued two summonses to Mr. Lamotte, one seeking documents and the other testimony relating to the taxpayer's utilization of a captive insurance tax structure.⁶⁴ As noted earlier, the court found that the IRS already had possession of the documents it sought and was therefore not entitled to a summons enforcement order with respect to the summons seeking documents.⁶⁵ Moreover, with respect to the IRS summons for Mr. Lamotte's testimony, the court found that he had properly invoked his Fifth Amendment privilege against self incrimination, as "the incriminating nature of the testimony sought by the government is evident on its face."⁶⁶

Civil Contempt

A taxpayer who "neglects or refuses to obey" an IRS summons may be held in civil contempt.⁶⁷ This year, six taxpayers were held in civil contempt for failing to comply with a court order enforcing an IRS summons.⁶⁸ Overall, contempt proceedings accounted for approximately seven percent of all summons-related cases. Unless the taxpayers complied with the court order, they were subject to arrest,⁶⁹ fines,⁷⁰ or both.⁷¹

The Clarke Case Revisited

The *Clarke* litigation continues as the taxpayers maintained their litigation push for an evidentiary hearing after the Supreme Court's 2014 decision that set the standard for obtaining such a hearing.⁷² After that decision, the case was remanded to the District Court for the Southern District of Florida, which denied the taxpayers' request for an evidentiary hearing and enforced the summons. On appeal, the Eleventh Circuit affirmed, holding that the fact that the summoned information might assist the IRS in preparing

63 *U.S. v. Chen*, 815 F.3d 72 (1st Cir. 2016), *aff'g in part, vacating in part, and remanding* 952 F.Supp.2d 321 (D.Mass. 2013).

64 *U.S. v. Lamotte*, 117 A.F.T.R.2d (RIA) 1725 (D. Mass. 2016), *adopting* 117 A.F.T.R.2d (RIA) 1718 (D. Mass. 2016), *appeal dismissed*, No. 16-1940 (1st Cir. August 2, 2016).

65 *Id.*

66 *Id.*, *adopting* 117 A.F.T.R.2d (RIA) 1718 (D. Mass. 2016), *appeal dismissed*, No. 16-1940 (1st Cir. August 2, 2016). In another case involving privilege, *Schaeffler v. U.S.*, 806 F.3d 34 (2d Cir. 2015), *vacating and remanding* 22 F. Supp. 3d 319 (S.D.N.Y. 2014), *dismissed as moot*, 117 A.F.T.R.2d (RIA) 2139 (S.D.N.Y. 2016), the Second Circuit found that the taxpayer had not waived the attorney-client privilege by sharing documents with a consortium of banks that had common legal interest with the taxpayer. The court also found that the work-product doctrine protected documents prepared at a time when the taxpayer believed that litigation was highly probable. However, the IRS subsequently withdrew the summons and the district court dismissed the case as moot.

67 IRC § 7604(b).

68 See *U.S. v. Anderson*, 117 A.F.T.R.2d (RIA) 1174 (N.D. Cal. 2016); *U.S. v. Belcik*, 117 A.F.T.R.2d (RIA) 926 (M.D. Fla. 2016), *adopting in part* 117 A.F.T.R.2d (RIA) 922 (M.D. Fla. 2016); *U.S. v. Butler*, 2016 U.S. Dist. LEXIS 59179 (W.D. Ky. 2016); *U.S. v. Singh*, 117 A.F.T.R.2d (RIA) 1069 (E.D. Cal. 2016), *enforcing* 116 A.F.T.R.2d (RIA) 5313 (E.D. Cal. 2015); *U.S. v. Soong*, 116 A.F.T.R.2d 5792 (N.D. Cal. 2015), *granting motion for civil contempt sanctions*, 113 A.F.T.R.2d (RIA) 1589 (N.D. Cal. 2014), *aff'd by* 117 A.F.T.R.2d (RIA) 1801 (9th Cir. 2016); *U.S. v. Thornton*, 621 F. App'x. 360 (8th Cir. 2015), *aff'g* 115 A.F.T.R.2d (RIA) 1258 (D. Minn. 2015), *cert. denied*, 136 S. Ct. 2424 (2016).

69 *U.S. v. Belcik*, 117 A.F.T.R.2d (RIA) 926 (M.D. Fla. 2016), *adopting in part* 117 A.F.T.R.2d (RIA) 922 (M.D. Fla. 2016).

70 *U.S. v. Soong*, 116 A.F.T.R.2d 5792 (N.D. Cal. 2015), *granting motion for civil contempt sanctions*, 113 A.F.T.R.2d (RIA) 1589 (N.D. Cal. 2014), *aff'd by* 117 A.F.T.R.2d (RIA) 1801 (9th Cir. 2016).

71 *U.S. v. Butler*, 2016 U.S. Dist. LEXIS 59179 (W.D. Ky. 2016).

72 *U.S. v. Clarke*, 816 F. 3d 1310 (11th Cir. 2016), *aff'g* 115 A.F.T.R.2d (RIA) 836 (S.D. Fla. 2015), *on remand from* 573 F. App'x 826 (11th Cir. 2014), *on remand from* 134 S. Ct. 2361 (2014), *vacating and remanding* 517 F. App'x 689 (11th Cir. 2013), *petition for cert. filed*, No. 16-358 (Sept. 19, 2016).

for tax court litigation did not make its motive improper, that the district court did not abuse its discretion by opting not to hold a status conference or permit additional evidence before determining if the IRS's motive was improper, and that the taxpayers' allegations failed to point to the IRS's bad faith or improper motive.⁷³ The taxpayers have once again petitioned for *certiorari*.⁷⁴

The Continued Impact of *United States v. Clarke* and *Microsoft* Litigation

The Supreme Court's decision in *Clarke* continued to have an impact on summons litigation, as taxpayers sought evidentiary hearings to challenge a summons. Most of these efforts were unsuccessful.⁷⁵ However, as discussed in this section last year, in *United States v. Microsoft*, Microsoft Corporation was successful in obtaining an evidentiary hearing in a summons enforcement case where the IRS used an outside law firm to assist in an audit of the company.⁷⁶ In that case, the court found that, by asserting that the IRS was improperly delegating an inherently governmental function to a third party, Microsoft had met its burden under *Clarke* and was entitled to an evidentiary hearing.⁷⁷

While Microsoft was successful in obtaining an evidentiary hearing, the IRS was ultimately successful in having the summons enforced.⁷⁸ In an opinion subsequent to the one granting the evidentiary hearing, although the court was "troubled" by the level of the outside law firm's involvement in the audit of the taxpayer, it concluded that this delegation of authority was not legally prohibited by IRC § 7602 and therefore granted the IRS's petition to enforce the summons.⁷⁹

Finally, as noted earlier, the IRS issued final regulations in July 2016 providing that outside parties with whom the IRS or the Office of Chief Counsel contracts for services — such as economists, engineers, consultants, or attorneys — may receive books papers, records, or other data summoned by the IRS and, in the presence of an IRS officer or employee, participate fully in the interview of a person who the IRS has summoned as a witness to provide testimony under oath.⁸⁰ Also of note is that members of both the House and Senate have introduced legislation that would prohibit individuals who are not IRS employees from receiving summoned records or taking summoned testimony.⁸¹

73 *U.S. v. Clarke*, 816 F.3d 1310 (11th Cir. 2016), *aff'g* 115 A.F.T.R.2d (RIA) 836 (S.D. Fla. 2015), *on remand from* 573 F. App'x 826 (11th Cir. 2014), *on remand from* 134 S. Ct. 2361 (2014), *vacating and remanding* 517 F. App'x 689 (11th Cir. 2013), *petition for cert. filed*, No. 16-358 (Sept. 19, 2016).

74 *Id.*

75 See, e.g., *Highland Capital Mgmt., L.P. v. U.S.*, 626 F. App'x 324 (2d Cir. 2015), *aff'g in part, vacating in part, and remanding in part* 51 F. Supp. 3d 544 (S.D.N.Y. 2014); *Gangi v. U.S.*, 638 F. App'x 16 (1st Cir. 2016), *aff'g* 2 F.Supp.3d 12 (D.Mass. 2014).

76 See National Taxpayer Advocate 2015 Annual Report to Congress 471; *U.S. v. Microsoft Corp.*, 115 A.F.T.R.2d (RIA) 2186 (W.D. Wash. 2015).

77 *U.S. v. Microsoft Corp.*, 115 A.F.T.R.2d (RIA) 2186 (W.D. Wash. 2015).

78 *U.S. v. Microsoft Corp.*, 154 F.Supp.3d 1134 (W.D. Wash. 2015).

79 *Id.* However, it appears that this litigation may not be over as Microsoft has withheld documents due to privilege claims. See *Microsoft Withholding Documents in IRS Summons Enforcement Case*, TAX NOTES TODAY (Sep. 14, 2016).

80 See Treas. Reg. § 301.7602-1(b)(3).

81 See Tax Administration Integrity Act, H.R. 3167, § 2, 114th Cong. (2015); Taxpayer Protection Act of 2016, S. 3156, § 135, 114th Cong. (2016).

CONCLUSION

The IRS may issue a summons to obtain information to determine whether a tax return is correct or if a return should have been filed to ascertain a taxpayer's tax liability or to collect a liability.⁸² Accordingly, the IRS may request documents and testimony from taxpayers who have failed to provide that information voluntarily.

Summons enforcement continues to be a significant source of litigation and the number of litigated cases rose slightly from last year. The IRS also continues to be successful in the vast majority of summons enforcement litigation. Taxpayers and third parties rarely succeed in contesting IRS summonses due to the significant burden of proof and strict procedural requirements.

⁸² IRC § 7602(a).

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

SUMMARY

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.¹ For this report, we reviewed 81 cases decided between June 1, 2015, and May 31, 2016. Several of the cases involved taxpayers failing to report items of income, including some specifically mentioned in Internal Revenue Code (IRC) § 61 such as wages,² interest,³ dividends,⁴ and annuities.⁵

TAXPAYER RIGHTS IMPACTED⁶

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

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

The Commissioner of Internal Revenue may identify particular items of unreported income or reconstruct a taxpayer's gross income using methods such as the bank deposits method.¹⁰ If the Commissioner of Internal Revenue determines a tax deficiency, the IRS issues a Statutory Notice

1 See, e.g., National Taxpayer Advocate 2015 Annual Report to Congress 476-80 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*); National Taxpayer Advocate 2014 Annual Report to Congress 472-76 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*); National Taxpayer Advocate 2013 Annual Report to Congress 355-61 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*).

2 Internal Revenue Code (IRC) § 61(a)(1). See, e.g., *Green v. Comm'r*, T.C. Memo. 2016-67.

3 IRC § 61(a)(4). See, e.g., *Friedman v. Comm'r*, T.C. Memo. 2015-177.

4 IRC § 61(a)(7). See, e.g., *Bell v. Comm'r*, T.C. Memo. 2015-111, *appeal docketed*, No. 16-70166 (9th Cir. Jan. 19, 2016).

5 IRC § 61(a)(9). See, e.g., *Tobias v. Comm'r*, T.C. Memo. 2015-164.

6 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a), 129 Stat. 2242, 3117 (2015) (codified at IRC § 7803(a)(3)).

7 IRC § 61(a).

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

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

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

of Deficiency.¹¹ If the taxpayer challenges the deficiency, the Commissioner's notice is entitled to a presumption of correctness; the taxpayer generally bears the burden of proving that the determination is erroneous or inaccurate.¹²

ANALYSIS OF LITIGATED CASES

In the 81 opinions involving gross income issued by the federal courts and reviewed for this report, gross income issues most often fall into two categories: (1) what is included in gross income under IRC § 61 and (2) what can be excluded under other statutory provisions. A detailed list of the cases appears in Table 4 of Appendix 3.

In 32 cases (40 percent), taxpayers were represented, while the rest were *pro se* (without counsel). Represented taxpayers prevailed in full or in part in five of 32 cases (16 percent), whereas *pro se* taxpayers prevailed in full or in part in three of 49 cases (six percent). Overall, taxpayers prevailed in full or in part in eight of 81 cases (ten percent).

Drawing on the full list in Table 4 of Appendix 3, we have chosen to discuss cases involving damage awards, disability benefits, Individual Retirement Account (IRA) distributions, cancellation of debt income, and the recognition of income from participation in a compensatory split-dollar life insurance arrangement.

Damage Awards

Taxation of damage awards continues to generate litigation. This year, taxpayers in at least four cases (five percent of those reviewed) challenged the Commissioner's inclusion of damage awards in their gross income, but no taxpayers prevailed in these cases.¹³

IRC § 104(a)(2) specifies that damage awards and settlement proceeds¹⁴ are taxable as gross income unless the award was received "on account of personal physical injuries or physical sickness."¹⁵ Congress added the "physical injuries or physical sickness" requirement in 1996;¹⁶ 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."¹⁷ Thus,

11 IRC § 6212. See also Internal Revenue Manual (IRM) 4.8.9.2, *Notice of Deficiency Definition* (Aug. 11, 2016).

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

13 In *Smallwood*, the taxpayer appealed the district court's grant of summary judgment in favor of the United States. The Court of Appeals for the Federal Circuit concluded that the district court failed to make a determination of what dollar amount of the taxpayer's settlement proceeds was attributable to her physical injuries or physical sickness within the meaning of § 104(a)(2) and therefore excludible from gross income, and consequently vacated and remanded the case to the district court for further proceedings. While the case is characterized as a win for the taxpayer in Table X.X, whether the taxpayer will prevail on the merits will be determined in a further proceeding.

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

15 IRC § 104(a)(2).

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

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

damage awards for emotional distress are not considered as received on account of physical injury or physical sickness, even if the emotional distress results in “insomnia, headaches, [or] stomach disorders.”¹⁸

To justify exclusion from income under IRC § 104, the taxpayer must show settlement proceeds are in lieu of damages for physical injury or sickness, and this is frequently difficult to prove unless explicit in the damage award.¹⁹ In *O’Connor v. Commissioner*, the taxpayer petitioned the Tax Court, and later appealed to the U.S. Court of Appeals for the Ninth Circuit, to exclude from his gross income payments he received from Covance Clinical Research Unit, Inc., for his participation in a gout medical study.²⁰ The taxpayer argued that the payment should be excluded from gross income as compensation received on account of physical injury or physical sickness.²¹ The gout study required the taxpayer to spend ten days confined to a medical facility where he adhered to a strict schedule including blood tests, urine tests, electrocardiograms, and vital screenings. He was also required to participate in outpatient visits after the inpatient stay was completed. The taxpayer received a Form 1099-MISC, *Miscellaneous Income*, from Covance but did not report the \$5,550 received on his 2008 Form 1040, *U.S. Individual Income Tax Return*.

As discussed above, the court looks for a “direct causal link” between the damages received and the physical injury or sickness sustained.²² However, because the taxpayer did not allege that he suffered physical injury or sickness on account of the study and had even suffered from gout before participating in the study, the court determined that he had not established a “direct causal link” between the payment and the gout from which he suffered. Furthermore, the taxpayer failed to produce the written contract with Covance to participate in the study and, due to this failure, the court held that “[m]ere participation in [a] study does not result in compensation for damages received on account of physical injury or physical sickness.”²³ As a result, the Ninth Circuit affirmed the Tax Court’s decision that the payment for the taxpayer’s participation in a medical research study was not excludible from gross income.²⁴ This appellate-level decision demonstrates that the courts look to the specific language of a settlement agreement or contract to determine whether damages are attributable to a physical injury or sickness sustained. Similarly, in *Dulanto v. Commissioner*, the Tax Court looked to the nature of the claim that was the actual basis for the settlement and rejected the taxpayer’s position that the damages the former employer paid as part of the settlement agreement for the resolution of claims in a class action lawsuit were not included in gross income.²⁵

As illustrated by continuing litigation of the characterization of settlement damages, the question of when damage awards can be excluded from gross income continues to confuse taxpayers. Although we did not identify any cases this year in which the courts specifically addressed mental illness, the National Taxpayer Advocate remains concerned that taxpayers continue to disagree with the IRS and courts’ interpretation that mental illness equates to emotional distress as opposed to physical sickness or injury. In the same

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

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

20 *O’Connor v. Comm’r*, 606 F. App’x 390 (9th Cir. 2015), *aff’g* T.C. Memo. 2012-317.

21 In the alternative, the taxpayer argued that the payment should be treated as a gift, under IRC § 102(a), which allows the exclusion from gross income the value of property acquired by gift, bequest, devise, or inheritance.

22 See *Lindsey v. Commissioner*, 422 F.3d 684, 688 (8th Cir. 2005), *aff’g* T.C. Memo. 2004-113.

23 *O’Connor v. Comm’r*, T.C. Memo. 2012-317.

24 *O’Connor v. Comm’r*, 606 F. App’x 390, 391 (9th Cir. 2015), *aff’g* T.C. Memo. 2012-317.

25 *Dulanto v. Comm’r*, T.C. Memo. 2016-34 (citing *U.S. v. Burke*, 504 U.S. 229, 237 (1992), *appeal docketed*, No. 16-72867 (9th Cir. Aug. 29, 2016)).

way that a physical injury or sickness may have mental or emotional side effects, many mental illnesses manifest themselves as physical symptoms. For instance, many people who have severe depression experience the following physical symptoms: stomachaches, indigestion, constant headaches, tightness in the chest, difficulty breathing, and fatigue.²⁶ Physical symptoms occur in other mental disorders, such as Post-Traumatic Stress Disorder (PTSD), which affects people who have experienced a traumatic event, such as mugging, rape, torture, being kidnapped or held captive, child abuse, car accidents, train wrecks, plane crashes, bombings, natural or human-caused disasters, or military combat.²⁷ Current research shows that the experience of trauma can cause neurochemical changes in the brain that create a vulnerability to hypertension and atherosclerotic heart disease, abnormalities in thyroid and other hormone functions, and increased susceptibility to infections and immunologic disorders that are associated with PTSD.²⁸ As discussed in the 2009 Annual Report to Congress, the interpretation that mental illness equates to emotional distress seems particularly outdated when considering the medical advancements in understanding the physical cause and symptoms of mental illness.²⁹

Social Security and Disability Benefits

Taxpayers often litigate the characterization of Social Security and other types of disability benefits because portions of these benefits may be excludible from gross income.³⁰ In *Campbell v. Commissioner*, the taxpayers were retired Los Angeles County firefighters with service-connected disabilities.³¹ The taxpayers were entitled to receive a disability pension and a service retirement pension. The taxpayers argued that all of pension compensation, rather than a portion, should be exempt from tax under IRC § 104(a)(1), which excludes from gross income “amounts received under workmen’s compensation acts as compensation for personal injury or sickness”.³² Under California law, if the firefighter also qualifies for a service retirement pension, based on the length of time worked, in an amount greater than the disability pension, the firefighter will receive the full service retirement pension. Although the taxpayers initially reported the pension payments on their returns, they subsequently filed refund claims on the basis that all the pension payments received were connected to a disability and therefore not taxable. After the IRS denied the refund claims, the taxpayers filed refund suits. The district court concluded that the portion of a firefighter’s service pension amount exceeding the guaranteed disability pension amount is not excludable from income and is therefore taxable. The taxpayers then challenged the IRS’s authority to issue Treasury Regulation § 1.104-1(b), which states that the exclusion under IRC § 104(a)(1) does not apply if the “retirement pension [amount] ... is determined by reference to the employee’s age or length of service ... even though the ... retirement is occasioned by an occupational

26 National Institute of Mental Health, *Signs and Symptoms of Depression*, <https://www.nimh.nih.gov/health/topics/depression/index.shtml> (last visited Sept. 1, 2016).

27 National Institute of Mental Health, *Post-Traumatic Stress Disorder*, <http://www.nimh.nih.gov/health/topics/post-traumatic-stress-disorder-ptsd/index.shtml> (last visited Sept. 1, 2016).

28 See U.S. Department of Veterans Affairs, *National Center for PTSD*, <http://www.ptsd.va.gov/professional/co-occurring/ptsd-physical-health.asp> (last visited Sept. 1, 2016).

