The 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 the types of taxpayer affected.[1] Through analysis of these issues, the National Taxpayer Advocate will, if appropriate, propose legislative recommendations to mitigate disputes that result in litigation.

The Taxpayer Advocate Service (TAS) used commercial legal research databases to identify the ten most litigated issues (Most Litigated Issues) in federal courts from June 1, 2008, through May 31, 2009. For purposes of this section of the Annual Report to Congress, the term "litigated" means cases in which the court issued an opinion.[2] This year's ten Most Litigated Issues are:

- Collection Due Process hearings (IRC §§ 6320 and 6330);
- Summons enforcement (IRC §§ 7602(a), 7604(a), and § 7609(a));
- Trade or business expenses (IRC § 162(a) and related Code sections);
- Gross income (IRC § 61 and related Code sections);
- Accuracy-related penalty (IRC § 6662);
- Frivolous Issues Penalty (IRC § 6673 and related appellate-level sanctions);
- Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax (IRC § 7403);
- Failure to file penalty (IRC § 6651(a)(1)) and estimated tax penalty (IRC § 6654);
- Family status issues (IRC §§ 2, 24, 32, and 151); and
- Relief from joint and several liability for spouses (IRC § 6015).

The issues are substantially similar to those identified in 2008, with one exception.[3] This year, civil actions to enforce federal tax liens or subject property to payment of tax under IRC § 7403 became a most litigated issue and edged out civil damages for certain unauthorized collection actions under IRC § 7433.[4] While the other nine issues remain substantially

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

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

3 *See* National Taxpayer Advocate 2008 Annual Report to Congress 455-545.

4 Civil damages for certain unauthorized collection actions under IRC § 7433 ranked sixth in 2008 with a total of 78 litigated cases reviewed. *See* National Taxpayer Advocate 2008 Annual Report to Congress 455-58.

the same, the order of the top ten issues changed, mainly due to a dramatic decrease in gross income cases.[5]

Once we identified the ten most litigated issues, TAS analyzed each one in four sections: summary of findings, description of present law, analysis of the litigated cases, and conclusion. Each case analyzed is listed in Appendix III, where the cases are categorized by type of taxpayer (*i.e.*, individual or business).[6] Appendix III 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.[7]

Beginning in 2007, our office expanded the "Most Litigated Issues" section of the Annual Report by adding a new "Significant Cases" discussion. This discussion summarizes important judicial decisions not included in the above-listed top ten issues that were deemed significantly relevant to tax administration.[8]

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 United States Bankruptcy Courts. With limited exceptions, taxpayers have an automatic right of appeal from decisions of the trial court.[9]

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, relief from joint and several liability, and determination of employment status.[10]

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5 Gross income cases decreased from 205 in 2008 to 109 in 2009. In 2008, 96 of the 205 cases involved the issue of whether the income earned in Antarctica could be excluded from gross income pursuant to IRC § 911. Frivolous issues penalty cases rose from the ninth ranking in 2008 to the sixth ranking in 209 with an increase of cases from 49 cases in 2008 to 62 cases in 2009. *See* National Taxpayer Advocate 2008 Annual Report to Congress 470-75. In 2009, however, we did not locate any cases where taxpayers pursued the Antarctica argument before the courts.

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

7 For purposes of this analysis, we considered the court's decision with respect to the issue analyzed only. A "split" decision is defined as a partial allowance on the specific issue analyzed. The citations also indicate whether decisions were on appeal at the time this report went to print.

8 One or more of the cases discussed in the "Significant Cases" section of this report were decided outside the June 1, 2008, through May 31, 2009 period used to identify the ten most litigated issues, but we nonetheless have included them because of their impact on tax administration.

9 *See* IRC § 7482, which provides that the United States Courts of Appeals (other than the United States Court of Appeals for the Federal Circuit) have jurisdiction to review the decisions of the Tax Court. There are exceptions to this general rule. For example, IRC § 7463 provides special procedures for small Tax Court cases (where the amount of deficiency or claimed overpayment totals $50,000 or less) from which appellate review is not available. *See also* 28 U.S.C. § 1294 (appeals from a United States District Court are to the appropriate United States Court of Appeals); 28 U.S.C. § 1295 (appeals from the United States Court of Federal Claims are heard in the United States Court of Appeals for the Federal Circuit); 28 U.S.C. § 1254 (appeals from the United States Courts of Appeals may be reviewed by the United States Supreme Court).

10 IRC §§ 6214; 7476-7479; 6330; 6015; 7436.

The federal district courts and United States Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,[11] and (2) the taxpayer has filed an administrative claim for refund.[12] The federal district courts are the only fora 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.[13]

ANALYSIS OF *PRO SE* LITIGATION

As in previous years, our analysis indicates that many taxpayers appeared before the courts *pro se*.[14] Table 3.0.1 lists the most litigated issues for the period June 1, 2008, through May 31, 2009, and identifies the number of cases, broken down by issue, in which taxpayers appeared without representation. As illustrated in the table below, the issues with the highest rates of *pro se* taxpayers are the frivolous issues penalty, family status issues, and the failure to file and estimated tax penalties.

TABLE 3.0.1, *Pro Se* Cases by Issue

Most Litigated Issue	Total Number of Litigated Cases Reviewed	*Pro Se* Litigation	Percentage of *Pro Se* Cases
Collection Due Process	170	123	72%
Summons Enforcement	158	115	73%
Trade or Business Expense	112	80	71%
Gross Income	109	74	68%
Accuracy-Related Penalty	101	60	59%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	62	55	89%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	61	36	59%
Failure to File and Estimated Tax Penalties	60	46	77%
Family Status Issues	48	45	94%
Joint and Several Liability	42	24	57%
Total	**923**	**658**	**71%**

Table 3.0.2 demonstrates that overall, taxpayers have a higher chance of prevailing in litigation if they are represented. However, *pro se* taxpayers actually experienced a substantially higher rate of success than represented taxpayers in litigation over the frivolous issues penalty and family status issues. These two issues also have the highest percentage of *pro se* taxpayers. With respect to the frivolous issues penalty, the data suggest either (1) an unwillingness on the part of representatives to accept these cases, or (2) a lack of demand for representation by these taxpayers. In addition, the data for family status issues suggest

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

12 IRC § 7422(a).

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

14 *"Pro Se"* means "for oneself; on one's own behalf; without a lawyer." *Black's Law Dictionary* 1236-37 (8th ed. 2004).

that there may be a lack of access to representation for the low and middle income taxpayers impacted by the various family status provisions of law, and a need for more low income taxpayer clinics and clinic volunteers to provide free or low cost representation. Further, the higher success rate for *pro se* taxpayers litigating these issues is noteworthy and indicates a potential failure in communications between taxpayers and the IRS at the administrative level.

