

## THE MOST LITIGATED TAX ISSUES

### MOST LITIGATED ISSUES: INTRODUCTION

Internal Revenue Code § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify the ten tax issues most often litigated in the federal courts, classified by type of taxpayer affected. Through analysis of these issues, the National Taxpayer Advocate will, if appropriate, make recommendations designed to mitigate disputes that result in litigation. The recommendations included in this analysis could minimize some of the litigation covered in this section.

Taxpayer Advocate Service (TAS) analysts and attorney-advisors utilized commercial legal research databases to identify the ten most litigated issues (Most Litigated Issues) in federal courts from June 1, 2005 through May 31, 2006.<sup>1</sup> For purposes of this section of the Annual Report to Congress, the term “litigated” means cases in which the court issued an opinion.<sup>2</sup> This year’s ten Most Litigated Issues are:

- ◆ Appeals From Collection Due Process hearings under IRC §§ 6320 and 6330;
- ◆ Gross income under IRC § 61 and related Code sections;
- ◆ Summons enforcement under IRC § 7604;
- ◆ Accuracy-related penalty under IRC § 6662(b)(1) and (2);
- ◆ Failure to file penalty under § 6651(a)(1) and failure to pay estimated tax penalty under IRC § 6654;
- ◆ Frivolous issues penalty under IRC § 6673 and related appellate-level sanctions;
- ◆ Trade or business expenses under IRC § 162(a) and related Code sections;
- ◆ Relief for joint and several liability for spouses, under IRC § 6015;
- ◆ Family status issues under IRC §§ 2, 21, 24, 32, and 151; and
- ◆ Charitable contribution deduction issues under IRC § 170.

The ten Most Litigated Issues are substantially similar to those identified in 2005, with one exception.<sup>3</sup> This year, charitable contribution deduction issues made the top ten list, taking the place of last year’s tenth most litigated issue: trust fund recovery penalties under IRC § 6672.<sup>4</sup> While the other nine issues remained substantially the same, there was a reordering of the top ten issues caused mainly by substantial increases in both IRS summons enforcement litigation and negligence and substantial underpayment

<sup>1</sup> Federal tax cases are tried in the United States Tax Court, the United States District Courts, the United States Court of Federal Claims, the United States bankruptcy courts, United States Courts of Appeals and the United States Supreme Court.

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

<sup>3</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 471.

<sup>4</sup> *Id.*

penalty litigation.<sup>5</sup> This increase may be due, in part, to the IRS's increased emphasis on enforcement.<sup>6</sup>

Once the top ten issues were identified, TAS personnel provided analysis for each issue in four sections: summary of findings, description of present law, analysis of the litigated case, and conclusion. Each case analyzed is listed in Appendix 3. Cases are categorized by type of taxpayer (*i.e.*, individual or business). Appendix 3 also provides the citation for each case, indicates whether the taxpayer in each case was represented at trial or argued the case *pro se*, and lists the court's decision in each case.<sup>7</sup>

### AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

Taxpayers generally have access to four different tribunals in which to initially litigate a tax matter: the United States Tax Court, United States district courts, the United States Court of Federal Claims, and the United States bankruptcy courts. With limited exceptions, taxpayers have an automatic right of appeal from decisions of the trial court.<sup>8</sup>

The Tax Court is generally a "prepayment" forum. In other words, taxpayers have access to 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, collection due process, and relief from joint and several liability.<sup>9</sup>

The federal district courts and Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,<sup>10</sup> and (2) the taxpayer has filed an administrative claim for refund.<sup>11</sup> The federal district courts are the only forums in which a taxpayer can receive a jury trial. Bankruptcy courts can adjudicate tax matters that were not previously adjudicated before the initiation of a bankruptcy case.<sup>12</sup>

<sup>5</sup> Litigated summons enforcement cases increased from 44 in 2005 to 101 in 2006 (130 percent) and litigated negligence and substantial underpayment penalty cases increased from 57 in 2005 to 92 in 2006 (61 percent). See National Taxpayer Advocate 2005 Annual Report to Congress, 473.

<sup>6</sup> Beginning in 2002, the IRS identified the increased use of summonses as part of the overall shift in audit priorities toward abusive schemes and promoter investigations. IRS News Release, IRS Sets New Priorities (Sept. 2002).

<sup>7</sup> 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.

<sup>8</sup> See IRC § 7482, which provides that United States Courts of Appeals 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) from which appellate review is not available. See also 28 U.S.C. § 1294, which provides that appeals from district court are to the appropriate Court of Appeals, and 28 U.S.C. § 1295, providing that appeals from the Court of Federal Claims are heard in the Court of Appeals for the Federal Circuit.

<sup>9</sup> IRC §§ 6214, 7476-7479, 6330, and 6015.

<sup>10</sup> 28 U.S.C. § 1346(a)(1). See *Flora v. United States*, 362 U.S. 145 (1960).

<sup>11</sup> IRC § 7422(a).

<sup>12</sup> See 11 U.S.C.A. §§ 505(a)(1) and (a)(2)(A).

**ANALYSIS OF PRO SE LITIGATION**

As in previous years, our analysis indicated that many taxpayers represented themselves before the courts *pro se*.<sup>13</sup> Table 3.1-01 lists the most litigated tax issues for the period June 1, 2005 through May 31, 2006, and identifies the number of cases in which taxpayers represented themselves.

**TABLE 3.1-01, PRO SE CASES BY ISSUE**

Most Litigated Issue	Total Number of Litigated Cases Reviewed	Pro Se Litigation	Percentage of Pro Se Cases
Collection Due Process	195	143	73%
Gross Income	106	77	73%
Summons Enforcement	101	70	69%
Frivolous Issues Penalty	98	97	99%
Accuracy-Related Penalty	92	51	55%
Failure to File and Failure to Pay Estimated Income Tax Penalties	78	62	79%
Trade or Business Expense	68	47	69%
Joint and Several Liability	51	26	51%
Family Status Issues	46	44	96%
Charitable Deduction Issues	26	17	65%
<b>Total</b>	<b>861</b>	<b>634</b>	<b>74%</b>

Table 3.1-02 demonstrates that overall, taxpayers have a higher chance of prevailing in litigation if they are represented.

**TABLE 3.1-02, 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
Collection Due Process	143	11	8%	52	8	15%
Gross Income	77	3	4%	29	6	21%
Summons Enforcement	70	3	4%	31	5	16%
Frivolous Issues Penalty	97	14	14%	1	0	0%
Negligence and Substantial Understatement Penalties	51	13	25%	41	16	39%
Failure to File and Failure to Pay Estimated Income Tax Penalties	62	2	3%	16	1	6%
Trade or Business Expense	47	10	21%	21	7	33%
Joint and Several Liability	26	6	23%	25	6	24%
Family Status Issues	44	7	16%	2	1	50%
Charitable Deduction Issues	17	6	35%	9	1	11%
<b>Totals</b>	<b>634</b>	<b>75</b>	<b>12%</b>	<b>227</b>	<b>51</b>	<b>22%</b>

<sup>13</sup> “Pro Se” means “for oneself; on one’s own behalf; without a lawyer.” *Black’s Law Dictionary* 1236-37 (7th ed. 1999).

LITIGATED  
ISSUE #1APPEALS FROM COLLECTION DUE PROCESS (CDP) HEARINGS UNDER INTERNAL REVENUE  
CODE SECTIONS 6320 AND 6330

## SUMMARY

Collection Due Process (CDP) hearings were created by the IRS Restructuring and Reform Act of 1998 (RRA 98).<sup>1</sup> These hearings provide taxpayers an impartial review by the Office of Appeals (Appeals) of the IRS's decision to file a lien or its proposal to undertake a levy action. At the CDP hearing, the taxpayer has the statutory right to raise any relevant issue relating to the unpaid tax or the lien or proposed levy, including the appropriateness of collection actions, collection alternatives, spousal defenses, and under certain limited circumstances, the underlying tax liability.<sup>2</sup>

Taxpayers have the right to judicial review of Appeals' determination, provided that they timely request the CDP hearing and timely petition the court.<sup>3</sup> Generally, collection action is stayed during the CDP hearing process and any judicial review that may follow.<sup>4</sup>

Since 2003, Collection Due Process has been the most frequently litigated tax issue in the federal courts during the annual periods analyzed for the Annual Report to Congress. This year is no exception, with the courts issuing at least 195 opinions from June 1, 2005, through May 31, 2006. In the past, some commentators decried the CDP hearing process as a poorly designed hindrance to the IRS collection process and a vehicle for taxpayers to raise frivolous arguments. In contrast, the National Taxpayer Advocate predicted that the courts would find ways to deal with frivolous CDP litigation and that over time, the true value of CDP judicial review would emerge.

This year's cases prove the National Taxpayer Advocate's point. Although some taxpayers continue to raise frivolous issues, the courts are striking a balance between giving these taxpayers an opportunity to raise nonfrivolous issues for consideration, and then imposing appropriate sanctions where taxpayers continue to proffer frivolous arguments.<sup>5</sup> On the other hand, taxpayers and the IRS are now presenting the courts with significant issues pertaining to the scope of judicial review – including the standard of

<sup>1</sup> Internal Revenue Service Restructuring and Reform Act of 1998, Pub.L. No. 105-206, § 3401, 112 Stat. 685 (1998).

<sup>2</sup> IRC §§ 6320(c) and 6330(c).

<sup>3</sup> IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B) set forth the time requirements for requesting a CDP hearing and IRC §§ 6320(c) and 6330(d) set forth the time requirements for obtaining judicial review of Appeals' determination.

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

<sup>5</sup> In a number of cases, the courts imposed monetary sanctions under IRC § 6673. See, e.g., *Call v. Comm'r*, T.C. Memo. 2005-289; *Florance v. Comm'r*, 97 A.F.T.R.2d (RIA) 1742 (5th Cir. 2006); *Parker II v. Comm'r*, T.C. Memo. 2005-231; *Rafi v. Comm'r*, 95 A.F.T.R.2d (RIA) 2652 (6th Cir. 2005); *Winterroth v. Comm'r*, 97 A.F.T.R.2d (RIA) 1746 (9th Cir. 2006).

review, the application of administrative law and the Administrative Procedure Act to CDP review, and the admissibility of evidence beyond the administrative record. Each of these cases brings IRS collection practices, and the attendant judicial oversight, within established administrative law and practice. This year's cases clearly demonstrate that CDP litigation provides lessons for the IRS and taxpayers about how tax can be effectively and efficiently collected without undermining taxpayer rights.

### PRESENT LAW

Current law provides taxpayers an opportunity for independent review of a Notice of Federal Tax Lien filed by the IRS<sup>6</sup> or a proposed levy action.<sup>7</sup> The purpose of CDP rights is to give taxpayers adequate notice of collection activity and a meaningful hearing *before* the IRS deprives them of property.<sup>8</sup> The hearing allows the taxpayer an opportunity to raise issues relating to the collection of the subject tax, including:

- ◆ Appropriateness of collection actions;<sup>9</sup>
- ◆ Collection alternatives such as installment agreement, offer in compromise, posting a bond or substitution of other assets;<sup>10</sup>
- ◆ Appropriate spousal defenses;<sup>11</sup>
- ◆ The existence or amount of the tax, but only if the taxpayer did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the tax liability;<sup>12</sup> and
- ◆ Any other relevant issue relating to the unpaid tax, the lien or the proposed levy.<sup>13</sup>

A taxpayer may not reintroduce an issue that was raised and considered at a prior administrative or judicial hearing if the individual participated meaningfully in the prior hearing or proceeding.<sup>14</sup>

Procedurally, the IRS must provide notice to the taxpayer of the lien filing and its intent to levy. The IRS must provide the Notice of Federal Tax Lien to the taxpayer not more than five business days after the day of filing notice of the lien.<sup>15</sup> The IRS must provide

<sup>6</sup> IRC § 6320.

<sup>7</sup> IRC § 6330.

<sup>8</sup> Prior to the enactment of RRA 98, the U.S. Supreme Court had held that a post-deprivation hearing was sufficient to satisfy due process concerns in the tax collection arena. See *Phillips v. Comm'r*, 283 U.S. 589, 595 – 601 (1931).

<sup>9</sup> IRC §§ 6330(c)(2)(A)(ii) and 6320(c).

<sup>10</sup> IRC §§ 6330(c)(2)(A)(iii) and 6320(c).

<sup>11</sup> IRC §§ 6330(c)(2)(A)(i) and 6320(c).

<sup>12</sup> IRC §§ 6330(c)(2)(B) and 6320(c).

<sup>13</sup> IRC § 6330(c)(2)(A) and 6320(c).

<sup>14</sup> IRC §§ 6330(c)(4) and 6320(c).

<sup>15</sup> IRC 6320(a)(2). The Notice of Federal Tax Lien can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail to the taxpayer's last known address.

the Notice of Intent to Levy to taxpayers at least 30 days before the day of the levy.<sup>16</sup> Further, the IRS must notify the taxpayer of his or her right to a CDP hearing after the filing of the Notice of Federal Tax Lien (NFTL) and before any levy action can take place. In the case of a lien, the CDP hearing notice must be provided to the taxpayer not more than five business days after the filing of the NFTL, and must inform the taxpayer of his or her right to request a CDP hearing within the 30-day period that begins on the expiration of the fifth business day after the filing of the NFTL.<sup>17</sup> In the case of a levy, the CDP hearing notice must be provided to the taxpayer no fewer than 30 days before the first levy and must inform the taxpayer of his or her right to request a hearing within 30 days from the date that the notice is sent.<sup>18</sup>

Under both lien and levy procedures, the taxpayer must return a signed, written request for a CDP hearing within the applicable period for requesting a hearing.<sup>19</sup> Taxpayers who request a CDP hearing after this time period (generally, 30 days from the date of the notice) will receive an “equivalent hearing,” which is similar to a CDP hearing except there is no judicial review of an equivalent hearing.<sup>20</sup> Recently issued final regulations require the taxpayer to put the reasons for the CDP hearing in writing (preferably using Form 12153, Request For a Collection Due Process Hearing), and the failure to provide the basis for hearing may result in a denial of a face-to-face hearing.<sup>21</sup> The final regulations also eliminate the availability for equivalent hearings if the taxpayer does not make a request for a hearing within a certain time period. The time period for filing a request for an equivalent hearing after the filing of an NFTL is one year from the end of the five-business-day period following the filing of the NFTL.<sup>22</sup> The time period for filing a request for an equivalent hearing prior to levy is one year from the date of issuance of the CDP notice.<sup>23</sup>

<sup>16</sup> IRC § 6331(d)(2). The Notice of Intent to Levy can be provided to the taxpayer in person, left at the taxpayer’s residence or dwelling, or sent by certified or registered mail to the taxpayer’s last known address.

<sup>17</sup> IRC § 6320(a)(2) and 6320(a)(3)(B).

<sup>18</sup> IRC § 6330(a)(2) and 6330(a)(3)(B). The CDP hearing notice can be provided to the taxpayer in person, left at the taxpayer’s residence or dwelling, or can be sent by certified or registered mail (return receipt requested) to the taxpayer’s last known address.

<sup>19</sup> IRC §§ 6330(a)(3)(B) and 6330 (a)(3)(B); Treas. Reg. §§ 301.6320-1(c) and 301.6330-1(c).

<sup>20</sup> Treas. Reg. §§ 301.6320-1(i) and 301.6330-1(i).

<sup>21</sup> Treas. Reg. §§ 301.6320-1(c)(2) Q&A-C1, 301.6320(d)(2) Q&A-D8, 301.6330-1(c)(2) Q&A-C1, and 301.6330-1(d)(2) Q&A-D8. The regulations require the IRS to provide the taxpayer an opportunity to “cure” any defect in a timely filed hearing request, including providing a reason for the hearing. In conjunction with issuing the regulations, the IRS revised Form 12153 to include space for the taxpayer to identify collection alternatives that he or she wants Appeals to consider. The new form also includes a description of common alternatives so taxpayers can apply them to the specific facts of their cases. See Form 12153, Request For Collection Due Process or Equivalent Hearing (Rev. 11-2006).

<sup>22</sup> Treas. Reg. § 301.6320-1(i)(2) Q&A-I7

<sup>23</sup> Treas. Reg. § 301.6330-1(i)(2) Q&A-I7.

When a taxpayer requests CDP hearings with respect to both a lien and a proposed levy, the IRS Appeals officer will attempt to conduct one hearing.<sup>24</sup> The IRS will suspend collection action throughout the hearing process, unless it determines that the collection of the tax is in jeopardy or the collection resulted from a levy on a state tax refund.<sup>25</sup> Collection activity is also suspended throughout any judicial review of Appeals' determination, unless the underlying tax liability is not at issue and the IRS can demonstrate to the court good cause to resume collection activity.<sup>26</sup>

Collection Due Process hearings are informal. The Office of Appeals presumptively establishes telephonic CDP hearings, and it is incumbent on the taxpayer to request a face-to-face hearing.<sup>27</sup> Courts have determined that, depending on the circumstances, a CDP hearing need not be face-to-face with the Appeals officer, but can take place by telephone,<sup>28</sup> or by an exchange of correspondence.<sup>29</sup> The hearing is to be held by an impartial officer from the Appeals function of the IRS, who is barred from engaging in *ex parte* communications with IRS personnel regarding the substance of the case.<sup>30</sup>

In addition to the issues described above that the taxpayer is permitted to address in the CDP hearing, the Appeals officer must obtain verification that the requirements of all applicable laws and administrative procedures have been satisfied for the IRS to proceed with collection activity.<sup>31</sup> In making its determination, Appeals must 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

<sup>24</sup> IRC § 6320(b)(4).

<sup>25</sup> IRC § 6330(e)(1) provides the general rule for suspending collection activity, and IRC § 6330(f) provides that if collection of the tax is deemed in jeopardy or the collection resulted from a levy on a state tax refund, section 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)).

<sup>26</sup> IRC §§ 6330(e)(1) and 6330(e)(2).

<sup>27</sup> Appeals Letter 3855 schedules a conference call, but provides information on the availability of a face-to-face conference. *See also* Treas. Reg. §§ 301.6320-1(d)(2) Q&A-D6, D8 and 301.6330-1(d)(2) Q&A-D6, D8. For a detailed discussion of issues relating to face-to-face and local office hearings before the Office of Appeals, see Most Serious Problem, Concerns with the IRS Office of Appeals, *supra*.

<sup>28</sup> *Katz v. Comm'r*, 115 T.C. 329, 337-38 (2000) (finding that telephone conversations between the taxpayer and Appeals Officer constituted a hearing as provided in IRC § 6320(b)); *Ho v. Comm'r*, T.C. Memo. 2006-41 (stating that a CDP hearing may be conducted by telephone or correspondence); *but see Garage v. U.S.*, 96 A.F.T.R.2d (RIA) 7201 (D. N.J. 2005) (remanding case for a face-to-face hearing when taxpayer was denied a face-to-face hearing and taxpayer was not told that the telephone conversation constituted a face-to-face hearing).

<sup>29</sup> *Ho v. Comm'r*, T.C. Memo. 2006-41 (stating that a CDP hearing may be conducted by telephone or correspondence); *Little v. U.S.*, 96 A.F.T.R.2d (RIA) 7086, 7090-91 (M.D. N.C. 2005), *aff'd*, 97 A.F.T.R.2d (RIA) 2227 (4th Cir. 2006); *Turner v. U.S.*, 372 F. Supp. 2d 1053, 1058 (S.D. Ohio 2005) (holding that written documentation, an offer for a telephone hearing, and an opportunity for an in-person hearing to raise relevant issues pertaining to the tax penalty did not violate taxpayer's right to a hearing under IRC § 6330).

<sup>30</sup> IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1), and 6330(b)(3). *See* Rev. Proc. 2000-43, 2000-2 C.B. 404.

<sup>31</sup> IRC §§ 6330(c)(1) and 6320(c).

that any collection action be no more intrusive than necessary.<sup>32</sup> Within 30 days of the appeals determination, the taxpayer may petition the United States Tax Court for judicial review of Appeals' determination.<sup>33</sup>

Where the validity of the tax liability is properly at issue in the CDP hearing, the amount of the tax liability will be reviewed by the court on a *de novo* basis.<sup>34</sup> Where the appropriateness of the collection action is at issue, the court will review the IRS's administrative determination for abuse of discretion.<sup>35</sup>

### ANALYSIS OF LITIGATED CASES

Collection Due Process was the most litigated tax issue in the federal court system between June 1, 2005, and May 31, 2006. One hundred and ninety-five (195) CDP court opinions were reviewed. Excluding unpublished Tax Court orders that were not included in most prior years' statistics, this represents a one percent decrease from the 197 CDP cases from last year's analysis, and a seven percent increase from the 182 CDP cases reported in 2004. The 195 decided cases do not reflect the full measure of CDP litigation involving taxpayers and the IRS during the review period. Not all CDP cases result in decisions for or against taxpayers. Some cases are resolved through negotiated settlements while other taxpayers do not pursue litigation after filing a petition with the court, resulting in dismissal of the action prior to the court issuing an opinion. Others are disposed of by unpublished order. Nevertheless, the 195 cases in which opinions were issued and published provide useful insight into the costs and benefits of CDP by shedding light on the situations of taxpayers utilizing CDP and the IRS interactions with these taxpayers. Table 1 in Appendix 3 provides a detailed listing of CDP opinions, including specific information about the types of taxpayers involved.

### LITIGATION SUCCESS RATE

Taxpayers prevailed in 15 of the 195 cases reviewed (or approximately 7 percent),<sup>36</sup> and prevailed in part in an additional four cases.<sup>37</sup> In five of the 15 cases in which taxpayers prevailed (approximately 33 percent), courts either remanded the case to Appeals

<sup>32</sup> IRC §§ 6330(c)(3)(C) and 6320(c).

<sup>33</sup> IRC §§ 6330(d)(1) and 6320(c). Prior to October 17, 2006, the taxpayer could also petition the district court where the Tax Court did not have jurisdiction over the underlying tax liability.

<sup>34</sup> The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing the IRS's administrative CDP determinations. H.R. Rep. No. 105-599 at 266 (Conf. Rep.). The term *de novo* means anew. *Black's Law Dictionary*, 447 (7th ed. 1999).

<sup>35</sup> *Cox v. Commissioner*, 126 T.C. 237, 246 (2006) (quoting *Sego v. Comm'r*, 114 T.C. 604, 610 (2000)). See also the discussion of standard of review, *infra*.

<sup>36</sup> *Clark v. Comm'r*, 125 T.C. 108 (2005) is included in the number of prevailing cases, as it resulted in a pro-taxpayer ruling. In *Clark*, the court raised the issue of jurisdiction sua sponte, holding that it had jurisdiction to review CDP determinations when the CDP hearing was requested after a levy of a taxpayer's state tax refund. Neither the Commissioner nor the taxpayer contested jurisdiction.

<sup>37</sup> *Bennett v. Comm'r*, T.C. Summ. Op. 2005-84; *Lites v. Comm'r*, T.C. Memo. 2005-206; *Pineda v. Comm'r*, T.C. Summ. Op. 2006-35; *Plumb v. Comm'r*, 96 A.F.T.R.2d (RIA) 5872 (S.D. Fla. 2005).

because issues of material fact remained, or ruled that the IRS abused its discretion.<sup>38</sup> Of the remaining ten cases where taxpayers prevailed, seven involved the existence or amount of underlying liability or application of the relief from joint and several liability under the provisions of IRC § 6015,<sup>39</sup> and two cases involved procedural rulings.<sup>40</sup> In one case, the court barred the IRS from proceeding with collection as a matter of law.<sup>41</sup> Table 3.1.1 below compares litigation success rates in CDP cases for the 2003, 2004, and 2005 Annual Reports to Congress.<sup>42</sup>

**TABLE 3.1.1, SUCCESS RATES IN CDP CASES**

Court Decisions	2003 Percentage	2004 Percentage	2005 Percentage	2006 Percentage
Decided for IRS	96%	95%	89%	90%
Decided for Taxpayer	1%	4%	8%	8%
Split Decision <sup>43</sup>	3%	1%	3%	2%

**ISSUES LITIGATED**

The cases discussed in this section are those which the National Taxpayer Advocate believes are significant for tax administration or instructive to Congress, IRS, and taxpayers. In many ways, each of the 195 cases decided during the period under review tells an important story. Because the filing of a lien and levying upon property are some of the most intrusive actions the IRS can take against a taxpayer, each case provides information about how taxpayers and the IRS behave and how problems can be avoided.

**Appeals Impartiality**

Internal Revenue Code §§ 6320(b)(3) and 6330(b)(3) require CDP hearings to be conducted by an “impartial” Appeals officer or employee – one “who has had no prior involvement with respect to the unpaid tax” before the first CDP lien or levy hearing. Taxpayers may waive the impartiality requirement.

<sup>38</sup> *Crawford v. U.S.*, 422 F.Supp.2d 1209 (D. Nev. 2006); *Drake v. Comm’r*, 125 T.C. 201 (2005); *Garage v. U.S.*, 96 A.F.T.R.2d (RIA) 7201 (D. N.J. 2005); *Sampson v. Comm’r*, T.C. Summ. Op. 2006-75; *Zapara v. Comm’r*, 126 T.C. 215 (2006).

<sup>39</sup> *Butti v. Comm’r*, T.C. Memo. 2006-66; *Creel v. Comm’r*, 419 F.3d 1135 (11th Cir. 2005); *Clark v. Comm’r*, T.C. Summ. Op. 2005-95; *Freije v. Comm’r*, 125 T.C. 14 (2005); *Norris v. Comm’r*, T.C. Memo. 2005-237; *Richard v. Comm’r*, T.C. Summ. Op. 2005-151; *Sherer v. Comm’r*, T.C. Memo. 2006-29.

<sup>40</sup> *Clark v. Comm’r*, 125 T.C. 108 (2005); *Mandody v. Comm’r*, 126 T.C. 195 (2006).

<sup>41</sup> *Manko v. Comm’r*, 126 T.C. 195 (2006).

<sup>42</sup> See *National Taxpayer Advocate 2005 Annual Report to Congress 479, Table 3.1.1* (Most Litigated Issue: Collection Due Process (CDP) Hearings) for 2002, 2003, and 2004 statistics.

<sup>43</sup> A “split” decision refers to a case with multiple issues where both the IRS and the taxpayer prevail on one or more substantive issues.

MOST LITIGATED TAX ISSUES

*Cox v. Commissioner*

The Appeals Officer in *Cox v. Commissioner*<sup>44</sup> conducted a CDP hearing and issued an adverse determination letter with respect to one tax year of the taxpayer. Later, this same Appeals Officer was assigned a CDP case for two other tax years of the same taxpayer. The taxpayer objected to the Appeals Officer's involvement in the second CDP hearing as prohibited "prior involvement" under IRC § 6330(b)(3).

The Tax Court found that this situation did not demonstrate the type of harm Congress meant to guard against, for three reasons. First, the later years were not the subject of a proceeding before the IRS. The court found that "[p]rior involvement contemplates a situation where the specific year or years were the explicit target of an administrative proceeding."<sup>45</sup> Second, the statute provides for combining lien and levy hearings before the same Appeals Officer, and the court found that as a practical matter, there would be no harm if the later period was first informally considered during the CDP hearing relating to another period. Third, the court took into consideration the "practical realities" of the hearings, noting that the information relevant to both hearings would be much the same.

The court noted, however, that even if, in theory, the arrangement did not violate the impartiality requirement, it still must look at the general requirement of impartiality in terms of the specific conduct of the Appeals Officer. Here, the court found that the administrative record did not show any bias or a "closed mind," noting the Appeals Officer's careful review of records and evidence, and his willingness to meet the taxpayer's scheduling needs.<sup>46</sup>

*Drake v. Commissioner*

In *Drake v. Commissioner*,<sup>47</sup> the Appeals Settlement Officer, upon receipt of the CDP case, conferred with an IRS Insolvency Unit Advisor and received a copy of the Advisor's memorandum to IRS Counsel, discussing the taxpayers' bankruptcy case. In that memorandum, the Advisor questioned whether the taxpayer and the taxpayer's attorney used the bankruptcy court to "defeat a Federal Tax Lien allowing a Debtor to walk away with the proceeds" and further commented on the conduct of the taxpayers' bankruptcy attorney. The Appeals Officer did not tell the taxpayer about his communications with the Insolvency Unit Advisor.