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

30 See, e.g., *Campbell v. U.S.*, 607 F. App’x 697 (9th Cir. 2015), *aff’g* 111 A.F.T.R.2d (RIA) 946 (C.D. Cal. 2013); *Shakir v. Comm’r*, T.C. Memo. 2015-147.

31 607 F. App’x 697 (9th Cir. 2015), *aff’g* 111 A.F.T.R.2d (RIA) 946 (C.D. Cal. 2013).

32 *Campbell v. U.S.*, 607 F. App’x 697 (9th Cir. 2015), *aff’g* 111 A.F.T.R.2d (RIA) 946 (C.D. Cal. 2013).

injury ...” The U.S. Court of Appeals for the Ninth Circuit held that the IRS had the authority to issue this regulation and affirmed the district court’s holding that the taxpayers were not entitled to a refund. As this case demonstrates, the characterization of Social Security and other disability benefits continues to be a disputed issue.

Individual Retirement Account (IRA) Distributions

IRC § 61(a) defines gross income as “all income from whatever source derived, including (but not limited to) ... (9) Annuities; ... and (11) Pensions.”³³ IRC § 408(d)(1) governs the tax treatment of distributions from individual retirement accounts (IRAs) and provides that they are generally included in gross income as amounts received as an annuity under IRC § 72.

Taxpayers in at least 12 cases argued that portions of their IRA distributions, pensions, or retirement accounts were excluded from gross income, prevailing in one case. In *McGaugh v. Commissioner*, the taxpayer had a self-directed IRA with Merrill Lynch as the custodian, and requested that Merrill Lynch purchase additional stock in a corporation; however, Merrill Lynch refused to purchase the stock directly, despite the fact it was not a prohibited transaction.³⁴ The taxpayer requested that Merrill Lynch issue a wire transfer to the corporation in which he wished to purchase stock, and, after sixty days the corporation issued the stock in the name of the taxpayer’s IRA. Merrill Lynch reported the transaction to the IRS due to its determination that the wire transfer was a distribution and not a rollover, and the IRS agreed. The Tax Court found that there was no “literal distribution” of the IRA funds to the taxpayer since he did not receive any cash, check, or wire transfer as the funds were sent to the corporation directly. Additionally, the Tax Court disagreed with the IRS’s assertion that, by wiring the funds at the instructions of the taxpayer, Merrill Lynch had put the funds at the taxpayer’s discretion, and found that at most the taxpayer was simply a conduit of the IRA funds, and thus the money was not includable as gross income.

In at least three cases this year, taxpayers challenged the taxability of distributions, specifically that the “rollover provisions” under IRC § 408(d) applied.³⁵ The “rollover provision” generally excludes from gross income IRA distributions that are transferred into an eligible retirement account within 60 days of receipt.³⁶ Taxpayers are limited under IRC § 408(d)(3)(B) to one nontaxable rollover per year.³⁷ Taxpayers are also only allowed to take advantage of the “rollover provision” as long as the transfer is not a prohibited transaction under IRC § 4975.

In *Thiessen v. Commissioner*, the taxpayers engaged in a prohibited transaction under IRC § 4975(c)(1)(B) and thus their transfer of funds from one IRA to another was not a “rollover” and was deemed to be a taxable distribution.³⁸ In 2003, the taxpayers attempted to “rollover” funds from a preexisting IRA to a self-directed IRA, and use those funds to acquire initial stock of a C corporation, with the taxpayers listed as the only officers and directors, which would in turn purchase a new business, all while the taxpayers

33 IRC § 61(a).

34 *McGaugh v. Comm’r*, T.C. Memo. 2016-28, *appeal docketed*, No. 16-2987 (7th Cir. July 21, 2016).

35 See, e.g., *McGaugh v. Comm’r*, T.C. Memo. 2016-28, *appeal docketed*, No. 16-2987 (7th Cir. July 21, 2016); *Thiessen v. Comm’r*, 146 T.C. 100 (2016); *Vandenbosch v. Comm’r*, T.C. Memo. 2016-29.

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

37 IRC § 408(d)(3)(B).

38 *Thiessen v. Comm’r*, 146 T.C. 100 (2016).

were personally guarantying repayment of the loan from the seller.³⁹ Seven years later, the taxpayers received a notice of deficiency due to the disqualification of the IRA from the “prohibited transaction.” Under § 4975(c)(1)(B), a “prohibited transaction” is “any direct or indirect ... lending of money or other extension of credit between a plan and a disqualified person,” with a “disqualified person” including any “fiduciary,” which is a person who “exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets.”⁴⁰ The court agreed with the IRS’s argument that the taxpayers’ guaranties of the loan were prohibited transactions under § 4975(c)(1)(B) since the guaranties were the taxpayers’ “indirect extensions of credit to [the taxpayers’] IRAs and that [the taxpayers’] participation in the prohibited transactions caused the IRAs to lose their status as IRAs.” Consequently, a taxable distribution occurred.⁴¹ This is an important case due to the challenges surrounding IRA finance structuring and the complexity of rollover rules for IRAs.

The IRS recently issued guidance to address the problem of rollovers that missed this 60-day window.⁴² A taxpayer is now allowed to self-certify (subject to verification on audit) that he or she is eligible for a waiver of the 60-day requirement instead of seeking a costly private letter ruling.⁴³ The revenue procedure provides 11 reasons for missing the deadline that are eligible for self-certification. It also provides a model letter that may be used for the self-certification. The National Taxpayer Advocate applauds the IRS for this change, which promotes taxpayers’ *right to a fair and just tax system*. It is likely that this change to a self-certification process will lead to a decrease in litigation in cases involving the 60-day rollover time frame. For example, had this revenue procedure been in place when the taxpayer in the *McGaugh*⁴⁴ case withdrew funds from his IRA, the taxpayer would probably have been able to self-certify.

Discharge of Indebtedness

We reviewed four cases in which taxpayers disputed the IRS’s determination that discharge of indebtedness was taxable income. A taxpayer’s gross income generally includes income from a discharge of indebtedness.⁴⁵ However, under certain circumstances, a taxpayer can exclude the amount of discharged indebtedness from gross income under IRC § 108(a). IRC § 108(a) provides, subject to limitation, that a taxpayer may exclude income from the discharge of indebtedness if the discharge occurs during bankruptcy, when the taxpayer is insolvent, if the indebtedness is qualified farm or business real estate debt, or if the indebtedness is qualified principal residence indebtedness discharged before January 1, 2017, or subject to an arrangement that is entered into and evidenced in writing before January 1, 2017.⁴⁶ The creditor may issue a Form 1099-C, *Cancellation of Debt*, to the taxpayer for

39 The taxpayers used an IRA funding structure, discussed above, to purchase a business, and did so at the advice of a certified professional accountant. The taxpayers filed a joint Form 1040, *U.S. Individual Income Tax Return*, for 2003 and reported the IRA distributions but stated they were “ROLLOVER,” and had no taxable IRA distributions or tax specifically related to the IRA. An important note is that the joint return did not disclose the personal guarantee of the taxpayers on the loan or put the IRS on notice of the nature and amount of any deemed distribution resulting from the guaranties, nor did it disclose the C corporation or the 2003 Form 1120, *U.S. Corporate Income Tax Return*, filed.

40 IRC §§ 4975(e)(2)(A), (e)(3)(A). See also IRC §§ 4795(e)(2)(F), (e)(6) (stating that the spouse of a “disqualified person” is also a “disqualified person”).

41 *Thiessen v. Comm’r*, 146 T.C. 100 (2016). See IRC § 408(e)(2)(A) (providing that “[i]f, during any taxable year of the individual for whose benefit any [IRA] is established, that individual or his beneficiary engages in any transaction prohibited by [§] 4975 with respect to such account, such account ceases to be an [IRA] as of the first day of such taxable year.”).

42 See Rev. Proc. 2016-47, 2016-37 I.R.B. 346, modifying Rev. Proc. 2003-16, 2003-4 I.R.B. 359.

43 *Id.*

44 *McGaugh v. Comm’r*, T.C. Memo. 2016-28, *appeal docketed*, No. 16-2987 (7th Cir. July 21, 2016).

45 IRC § 61(a)(12).

46 IRC § 108(a)(1)(A)-(E).

canceled debts of \$600 or more.⁴⁷ If a creditor has discharged a debt the taxpayer owes, the taxpayer must include the discharged amount in gross income, even if it is less than \$600 or a Form 1099-C is not received, unless one of the exceptions in IRC § 108(a) applies. The issuance of a Form 1099-C is not dispositive of whether or when the debt is actually discharged.⁴⁸ A debt is deemed to have been discharged, and a Form 1099-C is required, if and only if, an “identifiable event” has occurred.⁴⁹

In *Clark v. Commissioner*, the taxpayer had entered into a retail installment contract with a car dealership to purchase a car in 1999; however, by 2005, the taxpayer had defaulted on the contract and the vehicle was repossessed and sold at auction.⁵⁰ The terms of the retail installment contract provided that the seller could sell the repossessed car and the seller’s ability to assign all rights of the contract, without recourse, to AmeriCredit. After the repossession and sale of the car, AmeriCredit attempted to collect the debt of \$4,496.71, and assigned it to five separate third-party debt collectors between 2006 and June 29, 2011. In 2011, AmeriCredit reported a Form 1099-C discharging the taxpayer’s debt of \$4,496.71, but the taxpayer did not report any discharge of indebtedness income on her 2011 Form 1040.

In the petition to the Tax Court, the taxpayer, who was represented, alleged numerous arguments, with the case turning on the argument about the timing of the “identifiable event.” The taxpayer argued that the “identifiable event” occurred when AmeriCredit failed to receive payment on the debt after 36 months (December 2008), and the cancellation should have applied to 2008, which was the “expiration of the non-payment testing period” under Treasury Regulation § 1.6050P-1(b)(2)(i)(H). Under the relevant legal authority, there is a rebuttable presumption that an identifiable event has occurred during a calendar year if a creditor has not received a payment on a debt at any time during the testing period, generally 36 months, ending at the close of the year.⁵¹ The IRS argued, however, that because AmeriCredit took collection actions during the testing period, the presumption that the identifiable event occurred in 2008 is negated. The IRS relied on evidence of business records showing the debt being assigned, at different times, to five third-party debt collectors. No evidence, however, was introduced regarding what, if any, actions any of the assigned debt collectors took to collect the debt. Due to the IRS’s failure to provide evidence of “any significant, bona fide activity that would indicate an active creditor,” the court found that the IRS had failed to rebut the presumption of the identifiable event discharging the taxpayer’s debt occurring in 2008, and not in 2011.

47 IRS, *Instructions for Form 1099-A and 1099-C Acquisition or Abandonment of Secured Property and Cancellation of Debt*, <https://www.irs.gov/pub/irs-pdf/i1099ac.pdf> (Sept. 30, 2015).

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

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

50 *Clark v. Comm’r*, T.C. Memo. 2015-175.

51 See Treas. Reg. § 1.6060P-1(b)(2)(iv). Note that the IRS has issued final regulations which eliminate the 36-month testing period for information returns required to be filed, and payee statements required to be furnished, after December 31, 2016. 81 FR 78908 (Nov. 10, 2016). See also National Taxpayer Advocate 2010 Annual Report to Congress 383-86 (Legislative Recommendation: *Remove the 36-Month “Testing Period” that May Trigger Cancellation of Debt Reporting*).

Recognition of Income From Participation in Compensatory Split-Dollar Life Insurance Arrangements

In *Our Country Home Enterprises, Inc. v. Commissioner*, the Tax Court reviewed seven consolidated cases relating to income tax deficiencies from the inclusion of income from a “purported” welfare benefit plan, the Sterling Benefit Plan.⁵² The Tax Court first determined that the life insurance policies issued on the shareholders and employees (the individuals) as part of their participation in the Sterling Benefit Plan was a compensatory split-dollar life insurance arrangement.⁵³ A split-dollar life insurance arrangement is an arrangement between an owner of a life insurance contract and a nonowner of the contract (other than group term life insurance), under which either party to the arrangement pays all or part of the premiums, and the party paying the premiums is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the contract.⁵⁴ The Tax Court then turned to the issue of whether the shareholders/employees recognized income from their participation in the arrangement.⁵⁵ In determining the income tax treatment of split-dollar life insurance arrangements, *i.e.*, whether an income has been recognized, courts determine which of the two Treasury Regulation provisions apply: the economic benefit provisions or loan provisions.⁵⁶ The Tax Court found that the economic benefit provisions would apply, and thus, the value, per taxable year, of the economic benefits to a nonowner, *i.e.*, the shareholders/employees, equals:

the sum of (1) the cost of current life insurance protection that the nonowner [individual employee] receives during the year; (2) the amount of the insurance policy cash value to which the nonowner has current access during the year ... ; and (3) any other economic benefit provided to the nonowner (to the extent not previously included in income).⁵⁷

The taxpayers argued that none of the employees (individuals) received an “economic benefit” since they did not have a current or future right to the cash value of the life insurance policies by either direct receipt of cash or by causing the cash to be used to pay other benefits provided under the plan, such as medical or disability benefits, nor could they have caused the policies to be distributed to them.⁵⁸ However, the Tax Court disagreed with the taxpayers’ position and found that since the individuals did not make the premium payments on the insurance contracts and the corporate employers were the owners of the contracts, the employees received an economic benefit, which is includable in gross income, in the value of the death benefit for the life insurance contract minus the amount payable to the corporate employer

52 *Our Country Home Enters., Inc. v. Comm’r*, 145 T.C. 1 (2015). According to the Tax Court, these seven cases were selected as “test cases for issues relating to the Sterling [Benefit] Plan” and the parties in approximately 40 other cases pending before the Tax Court “have agreed to be bound by one or more of the decisions in these cases.” *Our Country Home Enters., Inc. v. Comm’r*, 145 T.C. No. 1 (2015). The petitioners of the cases are split into three groups: (1) Our Country Home Enterprises, Inc., which consists of two petitioners, Mr. Blake and his wholly owned C corporation, Our Country Home Enterprises; (2) Netversity, Inc., which also consists of two petitioners, Mr. Mejia and his wholly owned C corporation, Netversity; and (3) Code Environmental Services, Inc., which consists of three petitioners, Mr. Abramo, Mr. Brown, and Mr. Tomassetti, all of which are equal owners of the S corporation Code Environmental Services, Inc. *Our Country Home Enters., Inc. v. Comm’r*, 145 T.C. 1 (2015).

53 *Our Country Home Enters., Inc. v. Comm’r*, 145 T.C. 1 (2015).

54 Treas. Reg. §§ 1.61-22(b)(1); 1.7872-15.

55 The Tax Court also decided if the corporate employers could deduct the payments to the Sterling Benefit Plan and if the petitioners were subject to an accuracy-related penalty.

56 The economic benefit provisions are described in Treas. Reg. § 1.61-22(d)-(g). The loan provisions are described in Treas. Reg. § 1.7872-15.

57 *Our Country Home Enters., Inc. v. Comm’r*, 145 T.C. 1 (2015) (citing Treas. Reg. § 1.61-22(d)(2)).

58 See Treas. Reg. § 1.61-22(d)(4)(ii) (providing that nonowners are treated as having current access to the portion of the insurance policy’s cash value (1) to which the arrangement gives the employee a current or future right, and (2) that is directly or indirectly currently accessible by the employee, inaccessible by the employer, or inaccessible by the employer’s general creditors).

plus the portion of the cash value taxable to (or paid for by) the employee. For the final set of taxpayers, Netversity and Mr. Mejia, the payments made towards the Sterling Benefit Plan, which had not yet purchased a death benefit insurance plan, were “conferred [as] an economic benefit on Mr. Mejia for his primary (if not sole) benefit.”⁵⁹ Thus, the payment was a “constructive distribution,” which must be included in gross income as a taxable dividend under IRC § 301(c)(1). Although this case is specific to one purported welfare benefit plan and was a “test” case, it demonstrates the continuation of litigation involving “economic benefits” and split-dollar life insurance arrangements in general.

CONCLUSION

Taxpayers litigate many of the same gross income issues every year due to the complex nature of what constitutes gross income. As the definition is very broad and the courts broadly interpret accession to wealth as gross income, the IRS prevailed in full in 73 of 81 cases, and courts continued to narrowly interpret exclusions from gross income.

While the number of cases involving the tax treatment of settlements and awards has fluctuated in past years, it continues to be a steady and perennial area of confusion for taxpayers. The National Taxpayer Advocate has previously recommended a legislative change that would clarify the tax treatment of court awards and settlements by permitting taxpayers to exclude any payments received as a settlement or judgment for mental anguish, emotional distress, or pain and suffering.⁶⁰

59 The court also determined that these payments were not deductible as an ordinary and necessary business expense under IRC § 162(a). See Most Litigated Issue: *Trade and Business Expenses*, *supra*, for a discussion on what constitutes “ordinary and necessary” business expenses.

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

MLI #5 Trade or Business Expenses Under IRC § 162 and Related Sections

SUMMARY

The deductibility of trade or business expenses has long been among the ten Most Litigated Issues (MLIs) since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.¹ We identified 73 cases involving a trade or business expense issue that were litigated in federal courts between June 1, 2015 and May 31, 2016. The courts affirmed the IRS position in 50 of these cases, or about 68 percent, while taxpayers fully prevailed in only five cases, or about seven percent of the cases. The remaining 18 cases, or about 25 percent, resulted in split decisions.

TAXPAYER RIGHTS IMPACTED²

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*

PRESENT LAW

Internal Revenue Code (IRC) § 162(a) permits a taxpayer to deduct ordinary and necessary trade or business expenses paid or incurred during the taxable year.³ These expenses include:

- Reasonable allowance for salaries or other compensation for personal services actually rendered;
- Travel expenses while away from home in the pursuit of a trade or business; and
- Rentals or other payments for use of property in a trade or business.⁴

In addition to the general allowable expenses described above, IRC § 162 addresses deductible and nondeductible expenses incurred in carrying on a trade or business, and special rules for health insurance costs of self-employed individuals.⁵

The interaction of IRC § 162 with other code sections that explicitly limit or disallow deductions can become very complex. For example, the year in which the deduction for trade or business expenses can be taken depends on when the cost was paid or incurred, the useful life of an asset on the date when it is sold, or when the business operation is terminated.⁶

1 See National Taxpayer Advocate 1998-2015 Annual Reports to Congress.

2 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a), 129 Stat. 2242, 3117 (2015) (codified at IRC § 7803(a)(3)).

3 The taxable year in which a business expense may be deducted depends on whether the taxpayer uses the cash or accrual method of accounting. IRC § 446.

4 IRC § 162(a)(1), (2), and (3).

5 See, e.g., IRC § 162(c), (f), and (l). For example, illegal bribes, kickbacks, fines, and penalties are nondeductible payments.

6 See, e.g., IRC § 165 (deductibility of losses), IRC § 167 (deductibility of depreciation), and IRC § 183 (activities not engaged in for profit).

Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance over the years. The IRS, the Department of Treasury, Congress and the courts continue to pose questions and provide legal guidance about whether a taxpayer is entitled to certain trade or business deductions. The litigated cases analyzed for this report illustrate that this process is ongoing and involves the analysis of facts and circumstances unique to each case. When a taxpayer seeks judicial review of the IRS's determination of a tax liability relating to the deductibility of a particular expense, the courts must often address a series of questions, including but not limited to, the ones discussed below.

What Is a Trade or Business Expense Under IRC § 162?

Although “trade or business” is a widely used term in the IRC, neither the Code nor the Treasury Regulations provide a definition.⁷ The definition of a “trade or business” comes from common law, where the concepts have been developed and refined by the courts.⁸ The Supreme Court has interpreted “trade or business” for purposes of IRC § 162 to mean an activity conducted with “continuity and regularity” and with the primary purpose of earning income or making a profit.⁹

What Is an Ordinary and Necessary Expense?