TABLE 3.0.2, Outcomes for *Pro Se* and Represented Taxpayers

	Pro Se Taxpayers			Represented Taxpayers		
Most Litigated Issue	Total Cases	Taxpayer Prevailed in whole or in part	Percent	Total Cases	Taxpayer Prevailed in whole or in part	Percent
Collection Due Process	123	7	6%	47	7	15%
Summons Enforcement	115	1	1%	43	4	9%
Trade or Business Expense	80	28	35%	32	11	34%
Gross Income	74	1	1%	35	5	14%
Accuracy-Related Penalty	60	10	17%	41	7	17%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	55	4	7%	7	0	0%
Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax	36	4	11%	25	6	24%
Failure to File and Estimated Tax Penalties	46	7	15%	14	2	14%
Family Status Issues	45	9	20%	3	0	0%
Joint and Several Liability	24	7	29%	18	12	67%
Total	**658**	**78**	**12%**	**265**	**54**	**20%**

Significant Cases

The purpose of this section is to describe certain judicial decisions that generally do not involve any of the ten most litigated issues, but nonetheless highlight important issues relevant to tax administration.[1] These decisions are summarized below.

In *In re Bilski,* the Court of Appeals for the Federal Circuit held that a process is not a patentable subject matter unless it is either (1) tied to a particular machine or apparatus, or (2) transforms an article into a different state or thing.[2]

One of the requirements to obtain a patent from the United States Patent and Trademark Office (USPTO) is that the invention or discovery must be a "new and useful process, machine, manufacture, or composition of matter" under 35 U.S.C. § 101. Mr. Bilski submitted a patent application for a process to manage the risk of commodity price fluctuations (*i.e.,* hedging). The USPTO rejected his application because the process was not a patentable subject matter under 35 U.S.C. § 101. After the Board of Patent Appeals and Interferences upheld the USPTO's determination, Mr. Bilski appealed to the Court of Appeals for the Federal Circuit. In affirming the Board of Patent Appeals and Interferences, the Federal Circuit explained that a process may constitute a patentable subject matter only if it is either (1) tied to a particular machine or (2) transforms an article into a different state or thing (a "machine or transformation" test). Because Mr. Bilski's hedging process was not tied to a particular machine, the court focused on the transformation prong of the test. The court explained: "Purported transformations or manipulations simply of public or private legal obligations or relationships, business risks, or other such abstractions cannot meet the test because they are not physical objects or substances, and they are not representative of physical objects or substances."[3] The court went on to analogize the hedging claim to another case in which a process for arbitrating disputes was not patentable because it covered a "mental process."[4] Thus, the court concluded that the hedging process covered by Mr. Bilski's application was not a patentable subject matter.

1 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2008, and ending on May 31, 2009. For purposes of this section of the report, we generally use the same time period. However, we have included one or more cases decided after May 31, 2009, because the issues involved in those cases are particularly important.

2 *In re Bilski*, 545 F.3d 943 (Fed. Cir. 2008), *cert. granted, Bilski v. Doll*, 129 S.Ct. 2735 (June 1, 2009). For recent press coverage, see, *e.g.*, Jeremiah Coder, *Supreme Court Grants Certiorari in Bilski Patent Case*, 2009 TNT 103-2 (June 2, 2009); Congressional Research Service, R40681, *Current Issues in Patentable Subject Matter: Business Methods, Tax Planning Methods, and Genetic Materials* (June 8, 2009), *reprinted as,* CRS Report Examines Patents on Tax Planning Methods, 2009 TNT 130-13 (July 10, 2009).

3 *In re Bilski,* 545 F.3d at 963.

4 *In re Bilski,* 545 F.3d at 964-65 (citing *In re Comiskey*, 499 F.3d 1365 (Fed. Cir. 2007), *aff'd in part,* 554 F.3d 967 (Fed. Cir. 2009)).

Although this case did not involve a tax issue, it is nonetheless significant because it affects the extent to which tax strategies may be patented.[5] On one hand, the decision provides support for the view that it is very difficult to patent a tax strategy that is not tied to a computer or other machine. On the other hand, the court's failure to eliminate so-called business method patents leaves the door open to patent tax strategies, especially those that have some nexus to a computer or other machine. In addition, the court acknowledged that "[it] may in the future refine or augment the [machine or transformation] test or how it is applied."[6] Moreover, because the Supreme Court granted certiorari to hear the appeal of Mr. Bilski's case, this area of the law may continue to evolve.

In *RadioShack Corp. v. United States*, the Court of Appeals for the Federal Circuit held that the taxpayer's statute of limitations period for filing a telephone excise tax refund claim began to run when the taxpayer's telephone service provider filed a return.[7]

Over a number of years, RadioShack purchased long distance service and paid telecommunications excise taxes on the basis of the time and distance of its calls.[8] RadioShack was not required to file telephone excise tax returns or pay tax to the IRS. Rather, the telephone service provider collected the tax from RadioShack, filed excise tax returns, and paid it to the IRS. In the late 1990s, most telephone service providers moved to a time-only billing model, pursuant to which services were not subject to tax. Nonetheless, the IRS continued collecting the telephone excise tax on those services until May 2006.[9] In January 2006, RadioShack filed a class action refund suit in the Court of Federal Claims on behalf of itself and similarly situated taxpayers, seeking a refund of overpaid telephone excise taxes. On October 4, 2006, RadioShack filed a claim with the IRS for a refund of the 1996 excise taxes, which the IRS denied as time-barred (*i.e.*, filed after expiration of the applicable statute of limitations period). RadioShack then amended its complaint to specifically identify this claim, and the government moved to dismiss the suit for lack of jurisdiction.

Under IRC § 7422, the government argued that the court has no jurisdiction unless the claim is "duly filed with the Secretary, according to the provisions of law in that regard," including the statute of limitations provision of IRC § 6511(a). The IRS determined that RadioShack did not make a refund claim for its 1996 excise taxes within the statute of limitations period provided by IRC § 6511(a). IRC § 6511(a) requires that a

5 For additional discussion of this issue, see National Taxpayer Advocate 2007 Annual Report to Congress 512 (Key Legislative Recommendation: *Eliminate Tax Strategy Patents*). For further analysis of this decision, see, Jeremiah Coder, *News Analysis: Bilski Ruling Unlikely to Change Ground Rules for Tax Patents – For Now*, 2008 TNT 213-3 (Oct. 31, 2008); Linda M. Beale, *Tax Patents: At the Crossroads of Tax and Patent Law*, 121 Tax Notes 1023 (Dec. 1, 2008).