The Tax Court held that it was an abuse of discretion by the Appeals employee, who did not follow the requirements of IRS guidance with respect to *ex parte* communications. The court cited Revenue Procedure 2000-43, which specifically states that Appeals employees cannot engage in discussions of strengths or weaknesses of case issues that

<sup>44</sup> *Cox v. Comm'r*, 126 T.C. 237 (2006).

<sup>45</sup> *Id.* at 252 (2006).

<sup>46</sup> *Id.* at 253-55.

<sup>47</sup> *Drake v. Comm'r*, 125 T.C. 201 (2005).

appear to compromise Appeals' independence.<sup>48</sup> The guidance also requires the Appeals employee to give the taxpayer the opportunity to participate in any discussions involving "matters that are not ministerial, administrative or procedural."<sup>49</sup> The court noted that the guidance specifically prohibited *ex parte* communications of the "originating function's perception of the demeanor or credibility of the taxpayer or the taxpayer's representative."<sup>50</sup>

The court found that the *ex parte* communication with the Insolvency Unit Advisor was neither ministerial, administrative, nor procedural, nor did the Appeals employee provide the taxpayer with the opportunity to participate in the communication. Therefore, the court held, because the *ex parte* communication may have damaged the taxpayer's credibility, the Appeals employee abused his discretion. The court remanded the case for a new hearing before an independent Appeals Officer who has had no communication about the credibility of the taxpayer or the taxpayer's representative.

### Face-to-Face Hearing

As discussed elsewhere in this report, the National Taxpayer Advocate is concerned that the IRS Office of Appeals' increasing trend to centralize activity at its remote campus operations, and the subsequent reductions in local office staffing, reduce the opportunities to obtain a face-to-face hearing. The following case is instructive as to how difficult it can be for some taxpayers to receive a face-to-face hearing.

#### *Garage v. U.S.*

*Garage v. U.S.* involved the collection of a Trust Fund Recovery Penalty (TFRP) under IRC § 6672, for payment of withholding taxes attributable to a defunct corporation.<sup>51</sup> The taxpayer received two CDP final notices and timely submitted two hearing requests. The taxpayer's representatives held several phone conversations with the Appeals Officer, during which the representatives requested a face-to-face hearing. The Appeals Officer did not conduct a face-to-face hearing, and instead continued with telephone conferences. Although the taxpayer asserted that all taxes were paid, the Appeals Officer determined that IRS could proceed with collection.

In his submissions to the court, the taxpayer advanced seven grounds for redetermination. The court addressed only one position – the taxpayer's request for a face-to-face hearing. The court noted that the IRS regulations favor, if not mandate, a face-to-face hearing,<sup>52</sup> but also observed that the Tax Court does not remand cases for face-to-face

<sup>48</sup> Rev. Proc. 2000-43, 2000-2 C.B. 404.

<sup>49</sup> *Id.*, Q&A 6, at 406.

<sup>50</sup> *Drake v. Comm'r*, 125 T.C. 201, 209 (2005), citing Rev. Proc. 2000-43, Q&A 5, 2000-2 C.B. 404, 405-06.

<sup>51</sup> *Garage v. U.S.*, 96 A.F.T.R.3d (RIA) 7201 (D. N.J. 2005). IRC § 6672 authorizes the Secretary to assess a civil penalty equal to 100 percent of the trust fund portion of payroll taxes not remitted against a person responsible for withholding and remitting taxes who willfully avoided paying those taxes.

<sup>52</sup> *Garage v. U.S.*, 96 A.F.T.R.3d (RIA) 7201 (D. N.J. 2005), citing Treas. Reg. 301.6330-1(d)(2)(Q&A-D6).

hearings where such a hearing would be futile because the taxpayer's positions are frivolous. Here, the court was "troubled" by the taxpayer's uncontested assertion that the Appeals Officer did not tell the taxpayer's representative that the telephone calls constituted the CDP hearing. Concluding that the taxpayer's positions were not frivolous, the court held that the Appeals Officer abused his discretion in not granting a face-to-face conference.<sup>53</sup> The court remanded the case for a face-to-face hearing and consideration of the seven grounds for relief asserted by the taxpayer.

### Standard of Review and the Administrative Record

The most significant group of cases during this period involved the standard for judicial review and the scope of the record upon which such review will be conducted. The leading cases are discussed below in chronological order, because they evidence an evolving understanding of both the uniqueness of Collection Due Process hearings and the application of general principles of administrative law to these hearings.

#### *Living Care Alternatives of Utica, Inc.*

*In Living Care Alternatives of Utica, Inc., v. U.S.*,<sup>54</sup> the Sixth Circuit discussed the background to CDP hearings, and noted that prior to RRA 98, the IRS was able to levy on taxpayer property without providing any pre-deprivation hearing or procedural due process. The court noted that while Congress enacted RRA 98 to provide taxpayers with some additional protections before IRS action, these protections must be interpreted in the historical context of IRS collection. "Tax liens and levies are not typical collection actions; the IRS has much greater latitude and leeway than a normal creditor."<sup>55</sup> The court further noted that since the CDP process was grafted onto a system that historically had very little judicial oversight, there were no formal hearings or official records. "Since normal review of administrative decisions requires the existence of a record, ... Congress must have been contemplating a more deferential review of these tax appeals than of more formal agency decisions."<sup>56</sup>

Commenting on the requirement of a balancing test in IRC § 6330(c), the court further noted that "[t]his final balancing factor is novel in American tax law and injects into the calculus an equitable consideration for the taxpayer and his concerns."<sup>57</sup> Here, the

<sup>53</sup> The court stated that the remand remedies the procedurally unfair result brought about when an IRS appeals officer ignores a taxpayer's requests for a face-to-face hearing, determines that a particular telephone conversation constitutes the CDP hearing but fails to inform the taxpayer of this fact, and later, after the taxpayer has filed an appeal to the district court, takes the position that the taxpayer has waived the majority of his arguments because he failed to raise them in the CDP hearing. *Garage v. U.S.*, 96 A.F.T.R.2d (RIA) 9201, slip op. at 6 (D. N.J. 2005).

<sup>54</sup> *Living Care Alternatives of Utica, Inc., v. U.S.*, 411 F.3d 621 (6th Cir. 2005).

<sup>55</sup> *Id.* at 624.

<sup>56</sup> *Id.* at 625.

<sup>57</sup> *Id.* at 625. IRC § 6330(c)(3)(C) requires the Appeals Officer to make a determination that the "proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary."

taxpayer argued that the Appeals Officer did not meet the balancing test by failing to consider the effect of senior creditors on the amount collected, and that by proceeding with the levy, the IRS would effectively shut down the business, a nursing home. The court agreed that under IRC § 6331(j)(2)(C), prior to executing a levy, the IRS must investigate the existence of liens and determine that there is sufficient equity in the property to yield net sale proceeds to apply against the taxpayer's liability. The court held, however, that this statutory duty does not yet arise at the time of the CDP hearing, *i.e.*, the investigation of equity in the property must occur prior to the levy but not prior to the CDP hearing, and thus the Appeals Officer did not violate his duty to conduct a balancing analysis.

In discussing the application of the abuse of discretion standard, the court noted that the lack of “a formal record and conventional administrative review” makes application of the abuse of discretion standard difficult. The court denied the taxpayer's request for a remand for additional investigation, noting that “without a clear abuse of discretion in the sense of clear taxpayer abuse and unfairness by the IRS, as contemplated by Congress, the judiciary will inevitably become involved on a daily basis with tax enforcement details that judges are neither qualified, nor have the time, to administer.”<sup>58</sup>

### *Olsen v. U.S.*

The First Circuit cited approvingly *Living Care Alternatives'* analysis of CDP's historical context and the standard of review in *Olsen v. U.S.*<sup>59</sup> In *Olsen*, the court noted that “it must be borne in mind that taxpayers have further recourse, besides the CDP hearing, to post-deprivation procedures. While Congress clearly wanted to prevent mere bureaucratic harassment, we do not understand it to have intended to strip the IRS of effective and reasonable tax collection procedures.”

In its analysis of the taxpayer's allegation that the district court erred by denying the taxpayer's motion to conduct discovery and thereby supplement the administrative record, the court noted the Supreme Court's longstanding position that review of administrative decisions is usually limited to the agency's decision-making and the evidence on which such decision-making is based (citing *United States v. Carlo Bianchi & Co.*, 373 U.S. 709, 714-15 (1963)). The court further noted that the Supreme Court has extended the “record rule” to informal agency adjudications such as Collection Due Process hearings (citing *Florida Power & Light Co. v. Lorion*, 470 U.S. 729, at 744 (1985)). Although there are limited exceptions to the record rule where there is “a strong showing of bad faith or improper behavior” (citing *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402 (1971), overruled on other grounds by *Califano v. Sanders*, 430 U.S. 99 (1977)) on the part of the agency decision-maker, or where the record fails to explain the basis of the agency's action such that there can be no effective judicial review, the court found the

<sup>58</sup> *Living Care Alternatives of Utica, Inc. v. U.S.*, 631 F.3d 621 (6th Cir. 2005).

<sup>59</sup> *Olsen v. U.S.*, 414 F.3d 144, 150-51 (1st Cir. 2005).

record in the instant case adequate for judicial review and found no evidence of improper behavior.

### *Murphy v. Commissioner*

In *Murphy v. Commissioner*,<sup>60</sup> the United States Tax Court discussed the record rule and its 2004 decision in *Robinette v. Commissioner*.<sup>61</sup> Murphy sought to introduce testimony at trial about the special circumstances that limited his ability to pay his entire tax liability. The Commissioner objected to the introduction of this evidence on the ground of relevancy, complaining that this information was not provided at the CDP hearing.

In *Robinette*, the taxpayer sought to admit into evidence testimony and documents, outside of the administrative record, that were relevant to the issue of whether the Appeals Officer abused his discretion in determining the IRS could proceed with collection. The taxpayer asserted such evidence was germane to whether the Appeals Officer “had a closed mind to the arguments presented on petitioner’s behalf” and “failed to consider the facts and circumstances of this case.”<sup>62</sup>

The court declined to overrule *Robinette*, but sustained the Commissioner’s objection to the admission of certain testimony in all but one instance. The court noted that in *Robinette* it required the non-record testimony and documents to be related to issues raised at the CDP hearing and to be relevant and admissible under the Federal Rules of Evidence. The court found that Murphy’s trial testimony about the special circumstances relating to his ability to pay was related to the collection alternative considered at the CDP hearing, namely, an offer-in-compromise.<sup>63</sup> However, the court also found that this testimony was not relevant to whether the Appeals Officer abused her discretion in not granting an offer, on two grounds. First, the Appeals Officer determined that the taxpayer was not eligible for an “Effective Tax Administration” offer because he could not pay his liability in full. Second, the Appeals Officer could not abuse her discretion with respect to a “doubt as to collectibility with special circumstances” offer where she did not consider information that the taxpayer failed to provide her within a reasonable period of time.

The court did admit trial testimony by the Appeals Officer as to certain “unexplained notations and abbreviations” in the record, in order to explain those items. The court reasoned as follows:

An irregularity in the conduct of the hearing or of some defect in the record may not be apparent until after the hearing is concluded and the taxpayer receives notice of the resulting determination. The circumstances may justify allowing

<sup>60</sup> *Murphy v. Comm’r*, 125 T.C. 301 (2005).

<sup>61</sup> *Robinette v. Comm’r*, 123 T.C. 85 (2004), rev’d, 439 F.3d 455 (8th Cir. 2006).

<sup>62</sup> *Id.* at 107.

<sup>63</sup> Offers in compromise are provided for in IRC § 7122 and allow the IRS to compromise the taxpayer’s liability based on doubt as to liability, doubt as to collectibility, and effective tax administration. Treas. Reg. § 301.7122-1(b).

the taxpayer to raise the issue at trial and introduce evidence notwithstanding the taxpayer's failure to raise the issue at the section 6330 hearing.<sup>64</sup>

### *Robinette v. Commissioner*

Finally, in *Robinette v. Commissioner*,<sup>65</sup> the Eighth Circuit reversed the Tax Court and held that the Appeals Officer here did not abuse his discretion in allowing collection to proceed. Prior to the CDP hearing, the IRS had accepted an offer in compromise from Robinette, on which he subsequently defaulted by failing to timely file a tax return. At the CDP hearing, Robinette disputed whether he owed the reinstated liability, stating he had timely filed the return that the IRS claimed it did not have. The Appeals Officer determined that the return was not timely filed and that since the taxpayer proposed no new offer or other collection alternative, collection could proceed. The Tax Court, considering evidence not contained in the administrative record, determined that although the tax return was not timely filed, the breach of the offer conditions was immaterial and therefore the offer should not have been defaulted. The Tax Court held that the Appeals Officer had abused his discretion in allowing collection to proceed.

The Eighth Circuit found that the Tax Court's decision "was based in part on what we conclude was an erroneous application of administrative law and contract law."<sup>66</sup> The court noted a significant dispute over the scope of the record on which the court would conduct its "deferential judicial review." The court reasoned that both the Administrative Procedure Act and general principles of administrative law "limit the scope of judicial review to the administrative record," and that the Supreme Court has held that "exemptions from the APA are 'not lightly to be presumed.'" (Citing *Marcello v. Bonds*, 349 U.S. 302, 310 (1955).) The court observed the absence of any express intent by Congress to grant *de novo* review of CDP determinations where the underlying liability is not at issue, and cited legislative history in support of the application of the abuse of discretion standard, which in turn limits review to the administrative record. The court also discussed exceptions to the record rule, noting that where an informal proceeding such as CDP does not "adequately disclose the basis for the agency's decision," the reviewing court may receive evidence about what happened at the agency proceeding. But even in these instances, the court noted that this evidentiary proceeding is not a trial *de novo* (citing *Camp v. Pitts*, 411 U.S. 138, 143 (1973) (per curiam)).

Having concluded that it must limit its review to the information contained in the administrative record, the court held that the Appeals Officer did not abuse his discretion in allowing collection to proceed. The court analyzed the contractual terms of the offer in compromise, and found that the Tax Court erred by considering the materiality of the breach before determining whether the taxpayer's return-filing requirement (the compliance clause) was an express condition on the government's performance under

<sup>64</sup> *Murphy v. Comm'r*, 125 T.C. 301, 316-17 (2005), referencing *Olsen v. U.S.*, 414 F.3d 144, 155 (1st Cir. 2005).

<sup>65</sup> *Robinette v. Comm'r*, 439 F.3d 455 (8th Cir. 2006), rev'g 123 T.C. 85 (2004).

<sup>66</sup> *Id.* at 464.

the contract. Under the Eighth Circuit's analysis, Robinette's obligation to timely file his tax returns was an express condition on the government's performance, and he breached that condition. The court only then considered the materiality of the breach and found that Robinette presented no evidence at the hearing of immateriality or that enforcement of the condition would cause "disproportionate forfeiture." (Citing Restatement (Second) of Contracts section 229 (1981).)<sup>67</sup>

### Procedural Rulings

Several CDP cases involved issues of first impression or procedural import that may never have received judicial review but for the existence of the CDP hearing. In some instances, refund litigation may be available, but the *Flora* pre-payment rule may have barred the taxpayers from bringing a refund suit.<sup>68</sup> Thus, judicial review of agency determinations in CDP hearings provides an important check on agency action.

#### *Manko v. Commissioner*

The issue before the Tax Court in *Manko v. Commissioner*<sup>69</sup> was whether the Commissioner can proceed with collection without first issuing a Notice of Deficiency where the parties execute a closing agreement under IRC § 7121 on Form 906. Here, the taxpayers and the IRS entered into a closing agreement for certain partnership adjustments, and agreed to those adjustments on Form 906, Closing Agreement on Final Determination Covering Specific Matters. The closing agreement specifically stated that the agreement does not prevent the Commissioner from making other adjustments (non-partnership) for the years at issue.

Several years later the IRS sent the taxpayer, for the years under the closing agreement, multiple reports titled "Income Tax Examination Changes" and marked "Copy – Information Only." The IRS then assessed the deficiencies without issuing any Notices

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<sup>67</sup> The Eighth Circuit also disagreed with the Tax Court's holding that the Appeals Officer abused his discretion by not "hav[ing] an open mind regarding reinstatement." 123 T.C. 85, 112. The appeals court found that the Internal Revenue Manual was silent on whether the Appeals Officer could reinstate the offer during a CDP hearing, and that the Appeals Officer was instructed by the "National Office" that the offer could not be reinstated unless the IRS erred in declaring a default. Thus, the court found that the Appeals Officer did not abuse his discretion in failing to reinstate the offer. IRM 8.7.2.3.8 (Rev. 12-01-2006) now states that defaulted OICs will not be reinstated; however, a taxpayer may submit another OIC, which will be considered. The National Taxpayer Advocate believes that this policy is misguided and will advocate for reinstatement of defaulted OICs in certain circumstances.

<sup>68</sup> A taxpayer must generally fully pay the assessed tax for a taxable period to file a suit for refund. If the assessment is not fully paid, the district court or Federal Court of Claims will not have jurisdiction. See *Flora v. United States*, 362 U.S. 145 (1960).

<sup>69</sup> *Manko v. Comm'r*, 126 T.C. 195 (2006).

of Deficiency.<sup>70</sup> After the IRS issued a Final Notice of Intent to Levy and Your Right to a Hearing, the taxpayer timely filed a request for a CDP hearing. The taxpayers argued that they had never received a deficiency notice, had certain net operating losses that would decrease the amount of the liability, and had made payments toward the liability for the years at issue. The Appeals Officer sustained the levy action, relying on legal opinions of IRS counsel in the file.

The court first noted that it had jurisdiction to hear the case under IRC § 6330(d). It next determined that since the case presented a question of law, its decision in the case did not depend on a standard of review, but instead the court must reject erroneous views of law.<sup>71</sup> The court agreed that closing agreements are final and conclusive, and bind the parties as to the terms agreed upon.<sup>72</sup> Form 906 closing agreements, however, bind the parties as to specific matters and do not ultimately determine the tax liability for the year. The court noted that the Commissioner, in fact, made additional adjustments to those years, beyond the scope of the adjustments agreed to in Form 906.

The Tax Court then rejected the Commissioner's argument that the IRS merely computed the liability per the closing agreement's terms. The court found that the taxpayers were never allowed to challenge the Commissioner's computations: "Respondent deprived petitioners of the opportunity of filing a deficiency suit to dispute these computations."<sup>73</sup> Thus, the court held that the Commissioner could not proceed with collection. The court noted that its holding did not alter the terms of the closing agreement and therefore did not "frustrate the purpose" of the agreement.

### *Zapara v. Commissioner*

In *Zapara v. Commissioner* (Zapara II),<sup>74</sup> the Commissioner moved for reconsideration of the Tax Court's decision in *Zapara v. Commissioner*, (Zapara I).<sup>75</sup> The IRS in Zapara I issued a jeopardy levy on certain shares of stock. The IRS did not promptly sell the stock. During the subsequent CDP hearing, the taxpayers, concerned about the stocks' declining value, requested in writing to the Appeals Officer that the IRS sell the stock immediately.

<sup>70</sup> Generally, when the IRS determines that there is a deficiency in tax, the IRS must send a deficiency notice to the taxpayer prior to assessing the tax. The taxpayer has 90 days (150 days if the notice is addressed outside of the United States) to petition the Tax Court for redetermination of the deficiency. The IRS may assess the tax at the end of the 90-day or 150-day period if the taxpayer fails to petition the Tax Court. If the taxpayer petitions the Tax Court, the IRS may not assess the tax until the decision of the Tax Court has become final. I.R.C. § 6213(a). There are limited exceptions to the notice of deficiency requirement, such as assessments arising from mathematical or clerical errors, tentative carryback or refund adjustments, and assessments of amounts already paid. I.R.C. § 6213(b). Additionally, a taxpayer may waive this restriction on assessment. I.R.C. § 6213(d).

<sup>71</sup> *Manko v. Comm'r*, 126 T.C. 195, 199 (2006).

<sup>72</sup> *Id.* at 201, citing IRC § 7121(b).

<sup>73</sup> *Id.* at 203 (2006).

<sup>74</sup> *Zapara v. Comm'r*, 126 T.C. 215 (2006).

<sup>75</sup> *Zapara v. Comm'r*, 124 T.C. 223 (2005).

The Zapara I court found that the IRS violated IRC § 6335(f), which provides taxpayers some protection if the IRS does not publish a notice of sale “as soon as practicable” after it seizes property.<sup>76</sup> Under IRC § 6335(f), the taxpayer may request a sale within 60 days if the IRS takes too long to publish a notice of sale. The statute requires the Secretary to comply with the taxpayer’s request for sale unless the Secretary determines that it is not in the best interests of the United States and notifies the taxpayer within 60 days of the request. Since the IRS did not comply with the taxpayer’s request for sale or provide the required notice within 60 days of the request, the Tax Court remanded the case and ordered the Appeals Officer to credit against the taxpayers’ liability the value of the stock as of 60 days from the request for sale.

In Zapara II, the Commissioner moved for reconsideration on several grounds, including a challenge to the Tax Court’s authority to grant relief in the case. The Commissioner asserted that the taxpayers’ sole avenue for relief is an action for damages in the United States District Court under IRC § 7433(a). The Tax Court agreed that it does lack jurisdiction to award damages, but pointed out that the relief ordered in Zapara I was not “damages” but rather a “specific remedy.” The court stated that it did not determine whether the taxpayer suffered any loss in Zapara I, but instead “ordered specific relief that attempts to give petitioners the credit to which they would have been entitled had respondent complied with their request to sell the stock as required by section 6335(f).” The court reasoned that its authority to order such relief was within its inherent equitable powers that are exercised within its “statutorily defined sphere.” (Citing *Estate of Branson v. Commissioner*, 264 F.3d 904, 908 (9th Cir. 2001), *affg.* 113 T.C. 6 (1999)).<sup>77</sup>

### The “What Were They Thinking?” Category of Cases

In past years’ reports on CDP litigation, we have noted the relatively large number of cases involving frivolous issues, in which taxpayers insist on attempting to litigate the correctness of the underlying liability pursuant to dubious theories of tax law or procedure. We note that the courts have not been reticent in ordering monetary sanctions against these taxpayers, particularly when the court has earlier warned the taxpayer of the consequences of persisting with their frivolous positions. Frequently, when reviewing the cases, the reader’s response is, “What were they [the taxpayers] thinking?” On the other hand, sometimes one wonders why a particular case or issue ever made it all the way to litigation without being settled at an earlier stage. The cases discussed below put a different slant on our question, namely, “What was the IRS thinking?”

<sup>76</sup> IRC § 6335(b).

<sup>77</sup> The Tax Court further noted that the equitable remedy in Zapara I was appropriate because by not selling the stock as requested, the IRS had “thwarted” taxpayers’ statutory remedy under IRC § 6335(f), which was “tantamount to Respondent’s exercising dominion and control” over the property, and resulted in the risk of loss being assumed by the IRS. The court also noted that relief under IRC § 7433 is based on the IRS’s negligence or other bad acts, but that violations of IRC § 6335(f) do not require any culpability. Therefore, the court reasoned that Congress did not intend to eliminate equitable remedies under IRC § 6335(f) by enacting IRC § 7433.

*Crawford v. U.S.*

In *Crawford v. United States*,<sup>78</sup> the taxpayer's divorce decree provided for the taxpayer's ex-husband to pay the tax liability attributable to their joint return. The agreement provided for the transfer of a specific property to the ex-husband, who was required to sell it and apply the proceeds to the tax debt. Taxpayer transferred the property to her ex-husband in accordance with the agreement, but her ex-husband did not sell the property. In her CDP hearing, the taxpayer proposed that the IRS suspend collection against her while the IRS sought to collect from the property of the ex-husband. The taxpayer also agreed to enter into an installment agreement for any amount that was not paid off as a result of IRS collection against her ex-husband. The Appeals Officer determined that the IRS could proceed with collection against the taxpayer on the ground that the taxpayer's request to suspend collection against her and proceed against her former spouse was not a "collection alternative."

The court held that the IRS abused its discretion by not considering the taxpayer's proposed collection alternative and weighing it. The court found that both the statute and the regulations thereunder contemplate just such an approach where joint and several liability is a factor.<sup>79</sup> The court remanded the case for further consideration of the taxpayer's proposed collection alternative.

*Sherer v. Commissioner*

The taxpayer in *Sherer v. Commissioner*<sup>80</sup> failed to file his tax returns and the IRS subsequently prepared a "substitute for return" under IRC § 6020(b). The IRS then issued a notice of deficiency to the taxpayer's last known address as required under IRC § 6212(b), and later mailed a duplicate notice of deficiency to an address provided by U.S. Postal Service records. Both notices of deficiency were returned to the IRS as "unclaimed." The IRS filed a Notice of Federal Tax Lien and issued a CDP Final Notice. In the subsequent CDP hearing, the taxpayer contested the underlying liability, and showed that he did not reside at either address and never received the notices of deficiency. At the hearing, the Appeals Officer requested that the taxpayer file income tax returns for several years, including the year at issue in the CDP hearing. Instead of filing the returns, the taxpayer mailed several information statements, including brokerage and mortgage interest statements and investment firm account summaries showing the cost basis of the stock sold. The Appeals Officer still requested a tax return, and ultimately issued a notice of determination, citing the taxpayer's failure to file a tax return as grounds for letting stand the "substitute for return" assessment.

<sup>78</sup> *Crawford v. U.S.*, 422 F.Supp.2d 1209 (D. Nev. 2006).

<sup>79</sup> The court found that the collection alternatives set forth in 6330(c)(2)(A)(iii) is not an exclusive list, and that Treas. Reg. 301.6330-1(e)(3) (Q&A-E6) defines a collection alternative to include "a proposal to withhold the proposed or future collection action in circumstances that will facilitate the collection of the tax liability."

<sup>80</sup> *Sherer v. Comm'r*, T.C. Memo. 2006-29.

The Tax Court held that the taxpayer was entitled to raise the underlying liability at trial because he had shown that he didn't live at the address on the notices of deficiency and did not deliberately refuse delivery of the notices. Moreover, the court noted that it can receive information about a deficiency even if the taxpayer did not file a tax return. Under a *de novo* standard of review, the court found that the taxpayer submitted credible evidence as to basis in the stock sold, as well as of entitlement to a mortgage interest deduction. The court held that the taxpayer had no liability for the year in question and thus did not sustain the IRS's proposed collection action.

### *Sampson v. Commissioner*

In *Sampson v. Commissioner*,<sup>81</sup> the taxpayer had been a college student for several years, and sporadically employed before that time. In one year, the taxpayer won a car in a contest, sold it, reported the income from the award, but did not pay the resulting tax liability. The taxpayer submitted an offer in compromise (OIC), based on doubt as to collectibility, in the CDP hearing subsequent to the IRS filing a Notice of Federal Tax Lien. The Appeals Officer imputed "foregone" income to the taxpayer, based on the fact that the taxpayer had "chosen" to be a student rather than a worker,<sup>82</sup> and calculated the taxpayer's reasonable collection potential by averaging the foregone income based on the year in which the taxpayer received the automobile prize. The Appeals Officer then rejected the OIC on the ground that the taxpayer could fully pay the tax debt. When the taxpayer pointed out that the year in which he won a car was an aberrational year in terms of income, the Appeals Officer did not revise the calculation of reasonable collection potential.

In its summary opinion, the Tax Court reviewed IRS guidance about how to calculate future income in circumstances such as Sampson's. Where the taxpayer is temporarily unemployed or underemployed, the IRS calculates future income as if the taxpayer were fully employed. Where the taxpayer has a sporadic employment history or fluctuating income, the IRS calculates the average income over several prior years.<sup>83</sup> The court then found that Sampson qualified for income averaging because of his history of sporadic employment and that his average income was close to zero.

The court next discussed the "future income collateral agreement" provisions in the Internal Revenue Manual, and found that one example in the IRM, involving an offer in compromise submitted by a current medical student with prospects of higher future income, shows that IRS contemplated that a taxpayer could qualify for an OIC even

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<sup>81</sup> *Sampson v. Comm'r*, T.C. Summ. Op. 2006-75.

<sup>82</sup> In correspondence to the taxpayer, the Appeals Officer wrote:

Part of the process of evaluating an offer from a person who is unemployed is to consider what that person would earn if they [sic] were working. Usually that is done by looking at previous income history. In your case, that is problematical because of your history, but it seems clear that were you to find employment you would be able to pay the tax liability for 2002. The fact that you have chosen to go to school rather than work is not really relevant.

