

## STRENGTHEN TAXPAYER RIGHTS IN JUDICIAL PROCEEDINGS

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### Legislative Recommendation #45

## Repeal *Flora* and Expand the Tax Court’s Jurisdiction, Giving Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can

### PRESENT LAW

IRC § 7442 defines the jurisdiction of the United States Tax Court. IRC § 6212 requires the IRS to issue a “notice of deficiency” before assessing certain liabilities. When the IRS issues a notice of deficiency, IRC § 6213 authorizes the taxpayer to petition the U.S. Tax Court within 90 days (or 150 days if the notice is addressed to a person outside the U.S.) to review the IRS determination.

IRC §§ 6201 and 6671(a) authorize the IRS to assess other liabilities, including so-called “assessable” penalties (*e.g.*, penalties codified in IRC §§ 6671-6725), without first issuing a notice of deficiency. Assessable penalties are not computed by reference to a tax deficiency. For example, penalties under IRC §§ 6721 and 6707 for failure to file various information returns are assessable penalties. Although IRC § 6671(a) specifically references only the “penalties and liabilities provided by this subchapter” (*i.e.*, Chapter 68, Subchapter B of the Code), the IRS takes the position that various international information reporting penalties located in Chapter 61 are also assessable, such as the penalty under IRC § 6038 for failure to file Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations.<sup>1</sup> A taxpayer generally may not obtain judicial review of assessable penalties in the Tax Court, except in connection with the Tax Court’s limited jurisdiction to review the results of an IRS “Collection Due Process” (CDP) hearing, as described below.

The Anti-Injunction Act (IRC § 7421) and the tax exception to the Declaratory Judgment Act (28 U.S.C. § 2201) generally prohibit lawsuits to restrain the assessment or collection of tax. Once a taxpayer pays the tax, however, the taxpayer may file suit in a U.S. district court or the U.S. Court of Federal Claims under 28 U.S.C. § 1346(a)(1) to recover any tax the taxpayer believes has been erroneously assessed or collected. In *Flora v. United States*, 362 U.S. 145 (1960), the U.S. Supreme Court held that, with limited exceptions, a taxpayer must have “fully paid” the assessment (called the “full payment rule”) before filing suit in these courts.

One exception to the full payment rule applies to “divisible” taxes. When an assessment may be divisible into a tax on each transaction or event, the taxpayer need only pay enough to cover a single transaction or event before filing suit. For example, the trust fund recovery penalty under IRC § 6672(a) — a collection device that makes all “responsible persons” jointly and severally liable for a business’s unpaid trust fund taxes — is a divisible tax. After the IRS assesses the penalty, the responsible person need only pay the amount

<sup>1</sup> See, *e.g.*, Internal Revenue Manual (IRM) 21.8.2.20.2, Form 5471 Penalties Systemically Assessed from Late-Filed Form 1120 Series or Form 1065 (Mar. 26, 2018); IRM 21.8.2.21.2, Form 5472 Penalties Systemically Assessed from Late-Filed Form 1120 Series (Mar. 18, 2020).

due with respect to a single employee for a single quarter before filing suit.<sup>2</sup> IRC § 6331(i) provides that (notwithstanding IRC § 7421), if a taxpayer pays part of a “divisible” tax and sues for a refund in a proper federal trial court, the IRS generally cannot levy to collect the unpaid divisible tax during the suit’s pendency. But IRC § 6331(i)(2) only applies this levy ban to employment taxes and the trust fund recovery penalty.<sup>3</sup>

IRC § 6694(c) provides another exception to the full payment rule for those who have paid 15 percent of certain assessable preparer penalties. Similarly, IRC § 6703(c) provides an exception for those who have paid 15 percent of the assessable penalties under IRC §§ 6700 (promoting abusive tax shelters) and 6701 (aiding and abetting understatements).

Under IRC § 7422(a), the taxpayer must make a timely administrative claim for refund before filing suit. To be timely, IRC § 6511(a) generally requires that an administrative claim be filed by the later of (i) three years from the date the original return was filed or (ii) two years from the date the tax was paid. If the claim is filed within the three-year period, then IRC § 6511(b)(2)(A) provides that the taxpayer can only recover amounts paid within three years, plus any extension of time to file, before the date of the claim. Otherwise, IRC § 6511(b)(2)(B) provides that the taxpayer can only recover amounts paid within two years before the date of the claim.