IRC § 162(a) requires a trade or business expense to be both “ordinary” and “necessary” in relation to the taxpayer's trade or business to be deductible. In *Welch v. Helvering*, the Supreme Court stated that the words “ordinary” and “necessary” have different meanings, both of which must be satisfied for the taxpayer to benefit from the deduction.¹⁰ The Supreme Court describes an “ordinary” expense as customary or usual and of common or frequent occurrence in the taxpayer's trade or business.¹¹ The Court describes a “necessary” expense as one that is appropriate and helpful for the development of the business.¹²

Common law also requires that in addition to being ordinary and necessary, the amount of the expense must be reasonable for the expense to be deductible. In *Commissioner v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held “the element of reasonableness is inherent in the phrase ‘ordinary and necessary.’ Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount.”¹³

Is the Expense a Currently Deductible Expense or a Capital Expenditure?

A currently deductible expense is an ordinary and necessary expense paid or incurred during the taxable year in the course of carrying on a trade or business.¹⁴ No current deductions are allowed for the cost of

7 *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987). “The phrase ‘trade or business’ has been in section 162(a) and that section's predecessors for many years. Indeed, the phrase is common in the Code, for it appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations... The concept thus has a well-known and almost constant presence on our tax-law terrain. Despite this, the Code has never contained a definition of the words “trade or business” for general application, and no regulation has been issued expounding its meaning for all purposes. Nether has a broadly applicable authoritative judicial definition emerged.”

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

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

10 290 U.S. 111, 115 (1933) (suggesting an examination of “life in all its fullness” will provide an answer to the issue of whether an expense is ordinary and necessary).

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

12 See *Comm'r v. Heining*, 320 U.S. 467, 471 (1943).

13 176 F.2d 815, 817 (6th Cir. 1949), *cert. denied*, 338 U.S. 949 (1950).

14 IRC § 162(a).

acquisition, construction, improvement, or restoration of an asset expected to last more than one year.¹⁵ Instead, those types of expenses are generally considered capital expenditures, which may be subject to depreciation, amortization, or depletion over the useful life of the property.¹⁶

Whether an expenditure is deductible under IRC § 162(a) or is a capital expenditure under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach to applying principles of capitalization and deductibility.¹⁷

When Is an Expense Paid or Incurred During the Taxable Year, and What Proof Is There That the Expense Was Paid?

IRC § 162(a) requires an expense to be “paid or incurred during the taxable year” to be deductible. The IRC also requires taxpayers to maintain books and records that substantiate income, deductions, and credits, including adequate records to substantiate deductions claimed as trade or business expenses.¹⁸ If a taxpayer cannot substantiate the exact amounts of deductions by documentary evidence (*e.g.*, invoice paid, paid bill, or canceled check) but can establish that he or she had some business expenditures, the courts may employ the *Cohan* rule to grant the taxpayer a reasonable amount of deductions.

The Cohan Rule

The *Cohan* rule is one of “indulgence” established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.¹⁹ The court held that the taxpayer’s business expense deductions were not adequately substantiated, but stated that “the [Tax Court] should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent.”²⁰ In *Estate of Elkins v. Commissioner*, the Fifth Circuit recently described “the venerable lesson of Judge Learned Hand’s opinion in *Cohan*: In essence, make as close an approximation as you can, but never use a zero.”²¹

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

16 IRC § 167.

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

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

19 39 F.2d 540 (2d Cir. 1930). George M. Cohan was an actor, playwright, and producer who spent large sums travelling and entertaining actors, employees, and critics. Although Cohan did not keep a record of his spending on travel and entertainment, he estimated that he incurred \$55,000 in expenses over several years. The Board of Tax Appeals, now the Tax Court, disallowed these deductions in full based on Cohan’s lack of supporting documentation. Nevertheless, on appeal, the Second Circuit concluded that Cohan’s testimony established that legitimate deductible expenses had been incurred. As a result, the Second Circuit remanded the case back to the Board of Tax Appeals with instructions to estimate the amount of deductible expenses.

20 39 F.2d 540 (2d Cir. 1930) at 544, *aff’g and remanding* 11 B.T.A. 743 (1928).

21 767 F.3d 443, 449 n. 7 (5th Cir. 2014) (citing *Cohan*, 39 F.2d at 543-44), *rev’g* 140 T.C. 86 (2013).

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

- Travel expenses;
- Entertainment, amusement, or recreation expenses;
- Gifts; and
- Certain “listed property.”²²

A taxpayer must substantiate a claimed IRC § 274(d) expense with adequate records or sufficient evidence to establish the amount, time, place, and business purpose.²³ A contemporaneous log is not explicitly required, but a statement not made at or near the time of the expenditure has the same degree of credibility only if the corroborative evidence has “a high degree of probative value.”²⁴ In addition, entertainment expenses require proof of a business relationship to the taxpayer.²⁵

Who Has the Burden of Proof in a Substantiation Case?

Generally, the taxpayer bears the burden of proving that he or she is entitled to the business expense deductions and the IRS’s proposed determination of tax liability is incorrect.²⁶ IRC § 7491(a) provides that the burden of proof shifts to the IRS when the taxpayer:

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

ANALYSIS OF LITIGATED CASES

The deductibility of trade or business expenses has been one of the ten MLIs since the first edition of the National Taxpayer Advocate’s Annual Report to Congress in 1998.²⁷ This year, we reviewed 73 cases involving trade or business expenses that were litigated in federal courts from June 1, 2015 through May 31, 2016. Table 5 listed in Appendix 3 contains a list of the main issues in these cases. Figure 3.5.1 categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

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

23 Treas. Reg. § 1.274-5T(b).

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

25 Treas. Reg. § 1.274-5T(b)(3)(v).

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

27 See National Taxpayer Advocate 1998-2015 Annual Reports to Congress.

FIGURE 3.5.1, Trade or Business Expense Issues Cases Reviewed²⁸

Issue	Type of Taxpayer	
	Individual	Business
Substantiation of Expenses, Including Application of the <i>Cohan</i> Rule	5	31
Substantiation of Expenses Under IRC § 274(d)	3	22
Ordinary and Necessary Trade or Business Expenses	0	13
Not a Qualifying Trade or Business Carried on for Profit	1	16
Home Office	0	10

Taxpayers represented themselves (*pro se*) in 45 of the 73 cases (about 62 percent). Taxpayers were represented by counsel in 28 out of the 73 cases (about 38 percent). Of the 73 cases, the taxpayers prevailed in five cases in full, and in 18 cases in part. The IRS won in the remaining 50 cases, none of the *pro se* individual taxpayers prevailed.

As in previous years, individual taxpayers routinely claimed deductions for vehicle and transportation expenses without understanding, or knowledge of, the substantiation requirements under IRC § 274(d). Many *pro se* litigants were unable to meet the strict substantiation requirements.²⁹

Individual Taxpayers

None of the decisions involving individual taxpayers (where the term “individual” excludes a sole proprietorship) were issued as a regular opinion of the Tax Court.³⁰ All of the individual taxpayers appeared *pro se*. The court fully upheld the IRS in all of the cases.

The most common issue before the court was the substantiation of claimed business deductions.³¹ For example, in *Garcia v. Commissioner*, the husband was a truck driver who incurred expenses for meals and lodging while on the road for work.³² The married couple claimed deductions for token gifts he had given to workers who helped him to unload his truck, clothing and boots used for his job, and cell phone expenditures.³³ The taxpayer produced cancelled checks, credit card bills, and bank account statements to substantiate these expenses. However, the taxpayer did not maintain a contemporaneous record of the amount, timing, or business nature of the alleged unreimbursed employee business expenses as required under IRC § 274(d). The Tax Court disallowed these deductions because the taxpayer failed to

28 Multiple issues can appear within one case; therefore these figures will not match the total case count.

29 See *Avery v. Comm’r*, T.C. Memo. 2016-50 (denying deductions for vehicle and travel expenses).

30 Tax Court decisions are categorized into three types: regular decisions, memorandum decisions, and small tax case (“S”) decisions. The regular decisions of the Tax Court include cases which have some new or novel point of law, or in which there may not be general agreement, and therefore have the most legal significance. In contrast, memorandum decisions generally involve fact patterns within previously settled legal principles and therefore are not as legally significant. Finally, “S” case decisions (for disputes involving \$50,000 or less where the taxpayer has elected Small Case status) are not appealable and, thus have no precedential value. See IRC § 7463(b). See also U.S. Tax Court Rules of Practice and Procedure, Rules 170-175.

31 See, e.g., *Akey v. Comm’r*, T.C. Memo. 2015-227; *Garcia v. Comm’r*, T.C. Memo. 2016-21.

32 T.C. Memo. 2016-21.

33 The taxpayer stated that the cell phone was required by the employer and that he used it solely for business purposes which the court did not find credible.

maintain adequate records and because the costs of clothing the husband purchased was not specific to his employment.³⁴

Business Taxpayers

We reviewed 63 cases involving business taxpayers. Business taxpayers had a much better success rate compared to individual taxpayers. As stated above, individual taxpayers did not prevail in any cases. Meanwhile, business taxpayers received full or partial relief in 37 percent of cases (23 out of 63 cases).

Business taxpayers were represented by counsel in 35 percent (8 of 23) of favorably decided cases, including four cases where the taxpayer received full relief. Business taxpayers were represented by counsel in 40 percent (20 of 50) of the cases that the IRS won. To the extent that *pro se* taxpayers were successful in court, these favorable outcomes stemmed mostly from their ability to provide records substantiating deductions in cases where such substantiation was in controversy. Courts did, however, allow some of these deductions where the taxpayer produced sufficient evidence.³⁵

As was the case for the individual taxpayers, substantiation of expenses was by far the most prevalent issue, and in most instances, the courts denied the business taxpayers' deductions for failure to substantiate.³⁶ The courts allowed deductions for some expenses when business taxpayers were able to provide sufficient evidence in the form of records, receipts, or logs.³⁷ Courts occasionally applied the *Cohan* rule where the taxpayer presented sufficient documentation to prove an expense was incurred but had limited documentation of the precise amount.³⁸ As previously mentioned, however, IRC § 274(d) makes the *Cohan* rule unavailable in certain circumstances in which the taxpayer must substantiate the deductions.

Taxpayers were also denied business expense deductions under IRC § 262(a) when the courts found the expenses were related to personal rather than business activities. In *Jijun Chen v. Commissioner*, the taxpayer was the owner of a biotechnology company.³⁹ The taxpayer provided a self-created spreadsheet to substantiate several Schedule C expenses. This spreadsheet contained dates, names of vendors/ items, and amounts paid. The vendors listed were department stores, salons, music stores, and other common stores. The taxpayer failed to establish how the expenses incurred at these stores were done so by the biotechnology company in carrying on its trade or business. In fact, most of these business expense deductions were indeed personal in nature and were for the benefit of the taxpayer's children. The taxpayer's expenses related to an employee benefits program that consisted entirely for sending his children to daycare. The travel and entertainment expenses and depreciation of musical instruments were also related to the education of the taxpayer's children. The court could not find any relationship between these deductions and the ordinary and necessary needs of a biotechnology company. These expenses were personal in nature and thus disallowed.

34 Clothing costs may be deductible if the clothing is a type specifically required as a condition of employment, it is not suitable for wear as ordinary clothing, and it is not worn as ordinary clothing. *Pevsner v. Comm'r*, 628 F.2d 467, 469 (5th Cir. 1980) (citation omitted).

35 See, e.g., *Charley v. Comm'r*, T.C. Memo. 2015-232.

36 See *Philbrick v. Comm'r*, T.C. Memo. 2016-64; *Porter v. Comm'r*, T.C. Memo. 2015-122.

37 See *Charley v. Comm'r*, T.C. Memo. 2015-232 (business mileage expenses substantiated through index cards and credible testimony).

38 See *Arizaga v. Comm'r*, T.C. Memo. 2016-57.

39 T.C. Memo. 2015-167.

Courts likewise generally sustained IRS determinations that business expense deductions were not attributable to an activity engaged in for profit within the meaning of IRC § 183.⁴⁰ However, in *Roberts v. Commissioner*, the taxpayer successfully established that he was engaged in the business of horse-racing.⁴¹ To arrive at this conclusion, the Tax Court proceeded to examine the taxpayer's deductions using the nine-factor test of Treas. Reg. § 1.183-2(b).⁴² Not a single one of the nine factors is determinative nor are they the only factors that can be taken into account when making a determination of whether a taxpayer's activities are engaged in for profit. The Tax Court decided that Mr. Roberts's horse-racing business was run as a hobby rather than a business and thus disallowed the expenses above the hobby profits. Upon appeal, the Court of Appeals for the Seventh Circuit reversed the Tax Court due to evidence that supported that business nature of the horse-racing conducted by Mr. Roberts. The evidence in support of the business nature of the horse-racing included the fact that the taxpayer purchased land specifically for expanding his ability to breed, race, and train horses. He became certified as a licensed trainer by the state and obtained his horse-racing license. He worked long hours with the horses and ceased his involvement with his previous businesses. One of the horses in his care was nominated to run in the Triple Crown Races which had the potential to greatly increase the profits to his horse-racing business. In fact, the Seventh Circuit was able to find support for all nine factors that Mr. Roberts conducted the horse-racing activity with the hopes of turning a profit. The fact that the activity had a social aspect and the lack of profit for the years in question were not enough to nullify the business nature of his activities.

Conversely, in *Estate of Stuller v. U.S.*, the Court of Appeals for the Seventh Circuit found that the manner in which the taxpayer conducted the activity of horse-breeding was not engaged in a manner consistent with a profit motive.⁴³ The court applied the nine factor test and found that only one, the expectation of asset appreciation, supported the taxpayer's assertion that the horse-breeding was carried on for profit. The evidence showed that the taxpayer kept minimal business records and did not retain any records of expenses related to the activities of horse-breeding. The lack of records kept essentially made it impossible for the taxpayer to make sound business decisions. The taxpayer did not change the operation methods or try new techniques to improve profitability. Nor did the taxpayer consult with any experts in the industry to determine better methods for running a horse-breeding endeavor. The taxpayer was able to rely upon the earnings from other businesses rather than relying upon horse-breeding which is also indicative that the activity was not carried out with a profit motive. The taxpayer derived great pleasure from the horse-breeding operation so the significant amount of time spent engaged in the activity is not necessarily a factor weighing in the taxpayer's favor. Unlike in *Roberts v. Commissioner*, the court was unable to determine that the horse-breeding activities conducted by Mr. Stuller were for profit and thus disallowed the deductions.

Another frequently litigated area was related to deductions taken in support of home offices. Taxpayers also had difficulty validating their home office deductions, losing in cases where business use of a home

40 See, e.g., *Stuller, Estate of, v. U.S.*, 811 F.3d 890 (7th Cir. 2016) (corporation was not an activity run for profit, had poor recordkeeping, lacked business practices directed at making a profit); *Pouemi v. Comm'r*, T.C. Memo. 2015-161, *aff'd*, 633 F. App'x 186 (4th Cir. 2016) (real estate activity not conducted in a businesslike manner, lacked a business plan, did not maintain a business bank account, and did not keep business books or records).

41 820 F.3d 247 (7th Cir. 2016), *rev'g* T.C. Memo. 2014-74.

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

43 811 F.3d 890 (7th Cir. 2016).

residence was in question.⁴⁴ For instance, in *Grossnickle v. Commissioner*, the taxpayer, a real estate agent, sought to claim a home office expense for a room she rented from a family member.⁴⁵ The taxpayer failed to show any rents paid or other substantiation that she used the space exclusively as her principal place of business. Thus, the Tax Court denied the home office expenses.

CONCLUSION

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

The *Cohan* rule was also a factor in several decisions this year. This common law doctrine allows taxpayers to deduct estimated expenses in cases where the expenses clearly existed but documentation showing the exact amount of the expenses is not readily available. The National Taxpayer Advocate believes the IRS Office of Appeals should expand the use of the *Cohan* rule in assessing hazards of litigation and in seeking to reach settlements with taxpayers.⁴⁶ The Examination process that often leads to Appeals, however, does not employ the *Cohan* rule and has adopted a more stringent document request policy to close cases and bypass Appeals in several instances.⁴⁷

Through education, outreach, and partnering with stakeholders, the IRS can help taxpayers understand what trade or business deductions are allowable and how they must substantiate those expenses. The IRS should continue to reach out proactively to taxpayers about these issues.

Proactive education and outreach to taxpayers regarding trade or business expenses will likewise promote taxpayers' *rights to be informed* and *to challenge the IRS's position and be heard*. By helping taxpayers understand not only the legal requirements but also their rights, the IRS will encourage taxpayers to comply with their tax obligations and minimize the risk of litigation.

44 See *Hawk v. Comm'r*, T.C. Memo. 2015-139 (denying expenses related to the home office). See also *Jijun Chen v. Comm'r*, T.C. Memo. 2015-167.

45 T.C. Memo. 2015-127.

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

47 *Id.*

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

We reviewed 45 decisions issued by federal courts from June 1, 2015, to May 31, 2016, regarding the additions to tax for:

- Failure to file a tax return by the due date under Internal Revenue Code (IRC) § 6651(a)(1);
- Failure to pay an amount shown on a tax return under IRC § 6651(a)(2);
- Failure to pay an amount shown on a tax return within 21 days of the issuance of a notice and demand under IRC § 6651(a)(3);
- Failure to pay installments of the estimated tax under IRC § 6654; or
- Some combination of the four.¹

The phrase “addition to tax” is commonly referred to as a penalty, so we will refer to these additions to tax as the failure to file penalty, the failure to pay penalty, and the estimated tax penalty. Eight cases involved the imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties; four cases involved the estimated tax penalty and either the failure to file penalty or the failure to pay penalty under IRC §§ 6651(a)(2) or (a)(3); 32 involved the failure to file or failure to pay penalties; one case involved only the estimated tax penalty.

The IRS imposes the failure to file and failure to pay penalties unless the taxpayer can demonstrate the failure is due to reasonable cause and not willful neglect.² The estimated tax penalty is imposed unless the taxpayer can meet one of the statutory exceptions.³ Taxpayers were unable to avoid a penalty in 41 of the 45 cases.

TAXPAYER RIGHTS IMPACTED⁴

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

1 For the first time in the Most Litigated Issue on the failure to file, failure to pay, and failure to pay installments of estimated tax, we have included cases where a decision was made on penalties imposed under Internal Revenue Code (IRC) § 6651(a)(3) failure to pay amount due within 21 days of the issuance of a notice and demand.

2 IRC §§ 6651(a)(1), (a)(2).

3 IRC § 6654(e).

4 See Taxpayer Bill of Rights (TBOR), <https://taxpayeradvocate.irs.gov/taxpayer-rights>. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a), 129 Stat. 2242, 3117 (2015) (codified at IRC § 7803(a)(3)).

PRESENT LAW

Under IRC § 6651(a)(1), a taxpayer who fails to file a return on or before the due date (including extensions) will be subject to a failure to file penalty of five percent of the tax due (minus any credit the taxpayer is entitled to receive and payments made by the due date) for each month or partial month the return is late. This penalty will accrue up to a maximum of 25 percent, unless the failure is due to reasonable cause and not willful neglect.⁵ To establish reasonable cause, the taxpayer must show the exercise of ordinary business care and prudence but the taxpayer was still unable to file by the due date.⁶ The failure to file penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.⁷

The failure to pay penalties, IRC §§ 6651(a)(2) and (a)(3), apply to a taxpayer who fails to pay an amount shown as tax on the return. The penalty accrues at a rate of 0.5 percent per month on the unpaid balance for as long as it remains unpaid, up to a maximum of 25 percent of the amount due.⁸ When IRS imposes both the failure to file and failure to pay penalties for the same month, it reduces the failure to file penalty by the amount of the failure to pay penalty (0.5 percent for each month).⁹

The failure to pay penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.¹⁰ The taxpayer will not be held liable if the taxpayer can establish reasonable cause, *i.e.*, the taxpayer must show the exercise of ordinary business care and prudence but was still unable to pay by the due date, or that payment on that date would have caused undue hardship.¹¹ Courts will consider “all the facts and circumstances of the taxpayer’s financial situation” to determine whether the taxpayer exercised ordinary business care and prudence.¹² In addition, “consideration will be given to the nature of the tax which the taxpayer has failed to pay.”¹³ Failure to pay a deficiency within 21 calendar days from the date a notice and demand is issued (or ten business days if the amount exceeds \$100,000) may result in a penalty under IRC § 6651(a)(3). In general, the addition to tax is 0.5 percent of the tax not paid, for each month or part of a month that the tax remains unpaid, up to a maximum of 25 percent.¹⁴ As in IRC §§ 6651(a)(1) and (a)(2) discussed above, the taxpayer will not be liable for the penalty if failure to pay is due to reasonable cause and not to willful neglect.¹⁵

IRC § 6654 imposes a penalty on any underpayment of estimated tax by an individual or by certain estates or trusts.¹⁶ The law requires four installments per tax year, each generally 25 percent of the

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

6 Treas. Reg. § 301.6651-1(c)(1).

7 IRC § 6651(a)(1).

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

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

10 IRC § 6651(a)(2).

11 Treas. Reg. § 301.6651-1(c)(1). Even when a taxpayer shows undue hardship, the regulations require proof of the exercise of ordinary business care and prudence.