<sup>83</sup> IRM § 5.8.5.5(5) (Nov. 15, 2004).

though currently a student.<sup>84</sup> The court further noted that the future income calculation in Sampson’s case did not take into account that Sampson did not know what employment he could find after graduation, nor did it consider that Sampson’s expenses after graduation might increase (*e.g.*, he would have an obligation to repay student loans). Thus, the court held that the Appeals Officer abused his discretion in rejecting the offer on the ground that the taxpayer could fully pay the liability. The court remanded the case for reconsideration of the offer.

**PRO SE ANALYSIS**

One hundred and forty-three (or 73 percent) of the 195 cases litigated were brought before the courts by the taxpayer *pro se*, or without benefit of counsel. This is a modest decrease from 79 percent in the previous year.<sup>85</sup> Table 3.1.2 shows the breakdown of *pro se* and represented taxpayer cases and the decisions rendered by the court, indicating that approximately eight percent of *pro se* taxpayers receive some relief on judicial review while 15 percent of represented taxpayers received full or partial relief from their CDP appeals.

**TABLE 3.1.2, PRO SE AND REPRESENTED TAXPAYER CASES AND DECISIONS**

Court Decisions	Taxpayer <i>Pro Se</i>		Representative	
	Volume	Percentage of Total	Volume	Percentage of Total
Decided for IRS	132	92%	44	85%
Decided for Taxpayer	9	6%	6	11%
Split Decisions	2	2%	2	4%
Totals:	143	100%	52	100%

**CONCLUSION**

By the end of May 2006, we can say that CDP is an informal hearing, that the “record rule” applies to judicial review of these hearings, that there are narrow evidentiary exceptions to the record rule, that the appellate courts grant significant deference to the IRS’s determinations that collection may proceed, and that courts other than the Tax Court are loathe to involve themselves in the daily minutiae of tax enforcement details.

These rulings demonstrate the overriding importance of developing a complete and comprehensive administrative record. Since that record is in the control of the IRS, taxpayers will have to be vigilant in submitting evidence, raising issues, and corresponding in writing during the course of the CDP hearing. Given the large number of *pro se* taxpayers electing these hearings, taxpayers bear a great risk of being harmed if the IRS designs or implements its procedures in a manner that is not taxpayer-friendly. The National Taxpayer Advocate is very concerned that Appeals’ reluctance to grant

<sup>84</sup> IRM § 5.8.5.5(6) (Nov. 15, 2004).

<sup>85</sup> National Taxpayer Advocate 2005 Annual Report to Congress 487.

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face-to-face and local office hearings increases the likelihood that taxpayers will not develop the administrative record in such a way that courts will be able to conduct proper judicial review.

We have also identified two areas for improvement, one administrative and one legislative. Administratively, the National Taxpayer Advocate shall work with the IRS to clarify and expand the circumstances in which a defaulted offer can be reinstated.<sup>86</sup> Legislatively, the National Taxpayer Advocate is recommending in this report that Congress amend IRC § 6330 to require the Appeals Officer to make the investigation under IRC § 6331(j)(2)(C) as to whether there are other liens on the property and whether there are sufficient net sale proceeds to apply against the taxpayer's liability, *before* issuing a notice of determination in the CDP hearing.<sup>87</sup>

The question remains whether the IRS and taxpayers will learn from these cases. Do Appeals Officers, including Appeals personnel in campus locations who conduct these hearings, read these cases and learn how the courts view CDP hearings? How will taxpayers be educated about the requirements for an administrative record? Regardless of a case's outcome – whether it be for the taxpayer or for the IRS or a split decision – many of the cases identify an opportunity for the IRS to improve procedures, correspondence or communications with the taxpayer, or training for its employees.

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<sup>86</sup> See discussion of *Robinette v. Comm'r*, *supra*.

<sup>87</sup> See Additional Legislative Recommendation, *Collection Due Process and Uneconomical Levies*, *supra*; see also, discussion of *Living Care Alternatives of Utica, Inc.*, *supra*.

## LITIGATED

## ISSUE #2

## GROSS INCOME UNDER INTERNAL REVENUE CODE SECTION 61 AND RELATED SECTIONS

## SUMMARY

Taxpayers, when preparing their tax returns, must first determine the amount of gross income they received for that taxable year. This determination is necessary for the computation of their taxable income and the amount of tax that must be paid. Gross income under IRC § 61 has been included in the Most Litigated Issues section of each of the National Taxpayer Advocate's Annual Reports to Congress. The cases reviewed for this report can be separated into two major categories: (1) Income includible in gross income and (2) income specifically excluded from gross income by statute. Some of the statutory exclusions frequently addressed in the reviewed cases include the following:

- ◆ Awards and settlements;
- ◆ Disability and Social Security benefits; and
- ◆ Discharge of indebtedness income.

## PRESENT LAW

IRC § 61 broadly defines gross income as “all income from whatever source derived.”<sup>1</sup> The United States Supreme Court has broadly described gross income as any accession of wealth.<sup>2</sup> However, as the Internal Revenue Code has evolved, Congress has carved out numerous exceptions and exclusions to this broad definition of income.<sup>3</sup>

## ANALYSIS OF LITIGATED CASES

We analyzed 106 cases where gross income was an issue that were decided in the federal court system between June 1, 2005, and May 31, 2006.<sup>4</sup> As stated in previous Annual Reports to Congress, the issues most commonly litigated in gross income cases are what is includible under IRC § 61 and what is excludible from gross income under other statutory provisions.<sup>5</sup> Table 2 in Appendix 3 provides a detailed listing of the cases analyzed for this report. Of the 106 cases, 53 (50 percent) involved taxpayers who failed to report items of gross income.

The following are issues that were commonly raised in unreported income cases and exclusions from gross income cases. While a significant portion (44 percent) of the

<sup>1</sup> IRC § 61(a).

<sup>2</sup> *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 431 (1955).

<sup>3</sup> See, e.g., IRC §§ 104, 105, and 108.

<sup>4</sup> For purposes of our analysis, we reviewed federal cases involving IRC § 61 where the issue was whether the taxpayer had an item of unreported income or whether the taxpayer was entitled to exclude the item from gross income.

<sup>5</sup> National Taxpayer Advocate 2001 Annual Report to Congress 259; National Taxpayer Advocate 2002 Annual Report to Congress 258-71; National Taxpayer Advocate 2003 Annual Report to Congress 332-51; National Taxpayer Advocate 2004 Annual Report to Congress 515-22; and National Taxpayer Advocate 2005 Annual Report to Congress 488-97.

cases we identified during our review were “S” cases with no precedential value, they are nonetheless illustrative of the confusion surrounding the concept of gross income.

### Unreported Income

#### *Gambling Wages*

In four cases, taxpayers did not include their earnings from gambling in their gross income.<sup>6</sup> The taxpayers appeared *pro se* before the U.S. Tax Court and the IRS prevailed in all four cases. The court repeatedly held that a taxpayer is required to report income from gambling, even if the taxpayer is gambling only for recreational purposes and not as a professional gambler.

#### *Alimony*

Taxpayers also disputed the inclusion of alimony payments in their gross income. Alimony is includible in gross income under IRC § 71, which characterizes alimony or separate maintenance payments as gross income as long as the payments are not required anytime after the death of the payee spouse.<sup>7</sup> For example, when two married taxpayers divorced and failed to specify in the divorce settlement agreement what should happen to payments upon the death of the payee spouse, the Tax Court concluded such payments were properly includible in the payee spouse’s gross income under IRC § 71.<sup>8</sup> Similarly, in *Arias v. Commissioner*, the monthly payments paid to the taxpayer were alimony includible in gross income because the taxpayer’s former spouse had no liability to make any payments for any period after the death of the taxpayer.<sup>9</sup>

### Exclusions From Gross Income

#### *Awards and Settlements*

Taxation of awards and settlements remains one of the most frequently litigated issues related to gross income.<sup>10</sup> The central dispute in 19 cases was whether the award, or a portion of the award, should be excluded from gross income as an amount received “on account of personal physical injuries or physical sickness.”<sup>11</sup> Under IRC § 104(a)(2), any award, other than punitive damages, is excludible from gross income if the award is compensation for damages resulting from a physical injury or physical sickness.<sup>12</sup> The exclusion applies regardless of whether the award is received by lawsuit or by agreement, or whether the award comes in a lump sum or by periodic payments.

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<sup>6</sup> *Lange v. Comm’r*, T.C. Memo. 2005-176; *McQuarrie v. Comm’r*, T.C. Memo. 2006-93.

<sup>7</sup> IRC § 71.

<sup>8</sup> *Jobanson v. Comm’r*, T.C. Memo. 2006-105.

<sup>9</sup> *Arias v. Comm’r*, T.C. Summ. Op. 2006-20.

<sup>10</sup> *Allum v. Comm’r*, T.C. Memo. 2005-177; *Benavides v. U.S.*, 97 A.F.T.R.2d (RIA) 1512 (S.D. Tex. 2006).

<sup>11</sup> IRC § 104(a)(2).

<sup>12</sup> *Id.*

Courts interpret IRC § 104(a)(2) narrowly. Before an award can be excluded under IRC § 104(a)(2), a taxpayer must establish: (1) prosecution or settlement of the claim is based on tort or tort-type rights, and (2) the award was received on account of personal physical injuries or physical sickness.<sup>13</sup> The taxpayer must be able to show a clear causal connection between the award and the taxpayer's physical injury or physical sickness. Making this connection is difficult, as taxpayers successfully argued that some portion of the damages awarded was eligible for the IRC § 104(a)(2) exclusion in only two of the 19 cases we reviewed. For example, in *Lindsey v. Commissioner*, the taxpayer received a \$2 million payment in settlement of his claims for tortious interference with contract negotiations.<sup>14</sup> The taxpayer asserted, and had his physician testify, that he suffered from hypertension and stress-related symptoms during contract negotiations. In holding that the settlement payment was related to emotional distress and not physical sickness, the court noted that the payor of the award was never made aware that the taxpayer was suffering any physical sickness, "thereby belying the existence of a direct causal link between any physical sickness. . . and damages paid."<sup>15</sup>

The constitutionality of IRC § 104(a)(2) has recently been called into question by the United States Court of Appeals for the District of Columbia Circuit in *Murphy v. IRS*.<sup>16</sup> In that case, Ms. Murphy sued the New York National Guard for employment discrimination. Ms. Murphy provided medical testimony that she experienced physical, somatic,<sup>17</sup> and emotional injuries, including teeth grinding, due to the stress of the discrimination. Later Ms. Murphy settled the case, and the agreement allocated \$45,000 of the \$70,000 award to "emotional distress and mental anguish" and the remaining \$25,000 for "injury to professional reputation."<sup>18</sup> On their joint return, Mr. and Mrs. Murphy included the entire \$70,000 award in gross income and then later filed a claim for refund and instituted a refund suit in the U.S. District Court for the District of Columbia.<sup>19</sup> The district court ruled in the government's favor, and the taxpayers subsequently appealed. Although the Court of Appeals agreed Ms. Murphy's award was not received on account of personal physical injuries or physical sickness within the meaning of IRC § 104(a)(2), the court determined the award was not gross income. The court held that IRC § 104(a)(2) was "unconstitutional insofar as it permits the taxation of an award of damages for mental distress and loss of reputation," as "damages received solely in compensation for a personal injury are not income within the meaning of that

<sup>13</sup> *Comm'r v. Schleier*, 515 U.S. 323 (1995).

<sup>14</sup> *Lindsey v. Comm'r*, 422 F.3d 684 (8th Cir. 2005).

<sup>15</sup> *Id.* at 689.

<sup>16</sup> *Murphy v. IRS*, 460 F.3d 79 (D.C. Cir. 2006), judgment vacated and scheduled for oral argument, No. 05-5139 (D.C. Cir. Dec. 22, 2006).

<sup>17</sup> Quoting the American Heritage Dictionary, the Court of Appeals for the District of Columbia Circuit defined "somatic" as relating to, or affecting the body, especially as distinguished from a body part, the mind, or the environment." *Murphy*, 460 F.3d at 83.

<sup>18</sup> *Id.* at 81.

<sup>19</sup> See *Murphy v. IRS*, 362 F.Supp.2d 206 (D. D.C. 2005).

term in the Sixteenth Amendment.<sup>20</sup> While this case was not decided during the period covered by this report and the opinion is not yet final, the ultimate outcome of this case will impact future litigation of IRC § 104(a)(2) claims.<sup>21</sup>

### *Contingent Attorney's Fees*

In addition to disputing whether an award or a portion of an award qualifies for exclusion from gross income under IRC § 104(a)(2), taxpayers disputed whether the attorney's fees portion of the award was includible in gross income.<sup>22</sup> The Supreme Court resolved the issue of whether the attorney's fees portion of the award is also includible in gross income in *Commissioner v. Banks*, holding that the contingent attorney's fees portion of the award was taxable income to the plaintiff under the anticipatory assignment of income doctrine, which bars the taxpayer from excluding an economic gain from gross income when gain is assigned in advance to another party.<sup>23</sup>

In *Banks* and its companion case, *Commissioner v. Banaitis*, the taxpayers received settlement awards and their attorneys received a portion of those awards as contingency fees.<sup>24</sup> The taxpayers argued that even though the settlement awards were not excludible under IRC § 104(a)(2), they should not have to include the attorney's contingency fee portion of the award in gross income because applicable state law granted the attorneys a property interest in that portion of the award. The Supreme Court rejected that argument, holding the amounts representing the contingent fees were includible in gross income because the arrangement was an anticipatory assignment of income.<sup>25</sup>

In 2004, while the *Banks* and *Banaitis* cases were pending, Congress passed legislation to allow taxpayers to take an "above the line" deduction from gross income for the attorney's fees paid in connection with any action involving a claim of unlawful discrimination.<sup>26</sup> Taxpayers who receive taxable awards or settlements in contingency fee cases not alleging unlawful discrimination, do not, however, get the benefit of an "above the line" deduction from gross income for the attorney's fees paid; those taxpayers can only

<sup>20</sup> *Murphy*, 460 F.3d at 92. The Sixteenth Amendment provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

<sup>21</sup> This case was decided on August 22, 2006. On October 5, 2006, the United States filed a petition for rehearing en banc to the D.C. Circuit. On October 31, 2006, the Murphys filed their opposition to the petition for rehearing. On December 22, 2006, the D.C. Court of Appeals vacated the August 22, 2006 decision and ordered new briefing and oral argument. The D.C. Court of Appeals issued a second order on December 22, 2006, dismissing as moot the government's petition for rehearing en banc but providing that a new period for petitioning en banc will begin to run following the entry of a new panel judgment.

<sup>22</sup> *Allum v. Comm'r*, T.C. Memo. 2005-177; *Goode v. Comm'r*, T.C. Memo. 2006-48.

<sup>23</sup> *Comm'r v. Banks*, 543 U.S. 426 (2005).

<sup>24</sup> *Id.*; *Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003). In *Banaitis v. Commissioner*, an Oregon case, the court ruled that the state law afforded a property interest in the settlement and therefore the portion of the settlement paid directly for attorney's fees was excluded from income.

<sup>25</sup> *Comm'r v. Banks*, 543 U.S. at 434-36.

<sup>26</sup> Pub. L. No. 108-357, § 703, amended the definition of adjusted gross income in section 62(a). See IRC § 62(a)(20) ("costs involving discrimination suits, etc.").

deduct the attorney's fees paid on Schedule A as miscellaneous itemized deductions and are therefore subject to the two percent floor of IRC § 67.<sup>27</sup>

Therefore, in general, a taxpayer must include the portion of recovery paid to the attorney as a contingent fee in gross income. The taxpayer may be able to deduct attorney fees from gross income as a miscellaneous itemized deduction, but this deduction must be added back when computing alternative minimum taxable income.<sup>28</sup> Consequently, if a taxpayer argues unsuccessfully that an award is excludible under IRC § 104(a)(2), the taxpayer must also include the portion of the settlement paid as attorney's fees in gross income. Moreover, even if the taxpayer is able to claim a miscellaneous itemized deduction for the attorney's fees, the taxpayer may be subject to the alternative minimum tax.

### *Social Security and Disability Benefits*

The characterization of payments as Social Security or other types of disability benefits is often litigated because portions of these benefits may be excludible from gross income. For instance, in *Burnham v. Commissioner*, the taxpayer argued his disability pension was excludible under IRC § 105(c), which provides that amounts received by an employee through health or accident insurance for personal injuries or sickness will be included in gross income unless the payments are compensation for the loss of a member or function of the taxpayer's body, or permanent disfigurement, and computed according to the nature of the injury without consideration of the period of time the taxpayer is absent from work.<sup>29</sup> In *Burnham*, the amount the taxpayer received was based on the amount of time the taxpayer was absent from work, rather than the severity of the injury. Therefore, the payments were includible in the taxpayer's gross income.<sup>30</sup>

For tax purposes, Social Security benefits are treated one of three ways: entirely excluded from gross income, 50 percent excluded from gross income, or 85 percent excluded from gross income.<sup>31</sup> The treatment of a taxpayer's Social Security benefits will depend on the taxpayer's adjusted gross income and filing status.<sup>32</sup> It is not surprising that this complexity leads to disputes between the IRS and taxpayers. Moreover, the similarities between various types of benefits can lead taxpayers into thinking they are entitled to exclude the benefits from gross income under one of the provisions as in IRC § 104. For example, in *Green v. Commissioner*, the taxpayer received Social Security benefits but

<sup>27</sup> IRC § 67(a) provides that individuals are allowed miscellaneous itemized deductions only to the extent that the aggregate of such deductions exceeds two percent of adjusted gross income, where IRC § 62 defines adjusted gross income.

<sup>28</sup> IRC § 56.

<sup>29</sup> *Burnham v. Comm'r*, T.C. Summ. Op. 2006-8.

<sup>30</sup> *Id.*

<sup>31</sup> IRC § 86.

<sup>32</sup> *Id.*

did not report them in gross income.<sup>33</sup> The taxpayer claimed the benefits were in the nature of workmen's compensation and therefore excludible from gross income under IRC § 104(a)(1).<sup>34</sup> Although the taxpayer was injured on the job and received benefits as a result of those injuries, the Tax Court emphasized that the Social Security Act under which the benefits were paid is not in the nature of a workmen's compensation act.

### *Discharge of Indebtedness*

There were ten cases where the taxpayer was disputing the IRS's determination that the taxpayer received income from the cancellation of indebtedness. In three of the cases, the taxpayer prevailed, while one case resulted in a split decision. Generally, a taxpayer must include cancellation of indebtedness in gross income.<sup>35</sup> However, IRC § 108(a)(1)(B) permits the taxpayer to exclude cancellation of indebtedness from gross income if the discharge occurs when the taxpayer is insolvent.<sup>36</sup> In the Tax Court, the burden of proving insolvency is generally placed on the taxpayer.<sup>37</sup> For example, in *Coppertino v. Commissioner*, the taxpayer argued that cancellation of a debt by the Securities and Exchange Commission was excludible because she was insolvent. The taxpayer testified she did not own a home or any other property, and her only asset was a car with very minimal monetary value. In fact, the taxpayer testified she virtually lived out of her car. Moreover, the IRS was unable to provide the court with any evidence disputing the taxpayer's testimony.<sup>38</sup> Therefore, the taxpayer was considered insolvent and could exclude the cancellation of indebtedness from gross income.

### CONCLUSION

Although no clear patterns emerged from the cases, it is clear that gross income is an area of confusion and contention between taxpayers and the IRS. This year, taxpayers prevailed in only seven of the 106 cases, and two cases resulted in a split decision. Taxpayers appeared *pro se* in 75 cases (70 percent), and only prevailed in whole or in part in three of the 75 cases.

Because 50 percent of the cases involved unreported income, it is clear that some taxpayers will search out ways to avoid reporting taxable income, and the IRS needs to be diligent to ensure adherence to the law and proper tax collection.<sup>39</sup> In the other 50 percent of the cases we analyzed, however, many taxpayers raised legitimate issues

<sup>33</sup> *Green v. Comm'r*, T.C. Memo. 2006-39.

<sup>34</sup> IRC § 104(a)(1) provides that gross income does not include "amounts received under workmen's compensation acts as compensation for personal injuries or sickness."

<sup>35</sup> IRC § 61(a)(12).

<sup>36</sup> IRC § 108(a)(1)(B).

<sup>37</sup> U.S. Tax Court Rules of Practice and Procedure, Rule 142(a); *Traci v. Comm'r*, T.C. Memo. 1992-708.

<sup>38</sup> *Coppertino v. Comm'r*, T.C. Summ. Op. 2006-87.

<sup>39</sup> Unreported income is the single largest component of the "tax gap," accounting for roughly 80 percent of the tax gap (approximately \$285 billion per year). See updated estimates for the overall gap for tax year 2001 at [www.irs.gov/pub/irs-news/tax\\_gap\\_figures.pdf](http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf).

regarding gross income, such as when to exclude settlement awards and Social Security benefits. The complexity of Social Security and disability benefits suggests that the taxability of these types of payments will continue to confuse taxpayers and create contention with the IRS. Moreover, even with the D.C. Circuit's unusual move in vacating its earlier decision in *Murphy v. IRS*, the analysis employed by the court in the earlier decision leaves open the possibility that substantial physical problems caused by emotional distress could be considered physical injuries or physical sickness that would permit a taxpayer to exclude an award for those problems depending on the terms of the award.<sup>40</sup> Thus, *Murphy v. IRS* is a significant case that demonstrates how the law may evolve with modern medical science's understanding of the connection between mind and body, and the biological and neurological basis of mental problems.

<sup>40</sup> The court concluded that “Murphy no doubt suffered from certain physical manifestations of emotional distress,” but nonetheless did not find that Murphy’s award was excludible under IRC § 104(a)(2) “on account of personal physical injuries or physical sickness” because her award was characterized as compensation for mental pain and anguish and for injury to professional reputation. *Murphy*, 460 F.3d at 84.

LITIGATED  
ISSUE #3SUMMONS ENFORCEMENT UNDER INTERNAL REVENUE CODE SECTIONS 7602(A), 7604(A),  
AND 7609(A)

## SUMMARY

We reviewed 101 federal court opinions on issues related to IRS summons enforcement during the 12 months from June 1, 2005, through May 31, 2006.<sup>1</sup> The IRS has the authority to summon the production of books, records, or testimony from witnesses when investigating either a civil or criminal tax liability.<sup>2</sup> This information can be obtained from the person who is the subject of the investigation by serving a summons directly on that person.<sup>3</sup> The IRS can also obtain this information from third-party record keepers who are holding records relating to that person by serving summonses upon those record keepers, and providing notice of the summons to the person identified in the summons.<sup>4</sup>

When a summons is served upon the person who is the subject of the investigation, that person may contest the legality of the summons by waiting until the IRS brings a proceeding to enforce the summons and raising appropriate arguments at that time.<sup>5</sup> When a summons is served upon a third-party record keeper, a person identified in the summons can challenge the legality of a summons by intervening in a proceeding or by bringing a proceeding to quash the summons.<sup>6</sup> Generally, the burden on the IRS to demonstrate the validity of the summons is minimal and the burden upon the taxpayer to demonstrate the illegality of the summons is formidable.<sup>7</sup> The taxpayer prevailed in only three of the 101 cases.<sup>8</sup>

## PRESENT LAW

The IRS has broad authority under IRC § 7602 to issue summonses for the examination of a taxpayer's books and records or to direct testimony under oath.<sup>9</sup> The IRS has the authority to enforce a summons under IRC § 7604 by bringing suit in the appropriate United States District Court. The IRS also has the authority to obtain information

<sup>1</sup> A summons is a document notifying the person to whom it is directed that he must appear on the day designated and answer claims or give testimony or produce certain books, papers or other data. *Albachten v. Corbett*, 156 F. Supp. 863 (S.D. Cal. 1957).

<sup>2</sup> IRC § 7602; Treas. Reg. § 301.7602-1.

<sup>3</sup> IRC §§ 7602(a) and 7603(a).

<sup>4</sup> IRC §§ 7603(b) and 7609(a).

<sup>5</sup> IRC § 7609; see e.g., *U.S. v. Davis*, 636 F.2d 1028, 1034 (5th Cir. 1981).

<sup>6</sup> IRC § 7609(a) requires that anyone identified in a third-party summons (other than the person summoned) must be given notice of the summons. IRC § 7609(b) provides that those persons who are entitled to notice can intervene in a proceeding regarding the summons and can initiate a proceeding to quash the summons.

<sup>7</sup> *Connor v. U.S.*, 434 F.3d 676 (4th Cir. 2006), aff'g 94 A.F.T.R.2d (RIA) 7287 (W.D. Va. 2004). The burden upon the government is slight for the statute must be read broadly in order to ensure that the enforcement powers of the IRS are not unduly restricted. *U.S. v. Powell*, 9 U.S. 48, 53 (1968).

<sup>8</sup> *Investor Communications Int'l, Inc. v. U.S.*, 97 A.F.T.R.2d (RIA) 1293 (W.D. Wash. 2006); *Reiserer v. U.S.*, 96 A.F.T.R.2d (RIA) 5437 (W.D. Wash. 2005); *U.S. v. Monumental Life Insurance Co.*, 440 F.3d 729 (6th Cir. 2006).

<sup>9</sup> *LaMura v. U.S.*, 765 F.2d 974, 979, citing *U.S. v. Bisceglia*, 420 U.S. 141, 145-146 (1975).

related to an investigation from third-party record keepers pursuant to IRC § 7609, provided that notice is given to those identified in the summons so they have the opportunity to contest the summons. A summons can be contested on the grounds that the IRS has failed to satisfy the threshold requirements for issuing a summons, as set forth by the Supreme Court in *United States v. Powell*:

- ◆ The investigation must be conducted for a legitimate purpose;
- ◆ The inquiry must be relevant to that purpose;
- ◆ The IRS must not already possess the information; and
- ◆ All required administrative steps must have been taken.<sup>10</sup>

The IRS initially has the burden in a summons enforcement proceeding to show that the Powell requirements are satisfied. The burden shifts to the person attempting to quash the summons to demonstrate that the Powell requirements were not met or enforcement of the summons would be an abuse of process.<sup>11</sup> As noted above, the IRS's burden in satisfying the Powell requirements is minimal, while the taxpayer's burden to demonstrate that one of the factors has not been satisfied is heavy.<sup>12</sup>

There are other limitations on the issuance of a summons, including the restriction against issuing a summons after an IRS recommendation to the Department of Justice for criminal prosecution.<sup>13</sup> Additionally, the IRS may not obtain information protected by a statutory or common law privilege, such as:

- ◆ Attorney-client privilege;<sup>14</sup>
- ◆ Work product privilege;<sup>15</sup> or
- ◆ Tax practitioner privilege.<sup>16</sup>

<sup>10</sup> *United States v. Powell*, 379 U.S. 48, 58-59 (1964).

<sup>11</sup> *La Mura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985).

<sup>12</sup> The IRS burden can generally be satisfied by presenting the sworn affidavit of the agent who issued the summons attesting to the necessary facts. *Id.*

<sup>13</sup> IRC § 7602(d)(1).

<sup>14</sup> The attorney-client privilege generally provides protection from discovery of information where: (1) legal advice of any kind is sought, (2) from a professional legal advisor in his or her capacity as such, (3) the communication is related to this purpose, (4) made in confidence, (5) by the client, (6) and at the client's insistence protected, (7) from disclosure by the client or the legal advisor, (8) except where the privilege is waived. *U.S. v. Evans*, 113 F.3d 1457 (7th Cir. 1997), *citing* John Henry Wigmore, *Evidence in Trials at Common Law* § 2292 (John T. McNaughten rev. 1961).

<sup>15</sup> The work product doctrine protects against the discovery of documents and other tangible things prepared in anticipation of litigation. Fed. R. Civ. P. 26.

<sup>16</sup> IRC § 7525 extends the protection of the common law attorney-client privilege to federally authorized tax practitioners. Criminal tax matters and communications regarding tax shelters are exceptions to the privilege. IRC § 7525 (a)(2) and (b). The tax practitioner privilege is interpreted based on the common law rules of the attorney-client privilege. *U.S. v. BDO Seidman, LLP*, 337 F.3d 802, 810 – 812 (7th Cir. 2003).