6 *In re Bilski*, 545 F.3d at 956.

7 *RadioShack Corp. v. U.S.*, 566 F.3d 1358 (Fed. Cir. 2009), *aff'g* 82 Fed. Cl. 155 (2008).

8 *See* IRC §§ 4251-4254.

9 Notice 2006-50, 2006-1 C.B. 1141.

> [c]laim for credit or refund of an overpayment of any tax ... **in respect of which tax the taxpayer is required to file a return** shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid (emphasis added).[10]

The Court of Federal Claims agreed that RadioShack had not filed a timely claim for refund pursuant to IRC § 6511(a), and consequently, dismissed RadioShack's refund suit for lack of jurisdiction.[11] RadioShack appealed, arguing that IRC § 6511(a) only limits claims for taxes "in respect of which the taxpayer is required to file a return." Because it was not required to file a return with respect to excise taxes, RadioShack reasoned, IRC § 6511(a) did not limit the period within which it could file a claim for refund.

The United States Court of Appeals for the Federal Circuit disagreed with RadioShack.[12] The court, following the First and Eleventh Circuits, interpreted the phrase "the taxpayer" in IRC § 6511 to mean "a" taxpayer generally, rather than any taxpayer in particular.[13] Under this interpretation, the inquiry is whether the telephone excise tax is the type of tax for which a return must be filed by anyone. Because the telephone service provider was required to file a return to report the excise tax, it did not matter that RadioShack was not required to file a return or pay the tax. Consequently, its claim had to be filed within three years from when the return was filed by the telephone service provider or two years from when the tax was paid. Thus, RadioShack's claim was time-barred. The court did not discuss the difficulty a taxpayer might have in determining when a return is filed by a third party.

In *Keller v. Commissioner*, the Court of Appeals for the Ninth Circuit held that a taxpayer was not liable for the 40 percent gross valuation misstatement penalty because his understatement of tax was attributable to improperly claiming a deduction rather than overvaluing a deductible item.[14]

In 1995, Mr. Keller invested in a tax shelter scam orchestrated by Mr. Hoyt. Pursuant to this shelter, Mr. Keller deducted his seller-financed purchase of cows, which generated net operating loss carrybacks and refunds. However, some of the cows did not exist. The IRS denied the deduction and assessed a 40 percent penalty for gross valuation misstatements.[15]

10 IRC § 6511(a).

11 *RadioShack Corp. v. U.S.*, 82 Fed. Cl. 155 (2008), *aff'd*, 566 F.3d 1358 (Fed. Cir. 2009).

12 *RadioShack Corp. v. U.S.*, 566 F.3d 1358 (Fed. Cir. 2009), *aff'g* 82 Fed. Cl. 155 (2008).

13 *Id.* at 1362 (citing *Little People's School, Inc. v. U.S.*, 842 F.2d 570 (1st Cir. 1988) and *Wachovia Bank, N.A. v. U.S.*, 455 F.3d 1261 (11th Cir. 2006)). The court also purported to follow its own precedent, citing *Alexander Proudfoot Co. v. U.S.*, 454 F.2d 1379 (Fed. Cir. 1972) and *J.O. Johnson, Inc. v. U.S.*, 476 F.2d 1337 (Fed. Cir. 1973). However, those cases interpret "the taxpayer" in accord with its natural meaning, relying instead on the fact that the second clause of IRC § 6511(a) expressly applies in cases where no return was filed by "the taxpayer." *Id.*

14 *Keller v. Comm'r*, 556 F.3d 1056 (9th Cir. 2009), *rev'g* T.C. Memo. 2006-131.

15 IRC § 6662(b) imposes a penalty in the amount of 20 percent of the underpayment of tax attributable to, among other things, negligence or certain "substantial" valuation misstatements of more than 150 percent (or 200 percent in some cases). IRC § 6662(h) increases the amount of the penalty to 40 percent when there are certain "gross" valuation misstatements of more than 200 percent (or 400 percent in some cases).

While the taxpayer agreed that he was negligent and not entitled to any deduction, he challenged the 40 percent penalty for gross valuation misstatements. The taxpayer argued the penalty was not applicable because his underpayment was not "attributable to" a valuation overstatement, as required under IRC § 6662(h)(1). Rather, he had claimed a deduction to which he was not entitled at all.

The IRS argued, and the Tax Court agreed, that if the taxpayer's correct basis in the cows was zero because he had not acquired any cows, the basis claimed on his return was 400 percent or more of the correct amount, *i.e.*, a gross valuation misstatement.[16] On appeal, the Ninth Circuit concluded the Tax Court erred in upholding the gross valuation misstatement penalty.[17] The court reasoned that the taxpayer's tax deficiency "was 'attributable to' taking a depreciation deduction to which he was not entitled (at all) rather than 'attributable to' an overvaluation."[18] Thus, the gross valuation misstatement penalty did not apply.

The Ninth circuit acknowledged that the Second, Third, Fourth, Sixth, and Eighth Circuits have concluded that when overvaluation is intertwined with a tax avoidance scheme that lacks economic substance, an overvaluation penalty can apply.[19] However, the court also cited case law in the Ninth and Fifth Circuits in concluding that once the deduction is disallowed, it was irrelevant that the claimed basis in the cows purportedly acquired by the taxpayer was far in excess of their true value.[20] Because of the split among the circuits, the interpretation of "attributable to" in the context of a valuation misstatement may be the subject of further litigation.

In *Estate of Rosen*, the Tax Court held that the IRS could not reverse its erroneous application of the decedent's income tax payment to his estate tax liability after the three-year statute of limitations on assessment had expired with respect to the income tax return, and thus, the income tax overpayment offset the decedent's estate tax liability.[21]

In the spring of 2001, Mr. Rosen's estate filed Mr. Rosen's estate tax return and a final income tax return for 2000, and paid the liability reported on both returns. On August 13, 2001, the IRS mistakenly assessed only part of the liability shown on the income tax return. It also assessed additional amounts with respect to the estate tax return. While the IRS temporarily applied the income tax payments to the income tax account, it repeatedly reversed those transactions, applying those payments to the estate tax account. The IRS did not fully and permanently correct its year 2000 income tax assessment until 2005 – after the three-year statute of limitations on assessment in IRC § 6501 had expired with

16 *Keller v. Comm'r*, T.C. Memo. 2006-131, *rev'd*, 556 F.3d 1056 (9th Cir. 2009).