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

13 Treas. Reg. § 301.6651-1(c)(2).

14 IRC § 6651(a)(3).

15 IRC § 6651(a)(3).

16 IRC § 6654(a), (l).

required annual payment.¹⁷ The required annual payment is generally the lesser of 90 percent of the tax shown on the return for the current tax year or 100 percent of the tax for the previous tax year.¹⁸ The IRS will determine the amount of the penalty by applying the underpayment rate, according to IRC § 6621, to the amount of the underpayment for the applicable period.¹⁹

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

- The tax due (after taking into account any federal income tax withheld) is less than \$1,000;²⁰
- The preceding tax year was a full 12 months, the taxpayer had no liability for the preceding tax year, and the taxpayer was a U.S. citizen or resident throughout the preceding tax year;²¹
- The IRS determines that because of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;²² or
- The taxpayer retired after reaching age 62, or became disabled, in the tax year for which estimated payments were required, or in the tax year preceding that year, and the underpayment was due to reasonable cause and not willful neglect.²³

In any court proceeding, the IRS has the burden of producing sufficient evidence that it imposed the failure to file, failure to pay, or estimated tax penalties appropriately.²⁴

ANALYSIS OF LITIGATED CASES

We analyzed 45 opinions issued between June 1, 2015, and May 31, 2016, where the failure to file penalty, failure to pay penalty, or estimated tax penalty was in dispute. All but eight of these cases were litigated in the United States Tax Court. A detailed list appears in Table 6 in Appendix 3. Twenty-eight cases involved individual taxpayers and 17 involved businesses (including individuals engaged in self-employment or partnerships).

Of the 28 cases in which taxpayers appeared *pro se* (without counsel), taxpayers did not fully prevail in any, and only two cases resulted in split decisions. Of the 17 cases in which taxpayers had representation, taxpayers prevailed in full in one case, and in part in two cases.

Failure to File Penalty

In most of the cases reviewed, taxpayers could not successfully establish that the failures to file were due to reasonable cause. Circumstances suggesting reasonable cause are typically outside the taxpayer's control.²⁵ Frequent reasonable cause claims included medical illness and reliance on an agent. In 38 cases reviewed where the failure to file penalty was at issue, the taxpayers could not successfully establish that the failures to file were due to reasonable cause in 32 cases.

17 IRC §§ 6654(c)(1), (d)(1)(A).

18 IRC § 6654(d)(1)(B).

19 IRC § 6654(a).

20 IRC § 6654(e)(1).

21 IRC § 6654(e)(2).

22 IRC § 6654(e)(3)(A).

23 IRC § 6654(e)(3)(B).

24 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001) (applying IRC § 7491(c)). An exception to this rule relieves the IRS of this burden where the taxpayer's petition fails to state a claim for relief from the penalty (and therefore is deemed to concede the penalty). *Funk v. Comm'r*, 123 T.C. 213, 218 (2004).

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

Medical Illness

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

In *Poppe v. Commissioner*, the taxpayer argued that failure to file his 2007 tax return was due to reasonable cause because he suffered from an autistic spectrum disorder (ASD)²⁶ previously known as Asperger's Syndrome, which prevented him from filing his tax return timely for tax year (TY) 2007.²⁷ During the trial, the taxpayer offered the testimony of a licensed psychologist who explained that ASD can impede an individual's executive functions and social cognition and create a high dependency on routines. However, the Tax Court gave this testimony little weight because the individual who offered the testimony was a licensed psychologist and not a medical physician.²⁸ Further, the licensed psychologist did not treat the taxpayer during the time in which he claimed he was impaired from filing a tax return. In addition, the taxpayer was unable to show how ASD impaired his life in other ways. For instance, the taxpayer was a teacher from 2001 through 2006 and did not provide any documentation showing that he ever requested any accommodation while teaching. While a teacher, the taxpayer was also day-trading two hours per school day. In 2007, he began trading on a full-time basis. When conducting these trades on a full-time basis, the taxpayer had six monitors in his workstation that showed the status of his trades. Further, the taxpayer was able to collect and analyze information on which to base his trades. Despite the taxpayer's ability to function in these situations, he claims that he was unable to file his tax return for TY 2007 because he was distraught over losses he suffered for that year. Although the Tax Court was "sympathetic to [taxpayer's] plight," it was unable to find that the taxpayer's mental condition prevented him from conducting his business affairs.²⁹ Therefore, the taxpayer's failure to file the 2007 tax return timely was not due to reasonable cause.³⁰

26 Centers for Disease Control and Prevention (CDC), *Facts about ASD* (Mar. 2016), <http://www.cdc.gov/ncbddd/autism/facts.html>. ASD is a developmental disability that can cause significant social, communication, and behavioral challenges. Individuals with ASD might not point at objects to show interest, have trouble relating to others or not have an interest in other people at all, avoid eye contact and want to be alone, have trouble understanding other people's feelings or talking about their own feelings, appear to be unaware when people talk to them but respond to other sounds, have trouble expressing their needs using typical words or motions, repeat actions over and over again, have trouble adapting when a routine changes, lose skills they once had (for example, stop saying words they were using), etc.

27 *Poppe v. Comm'r*, T.C. Memo. 2015-205.

28 National Taxpayer Advocate 2013 Annual Report to Congress 302; National Taxpayer Advocate 2015 Annual Report to Congress 368. The National Taxpayer Advocate has previously recommended that the IRS consider letters from other health professionals such as clinical psychologists or social workers, when determining if a taxpayer was unable to file a refund claim required under IRC § 6511(a) due to a mental disability that rendered him or her unable to manage his or her financial affairs, thereby meeting the definition of disability under IRC § 6511(h).

29 The court relied on *Hardin v. Comm'r*, T.C. Memo. 2012-162, even though the taxpayer suffered from attention deficit hyperactivity disorder, posttraumatic stress syndrome, and bipolar disorder; his mental condition did not prevent him from engaging in activities that required a high degree of concentration and ability to analyze and organize information.

30 Due to the resolution of the issues raised in the notice of deficiency, the taxpayer had no tax liability. Consequently, when the stipulated decision was entered, there was no failure to file penalty due from the taxpayer.

Reliance on Agent

The U.S. Supreme Court, in *United States v. Boyle*, held that taxpayers have a non-delegable duty to file a tax return on time.³¹ The Court noted that “[i]t requires no special training or effort to ascertain a deadline and make sure that it is met.”³² Therefore, a taxpayer’s reliance on an agent to file a tax return does not excuse any failure to comply with a known filing requirement.

In *Redstone v. Commissioner*, the taxpayer conducted a transaction where he transferred stock into trusts that were being held for his children.³³ The taxpayer did not file a gift tax return for these transactions, and the IRS therefore imposed a failure to file penalty. The taxpayer argued that he was not liable for the failure to file penalty because he reasonably relied on the advice of a tax professional. In fact, the tax advisors offered the taxpayer advice about his gift tax filing requirements on 34 occasions beginning in 1970. Further, the evidence showed that the taxpayer relied on a written memorandum that stated no gift tax return was required to be filed because the taxpayer had not made a taxable gift and that the taxpayer relied on this advice in good faith. Therefore, the Tax Court concluded that the taxpayer was not liable for an addition to tax for failure to file a gift tax return.

In *West v. Commissioner*, the estate (hereafter referred to as the taxpayer) failed to file a timely estate tax return.³⁴ The taxpayer argued that it reasonably relied on the advice of a tax professional. After the death of June West, the executors of her estate, her children — Peter, Lesley, and John, began working with their mother’s attorney, John Rodgers, to settle the estate. On January 3, 2010, Peter West emailed Mr. Rodgers seeking guidance as to “what legal followups are needed in the short term.”³⁵ Mr. Rodgers responded via email the following day informing Peter West that the estate would need to pay any outstanding bills, possibly file a federal estate tax return, and file her final Form 1040, *U.S. Individual Income Tax Return*, and a trust income tax return. Mr. Rodgers went on to say in his email, “[t]his all takes as short as a few months or (if an estate tax return is required) as long as [two] years.”³⁶

The following day, Peter West, again via email, responded that he was “sure there will be tax due” on the estate and that he “assume[d]” that John Renner, the accountant hired to do June West’s 2009 taxes, “would also take care of preparing estate taxes.”

On or about February 1, 2010, the executors of the estate met with Mr. Rodgers in person to discuss issues relating to the estate. During this meeting, the executors of the estate did not inquire about the filing and payment deadlines for the estate tax, nor did Mr. Rodgers volunteer that information. In fact, as Peter West later testified at his deposition, “[Rodgers] only gave the executors of the estate, both in the prior email and during the meeting, a general timeframe of two years for the taxes.” Following this February meeting, the executors of the estate had no further contact with Rodgers until November 2010, at which time the filing deadline for the estate tax return had already passed.

In November 2010, Peter West met with his siblings and thereafter emailed Mr. Rodgers inquiring as to what needed to be done to start work on the estate taxes. Mr. Rodgers interpreted this question as Peter West’s hiring him to prepare the estate tax return, and Mr. Rodgers began work preparing the estate tax return in December 2010. Mr. Rodgers was not concerned that the deadline for filing had already

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

32 *Id.* at 252.

33 *Redstone v. Comm’r*, T.C. Memo. 2015-237.

34 *West v. Comm’r*, 141 F.Supp. 3d 498 (E.D. Va. 2015).

35 *Id.* at 499.

36 *Id.*

passed, and he never mentioned this fact to the executors, as he mistakenly assumed that Mr. Renner, the accountant, had obtained the appropriate extension, as Peter West had earlier advised Mr. Rodgers that Mr. Renner would “take care of preparing estate taxes.”

In March 2011, Lesley West filed the tax return and paid the associated taxes. Shortly after filing the tax return, Lesley received a notice indicating the taxpayer owed the failure to file penalty. In June 2011, Mr. Rodgers filed a request with the IRS to abate these penalties on the basis of reasonable cause. The request was denied, and the taxpayer paid the penalties. Mr. Rodgers subsequently filed a claim for refund on behalf of the estate.

The taxpayer subsequently filed a refund suit, claiming that the failure to file penalty should be abated on the basis of reasonable cause for reliance on Mr. Rodgers’s legal advice, and that the penalty paid by the taxpayer should thereby be refunded.

The taxpayer argued that it had reasonable cause for failing to file the tax return because it had reasonably relied on Mr. Rodgers’ statement that “[t]his all takes as short as a few months or ... as long as [two] years.” The taxpayer interpreted this statement as saying it had up to two years to file the tax return. However, the court determined that this email from Mr. Rodgers was not legal advice as to the estate tax return filing deadline. The court then concluded that no reasonable person exercising ordinary business care and prudence would rely on the email for that purpose; rather, a reasonable person would have sought clarification, which the executors might have done during the face-to-face meeting with Mr. Rodgers in February. Furthermore, the court pointed out that the executors had ample opportunity to seek clarity as to the deadline but chose instead to construe vague language as specifying a “two-year” filing deadline. The court concluded that Rodgers never offered any legal advice as to the filing deadline and thus held that the taxpayer’s claim of reasonable cause based on reliance on the erroneous advice of counsel fails because the taxpayer never actually received advice from Mr. Rodgers as to an estate tax return filing deadline.³⁷

Failure to Pay an Amount Shown Penalty

A taxpayer can file a tax return by the due date and still be liable for a penalty under IRC § 6651(a)(2) if the amount shown on the tax return is not timely paid. Further, under IRC § 6651(a)(3), a penalty may apply if a taxpayer fails to pay a deficiency within 21 calendar days from the date a notice and demand is issued (or ten business days if the amount exceeds \$100,000). As described above, to assert a reasonable cause defense for purposes of the failure to pay penalty, the taxpayer must show that he or she exercised ordinary business care and prudence in providing for payment of tax liabilities but nevertheless was either unable to timely pay the tax or would suffer undue hardship if the payment was made on time.³⁸ In cases where individual taxpayers disputed that they were subject to the failure to pay penalty, many of their arguments for reasonable cause were similar to those used for the failure to file penalty under IRC § 6651(a)(1). The taxpayers often unsuccessfully argued medical illness or reliance on an agent or failed to make a separate and distinct argument relevant to the failure to pay.³⁹

However, a taxpayer can prevail on the failure to pay penalty when the IRS cannot meet its burden of production under IRC § 7491(c). Specifically, the IRC §§ 6651(a)(2) or (a)(3) penalties apply only when

³⁷ West, 141 F.Supp.3d at 503. See also Treas. Reg. § 301.6651-1(c)(1).

³⁸ See Treas. Reg. § 301.6651-1(c)(1).

³⁹ See, e.g., *Akey v. Comm’r*, T.C. Memo. 2015-227 (illness and break-in did not establish reasonable cause); *Poppe*, T.C. Memo. 2015-205 (mental condition did not establish reasonable cause); and West, 141 F. Supp. 3d at 498 (reliance on tax professional did not establish reasonable cause).

the taxpayer's *filed* tax return shows an amount due.⁴⁰ If the taxpayer did not file a tax return, the IRS can only assess the penalties if it has introduced a Substitute for Return (SFR) that satisfies the requirements of IRC § 6020(b). If the IRS cannot produce the SFR, it fails to meet its burden of production under IRC § 7491.⁴¹

In *Nutrition Formulators, Inc. v. Commissioner*, the taxpayer petitioned the Tax Court to reconsider the IRS Settlement Officer's determination in a Collection Due Process hearing that the failure to pay penalty for unpaid employment taxes for tax periods ending June 30, September 30, and December 31, 2011, and March 31, 2012, should not be abated for reasonable cause.⁴² The taxpayer argued that the company was a victim of embezzlement perpetrated by their former accountant and that the embezzlement exceeded the amount its former Certified Public Accountant was to pay in restitution. In addition, the taxpayer argued that it was impaired from paying its taxes due to the expenses it incurred for relocating its manufacturing operations to comply with Food and Drug Administration (FDA) regulations. However, the taxpayer was unable to show that the embezzlement impaired its ability to pay its taxes. Further, it could not show that the FDA regulations required its manufacturing operation to relocate, or that the debt incurred as a result of this relocation impaired its ability to timely pay taxes. Therefore, the Tax Court held that the taxpayer did not have reasonable cause for failure to timely pay its taxes.

In *Ibarra v. Commissioner*, the taxpayer was assessed a failure to pay penalty for TY 2010.⁴³ The taxpayer argued that he was unable to pay his tax liability due to the fact that he lost his job earlier in the year and incurred large expenses for treatment of his wife's pancreatic cancer. The taxpayer's insurance did not cover all the expenses associated with his wife's round-the-clock care, and in fact, he eventually had to rely on charitable organizations to help pay for oncologists and other caretakers. However, paying the tax liability due after withholdings were considered would have caused the taxpayer to suffer undue hardship. The Tax Court held that the taxpayer had reasonable cause for failing to pay his 2010 tax liability. Although this case has no precedential value,⁴⁴ it illustrates that courts do consider the unique circumstances of a taxpayer's case and can reach a just result.

Estimated Tax Penalty

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

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

The IRS has the burden under IRC § 7491(c) to produce evidence that IRC § 6654(d)(1)(B) requires an annual payment from the taxpayer.

40 IRC §§ 6651(a)(2), (g)(2).

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

42 *Nutrition Formulators, Inc. v. Comm'r*, T.C. Memo. 2016-60.

43 *Ibarra v. Comm'r*, T.C. Summ. Op. 2015-70.

44 See IRC § 7463(b).

In *Evans v. Commissioner*, the IRS determined that the taxpayer was liable for an IRC § 6654(a) addition to tax of \$8,840 for TY 2009.⁴⁵ To meet its burden of production under IRC § 7491(c), the IRS had to show that the taxpayer had a “required annual payment” as defined in IRC § 6654(d)(1)(B). This burden requires the IRS to produce evidence that allows the court to determine the amount of the required annual payment. To determine the amount of the taxpayer’s required annual payment for 2009, the court needed to know whether the taxpayer filed a return for the preceding tax year and if so, the amount of the “tax shown” on that return. Therefore, it was required that the IRS produce evidence that the taxpayer filed a tax return for 2008, and if so, the amount of “tax shown” on that return. In this case, the IRS was unable to meet its burden of production. The IRS’s opening brief contained no findings of fact regarding whether the taxpayer filed a tax return for TY 2008, and if so, the amount shown on that return. The only evidence that the IRS produced regarding the filing of a 2008 tax return was a transcript of account for TY 2008. The court reviewed the transcript and found it “inscrutable” in regards to whether or not a tax return was filed in 2008 or if the IRS later issued a Statutory Notice of Deficiency (SNOD) for that tax year.

The taxpayer provided a copy of his 2008 tax return. For the purpose of the required annual payment, the taxpayer must have sent it prior to the issuance of a SNOD. Because the Tax Court was unable to tell from the transcript when, if ever, the IRS had issued a SNOD for TY 2008, the Tax Court held that the tax return was filed prior to the issuance of a SNOD. The Tax Court determined that the 2008 tax return the taxpayer mailed qualifies as a tax return for the purpose of IRC § 6654. Because the amount shown on the 2008 tax return was zero, the estimated payment due for 2009 was also zero. Therefore, the taxpayer was not liable for the IRC § 6654(a) addition to tax.

CONCLUSION

Taxpayers prevailed in full in only one of 45 (or two percent) of the failure to file, failure to pay, and estimated tax penalty cases analyzed in this report. Four taxpayers prevailed in part (about nine percent) of the failure to file, failure to pay, and estimated tax penalty cases. Considering the limited resources most taxpayers have when litigating a case against the IRS, and the immense resources possessed by the IRS, a rather low, eleven percent, taxpayer success rate does not seem surprising. Additionally, this is about a six percent decline from the prior year’s success rate (17 percent).⁴⁶

It is critical that IRS employees look closely and thoroughly at the case facts when assessing reasonable cause claims rather than solely relying on the Reasonable Cause Assistant (RCA) software,⁴⁷ which is designed to help IRS employees make fair and consistent abatement determinations.⁴⁸ The RCA program allows IRS employees to override the results in certain circumstances, but employees must understand the definition of reasonable cause to apply the override.⁴⁹ Thus, a close review by an employee is essential to

45 *Evans v. Comm’r*, T.C. Memo. 2016-7.

46 National Taxpayer Advocate 2015 Annual Report to Congress 499.

47 The Reasonable Cause Assistant (RCA) can only consider failure to file or failure to pay penalties for certain individual tax returns.

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

49 Internal Revenue Manual (IRM) 20.1.1.3.6.10(3) (Nov. 25, 2011) (“[F]air and consistent application of penalties requires employees to make a final penalty relief determination consistent with the RCA conclusion ... [U]nderstanding that the individual facts and circumstances vary for each case and that there may be unique facts and circumstances in certain cases that RCA cannot consider, an ‘override (abort)’ function is available in RCA.”)

ensure that the failure to file penalty or the failure to pay penalty is imposed appropriately. Additionally, as previously recommended by the National Taxpayer Advocate, Congress should amend IRC § 6404 to authorize the Secretary of the Treasury to grant a one-time abatement of the failure to file penalty (IRC § 6651(a)(1)) and failure to pay penalty (IRC § 6651(a)(2)) for first time filers and taxpayers with a consistent history of compliance, where no countervailing factors are present.⁵⁰ To promote voluntary compliance and to uphold a taxpayer's *right to a fair and just tax system* and *the right to pay no more than the correct amount of tax*, the facts of taxpayers' individual cases must be carefully considered.