There are also limitations to these privileges. For example, they extend to “tax advice” but not to tax return preparation materials.<sup>17</sup> Further, the identities of clients are not generally considered privileged information, except in rare cases where so much of the actual confidential communication has been disclosed that merely identifying the client would effectively disclose that communication.<sup>18</sup> Another limitation is the so-called “crime-fraud” exception, which permits discovery of communications between an attorney and client that are in furtherance or perpetration of a fraud.<sup>19</sup>

When the IRS serves a summons on a third-party recordkeeper, the IRS is required to give notice of the summons to any person identified in the description of the books and records contained in the summons in order that the person(s) can contest the summons.<sup>20</sup> The IRS must provide notice to the person within three days of the day on which the summons is served to the recordkeeper, but no later than the 23rd day before the day fixed on the summons on which the records will be reviewed.<sup>21</sup> Persons entitled to notice under IRC § 7609(a)(2) may bring a proceeding to quash a third-party summons in the appropriate federal district court. These proceedings must be brought within 20 days after notice of the summons is served.<sup>22</sup>

Several exceptions apply to the IRC § 7609 notice procedures. Summonses issued “in aid of collection” of an assessed liability or judgment rendered against a person whose liability is at issue are generally exempt from IRC § 7609 notice procedures.<sup>23</sup> In other words, the IRS is not required to give notice to persons identified in the summons where the purpose is to aid the collection of a liability. However, the courts have interpreted the “aid of collection” exception to apply only where the taxpayer upon whose liability the summons is issued owns a legally identifiable interest in the account or other property for which records are summoned.<sup>24</sup> In addition, summonses issued by the IRS in connection with a criminal investigation are also generally exempt from IRC § 7609 procedures. However, the exemption only applies if the summons is not issued to a third-party recordkeeper.<sup>25</sup>

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<sup>17</sup> *U.S. v. Frederick*, 182 F.3d 496 (7th Cir. 1999).

<sup>18</sup> *U.S. v. Blackman*, 72 F.3d 1418, 1424 (9th Cir. 1995).

<sup>19</sup> *U.S. v. Zolin*, 491 U.S. 554 (1989).

<sup>20</sup> IRC § 7609(a); Treas. Reg. § 301.7609-3(a); see also *Ip v. U.S.*, 205 F.3d 1168, 1172 (9th Cir. 2000) (stating “The purpose of the notice provision is to allow people to assert defenses, such as attorney-client privilege or relevancy objections, that would be unavailable to them in the absence of notice.”).

<sup>21</sup> IRC § 7609(a)(1).

<sup>22</sup> IRC § 7609(b)(2)(A).

<sup>23</sup> IRC § 7609(c)(2)(D); Treas. Reg. § 301.7609-4(a).

<sup>24</sup> *Ip v. U.S.*, 205 F.3d 1168, 1172-1176 (9th Cir. 2000)

<sup>25</sup> IRC § 7609(c)(2)(E).

### ANALYSIS OF LITIGATED CASES

This is the second year that summons enforcement has appeared in the National Taxpayer Advocate's Annual Report to Congress as a Most Litigated Issue. In the 2005 Annual Report, we reviewed 44 cases with primary issues related to summons enforcement, and predicted the number of cases would increase as the IRS became more aggressive in its enforcement initiatives. The number of summons enforcement cases not only increased, as expected, but more than doubled in the 12 months following the period covered by the last Annual Report.

A detailed listing of this year's cases can be found in Table 3 in Appendix III. Summons enforcement is the primary issue in all of these cases. The court ruled in favor of the IRS in 93 of the 101 cases, while taxpayers prevailed in three cases and five cases ended in split decisions. Attorneys represented taxpayers in 31 cases, while 70 cases involved taxpayers who were *pro se*, *i.e.*, without counsel. Arguments raised by litigants against the IRS summons generally fell into the following categories:

- ◆ **Powell Requirements:** Only two of the litigants prevailed when attacking IRS summonses based on satisfaction of the *Powell* requirements.<sup>26</sup> The burden on the IRS is "slight" while the burden on those challenging the summons is significant.<sup>27</sup> Courts found the taxpayers failed to prove that revenue agents' tactics amounted to abuse of process or lack of good faith.<sup>28</sup> Likewise, the IRS generally defeated taxpayers' claims that the agency already possessed the information by providing affidavits to the contrary from the agents who issued the summonses.<sup>29</sup> Further, many taxpayers raised the generally unsuccessful argument that the IRS requested documents that were not relevant to the investigation.<sup>30</sup>

The third-party recordkeeper in *U.S. v. Monumental Life Insurance Co.* successfully petitioned to quash the summons by challenging the satisfaction of the Powell requirements. The IRS issued a third-party summons to the insurance company in connection with an investigation of a client. The company proved the IRS already possessed much of the requested information about insurance products

<sup>26</sup> *U.S. v. Monumental Life Insurance Co.*, 440 F.3d 729 (6th Cir. 2006), *rev'g* 345 F. Supp.2d 712 (W.D. Ky. 2004); *The Frost National Bank v. U.S.*, 97 A.F.T.R.2d (RIA) 2769 (W.D. Tex. 2006), *adopting* 97 A.F.T.R.2d (RIA) 2771 (W.D. Tex. 2005).

<sup>27</sup> *U.S. v. Kis*, 658 F.2d 526, 535-37 (7th Cir. 1981).

<sup>28</sup> *See, e.g., U.S. v. Holu*, 96 A.F.T.R.2d (RIA) 5843 (D. Haw. 2005).

<sup>29</sup> *See, e.g., Conner v. U.S.* 434 F.3d 676 (4th Cir. 2006), *aff'g* 94 A.F.T.R.2d (RIA) 7287 (W.D. Va. 2004); *Boelter v. U.S.* 96 A.F.T.R.2d (RIA) 5968 (W.D. Wash. 2005); *Jordon v. U.S.*, 97 A.F.T.R.2d (RIA) 2919 (M.D. Ala. 2006); *U.S. v. Geary*, 96 A.F.T.R.2d (RIA) 5839 (D. Haw. 2005); *U.S. v. Trenholm*, 96 A.F.T.R.2d (RIA) 5856 (D. Haw. 2005) (Availability of information through discovery of ongoing Tax Court proceeding did not render summonses unenforceable), *adopting* 2005 WL 3200080 (D. Haw. 2005); *but see U.S. v. Monumental Life Ins. Co.*, 440 F.3d 729 (6th Cir. 2006), *rev'g* 345 F. Supp. 2d 712 (W. D. Ky. 2004); *Reiserer v. U.S.*, 96 A.F.T.R.2d (RIA) 5437 (W.D. Wash. 2005).

<sup>30</sup> *See, e.g., Beaumont Key Services, L.L.C. v. U.S.*, 96 A.F.T.R.2d (RIA) 5828 (N.D. Tex. 2005); *O'Doherty v. U.S.*, 97 A.F.T.R.2d (RIA) 322 (N.D. Ill. 2005); *Martini v. U.S.*, 97 A.F.T.R.2d (RIA) 2592 (D. Nev. 2006), *clarifying* 2006 WL 240803 (D. Nev. 2006); *Wilde v. U.S.*, 385 F.Supp.2d 966 (D. Ariz. 2005).

from a completely unrelated case heard before the United States Tax Court. The IRS countered by claiming that IRC § 6103 prevented it from using the information received in one case for an unrelated case. However, the court stated internal use for an investigation of another taxpayer did not violate IRC § 6103. Further, the IRS failed to show the documents were inaccessible merely because they were locked away in a file somewhere. The court also agreed that the requested information was too broad in scope and not relevant to the investigation. Accordingly, the court denied enforcement of the summons.<sup>31</sup>

- ◆ **Notice:** Both taxpayers and the IRS raised the issue of insufficient notice. Taxpayers raised the issue in several cases in an attempt to invalidate summonses.<sup>32</sup> Also, because entitlement to notice confers standing to challenge a summons issued to a third-party recordkeeper under IRC § 7609(b), the IRS also raised entitlement to notice as a means to argue that litigants did not have standing to contest the summons. Generally, the IRS is not required to give notice of a summons in aid of collection, provided the taxpayer who is the subject of the investigation has a legally significant interest in the account or other property for which records are sought.<sup>33</sup> Further, notice is not required where the summons is issued in connection with a criminal investigation and is not issued to a third-party recordkeeper.<sup>34</sup>

The district court in *Stewart v. U.S.*<sup>35</sup> held the IRS was not required to give the taxpayer's spouse notice of the summons because the summons did not identify the spouse. In *Stewart*, notice to the spouse was not even required when the IRS sought records relating to joint accounts owned by both the taxpayer and the spouse.

- ◆ **Criminal Referral:** Taxpayers also raised IRC § 7602(d) to invalidate summonses where taxpayers perceived an impending referral to the Department of Justice (DOJ) for criminal prosecution. The IRS is prohibited from issuing a summons or beginning an enforcement proceeding on a summons if a referral to the DOJ is in effect.<sup>36</sup> Courts generally accept the testimony of the IRS agent who issued the summons that no criminal referral has been made, unless the person contesting the summons can provide direct evidence to the contrary.<sup>37</sup>

<sup>31</sup> *U.S. v. Monumental Life Insurance Co.*, 440 F.3d 729 (6th Cir. 2006), *rev'g* 345 F. Supp.2d 712 (W.D. Ky. 2004).

<sup>32</sup> *Cox v. U.S.*, 97 A.F.T.R.2d (RIA) 1121 (E.D. Cal. 2006), *adopting* 97 A.F.T.R.2d (RIA) 1121 (E.D. Cal. 2006); *Jordon v. U.S.*, 97 A.F.T.R.2d (RIA) 2919 (M.D. Ala. 2006).

<sup>33</sup> *Ip v. U.S.*, 205 F.3d 1168,1176 (9th Cir. 2000); *Holland v. U.S.*, 96 A.F.T.R.2d (RIA) 5667 (N.D. Okla. 2005); *Remedios v. Wells Fargo Bank*, 97 A.F.T.R.2d (RIA) 2468 (E.D. Cal. 2006).

<sup>34</sup> *Dirr v. U.S.*, 97 A.F.T.R.2d (RIA) 1784 (E.D. Tenn. 2006); *O'Doherty v. U.S.*, 97 A.F.T.R.2d (RIA) 322 (N.D. Ill. 2005).

<sup>35</sup> *Stewart v. U.S.*, 96 A.F.T.R.2d (RIA) 6877, 6879 (D. Or. 2005), *adopting* 96 A.F.T.R.2d (RIA) 6877 (D. Or. 2005).

<sup>36</sup> IRC § 7602(d).

<sup>37</sup> *Huston v. U.S.*, 96 A.F.T.R.2d (RIA) 6228 (D. Del. 2005); *Travis v. Miki*, 394 F. Supp.2d 1277 (D. Haw. 2005).

- ◆ **Constitutional Arguments:** Taxpayers also raised several constitutional arguments. Some claimed summonses were too broad in violation of the Fourth Amendment's restrictions against unreasonable searches and seizures. However, courts have ruled a summons is not overly broad for constitutional purposes if it satisfies the *Powell* requirements.<sup>38</sup> Taxpayers also raised Fifth Amendment protections but succeeded in only one instance, where there was a substantial and real hazard of self-incrimination and the matter could have turned into a criminal investigation.<sup>39</sup> Although the Fifth Amendment privilege may be applicable in summons cases, it is inapplicable where the summons seeks only nontestimonial data and the requested material would not harm the taxpayer.<sup>40</sup> In addition, the Fifth Amendment does not protect individuals against the forced production of records of entities that happen to be in the possession of the individual.<sup>41</sup>
- ◆ **Privilege:** Taxpayers unsuccessfully argued privilege as a bar to disclosure of the summoned information.<sup>42</sup> In general, work product protection is waived when the requested documents are shared with an adverse party. Similarly, the attorney-client privilege protection is waived when the requested documents are shared with a third party.<sup>43</sup> The IRS prevailed where the taxpayers or their consultants asserted that the identities of taxpayers were within the attorney-client or tax practitioner privilege.<sup>44</sup>
- ◆ **Timeliness of Taxpayer's Petition or Notice and the Doctrine of Equitable Tolling:** Courts dismissed taxpayers' petitions to quash the summons where the taxpayer either failed to file the petition in a timely manner<sup>45</sup> or failed to send notice of the petition to the IRS in accordance with IRC § 7609(b)(2).<sup>46</sup> Courts also

<sup>38</sup> *U.S. v. Back to Health Chiropractic*, 96 A.F.T.R.2d (RIA) 7061 (E.D. Tenn. 2005), *adopting* 96 A.F.T.R.2d (RIA) 7061 (E.D. Tenn. 2005); *U.S. v. Hopper*, 96 A.F.T.R.2d (RIA) 6899 (E.D. N.Y. 2005); *Johnson v. U.S.*, 96 A.F.T.R.2d (RIA) 7314 (W.D. Pa. 2005); *U.S. v. Norwood*, 420 F.3d 888 (8th Cir. 2005), *aff'g* 343 F. Supp.2d 860 (D. N.D. 2004).

<sup>39</sup> *U.S. v. Back to Health Chiropractic*, 96 A.F.T.R.2d (RIA) 7061 (E.D. Tenn. 2005), *adopting* 96 A.F.T.R.2d (RIA) 7061 (E.D. Tenn. 2005).

<sup>40</sup> *U.S. v. Elliott*, 96 A.F.T.R.2d (RIA) 5503 (W.D. N.C. 2005); *U.S. v. Gippetti*, 96 A.F.T.R.2d (RIA) 6978 (3d Cir. 2005), *vacating and remanding* 94 A.F.T.R.2d (RIA) 6093 (D. N.J. 2004); *U.S. v. Hopper*, 96 A.F.T.R.2d (RIA) 6899 (E.D. N.Y. 2005); *U.S. v. Marra*, 96 A.F.T.R.2d (RIA) 6471 (D. N.J. 2005); *U.S. v. Norwood*, 420 F.3d 888 (8th Cir. 2005), *aff'g* 343 F. Supp.2d 860 (D. N.D. 2004).

<sup>41</sup> *Travis v. Miki*, 394 F.Supp.2d 1277 (D. Haw. 2005); *Johnson v. U.S.*, 96 A.F.T.R.2d (RIA) 7314 (W.D. Pa. 2005);.

<sup>42</sup> *Jordan v. U.S.*, 97 A.F.T.R.2d (RIA) 2919 (M.D. Ala. 2006); *U.S. v. Holmes*, 98 A.F.T.R.2d (RIA) 5559 (D. Ariz. 2006).

<sup>43</sup> *Unocal v. U.S.*, 97 A.F.T.R.2d (RIA) 522 (N.D. Cal. 2005).

<sup>44</sup> *U.S. v. BDO Seidman, LLP*, 337 F.3d 802 (7th Cir. 2003); *Boelter v. U.S.*, 96 A.F.T.R.2d (RIA) 5968 (W.D. Wash. 2005).

<sup>45</sup> *Capstick v. U.S.*, 96 A.F.T.R.2d (RIA) 5657 (W.D. Wash. 2005); *but see Investor Communications Int'l, Inc. v. U.S.*, 97 A.F.T.R.2d (RIA) 1293 (W.D. Wash. 2006); *Linstruth v. U.S.*, 97 A.F.T.R.2d (RIA) 2231 (S.D. Ohio 2005); *Schulz v. U.S.*, 97 A.F.T.R.2d (RIA) 859 (E.D. N.Y. 2005).

<sup>46</sup> *Justin v. U.S.*, 97 A.F.T.R.2d (RIA) 966 (W.D. N.C. 2006), *adopting* 97 A.F.T.R.2d (RIA) 966 (W.D. N.C. 2006); *Bharose v. U.S.*, 96 A.F.T.R.2d (RIA) 6779 (E.D. Cal. 2005); *Environmental Sound Solutions v. Chynoweth*, 2006 WL 1409635 (E.D. Cal. 2006); *Marks v. U.S.*, 97 A.F.T.R.2d (RIA) 433 (S.D. N.Y. 2006).

refused to apply the doctrine of equitable tolling to extend the statutory deadlines under IRC § 7609.<sup>47</sup>

- ◆ **Contempt of Court Charges:** In several cases, the courts recommended the taxpayers face contempt of court charges. Generally, where the government petitions for a civil contempt finding, it must establish by clear and convincing evidence that the summoned party violated the court's order. Once a prima facie showing is made to enforce the summons, the burden shifts to the summoned party to show why he or she cannot comply with the order. Unavailability of the documents will not satisfy the burden of production. The taxpayer must show that he has made in good faith all reasonable efforts to comply.<sup>48</sup>
- ◆ **No Protection Under Right to Financial Privacy Act:** Several taxpayers unsuccessfully claimed that enforcement of the summons would violate the Right to Financial Privacy Act.<sup>49</sup> However, the courts uniformly dismissed this argument. Congress expressly exempted requests for information under the Internal Revenue Code from the Act's requirements.<sup>50</sup>

### CONCLUSION

The IRS may issue a summons to obtain information needed to determine the correctness of a return, determine if a tax return should have been filed, determine a taxpayer's tax liability, or to collect a taxpayer's liability.<sup>51</sup> For these purposes, the IRS may summon documentation from taxpayers who have failed to voluntarily provide that information to the IRS. It appears that as the IRS continues its aggressive enforcement policy, it will continue to heavily rely on the summons enforcement tool, and we expect the courts will continue to see increased numbers of these cases.

<sup>47</sup> *Capstick v. U.S.*, 96 A.F.T.R.2d (RIA) 5657 (W.D. Wash. 2005) (dicta); *Nelson v. U.S.*, 96 A.F.T.R.2d (RIA) 5633 (W.D. Wash. 2005).

<sup>48</sup> *U.S. v. Koehler*, 96 A.F.T.R.2d (RIA) 6528 (M.D. Fla. 2005), *adopting* 96 A.F.T.R.2d (RIA) 6129 (M.D. Fla. 2005); *U.S. v. Montgomery Global Advisors V LLC*, 96 A.F.T.R.2d (RIA) 5849 (N.D. Cal. 2005); *U.S. v. Rose*, 97 A.F.T.R.2d (RIA) 2668 (S.D. Cal. 2006).

<sup>49</sup> 12 U.S.C. § 3401 *et seq.*

<sup>50</sup> 12 U.S.C. § 3413(c). *Kernan v. IRS*, 97 A.F.T.R.2d (RIA) 1636 (D. Ariz. 2006); *Johnson v. U.S.*, 96 A.F.T.R.2d (RIA) 7314 (W.D. Pa. 2005).

<sup>51</sup> IRC § 7602(a).

LITIGATED  
ISSUE #4ACCURACY-RELATED PENALTY UNDER INTERNAL REVENUE CODE  
SECTION 6662(B)(1) AND (2)

## SUMMARY

Taxpayers who underpay the required amount of income tax are subject to an accuracy-related penalty if the underpayment is attributable to the taxpayers' negligence or a substantial understatement of tax.<sup>1</sup> While the IRS is authorized to impose other accuracy-related penalties as well, these other issues are not litigated with the same frequency as the negligence and substantial understatement penalty issues, and therefore are not addressed in this analysis.<sup>2</sup> During the review period for this report (June 1, 2005 through May 31, 2006), we identified 92 cases where IRC § 6662(b)(1) and (2) penalties were in dispute. The taxpayers fully prevailed in 26 of those cases, the IRS in 63, and there were three split decisions in which the court ruled partially in favor of each party on the accuracy-related penalty issue.

## PRESENT LAW

The amount of the accuracy-related penalty equals 20 percent of the portion of the underpayment<sup>3</sup> attributable to negligence or the substantial understatement of income tax.<sup>4</sup> The IRS can assert more than one of the accuracy-related penalties if applicable; however, the total penalty amount generally cannot exceed 20 percent of the underpayment of tax.<sup>5</sup> The standards for whether taxpayers have been negligent and whether taxpayers have substantially understated their income tax liabilities are very different, but both components of the accuracy-related penalty provide that taxpayers can avoid penalties if they can show there was reasonable cause for the underpayment.

*Negligence*

The penalty under IRC § 6662(b)(1) is imposed if the taxpayer's underpayment is occasioned by taxpayer's negligence or disregard of the rules or regulations. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the tax law, including any failure by the taxpayer to keep adequate books and records or to substantiate items that gave rise to the underpayment.<sup>6</sup> Negligence is strongly indicated where a taxpayer fails to include on a tax return income that was reflected on an information return, or where the taxpayer fails to make a reasonable attempt to ascertain

<sup>1</sup> IRC § 6662(b)(1) applies to negligence and IRC § 6662(b)(2) applies to substantial understatements.

<sup>2</sup> IRC § 6662(b)(3) imposes a penalty for substantial valuation misstatement for income taxes; IRC § 6662(b)(4) imposes a penalty for substantial overstatement of pension liabilities; and IRC § 6662(b)(5) imposes a penalty for substantial estate or gift tax valuation understatements.

<sup>3</sup> For IRC § 6662(b) to apply, there must be an underpayment of tax. See *Coburn v. Comm'r*, T.C. Memo. 2005-283 (court found in taxpayer's favor on the issue of whether there was a deficiency in tax, and, therefore, there was no underpayment of tax on which a penalty could be imposed).

<sup>4</sup> IRC § 6662(a).

<sup>5</sup> Treas. Reg. § 1.6662-2(c). The penalty is increased to 40 percent if any portion of the underpayment is due to a gross valuation misstatement. See IRC § 6662(h)(1).

<sup>6</sup> Treas. Reg. § 1.6662-3(b)(1).

the correctness of a deduction, credit, or exclusion on a return.<sup>7</sup> The IRS considers various other factors in its determination as to whether negligence was causally related to the underpayment of tax.<sup>8</sup>

#### *Substantial Understatement*

In general, an “understatement” is the difference between (1) the correct amount of tax, and (2) the amount of tax which the taxpayer reported on the return reduced by any rebate.<sup>9</sup> The understatement of tax is substantial if it exceeds the greater of \$5,000 or ten percent of the tax required to be shown on the return.<sup>10</sup>

#### *Reasonable Cause*

The IRC § 6662(a) penalty is not imposed with respect to any portion of the underpayment as to which the taxpayer acted with reasonable cause and in good faith.<sup>11</sup> Thus, while the IRS may propose assessment of the accuracy-related penalty, a taxpayer may be able to demonstrate to the IRS or to a court that the taxpayer had reasonable cause for the underpayment. The decision as to whether a taxpayer acted with reasonable cause and in good faith is made by taking into account all of the pertinent facts and circumstances.<sup>12</sup> Generally, the most important factor is the extent of the taxpayer’s effort to determine the proper tax liability.<sup>13</sup> Reliance upon the advice or opinion of a tax professional can constitute reasonable cause if: (1) the adviser is a competent professional who has sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser’s judgment.<sup>14</sup>

#### *Penalty Assessment and Litigation Process*

The accuracy-related penalty is generally proposed as part of the IRS examination process.<sup>15</sup> With the exception of penalties automatically calculated through electronic means, the IRS may not assess a penalty unless managerial approval is made in writing

<sup>7</sup> Treas. Reg. § 1.6662-3(b)(1)(i), (ii).

<sup>8</sup> These factors include the taxpayer’s history of non-compliance, failure to maintain adequate books and records, actions taken by the taxpayer to ensure the tax as reported was correct and underreported income coupled with an inadequate explanation by the taxpayer. IRM 4.10.6.2.1.

<sup>9</sup> IRC § 6662(d)(2)(A).

<sup>10</sup> IRC § 6662(d)(1)(A)(i), (ii). There is a special rule for corporations (other than S corporations or personal holding companies) such that an understatement is substantial if it exceeds the lesser of 10 percent of the tax required to be shown on the return or \$10,000,000. IRC § 6662(d)(1)(B)(i), (ii).

<sup>11</sup> IRC § 6664(c)(1).

<sup>12</sup> Treas. Reg. § 1.6664-4(b)(1).

<sup>13</sup> *Id.*

<sup>14</sup> *Neonatology Associates, P.A. v. Comm’r*, 115 T.C. 43, 99 (2000) (citations omitted).

<sup>15</sup> IRM 20.1.5.3.

before the initial determination is made to assess the penalty.<sup>16</sup> Once it determines that the accuracy-related penalty is appropriate, the IRS must follow the same deficiency procedures (*i.e.*, §§ 6211-6213) it follows with other proposed adjustments in the examination process.<sup>17</sup> Deficiency procedures require the IRS to send a notice of deficiency with the proposed adjustments informing the taxpayer of the right to protest the deficiency in the U.S. Tax Court by timely filing a petition.<sup>18</sup> Before a taxpayer receives a notice of deficiency, a taxpayer may have other opportunities to engage the IRS on the merits of the penalty.<sup>19</sup> There are also two other avenues through which taxpayers can litigate the accuracy-related penalty: refund litigation,<sup>20</sup> and in Collection Due Process hearings under certain circumstances.<sup>21</sup>

### *Burden of Proof*

In court proceedings, the IRS bears the initial burden of production as to the accuracy-related penalty, which means the IRS must come forward with evidence to demonstrate that imposition of the penalty is warranted.<sup>22</sup> The taxpayer bears the burden of proof as to any exception to the accuracy-related penalty, such as reasonable cause.<sup>23</sup>

### ANALYSIS OF LITIGATED CASES

In prior reports, we have analyzed only the negligence penalty cases under IRC § 6662(b)(1) and have not included the substantial understatement penalty cases under IRC § 6662(b)(2), generally due to the higher number of negligence cases.<sup>24</sup> However,

<sup>16</sup> IRC § 6751(b). However, when a taxpayer responds to the proposed assessment of the accuracy-related penalty, the IRS must consider whether the penalty is appropriate. IRM 20.1.5.1.3(4).

<sup>17</sup> IRC § 6665(a)(1).

<sup>18</sup> IRC § 6213(a).

<sup>19</sup> 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 return during which time the taxpayer can raise issues related to the deficiency including the reasonable cause exception. If the issue is not resolved after the 30-day letter, the IRS sends a statutory notice of deficiency to the taxpayer. IRM 4.31.6.2.5.

<sup>20</sup> Taxpayers may also litigate the accuracy-related penalty by paying the tax liability (including the penalty) in full, filing a timely claim for refund, and then instituting a refund suit in the appropriate United States District Court or the Court of Federal Claims. 28 U.S.C. § 1346; IRC § 7422(a); *Flora v. U.S.*, 362 U.S. 145 (1960) (requiring full payment of tax liabilities as a precondition to district court jurisdiction for refund litigation).

<sup>21</sup> IRC §§ 6320 and 6330 provide for due process hearings in which a taxpayer can raise a variety of issues including the underlying liability, provided the taxpayer did not receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute such liability. IRC § 6330(c)(2).

<sup>22</sup> IRC § 7491(c) provides that "the Secretary shall have the initial 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."

<sup>23</sup> *Id.*

<sup>24</sup> See Table 4 in Appendix 3 for a listing of IRC § 6662(b)(1) and (2) cases. Of the 92 cases listed in the table, there were 45 in which the courts addressed the negligence penalty alone and 36 cases addressing the substantial understatement penalty alone. In six cases, multiple accuracy-related penalties were at issue, and in five cases it was not possible to determine which of the accuracy-related penalties were at issue.

the IRS can assert either or both penalties for the same underpayment of tax, provided the total penalty does not exceed 20 percent of the underpayment.<sup>25</sup> Further, the IRC § 6662(b)(1) and (b)(2) penalties are frequently litigated in the same cases. Courts do not always specify the particular accuracy-related penalty being sustained, and will in some cases rule that the accuracy-related penalty either applies or does not apply, without specifying under which subsection. Therefore, in this report, we will report on both IRC § 6662(b)(1) and IRC § 6662(b)(2) cases together.

### Issues Litigated

In 20 of the 92 cases, taxpayers presented no evidence of reasonable cause or other defenses to the IRS's imposition of the accuracy-related penalty for negligence and substantial understatement of income tax. In the majority of cases, however, taxpayers either argued that the underlying income was not taxable and therefore the penalty was inapplicable, or they presented evidence in support of their claims that the IRS should abate the penalty based on reasonable cause.

### *Underlying Liability*

The accuracy-related penalty cases often involved the issue of whether the income that gave rise to the underpayment penalty was taxable. For example, in five cases, the income at issue was cancellation of indebtedness (COD) income.<sup>26</sup> While the courts did not always agree with the taxpayer about whether the taxpayer had COD income, the courts did agree in each case that the taxpayer was not liable for the accuracy-related penalty.<sup>27</sup> In four of the cases, the U.S. Tax Court held that the IRS failed to prove the elements necessary to hold the taxpayers liable for COD income, and in one case, the Tax Court held there was reasonable cause for the taxpayer to believe the income was not taxable, and, therefore, the penalty was abated.