17 *Keller v. Comm'r*, 556 F.3d 1056 (9th Cir. 2009), *rev'g* T.C. Memo. 2006-131.

18 *Id.* at 1061.

19 *Id.* at 1061 (citing *Merino v. Comm'r*, 196 F.3d 147, 155 (3d Cir. 1999); *Zfass v. Comm'r*, 118 F.3d 184, 190-91 (4th Cir. 1997); *Illes v. Comm'r*, 982 F.2d 163, 166-67 (6th Cir. 1992); *Gilman v. Comm'r*, 933 F.2d 143, 149-52 (2d Cir. 1991); *Massengill v. Comm'r*, 876 F.2d 616, 619-20 (8th Cir. 1989)).

20 *Keller*, 556 F.3d at 1059-1062 (citing *Gainer v. Comm'r*, 893 F.2d 225, 226 (9th Cir. 1990); *Todd v. Comm'r*, 862 F.2d 540 (5th Cir. 1988)).

21 *Estate of Rosen v. Comm'r*, 131 T.C. No. 8 (2008).

respect to the income tax return. Once the income tax payment was correctly applied to the income tax liability, the IRS's records reflected that the estate had an outstanding estate tax liability. On July 7, 2004 the IRS issued a notice of deficiency with respect to the estate tax return, and the estate petitioned the Tax Court for a redetermination.

The IRS argued that its income tax assessment was not time-barred because it was carrying out the estate's original intent in tendering the funds to pay the decedent's income tax liability.[22] The court rejected this argument, reasoning that the estate intended the IRS to apply its income tax payments to the decedent's income tax liability, which the IRS had done upon receipt of those funds and only later applied the funds to the unpaid estate tax liability.

Then the IRS argued, in a post-trial brief, that the principles of *Lewis v. Reynolds*, 284 U.S. 281 (1932), should prevent the estate from applying the credit to the estate tax liability. According to the court, the principles of *Reynolds* require a taxpayer's claim for an income tax refund to be reduced by the amount of the correct income tax liability for the same year, even if the IRS could no longer assess a deficiency for that year. The court found the *Reynolds* principles inapplicable to the estate tax refund because the decedent's proper income tax liability was not before the court. Thus, the court held that the income tax overpayment represented a payment of the estate tax and would be taken into account in calculating any overpayment of estate tax.

In *Countryside L.P. v. Commissioner,* the Tax Court held that the exception to the tax practitioner privilege applicable to written communications promoting a corporate tax shelter did not apply to handwritten notes or meeting minutes because (1) they were not a "written communication" and (2) the routine advice provided by the practitioner did not "promote" a shelter.[23]

Mr. Egan, a federally authorized tax practitioner, met regularly with Countryside, a long-standing client, to discuss confidential tax matters, allegedly including a corporate tax shelter. Some of these confidential communications were documented by Countryside in meeting minutes and handwritten notes. In connection with a tax controversy, the IRS attempted to compel Countryside to produce these documents. Countryside claimed they were protected from disclosure pursuant to the federally authorized tax practitioner privilege set forth in IRC § 7525, which extends the common-law attorney-client privilege to certain communications between a client and a federally authorized tax practitioner. These protections do not apply, however, to written communications made in connection with the promotion of participation of the client in any tax shelter.[24]

22 The IRS also argued that the court had no jurisdiction to review the IRS's application of the disputed payment on the basis that the case would require the court to determine not just the amount of any estate tax overpayment, but also the amount of any income tax liability. The court disagreed, noting that in determining whether an estate made any payment of estate tax that would give rise to an overpayment, the court could decide whether the particular payment at issue was a payment of estate tax.

23 *Countryside L.P. v. Comm'r*, 132 T.C. No. 17 (Jun. 8, 2009) (hereinafter *Countryside*).

24 IRC § 7525(b).

The IRS argued that notes of oral communications are written communications, while Countryside argued they were not because it did not share the notes with anyone. The court agreed with Countryside in holding that the handwritten notes were not a written communication for purposes of the exception to the privilege.

Next, the court examined whether Mr. Egan had "promoted" a shelter for purposes of the exception to the privilege. Because the court determined the term "promotion" was ambiguous, it turned to legislative history of IRC § 7525, which stated: "The Conferees do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client."[25] In determining that Mr. Egan was not a promoter, the court focused on the fact that he had a longstanding relationship with the taxpayer, did not rely on generic materials, answered questions within his area of expertise upon request, and billed at an hourly rate.[26] Thus, the court held that both the notes and the minutes were protected by the privilege.

In *Mayo Foundation for Medical Education and Research v. United States*, the Court of Appeals for the Eighth Circuit reversed the District Court by holding that (1) a hospital's medical residents were not eligible for the student exemption from Federal Insurance Contributions Act (FICA) taxes because they were full-time employees, and (2) the applicable Treasury Regulations were valid.[27]

FICA taxes must generally be paid on all wages.[28] However, payments for services performed by students in the employ of a "school, college, or university ... if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university" are generally not subject to FICA taxes.[29] In 1998, the Eighth Circuit held that medical residents were eligible for this student exception to FICA, prompting taxpayers to submit more than 7,000 claims for refund.[30] In 2004, the IRS amended the FICA regulations, in part to make clear that (1) an institution would not be considered a "school, college, or university" unless education was its "primary function,"[31] and (2) a person whose normal work schedule is 40 hours or more per week is a full-time employee and ineligible for the student exception.[32] Both the Mayo Foundation and the University of Minnesota

25 *Countryside* at 4 (quoting H. Conf. Rept. 105-599, at 269 (1998), 1998-3 C.B. 747, 1023).

26 By contrast, the Seventh Circuit subsequently took a more expansive view of the definition of promotion, minimizing the importance of the legislative history quoted above, and suggesting a promotion could encompass "individualized tax advice." *Valero Energy Corp. v. U.S.*, 569 F.3d 626 (7th Cir. 2009). Thus, litigation is likely to continue in this area.

27 *Mayo Found. for Med. Educ. and Research v. U.S.*, 568 F.3d 675 (8th Cir. 2009), *rev'g* 503 F. Supp. 2d 1164 (D. Minn. 2007), and *rev'g Regents of the Univ. of Minn. v. U.S.*, 101 A.F.T.R.2d (RIA) 1532 (D. Minn. 2008), *rehearing en banc denied* (Sept. 17, 2009) (hereinafter *Mayo III*). For prior coverage, see National Taxpayer Advocate 2008 Annual Report to Congress 459, 462-63.