If the IRS issues a notice of claim disallowance, IRC § 6532 provides that the taxpayer has two years from the date of the notice in which to file suit. If the IRS does not issue a notice of claim disallowance, the taxpayer may file suit after six months.<sup>4</sup> However, IRC § 7422(j) provides a special exception to the full payment rule for suits by estates that have elected to pay the estate tax in installments under IRC § 6166.

Under IRC §§ 6330 and 6320, the Tax Court may review an assessed liability if the IRS issues levies or liens to collect an assessment and the taxpayer requests a CDP hearing. However, IRC §§ 6330(c)(2)(B) and 6320(c), and Treas. Reg. §§ 301.6320-1(e)(3), A-E2 and 301.6330-1(e)(3), A-E2, effectively provide that the Tax Court may do so only if the taxpayer did not receive a notice of deficiency and did not have an opportunity to raise the dispute in an administrative appeal. In practice, the IRS generally provides the opportunity for an administrative appeal, thereby depriving taxpayers of the opportunity to have the Tax Court review the underlying liability.

Under 11 U.S.C. § 505(a)(1), a bankruptcy court “may” review a tax dispute, but it generally will not do so unless resolution of the dispute would benefit the taxpayer’s other creditors.

Under IRC § 7803(a)(3), the Commissioner must ensure that IRS employees are familiar with and act in accord with the taxpayer rights afforded by the IRC, including the right to appeal most IRS decisions in an independent forum.

<sup>2</sup> See, e.g., *Steele v. United States*, 280 F.2d 89 (8th Cir. 1960).

<sup>3</sup> In such cases, the government may, but generally is not required to, file a counterclaim for the unpaid amounts that involve the same or similar issue (e.g., taxes for other employees), even if they relate to different periods. See Fed. R. Civ. P. 13(a); Chief Counsel Directives Manual (CCDM) 34.5.1.1.2.5 (Aug. 11, 2004). Counterclaims by the government for unpaid taxes help ensure the collection period under IRC § 6502(a) does not expire with respect to the unpaid amounts while refund litigation is pending with respect to the amounts that have been paid. *Id.*

<sup>4</sup> Rev. Rul. 56-381, 1956-2 C.B. 953, says that the period for filing suit does not begin to run until the IRS sends the notice.

## REASONS FOR CHANGE

All taxpayers should have an opportunity to obtain judicial review of adverse IRS determinations. Under current law, however, there are circumstances in which taxpayers do not have that right. Assessable penalties are not subject to judicial review unless a taxpayer is wealthy enough to first fully pay the penalties assessed.<sup>5</sup>

Even taxpayers who fully pay may lose the opportunity to recover a portion of their payments if they pay in installments. Payments made more than two or three years before a taxpayer fully pays and files a refund claim generally cannot be recovered. Thus, a taxpayer who is not affluent enough to pay his or her alleged debt within this period will lose the right to request a refund of the early payments, even if the taxpayer eventually pays in full and the court agrees with the taxpayer on the merits of the refund claim.

In 2000, U.S. Tax Court Judge Howard Dawson wrote:

It is unfortunate and unfair that a taxpayer's financial condition is an important aspect of forum selection. It is obviously inequitable to have a procedure where the doors of certain courts are open to those with the financial resources to pay their putative tax liability in advance and closed to those who cannot raise the money required. This is an aberration in the system that is indefensible. It clearly favors rich individuals and wealthy corporations over low- and middle-income persons and small corporations. I am too much of a populist to believe that this is good for the tax litigation system. Why should a select group of taxpayers be able to utilize differences in court procedures to gain a significant advantage? Why should some taxpayers be able to select a forum where the trend of prior decisions seems more conducive to success while others for financial reason do not have that choice?<sup>6</sup>