### *Taxpayer's Subjective Belief as Reasonable Cause*

The most important factor in determining whether a taxpayer has demonstrated reasonable cause is the extent to which the taxpayer attempted to determine his or her correct tax.<sup>28</sup> An honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge, and education of the taxpayer may indicate reasonable cause

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<sup>25</sup> Treas. Reg. § 1.6662-2(c).

<sup>26</sup> IRC § 61(a)(12) provides that gross income includes cancellation of indebtedness income. To the extent that a taxpayer has been released from indebtedness, the taxpayer has realized an accession to income that is taxable because the cancellation of indebtedness effects a freeing of assets previously offset by the liability arising from such indebtedness. *U.S. v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931). There are various exclusions from gross income for COD income, including the circumstance where the taxpayer is insolvent at the time the debt was forgiven. IRC § 108(a)(1)(B).

<sup>27</sup> See, e.g., *Coburn v. Comm'r*, T.C. Memo. 2005-283 (holding that loan was non-recourse to the taxpayer and therefore, income could not be COD income); *Tabrezi v. Comm'r*, T.C. Memo. 2006-61 (holding IRS could not demonstrate that taxpayer was solvent prior to the debt cancellation).

<sup>28</sup> Treas. Reg. § 1.6664-4(b)(1).

and good faith or the lack thereof.<sup>29</sup> Thus, an attorney's claim of honest belief about the tax-free nature of retirement distributions was not deemed to be reasonable cause because of his educational background and level of sophistication.<sup>30</sup> In contrast, when a taxpayer makes concerted efforts to determine whether he should have received Forms 1099, U.S. Information Return, for owning education accounts, including contacting the bank where the accounts were established, consulting a financial adviser, and contacting his former spouse, the totality of the circumstances led the Tax Court to conclude the taxpayer had reasonable cause and had acted in good faith.<sup>31</sup>

In four cases, the accuracy-related penalty was litigated in conjunction with the issue of whether settlement proceeds were taxable and whether there was reasonable cause for taxpayers to believe that the proceeds were not taxable. Settlement proceeds received for a tort-type injury that compensate for physical injury or illness are not taxable.<sup>32</sup> Where the evidence demonstrated that the taxpayer had made a reasonable effort to determine the correct amount of tax liability, the Tax Court found reasonable cause.<sup>33</sup> However, where there appeared to be an attempt to manipulate a settlement agreement for tax purposes, courts were unwilling to find reasonable cause.<sup>34</sup>

Thus, the cases demonstrate that where taxpayers make a reasonable effort to ascertain the correct amount of tax, courts are willing to find reasonable cause. However, where taxpayers engage in manipulation, fail to investigate the tax consequences of their income, or ignore important facts, courts decline to conclude reasonable cause exists.

#### *Reliance on Advice of Tax Professional as Reasonable Cause*

In 25 cases, taxpayers asserted reliance upon a tax professional as a basis to avoid the accuracy-related penalty; however, only eight taxpayers could meet the necessary burden

<sup>29</sup> Treas. Reg. § 1.6664-4(b)(1).

<sup>30</sup> *Sadberry v. Comm'r*, 96 A.F.T.R.2d (RIA) 7119 (5th Cir. 2005).

<sup>31</sup> *Monte v. Comm'r*, T.C. Summ. Op. 2005-77.

<sup>32</sup> Two independent requirements must be met before proceeds from a settlement may be excluded under section 104(a)(2). First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is based upon tort or tort type rights. *Comm'r v. Schleier*, 515 U.S. 323, 337 (1995); see Treas. Reg. § 1.104-1(c). Second, the taxpayer must show that the damages were received on account of personal physical injuries or physical sickness. *Schleier*, 515 U.S. at 337; see IRC § 104(a)(2). See Most Litigated Issue, *Gross Income*, supra.

<sup>33</sup> *Kenton v. Comm'r*, T.C. Memo. 2006-13 (holding that taxpayer made reasonable inquiry into the applicable law when excluding contingent legal fees from gross income, as the Supreme Court had only recently concluded that legal fees incurred by taxpayers under contingent fee agreements could not be excluded from gross income).

<sup>34</sup> *Goode v. Comm'r*, T.C. Memo. 2006-48 (holding that reliance on allocation in settlement agreement was not in good faith where allocation of damages to physical injury was suspect); *Tamberella v. Comm'r*, 96 A.F.T.R.2d (RIA) 5311 (2d Cir. 2005) (where taxpayer ignored allocations to non-physical damages in settlement agreement and failed to demonstrate that mental illness contributed to failure to report the income); *Green v. Comm'r*, T.C. Memo. 2005-250 (where taxpayer knew he had received taxable punitive damages but did not report the income).

of proof.<sup>35</sup> Courts ruling against taxpayers in these cases did so for a variety of reasons, including:

- ◆ Reliance on the tax adviser was unreasonable in light of taxpayer's prior knowledge that the adviser had previously been convicted of tax fraud;<sup>36</sup>
- ◆ Reliance on adviser could not be a defense to a negligence penalty where the negligence was the taxpayer's failure to substantiate his deductions;<sup>37</sup>
- ◆ Reliance on tax shelter promoters and tax advisers referred by promoters is not reasonable because their advice is biased,<sup>38</sup> and
- ◆ Reliance is unreasonable where the adviser is not provided all necessary documentation.<sup>39</sup>

#### *Reliance on Other Factors as Reasonable Cause*

Taxpayers also argued with varying degrees of success that there was reasonable cause to excuse their underpayment of tax based upon reliance on other factors. For example, relying on a Treasury Regulation that conflicts with the statute is not reasonable cause for omitting income where the taxpayer was placed on notice by his employer and the IRS as to the taxable nature of income.<sup>40</sup> On the other hand, reliance on IRS determinations on charitable deductions from audits in previous tax years was reasonable for purposes of abating the accuracy-related penalty.<sup>41</sup> Similarly, when the IRS did not disallow deductions for expenses related to lemon farming in an earlier audit, the Tax Court concluded the taxpayer's reliance on the tax treatment in that earlier audit was reasonable cause for deducting the same expenses in a subsequent year, and the penalty was abated.<sup>42</sup>

Taxpayers also argued that the absence of certain information can constitute reasonable cause and were met with limited success. For example, a taxpayer may not rely on the absence of substantiating documentation in support of a reasonable cause finding.<sup>43</sup> Additionally, taxpayers cannot rely on the absence of Forms 1099 to establish reasonable

<sup>35</sup> See, e.g., *Facq v. Comm'r*, T.C. Memo. 2006-111 (reliance on tax professional was reasonable cause for taxpayer's improper exclusion of gain); *Teymourian v. Comm'r*, T.C. Memo. 2005-232 (reliance on tax professional was reasonable cause for the incorrect tax treatment of constructive dividends and rental income).

<sup>36</sup> *Egan v. Comm'r*, T.C. Memo. 2005-234.

<sup>37</sup> *Lee v. Comm'r*, T.C. Memo. 2006-70.

<sup>38</sup> *Van Scoten v. Comm'r*, 439 F.3d 1243 (10th Cir. 2006); *Mortensen v. Comm'r*, 440 F.3d 375 (6th Cir. 2006).

<sup>39</sup> *King v. Comm'r*, T.C. Memo. 2006-112; *Jackson v. Comm'r*, T.C. Memo. 2005-159.

<sup>40</sup> *Smith v. Comm'r*, T.C. Memo. 2006-51 (taxpayer had no reasonable basis for omitting income by relying on Treas. Reg. § 1.931-1 (which erroneously included Johnston Island as a territory from which income earned is not taxable) when IRC § 931 provided otherwise and the IRS and taxpayer's employer notified taxpayer that the income was taxable).

<sup>41</sup> *Sklar v. Comm'r*, 125 T.C. 281 (2005), *appeal docketed*, No. 06-72961 (9th Cir. June 8, 2006).

<sup>42</sup> *Bangs v. Comm'r*, T.C. Memo. 2006-83.

<sup>43</sup> *Maxfield v. Comm'r*, T.C. Summ. Op. 2006-27; *Kolbeck v. Comm'r*, T.C. Memo. 2005-253.

cause for failing to report income.<sup>44</sup> A taxpayer was, however, able to provide oral testimony rather than books and records to substantiate deductions.<sup>45</sup>

### **Pro Se Analysis**

Taxpayers were *pro se*, or representing themselves, in 51 (or 55 percent) of the cases. These taxpayers fully prevailed in 12 cases and received partial relief in one other. Thus, of the 29 cases in which taxpayers prevailed in full or in part, taxpayers were unrepresented in almost half of the cases.

### **CONCLUSION**

The accuracy-related penalty cases demonstrate that courts are willing to find reasonable cause where taxpayers make a reasonable attempt to determine the correct amount of tax. In finding reasonable cause, courts assessed the effort of taxpayers and their sophistication, as well as the complexity of the legal issues. Where taxpayers knew or should have known facts that would have led to a determination that the income was taxable, courts did not find reasonable cause to abate the accuracy-related penalty.

<sup>44</sup> *PK Ventures, Inc. v. Comm’r*, T.C. Memo. 2006-36; *Snyder v. Comm’r*, T.C. Memo. 2006-92.

<sup>45</sup> *Allemeier v. Comm’r*, T.C. Memo. 2005-207.

**LITIGATED  
ISSUE #5****FAILURE TO FILE PENALTY UNDER INTERNAL REVENUE CODE SECTION 6651(A)(1) AND  
ESTIMATED TAX PENALTY UNDER INTERNAL REVENUE CODE SECTION 6654****SUMMARY**

We reviewed 78 decisions regarding the addition to tax under IRC § 6651(a)(1) for failure to file a timely tax return or the addition to tax under IRC § 6654 for failure to pay estimated income tax that were issued by the federal court system from June 1, 2005, to May 31, 2006, the period which this report covers.<sup>1</sup> The phrase “addition to tax” is commonly referred to as a penalty. We will refer to these two additions to tax as the failure to file penalty and the estimated tax penalty. The IRS prevailed in all but two cases;<sup>2</sup> one other case resulted in a split decision.<sup>3</sup> Of the 78 cases, 43 involved the estimated tax penalty being imposed in conjunction with the failure to file penalty, while only one involved the estimated tax penalty without the failure to file penalty being imposed.

The failure to file penalty is mandatory unless the taxpayer can demonstrate that the failure to timely file a tax return is a result of reasonable cause and not due to willful neglect.<sup>4</sup> The penalty for failure to pay estimated taxes is also mandatory unless the taxpayer can meet one of the exceptions listed in the statute.<sup>5</sup> In the cases analyzed, it was very difficult for the taxpayer to avoid the failure to file penalty based on reasonable cause or the estimated tax penalty based on any of the statutory exceptions.

**PRESENT LAW**

Under IRC § 6651(a)(1), a taxpayer who fails to file a tax return before its due date (including extensions) will be subject to a five percent penalty for each month or partial month the return is late.<sup>6</sup> This penalty generally accumulates for each month the return is not filed up to a maximum of 25 percent.<sup>7</sup> The penalty is based on the amount of tax due, minus any credit the taxpayer is entitled to receive or payment made by the due date.<sup>8</sup> The failure to file penalty applies to income, estate, gift, and certain excise tax returns.<sup>9</sup> IRC § 6698 provides for a penalty for failure to file partnership returns, which is based on different criteria but also carries a reasonable cause component.<sup>10</sup>

<sup>1</sup> IRC § 6651(a)(2) and (a)(3) also impose additions to tax for failure to pay taxes; however, only a small number of cases involved these penalties, and therefore, we have not included them in our analysis.

<sup>2</sup> *Doudney v. Comm’r*, T.C. Memo. 2005-267; *McManus v. Comm’r*, T.C. Memo. 2006-57.

<sup>3</sup> *Leggett v. Comm’r*, T.C. Memo. 2005-185.

<sup>4</sup> IRC § 6651(a)(1).

<sup>5</sup> IRC § 6654(e).

<sup>6</sup> IRC § 6651(a)(1).

<sup>7</sup> *Id.* The penalty is increased to 15 percent per month up to a maximum of 75 percent if the failure to file is fraudulent. IRC § 6651(f).

<sup>8</sup> IRC § 6651(b).

<sup>9</sup> IRC § 6651(a)(1).

<sup>10</sup> IRC § 6698.

IRC § 6654 imposes a penalty for failure to pay estimated income tax where prepayments of tax, either through withholding or by making estimated quarterly tax payments during the course of a year, do not equal the percentage of total liability required. In general, the amount required to be paid through each such estimated quarterly payment is 25 percent of the “required annual payment,” where the “required annual payment” is the lesser of 90 percent of the tax shown on the return for that year or 100 percent of the tax shown on the return of the individual for the preceding taxable year.<sup>11</sup> The amount of the penalty will be determined by applying the underpayment rate according to IRC § 6621 to the amount of the underpayment for the period of the underpayment.<sup>12</sup> The penalty for failure to pay estimated tax applies to income tax returns of individuals and certain estates and trusts.<sup>13</sup>

The IRS has the burden of production in any court proceeding with respect to the liability of any individual for the IRC § 6651(a) penalty and the IRC § 6654(a) penalty.<sup>14</sup> The IRS must produce sufficient evidence indicating that it is appropriate to impose the relevant penalty.<sup>15</sup> It is very unusual for the IRS not to meet this burden. Once the IRS does so, the taxpayer must come forward with evidence sufficient to persuade a court that the IRS’s determination is incorrect.<sup>16</sup>

The taxpayer also bears the burden of proof with regard to issues of reasonable cause.<sup>17</sup> To prove reasonable cause and avoid the IRC § 6651 penalty, a taxpayer must show that he or she exercised ordinary business care and prudence, but was still unable to file by the due date.<sup>18</sup> As discussed in greater detail below, however, there is only a limited reasonable cause exception to the IRC § 6654 penalty; generally the imposition of the IRC § 6654 penalty is mandatory where the estimated payments do not equal the statutorily required percentage.

### ANALYSIS OF LITIGATED CASES

We analyzed 78 opinions issued between June 1, 2005, and May 31, 2006, where the failure to file penalty or the estimated tax penalty was in dispute. All but seven of these cases were litigated in the United States Tax Court. A detailed listing of these cases

<sup>11</sup> IRC § 6654(d).

<sup>12</sup> IRC § 6654(a)(1) – (3).

<sup>13</sup> IRC §§ 6654(a); 6654(l).

<sup>14</sup> IRC § 7491(c). An exception to this rule alleviates the IRS from this initial burden where the taxpayer’s petition fails to state a claim for relief from the penalty, such as where the taxpayer only makes frivolous arguments. *Funk v. Comm’r*, 123 T.C. 213 (2004).

<sup>15</sup> *Higbee v. Comm’r*, 116 T.C. 438, 446 (2001).

<sup>16</sup> *Higbee v. Comm’r*, 116 T.C. 438, 446 (2001) at 447.

<sup>17</sup> *Id.*

<sup>18</sup> Treas. Reg. § 301.6651-1(c)(1).

appears in Table 5 in Appendix 3.<sup>19</sup> Taxpayers were represented by attorneys in only 16 cases. Of the 62 cases in which taxpayers appeared *pro se*, only one case was resolved in the taxpayer's favor and one other case resulted in a split decision. Thus, taxpayers were unrepresented in the vast majority of cases decided in the IRS's favor.

#### *Failure to File Penalty*

A common basis for the courts ruling against taxpayers in the cases we analyzed was the lack of any evidence offered to show that the failure to file was due to reasonable cause.<sup>20</sup> In fact, in more than 50 percent of the cases, the taxpayer did not present any evidence of reasonable cause.

In cases where taxpayers did present evidence of reasonable cause in defense of their failures to file timely (or at all), the arguments included the following:

- ◆ **Medical Illness:** Depending on the facts and circumstances, a medical illness may establish reasonable cause for failing to file a tax return timely.<sup>21</sup> However, medical illness did not establish reasonable cause when the illness did not prevent the taxpayer from functioning in other aspects of life, such as work.<sup>22</sup> Similarly, health issues of one spouse did not constitute reasonable cause for the late filing of a joint return when those health issues did not prevent the other spouse from tending to the return.<sup>23</sup>
- ◆ **Unavailability of Records:** Generally, the unavailability of records does not constitute reasonable cause.<sup>24</sup> However, taxpayers who use ordinary business care and prudence to obtain the records may be able to demonstrate reasonable cause for not timely filing.<sup>25</sup> When taxpayers (husband and wife) raised the unavailability of records due to a subpoena issued for their bankruptcy proceeding as a basis for determining reasonable cause, the Tax Court rejected this argument, noting that although the records were unavailable, taxpayers should have made an attempt to file a return reporting income and expenses as accurately as they could.<sup>26</sup>

<sup>19</sup> Sixty-nine cases involved individual taxpayers, and nine involved businesses (including individuals engaged in self-employment or partnerships).

<sup>20</sup> *Barrett v. Comm'r*, T.C. Summ. Op. 2006-42; *Ferguson v. Comm'r*, T.C. Memo. 2006-32; *Howard v. Comm'r*, T.C. Memo. 2005-144.

<sup>21</sup> *Harbour v. Comm'r*, T.C. Memo. 1991-532. In *Harbour*, the taxpayer was in a coma during the month before his tax return was due. Clearly, he was not able to work during this time or participate in any other life activities. Therefore, the Tax Court determined this medical condition was a reasonable cause for failure to timely file his tax return.

<sup>22</sup> *Gropper v. U.S.*, 96 A.F.T.R.2d (RIA) 7133 (E.D. Pa. 2005); *Jordan v. Comm'r*, T.C. Memo. 2005-266.

<sup>23</sup> *Lites v. Comm'r*, T.C. Memo. 2005-206.

<sup>24</sup> *Crocker v. Comm'r*, 92 T.C. 899, 913 (1989) (citation omitted).

<sup>25</sup> *Haley v. Comm'r*, T.C. Memo. 1977-348.

<sup>26</sup> *Ferguson v. Comm'r*, T.C. Memo. 2006-32.

- ◆ **Reliance on Tax Professional:** Some taxpayers argued that reliance upon a professional to timely file the return was a defense to the failure to file penalty.<sup>27</sup> However, the Supreme Court has made clear in *United States v. Boyle* that taxpayers have a non-delegable duty to file a return on time, and the taxpayer's reliance on an agent does not excuse the failure.<sup>28</sup>
- ◆ **Reliance on Spouse or Other Agent:** The *Boyle* rule against reliance on third parties to file tax returns also applies to reliance on family members. A taxpayer was unable to rely on her spouse to file a return.<sup>29</sup> Similarly, reliance on the advice of others regarding the obligation to file or the date for filing did not constitute reasonable cause.<sup>30</sup>
- ◆ **“Zero Return” Filers/Returns Filed Under Protest, Disclaiming Liability:** Under the longstanding decision in *Beard v. Commissioner*, a return must be signed under penalties of perjury, purport to be a return, and represent an honest and reasonable attempt to satisfy the requirements of the tax laws.<sup>31</sup> Some taxpayers protested their obligation to pay taxes by filing tax returns with zeroes on every line of the tax return.<sup>32</sup> These taxpayers argued unsuccessfully that because they filed a tax return, they should not be assessed a failure to file penalty; a “zero return” does not, however, constitute a tax return for purposes of IRC § 6651.

Similarly, where a taxpayer attached a cover page to each of his returns indicating he was filing the returns under protest and also wrote “under protest” in the jurat / signature box on the return, the Tax Court held that such returns did not satisfy the test for a valid return enunciated in *Beard*.<sup>33</sup>

The one constant theme throughout these different types of cases is that the existence of reasonable cause in any given case depends on all the facts and circumstances of the case.<sup>34</sup> Moreover, to the extent that the Tax Court finds that a taxpayer's argument for

<sup>27</sup> *Thibodeaux v. Comm'r*, T.C. Summ. Op. 2005-105.

<sup>28</sup> *United States v. Boyle*, 469 U.S. 241, 252 (1985) (“It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not ‘reasonable cause’ for a late filing under § 6651(a)(1).”).

<sup>29</sup> *Bennett v. Comm'r*, T.C. Summ. Op. 2005-84.

<sup>30</sup> *Martella v. Comm'r*, T.C. Memo. 2005-216 (taxpayer relied on advice available on the internet from unofficial non-governmental third parties regarding the obligation to file); *Welch v. U.S.*, 97 A.F.T.R.2d (RIA) 2453 (D.N.J. 2006) (taxpayer relied on oral advice of IRS employee regarding extended due date).

<sup>31</sup> *Beard v. Commissioner*, 82 T.C. 766, 777 (1986) (citation omitted), *aff'd*, 793 f.2d 139 (6th Cir. 1986).

<sup>32</sup> *Bonaccorso v. Comm'r*, T.C. Memo. 2005-278; *Coulton v. Comm'r*, T.C. Memo. 2005-199.

<sup>33</sup> *Lange v. Commissioner*, T.C. Memo. 2005-200; *Lange v. Commissioner*, T.C. Memo. 2005-176.

<sup>34</sup> IRM 20.1.1.3.1(1).

reasonable cause is frivolous or groundless, the Tax Court may require a taxpayer to pay a penalty under IRC § 6673 of up to \$25,000.<sup>35</sup>

#### *Failure to Pay Estimated Tax*

When the estimated tax penalty under IRC § 6654(a) is imposed, it is almost always imposed in conjunction with IRC § 6651(a)(1). In fact, in 43 of the 78 cases we reviewed, The IRC § 6654(a) penalty was imposed in conjunction with the IRC § 6651(a)(1) penalty. Although these two code sections are often applied in conjunction with one another, the analysis under IRC § 6654(a) is different than the analysis under IRC § 6651(a)(1). One of the most significant differences is IRC § 6654(a) does not provide for a broadly applicable reasonable cause exception. To avoid the estimated tax penalty, the taxpayer has the burden of proving one of the following exceptions:

- ◆ The tax is a small amount;<sup>36</sup>
- ◆ There is no tax liability for the preceding year;<sup>37</sup>
- ◆ The Secretary determines that by reason of casualty, disaster, or other unusual circumstances the imposition of the penalty would be against equity and good conscience;<sup>38</sup> or
- ◆ The taxpayer retired after reaching the age of 62 or became disabled in the taxable year for which estimated payments were required to be made or in the taxable year preceding such year and the underpayment was due to reasonable cause and not willful neglect.<sup>39</sup>

The first three exceptions are fairly straightforward, but the last exception depends more on the facts and circumstances of the case. It is often as difficult for taxpayers to meet the retired or disabled reasonable cause exception as it is for them to meet the broader reasonable cause exception under IRC § 6651. For example, a taxpayer who was disabled because of a detached retina did not have reasonable cause for failing to timely make estimated tax payments, and therefore, was liable for the addition to tax for failure to pay estimated tax.<sup>40</sup> Again, the existence of reasonable cause depends on the specific facts and circumstances of each particular case.

In the only two cases where the taxpayers prevailed on the estimated tax penalty, the taxpayers' success was as a result of the IRS failing to meet its burden of production

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<sup>35</sup> *Holmes v. Commissioner*, T.C. Memo. 2006-80 (taxpayer subject to \$2,000 penalty for frivolous argument that filing returns is voluntary); *Wheeler v. Commissioner*, T.C. Memo. 2006-109 (taxpayer subject to \$3,000 penalty for frivolous arguments that he had no obligation to file).

<sup>36</sup> IRC § 6654(e)(1).

<sup>37</sup> IRC § 6654(e)(2).

<sup>38</sup> IRC § 6654(e)(3)(A).

<sup>39</sup> IRC § 6654(e)(3)(B).

<sup>40</sup> *Cooksey v. Comm'r*, T.C. Summ. Op. 2006-84.

regarding the appropriateness of the penalty.<sup>41</sup> In order for the IRS to meet the burden of production, it must produce sufficient evidence indicating that it is appropriate to impose the relevant penalty.<sup>42</sup> In the context of the estimated tax penalty, the IRS must show that the taxpayer did not make estimated tax payments for that tax year. These two cases are noteworthy because it is very unusual for the IRS not to meet the burden of production.

### CONCLUSION

The United States tax system relies on taxpayers' willingness to voluntarily and accurately report their income, file returns, and pay taxes. Penalties encourage this type of compliance and deter noncompliance, while also attempting to establish fairness in the system by imposing an additional cost on the noncompliant taxpayer. The penalties for failure to file and failure to pay estimated tax were designed to encourage compliance and make it clear that noncompliance would not be tolerated.<sup>43</sup> Further, both penalties seek to establish fairness by penalizing those taxpayers who do not comply with the filing deadline and tax payment responsibilities.

In regards to the failure to file penalty, the IRS should determine whether this penalty positively influences compliance as intended. Congress should again consider the National Taxpayer Advocate's recommendation of a one-time abatement of the penalty for taxpayers who comply with their filing obligations, but in an untimely manner.<sup>44</sup> This proposal would both broaden the definition of reasonable cause, providing the IRS the authority to abate a late filing penalty for inadvertent taxpayer mistakes, while still encouraging the IRS's goal of voluntary compliance.

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<sup>41</sup> *Leggett v. Comm'r*, T.C. Memo. 2005-185; *McManus v. Comm'r*, T.C. Memo. 2006-57.

<sup>42</sup> *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001).

<sup>43</sup> See Policy Statement P-1-18 dated April 27, 1992, IRM 1.2.1.2.3.

<sup>44</sup> National Taxpayer Advocate 2001 Annual Report To Congress 188. This provision was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003. See H.R. 1528, 108th Cong. § 106 (2003).

LITIGATED  
ISSUE #6FRIVOLOUS ISSUES PENALTY UNDER INTERNAL REVENUE CODE SECTION 6673 AND  
RELATED APPELLATE-LEVEL SANCTIONS

## SUMMARY

During the 12 months between June 1, 2005, and May 31, 2006, the federal court system issued decisions in at least 73 cases involving the IRC § 6673 penalty and at least 25 cases involving an analogous penalty at the appellate level.<sup>1</sup> These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, or unreasonably failing to pursue administrative remedies.<sup>2</sup> In 24 of the 73 cases involving IRC § 6673, the U.S. Tax Court decided not to impose the penalty but warned taxpayers that sanctions may be imposed in the future if they engaged in similar conduct.<sup>3</sup> Nonetheless, we included these cases in our analysis to help illustrate what conduct will and will not be tolerated by the courts.

## PRESENT LAW

The 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.<sup>4</sup> The maximum penalty is \$25,000.<sup>5</sup> In some cases, the IRS requests that the Tax Court impose the penalty; in other cases, the court may exercise its discretion, *sua sponte*,<sup>6</sup> to impose the penalty.

Taxpayers who institute an action pursuant to IRC § 7433<sup>7</sup> in a United States district court for damages against the United States could be subject to a maximum penalty of \$10,000 if the court determines that the taxpayer's position in the proceedings is frivolous or groundless.<sup>8</sup>

<sup>1</sup> In 11 cases, the U.S. Court of Appeals both affirmed the imposition of the IRC § 6673 penalty by the U.S. Tax Court and imposed an additional sanction against the taxpayer for filing a frivolous appeal. Thus, the total number of cases we have identified involving frivolous claims is 87.

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

<sup>3</sup> See, e.g., *Balice v. Comm'r*, T.C. Memo. 2005-161.

<sup>4</sup> IRC § 6673(a)(1)(A), (B), (C).

<sup>5</sup> IRC § 6673(a)(1).

<sup>6</sup> "Sua sponte" is a term that means without prompting or suggestion. Thus, for conduct that the Tax Court finds particularly offensive, the Tax Court can choose to impose a penalty under IRC § 6673 even if the IRS has not requested that the penalty be imposed. See, e.g., *Call v. Comm'r*, T.C. Memo. 2005-289 (Tax Court imposed \$5,000 penalty without being asked to do so where taxpayer presented frivolous arguments to delay collection proceedings).

<sup>7</sup> IRC § 7433(a) allows taxpayers a cause of action against the IRS, as follows:

If, in connection with any collection of Federal tax with respect to a taxpayer, any officer or employee of the Internal Revenue Service recklessly or intentionally, or by reason of negligence, disregards any provision of this title, or any regulation promulgated under this title, such taxpayer may bring a civil action for damages against the United States in a district court of the United States. Except as provided in section 7432, such civil action shall be the exclusive remedy for recovering damages resulting from such actions.

<sup>8</sup> IRC § 6673(b)(1).