28 *See* IRC § 3101 *et. seq.*

29 IRC § 3121(b)(10).

30 *Mayo III*, 568 F.3d at 676-677 (citing *Minnesota v. Apfel*, 151 F.3d 742 (8th Cir. 1998) and providing the 7,000 claim figure).

31 Treas. Reg. § 31.3121(b)(10)-2(c); T.D. 9167, 69 Fed. Reg. 76,404, 76,407 (Dec. 21, 2004).

32 *Id.*

filed refund suits in district court. In both cases, the district court held that the regulations were invalid and that the residents were eligible for the student exception.[33]

The Eighth Circuit reversed, holding the residents were not eligible for the student exception. In reviewing the validity of the new regulations, the court applied the test set forth in *Chevron*, pursuant to which, agency regulations are entitled to deference unless they contradict an unambiguous statute or set forth an unreasonable construction of it.[34] While acknowledging that four circuits had concluded the statute was unambiguous, the court held that the statute was ambiguous on the question of whether a medical resident working full-time can be considered a "student who is enrolled and regularly attending classes" within the meaning of IRC § 3121(b)(10), and distinguished those four decisions on the basis that they did not construe the validity of the new regulations.[35]

According to the court, the new regulation's interpretation of that phrase was reasonable. Thus, the student exception was inapplicable to the residents. As a consequence, the stipends the residents received were subject to FICA. The Eighth Circuit, however, did not disturb the district court's conclusion that the regulations may be invalid in certain respects. Specifically, it agreed, in dicta, with the district court's conclusion that the provision of the new regulations suggesting Mayo is not a "school, college, or university" within the meaning of IRC § 3121(b)(10) unless its "primary function" is education, was "arbitrary and unreasonable," at least in this context.[36]

In *Williams v. Commissioner,* the Tax Court held that it lacked jurisdiction to redetermine the taxpayer's liability for the foreign bank account report penalties (FBAR).[37]

Upon receipt of a notice of deficiency covering income taxes for years 1993 – 2000, the taxpayer filed a petition seeking, among other things, a redetermination of penalties imposed under 31 U.S.C. § 5321 for failure to file foreign bank account reports (FBARs) to disclose his Swiss bank accounts. The IRS can assess the FBAR penalty and "commence a civil action to recover" it.[38]

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33 *Mayo Found. for Med. Educ. and Research v. U.S.*, 503 F. Supp. 2d 1164 (D. Minn. 2007) (concluding the regulations were invalid because they were inconsistent with the plain meaning of "school, college, or university" provided by the statute, which was not ambiguous); *Regents of the University of Minnesota v. U.S.*, 101 A.F.T.R.2d (RIA) 1532 (D. Minn. 2008) (citing *Mayo Found. for Med. Educ. and Research*, 503 F. Supp. 2d at n.6 for the proposition that the regulations were invalid). In both cases, the district court also rejected the IRS's argument that the residents were actually employees of the hospitals where they performed services.

34 *Mayo III,* 568 F.3d at 679 (citing *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)).

35 *Mayo III*, 568 F.3d at 679 and n.2 (citing *U.S. v. Mount Sinai Med. Ctr. of Fla., Inc.*, 486 F.3d 1248, 1251-56 (11th Cir. 2007); *U.S. v. Mem'l Sloan-Kettering Cancer Ctr.*, 563 F.3d 19, 27 (2d Cir. 2009); *U.S. v. Detroit Med. Ctr.*, 557 F.3d 412, 417-18 (6th Cir. 2009); *Univ. of Chi. Hosps. v. U.S.*, 545 F.3d 564, 567 (7th Cir. 2008)).

36 *Mayo III*, 568 F.3d at 684. Similarly, the court did not address the district court's conclusion that the residents were employed by the University rather than the hospitals where the services were performed.

37 *Williams v. Comm'r*, 131 T.C. No. 6 (2008). For a discussion of FBAR, see Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges, supra.*

38 31 U.S.C. § 5321(b)(2); 31 C.F.R. § 103.56(g).

For certain taxes, the IRS is required to issue a notice of deficiency before making an assessment.[39] Upon receipt of this notice, the filing of a timely petition with the Tax Court triggers the court's "deficiency" jurisdiction to redetermine the tax shown in the notice.[40] Because the IRS is not required to issue a notice of deficiency before assessing the FBAR penalty, the court reasoned, the FBAR penalty falls outside the court's deficiency jurisdiction.

Similarly, in connection with the issuance of a lien or a levy to collect a tax, the IRS must issue a notice of determination and provide an opportunity for a hearing.[41] Under certain circumstances, this notice triggers the court's jurisdiction to review the IRS's determination with respect to the tax liability.[42] The court reasoned that because the FBAR penalty is not a "tax," the IRS has no authority to collect it using liens and levy procedures, which could give rise to jurisdiction. Because the Tax Court could not identify any statutory authority that would give it jurisdiction, it held that it had no jurisdiction to redetermine liability for the FBAR penalty.

In *Morrison v. Commissioner,* the Court of Appeals for the Ninth Circuit held that a taxpayer can recover fees from the government under IRC § 7430 even if a third party pays the fees, provided the taxpayer agrees to repay to the third party any fees reimbursed by the government.[43]

Caspian, a corporation, and one of its shareholders, Mr. Morrison, used the same law firm in consolidated proceedings to challenge deficiencies asserted by the IRS against each of them. Caspian paid the litigation costs, and Mr. Morrison purportedly agreed to repay Caspian any reimbursement for costs he received from the government. After prevailing in the Tax Court, each applied for reimbursement of their respective portions of the attorney fees. Caspian's request was granted, but Mr. Morrison's was denied.

A taxpayer prevailing in litigation with the IRS may be awarded reasonable costs "paid" or "incurred" in connection with the proceeding, if the IRS position was not substantially justified, and the taxpayer (1) has a net worth below a certain threshold, (2) exhausted available administrative remedies within the IRS, and (3) did not unreasonably protract the proceedings.[44] After turning to the dictionary for the meaning of "incur," the Tax Court held that Mr. Morrison was not entitled to reimbursement for costs because he did not pay or incur any, as required under IRC § 7430.[45]

39 *See* IRC §§ 6212-6214.

40 *See* IRC § 6213.

41 *See generally* IRC §§ 6320 and 6330.

42 *See* IRC §§ 6320(c) and 6630(d)(1); *Goza v. Comm'r,* 114 T.C. 176, 182 (2000).

43 *Morrison v. Comm'r*, 565 F.3d 658 (9th Cir. 2009), *rev'g* T.C. Memo. 2006-103.