Due to its specialization, the Tax Court is better equipped to consider tax controversies than other courts. Moreover, it is more accessible to unsophisticated and unrepresented taxpayers than other courts because it uses informal procedures, particularly in disputes that do not exceed \$50,000.<sup>7</sup> However, confusing IRS correspondence, illiteracy, language barriers, and unequal access to competent tax professionals can cause taxpayers — particularly low-income taxpayers — to miss the deadline for filing a petition with the Tax Court after receiving a notice of deficiency.<sup>8</sup> A TAS study found that when the IRS sent an audit notice to those claiming the Earned Income Tax Credit (EITC), a refundable tax credit for the working poor, almost 40 percent did not understand what the IRS was questioning, and only about half the respondents felt like they knew what they needed to do. Thus, many are also unlikely to understand whether and how to timely petition the Tax Court and could benefit from alternative avenues for obtaining judicial review.

<sup>5</sup> However, the IRS faces significant litigation risk if, without express authorization, it continues to treat penalties that are not located in Chapter 68, Subchapter B, as assessable. See National Taxpayer Advocate 2020 Annual Report to Congress (Most Serious Problem: *International: The IRS's Assessment of International Penalties Under IRC §§ 6038 and 6038A Is Not Supported by Statute, and Systemic Assessments Burden Both Taxpayers and the IRS*).

<sup>6</sup> Howard Dawson, *Should the Federal Civil Tax Litigation System Be Restructured?*, 40 TAX NOTES 1427 (2000).

<sup>7</sup> IRC § 7463.

<sup>8</sup> See, e.g., Carlton M. Smith, *Let the Poor Sue for Refund Without Full Payment*, 125 TAX NOTES 131 (Oct. 5, 2009). Low income taxpayers have difficulty understanding math error notices and making timely abatement requests so that they can get access to the Tax Court. See, e.g., National Taxpayer Advocate 2014 Annual Report to Congress 163-171 (Most Serious Problem: *Math Error Notices: The IRS Does Not Clearly Explain Math Error Adjustments, Making It Difficult for Taxpayers to Understand and Exercise Their Rights*).

The National Taxpayer Advocate recommends that Congress provide all taxpayers with a realistic opportunity to obtain judicial review of adverse IRS liability determinations, without regard to their ability to pay.

## RECOMMENDATIONS<sup>9</sup>

- Amend IRC § 6212 to expand the deficiency process to cover all penalties in Title 26, including the penalties located in Chapter 68, Subchapter B, and those located in Chapter 61, so that taxpayers can obtain judicial review by the Tax Court before they are assessed.
- Clarify that a person is not required to fully pay before filing suit in a U.S. district court or the U.S. Court of Federal Claims under 28 U.S.C. § 1346(a)(1) (*i.e.*, repeal the *Flora* Court's full payment rule).<sup>10</sup>
- Amend IRC §§ 7442 and 7422 to give the Tax Court jurisdiction to determine liabilities in refund suits to the same extent as the U.S. district courts and the U.S. Court of Federal Claims, without regard to how much of the liability has been paid.<sup>11</sup>

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<sup>9</sup> For more detail, see National Taxpayer Advocate 2018 Annual Report to Congress 364-386 (Legislative Recommendation: *Fix the Flora Rule: Give Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can*).

<sup>10</sup> IRC § 7422(e) and the doctrines of *res judicata* and *collateral estoppel* should help ensure the IRS does not re-litigate the same issues with respect to unpaid liabilities. See, *e.g.*, CCDM 34.5.1.1.2.2.4 (Aug. 11, 2004).

<sup>11</sup> If the full payment rule is repealed, is limited, or does not apply to the Tax Court's new jurisdiction to review claims, Congress should make clear that the suits it intends to authorize do not violate IRC § 7421 or 28 U.S.C. § 2201 with respect to unpaid amounts that will be decided in connection with the taxpayer's suit. It should also prevent the IRS from collecting the unpaid portions during these suits. It could do so by expanding the scope of IRC § 6331(i), which prevents the IRS from levying while a taxpayer is litigating a divisible tax and IRC § 6331(i)(4)(B), which allows a court to enforce this rule by enjoining collection, notwithstanding IRC § 7421.