In addition, IRC § 7482(c)(4),<sup>9</sup> § 1927 of Title 28 of the U.S. Code,<sup>10</sup> and Rule 38 of the Federal Rules of Appellate Procedure<sup>11</sup> (among other laws and rules of procedure) authorize Federal courts to impose penalties against taxpayers for raising frivolous arguments or using litigation tactics primarily to delay the collection process. Because the sources of authority for imposing appellate-level sanctions are numerous and some of these sanctions may be imposed in non-tax cases, this report focuses primarily on the IRC § 6673 penalty. However, the table of cases presented in Table 6 of Appendix 3 lists 25 cases we identified in which U.S. Courts of Appeals considered the imposition of appellate-level sanctions under other authorities. It imposed such sanctions in 22 of those cases.

### ANALYSIS OF LITIGATED CASES

We analyzed 73 opinions issued between June 1, 2005 and May 31, 2006, where the IRC § 6673 penalty was addressed. Fifty-five of these opinions were issued by the Tax Court, one was issued by a U.S. District Court, and 17 were issued by U.S. Courts of Appeals on appeals brought by taxpayers who sought review of the Tax Court's imposition of the penalty. Notably, the Courts of Appeals sustained the Tax Court's imposition of the penalty in each of the 17 cases it decided. A detailed listing of all cases is presented in Table 6 of Appendix 3. We identified only 8 cases that unambiguously involved business taxpayers (which includes a taxpayer filing a Form 1040 with a Schedule C, E, or F), and the status of a taxpayer as either an individual filer or a business filer was unclear in at least 12 other cases. With the exception of one unusual case,<sup>12</sup> no taxpayer was represented by an attorney; thus, all taxpayers except in that case appeared *pro se*. In the 42 cases where either the IRS sought the imposition of the IRC § 6673 penalty or the Tax Court imposed it *sua sponte*, the taxpayer prevailed in only 10 cases. Therefore, taxpayers were unrepresented in virtually all IRC § 6673 penalty cases, and the IRS was successful in obtaining the penalty about 75 percent of the time.

The taxpayers in these cases presented a wide variety of arguments that generally have been rejected by the courts on numerous occasions. In summarizing the nature of frivolous taxpayer claims, one U.S. Court of Appeals has observed:

Some people believe with great fervor preposterous things that just happen to coincide with their self-interest. 'Tax protesters' have convinced them-

<sup>9</sup> IRC § 7482(c)(4) provides that the United States Courts of Appeals and the United States Supreme Court have the authority to impose a penalty in any case where the Tax Court's decision is affirmed if the appeal was instituted or maintained primarily for delay or the taxpayer's position in the appeal was frivolous or groundless.

<sup>10</sup> 28 U.S.C. § 1927 authorizes federal courts to sanction an attorney or any other person admitted to practice before any court of the United States or any Territory thereof for unreasonably and vexatiously multiplying proceedings.

<sup>11</sup> 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 of the appellee.

<sup>12</sup> *Dixon v. Comm'r*, T.C. Memo. 2006-67, appeal docketed, No. 06-74649 (9th Cir. Sept. 26, 2006).

selves that wages are not income, that only gold is money, that the Sixteenth Amendment is unconstitutional, and so on.<sup>13</sup>

Among the cases we reviewed, taxpayers raised the following arguments that the Tax Court has deemed frivolous and groundless and consequently were subject to a penalty under IRC § 6673(a)(1) (or, in some cases, were warned that such arguments were frivolous and could lead to a penalty in the future if the same frivolous positions were maintained):

- ◆ **The income tax is unconstitutional:** Constitutional objections to the income tax are varied. In *Lewis v. Commissioner*, the taxpayer argued that the assessment of tax violates “most basic ‘DUE PROCESS’ protections as provided by [the] 4th, 5th, 6th and 7th Amendments.”<sup>14</sup> In *Taylor v. Commissioner*, the taxpayer argued that requiring individuals to file and sign tax returns violates the 5th Amendment protection against self-incrimination.<sup>15</sup> In *Stallard v. Commissioner*, the taxpayer argued that the income tax constitutes a “taking of property without due process of law, in violation of the 5th Amendment.”<sup>16</sup> In *Forrest v. Commissioner*, the taxpayer challenged the validity of the 16th Amendment, which authorizes a direct tax on income.<sup>17</sup>
- ◆ **No statute imposes liability for tax:** The majority of taxpayers in the cases we reviewed did not dispute the constitutionality of the income tax. Several argued simply that no law authorizes the imposition of income tax.<sup>18</sup>
- ◆ **IRS forms do not display a valid OMB control number:** One taxpayer argued that he was not required to file tax returns because IRS forms do not display a valid control number issued by the Office of Management and Budget, in violation of the Paperwork Reduction Act of 1980.<sup>19</sup> Similarly, the Tax Court rejected an argument that a notice of deficiency was invalid without an OMB control number.<sup>20</sup>
- ◆ **The payment of tax is voluntary:** This argument, presumably a corollary to the argument that the payment of tax is not required by law, was made in several cases.<sup>21</sup>
- ◆ **Texas residents are not subject to the income tax:** Taxpayers who reside in Texas have advanced several arguments in opposition to the assessment or collection of

<sup>13</sup> *Coleman v. Comm’r*, 791 F.2d 68, 69 (7th Cir. 1986).

<sup>14</sup> T.C. Memo. 2006-73.

<sup>15</sup> T.C. Memo. 2006-67.

<sup>16</sup> T.C. Memo. 2006-42, *appeal docketed*, No. 06-1190 (D.C. Cir. June 1, 2006).

<sup>17</sup> T.C. Memo. 2005-228.

<sup>18</sup> See, e.g., *Horowitz v. Comm’r*, T.C. Memo. 2006-91 (taxpayer stated he could not find any “statute or regulation making [me] liable for an income tax.”); *Bonaccorso v. Comm’r*, T.C. Memo. 2005-278 (taxpayer received compensation exceeding \$90,000 in each year at issue yet contended, “I found no code section that made me liable for any income tax.”).

<sup>19</sup> *Saxon v. Comm’r*, T.C. Memo. 2006-52.

<sup>20</sup> *Holliday v. Comm’r*, T.C. Memo. 2005-240.

<sup>21</sup> See, e.g., *Holmes v. Comm’r*, T.C. Memo. 2006-80; *Crow v. Comm’r*, T.C. Summ. Op. 2005-124.

income tax against them. In *Holmes v. Commissioner*, the taxpayer asserted that his domicile is outside the United States because he lived in the “compact state of Texas state republic.”<sup>22</sup> In *Hennard v. Commissioner*, the taxpayer argued that the IRS is not authorized to practice law in Texas.<sup>23</sup>

- ◆ **Private sector wages are not subject to the income tax:** In *Lange v. Commissioner*, the taxpayer argued that the income tax properly applies only to wages received from the government – not to wages received from private sector employers.<sup>24</sup>
- ◆ **Notices of deficiency are not properly signed:** At least one taxpayer argued that a notice of deficiency was invalid because the person sending it lacked sufficient authority to sign the notice.<sup>25</sup>
- ◆ **Income earned is not described in IRC § 861:** Taxpayers sometimes argue that compensation for services is not subject to tax because it is not listed in IRC § 861 as one of the “items of gross income [that] shall be treated as income from sources within the United States.”<sup>26</sup> The Internal Revenue Code is clear, however, that compensation for services is subject to tax under IRC § 61(a)(1).

While many of the cases we reviewed involved the penalty under IRC § 6673(a)(1)(B) against taxpayers for taking a frivolous or groundless position in a Tax Court proceeding, the Tax Court also imposed the penalty under IRC § 6673(a)(1)(A) against taxpayers for instituting or maintaining proceedings primarily for delay:

- ◆ **Collection Due Process (CDP) claims were maintained to delay collection of tax:** When the IRS is proposing to impose a levy, the taxpayer has a right to a Collection Due Process hearing with the IRS Office of Appeals.<sup>27</sup> The taxpayer may appeal an adverse administrative determination to the Tax Court. These rights were established by Congress, and the National Taxpayer Advocate believes that CDP reviews are critical to ensuring the protection of taxpayer rights in the collection process. In the nine CDP cases where the Tax Court imposed the IRC § 6673 penalty, however, the court generally concluded that the taxpayer had abused the CDP process to delay collection.<sup>28</sup>

In only one case we reviewed did taxpayers ask the Tax Court to sanction the IRS’s attorney. In *Dixon v. Comm’r*, a group of taxpayers who had engaged in a tax-shelter

<sup>22</sup> T.C. Memo. 2006-80.

<sup>23</sup> T.C. Memo. 2005-275.

<sup>24</sup> T.C. Memo. 2005-200, *appeal docketed*, No. 06-1116 (6th Cir. Jan. 25, 2006).

<sup>25</sup> *Lewis v. Comm’r*, T.C. Memo. 2006-73.

<sup>26</sup> See, e.g., *Woods v. Comm’r*, T.C. Memo. 2006-38.

<sup>27</sup> IRC § 6330(a)(3)(B).

<sup>28</sup> See, e.g., *Carrillo v. Comm’r*, T.C. Memo. 2005-290; *Quigley v. Comm’r*, T.C. Memo. 2005-153.

## MOST LITIGATED

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transaction sought sanctions against the IRS under IRC § 6673(a)(2)(B)<sup>29</sup> for its conduct before the U.S. Court of Appeals for the Ninth Circuit. The Court of Appeals for the Ninth Circuit found that IRS attorneys had perpetrated a fraud on the court and remanded the consolidated cases to the Tax Court to determine whether the taxpayers were entitled to attorneys' fees and expenses.<sup>30</sup> The Tax Court concluded that an award of attorneys' fees was appropriate under IRC § 7430 but not under § 6673.<sup>31</sup>

**CONCLUSION**

Taxpayers did not raise genuine issues in virtually any of the cases we analyzed. These taxpayers raised frivolous arguments, which have been repeatedly litigated and rejected in the past. The courts have consistently stated that these boilerplate arguments are frivolous and without merit. The message of these cases is clear: Where taxpayers assert frivolous arguments to impede or delay the collection of tax, the IRS often will seek the imposition of a penalty under IRC § 6673 (in addition to tax, interest, and other penalties that may apply), and the Tax Court in most cases will impose the penalty. Moreover, even if the IRS does not request a penalty, taxpayers may face sanctions if the Tax Court concludes their conduct falls within the conduct that Congress made subject to IRC § 6673. Finally, U.S. Courts of Appeals almost invariably will sustain the Tax Court's imposition of the IRC § 6673 penalty and will generally impose further sanctions on taxpayers who pursue frivolous appeals.

<sup>29</sup> IRC § 6673(a)(2)(B) provides that if the Tax Court finds that an attorney appearing on behalf of the Commissioner of Internal Revenue multiplied the proceedings unreasonably and vexatiously, the Tax Court may require that the United States pay the excess costs, expenses, and attorneys' fees.

<sup>30</sup> See *Dixon v. Comm'r*, 316 F.3d 1041 (9th Cir. 2003).

<sup>31</sup> *Dixon v. Comm'r*, T.C. Memo. 2006-97, *appeal docketed*, No. 06-74649 (9th Cir. Sept. 26, 2006).

**LITIGATED  
ISSUE #7****TRADE OR BUSINESS EXPENSES UNDER INTERNAL REVENUE CODE SECTION 162 AND  
RELATED SECTIONS****SUMMARY**

The deductibility of trade or business expenses is perennially one of the ten most litigated tax issues in the federal courts. We identified 68 cases that included a trade or business expense issue and were litigated between June 1, 2005 and May 31, 2006. The courts affirmed the IRS position in 75 percent of the cases, while taxpayers prevailed less than five percent of the time.<sup>1</sup> The remaining cases resulted in split decisions.

**PRESENT LAW**

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

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

Although “trade or business” is one of the most widely used terms in the IRC, neither the Code nor the Treasury Regulations provide a definition.<sup>2</sup> The definition of “trade or business” comes from the common law of federal income tax, where the concepts have been developed and refined by the courts.<sup>3</sup> 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 making income or a profit.<sup>4</sup>

*What is an ordinary and necessary expense?*

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

<sup>1</sup> The IRS prevailed in 51 of 68 cases, while taxpayers prevailed in only three.

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

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

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

<sup>5</sup> 290 U.S. 111, 113 (1933).

“ordinary” expense as customary or usual and of common occurrence in the taxpayer’s trade or business.<sup>6</sup> The Court describes a “necessary” expense as one that is appropriate and helpful for development of the business.<sup>7</sup>

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

*When is an expense paid or incurred during the taxable year?*

IRC § 162(a) requires an expense to be “paid or incurred during the taxable year” in order to be deductible. The Code also requires a taxpayer to maintain books and records that substantiate income, deductions, and credits – including adequate records to substantiate deductions claimed as trade or business expenses.<sup>9</sup> If a taxpayer is unable to substantiate deductions by documentary evidence (*e.g.*, invoice, paid bill, or canceled check) but can establish that he or she had some deductible business expenditures, the courts may opt to employ the Cohan rule to grant the taxpayer a reasonable amount of deductions.

The *Cohan* rule is a rule of “indulgence” established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.<sup>10</sup> In *Cohan*, the court held that the taxpayer’s business expense deductions were not adequately substantiated, but “... the [Tax Court] should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent.”<sup>11</sup>

The *Cohan* rule may not be utilized in situations where IRC § 274(d) applies. Section 274(d) provides that unless a taxpayer complies with strict substantiation rules, no deduction is allowable for (1) traveling expenses, (2) entertainment expenses, (3) gifts, or (4) certain “listed property.”<sup>12</sup> A taxpayer is required to substantiate a claimed IRC §

<sup>6</sup> *Deputy v. Du Pont*, 308 U.S. 488, 495 (1940).

<sup>7</sup> *Comm’r v. Tellier*, 383 U.S. 687, 679 (1996) (citations omitted).

<sup>8</sup> *Comm’r v. Lincoln Elec. Co.*, 176 F.2d 815, 817 (6th Cir. 1949) (citation omitted).

<sup>9</sup> IRC § 6001. See also Treas. Reg. § 1.6001-1 and Treas. Reg. § 1.446-1(a)(4).

<sup>10</sup> 39 F.2d 540 (2nd Cir. 1930).

<sup>11</sup> *Cohan v. Comm’r*, 39 F.2d 540, 544 (2nd Cir. 1930).

<sup>12</sup> “Listed property” includes any property used as a means of transportation; any property of a type generally used for purposes of entertainment, recreation, or amusement; computer or peripheral equipment (except when used exclusively at a regular business establishment); cell phones; or other property specified in regulations. IRC § 280F(d)(4)(A) and (B).

274(d) expense with adequate records or sufficient evidence corroborating the taxpayer's statement establishing the amount, time, place, and business purpose of the expense.<sup>13</sup>

*Who has the burden of proof in a substantiation case?*

Generally, a taxpayer bears the burden of proving entitlement to the business expense deductions and that the IRS's proposed determination of tax liability is incorrect.<sup>14</sup>

Section 7491(a) provides that the burden of proof shifts to the IRS when a taxpayer:

- ◆ Introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer's liability;
- ◆ Complies with the requirements to substantiate deductions;
- ◆ Maintains all records required under the Code; and
- ◆ Cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.<sup>15</sup>

#### ANALYSIS OF LITIGATED CASES

Trade or business expense cases have been one of the ten most litigated tax issues in the federal courts since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.<sup>16</sup> We reviewed 68 cases involving various trade or business expense issues that were litigated in federal courts from June 1, 2005, through May 31, 2006. Table 7 in Appendix 3 contains a detailed listing of those cases.

Table 3.7.1 categorizes the main trade or business expense issues raised by taxpayers. Cases involving more than one issue are included in more than one category. In *Her v. Commissioner*,<sup>17</sup> for example, the taxpayer raised three distinct trade or business expense issues, so *Her* is included in three categories in Table 3.7.1.

<sup>13</sup> Treas. Reg. § 1.274-5T(b).

<sup>14</sup> See *Welch v. Helvering*, 290 U.S. 111, 115 (1933) and Tax Court Rule 142(a).

<sup>15</sup> IRC § 7491(a)(1) applies to a court proceeding in which the examination started after July 22, 1998, and if there is no examination, to the taxable period or events which started or occurred after July 22, 1998.

<sup>16</sup> National Taxpayer Advocate 1998-2005 Annual Reports to Congress.

<sup>17</sup> T.C. Summ. Op. 2005-187.

**TABLE 3.7.1, TRADE OR BUSINESS EXPENSE CASES AND ISSUES**

Issue	Type of Taxpayer	
	Individual	Business (including sole-proprietors)
Substantiation of Expenses <sup>18</sup>	9	28
Profit Objective <sup>19</sup>	2	13
Ordinary and Necessary Trade or Business Expenses <sup>20</sup>	6	10
Personal vs. Business Expenses <sup>21</sup>	3	6
Travel Expenses <sup>22</sup>	2	3
Compensation Expense Issues <sup>23</sup>	0	4
Education Expenses <sup>24</sup>	2	0

**TABLE 3.7.2, PREVAILING PARTY IN TRADE OR BUSINESS EXPENSE COURT DECISIONS, PRO SE TAXPAYER VERSUS TAXPAYERS WITH REPRESENTATION**

Type of Taxpayer	IRS	Taxpayer	Split	Total
<i>Pro Se</i>	37	1	9	47
Represented	14	2	5	21
<b>Totals</b>	<b>51</b>	<b>3</b>	<b>14</b>	<b>68</b>

Over two-thirds of the taxpayers litigating trade or business deduction issues represented themselves (*pro se*). In terms of percentage, represented taxpayers fared somewhat better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in one-third of litigated cases (seven of 21), while *pro se* taxpayers received relief in 21 percent of litigated cases (ten of 47).<sup>25</sup> In terms of the number of cases, however,

<sup>18</sup> IRC § 6001 and Treas. Reg. § 1.6001 require a taxpayer to maintain books and records that substantiate income, deductions, and credits. Treasury Regulation § 1.162-17 provides guidance regarding maintaining adequate records to substantiate deductions claimed as trade or business expenses.

<sup>19</sup> IRC § 183(a) provides that no deduction attributable to an activity shall be allowed if such activity is not engaged in for profit.

<sup>20</sup> IRC § 162(a) allows deductions for ordinary and necessary trade or business expenses paid or incurred during the taxable year.

<sup>21</sup> IRC § 262(a) provides that generally, personal, living and family expenses are not deductible.

<sup>22</sup> IRC § 162(a)(2) allows a trade or business expense deduction for traveling expenses incurred “away from home in the pursuit of a trade or business.” A taxpayer’s “home” for purposes of IRC § 162(a)(2) is his or her principal place of business. *Kroll v. Commissioner*, 49 T.C. 557, 561-562 (1968).

<sup>23</sup> IRC § 162(a)(1) allows a trade or business expense deduction for a “reasonable allowance for salaries or other compensation for personal services actually rendered.”

<sup>24</sup> Treas. Reg. § 1.162-5(a) provides that a taxpayer may deduct educational expenses under IRC § 162(a) if the education maintains or improves skills required by the individual in his or her employment or other trade or business or meets the express requirements of the individual’s employer.

<sup>25</sup> Only one *pro se* taxpayer received full relief. *Castagnetta v. Comm’r*, T.C. Summ. Op. 2006-24. *Castagnetta* is particularly notable because the taxpayer not only received full relief representing himself, but he was able to prevail on the difficult issue of whether gambling activities constituted a trade or business.

*pro se* taxpayers fared better. *Pro se* taxpayers received full or partial relief in ten cases, compared to seven cases for represented taxpayers.

### COURT DECISIONS

Table 3.7.3 reflects the disposition of court decisions in each category of cases.

**TABLE 3.7.3, PREVAILING PARTY IN TRADE OR BUSINESS EXPENSE COURT DECISIONS, INDIVIDUAL VERSUS BUSINESS.**<sup>26</sup>

Type of Taxpayer	IRS	Taxpayer	Split	Total
Individual	11	1	5	17
Business	40	2	9	51
<b>Totals</b>	<b>51</b>	<b>3</b>	<b>14</b>	<b>68</b>

### INDIVIDUALS

Seventeen of the 68 cases analyzed were litigated by individual taxpayers. The most prevalent issue in these cases was the substantiation of the claimed trade or business expense deductions. For example, in *Joseph v. Commissioner*,<sup>27</sup> the taxpayer was denied \$33,785 in deductions claimed for travel expenses incurred while traveling to England to attend English literature courses at Worcester College at Oxford. The taxpayer was a high school English teacher working in Chicago, Illinois. The IRS denied the taxpayer's deductions for several reasons, including the taxpayer's failure to adequately substantiate the travel expenses as required under IRC § 274(d). At trial, the taxpayer produced only one "Copy Statement" showing lodging costs in the United Kingdom.<sup>28</sup> The court believed that the Copy Statement was "requested in anticipation of litigation" and that taxpayer's trial testimony was self serving. Therefore, the court sustained the IRS's denial of taxpayer's travel expense deductions because (among other reasons) the taxpayer had failed to adequately substantiate these expenses.

### BUSINESS TAXPAYERS

Fifty-one of the 68 litigated trade or business expense cases involved business taxpayers. These taxpayers had slightly less success than individual taxpayers in receiving a favorable outcome. Business taxpayers received full or partial relief in 22 percent of cases (11 of 51) compared to 35 percent for individual taxpayers (six of 17).

As with individual taxpayers, substantiation of expenses was also the most prevalent issue in the business taxpayer trade or business deduction cases. For example, in

<sup>26</sup> Business taxpayers include any business entity and individual taxpayers filing either Form 1040 Schedules C or F (*i.e.*, sole proprietors).

<sup>27</sup> T.C. Memo. 2005-169.

<sup>28</sup> The Copy Statement reflected rental costs of £4,556.

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*Christensen v. Commissioner*,<sup>29</sup> the IRS denied the taxpayer's business expense deductions for his 1998-2001 tax years because of the taxpayer's failure to substantiate his expenses. The taxpayer provided no substantiation at trial, but testified that all substantiating documents were destroyed in "hard disk crashes," or lost while moving. The court did not find the taxpayer's testimony regarding his business expenses persuasive, and because the taxpayer provided no documentary evidence the court was unable to estimate the taxpayer's expenses under *Cohan*. Thus, the court sustained the IRS's position and did not allow the taxpayer's unsubstantiated business expense deductions.

Another prevalent issue litigated by business taxpayers was the question of whether the taxpayers' business expense deductions were attributable to a legitimate "for profit" activity constituting an actual trade or business. Three such cases involved tax advice given by a group known as "Renaissance TTP, Inc." or "The Tax People."<sup>30</sup> The Tax People developed and promoted a multi-level marketing program called, "The Tax Relief System" (TRS). The Tax People marketed TRS primarily to taxpayers operating home-based businesses and claimed that it would "turn most of your everyday expenses into business expenses." The Tax People also guaranteed that taxpayers using TRS would generate at least \$5,000 in federal income tax deductions for the first 12 months the taxpayer operated his or her home business. TRS participants would purchase the TRS materials with a down payment (typically \$300) and monthly payments of \$100, and would then attempt to sell the TRS materials to other taxpayers by recruiting them as "downline" distributors. The participants would then claim trade or business expense deductions for numerous items, such as automobile expenses, office expenses, advertising, etc. The IRS denied these deductions in all three TRS cases on the grounds that participation in TRS did not constitute a trade or business for purposes of IRC § 162(a). The Tax Court sustained the IRS in all three cases. In the *Abloso* case, the court stated, "In essence, petitioner did little more than pay a monthly membership fee to TRS for generally misleading or ill-advised tax products and services. Petitioner's participation

<sup>29</sup> T.C. Memo. 2006-62.

<sup>30</sup> *Abloso v. Commissioner*, T.C. Summ. Op. 2006-60; *Sears v. Commissioner*, T.C. Summ. Op. 2006-47; and *Her v. Commissioner*, T.C. Summ. Op. 2005-187.

in the TRS program hardly constitutes a trade or business within the meaning of section 162(a).<sup>31</sup>

## CONCLUSION

As in previous years, taxpayers continued to challenge IRS denials of trade or business expense deductions, and represented taxpayers fared better than their *pro se* counterparts. While the IRS generally prevailed in these cases, the courts did not always favor the IRS's application of the law to the taxpayers' facts and circumstances. Thus, the definition of an allowable trade or business expense is open to interpretation.

Many of the cases analyzed demonstrate taxpayer confusion over legal requirements. The Renaissance / Tax People cases in particular show not only that taxpayers misunderstand the rules, but also how taxpayers can be harmed when unscrupulous individuals exploit this lack of understanding. Thus, the IRS can minimize litigation by providing clear guidance on the deductibility of trade or business expenses. In the Renaissance / Tax People cases, the IRS helped educate and alert taxpayers to these types of scams by prosecuting the people responsible. Through education, outreach, and partnering with stakeholders, the IRS can help taxpayers understand what trade or business expense deductions are allowable, how to substantiate those expenses, and how to avoid participating in schemes that advertise business expense deductions that appear "too good to be true."<sup>32</sup> The IRS should proactively reach out to educate taxpayers about this issue – particularly self-employed and small business taxpayers.<sup>33</sup> By helping these taxpayers understand the requirements for deducting trade or business expenses, the IRS will encourage compliance and minimize litigation.

<sup>31</sup> *Abloso v. Commissioner*, T.C. Summ. Op. 2006-60, 8. The United States government prosecuted the individuals behind the Renaissance/Tax People scheme, for numerous cases of fraud including tax, mail and wire fraud. At least 50,000 people participated in the Renaissance/Tax People scam. See United States Department of Justice News Release, *Tax Scheme Founder Arrested while Crossing Border into United States*, Oct. 26, 2004, and David Cay Johnston, *Judge Closes Down Tax-Advice Company*, N.Y. Times, May 16, 2001, C4. On May 16, 2001, the United States District Court in Kansas ruled that the Renaissance/Tax People company was an illegal pyramid scheme where investors had no chance of making a profit. David Cay Johnston, *Judge Closes Down Tax-Advice Company*, N.Y. Times, May 16, 2001, C4. In August 2004, a federal grand jury returned a 148-count indictment against the founder of the Renaissance/Tax People company that included tax fraud charges. In October 2004, the company's founder was arrested crossing the border from Mexico into the United States. United States Department of Justice News Release, *Tax Scheme Founder Arrested while Crossing Border into United States*, Oct. 26, 2004. The people responsible for the Renaissance/Tax People scheme are scheduled to be tried for tax fraud and other offenses in November 2006. *A Tune up on Corporate Tax Issues: What's going on under the Hood?*, Hearing before the Senate Comm. on Finance, (written statement of Eileen J. O'Connor, Assistant Attorney General, Tax Division, U.S. Dept. of Justice, June 13, 2006) (available at <http://finance.senate.gov/hearings/testimony/2005test/061306testeo.pdf>).

<sup>32</sup> The Taxpayer Advocate Service is sponsoring research conducted by the Office of Program Evaluation and Risk Analysis (OPERA) to identify and potentially supplement what the IRS is doing to detect and combat emerging abusive tax schemes. See National Taxpayer Advocate's Report to Congress, Fiscal Year 2007 Objectives, 10-11, and *The Tax Gap and Tax Shelters: Hearing Before the Senate Comm. on Finance*, 108th Cong. (Jul. 21, 2004)(testimony of Nina E. Olson, National Taxpayer Advocate).

<sup>33</sup> See Most Serious Problem, *Small Business Outreach*, supra.

**LITIGATED****ISSUE #8****RELIEF FROM JOINT AND SEVERAL LIABILITY UNDER INTERNAL REVENUE CODE SECTION 6015****SUMMARY**

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

IRC § 6015 provides three avenues for relief from joint and several liability. Section 6015(b) provides “traditional” relief for deficiencies and is similar to the innocent spouse relief formerly provided in section 6013(e). Section 6015(c) also provides relief for deficiencies for certain divorced or separated spouses; this section allocates the liability to each spouse. Section 6015(f) provides “equitable” relief from deficiencies and underpayments, but it only applies if a taxpayer is not eligible for relief under IRC § 6015(b) or (c). A taxpayer generally files Form 8857, Request for Innocent Spouse Relief, to request relief.

We reviewed 51 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2005 and May 31, 2006. The jurisdiction of the court and the taxpayer’s knowledge or constructive knowledge were frequent subjects of litigation. The National Taxpayer Advocate has proposed legislation to address both of these issues.<sup>2</sup>

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

IRC § 6015(b) provides full or partial relief from joint and several liability if the requesting spouse can demonstrate that:

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

<sup>1</sup> IRC § 6013(d)(3). We use the terms “deficiency” and “understatement” interchangeably for purposes of this discussion and the case table.