44 IRC § 7430.

45 *Morrison v. Comm'r*, T.C. Memo. 2006-103, rev'd, 565 F.3d 658 (9th Cir. 2009).

The Ninth Circuit rejected the Tax Court's narrow reading of what it means to incur costs, concluding that the Tax Court conflated the terms "paid" or "incurred."[46] It held that an individual may incur costs for purposes of IRC § 7430 even if those costs are initially paid by a third party, provided he assumes an absolute or contingent obligation to repay any costs he can recover.

After reviewing the legislative history, the court observed that the purpose of IRC § 7430 is to (1) deter overreaching by the IRS, and (2) enable individual taxpayers to vindicate their rights regardless of their economic circumstances. Disallowing attorney's fees and costs in such circumstances would neither remove the financial disincentive to litigate against the government, nor deter the government's unreasonable denial of taxpayer claims. It would also increase the costs to *pro bono* organizations of assisting taxpayers who could not otherwise afford to pay to litigate meritorious claims.[47]

The only rationale the court could identify for interpreting the fee shifting rules more narrowly was to prevent wealthy plaintiffs from circumventing the net worth limitations by funding litigation by others. However, the court observed that this is not a problem in tax litigation because the government itself selects the petitioner when it determines who to audit. Thus, the Ninth Circuit reasoned, its statutory interpretation was more consistent with the purpose of the statute.

In *United States v. McFerrin*, the Court of Appeals for the Fifth Circuit extended the "*Cohan* rule" to hold that a taxpayer who establishes the existence of qualified expenses for purposes of the IRC § 41 research credit, is entitled to rely on rough estimates, rather than contemporaneous documentation, to determine the amount of those expenditures.[48]

Although in 1999 Mr. McFerrin's business engaged in "qualified research" that would have been eligible for research credits pursuant to IRC § 41, he did not claim any research credit on his 1999 returns.[49] After engaging a firm to determine the extent to which he was eligible for the research credit, Mr. McFerrin filed amended returns for 1999 to claim the credit. The IRS issued a refund for 1999, but subsequently filed suit to recover the refund, plus interest.[50]

The IRS argued, in part, that even if qualified research occurred, Mr. McFerrin was not eligible for the credit because he failed to provide adequate documentation to substantiate the

46 The statute uses the term "incurred" in one place and "paid or incurred" in others. *Compare* IRC § 7430(a) *with* IRC §§ 7430(c)(1)(B)(iii) and 7430(c)(3)(B).

47 *Morrison v. Comm'r*, 565 F.3d at 662-64 (citations omitted).

48 *U.S. v. McFerrin*, 570 F.3d 672 (5th Cir. 2009), *vacating* 102 A.F.T.R.2d (RIA) 6269 (S.D. Tex. 2008). The so-called *Cohan* rule is a reference to *Cohan v. Comm'r,* 39 F.2d 540, 544 (2d Cir. 1930). The *Cohan* rule is discussed in greater detail in the Most Litigated Issue section entitled, *Gross Income Under Internal Revenue Code Section 61 and Related Sections, infra.*

49 For a discussion of how sunsetting the research credit (*i.e.*, making it temporary) increases complexity and reduces any incentive it provides for conducting research, see National Taxpayer Advocate 2008 Annual Report to Congress 397, 406.

50 *See* IRC § 7405 (authorizing civil actions to recover erroneous refunds).

costs associated with the research. According to regulations, "[a] taxpayer claiming ... [the research credit] must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit."[51] Those regulations are consistent with the general rule that requires taxpayers to retain documentation sufficient to establish the amount of gross income, deductions, and credits.[52] Consequently, the district court ruled in the government's favor, and ordered Mr. McFerrin to repay the refund, plus interest.[53]

Pursuant to the so-called *Cohan* rule, however, when a taxpayer is entitled to a deduction, but the amount can not be adequately substantiated by documentation, courts have sometimes allowed a deduction if there is a basis upon which to estimate the deductible amount.[54] The *Cohan* rule does not apply to all types of deductions. For example, it does not apply to deductions for travel, meals, or entertainment because Congress has imposed specific contemporaneous documentation requirements.[55] On appeal, the Fifth Circuit held that a court must first determine whether any qualified research occurred, and if so, then estimate the expenses related to that research, thereby extending the *Cohan* rule to qualified research expenditures.[56] This holding is likely to make it easier for taxpayers to claim the research credit even if they cannot substantiate and document the amount of their qualified expenses with precision.

In *Bakersfield Energy*, the Court of Appeals for the Ninth Circuit held that an overstatement of basis was not an omission of gross income for purposes of extending the statute of limitations on assessment under IRC § 6501(e).[57]

On October 4, 2005, the IRS determined that Bakersfield Energy, a partnership, had overstated its basis on the sale of an oil and gas property reflected in its 1998 return. The general rule is that the IRS is required to assess tax within three years after a return is filed, but a longer six-year period applies when a taxpayer omits from gross income an amount greater than 25 percent of the gross income stated in the return.[58] In *The Colony, Inc. v. Commissioner*, the Supreme Court held that an overstatement of basis was not an omission

51 Treas. Reg. § 1.41-4(d).

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

53 *U.S. v. McFerrin*, 102 A.F.T.R.2d (RIA) 6269 (S.D. Tex. 2008), *vacated*, 570 F.3d 672 (5th Cir. 2009).

54 *Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930). For an interesting discussion of the *Cohan* rule, see J. Russell Hamilton and Shane Webster, *How Close is Close Enough?*, 97 Tax Notes 1231 (Dec. 2, 2002).

55 IRC § 274(d); Treas. Reg. § 1.274-5T(a)(4).

56 The IRS audit technique guide, which expressly rejects the *Cohan* rule in the context of the research credit, may now be obsolete. *See* Large and Mid-Size Business Division (LMSB), LMSB-04-0508-030, *Research Credit Claims Audit Techniques Guide (RCCATG): Credit for Increasing Research Activities § 41* (May 2008), http://www.irs.gov/businesses/article/0,,id=183208,00.html#6. For additional analysis of these issues, see *e.g.*, Jeremy M. Fingeret *et. al.*, *Cases Confirm Applicability of Estimates in Research Credit Claims*, 2009 TNT 161-6 (Aug. 24, 2009).

57 *Bakersfield Energy Partners, LP v. Comm'r,* 568 F.3d 767 (9th Cir. 2009), *aff'g* 128 T.C. 207 (2007) (hereinafter *Bakersfield Energy*). For a discussion of the Tax Court decision, see National Taxpayer Advocate 2007 Annual Report to Congress 563-64.