⁵⁰ National Taxpayer Advocate 2001 Annual Report to Congress 188.

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

Internal Revenue Code (IRC) § 7403 authorizes the United States to file a civil action in U.S. District Court against a taxpayer who has refused or neglected to pay any tax, to enforce a federal tax lien, or to subject any of the delinquent taxpayer's property to the payment of tax. We identified 32 opinions issued between June 1, 2015, and May 31, 2016 that involved civil actions to enforce liens under IRC § 7403. The IRS prevailed in 30 of these cases. One case was a split decision. The total number of cases represents approximately a 27 percent decrease from the previous year.¹ This is the second consecutive year that the number of lien enforcement cases decreased. The number of cases dropped by approximately 15 percent in the 2015 reporting period compared to the number of cases in 2014.

TAXPAYER RIGHTS IMPACTED²

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

PRESENT LAW

Internal Revenue Code (IRC) § 7403 authorizes the United States to enforce a federal tax lien with respect to a taxpayer's delinquent tax liability or to subject any property, right, title, or interest in property of the delinquent taxpayer to the payment of a liability, by initiating a civil action against the taxpayer in the appropriate United States District Court.³ When the United States files a complaint in the United States District Court to enforce a lien under IRC § 7403, it is required to name all parties having liens on or otherwise claiming interest in the relevant property as parties to the action.⁴ The law of the state where the property is located determines the nature of a taxpayer's legal interest in the property.⁵ However, once it is determined that the taxpayer has an interest under state law in the property, federal law controls whether the property is exempt from attachment of the lien.⁶

IRC § 7403(c) directs the court to “finally determine the merits of all claims to and liens upon the property,” and if the United States proves a claim or interest, the court may order an officer of the court to sell the property and distribute the proceeds in accordance with the court's findings with respect to the interests of the parties, including the United States' claim for the delinquent tax liability.⁷ Ordering

1 National Taxpayer Advocate 2015 Annual Report to Congress 509.

2 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

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

4 IRC § 7403(b).

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

6 *U.S. v. Rodgers*, 461 U.S. 677, 683 (1983).

7 IRC § 7403(c).

the sale of a taxpayer's property is a powerful collection tool and directly affects any parties who have an interest in the property subject to sale. Based on the Supreme Court case *United States v. Rodgers*, however, the court is not required to authorize a forced sale and may exercise limited equitable discretion. Under *Rogers*, when a forced sale involves the interests of a third party who does not have a federal tax debt, the court should consider the following four factors when determining whether the property should be sold:

1. The extent to which the government's financial interests would be prejudiced if they were relegated to a forced sale of the partial interest of the delinquent taxpayer;
2. Whether the innocent third party with a separate interest in the property, in the normal course of events, has a legally recognized expectation that the property would not be subject to a forced sale by the delinquent taxpayer or taxpayer's creditors;
3. The likely prejudice to the third party in personal dislocation costs and inadequate compensation; and
4. The relative character and value of the non-liable and liable interests held in the property.⁸

In cases where the United States holds a first priority lien, it may offer bids at the sale of the foreclosed property, up to an amount equal to the amount of the lien, plus selling expenses.⁹ If a foreclosure action is initiated by another creditor, then IRC § 7403(c) authorizes the United States to intervene in the action to assert any lien on the property that is the subject of such action.¹⁰

If the case was initiated in a state court, the United States may remove the case to a U.S. District Court.¹¹ However, if the foreclosure action is adjudicated under state court proceedings, federal tax liens that are junior to other creditors may be effectively removed, even if the United States is not a party to the proceeding.¹² While the action is pending, the court may appoint a receiver empowered in equity to preserve and operate the property prior to the sale, upon the government's certification that it is in the public interest.¹³

For the Department of Justice (DOJ) to file the foreclosure suit, the IRS must first request that DOJ take such action.¹⁴ The Internal Revenue Manual (IRM) provides procedures with respect to what actions the IRS must take before requesting that the DOJ commence a foreclosure proceeding.¹⁵ With respect to a recommendation to foreclose on a taxpayer's principal residence, there are special procedures that the IRS

⁸ *Rogers*, 461 U.S. at 709-11.

⁹ IRC § 7403(c).

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

¹¹ 28 U.S.C. § 1444.

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

¹³ IRC §§ 7403(d) and 7402(a).

¹⁴ IRC § 7401. The IRS prepares a suit recommendation package, and then the IRS Office of Chief Counsel reviews it, and if it agrees sends a letter to the DOJ asking the DOJ to commence the litigation. Chief Counsel Directives Manual, 34.6.1.1.1, *Steps Prior to Litigation*, (Oct. 7, 2015).

¹⁵ Internal Revenue Manual (IRM) 5.17.4.8, *Foreclosure of Federal Tax Lien*, (Aug. 1, 2010).

must follow before initiating a referral to DOJ.¹⁶ The IRM instructs the IRS to refer a case to DOJ to pursue a suit to foreclose only when there are no reasonable administrative remedies and hardship issues. Under IRM procedures, the IRS is required to take the following actions and describe the results in a suit recommendation narrative that accompanies the referral:

- Attempt to personally contact the taxpayer and inform them that a suit to foreclose the tax lien on the principal residence is the next planned action;
- Attempt to identify the occupants of the principal residence;
- Attempt to discuss administrative remedies with the taxpayer such as an offer in compromise (including Effective Tax Administration offer or an offer with consideration of special circumstances), when appropriate;
- Advise the taxpayer about TAS, provide Form 911, *Request for Taxpayer Advocate Assistance (and Application for Taxpayer Assistance Order)*, and explain its provisions;¹⁷ and
- Include a summary statement in the case history, along with the information on the taxpayer and the occupants of the principal residence, including children.¹⁸

ANALYSIS OF LITIGATED CASES

We reviewed 32 opinions issued between June 1, 2015, and May 31, 2016, that involved civil actions to enforce federal tax liens. Table 7 in Appendix 3 contains a detailed list of those cases. Fifty-six percent of the taxpayers appeared *pro se* and 44 percent were represented. Taxpayers with representation received partial relief in one case. Generally, *pro se* taxpayers did not fare well and only one received full relief.

Foreclosure of Tax Liens Where Non-Liable Taxpayer Had Interest in Property

In *United States v. Staton*,¹⁹ the United States filed suit to foreclose on a residence located in Hawaii to satisfy in part the delinquent tax liabilities of Ronald Staton. Mr. Staton owned the residence with his wife, Brenda Staton, as tenants by the entirety.

Since Mrs. Staton was a non-liable third party, the court examined the *Rodgers* factors to determine whether foreclosure of the tax liens would unduly harm Mrs. Staton.²⁰ The court considered all the *Rodgers* factors and found that they favored the United States' foreclosure action, and thus, the court found

16 IRM 5.17.4.8.2.5, *Lien Foreclosure on a Principal Residence* (Jan. 8, 2016). In 2012, TAS issued an Advocacy Proposal to the IRS recommending that the IRS consider the negative impact on the taxpayer of a suit to foreclose on a principal residence prior to forwarding the case to the DOJ. TAS, *Memorandum for Director, Collection Policy* (Aug. 20, 2012). The National Taxpayer Advocate followed this advocacy proposal with a legislative recommendation that Congress amend IRC § 7403 to require that the IRS, before recommending that DOJ file a suit to foreclose, first determine whether the taxpayer's other property or rights to property, if sold, are insufficient to pay the amount due, and that the foreclosure and sale of the residence will not create an economic hardship due to the financial condition of the taxpayer. National Taxpayer Advocate 2012 Annual Report to Congress 537-43 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*). Following this recommendation, TAS worked closely with the IRS to develop an Internal Guidance Memorandum (IGM) to address the issues raised by the National Taxpayer Advocate. Prior to the release of the IGM in 2013, the IRM provisions relating to referring cases under § 6334(e)(1) required the IRS to consider who is living in the residence in determining whether referral to DOJ was appropriate but the procedures under § 7403 did not.

17 If the taxpayer indicates that the planned foreclosure of the principal residence would create a hardship, the Revenue Officer (RO) will assist the taxpayer with the preparation of Form 911 and forward the form to the local TAS office if the RO cannot or will not provide the requested relief.

18 IRM 5.17.4.8.2.5, *Lien Foreclosure on a Principal Residence* (Jan. 8, 2016).

19 *U.S. v. Staton*, 116 A.F.T.R.2d (RIA) 5947 (D. Haw. 2015).

20 *U.S. v. Staton*, 116 A.F.T.R.2d (RIA) 5947 (D. Haw. 2015). For discussion of the *Rodgers* factors, see Present Law section, *supra*.

the entry of an order of foreclosure appropriate.²¹ As part of the *Rodgers* analysis, the court considered Mrs. Staton's one-half interest in the residence.²² The first factor, economic prejudice to the government, favored the foreclosure sale because a sale of a partial interest in the single-family property located on a single lot "would be impractical." Regarding the second factor, Mrs. Staton failed to present any authority that would shield her ownership interest from the sale. After "guess[ing] at her actual expectations as to her property rights," the court determined that she "could have no legally cognizable expectation that the residence could not be sold" to satisfy her husband's tax liabilities. Considering the third factor, the court concluded that there was no potential for unusual dislocation costs or undercompensation to Mrs. Staton. Finally, in regard to the fourth factor, since the ownership interest between liable and non-liable spouses was equivalent (*e.g.*, tenants by the entirety), the court determined that it weighed in favor of a foreclosure sale. The court acknowledged that the Statons were retired, and Mr. Staton had a health problem and that "the Court does not like to see people lose their homes." The court went on to say, however, that DOJ had been working with the Statons for almost three years to resolve the tax problem without the need for the sale and that if the Statons were successful in raising the funds necessary to pay the United States before the sale occurred, the court would immediately stop the sale.

Impact of Lien Filing and Indexing on Validity of Federal Tax Liens

In *TPF Deeds, LLC v. United States*,²³ the IRS properly assessed taxes against the taxpayer, Ernest Hewlett, in 2004, and then from 2005 to 2009 recorded seven Notices of Federal Tax Liens in Wasatch County, Utah with respect to the outstanding tax liability. In 2006, Ernest Hewlett, along with his wife Colleen Hewlett and their son Michael, purchased real property in Wasatch County. Ernest Hewlett was a one-third owner of the property. When they purchased the property, the federal tax lien attached to Ernest Hewlett's interest. On the same day the property was purchased, it was conveyed to his daughter, Celeste Hewlett. In 2009, Celeste Hewlett financed the property through SourceOne Financial, Inc., which ordered a title report that identified no tax liens or any other exceptions. In less than a month, SourceOne assigned majority interest in the deed to TPF Deeds, LLC. When Celeste Hewlett defaulted on the loan, a nonjudicial foreclosure proceeding was instituted, and a Trustee's Deed was recorded in favor of SourceOne and TPF Deeds for their respective interests. The IRS was not given notice of the nonjudicial foreclosure action. SourceOne discovered there was a tax lien on the property when it tried to sell its interest to a potential buyer and that party's title report showed a Notice of Federal Tax Lien (NFTL) having been filed for the tax liabilities of Ernest Hewlett.

The court found (upon a stipulation by the United States) that six of the seven liens were ineffective against the property.²⁴ However, the Court held that the lien relating to Ernest Hewlett's tax year 1997 liabilities, for which an NFTL had been filed with the county's Recorder's Office on August 26, 2005, attached to the property and was superior to the plaintiffs' interest in the property. The court found that the lien attached to the property because it was created before Mr. Hewlett acquired a one-third interest in the property.

The court also found the IRS's NFTL filed on August 26, 2005, established a lien superior to the plaintiffs' because the IRS followed the two main requirements of IRC § 6323(f): (1) the filing of the lien in the proper place, and (2) in a proper manner so that a reasonable inspection will reveal it.

21 *U.S. v. Staton*, 116 A.F.T.R.2d (RIA) 5947 (D. Haw. 2015).

22 See *U.S. v. Rodgers*, 461 U.S. 677 (1983).

23 *TPF Deeds, LLC v. U. S.*, 138 F. Supp. 3d 1268 (D. Utah 2015).

24 The government conceded that only one lien, Lien No. 2, or the lien for unpaid federal income taxes for the 1997 tax year, had priority over lenders' interests in the subject property.

The plaintiffs argued that the filing of the NFTL did not satisfy the second prong because when they conducted their search, they did not locate the notice of tax lien filing; hence, it was not filed in a manner so a reasonable inspection would reveal it.²⁵ The plaintiffs argued that it was not filed in the proper manner because when the plaintiffs searched the taxpayer's full name "Ernest Hewlett" and "Hewlett, Ernest" in the county records, they came up with no results. However, the court pointed out that merely searching Hewlett, or not using commas and quotation marks when searching the taxpayer's full name, yielded results that show that the IRS had filed a NFTL. The court found that the lien was properly recorded so that a reasonable inspection would reveal it and thus had priority over lenders' interests in the subject property.²⁶

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

The number of opinions that involved foreclosure of federal tax liens against property titled in the name of a taxpayer's nominee or alter ego showed a slight increase over last year, with 14 in 2016, compared to 13 in 2015. A nominee is one "who holds bare legal title to property for the benefit of another."²⁷ Courts typically look at the following factors to assess whether an entity is a nominee of a taxpayer:

- The nominee paid no or inadequate consideration;
- The property was placed in the name of the nominee in anticipation of the tax debt or litigation while the transferor retained control;
- There is a close relationship between the transferor and the nominee;
- The parties to the transfer failed to record the conveyance;
- The transferor retained possession (or control); and
- The transferor continues to enjoy the benefits of property.²⁸

Courts have also noted that an additional factor to consider is whose funds were used for the purchase of real property.²⁹ However, the courts have held that no single factor is determinative.³⁰ In *United States v. Sollenberger*,³¹ the court held that several companies set up by members of the Sollenberger family as part of an "asset protection strategy" were merely nominees over which the taxpayers exercised control or alternatively, the entity was a successor of one of the taxpayers.³² The court also set aside sham mortgage deeds held by the taxpayers over several properties. Since the entities were merely nominees, the court held that the government's liens validly attached to the properties.³³

25 IRC § 6323(f)(4).

26 The court also rejected the plaintiffs' equitable subordination argument.

27 *Nominee*, BLACK'S LAW DICTIONARY (10th ed. 2014). See also *U.S. v. Beeman*, 108 A.F.T.R.2d (RIA) 5074 (W.D. Penn. 2011).

28 See, e.g., *U.S. v. Sollenberger*, 150 F. Supp.3d 393, 401 - 02 (M.D. Pa. 2015) (citing *U.S. v. Klimek*, 952 F.Supp. 110, 1113 (E.D. PA 1997)); See also *U.S. v. Sabby*, 113 A.F.T.R.2d (RIA) 1335 (D. Minn. 2014) (quoting *Scoville v. U.S.*, 250 F.3d 1198, 1202 (8th Cir. 2001)).

29 *U.S. v. Sollenberger*, 150 F. Supp.3d 393, 402 (M.D. Pa. 2015) (citing *Nobel v. Morchesky*, 697 F.2d 97, 103 (3rd Cr. 1982)).

30 *U.S. v. Sollenberger*, 150 F. Supp.3d, 393, 402 (citing *In re: Richards*, 23 B.R.571, 579 (E.D. Pa. 1999)).

31 *U.S. v. Sollenberger*, 150 F. Supp.3d 393 (M.D. Pa. 2015).

32 *U.S. v. Sollenberger*, 150 F. Supp.3d 393 (M.D. Pa. 2015).

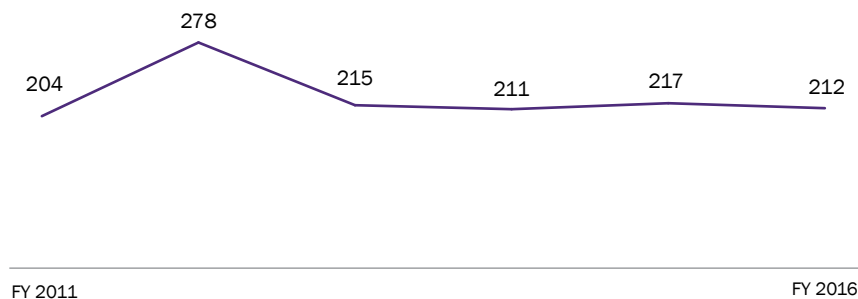
33 *U.S. v. Sollenberger*, 150 F. Supp.3d 393 (M.D. Pa. 2015).

CONCLUSION

As noted above, this was the second consecutive year that the number of lien enforcement cases decreased. The number of cases dropped by approximately 15 percent from 2014 to 2015 and approximately 27 percent in the past year. It is unclear whether the decrease in the number of litigated cases was directly related to the changes the IRS made in its principal residence referral to DOJ procedures that were instituted in 2013, but with a second consecutive year of decreasing DOJ referrals, the changes seem to have had a positive effect on enforcing taxpayer rights. The number of referrals decreased to 215 in fiscal year (FY) 2013, and slightly fluctuated thereafter, with 211 cases referred in FY 2014, 217 cases referred in FY 2015, and 212 cases referred in FY 2016, as shown in Figure 3.7.1.³⁴

FIGURE 3.7.1

Liens Cases Referred to U.S. Department of Justice



The National Taxpayer Advocate anticipates the updated IRM will have a positive effect on taxpayer rights in future years, as the IRS refers fewer suits to foreclose tax liens on taxpayers undergoing a hardship or in situations where there are reasonable alternatives. The National Taxpayer Advocate continues to recommend that Congress adopt the legislative recommendation to codify the approach used in the IRM so it cannot be reversed administratively.³⁵

To address taxpayer burden and enhance the taxpayer *rights to privacy, to a fair and just tax system, and to appeal the IRS's decision in an independent forum*, the National Taxpayer Advocate has also recommended that Congress amend IRC §§ 6320 and 6330 to extend Collection Due Process rights to “affected third parties,” known as nominees, alter egos, and transferees, who hold legal title to property subject to IRS collection actions.³⁶ Nominee cases represented about 42 percent (14 of 33) of lien cases seen in this reporting period.

³⁴ National Taxpayer Advocate 2014 Annual Report to Congress 508 (FY 2010 to FY 2013). DOJ Tax Division, *Suits to Foreclose Tax Lien – Summary by Fiscal Year of Case Receipt* (Oct. 2014) and DOJ Tax Division, *Suits to Foreclose Tax Lien – Summary by Fiscal Year of Case Receipt* (Oct. 2015).

³⁵ National Taxpayer Advocate 2012 Annual Report to Congress 537-43 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*).

³⁶ National Taxpayer Advocate 2012 Annual Report to Congress 544-52 (Legislative Recommendation: *Amend IRC §§ 6320 and 6330 to Provide Collection Due Process Rights to Third Parties (Known as Nominees, Alter Egos, and Transferees) Holding Legal Title to Property Subject to IRS Collection Actions*).

MLI
#8

Charitable Deductions Under IRC § 170

SUMMARY

Subject to certain limitations, taxpayers can take deductions from their adjusted gross incomes (AGIs) for contributions of cash or other property to or for the use of charitable organizations.¹ To take a charitable deduction, taxpayers must contribute to a qualifying organization² and substantiate contributions of \$250 or more.³ Litigation generally occurred in this reporting cycle in the following three areas:

- Substantiation of the charitable contribution;
- Valuation of the charitable contribution; and
- Requirements for a qualified conservation easement.

TAS reviewed 26 cases decided between June 1, 2015, and May 31, 2016, with charitable deductions as a contested issue. The IRS prevailed in 19 cases, taxpayers prevailed in three cases, and the remaining four cases resulted in split decisions. Taxpayers represented themselves (appearing *pro se*) in ten of the 26 cases (about 38 percent), with one taxpayer prevailing in full, the IRS in seven cases, and the remaining two resulted in split decisions.