<sup>2</sup> The National Taxpayer Advocate has proposed legislation in this report to restore the Tax Court’s jurisdiction in certain cases. See National Taxpayer Advocate 2006 Annual Report to Congress, *infra/supra* (Key Legislative Recommendation: Innocent Spouse Relief). The National Taxpayer Advocate has also proposed to eliminate joint and several liability on certain returns. See National Taxpayer Advocate 2005 Annual Report to Congress 407 (Key Legislative Recommendation: Another Marriage Penalty: Taxing the Wrong Spouse). Thus, the proposal would virtually eliminate the need for innocent spouse relief and the need to inquire about one spouse’s knowledge.

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

#### **Allocation of Liability Under IRC § 6015(c)**

IRC § 6015(c) relieves the requesting spouse of liability for deficiencies allocable solely to the nonrequesting spouse. To obtain relief under this section, the requesting spouse must demonstrate that:

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

This election allocates to each joint filer that portion of the deficiency on the joint return attributable to each joint filer as calculated under the allocation provisions of IRC § 6015(d).

A taxpayer is ineligible to make an election under IRC § 6015(c) if the IRS demonstrates that, at the time the return was signed, the requesting taxpayer had “actual knowledge” of any item giving rise to the deficiency. Additionally, relief is denied for amounts attributable to fraud, fraudulent schemes, or certain transfers of disqualified assets.<sup>3</sup>

#### **Equitable Relief Under IRC § 6015(f)**

IRC § 6015(f) provides equitable relief from both deficiencies and underpayments for taxpayers who can demonstrate that:

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

<sup>3</sup> IRC § 6015(c)(4); IRC § 6015(d)(3)(C).

Revenue Procedure 2003-61 lists some of the factors the IRS considers in determining whether equitable relief is appropriate.<sup>4</sup> These factors include marital status, economic hardship, knowledge or reason to know, legal obligations of the nonrequesting spouse, significant benefit to the requesting spouse, compliance with income tax laws, and abuse.

Unlike IRC § 6015(b) and (c), which relieve taxpayers from deficiencies in tax, equitable relief under IRC § 6015(f) is available for both deficiencies and underpayments.

### Judicial Review

Taxpayers seeking relief under IRC § 6015 generally file Form 8857, *Request for Innocent Spouse Relief*. After reviewing the request, the IRS issues a Notice of Determination granting or denying relief in whole or in part. The taxpayer has 90 days from the date the IRS mails the notice to file a petition with the U.S. Tax Court.<sup>5</sup> The taxpayer may also petition the Tax Court if he or she does not receive a determination within six months of filing Form 8857.<sup>6</sup> The taxpayer may also raise relief from joint and several liability in a Collection Due Process proceeding,<sup>7</sup> a deficiency proceeding,<sup>8</sup> a bankruptcy proceeding,<sup>9</sup> or a refund suit.

### Intervention by Nonrequesting Spouse

When a spouse requests innocent spouse relief, the IRS must notify the nonrequesting spouse and give him or her an opportunity to submit relevant information.<sup>10</sup> Upon request of either spouse, the IRS will generally share with one spouse the information

<sup>4</sup> Rev. Proc. 2003-61, 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1 C.B. 447. Section 4.01 of this revenue procedure sets out seven threshold conditions that must be met by the taxpayer to be eligible for relief under IRC § 6015(f). The seven threshold conditions are: the requesting spouse filed a joint return for the taxable year in question; the relief is not available to the requesting spouse under IRC § 6015(b) or (c); the requesting spouse applies for relief no later than two years after the date of the IRS's first collection activity; no assets were transferred between the spouses as part of a fraudulent scheme; the nonrequesting spouse did not transfer disqualified assets to the requesting spouse; the requesting spouse did not file, or failed to file, with a fraudulent intent; and the income tax liability from which the relief is sought is attributable to the nonrequesting spouse. Section 4.02 establishes three elements the taxpayer can prove to qualify for relief from liability for an underpayment: spouses are no longer married, are legally separated, or not members of the same household for the last 12 months; the requesting spouse had no knowledge, or reason to know, that the nonrequesting spouse would not pay the income tax liability; and the requesting spouse will suffer economic hardship if the IRS does not provide relief. Finally, if the taxpayer satisfies the threshold conditions, but fails to prove the section 4.02 elements, section 4.03 provides the nonexclusive factors the IRS considers in determining whether equitable relief is appropriate.

<sup>5</sup> IRC § 6015(e)(1)(A)(ii).

<sup>6</sup> IRC § 6015(e)(1)(A)(i)(II).

<sup>7</sup> IRC § 6320(c); § 6330(c)(2)(A)(i).

<sup>8</sup> IRC § 6213; *Corson v. Comm'r*, 114 T.C. 354, 363 (2000).

<sup>9</sup> 11 USCA § 505(a)(1).

<sup>10</sup> IRC § 6015(h)(2); Treas. Reg. § 1.6015-6.

submitted by the other spouse.<sup>11</sup> Additionally, the IRS must notify the nonrequesting spouse of the preliminary and final determination of the requesting spouse's claim for relief.<sup>12</sup> The nonrequesting spouse may not petition from the final determination of relief<sup>13</sup>, but has the opportunity to become a party to any innocent spouse proceeding in the Tax Court.<sup>14</sup>

### ANALYSIS OF LITIGATED CASES

We analyzed 51 opinions issued between June 1, 2005, and May 31, 2006. Seventy-five percent (38 out of 51) were decided in the Tax Court, 16 percent (eight out of 51) in courts of appeals, six percent (three out of 51) in district courts, and four percent (two out of 51) in bankruptcy courts. Seventy-six percent (39 out of 51) were decided in favor of the IRS, 20 percent (ten out of 51) in favor of the taxpayer, and four percent (two out of 51) were split decisions. In about 51 percent (26 out of 51) of the cases the taxpayers appeared *pro se* (*i.e.*, they represented themselves). The nonrequesting spouse intervened in approximately 14 percent of the cases (seven out of 51).<sup>15</sup>

Only about 65 percent of the cases (33 out of the 51) involved an analysis of whether to grant relief. The other 35 percent (18 cases) involved procedural issues. Of the cases involving procedural issues, 72 percent (13 out of 18) were decided in favor of the IRS, 22 percent (four out of 18) in favor of the taxpayer, and six percent (one out of 18) were split decisions. Of the 33 cases decided on the merits, 79 percent (26 out of 33) were decided in favor of the IRS, 18 percent (six out of 33) in favor of the taxpayer (including one case where only the intervenor opposed granting relief), and three percent (one out of 33) were split decisions. See Table 8 in Appendix 3 for a detailed breakdown of the decided cases.

### Procedural Issues

Uncertainty associated with procedural issues was a significant subject of litigation. As noted above, 35 percent of the cases (18 out of 51) involved procedural issues such as

<sup>11</sup> Treas. Reg. § 1.6015-6(a)(1). In cases of alleged spousal abuse, the IRS will not share the requesting spouse's contact information with the nonrequesting spouse. IRM 25.15.3.3.1 (Sept. 1, 2006).

<sup>12</sup> Treas. Reg. § 1.6015-6(a)(2).

<sup>13</sup> *Maier v. Comm'r*, 119 T.C. 267, 276 (2002), aff'd, 360 F.3d 361, 365 (2d Cir. 2004).

<sup>14</sup> IRC § 6015(e)(4); *King v. Commissioner*, 115 T.C. 118 (2000).

<sup>15</sup> The nonrequesting spouse only intervened in cases decided on the merits. Only 33 of the cases that we reviewed were decided on the merits. The nonrequesting spouse intervened in 18 percent (6 out of 33) of these cases.

whether the court had jurisdiction,<sup>16</sup> whether the taxpayer properly requested relief,<sup>17</sup> and the consequences of the decision to grant relief.<sup>18</sup> Perhaps the most important procedural issues involved the availability of judicial review of IRS determinations under IRC § 6015, as illustrated by the following cases.

*Commissioner v. Ewing*<sup>19</sup>

The taxpayer filed a joint return in 1995 that reflected an underpayment of estimated tax attributable to the husband's business. In 1999, the taxpayer sought relief from the unpaid 1995 tax liability under IRC § 6015(f). The IRS denied relief and the taxpayer petitioned the Tax Court. In two separate opinions, the Tax Court determined it had jurisdiction under IRC § 6015(e) to review the IRS's determination and granted the taxpayer's request for relief. The Ninth Circuit Court of Appeals reversed, holding that the Tax Court had no jurisdiction to review the IRS's decision.

The Ninth Circuit based its decision on the text of IRC § 6015(e)(1), which provides for Tax Court jurisdiction "[i]n the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply." The Ninth Circuit reasoned the Tax Court did not have jurisdiction because the IRS had not asserted a deficiency. It did not reach the issue of whether jurisdiction might also fail on the basis that the taxpayer sought relief solely under IRC § 6015(f) (*i.e.*, did not elect relief under IRC § 6015(b) or IRC § 6015(c)).

Both the Eighth Circuit Court of Appeals and Tax Court recently decided to follow the Ninth Circuit's holding in *Ewing*.<sup>20</sup> As a result, the IRS will now routinely file a motion to dismiss for lack of jurisdiction in cases under IRC § 6015(f) where the IRS has not

<sup>16</sup> See, e.g., *Bartman v. Comm'r*, 446 F.3d 785 (8th Cir. 2006), vacating 122 T.C. 32 (2004) (no jurisdiction to review IRC § 6015(f) underpayment cases); *Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), *aff'g in part and vacating in part* T.C. Memo. 2004-93 (no jurisdiction to review IRC § 6015(f) underpayment cases); *Sjodin v. Comm'r*, 97 A.F.T.R.2d (RIA) 2622 (8th Cir. 2006) (no jurisdiction to review IRC § 6015(f) underpayment cases); *Christensen v. Comm'r*, T.C. Memo. 2005-299 (no jurisdiction over IRC § 66(c) or IRC § 6013(e) claims); *Parlin v. Comm'r*, T.C. Memo. 2006-18 (no jurisdiction because petition was not timely filed).

<sup>17</sup> See, e.g., *U.S. v. Feda*, 97 A.F.T.R.2d (RIA) 1985 (N.D. Ill. 2006) (district court not the proper forum to apply for relief when not requested administratively first); *Clark v. Comm'r*, T.C. Summ. Op. 2005-95 and *Ferris v. Comm'r*, T.C. Summ. Op. 2005-131 (application for relief was timely even though received by the IRS after the two-year limitation period expired because the IRS failed to send the notice required by RRA 98).

<sup>18</sup> See, e.g., *Ordlock v. Comm'r*, 126 T.C. 47 (2006) (discussing the consequences of granting relief to taxpayers in community property jurisdictions); *Estate of Capehart v. Comm'r*, 125 T.C. 211 (2005) (discussing consequences of granting relief under 6015(c) and how to allocate liability under 6015(d)); *Dennard v. Comm'r*, T.C. Summ. Op. 2005-115 (discussing why no refund was due even though relief was granted).

<sup>19</sup> *Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), *rev'g Ewing v. Comm'r*, 118 T.C. 494 (2002).

<sup>20</sup> *Bartman v. Comm'r*, 446 F.3d 785 (8th Cir. 2006) (following the Ninth Circuit's decision in *Ewing*); *Sjodin v. Comm'r*, 97 A.F.T.R.2d (RIA) 2622 (8th Cir. 2006) (same); *Billings v. Commissioner*, 127 T.C. No. 2 (July 25, 2006) (same). *Billings* is not included in the case table because it was decided after May 31, 2006.

asserted a deficiency.<sup>21</sup> The National Taxpayer Advocate has proposed legislation to restore the Tax Court's jurisdiction to review such cases.<sup>22</sup>

Forty eight percent (16 of 33) of the cases decided on the merits involved requests for relief from liability for underpayments under IRC § 6015(f) (*i.e.*, where a joint tax liability was properly reported on the return, but not paid). The IRS's decision not to grant underpayment relief under IRC § 6015(f) was the most frequent subject of litigation. Thus, absent legislation, litigation is likely to decline significantly in the future, not because factual determinations are becoming easier or the law is becoming more settled, but rather because the Tax Court now lacks jurisdiction to review such decisions.

Nonetheless, in several other cases courts rejected various arguments that would have deprived the taxpayer of the ability to obtain administrative or judicial review of the request for relief.<sup>23</sup> *In re Drake* provides an example.<sup>24</sup>

#### *In re Drake*

The taxpayer requested relief under IRC § 6015 prior to filing bankruptcy. The IRS issued a notice of determination denying the taxpayer's request for relief during the bankruptcy process. The taxpayer filed a petition in Tax Court for review of the IRS's determination, but the court held it did not have jurisdiction because bankruptcy law imposes a "stay" that prevents the taxpayer from filing a Tax Court petition during the bankruptcy process.<sup>25</sup> If the taxpayer had not filed a petition, the time for filing would have expired without any opportunity for judicial review.<sup>26</sup> The taxpayer filed a motion with the bankruptcy court to review the IRS's determination and redetermine her liability. The bankruptcy court held that the IRS violated the stay when it issued a notice of determination denying her request for relief. As a consequence of that violation, the

<sup>21</sup> Notice CC-2006-020 (Aug. 25, 2006).

<sup>22</sup> See National Taxpayer Advocate 2001 Annual Report to Congress 159-165 (proposing to grant Tax Court jurisdiction to review determinations under IRC § 6015(f)) and National Taxpayer Advocate 2006 Annual Report to Congress, *supra*. Similar proposals were recently introduced in the House (H.R. 6111) and the Senate (S. 3523). The House bill passed both houses of Congress and was referred to the President on December 9, 2006.

<sup>23</sup> The court decided in favor of the taxpayer in the following cases involving procedural issues. *In re Drake*, 336 B.R. 155 (Bankr. D. Mass. 2006), *motion for reconsideration denied* 97 A.F.T.R.2d (RIA) 2491 (Bankr. D. Mass. 2006) (Notice of Determination violated bankruptcy stay and was void; request for relief remained in Appeals); *United States v. Battersby*, 398 F.Supp.2d 865 (N.D. Ohio 2005) (court stayed foreclosure pending the outcome of taxpayer's request for relief under IRC § 6015); *Clark v. Comm'r*, T.C. Summ. Op. 2005-95 (taxpayer's request for relief was timely and should have been considered on the merits); *Ferris v. Comm'r*, T.C. Summ. Op. 2005-131; *Thomas v. Comm'r*, T.C. Summ. Op. 2005-102 (petitioner not barred by res judicata). In each of these cases, except *Battersby*, the court's decision preserved the taxpayer's right to judicial review of the IRS's determination.

<sup>24</sup> *In re Drake*, 336 B.R. 155 (Bankr. D. Mass. 2006).

<sup>25</sup> The Tax Court suggested that the taxpayer might seek review of the IRS's determination by the bankruptcy court. *Drake v. Comm'r*, 123 T.C. 320, n.4 (2004).

<sup>26</sup> The National Taxpayer Advocate recommended a legislative change in her 2004 Annual Report to Congress to create a tolling provision in IRC § 6015, which would toll the period for filing in the Tax Court until the automatic bankruptcy stay lapses. See National Taxpayer Advocate 2004 Annual Report to Congress 490.

notice was void and the relationship between the taxpayer and the IRS was the same as it was the day before the IRS issued it, *i.e.*, the request for relief remained with Appeals. The bankruptcy court further held that the automatic stay was no longer a bar to issuing a notice of determination, from which the taxpayer could petition the Tax Court.

Although availability of judicial review was a very important procedural issue, a number of other important cases addressed the consequences flowing from the decision to grant relief, such as *Ordlock v. Commissioner*, discussed below.<sup>27</sup>

### *Ordlock v. Commissioner*

The IRS granted the taxpayer's request for innocent spouse relief under IRC § 6015(b). By the time the IRS granted relief, the taxpayer had paid much of the liability with community property. She sought a refund of this community property.

The IRS argued that pursuant to IRC § 6321, a lien attaches to the entire amount of the community property, and thus, no refund of community property could be granted. However, IRC § 6015(a) provides "[a]ny determination under this section shall be made without regard to community property laws." IRC § 6015(g)(1) further provides that "notwithstanding any other law or rule of law ... credit or refund shall be allowed or made to the extent attributable to the application of this section." The taxpayer argued that a plain reading of the statutory language entitled her to a refund of certain community property assets used to pay her spouse's tax liability.

The Tax Court held that the taxpayer was not entitled to a refund of overpayments attributable to community property. The court reasoned that the "determination" referenced in IRC § 6015(a) refers only to a determination of whether a taxpayer is entitled to relief under IRC § 6015, not a determination of whether the IRS could retain community property under state law to satisfy the separate liability of one spouse. The court explained that the language in IRC § 6015(g)(1), which purports to apply "notwithstanding any other law," should not be read to ignore state law for purposes of defining property interests subject to a federal tax lien under IRC § 6321.<sup>28</sup>

### Review on the Merits

While the courts considered many factors in determining the appropriateness of relief on the merits under IRC § 6015, the most significant was whether the requesting taxpayer had actual or constructive knowledge of the tax deficiency. All three avenues for relief contain a knowledge element or factor, making it the linchpin in most of the

<sup>27</sup> *Ordlock v. Comm'r*, 126 T.C. 47 (2006). See also, *Estate of Capehart v. Comm'r*, 125 T.C. 211 (2005) (discussing consequences of granting relief under 6015(c) and how to allocate liability under 6015(d)); *Denard v. Comm'r*, T.C. Summ. Op. 2005-115 (discussing why no refund was due even though relief was granted).

<sup>28</sup> The National Taxpayer Advocate's 2005 legislative proposal would require the IRS to exhaust reasonable collection efforts against a liable spouse before pursuing collection from a nonliable spouse. See National Taxpayer Advocate 2005 Annual Report to Congress 407 (Key Legislative Recommendation: Another Marriage Penalty: Taxing the Wrong Spouse).

courts' analyses.<sup>29</sup> Taxpayers generally were not successful if they could not show a lack of actual or constructive knowledge in IRC § 6015(b) or (f) cases.<sup>30</sup>

Proving actual knowledge under IRC § 6015(c) was an issue in each of the nine cases involving IRC § 6015(c) that were decided on the merits. In such cases, the IRS has the burden of proving actual knowledge. The IRS prevailed in eight of the nine cases in which actual knowledge under IRC § 6015(c) was litigated.<sup>31</sup> In the ninth case, the IRS conceded that the requesting spouse did not have actual knowledge, but the intervenor disagreed.<sup>32</sup> Frequent litigation involving the actual knowledge requirement under IRC § 6015(c) was also noted in last year's Annual Report to Congress. In that report we noted that this issue was litigated in 14 cases and the IRS was unable to prove actual knowledge in four of those cases.<sup>33</sup>

The National Taxpayer Advocate has proposed legislation that would tax each spouse on only his or her own income, reducing or eliminating the need for innocent spouse relief.<sup>34</sup> While retaining married-filing-jointly status, this proposal would reduce or eliminate the need to inquire about one spouse's knowledge.

## CONCLUSION

Inclusion as one of the "most litigated issues" suggests that an issue either involves unsettled areas of law or difficult factual determinations, and the issue could potentially benefit from legislative attention. A decrease in litigation involving relief under IRC § 6015(f) should not be taken as a sign that IRC § 6015 is not in need of legislative attention. Such a reduction would be the logical result of recent cases holding that the Tax Court no longer has jurisdiction to review certain controversies arising under IRC § 6015(f). In fact, the cases reviewed for this report suggest that determining what a taxpayer knew or should have known generates a significant amount of controversy and will likely continue to do so even if courts are unable to review many of the IRS's determinations under IRC § 6015.

<sup>29</sup> See IRC § 6015(b)(1)(C); IRC § 6015(c)(3)(C); Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.02(1)(b), § 4.03(2)(a)(iii).

<sup>30</sup> Revisions to IRS guidance in 2003 place less emphasis on knowledge in section 6015(f) determinations. See Rev. Proc. 2003-61, 2003-2 C.B. 296.

<sup>31</sup> See *Clark v. Comm'r*, T.C. Summ. Op. 2006-34; *Elias v. Comm'r*, T.C. Summ. Op. 2005-67; *Glenn v. Comm'r*, T.C. Summ. Op. 2005-127; *Packer v. Comm'r*, T.C. Summ. Op. 2006-22; *Stringham v. Comm'r*, T.C. Summ. Op. 2006-44; *Sylve v. Comm'r*, T.C. Summ. Op. 2005-137; *Thomas v. Comm'r*, T.C. Summ. Op. 2005-100; *Young v. Comm'r*, T.C. Summ. Op. 2005-135.

<sup>32</sup> See *Vasquez v. Comm'r*, T.C. Summ. Op. 2005-133.

<sup>33</sup> National Taxpayer Advocate 2005 Annual Report to Congress 531, 533, 593 (Most Litigated Issue: Relief From Joint and Several Liability).

<sup>34</sup> National Taxpayer Advocate 2005 Annual Report to Congress 407 (Key Legislative Recommendation: Another Marriage Penalty: Taxing the Wrong Spouse).

**LITIGATED**

ISSUE #9

**FAMILY STATUS ISSUES UNDER INTERNAL REVENUE CODE SECTIONS 2, 21, 24, 32, AND 151**

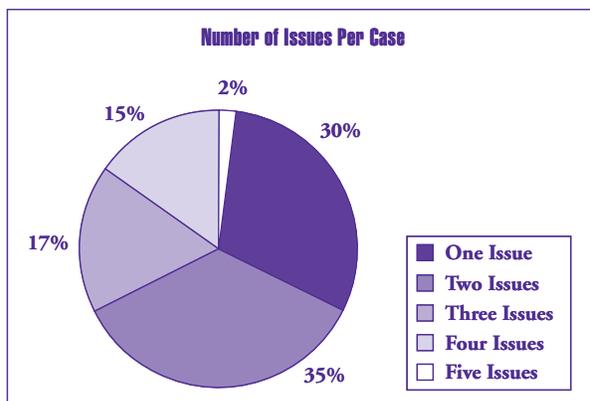
**SUMMARY**

Family status issues involve exemptions, credits, and filing status claimed by taxpayers when they prepare their federal tax returns. Litigated cases often include multiple family status issues with similar factual determinations. This report combines the following issues into a single “family status” category:

- ◆ Head of household filing status;<sup>1</sup>
- ◆ Child and dependent care credit;<sup>2</sup>
- ◆ Child tax credit;<sup>3</sup>
- ◆ Earned income tax credit (EITC);<sup>4</sup> and
- ◆ Dependency exemption.<sup>5</sup>

We reviewed 46 federal court opinions issued between June 1, 2005, and May 31, 2006. More than two-thirds of these cases dealt with multiple family status issues, with the determination of one issue often affecting others. For example, a denial of the dependency exemption will result in the summary denial of the child tax credit, and may jeopardize eligibility for head of household filing status and the child and dependent care credit. The chart below illustrates the extent to which these claims were litigated together.

**TABLE 3.9.1, FAMILY STATUS ISSUES PER CASE**



<sup>1</sup> IRC § 2(b).

<sup>2</sup> IRC § 21.

<sup>3</sup> IRC § 24.

<sup>4</sup> IRC § 32.

<sup>5</sup> IRC § 151.

## PRESENT LAW

### Uniform Definition of Qualifying Child

Prior to 2005, there were six definitions of a “child” for purposes of the most basic provisions of the Internal Revenue Code.<sup>6</sup> These family status provisions potentially affect 81 million taxpayers and 79 million children.<sup>7</sup> The Working Families Tax Relief Act (WFTRA)<sup>8</sup> introduced a uniform definition of a qualifying child (UDOC) that changed five of the family status definitions, effective for tax years beginning after December 31, 2004. The intent of the UDOC legislation was to bring about some uniformity for the vast majority of taxpayers who had to meet multiple tests just to determine whether they were eligible to claim an exemption, credit, or filing status under the basic family status provisions.<sup>9</sup>

Under UDOC, a dependent must be either a “qualifying child” or a “qualifying relative.”<sup>10</sup> The other family status provisions incorporate the definition of a qualifying child, but retain rules specific to each code section (such as age and income restrictions).

### *Qualifying Child*

In general, four tests must be met to claim someone as a qualifying child under UDOC.

1. **Relationship Test.** The child must be the taxpayer’s child (including an adopted child, stepchild, or eligible foster child), brother, sister, stepbrother, stepsister, or descendent of one of these relatives. An adopted child includes a child lawfully placed with a taxpayer for legal adoption even if the adoption is not final. An eligible foster child is any child placed with a taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.<sup>11</sup>
2. **Residency Test.** The child must live with the taxpayer for more than half of the tax year. Exceptions apply for temporary absences for special circumstances: children who were born or died during the year, children of divorced or separated parents, and kidnapped children.<sup>12</sup>

<sup>6</sup> IRC § 2(b) (Head of Household); IRC § 21 (Child and Dependent Care Credit); IRC § 24 (Child Tax Credit); IRC § 32 (Earned Income Tax Credit); IRC § 151 (Dependency Exemption). IRC § 7703(b) provides an exception to the general determination of whether an individual is married and states that certain married persons who are living apart from their spouses may be treated as unmarried. Although the new uniform definition did not alter the rules in § 7703(b), there is a proposal in the 2007 budget that will improve upon the current rules. Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2007 Revenue Proposals* (Feb. 2006), 58-61.

<sup>7</sup> IRS Compliance Data Warehouse, *Tax Year 2004 Individual Return Transaction File*.

<sup>8</sup> The Working Families Tax Relief Act, Pub. L. No. 108-311, § 201, 118 Stat. 1166 (2004).

<sup>9</sup> Nina E. Olson, *Uniform Qualifying Child Definition: Uniformity for Most Taxpayers*, 111 Tax Notes 225 (Apr. 10, 2006). See also Additional Legislative Recommendation, *Uniform Definition of Qualifying Child Fixes*, *supra*.

<sup>10</sup> IRC § 152(a).

<sup>11</sup> IRC §§ 152(c)(1)(A), 152(c)(2), and 152(f)(1).

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

3. **Age Test.** The child must be under a certain age, depending on the tax benefit claimed, to be a qualifying child.<sup>13</sup>
4. **Support Test.** The child cannot provide more than half of his or her own support during the year.<sup>14</sup>

#### *Qualifying Relative*

If an individual does not meet the requirements for a qualifying child, he or she may be eligible as a dependent if the individual meets the requirements for a qualifying relative. In general, four tests must be met to claim someone as a qualifying relative.

1. **Relationship Test.** The individual must be a child or a descendant of a child; a brother, sister, stepbrother, or stepsister; the father or mother, or an ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister of the taxpayer; a brother or sister of the father or mother of the taxpayer; a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or an individual (other than the spouse) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.<sup>15</sup>
2. **Gross Income Test.** A qualifying relative must have gross income below the exemption amount for the taxable year.<sup>16</sup>
3. **Support Test.** The taxpayer must provide more than one-half of the individual's support for the calendar year in which the taxable year begins.<sup>17</sup>
4. **Not a Qualifying Child.** A qualifying relative may not be a qualifying child of such taxpayer or of any other taxpayer for any taxable year beginning in the calendar year in which the taxable year begins.<sup>18</sup>

#### *Tie-Breaker Rule*

Sometimes a child meets the tests to be a qualifying child of more than one person. However, only one person can treat the child as a qualifying child. If the taxpayers have the same qualifying child, they may decide among themselves who will claim the child. If they cannot agree and more than one taxpayer files a return claiming the same child, the IRS will use the tie-breaker rules explained in the following table to determine which taxpayer will be allowed to claim the child.<sup>19</sup> In the past, these tiebreaker rules applied

<sup>13</sup> IRC § 152(c)(1)(C).

<sup>14</sup> IRC § 152(c)(1)(D).

<sup>15</sup> IRC §§ 152(d)(1)(A) and 152(d)(2). However, IRC § 152(f)(3) provides that an individual shall not be treated as a member of the taxpayer's household if at any time during the taxable year the relationship between such individual and the taxpayer is in violation of local law.

<sup>16</sup> IRC § 152(d)(1)(B).

<sup>17</sup> IRC § 152(d)(1)(C).

<sup>18</sup> IRC § 152(d)(1)(D).