58 IRC §§ 6501(a); 6501(e). Even if the IRS can establish the omission, however, the three-year statute of limitations will still apply if the taxpayer can show that the "adequate disclosure" safe harbor applies. IRC § 6501(e)(1)(A)(ii). While IRC § 6229, which largely mirrors IRC § 6501, is technically the applicable code section, both parties agreed that precedents interpreting IRC § 6501 have been held equally applicable to IRC § 6229.

of gross income under the predecessor of IRC § 6501 because no income was "left out" of the return.[59] The IRS attempted to distinguish *Colony*. It argued that *Colony* was inapplicable because it was decided under the provisions of the 1939 Code. It also distinguished *Colony* on the basis that it involved the sale of goods and services (*i.e.*, the sale of residential lots by a taxpayer whose principal business was the development and sale of lots) rather than the sale of business property (*i.e.*, the sale of property reported on Form 4797, *Sale of Business Property*). The Ninth Circuit rejected these arguments, noting that the language in IRC § 6501(e)(1)(A) is identical to the language in the 1939 Code that the Supreme Court construed in *Colony*, and that nothing in *Colony* shows that the Supreme Court intended to limit its rational to taxpayers in a trade or business.[60] Thus, it held that the six-year period of limitations did not apply when a taxpayer overstates its basis in an asset.[61]

59 *The Colony, Inc. v. Comm'r*, 357 U.S. 28 (1958) (hereinafter *Colony*). Although *Colony* was decided on the basis of the predecessor of current IRC § 6501(e), the Court noted that its decision was "in harmony" with the unambiguous language of IRC § 6501, which had recently been enacted. *Id.* at 37.

60 *Bakersfield Energy*, 568 F.3d at 775-76.

61 The Court of Appeals for the Federal Circuit and the Tax Court also recently agreed with the Ninth Circuit in holding that an overstatement of basis did not trigger the longer six-year statute of limitations. *See Beard v. Comm'r*, T.C. Memo. 2009-184; *Intermountain Insurance Service of Vail, LLC v. Comm'r*, T.C. Memo. 2009-195; *Salman Ranch, Ltd. v. U.S.*, 573 F.3d 1362 (Fed. Cir. 2009), *rev'g* 79 Fed. Cl. 189 (2007).

MLI #1

Appeals 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).[1] CDP hearings provide taxpayers with an independent review by the IRS Office of Appeals (Appeals) of the decision to file a lien or the IRS's proposal to undertake a levy action. In other words, a CDP hearing gives taxpayers an opportunity for meaningful hearings in front of appeals officers *before* the IRS proceeds with collection. At the CDP hearing, the taxpayer has the statutory right to raise any relevant issues related to the unpaid tax, the lien, or the proposed levy, including the appropriateness of collection action, collection alternatives, spousal defenses, and under certain circumstances, the underlying tax liability.[2]

Taxpayers have the right to judicial review of Appeals' determinations provided they timely request the CDP hearing and timely petition the court.[3] Generally, the IRS suspends collection action during the hearing and any judicial review that may follow.[4]

Since 2003, CDP has been one of the tax issues most frequently litigated in the federal courts and analyzed for the National Taxpayer Advocate's Annual Report to Congress. The trend continues this year, with the courts issuing at least 170 opinions during the review period of June 1, 2008, through May 31, 2009.[5] The cases discussed below demonstrate that the CDP process serves an important function by providing taxpayers with a forum to raise legitimate issues before the IRS deprives them of property. Many of these decisions provide guidance on substantive issues. Where taxpayers attempted to use the process inappropriately, courts imposed sanctions or warned taxpayers about the possibility of sanctions being imposed in the future.

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

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

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

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

5 For a list of all of the cases reviewed, see Appendix III, Table 1, *infra*.

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of a Notice of Federal Tax Lien (NFTL) filed by the IRS, or of a proposed levy action.[6] As noted above, the purpose of CDP rights is to give taxpayers adequate notice of IRS collection activity and a meaningful hearing *before* the IRS deprives them of property.[7] The hearing allows taxpayers an opportunity to raise issues relating to the collection of the subject tax, including:

- Appropriateness of collection actions;[8]
- Collection alternatives such as an installment agreement (IA), offer in compromise (OIC), posting a bond, or substitution of other assets;[9]
- Appropriate spousal defenses;[10]
- The existence or amount of the 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;[11] and
- Any other relevant issue relating to the unpaid tax, the NFTL, or the proposed levy.[12]

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

Procedural Collection Due Process Requirements

The IRS must provide a CDP notice to the taxpayer whenever it has filed an NFTL or it intends to levy, not more than five business days after the day of filing the lien notice, or at least 30 days before the day of the levy.[14] In a lien filing, the notice must inform the taxpayer of his or her right to request a CDP hearing within the 30-day period that begins on the day after the end of the five-business-day period after the filing of the NFTL.[15] In the case of a levy, the notice must inform the taxpayer of his or her right to request a hearing within the 30-day period beginning on the day after the date on the CDP notice.[16]

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

7 Prior to the enactment of RRA 98, the U.S. Supreme Court had held that a post-deprivation hearing was sufficient to satisfy due process concerns in the tax collection arena. *See U.S. v. National Bank of Commerce*, 472 U.S. 713, 719-22 (1985); *Phillips v. Comm'r*, 283 U.S. 589, 595-601 (1931).

8 IRC § 6330(c)(2)(A)(ii).

9 IRC § 6330(c)(2)(A)(iii).

10 IRC § 6330(c)(2)(A)(i).

11 IRC § 6330(c)(2)(B).

12 IRC § 6330(c)(2)(A).

13 IRC § 6330(c)(4).

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

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

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

Requesting a Collection Due Process Hearing

Under both lien and levy procedures, the taxpayer must return a signed and dated written request for a CDP hearing within the applicable period.[17] Taxpayers who request a CDP hearing after this time (generally 30 days from the date of the notice) will receive an "equivalent hearing," which is similar to a CDP hearing without judicial review.[18] The regulations require taxpayers to provide their reasons for requesting a hearing (preferably using Form 12153, *Request for a Collection Due Process or Equivalent Hearing*). Failure to provide the basis for the hearing may result in denial of a face-to-face hearing.[19] The regulations also provide that taxpayers must separately request an equivalent hearing within the one-year period beginning the day after the five-business-day period following the filing of the NFTL, or with respect to a levy, within the one-year period beginning the day after the date of the CDP notice.[20]