TAXPAYER RIGHTS IMPACTED⁴

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal the IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

Charitable contributions made within the taxable year are generally deductible by taxpayers, but in the case of individual taxpayers, a taxpayer must itemize deductions from income on his or her income tax return in order to deduct the contribution.⁵ Transfers to charitable organizations are deductible only if they are contributions or gifts,⁶ not payments for goods or services.⁷ A contribution or gift will be allowed as a deduction under IRC § 170 only if it is made “to” or “for the use of” a qualifying organization.⁸

1 Internal Revenue Code (IRC) § 170.

2 To claim a charitable contribution deduction, a taxpayer must establish that he or she made a gift to a qualified entity organized and operated exclusively for an exempt purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual. IRC § 170(c)(2).

3 IRC § 170(f)(8)(A).

4 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

5 IRC §§ 63(d) and (e), 161, and 170(a).

6 The Supreme Court of the United States has defined “gift” as a transfer proceeding from a “detached and disinterested generosity.” *Comm'r v. Duberstein*, 363 U.S. 278, 285 (1960).

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

8 IRC § 170(c).

For individuals, charitable contribution deductions are generally limited to 50 percent of the taxpayer's contribution base (AGI computed without regard to any net operating loss carryback to the taxable year under IRC § 172).⁹ However, subject to certain limitations, individual taxpayers can carry forward unused charitable contributions in excess of the 50 percent contribution base for up to five years.¹⁰ Corporate charitable deductions are generally limited to ten percent of the taxpayer's taxable income and are also available for carryforward for up to five years, subject to limitation.¹¹ Taxpayers cannot deduct services that they offer to charitable organizations; however, incidental expenditures incurred while serving a charitable organization and not reimbursed, may constitute a deductible contribution.¹²

Substantiation

For cash contributions, taxpayers must maintain receipts from the charitable organization, copies of cancelled checks, or other reliable records showing the name of the organization, the date, and the amount contributed.¹³ Deductions for single charitable contributions of \$250 or more are disallowed in the absence of a contemporaneous written acknowledgement from the charitable organization.¹⁴

The donor is generally required to obtain the contemporaneous written acknowledgment no later than the date he or she files the return for the year in which the contribution is made, and it must include:

- The name of the organization;
- The amount of cash contribution;
- A description (but not the value) of non-cash contribution;
- A statement that no goods or services were provided by the organization in return for the contribution, if that was the case;
- A description and good faith estimate of the value of goods or services, if any, that an organization provided in return for the contribution; and
- A statement that goods or services, if any, that an organization provided in return for the contribution consisted entirely of intangible religious benefits, if that was the case.¹⁵

For each contribution of property other than money, taxpayers generally must maintain a receipt showing the name of the recipient, the date and location of the contribution, and a description of the property.¹⁶ When taxpayers contribute property other than money, the amount of the allowable deduction is the fair market value of the property at the time of the contribution.¹⁷ This general rule is subject to certain exceptions that in some cases limit the deduction to the taxpayer's cost basis in the property.¹⁸ For

9 IRC §§ 170(b)(1)(A) and (G).

10 IRC § 170(d)(1).

11 IRC §§ 170(b)(2) and (d)(2).

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

13 Treas. Reg. § 1.170A-13(a)(1).

14 IRC § 170(f)(8). See also Treas. Reg. § 1.170A-13(f).

15 IRS Pub. 1771, *Charitable Contributions Substantiation and Disclosure Requirements* (Rev. 3-2016).

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

17 Treas. Reg. § 1.170A-1(c)(1).

18 Treas. Reg. § 1.170A-1(c)(1). Note that the deduction is reduced for certain contributions of ordinary income and capital gain property. See IRC § 170(e).

claimed contributions exceeding \$5,000, the taxpayer must obtain a qualified appraisal prepared by a qualified appraiser.¹⁹

ANALYSIS OF LITIGATED CASES

TAS reviewed 26 decisions entered between June 1, 2015, and May 31, 2016, involving charitable contribution deductions claimed by taxpayers. Table 8 in Appendix 3 contains a detailed list of those cases. Of the 26 cases, the most common issues were: substantiation (or lack thereof) of the claimed contribution (12 cases), value of the property contributed (five cases), and contribution of an easement (nine cases).²⁰

Qualified Conservation Contribution

For a gift to constitute a qualified contribution under IRC § 170, the donor-taxpayer must possess a transferrable interest in the property and intend to irrevocably relinquish all rights, title, and interest to the property without any expectation of some benefit in return.²¹ Taxpayers generally are not permitted to deduct gifts of property consisting of less than the taxpayer's entire interest in that property.²² Nevertheless, taxpayers may deduct the value of a contribution of a partial interest in property that constitutes a "qualified conservation contribution,"²³ also known as a conservation easement. A contribution will constitute a qualified conservation contribution only if it is of a "qualified real property interest" made to a "qualified organization" "exclusively for conservation purposes."²⁴ All three conditions must be satisfied for the donation to be deemed a "qualified conservation contribution."

In *Carroll v. Commissioner*, the taxpayers, a married couple who filed a joint return, attempted to donate a conservation easement on the property on which they resided, and would continue to reside, to the Maryland Environmental Trust and the Land Preservation Trust, Inc. as joint easement holders.²⁵ In tax years 2005, 2006, 2007, and 2008, the taxpayers claimed a charitable contribution deduction for 2005 and carryover deductions for the subsequent years. The IRS disallowed the non-cash charitable contributions and issued a notice of deficiency. The easement agreement contained language addressing the valuation of the share of the donee organizations in the event of the extinguishment of the easement.²⁶

Treasury Regulation § 1.170A-14(g)(6) specifically addresses the valuation of a conservation easement in the event of extinguishment in order to satisfy the "in perpetuity" requirement of IRC § 170 for a qualified conservation easement.²⁷ The regulations require that a donee receive a vested property interest of the fair market value of the proportionate value of the conservation easement at the time

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

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

21 IRC § 170(f)(3).

22 IRC § 170(f)(3).

23 IRC § 170(b)(1)(E).

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

25 *Carroll v. Comm'r*, 146 T.C. No. 13 (2016).

26 *Id.*

27 See Treas. Reg. § 1.170A-14(g)(6) and IRC § 170(h)(5)(A).

of the donation for purposes of determining the proceeds awarded to the donee in the event of an extinguishment of the easement and the sale of the property.²⁸ For example, if the fair market value of an entire property on the date of the donation was two million dollars and the value of the conservation easement was one million dollars, the donee organization is entitled to a 50 percent interest in the proceeds of the sale of the entire property should the easement be extinguished. In the easement agreement between taxpayers and the donee organizations, taxpayers set the value of the easement, for purposes of extinguishment, at the value of the deduction allowed for federal income tax purposes and subject to change due to any disallowance by the IRS or subsequent court proceedings.²⁹ The Tax Court held that this language failed to satisfy the in perpetuity aspect of a qualified conservation easement since the value was fixed to the allowed charitable deduction amount and not the fair market value, and a disallowance of the deduction with an extinguishment of the easement would result in a windfall for the taxpayers, or their heirs, since the value of the deduction would then be zero, leaving the donee organizations with no entitlement to the extinguishment proceeds.³⁰

A conservation easement must be protected in perpetuity for it to qualify as a “qualified conservation contribution” pursuant to the IRC and Treasury regulations.³¹ In last year’s Most Litigated Issue on IRC § 170, we discussed the *Mitchell*³² case for the premise that a mortgage must be subordinated to the easement at the time of the donation, which has now been cited in other circuits.³³

Conservation Easement Valuation

To receive a deduction for most contributions of property in excess of \$5,000, taxpayers must provide a qualified appraisal of the property that is donated.³⁴ In *Palmer Ranch Holdings LTD v. Commissioner*, the corporate taxpayer owned an 89 acre parcel of land in Sarasota County, Florida, which was home to a bald eagle’s frequent route from a nest to waterways.³⁵ The corporation donated a conservation easement to the county and took a deduction for over \$25 million.³⁶ The IRS disallowed the deduction on the basis that the taxpayer had overvalued the worth of the easement.³⁷ The Tax Court agreed with the taxpayer’s characterization of the highest and best use of the property; however, it still rejected the valuation provided by the taxpayer.³⁸ Both the taxpayer and the IRS appealed the Tax Court’s decision to the Eleventh Circuit.³⁹

In determining the fair market value of a conservation easement, the “before and after” valuation, which compares the values of the property with and without the easement, is generally accepted.⁴⁰ The valuation also takes into consideration “any effect from zoning, conservation, or historic preservation

28 Treas. Reg. § 1.170A-14(g)(6)(ii).

29 *Carroll v. Comm’r*, 146 T.C. No. 13 (2016).

30 *Id.*

31 IRC § 170(h)(1); Treas. Reg. § 1.170A-14(g).

32 775 F.3d 1243 (10th Cir. 2015), *aff’g* 138 T.C. 324 (2012).

33 National Taxpayer Advocate 2015 Annual Report to Congress 515-22 (Most Litigated Issue: *Charitable Deductions Under IRC § 170*). See *Minnick v. Comm’r*, 796 F.3d 1156 (9th Cir. 2015), *aff’g* T.C. Memo. 2012-345.

34 IRC § 170(f)(11)(C).

35 812 F.3d 982 at 985 (11th Cir. 2016), *aff’g in part, rev’g in part, and remanding for further proceedings* T.C. Memo. 2014-79.

36 *Id.*

37 *Id.*

38 *Id.* at 992-93.

39 *Id.* at 993.

40 See *Hilborn v. Comm’r*, 85 T.C. 677, 688 (1985); Treas. Reg. § 1.170A-14(h)(3)(i).

laws that already restrict the property's potential highest and best use."⁴¹ Both the taxpayer and the IRS relied heavily on expert opinion testimony as to the pre- and post-contribution values of the property. Ultimately, however, the Tax Court agreed with the taxpayer's experts' view that the highest and best use of the property was moderate density residential zoning. The court characterized the argument from the IRS as being based on hearsay evidence from minutes taken at a board meeting years prior, where a zoning board had speculated on the use of the parcel at hand when deciding a zoning issue related to a contiguous property.⁴² Although the Tax Court accepted the highest and best use of the property as presented by the taxpayer's experts, it nonetheless reduced the value of the easement from the proposed \$25,200,000 to \$21,005,278.⁴³ The Eleventh Circuit affirmed the Tax Court's finding of the highest and best use of the property, but rejected the Tax Court's proposed reduction of the value of the property.⁴⁴ The Eleventh Circuit found error in the Tax Court's failure to explain its departure from the comparable sales method of valuation, which was proposed by both the taxpayer and the IRS, and found error in the Tax Court using evidence outside the record to value the property.⁴⁵ As a result, the Eleventh Circuit remanded the case to the Tax Court to either use the comparable sales method or explain the departure method, and to stick to only that evidence which was on record for the purposes of making a valuation determination.⁴⁶

Substantiation

Twelve cases involved the substantiation of deductions for charitable contributions. When determining whether a claimed charitable contribution deduction is adequately substantiated, courts tend to follow a strict interpretation of IRC § 170. Treasury Regulation § 1.170A-13(a)(1) requires the taxpayer to maintain a canceled check or a receipt from the donee organization to substantiate a cash contribution.⁴⁷ In the absence of a canceled check or a receipt from the donee organization, the taxpayer must maintain other reliable written records showing the name of the donee and the date and the amount of the contribution.⁴⁸

In *Gracia v. Commissioner*, the married taxpayers filed a timely tax return and claimed \$2,415 in donations which the IRS accepted, and additional contributions of \$390 for travel expenses incurred in performing services for their church, \$3,560 for clothing donations, \$5,350 for cash and property donations.⁴⁹ The IRS selected the return for examination. The taxpayers were able to produce one receipt for a \$400 cash donation during the trial. The court found no substantiation for any of the other disputed claimed charitable contributions and disallowed all of them, despite the taxpayers attempting

41 Treas. Reg. § 1.170A-14(h)(3)(ii).

42 812 F.3d 982 at 992 (11th Cir. 2016), *aff'g in part, rev'g in part, and remanding for further proceedings* T.C. Memo. 2014-79.

43 *Id.* at 993.

44 *Id.* at 1002.

45 *Id.* at 1003.

46 *Id.*

47 The IRS issued a Notice of Proposed Rulemaking on Sept. 17, 2015, that would implement the exception to the "contemporaneous written acknowledgment" requirement for substantiating charitable contribution deductions of \$250 or more and would provide rules concerning the time and manner for donee organizations to file information returns that report the requirement information about contributions. See Prop. Treas. Reg. § 1.170A-13(f)(18)-(19), 80 Fed. Reg. 55,802 (Sept. 17, 2015). On Jan. 8, 2016 the IRS withdrew the proposed regulations after receiving numerous comments concerned about the potential for identity theft when providing a donee organization donors' taxpayer identification numbers and requiring the donee to maintain that information for several years. IRS, *Withdrawal of Notice of Proposed Rulemaking*, FR Doc. 2016-189 (Jan. 8, 2016).

48 Treas. Reg. § 1.107A-13(a)(1)(iii).

49 T.C. Memo. 2016-21.

to create a log of items donated and securing a letter purporting to detail donations to an unattended clothing bin, as neither document was a contemporaneous writing.⁵⁰

CONCLUSION

IRC § 170 and the accompanying Treasury Regulations provide detailed requirements with which taxpayers must strictly comply. The statutory and regulatory requirements to qualify for a deduction become more stringent as deductions increase in size. Most of the charitable contribution cases reviewed this year addressed issues regarding substantiation of contributions or the complex rules governing the donation of a conservation easement.

Due to the complex nature of the rules and regulations surrounding charitable contributions, it is likely that litigation will continue in this area of the law. Taxpayers must carefully follow all aspects of the relevant laws and regulations when attempting to make a charitable contribution. Particularly, taxpayers must pay attention to the requirements for substantiation of a charitable contribution and to the elements of donating a qualified conservation easement.

50 T.C. Memo. 2016-21. The IRS initially allowed \$2,415 in cash charitable contributions claimed on the taxpayers' tax return. At issue in the trial were additional contributions of \$400 in cash, which the taxpayers substantiated at trial: \$390 for travel expenses related to charitable activities, \$3,560 of donated clothing and \$5,350 of additional cash and gifts. The taxpayers were unable to substantiate the latter three items.

MLI
#9Frivolous Issues Penalty Under IRC § 6673 and Related
Appellate-Level Sanctions

SUMMARY

From June 1, 2015 through May 31, 2016, the federal courts issued decisions in at least 19 cases involving Internal Revenue Code (IRC) § 6673 “frivolous issues” penalty and in at least five cases involving similar penalties at the appellate level.¹ These penalties are imposed for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal.² In five of the cases TAS reviewed, taxpayers escaped liability for the penalty and two cases resulted in a split decision on the requested penalties.³ Additionally, in three cases, the courts raised the issue of penalties *sua sponte* and did not impose the contemplated penalties but warned the taxpayers they could face sanctions for similar conduct in the future.⁴ Nonetheless, TAS included these cases in its analysis to illustrate what conduct will and will not be tolerated by the courts.

TAXPAYER RIGHTS IMPACTED⁵

- *The Right to Appeal an IRS Decision in an Independent Forum*

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.⁶ The maximum penalty is \$25,000.⁷ In some cases, the IRS requests that the Tax Court impose the penalty.⁸ In other cases, the Tax Court exercises its discretion, *sua sponte*,⁹ to consider whether the penalty is appropriate.

- 1 One of these cases also reviewed the Tax Court’s imposition of the Internal Revenue Code (IRC) § 6673 penalty; it is only counted once, our total case count is 23 distinct cases. See *Myers v. Comm’r*, 630 F. App’x 207 (4th Cir. 2016) (denying the Commissioner’s motion for sanctions but upholding \$5000 IRC § 6673 penalty), *aff’g* T.C. docket No. 30321-13L (May 28, 2015).
- 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 are authorized to impose sanctions under IRC § 7482(c)(4), 28 U.S.C. § 1927, or Rule 38 of the Federal Rules of Appellate Procedure, although some appellate-level penalties may be imposed under other authorities.
- 3 See, e.g., *Hare v. Comm’r*, T.C. Memo. 2015-250.
- 4 “*Sua sponte*” means without prompting or suggestion, on its own motion. BLACK’S LAW DICTIONARY (10th ed. 2014). Thus, for conduct that it finds particularly offensive, the Tax Court can choose to impose a penalty under IRC § 6673 even if the IRS has not requested the penalty. See, e.g., *Shakir v. Comm’r*, T.C. Memo. 2015-147.
- 5 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).
- 6 IRC § 6673(a)(1)(A), (B), and (C).
- 7 IRC § 6673(a)(1).
- 8 The standards for the IRS’s decision to seek sanctions under IRC § 6673(a)(1) are found in the Chief Counsel Directives Manual. See Chief Counsel Directives Manual (CCDM) 35.10.2 (Aug. 11, 2004). For sanctions of any attorney or other person authorized to practice before the Tax Court, under IRC § 6673(a)(2), all requests for sanctions are reviewed by the designated agency sanctions officer (currently the Associate Chief Counsel (Procedure & Administration)). This review ensures uniformity on a national basis. See, e.g., CCDM 35.10.2.2.3 (Aug. 11, 2004).
- 9 See, e.g., *Crummey v. Comm’r*, T.C. Memo. 2016-9, *appeal docketed*, No. 16-60620 (5th Cir. Sept. 16, 2016).

Taxpayers who institute actions in United States District Courts under IRC § 7433¹⁰ for certain unauthorized collection actions can be subject to a maximum penalty of \$10,000 if the court determines the taxpayer's position in the proceedings is frivolous or groundless.¹¹ In addition, IRC § 7482(c)(4) (United States Courts of Appeal and the Supreme Court),¹² §§ 1912 (United States Courts of Appeal and the Supreme Court) and 1927 (all federal courts) of Title 28 of the U.S. Code,¹³ and Rule 38 of the Federal Rules of Appellate Procedure (United States Court of Appeals)¹⁴ (among other laws and rules of procedure) authorize various federal courts to impose penalties against taxpayers or their representatives for raising frivolous arguments or using litigation tactics primarily to delay the collection process. Because the sources of authority for imposing appellate-level sanctions are numerous and some of these sanctions may be imposed in nontax cases, this report focuses primarily on the IRC § 6673 penalty.

ANALYSIS OF LITIGATED CASES

We analyzed 19 opinions issued between June 1, 2015, and May 31, 2016, in which courts addressed the IRC § 6673 penalty. Thirteen of these opinions were issued by the Tax Court, and six were issued by U.S. Courts of Appeals in cases brought by taxpayers seeking review of the Tax Court's imposition of the penalty. The Courts of Appeals sustained the Tax Court's position in all six cases. Five decisions were issued by other courts on similar penalties (one of these cases also reviewed the Tax Court's imposition of the IRC § 6673 penalty; it is only counted once, our total case count is 23 distinct cases).¹⁵

In seven cases, the Tax Court imposed penalties under IRC § 6673, with the amounts ranging from \$1,000 to \$15,000. In four cases, taxpayers prevailed when the IRS asked the court to impose a penalty, and in one case, the court fined the taxpaying husband but not the taxpaying wife, resulting in a split decision.¹⁶ In most of these cases, the court warned the taxpayers not to bring similar arguments in the future.¹⁷ All taxpayers appeared *pro se* (represented themselves) before the Tax Court. The taxpayers 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*:

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

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

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 See *Myers v. Comm'r*, 630 F. App'x 207 (4th Cir. 2016) (denying the Commissioner's motion for sanctions but upholding \$5000 IRC § 6673 penalty), *aff'g* T.C. docket No. 30321-13L (May 28, 2015).