<sup>19</sup> IRC § 152(c)(4).

only to a qualifying child for the EITC. Beginning in 2005, these rules apply to five family status provisions. Other taxpayers generally cannot take any of the five tax benefits unless he or she has a different qualifying child – that is, taxpayers may not “split the baby” to divide the benefits.<sup>20</sup>

**TABLE 3.9.2, TIE-BREAKER RULE**

<b>When More Than One Person Files a Return Claiming the Same Qualifying Child</b>	
<b>IF . . .</b>	<b>THEN the child will be treated as the qualifying child of the . . .</b>
Only one of the persons is the child's parent,	Parent.
Both persons are the child's parent,	Parent with whom the child lived for the longer period of time. If the child lived with each parent for the same amount of time, then the child will be treated as the qualifying child of the parent with the highest adjusted gross income (AGI).
None of the persons is the child's parent,	Person with the highest AGI.

#### *Special Rule for Divorced or Separated Parents*

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

- ◆ The parents are divorced or legally separated or lived apart at all times during the last six months of the year;
- ◆ The child received over half of his or her support from the parents;
- ◆ The child is in custody of one or both of the parents for more than half the year; and
- ◆ The custodial parent signs a written statement that he or she will not claim the child as a dependent.<sup>21</sup>

A custodial parent is the parent having custody of the child for the greater part of the year.<sup>22</sup> The noncustodial parent is the parent who is not the custodial parent.<sup>23</sup> The special rule for divorced or separated parents enables the custodial parent to transfer the dependency exemption and child tax credit to the noncustodial parent; it does not enable the noncustodial parent to claim head of household filing status, the credit for child and dependent care expenses, or the EITC.

<sup>20</sup> CC Notice 2006-86, 2006-41 I.R.B. 680. There is an exception to the “split the baby” rule for divorced or separated parents, discussed below.

<sup>21</sup> IRC § 152(e). See also Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents (used to transfer the dependency exemption to the noncustodial parent). The custodial parent may use a similar written statement that meets the requirements of the form in lieu of using the Form 8332.

<sup>22</sup> IRC § 152(e)(4)(A).

<sup>23</sup> IRC § 152(e)(4)(B).

**ANALYSIS OF LITIGATED CASES**

The opinions discussed below are based on law in effect for tax years prior to the effective date of UDOC. There is no discussion of the UDOC (primarily because the cases did not include sufficient facts to determine whether UDOC would have changed the result) or other novel issues of law in the cases examined for this report. The opinions discussed factual disputes and clarified misconceptions regarding the law. Therefore, the discussion focuses on typical contested issues, rather than novel issues of law. A majority of the cases litigated during this period were small tax cases.<sup>24</sup>

*Pro Se Analysis*

Taxpayers were represented by counsel in only two of the 46 cases litigated this year,<sup>25</sup> even though many of the cases were highly fact-specific and involved a complicated web of statutory provisions. It appeared that many of the taxpayers did not understand either the law or how to present relevant evidence. The assistance of counsel might have made a difference in the outcome of these cases. A detailed listing of all family status cases analyzed appears in Table 9 in Appendix 3.

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

We reviewed 19 cases involving head of household status during the reporting period, with two taxpayers prevailing on their claims.<sup>26</sup>

In *Lozoya v. Commissioner*,<sup>27</sup> the taxpayer's wife left him and their two dependent children in 2001. The IRS determined the taxpayer must file as married filing separately because he was married and his wife did not sign a joint return with him. IRC § 7703(b), however, allows a married taxpayer to file as unmarried when the taxpayer:

- a. Files a separate return;
- b. Pays over half the cost of maintaining the household during the year; and
- c. Uses that household as the principal place of abode together with at least one dependent child; if
- d. During the last six months of the taxable year, such individual's spouse is not a member of such household.

The parties disagreed only about whether the taxpayer and his wife shared the same household for the last six months of 2001. The taxpayer and his son testified that the taxpayer's wife left the household in June 2001. The court found their testimony to be

<sup>24</sup> In certain tax disputes involving \$50,000 or less, taxpayers may elect to have their case conducted under the simplified small tax case procedure. Trials in small tax cases generally are less formal and result in a speedier disposition. However, decisions entered pursuant to small tax case procedures may not be appealed or cited as precedent. See IRC § 7463.

<sup>25</sup> *Melton v. Comm'r*, T.C. Summ. Op. 2005-152; *Omans v. Comm'r*, T.C. Summ. Op. 2005-110.

<sup>26</sup> *Lozoya v. Comm'r*, T.C. Summ. Op. 2005-73; *Washington v. Comm'r*, T.C. Summ. Op. 2006-81.

<sup>27</sup> T.C. Summ. Op. 2005-73.

credible and held that the taxpayer qualified for head of household filing status for the 2001 tax year.

In *Washington v. Commissioner*,<sup>28</sup> the taxpayer claimed head of household filing status for the 2003 tax year. During the period in question, the taxpayer resided in Louisiana with a live-in girlfriend and her 14 year old daughter. Although the taxpayer considered his live-in girlfriend his “common law wife,” the state of Louisiana does not recognize the doctrine of common law marriage. Therefore, the taxpayer met the first prong of the head of household test – that he must be unmarried at the end of the taxable year.<sup>29</sup> With respect to the second prong (that the taxpayer must maintain a household that is the principal place of abode of an individual for whom the taxpayer is entitled to a dependency exemption under IRC § 151<sup>30</sup>), the IRS conceded the taxpayer’s entitlement to the dependency exemption for the girlfriend’s child. The U.S. Tax Court held that the taxpayer satisfied the requirements of IRC § 2(b) and qualified for head of household filing status for the 2003 tax year.

### Child Tax Credit – IRC § 24

We reviewed 21 cases involving the child tax credit during the reporting period. Before 2005, one of the requirements for a taxpayer to claim the child tax credit was for a taxpayer to be able to claim a dependency exemption for the child. Because qualifying for the dependency exemption was required to claim the child tax credit, the child tax credit was often summarily denied where the dependency exemption was denied. In the three cases where the taxpayer prevailed, the Tax Court held the taxpayers were entitled to claim the child tax credit because they were entitled to dependency exemption deductions under § 151.<sup>31</sup>

### Earned Income Tax Credit – IRC § 32

#### Introduction

We analyzed 24 cases involving the EITC during the reporting period. The taxpayers prevailed in three of those cases.<sup>32</sup>

In *Beckford v. Commissioner*,<sup>33</sup> the taxpayer claimed EITC for his niece in the 2003 tax year. The IRS denied the EITC claim because the niece did not meet the relationship requirement and the taxpayer did not show that he cared for the niece as his own child

<sup>28</sup> T.C. Summ. Op. 2006-81.

<sup>29</sup> IRC § 2(b)(1).

<sup>30</sup> IRC § 2(b)(1).

<sup>31</sup> *Litton v. Comm’r*, T.C. Summ. Op. 2006-56; *Manzueta v. Comm’r*, T.C. Summ. Op. 2005-185; *Omans v. Comm’r*, T.C. Summ. Op. 2005-110.

<sup>32</sup> *Beckford v. Comm’r*, T.C. Summ. Op. 2006-80; *Lozoya v. Comm’r*, T.C. Summ. Op. 2005-73; *Vogt v. Comm’r*, T.C. Summ. Op. 2005-107.

<sup>33</sup> T.C. Summ. Op. 2006-80.

(this “cares for” rule was in place in 2003, but was eliminated by the uniform definition of a qualifying child for returns beginning after December 31, 2004).<sup>34</sup> Although the taxpayer was not eligible to claim EITC under IRC § 32(c)(1)(A)(i) for a qualifying child, the court held that the taxpayer was an “eligible individual” under IRC § 32(c)(1)(A)(ii), which does not require any qualifying children. For 2003, a taxpayer was eligible under this subsection only if his adjusted gross income was less than \$11,230; the taxpayer’s adjusted gross income was \$11,132.

As discussed above, the taxpayer’s wife in *Lozoya v. Commissioner*<sup>35</sup> moved out of the home in June 2001. The Tax Court held that under IRC § 7703(b), the wife is not considered a member of the taxpayer’s household and determined that the taxpayer qualified for head of household filing status for the 2001 tax year. The court further held that since the taxpayer qualified for that filing status, it follows that he also qualified for the EITC for his two children.

In *Vogt v. Commissioner*,<sup>36</sup> the sole issue for EITC eligibility was whether the taxpayer’s adjusted gross income exceeded the income limitation for the 2001 tax year. The IRS stated at trial that the EITC is not available for taxpayers with income in excess of \$11,610. The court explained that in 2001, the EITC phase-out range for taxpayers with two dependents began at \$13,090 and the EITC was phased out completely when taxpayers’ adjusted gross income reached \$32,121. Because the taxpayers here had adjusted gross income of less than \$32,121 for the tax year 2001, the court held they were entitled to a portion of the EITC.

### Dependency Exemption – IRC § 151

We analyzed 38 cases involving the dependency exemption, with taxpayers prevailing in only three of them.<sup>37</sup>

In *Hartfield v. Commissioner*,<sup>38</sup> the taxpayer lived with his girlfriend and her minor child for the entire year in 2003. During that time, the taxpayer paid the full costs of supporting the child, including housing, clothing, food, personal hygiene, transportation, and school supplies. To qualify as a dependent under the law in effect at that time, an indi-

<sup>34</sup> Under the prior rules, IRC § 32(c)(3)(B)(i)(II) required that a taxpayer claiming as a qualifying child a brother, sister, stepbrother, or stepsister, or a descendant of any such individual must care for the child as the taxpayer’s own child. There was a great deal of uncertainty on the part of taxpayers as to what constituted “caring for” the child as one’s own child. See *Gilmore v. Commissioner*, T.C. Summ. Op. 2004-38; *Barajas v. Commissioner*, T.C. Summ. Op. 2002-59. Because the “cares for” test was vague and hard to administer, and introduced a type of support test into the EITC definition of qualifying child because it will require a showing of activities such as purchasing food, clothing, medical care, and other items, Congress eliminated the “cares for” requirement when it passed the UDOC rules.

<sup>35</sup> T.C. Summ. Op. 2005-73.

<sup>36</sup> T.C. Summ. Op. 2005-10 7.

<sup>37</sup> *Hartfield v. Comm’r*, T.C. Summ. Op. 2006-77; *Litton v. Comm’r*, T.C. Summ. Op. 2006-56; *Omans v. Comm’r*, T.C. Summ. Op. 2005-110.

<sup>38</sup> T.C. Summ. Op. 2006-77.

vidual must have received over half his or her support from the taxpayer, have had the same principal place of abode as the taxpayer, and have been a member of the taxpayer's household.<sup>39</sup> The court was satisfied that the taxpayer met all of these requirements, and held the taxpayer was entitled to a dependency exemption deduction for the 2003 tax year.

In *Litton v. Commissioner*,<sup>40</sup> the taxpayer and her ex-husband had joint custody of their children. In the case of a child of divorced parents, if a child receives over half of his support during the year from one or both his parents and is in the custody of one or both parents for more than half of the year, then the child shall be treated as receiving over half of his support during the year from the parent having physical custody for a greater portion of the year.<sup>41</sup> That parent is referred to as the "custodial parent." The issue in question was which parent had physical custody and was the custodial parent. The taxpayer contended she was the custodial parent because the children were in her physical custody for more than half of the year. In support of her contention, the taxpayer presented into evidence a day planner showing she had physical custody of the children for 195 days in 2003, which is more than half of the year. However, the husband disputed the taxpayer's method of counting "days," arguing that the children spent the night with him on many of the Sundays included in the taxpayer's calculation of 195 days. On balance, and in light of the facts and circumstances of this case, the Tax Court concluded the children spent more than 50 percent of the time with the taxpayer. Accordingly, the court held that the taxpayer was entitled to dependency exemption deductions for her son and daughter in the taxable year 2003.

In *Omans v. Commissioner*,<sup>42</sup> the taxpayer and his wife divorced in 1993. The divorce decree awarded the wife physical custody of their two minor children. A noncustodial parent may be entitled to dependency exemption deductions if one of the exceptions in IRC § 152(e) is satisfied. IRC § 152(e)(2) provides that a child shall be treated as having received over half of his or her support from the noncustodial parent if the custodial parent signs a written declaration that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year, and the noncustodial parent attaches such written declaration to the noncustodial parent's return for the taxable year beginning during such calendar year.<sup>43</sup> The settlement agreement attached to the taxpayer's 1998 return contains the names of the two children, the custodial parent's signature as witnessed by a notary's certification, the date of her signature, and taxpayer's name.

<sup>39</sup> IRC § 151.

<sup>40</sup> T.C. Summ. Op. 2006-56.

<sup>41</sup> IRC § 152(e)(1). Under UDOC, custodial parent is the parent having custody for the greater portion of the calendar year. IRC § 152(e)(4)(n).

<sup>42</sup> T.C. Summ. Op. 2005-110.

<sup>43</sup> Under UDOC, the noncustodial parent may still claim the child as a dependent if certain requirements are met under IRC § 152(e)(2).

Although the settlement agreement did not list each and every year to which the taxpayer's entitlement to the dependency exemption deductions was to apply, the court found that it clearly refers to the separate returns of the taxpayer and his ex-wife "for the 1992 tax year and for each year thereafter," thus including the year at issue. The IRS contended that the custodial parent's signature failed to signify her intent to not claim the dependency exemption deductions, due to the absence of the language "will not claim" from the settlement agreement. The Tax Court found the custodial parent's notarized signature indicated more than a mere acknowledgment of the form of the settlement agreement, and that it signified the custodial parent's sworn agreement to the settlement agreement's contents, including the taxpayer's entitlement to the dependency exemption deductions.

### CONCLUSION

Family status provisions are fundamental components of the tax code, and yet they have complicated and sometimes conflicting eligibility standards. Because of this complexity, tax filing can be a difficult and confusing exercise for low and middle income families. Taxpayers who wish to claim the family status credits and deductions often do not understand the qualification requirements or how to properly satisfy them. Further, such taxpayers often lack legal representation when they go before the courts, which may affect the outcomes of their cases.

The changes to family status provisions made by the Working Families Tax Relief Act may ease the burden of proving eligibility somewhat through UDOC. Under the old rules, support was the key element in determining whether a taxpayer qualified for dependency exemptions, which in turn affected eligibility for other related provisions. The uniform definition of child replaced the support test with the residency test, which may be easier for a taxpayer to prove. The court often looked to custody agreements, calendars or planners, and testimony as evidence of where the child resided on various days. Because the family status provisions incorporating the uniform definition of child were not effective until tax year 2005, it may be several years before courts issue opinions involving these provisions.

## LITIGATED

## ISSUE #10

## CHARITABLE DEDUCTIONS UNDER INTERNAL REVENUE CODE SECTION 170

## SUMMARY

Subject to certain limitations, taxpayers can take a deduction from their adjusted gross income for contributions of cash or other property to charitable organizations.<sup>1</sup> Taxpayers must contribute to certain qualifying organizations,<sup>2</sup> and are required to substantiate contributions of \$250 or more.<sup>3</sup> Litigation generally arises over one of four issues:

- ◆ Whether the organization to which a contribution is made is charitable in nature;
- ◆ Whether the property that is contributed qualifies as a charitable contribution;
- ◆ Whether the amount deducted equals the fair market value of the property contributed; and
- ◆ The extent to which the taxpayer has substantiated the contribution.

For this report, we reviewed 26 cases with charitable deductions as a contested issue. The government prevailed in 19 cases and there were seven split decisions, *i.e.*, the court ruled partially in favor of the taxpayer and partially in favor of the government.

## PRESENT LAW

Taxpayers can generally take a deduction for charitable contributions made within the taxable year.<sup>4</sup> Deductions of charitable contributions for individuals are generally limited to 50 percent of the taxpayer's contribution base (which is adjusted gross income computed without regard to any net operating loss carryback to the taxable year under IRC § 172).<sup>5</sup> However, subject to certain limitations, individual taxpayers are permitted to carry forward unused charitable contributions in excess of the 50 percent contribution base for up to five years.<sup>6</sup> Corporate charitable deductions are generally limited to ten percent of the taxpayer's taxable income.<sup>7</sup> No deduction is allowed for services that taxpayers offer to charitable organizations;<sup>8</sup> however, expenditures made incident to

<sup>1</sup> IRC § 170.

<sup>2</sup> To claim a charitable contributions deduction, a taxpayer must establish that a gift was made to a qualified entity organized and operated exclusively for an exempt purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual. IRC § 170(c)(2).

<sup>3</sup> IRC § 170(f)(8).

<sup>4</sup> IRC § 170(a)(1).

<sup>5</sup> IRC § 170(b)(1)(A), (F).

<sup>6</sup> IRC § 170(d)(1).

<sup>7</sup> IRC § 170(b)(2).

<sup>8</sup> Treas. Reg. § 1.170A-1(g).

the rendition of services to a charitable organization and which are not reimbursed may constitute a deductible contribution.<sup>9</sup>

### *Substantiation*

Deductions for charitable contributions of \$250 or more are disallowed in the absence of a contemporaneous written receipt from the recipient of the contribution.<sup>10</sup> For cash contributions, taxpayers are required to maintain receipts from the charitable organization, copies of cancelled checks, or other reliable records showing the name of the organization and the date and amount contributed.<sup>11</sup> For charitable contributions of property other than money, taxpayers generally must maintain for each contribution a receipt from the recipient of the contribution showing the following information: (1) the name of the recipient; (2) the date and location of the contribution; and (3) a description of the property.<sup>12</sup> When property other than money is contributed, the amount of the allowable deduction is the fair market value of the property at the time of the contribution.<sup>13</sup>

### *Cohan Doctrine*

In cases where taxpayers have provided credible evidence of having made a charitable contribution but have difficulty substantiating the precise amount of the payment, a judicial doctrine has evolved that allows courts to determine, based on the best evidence at hand, the amount of the charitable contribution.<sup>14</sup> The Cohan doctrine does not relieve the taxpayer of the responsibility of substantiating his or her charitable contribution, although it can assist taxpayers who can demonstrate that contributions were made but have not kept records of the precise amounts contributed.<sup>15</sup>

## ANALYSIS OF LITIGATED CASES

Of the 26 charitable deduction cases we reviewed, three involved the issue of whether the recipient was a qualified charitable organization, six cases involved a dispute over

<sup>9</sup> *Id.* Meal expenditures in conjunction with offering services to qualifying organizations are not deductible unless the expenditures are away from the taxpayer's home. *Id.*; see also *Work v. Comm'r*, T.C. Memo. 2005-259 (holding taxpayer did not substantiate fact that meal expenses associated with volunteer efforts were incurred away from home). Likewise, travel expenses associated with contribution are not deductible if there is a significant element of personal pleasure involved with the travel. IRC § 170(j).

<sup>10</sup> IRC § 170(f)(8); see also Treas. Reg. § 1.170A-13(f).

<sup>11</sup> Treas. Reg. § 1.170A-13(a)(1).

<sup>12</sup> Treas. Reg. § 1.170A-13(b)(1).

<sup>13</sup> Treas. Reg. § 1.170A-1(c)(1). Note that the fair market value must be reduced for certain contributions of ordinary income and capital gain property. See IRC § 170(e).

<sup>14</sup> *Cohan v. Commissioner*, 39 F.2d 540, 543-44 (2d Cir. 1930). In *Cohan*, a theatrical production manager claimed unsubstantiated deductions for the entertainment of actors, employees, and dramatic critics. He did not maintain records of these expenses, but knew that they were substantial sums. The Second Circuit determined that the Board of Tax Appeals was authorized to estimate unsubstantiated taxpayer expenses when it is certain that expenses were incurred, but the amount could not be quantified. *Id.* at 543.

<sup>15</sup> See, e.g., *Robinette v. Comm'r*, T.C. Summ. Op. 2006-69; *Finch v. Comm'r*, T.C. Summ. Op. 2006-54.

the valuation of the property, five involved the issue of whether the property contributed qualified as a deductible contribution, and 15 cases involved the taxpayers' substantiation (or lack thereof) of the claimed contributions.<sup>16</sup>

### *Qualifying Charitable Organization*

To be deductible, a charitable contribution must be made to a qualifying charitable organization.<sup>17</sup> In three cases, taxpayers' deductions were rejected for failing to meet this threshold test. In one case, the U.S. Tax Court held that contributions to one's sick family members, while laudable, do not constitute contributions to a qualifying organization.<sup>18</sup> In another case, the Tax Court held that a Christian center may not be a qualifying organization where the taxpayer fails to demonstrate that it is operated exclusively for religious purposes.<sup>19</sup> In a third case, the taxpayers (husband and wife) made a variety of payments for which they claimed charitable deductions.<sup>20</sup> The Tax Court concluded that only a contribution to the American Heart Association was legitimate, as "[n]othing establishes that any [of the other deductions] were made to qualified donees."<sup>21</sup>

### *Qualified Contribution*

To constitute a qualified contribution for purposes of IRC § 170, the donor-taxpayer must possess a transferable property interest in the property and intend to irrevocably relinquish all rights, title and interest to the property without an expectation of some benefit in return.<sup>22</sup> Thus, a charitable deduction for the non-renewal of grazing rights failed because the taxpayer had no transferable property interest in the grazing license, and the government received no benefit from the taxpayer's waiver of the renewal of that license.<sup>23</sup> Likewise, where the transfer of real property from the taxpayer to the charitable organization does not satisfy all legal requirements before the year's end, the

<sup>16</sup> Some cases contained one or more of these issues, which explains a total of greater than 26. See, e.g., *Haas v. Comm'r*, T.C. Summ. Op. 2006-9 (involving substantiation and valuation of the contribution).

<sup>17</sup> Qualifying charitable organizations include: (1) federal, state or local governments, and (2) corporations, trusts or funds organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, no part of the net earnings of which inure to the benefit of a private individual or shareholder. See IRC § 170(c) for a full description of qualifying organizations.

<sup>18</sup> *Westbrook v. Comm'r*, T.C. Summ. Op. 2006-3.

<sup>19</sup> *Triplett v. Comm'r*, T.C. Summ. Op. 2005-148 (holding the failure to provide a list of members or to demonstrate that the center performed religious services demonstrated that the organization was not operated exclusively for religious purposes).

<sup>20</sup> *Deihl v. Comm'r*, T.C. Memo. 2005-287.

<sup>21</sup> *Id.*

<sup>22</sup> IRC § 170(f)(3) requires that taxpayers relinquish all rights, title and interest in property contributed. See *Sklar v. Comm'r*, 125 T.C. 281 (2005) (holding payments for private tuition were made in expectation of a return benefit, i.e., education, and therefore were not deductible as charitable contributions), *appeal docketed*, No. 06-72961 (9th Cir. June 8, 2006); see also *Rev. Rul. 67-246*, 1967-2 C.B. 104.

<sup>23</sup> *Bischel v. U.S.*, 415 F. Supp. 2d 1211 (D. Nev. 2005).

taxpayer's deduction will be denied for that year.<sup>24</sup> The existence of personal benefit from the transfer also determined the outcome in two cases. A charitable deduction for payment of tuition to a private school failed because the taxpayer received a substantial benefit in return for the contribution, *i.e.*, a private education for his children, in return for the payment.<sup>25</sup> Similarly, where a taxpayer expends travel costs while contributing services to a charitable organization, the taxpayer may not take a deduction for those expenses when there is a significant personal benefit associated with those expenses.<sup>26</sup>

A taxpayer may make a charitable contribution of an interest in realty that is less than all of all the taxpayer's right, title, and interest to the property, provided that the contribution satisfies the IRC § 170(h) definition of a qualified conservation contribution.<sup>27</sup> However, as the Tax Court held, the grant of a conservation easement that limits development to a specified number of lots is not a qualified contribution if the existence of a circumstance (such as a floodplain) would have precluded additional development regardless of whether the conservation easement had been granted.<sup>28</sup> Likewise, preserving land from development does not satisfy qualified conservation purpose requirements unless a historic structure or historically important land area is being preserved.<sup>29</sup>

### Valuation

Six cases involved disputes between the IRS and taxpayers as to the value of property contributed. When taxpayers contribute non-cash items, they must determine the fair market value of the property as of the date of the contribution.<sup>30</sup> Fair market value is the price at which the property would change hands between a willing buyer and a willing seller,<sup>31</sup> thus the price paid by taxpayer for the property is more persuasive as to fair market value than expert appraisals.<sup>32</sup> Determining the fair market value of non-cash property with precision can be difficult for taxpayers. Consequently, if taxpayers can

<sup>24</sup> *Kaplan v. Comm'r*, T.C. Memo. 2006-16.

<sup>25</sup> *Sklar v. Comm'r*, 125 T.C. 281 (2005), *appeal docketed*, No. 06-72961 (9th Cir. June 8, 2006).

<sup>26</sup> *Field v. Comm'r*, T.C. Summ. Op. 2005-184.

<sup>27</sup> A qualified conservation contribution requires that the contribution be of a "qualified real property interest" (*i.e.*, the entire interest of the donor other than a qualified mineral interest, a remainder interest or a restriction on the use that can be made of the property, IRC § 170(h)(2)), to a "qualified organization" (*i.e.*, generally organizations that qualify under IRC § 501(c)(3), IRC § 170(h)(3)), and exclusively for conservation purposes (*i.e.*, the preservation of land areas for outdoor recreation by or education of the general public, the protection of wildlife, the preservation of open spaces or the preservation of historic structures, IRC § 170(h)(4)(A)-(B)). The conservation purpose must be protected in perpetuity. IRC § 170(h)(5)(A).

<sup>28</sup> *Turner v. Comm'r*, 126 T.C. 299, 314 (2006).

<sup>29</sup> *Id.* at 316 (holding there was no actual historic structure on the land and the easement's limitation on development on land near the historic structure does not preserve the historic structure).

<sup>30</sup> Treas. Reg. § 1.170A-1(c)(1).

<sup>31</sup> Treas. Reg. § 1.170A-1(c)(2).

<sup>32</sup> *Wortmann v. Comm'r*, T.C. Memo. 2005-227.

demonstrate that they donated property, courts are willing to apply the *Cohan* doctrine to arrive at a reasonable fair market value.<sup>33</sup>

### Substantiation

Fifteen cases involved the issue of taxpayers' substantiation of deductions for charitable contributions, with the IRS fully prevailing in ten cases and split decisions resulting in the other five. In the cases in which the IRS fully prevailed, there was no particular finding of lack of credibility on the part of the taxpayers; rather, the decisions reflect that the substantiation requirement is a prerequisite to the charitable deduction. In the cases where taxpayers were allowed a partial deduction, the courts generally applied the *Cohan* doctrine when taxpayers were able to demonstrate that contributions were made but were unable to demonstrate the precise amounts.<sup>34</sup> However, as the Tax Court noted in several cases: "[We] may estimate the amount of the deductible expense, bearing heavily against the taxpayer whose inexactitude in substantiating the amount of the expense is of his own making."<sup>35</sup>

### Pro Se Analysis

In 17 of the 26 cases we reviewed, taxpayers were *pro se*, i.e., representing themselves. None of the taxpayers who appeared *pro se* were entitled to a charitable deduction in full, but six of the seven taxpayers who received partial relief from the courts in these cases were *pro se*. The fact that unrepresented taxpayers were able to obtain some relief in six of these seven cases may reflect the fact that courts are willing to apply the *Cohan* doctrine in taxpayers' favor, provided the taxpayers can demonstrate credible evidence that charitable contributions were made.

### CONCLUSION

Internal Revenue Code § 170 and the applicable Treasury Regulations provide detailed requirements as to what constitutes adequate substantiation for the charitable deduction. These cases demonstrate that courts apply the *Cohan* doctrine to provide some relief to taxpayers who can demonstrate that a contribution has been made; however, on balance, these cases reflect that the courts strictly interpret IRC § 170 and its accompanying regulations.

<sup>33</sup> *Ritchie v. Comm'r*, T.C. Summ. Op. 2005-181.

<sup>34</sup> *Robinette v. Comm'r*, T.C. Summ. Op. 2006-69; *Finch v. Comm'r*, T.C. Summ. Op. 2006-54; *Haas v. Comm'r*, T.C. Summ. Op. 2006-9; *Brown v. Comm'r*, T.C. Summ. Op. 2005-85; *Kendrix v. Comm'r*, T.C. Memo. 2006-9, appeal docketed, No. 06-72814 (9th Cir. June 1, 2006), appeal dismissed (July 21, 2006), motion to reconsider filed (Aug. 3, 2006).

<sup>35</sup> See, e.g., *Robinette v. Comm'r*, T.C. Summ. Op. 2006-69 (citation omitted); *Finch v. Comm'r*, T.C. Summ. Op. 2006-54 (citation omitted).