16 See *Stanley v. Comm'r*, T.C. Memo. 2016-26.

17 See, e.g., *Martens v. Comm'r*, T.C. Memo. 2015-213.

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.¹⁸

In the Tax Court cases TAS reviewed, taxpayers raised the following issues that the court deemed frivolous. Consequently, the taxpayers were subject to a penalty under IRC § 6673(a)(1), or, in some cases, the court warned that such arguments were frivolous and could lead to a penalty in the future if the taxpayers maintained the same positions:

- **Taxes and procedures to collect taxes are unconstitutional:** TAS identified two cases this year where taxpayers made arguments that taxes or how they are collected are unconstitutional.¹⁹ The taxpayers in these cases advanced common arguments regarding the constitutionality of the income tax and procedures to collect it, including that their Fifth Amendment rights were denied and that they were not afforded due process under the Fourteenth Amendment. Both courts in these cases imposed penalties on the taxpayers.
- **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 one case, the taxpayer argued that IRS forms and notices violated PRA, and therefore he had no duty to file a tax return.²⁰ The taxpayer asserted that OMB had not approved IRS Form 1040, *U.S. Individual Income Tax Return*, in violation of the PRA. The court raised the issue *sua sponte* but declined to impose the penalty, and instead warned the taxpayer against future similar behavior.
- **Taxpayers are not United States persons or wages are not income:** Taxpayers in at least four cases presented arguments that they are not United States persons subject to tax or that wage income is not taxable.²¹ In one case, a taxpayer argued that the definition of income is a cat with a pink bow, and he earned no income.²² The court imposed a penalty of \$3,500 in this case.

CONCLUSION

Taxpayers in the cases analyzed this year presented the same arguments raised and repeated every year, which the courts routinely and universally reject.²³ Of the 23 cases reviewed, taxpayers avoided the IRC § 6673 penalty where the IRS requested it in only four cases and one split decision; the Tax Court often warned the taxpayers in these cases not to bring similar arguments in the future. Moreover, even when the Tax Court acknowledges that a penalty will likely not dissuade the taxpayer from raising frivolous arguments in the future, it nonetheless recognizes that the penalty “serves as a warning to other taxpayers considering these or similar arguments.”²⁴ Where the IRS has not requested the penalty, the court may

¹⁸ *Crain v. Comm’r*, 737 F.2d 1417, 1417-18 (5th Cir. 1984). See, e.g., *Foryan v. Comm’r*, T.C. Memo. 2015-114.

¹⁹ See *Clark, U.S. v.*, 642 F. App’x 614 (7th Cir. 2016), *aff’g* 116 A.F.T.R.2d (RIA) 5229 (E.D. Wis. 2015); *Briggs v. Comm’r*, T.C. Memo. 2016-86.

²⁰ See *Shakir v. Comm’r*, T.C. Memo. 2015-147.

²¹ See, e.g., *Foryan v. Comm’r*, T.C. Memo. 2015-114; *Leyshon v. Comm’r*, T.C. Memo. 2015-104, *aff’d by docket No. 15-2020* (4th Cir. May 20, 2016).

²² *Bruhwiller v. Comm’r*, T.C. Memo. 2016-18.

²³ See, e.g., National Taxpayer Advocate 2015 Annual Report to Congress 523-26.

²⁴ *Nitschke v. Comm’r*, T.C. Memo. 2016-78, *motion to vacate denied* (June 2, 2016).

nonetheless raise the issue *sua sponte*, and in all cases identified either imposed the penalty or cautioned the taxpayer that similar future behavior will result in a penalty.²⁵

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, 2015, and May 31, 2016, continuing a trend of upholding all penalties in cases TAS has analyzed since June 2005.

25 See, e.g., *Crummey v. Comm’r*, T.C. Memo. 2016-9 (court raised the issue *sua sponte* and warned the taxpayer not to assert similar arguments in the future).

MLI #10 Trust Fund Recovery Penalty (TFRP) Under IRC § 6672

SUMMARY

The trust fund recovery penalty (TFRP) (also known as the 100 percent penalty) applies to a person who has a responsibility to collect, truthfully account for, and pay over “trust fund” taxes imposed on another person that he or she willfully fails to remit such taxes to the IRS.¹ Typically, a TFRP arises when a struggling business fails to remit withheld income taxes, Social Security and Medicare taxes, railroad retirement taxes, or collected excise taxes to the IRS.² To establish liability under IRC § 6672, the IRS must conclude a person was responsible for withholding and paying over to the IRS payroll taxes and that the failure to do so was willful.³ The statute does not contain a reasonable cause exception.⁴ Whether a person actually had the responsibility to withhold payroll taxes and whether he or she willfully failed to do so are mixed questions of law and fact frequently litigated in United States district courts, bankruptcy courts, and the Court of Federal Claims. The TFRP has not been a most litigated issue since 2005.⁵

TAXPAYER RIGHTS IMPACTED⁶

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS’s Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Finality*
- *The Right to a Fair and Just Tax System*

- 1 Internal Revenue Code (IRC) § 6672(a). IRC § 7501 provides that taxes withheld from others, which are to be paid to the United States, are held in a special fund in trust for the United States. Thus, these amounts are referred to as the “trust fund” taxes.
- 2 See generally IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (Federal Insurance Contributions Act (FICA)); IRC §§ 3201, 3202, 3211, 3221, 3231-3233 and 3241 (Railroad Retirement Tax Act (RRTA)); IRC §§ 3301-3311 (Federal Unemployment Tax Act (FUTA)); IRC §§ 3401-3407 (collection of income at source on wages). For excise taxes, see, e.g., IRC §§ 4251; 4261; 4271. IRC § 6672 applies to taxes collected and paid over by a third party. It does not apply to taxes directly imposed on the person or entity required to pay them, e.g., it does not apply to the employer’s share of FICA or FUTA. IRC §§ 3101 and 3301. See also National Taxpayer Advocate 2007 Annual Report to Congress 395-410 (Most Serious Problem: Assessment and Processing of the Trust Fund Recovery Penalty (TFRP)).
- 3 See *Cline v. U.S.*, 997 F.2d 191 (6th Cir. 1993); *McGlothin v. U.S.*, 720 F.2d 6 (6th Cir. 1983).
- 4 There is a split in circuits on the issue of whether reasonable cause could have an effect on a willfulness determination. The Courts of Appeals for the Second, Fifth, Tenth, and Eleventh Circuits have determined that the reasonable cause defense could apply to willfulness determinations under IRC § 6672, but in very limited circumstances. See *Smith v. U.S.*, 555 F.3d 1158, 1170 (10th Cir. 2009); *Thosteson v. U.S.*, 331 F.3d 1294, 1301 (11th Cir. 2003); *U.S. v. Winter*, 196 F.3d 339, 345 (2d Cir. 1999); *Logal v. U.S.*, 195 F.3d 229, 233 (5th Cir. 1999). The Eighth and First Circuits have determined that reasonable cause is not a defense. See *Olsen v. U.S.*, 952 F.2d 236 (8th Cir. 1991); *Harrington v. U.S.*, 504 F.2d 1306 (1st Cir. 1974).
- 5 See National Taxpayer Advocate 2005 Annual Report to Congress 543-48 (Most Litigated Issue: *Trust Fund Recovery Penalty under Internal Revenue Code Section 6672*).
- 6 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

PRESENT LAW

Internal Revenue Code (IRC) § 6672 provides for assessment of the TFRP against those deemed responsible persons who fail to withhold and remit to the IRS income taxes, employment taxes and certain types of excise taxes, often referred to as the “trust fund” taxes, from payments to employees.⁷ To establish liability under IRC § 6672, the IRS must conclude a person was responsible for collecting, accounting for, and paying over payroll taxes to the IRS and have willfully failed to perform any of these activities, or willfully attempted to evade or defeat any such tax or its payment.⁸ The term “person” in IRC § 6672 includes, but is not limited to, the following:

- Officer or employee of a corporation;
- Partner or employee of a partnership;
- Member or employee of a Limited Liability Corporation (LLC);
- Corporate director or shareholder;
- Another corporation;
- Surety or lender;
- Payroll Service Provider (PSP);
- Responsible parties within a PSP;
- Professional Employer Organization (PEO);
- Responsible parties within a PEO; and
- Responsible parties within the common law employer (client of PSP/PEO).⁹

TFRP is equal to 100 percent of the trust fund portion of the taxes that were not remitted.¹⁰ TFRP is not dischargeable in bankruptcy.¹¹ Whether a taxpayer can obtain relief from the TFRP typically depends on whether the taxpayer can demonstrate that he or she was not a “responsible person” or did not act “willfully” under IRC § 6672.¹²

⁷ See generally IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (FICA); IRC §§ 3201, 3202, 3211, 3221, 3231-3233 and 3241 (RRTA); IRC §§ 3301-3311 (FUTA); IRC §§ 3401-3407 (collection of income at source on wages). For excise taxes, see, e.g., IRC §§ 4251; 4261; 4271. IRC § 7501 provides that taxes withheld from others, which are to be paid to the United States, are held in a special fund in trust for the United States. These taxes are often referred to as the “trust fund” taxes.

⁸ *U.S. v. Carrigan*, 31 F.3d 130, 133-34 (3d Cir. 1994). See also *Cline v. U.S.*, 997 F.2d 191 (6th Cir. 1993); *McGlothin v. U.S.*, 720 F.2d 6 (6th Cir. 1983).

⁹ Internal Revenue Manual (IRM) 5.17.7.1.1, *Persons Subject to the Trust Fund Recovery Penalty* (July 18, 2012). Consistent with recommendations by the National Taxpayer Advocate, the IRS has issued internal guidance stating that it can assess the TFRP against third-party payers and updated several IRMs. See also IRM 5.7.3.3.3, *Pre-levy Notice and Collection Due Process (CDP)* (July 19, 2012); Small Business/Self-Employed (SB/SE), *Interim Guidance for Conducting Trust Fund Recovery Penalty Investigations in Cases Involving a Third-Party Payer*, SBSE-05-0711-044 (July 1, 2011). See National Taxpayer Advocate 2007 Annual Report to Congress 337, 538 (Most Serious Problem: *Third Party Payers*; *Legislative Recommendation: Taxpayer Protection from Third Party Payer Failures*); National Taxpayer Advocate 2004 Annual Report to Congress 394-99.

¹⁰ IRC § 6672. TFRP assessments do not include the interest and penalties owed on the underlying employment tax liabilities owed by the employer. See *Williams v. U.S.*, 330 F.2d 960 (2d Cir. 1991). However, interest will begin to accrue on the TFRP if it is not paid within twenty-one days from the date of the notice and demand. IRC § 6601(e)(2).

¹¹ See 11 U.S.C. §§ 523(a)(1)(A); §507(a)(8)(C).

¹² The IRS also considers collection potential before assessing the TFRP. IRM 5.7.5.1.1(2) (Nov. 12, 2014) states that the penalty will “normally not be assessed when: [t]here is no present or future collection potential” or “[n]either the responsible person nor his or her assets or income sources can be located.”

Who Is a Responsible Person?

A “responsible person” is someone with significant, not necessarily exclusive, control over the company’s finances.¹³ Significant control is the final or significant word over which bills or creditors get paid.¹⁴ The determination of whether one is a responsible person within the meaning of IRC § 6672 is a matter of status, duty, and authority. Courts have recognized the following non-exhaustive five characteristics as being indicative of a person’s status as a “responsible person”:

- Employment as a corporate officer;
- Control over financial affairs;
- The authority to disburse corporate funds;
- Ownership of stock; and
- The ability to hire and fire employees.¹⁵

In general, the IRS will not seek to assess the penalty against non-owner employees of the business entity who act solely under the control of others and are not in a position to act independently of others.¹⁶ On the other hand, instructions from a superior to not pay taxes do not immunize a person who is otherwise responsible.¹⁷ In addition, the term “responsible person” can include corporations and other artificial entities.¹⁸ More than one person may be determined to be responsible.¹⁹ Each responsible person is jointly and severally liable for the penalty.²⁰ Even though the IRS may make TFRP assessments against more than one responsible person, it ultimately collects the total amount only once.²¹ Responsible persons may seek contribution to allow jointly liable responsible persons to recover a proportionate share from other responsible persons.²²

Willfulness

The willfulness component of the statute is satisfied if the person had knowledge of the employer’s obligation to pay withholding taxes and knew the funds were being used for other purposes.²³ Willfulness requires a voluntary, conscious and intentional act but does not require specific criminal intent or evil

13 This control does not need to be absolute. *U.S. v. Carrigan*, 31 F.3d 130, 133 (3d Cir. 1994) (citation omitted).

14 *Quattrone Accountants, Inc. v. IRS*, 895 F.2d 921, 927 (3d Cir. 1990).

15 *E.g., George v. U.S.*, 819 F.2d 1008 (11th Cir. 1987); *Smith v. U.S.*, 555 F.3d 1158 (10th Cir. 2009). When conducting trust fund responsibility interviews with potentially responsible persons, the IRS uses Form 4180, *Report of Interview with Individual Relative to Trust Fund Recovery Penalty*, in order to make a determination regarding responsibility. See IRM 5.7.4.2, *TFRP Interviews and Investigations* (Nov. 12, 2015).

16 IRM 5.7.3.3.1.2, *Non-Owner Employees* (Nov. 12, 2010) (noting that “[i]n general, non-owner employees who act solely under the dominion and control of others, and who are not in a position to make independent decisions on behalf of the business entity, will not be assessed the TFRP”). See also IRM 1.2.14.1.3, *Policy Statement 5-14 (Formerly P-5-60)* (June 9, 2003). “Non-owner employees” are those who do not own any stock, interest, or other “entrepreneurial stake” in the company. IRM 5.7.3.3.1.2(1) (Nov. 12, 2010). See also *U.S. v. Rem*, 38 F.3d 634 (2d Cir. 1994).

17 *E.g., Brounstein v. U.S.*, 979 F.2d 952, 955 (3d Cir. 1992) (citations omitted).

18 *Pac. Nat’l Ins. Co. v. U.S.*, 422 F.2d 26, 30 (9th Cir. 1970).

19 See *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970), *cert. denied* 400 U.S. 821 (1970); *Gephart v. U.S.*, 818 F.2d 469 (6th Cir. 1987).

20 *Brown v. U.S.*, 591 F.2d 1136 (5th Cir. 1979).

21 IRM 1.2.14.1.3, *IRS Policy Statement 5-14 (Formerly P-5-60)* (June 9, 2003).

22 IRC § 6672(d).

23 See *Hochstein v. U.S.*, 900 F.2d 543, 548 (2d Cir. 1990), *cert. denied*, 504 U.S. 985 (1992). A person has acted with willfulness if his or her actions were voluntary, conscious, and intentional as opposed to being merely negligent. See also *Kalb v. U.S.*, 505 F.2d 506, 511 (2d Cir. 1974).

motive.²⁴ The responsible person bears the burden to prove that his or her actions were not willful.²⁵ The courts apply these general standards to determine whether a responsible person acted willfully:

- *Deliberate choice* – Willfulness exists where the responsible person knows of the obligation to pay the withholding taxes and makes the deliberate choice to pay the withheld tax funds to other creditors, instead of paying the taxes over to the IRS;²⁶
- *Knowledge of nonpayment of taxes* – Willfulness exists if the responsible person obtains knowledge of a withholding tax delinquency and continues to permit payments to be made to other creditors;²⁷ and
- *Reckless disregard* – Willfulness exists where the responsible person acts with a reckless disregard of a known or obvious risk that withholding taxes will not be remitted, including failing to investigate or correct mismanagement after being notified that withholding taxes have not been paid.²⁸ Any voluntary act to prefer any creditor over the United States fulfills this criterion.²⁹

Procedural Issues

The IRS conducts an investigation, including interviewing potentially responsible persons, before making an assessment.³⁰ The period in which the IRS may assess the TFRP against a responsible person is the same period during which the IRS may assess against the employer for the underlying employment tax liability.³¹ The responsible person and the IRS may agree to extend the period for assessing the TFRP by executing a Form 2750, *Waiver Extending Statutory Period for Assessment of Trust Fund Recovery Penalty*.³²

Before the IRS can assess the penalty, however, it must send Letter 1153 (DO), *10-Day Notification Letter, 100% Penalty Proposed Against Filer for Corporation*, to the taxpayer informing him or her of the proposed assessment.³³ In the Letter 1153, the IRS encloses Form 2751, *Proposed Assessment of Trust Fund Recovery Penalty*, setting forth the periods and amounts of the proposed TFRP assessment, and offering the taxpayer an opportunity to appeal the proposed assessment to the Office of Appeals.³⁴ The taxpayer has 60 days from the date of the letter to submit a written request for appeal.³⁵ If the taxpayer

24 See, e.g., *Thomas v. U.S.*, 41 F.3d 1109 (7th Cir. 1994); *Barnett v. I.R.S.*, 988 F.2d 1449, 1457 (5th Cir. 1993).

25 See, e.g., *Morgan v. U.S.*, 937 F.2d 281, 286 (5th Cir. 1991).

26 See *Howard v. U.S.*, 711 F.2d 729 (5th Cir. 1983); *Mazo v. U.S.*, 591 F.3d 1151 (5th Cir. 1979).

27 See, e.g., *Gephart v. U.S.*, 818 F.2d 469 (6th Cir. 1987); *Stettler v. U.S.*, 98-1 U.S.T.C. ¶ 50,136 (10th Cir. 1998); *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970), *cert. denied*, 400 U.S. 821 (1970); *Thosteson v. U.S.*, 331 F.3d 1294 (11th Cir. 2003), *cert. denied*, 540 U.S. 1105 (2004).

28 See, e.g., *George v. U.S.*, 819 F.2d 1008 (11th Cir. 1987); *Denbo v. U.S.*, 988 F.2d 1029 (10th Cir. 1993); *Honey v. U.S.*, 963 F.2d 1083 (8th Cir. 1992), *cert. denied*, 506 U.S. 1028 (1992); *Godfrey v. U.S.*, 748 F.2d 1568 (Fed. Cir. 1984); *Mazo v. U.S.*, 591 F.2d 1151 (5th Cir. 1979).

29 See *Hochstein v. U.S.*, 900 F.2d 543, 548 (2d Cir. 1990), *cert. denied*, 504 U.S. 985 (1992). Funds that are legally obliged to be paid to another creditor do not fulfill this.

30 IRM 5.7.4.2, *TFRP Interviews and Investigations* (Nov. 12, 2015). The plain language of § 6672 does not oblige the IRS to attempt to collect trust fund taxes from the employer before assessing the TFRP penalty against a responsible person.

31 *Lauckner v. U.S.*, 68 F.3d 69 (3d Cir. 1995), *acq.* 1996-2 C.B. 1.

32 See also Treasury Inspector General for Tax Administration (TIGTA), *Revisions to Trust Fund Recovery Penalty Procedures Are Warranted*, 2016-30-046 (June 30, 2016) (discussing the IRS procedures on TFRP and recommendations).

33 IRC § 6672(b)(1). The IRS's policy is not to pursue the TFRP so long as there is an installment agreement (IA) in place with the business, unless there are statute of limitations issues or a default on IA is entered. IRM 1.2.14.1.3(8) (June 9, 2003).

34 See IRS Letter 1153, *10-Day Notification Letter, 100% Penalty Proposed Against Filer for Corporation* (Mar. 2002).

35 IRM 5.7.6.1.3(2) (Dec. 7, 2012). See also IRC § 6672(b)(2) (providing that the IRS has must send a preliminary notice 60 days prior to the assessment of the penalty). If the penalty per period is over \$25,000, the taxpayer must submit a formal written protest. See 5.7.6.1.5, *Formal Written Protest* (Apr. 13, 2006). Additionally, if the letter is addressed outside of the United States, the taxpayer has 75 days to request an appeal. IRM 5.7.6.1.3(2) (Dec. 7, 2012).

and the IRS still cannot agree on the proposed assessment after the appeals conference, the taxpayer can pay a specified portion of the liability and file a claim for refund in the Court of Federal Claims or the appropriate district court.³⁶ When the government produces a certificate that the penalty assessments for failure to pay withholding taxes were made, the government is entitled to a presumption of correctness in the courts, while the person challenging the assessment bears the burden of proving by a preponderance of the evidence that he or she was not liable.³⁷

ANALYSIS OF LITIGATED CASES

We reviewed 21 opinions issued by federal courts in which the TFRP was an issue. Taxpayers prevailed in whole or in part in four of the 21 cases. In one of these cases the court denied the IRS's motion for summary judgment, thereby requiring the parties to go to trial on any remaining contested issue.³⁸ In the remaining cases, the taxpayer prevailed for procedural reasons.³⁹

Pro Se Analysis

Only six of the 21 (29 percent) of the taxpayers in TFRP cases were *pro se*, or unrepresented by counsel. Of these six cases, taxpayers prevailed in one of the cases (approximately 16 percent). Those who were represented for this reporting year actually fared worse than those who represented themselves; they prevailed in whole or in part in only two of the 15 cases (approximately 13 percent). While the issues related to IRC § 6672 are procedurally and substantively complex, and generally require competent counsel, *pro se* taxpayers fared better overall due to the success of two litigants in a substantially smaller pool of cases than the represented taxpayers.

The IRS Failed to Follow Proper Procedures

In both cases in which the taxpayer prevailed, the IRS failed to follow the pre-assessment procedures for TFRP depriving taxpayers of the *right to challenge the IRS's position and be heard*. In *United States v. Appelbaum*, the court found that the IRS failed to mail the defendant Letter 1153, *10-Day Notification Letter, 100% Penalty Proposed Against File for Corporation*.⁴⁰ Because of this failure, assessments made by the IRS prior to the mailing of the letter were not valid. The three year statute of limitations for the IRS to make a valid assessment had already run by the time the case was decided, and so the taxpayer prevailed.

In *Romano-Murphy v. Commissioner*, the court likewise found in favor of the taxpayer because of procedural errors made by the IRS.⁴¹ In this case, the taxpayer was the Chief Operating Officer of Nurses PRN, LLC from July 2002 until June 2005. The IRS sent Romano-Murphy a Letter 1153, *Notice of*

36 IRC § 6672(c) provides that if the taxpayer makes the required payment within 30 days of notice and demand for payment and files suit within 30 days of the IRS denial of refund, levy action will be stayed until the conclusion of the court proceedings. IRS Letter 1153 instructs taxpayers who wish to contest the IRS assessment that they can appeal the assessment without paying the entire TFRP by: (1) paying the contested payroll tax for at least one employee for each period of liability that the taxpayer wishes to contest; (2) filing a claim for refund for the amounts paid using IRS Form 843, *Claim for Refund and Request for Abatement*; and (3) posting a bond with the IRS for 1.5 times the amount of the penalty that is left after making the payment for one employee. As the Trust Fund Recovery cases demonstrate, once the case is filed, the IRS typically counterclaims for the balance of the unpaid liability, thereby placing the entire TFRP liability at issue.

37 *E.g.*, *Fidelity Bank v. U.S.*, 616 F.2d 1181, 1186 (10th Cir. 1980); *Barnett v. U.S.*, 988 F.2d 1449, 1453 (5th Cir. 1993).

38 *Wallis v. U.S.*, 117 A.F.T.R.2d (RIA) 583 (W.D. Va. 2016).

39 *Romano-Murphy v. Comm'r*, 816 F.3d 707 (11th Cir. 2016), *rev'g and remanding* T.C. Memo. 2012-330; *U.S. v. Appelbaum*, 117 A.F.T.R.2d (RIA) 633 (W.D.N.C. 2016), *appeal docketed*, No. 16-1949 (4th Cir. Aug. 19, 2016).

40 *U.S. v. Appelbaum*, 117 A.F.T.R.2d (RIA) 633 (W.D.N.C. 2016), *appeal docketed*, No. 16-1949 (4th Cir. Aug. 19, 2016).

41 *Romano-Murphy v. Comm'r*, 816 F.3d 707 (11th Cir. 2016), *rev'g and remanding* T.C. Memo. 2012-330.

Proposed Assessment, in July 2006. In September 2006, Romano-Murphy responded to the letter to request “a conference to discuss the supporting documents contained with her formal written protest.” The IRS did not respond to the letter and the letter was never forwarded to the appeals department. Following a decision in November 2012 by the Tax Court, Romano-Murphy appealed to the Court of Appeals for the Eleventh Circuit. This was the first time that Romano-Murphy raised the issue of the IRS’s failure to provide her with a pre-assessment determination following her response to Letter 1153. The court found that a taxpayer who submitted a timely and written protest to Letter 1153 was entitled to a pre-assessment conference or a final administrative determination to that protest. The court rejected the IRS’s view that it has “unfettered discretion to resolve (or not resolve) timely pre-assessment protests,” and held that the IRS cannot “ignore, disregard, or discard” a timely protest. Because the IRS had never provided a pre-assessment conference and determination to the taxpayer, the taxpayer prevailed and the case was remanded to the Tax Court to determine whether this error was harmless. This is an extremely important decision for taxpayers who seek to resolve TFRP-related disputes pre-assessment because there is no prepayment judicial forum for the trust fund penalty.⁴² This case is relevant to protecting the taxpayers’ *right to challenge the IRS’s position and be heard* and the *right to appeal an IRS decision in an independent forum*, specifically the right to participate in the independent administrative appeals process.

Taxpayer Was a Responsible Person

An individual can be held personally liable under IRC § 6672 if (1) he or she is a “responsible person” and (2) he or she willfully failed to pay over to the government the amount of taxes otherwise due, or willfully attempted in any manner to evade or defeat any such tax or the payment thereof.⁴³ Once the IRS has made a TFRP assessment, the burden shifts to the taxpayer to disprove one or both elements. As discussed above, a “responsible person” is one who has significant, but not necessarily exclusive, control over a company’s finances and this determination, under IRC § 6672, looks to status, duty, and authority. Specifically, courts look at five, non-exhaustive, characteristics as being indicative of a person’s status as a “responsible person”: (1) employment as a corporate officer; (2) control over financial affairs; (3) the authority to disburse corporate funds; (4) ownership of stock; and (5) the ability to hire and fire employees.⁴⁴ There can be more than one “responsible person” for the purposes of IRC § 6672 liability. For example, in *Waterhouse v. United States*, the taxpayer, former vice-president and current 40 percent owner of company, alleged that he was not a “responsible person” since his role was not in the “administrative end of the business.”⁴⁵ Despite the court’s acknowledgment that he was not the “primary party responsible for administering [the company’s] finances,” the taxpayer was found a “responsible person” due to his authority to sign checks, history of making financial decisions regarding production and payroll, authority to hire and fire employees, and equal owner of the company.⁴⁶

42 See IRC § 6672(a) (stating that the penalty for TFRP is a “penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.”).

43 IRC § 6672; *McGlothlin v. U.S.*, 720 F.2d 6, 8 (6th Cir. 1982).

44 *E.g.*, *George v. U.S.*, 819 F.2d 1008 (11th Cir. 1987); *Smith v. U.S.*, 555 F.3d 1158 (10th Cir. 2009).

45 *Waterhouse v. U.S.*, 122 Fed. Cl. 276 (2015).

46 *Waterhouse v. U.S.*, 122 Fed. Cl. 276 (2015). See also *Godfrey v. U.S.*, 748 F.2d 1568, 1576 (Fed. Cir. 1984) (stating “where a person has authority to sign the checks of the corporation or to prevent their issuance by denying a necessary signature or where a person controls the disbursement of the payroll or controls the voting stock of the corporation he will generally be held ‘responsible.’”).

The Availability of Unencumbered Funds Affecting Willfulness

In four cases, taxpayers argued that the willfulness element of the TFRP liability test could be rebutted because TFRP is limited to unencumbered funds.⁴⁷ In *Schiffmann v. United States*, taxpayers, the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of a corporation, argued that they could not be liable for the corporation's unremitted payroll taxes because its funds were "largely encumbered."⁴⁸ The court held otherwise, stating that "funds are deemed encumbered only if the taxpayer is legally obligated to use them for some other purpose."⁴⁹ Likewise, in *In re Cherne*, the court held that the mere existence of an informal arrangement between the taxpayer's company and a financing company that resembled a "lock box" agreement was not sufficient to hold that those funds were encumbered.⁵⁰ In *Ruscitto v. United States*, the taxpayer also unsuccessfully argued that a third party's control of his company's finances under a surety agreement negated a finding of willfulness on his part.⁵¹

Conduct Is Willful When the Taxpayer Acted Recklessly

In three cases, the IRS did not show that the taxpayer had actual knowledge of their corporation's failure to remit the proper amount of employment taxes to the IRS.⁵² Rather, the IRS showed that the individual had behaved recklessly. For example, in *Byrne v. United States*, the court found the taxpayers liable for the respective corporate payroll taxes for the third and fourth quarters of 2000.⁵³ Because the taxpayers knew that the fellow investor they entrusted with the responsibility to remit the payroll taxes for 1999 and the first and second quarters of 2000 had not actually done so, their failure to verify that he was performing his duties in the third and fourth quarters of 2000 was reckless.

Willfulness Is Not Negated Because the Action Is Taken Based on the Directions of Superiors

Taxpayers also argued they are not responsible because the corporate form deprived them of the ability to make the outstanding tax payments. In *Schiffmann v. United States*, for instance, taxpayers (the CEO and CFO of a corporation) argued that their ability to pay the outstanding taxes in particular was not recognized by their board of directors. The court rejected this claim, and found that it was relevant that no resolution was made to this effect by a majority of the board members.⁵⁴

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- 47 *In re Cherne*, 116 A.F.T.R.2d (RIA) 6235 (D. Idaho 2015), *aff'g* 514 B.R. 616 (Bankr. Idaho 2014), *appeal docketed*, No. 15-35802 (9th Cir. Oct. 19, 2015); *Karban v. U.S.*, 117 A.F.T.R.2d (RIA) 1214 (E.D. Mich. 2016), *appeal docketed*, No. 16-1606 (6th Cir. May 11, 2016); *Ruscitto v. U.S.*, 629 F. App'x 429 (3d Cir. 2015), *aff'g* 111 A.F.T.R.2d (RIA) 2166 (W.D. Pa. 2014); *Schiffmann v. U.S.*, 811 F.3d 519 (1st Cir. 2016), *aff'g* 114 A.F.T.R.2d (RIA) 6241 (D.R.I. 2014). When a responsible person is not aware of a tax delinquency, but subsequently becomes aware of the delinquency, he or she is required to use all "unencumbered funds" available to the corporation, including unencumbered funds acquired thereafter, to pay the back taxes. See *Garsky v. U.S.*, 600 F.2d 86, 91 (7th Cir. 1979) (citations omitted).
- 48 *Schiffman v. U.S.*, 811 F.3d 519 (1st Cir. 2016), *aff'g* 114 A.F.T.R.2d (RIA) 6241 (D.R.I. 2014). For funds to be considered "encumbered," the taxpayer must be legally obligated to use the funds for a purpose other than satisfying the preexisting employment tax liability and the legal obligation is superior to the interests of the IRS in the funds, such as a secured creditor. See *Honey v. U.S.*, 963 F.2d 1083, 1090 (8th Cir. 1992), *cert. denied*, 506 U.S. 1028 (1992); *U.S. v. Kim*, 111 F.3d 1351 (7th Cir. 1997).
- 49 *Schiffman v. U.S.*, 811 F.3d 519 (1st Cir. 2016), *aff'g* 114 A.F.T.R.2d (RIA) 6241 (D.R.I. 2014) (citing *Nakano v. U.S.*, 742 F.3d 1208, 1212 (9th Cir. 2014), *cert. denied*, 134 S.Ct. 2680 (2014)).
- 50 *In re Cherne*, 116 A.F.T.R.2d (RIA) 6235 (D. Idaho 2015), *aff'g* 514 B.R. 616 (Bankr. Idaho 2014), *appeal docketed*, No. 15-35802 (9th Cir. Oct. 19, 2015).
- 51 *Ruscitto v. U.S.*, 629 F. App'x 429, 432 (3d Cir. 2015), *aff'g* 111 A.F.T.R.2d (RIA) 2166 (W.D. Pa. 2014).
- 52 *Byrne v. U.S.*, 116 A.F.T.R.2d (RIA) 5502 (E.D. Mich. 2015), *appeal docketed*, No. 15-2396 (6th Cir. Nov. 16, 2015); *Troost v. U.S.*, 116 A.F.T.R.2d (RIA) 6043 (N.D. Tex. 2015), *adopting* 116 A.F.T.R.2d (RIA) 6039 (N.D. Tex. 2015); *U.S. v. Sabaratnam*, 116 A.F.T.R.2d (RIA) 6459 (C.D. Cal. 2015), *appeal docketed*, No. 15-56463 (9th Cir. Sept. 23, 2015).
- 53 *Byrne v. U.S.*, 116 A.F.T.R.2d (RIA) 5502 (E.D. Mich. 2015), *appeal docketed*, No. 15-2396 (6th Cir. Nov. 16, 2015).
- 54 *Schiffman v. U.S.*, 811 F.3d 519 (1st Cir. 2016), *aff'g* 114 A.F.T.R.2d (RIA) 6241 (D.R.I. 2014).

CONCLUSION

The TFRP cases reviewed often involved officers of small businesses, such as CEOs or CFOs, who had a key role in determining financial expenditures. Often the TFRP liability arose when these companies experienced difficulties, and faced a choice between “borrowing” the trust fund monies, or being unable to remain open. Where the taxpayer made this choice, and the struggling business ultimately failed, the taxpayer faced TFRP under IRC § 6672.

To avoid TFRP liability, a responsible person must use all unencumbered funds to pay the back taxes after he or she obtains knowledge of a trust fund tax delinquency.⁵⁵ This duty extends not only to funds available at the time the responsible person becomes aware of the delinquency, but also to any funds acquired thereafter regardless of why the delinquency occurred.⁵⁶ This outcome does not change if the delinquency resulted from a third party bad act, such as mismanagement, embezzlement by a trusted employee, or by a third party payer.⁵⁷ Sometimes, a responsible person must timely resign to eliminate liability for trust fund taxes collected but not remitted to the IRS after the date of resignation.⁵⁸

The courts’ interpretation of TFRP may cause unjust results when a responsible person of a struggling business tries to resolve past tax delinquency, which resulted from an intervening bad act, and agrees to repay the liability in installments instead of liquidating the business.⁵⁹ In order to prevent business owners from facing the dilemma of whether to resign or to attempt to keep the business afloat while repaying the IRS debt, the National Taxpayer Advocate has previously recommended amending IRC § 6672 to provide

55 *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970), *cert. denied*, 400 U.S. 821 (1970) (the responsible party knew those taxes were due but nevertheless wrote checks to other creditors and suppliers); *Wright v. U.S.*, 809 F.2d 425 (7th Cir. 1987); *Howard v. U.S.*, 711 F.2d 729 (5th Cir. 1983); *Mazo v. U.S.*, 591 F.2d 1151 (5th Cir. 1979). Encumbered funds are money that the taxpayer is legally obligated to use for a purpose other than satisfying the preexisting tax liability. The claim of the other creditor must be superior to the IRS. *Honey v. U.S.*, 963 F.2d 1083 (8th Cir. 1992), *cert. denied*, 506 U.S. 1028 (1992); *U.S. v. Kim*, 111 F.3d 1351 (7th Cir. 1997).

56 *Garsky v. U.S.*, 600 F.2d 86 (7th Cir. 1979); *U.S. v. Kim*, 111 F.3d 1351 (7th Cir. 1997). Even if money intended for payment of taxes was embezzled, the responsible party remains liable for the penalty. *Anuforo v. Comm’r*, 106 A.F.T.R.2d (RIA) 5596 (8th Cir. 2010). See also *Purcell v. U.S.*, 1 F.3d 932 (9th Cir. 1993); *Buffalow v. U.S.*, 109 F.3d 570, 573 (9th Cir. 1997).

57 *Anuforo v. Comm’r*, 106 A.F.T.R.2d (RIA) 5596 (8th Cir. 2010); *McCloskey v. U.S.*, 104 A.F.T.R.2d (RIA) 6378 (W.D. Pa 2009). See also National Taxpayer Advocate 2007 Annual Report to Congress 337, 538 (Most Serious Problem: *Third Party Payers*; *Legislative Recommendation: Taxpayer Protection from Third Party Payer Failures*). See National Taxpayer Advocate 2010 Annual Report to Congress 400, 405 (Legislative Recommendation: *Revise the Willfulness Component of the Trust Fund Recovery Penalty Statute to Encourage Business Owners to Continue Operation of Financially Struggling Businesses When the Tax Liability Accrues Due to an Intervening Bad Act*) (recommending that Congress amend IRC § 6672 to provide that the conduct of a responsible person who obtains knowledge of trust fund taxes not being timely paid because of an intervening bad act shall not be deemed willful if the delinquent business: (1) promptly makes payment arrangements to satisfy the liability based upon the IRS’s determination of the minimal working capital needs of the business, and (2) remains current with payment and filing obligations).

58 See *Maggy v. U.S.*, 560 F.2d 1372 (9th Cir. 1977), *cert. denied*, 439 U.S. 821 (1978).

59 For example, in *Baimbridge v. United States* the potentially responsible person attempted to address the willfulness component of the TFRP liability test by arguing that the corporation had entered into an IA for the repayment of the delinquent tax, and therefore, the IRS should be estopped from assessing the penalties because it was fully aware that the business was going to continue operation and satisfy non-IRS creditors. *Baimbridge v. U.S.*, 335 F. Supp. 2d 1084 (S.D. Cal. 2004). The court noted “that serious injustice may result from a penalty assessment being predicated on non-IRS payments which were contemplated by the installment agreement” and denied the IRS’s motion for summary judgment on the issue of willfulness, thereby requiring the parties to go to trial.

businesses with “working capital” to keep their doors open, while entering into payment arrangements with the IRS.⁶⁰

The IRS assessment of TFRP impacts several important taxpayer rights including the *right to challenge the IRS’s position and be heard*, the *right to appeal an IRS decision in an independent forum*, and the *right to fair and just tax system*. As discussed in *Romano-Murphy v. Commissioner*, taxpayers have the *right to challenge the IRS’s position and be heard*, including the right to a pre-assessment conference and administrative determination on their timely protest of the proposed TFRP. Additionally, taxpayers have the *right to a fair and just tax system* which takes into consideration all the facts and circumstances that may affect a taxpayer’s underlying liability for TFRP, including if they are a “responsible person,” if they acted willfully, if funds were encumbered or not, and for the IRS to take into consideration any factors that would negate willfulness.

60 See National Taxpayer Advocate 2010 Annual Report to Congress 400-05 (Legislative Recommendation: *Revise the Willfulness Component of the Trust Fund Recovery Penalty Statute to Encourage Business Owners to Continued Operations of Financially Struggling Businesses When the Tax Liability Accrues Due to an Intervening Bad Act*). In cases where the delinquency is due to third party bad acts, such as embezzlement by an employee or third party payer, the courts have not provided any relief to these business owners who opt to spend even a single penny on operating costs rather than providing all available funds to pay back trust fund taxes. See, e.g., *Anuforo v. Comm’r*, 614 F.3d 799 (8th Cir. 2010); *McClouskey v. U.S.*, 104 A.F.T.R.2d (RIA) 6378 (W.D. Pa. 2009). The U.S. Supreme Court has allowed this “minimum working capital,” used to maintain operations and avoided liquidation of the business, and limited the application of the TFRP in cases where a financially troubled company changed ownership and an individual became a responsible person after the liability accrued. See *Slodov v. U.S.*, 436 U.S. 238 (1978). Additionally, the National Taxpayer Advocate recommended that the IRS be given authority to determine “minimal working capital” needs of a financial struggling company, which would be modeled off of the IRC § 7122(d)(2) requirement for allowable living expense analysis, and would require the IRS to conduct a thorough analysis of all facts and circumstances of each taxpayer and ensure that its determination will not leave the taxpayer without adequate funds to meet its basic operating expenses, including current and future tax obligations. National Taxpayer Advocate 2010 Annual Report to Congress 400-05 (Legislative Recommendation: *Revise the Willfulness Component of the Trust Fund Recovery Penalty Statute to Encourage Business Owners to Continued Operations of Financially Struggling Businesses When the Tax Liability Accrues Due to an Intervening Bad Act*).