Conduct of a CDP Hearing

The IRS will suspend collection action throughout the CDP hearing process unless it determines the collection of tax is in jeopardy, the collection resulted from a levy on a state tax refund, or the IRS has served a disqualified employment tax levy.[21] The IRS also suspends collection activity throughout any judicial review of Appeals' determination, unless the underlying tax liability is not at issue and the IRS can demonstrate to the court good cause to resume collection activity.[22]

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

17 IRC §§ 6330(a)(3)(B) and 6320(a)(3)(B); Treas. Reg. §§ 301.6320-1(c)(2) A-C1(ii) and 301.6330-1(c)(2) A-C1(ii).

18 Treas. Reg. §§ 301.6320-1(i)(1) and 301.6330-1(i)(1).

19 IRC §§ 6320(b)(1) and 6330(b)(1); Treas. Reg. §§ 301.6320-1(c)(2) A-C1, 301.6330-1(c)(2) A-C1, 301.6320-1(d)(2) A-D8 and 301.6330-1(d)(2) A-D8. The regulations require the IRS to provide the taxpayer an opportunity to "cure" any defect in a timely filed hearing request, including providing a reason for the hearing. In conjunction with issuing regulations, the IRS revised Form 12153 to include space for the taxpayer to identify collection alternatives that he or she wants Appeals to consider. The current form also includes a description of common alternatives so taxpayers can apply them to the specific facts of their cases. *See* Form IRS 12153, *Request For Collection Due Process or Equivalent Hearing* (Rev. 11-2006).

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

21 IRC § 6330(e)(1) provides the general rule for suspending collection activity. IRC § 6330(f) provides that if collection of the tax is deemed in jeopardy, the collection resulted from a levy on a state tax refund, or the IRS served a disqualified employment tax levy, IRC § 6330 does not apply, except to provide the opportunity for a CDP hearing within a reasonable time after the levy. *See Clark v. Comm'r*, 125 T.C. 108, 110 (2005) (citing *Dora v. Comm'r,* 119 T.C. 356 (2002)). A disqualified employment tax levy is any levy to collect employment taxes for any taxable period if the person subject to the levy (or any predecessor thereof) requested a CDP hearing with respect to unpaid employment taxes arising in the most recent two-year period before the beginning of the taxable period with respect to which the levy is served. IRC § 6330(h).

22 IRC §§ 6330(e)(1) and (e)(2).

23 IRC § 6320(b)(4).

24 *Katz v. Comm'r,* 115 T.C. 329, 337-38 (2000) (finding that telephone conversations between the taxpayer and the appeals officer constituted a hearing as provided in IRC § 6320(b)).

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

CDP regulations state that taxpayers who provide non-frivolous reasons for opposing the IRS collection action will generally be offered, but not guaranteed, a face-to-face conference. Taxpayers making frivolous arguments or requesting collection alternatives when they are not in compliance with their filing requirements are not entitled to a face-to-face conference.[26]

The CDP hearing is to be held by an impartial officer from Appeals, who is barred from engaging in *ex parte* communication with IRS employees regarding the substance of the case and has had "no prior involvement" in the case.[27] In addition to the issues raised by the taxpayer, the Appeals officer must verify that the IRS has met the requirements of all applicable laws and administrative procedures.[28] In its determination, Appeals must weigh the issues raised by the taxpayer and decide whether the proposed collection action balances the need for efficient collection of taxes with the legitimate concern of the taxpayer that any collection be no more intrusive than necessary.[29]

On December 6, 2006, Congress passed the Tax Relief and Health Care Act of 2006 (TRHCA).[30] Section 407 of the TRHCA changed the CDP process by providing that the IRS may disregard any portion of a hearing request that is based on a position identified as frivolous by the IRS or reflects a desire to delay or impede the administration of federal tax laws.[31] Section 407 also amended IRC § 6702 to create a frivolous submission penalty for such requests.[32] A CDP hearing request is subject to the penalty if any portion of the request "(i) is based on a position which the Secretary has identified as frivolous...or (ii) reflects a desire to delay or impede the administration of the Federal tax laws."[33]

Section 407 also amended IRC §§ 6320(b)(1) and 6330(b)(1) to require taxpayers to include the grounds for requesting the hearing in writing in their CDP hearing requests.[34] IRC § 6330(c)(4) was amended to provide that an issue may not be raised at a hearing if the

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

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

28 IRC § 6330(c)(1).

29 IRC § 6330(c)(3)(C).

30 Pub. L. No. 109-432, 120 Stat. 2922 (2006). The provisions set forth in section 407 are effective for submissions made and issues raised after the date on which the IRS first prescribed a list of frivolous positions. Notice 2007-30, 2007-1 C.B. 883, which was published on or about April 2, 2007, provided the first published list of frivolous positions. Notice 2008-14, 2008-1 C.B. 310, provides the current list of frivolous positions.

31 IRC § 6330(g).

32 The frivolous submission penalty applies to the following submissions: CDP hearing request, OIC, IA request, and application for a Taxpayer Assistance Order (TAO).

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

34 IRC §§ 6320(b)(1) and 6330(b)(1).

issue is based on a position identified as frivolous by the IRS or reflects a desire to delay or impede the administration of federal tax laws.[35]

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

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

Judicial Review of Collection Due Process Determination

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

ANALYSIS OF LITIGATED CASES

CDP was the most frequently litigated tax issue in the federal court system between June 1, 2008, and May 31, 2009. We reviewed 170 CDP court opinions, a five percent decrease from the 179 cases in last year's analysis. However, these 170 opinions do not reflect the full number of CDP cases filed because the court does not issue an opinion in all cases. Some cases are resolved through settlements, and in other cases taxpayers do not pursue litigation after filing a petition with the court, resulting in dismissal of the action prior to the court issuing an opinion. Additionally, the Tax Court disposes of some cases by issuing unpublished orders. Table 1 in Appendix III provides a detailed list of the 170 CDP opinions reviewed, including specific information about the issue(s) considered, the types of taxpayers involved, and the outcomes of the cases.

35 IRC § 6330(c)(4).

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

37 IRC § 6330(h).

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

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

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

Litigation Success Rate

Taxpayers prevailed in full in seven of the 170 cased reviewed (approximately four percent), and prevailed in part in an additional seven cases.[41] Of the cases in which the courts found for the taxpayer in whole or in part, the taxpayers appeared *pro se* in seven cases[42] and were represented in the remaining seven.[43]

Table 3.1.1 below compares litigation success rates in CDP cases reported in the 2003 through 2009 Annual Reports to Congress.[44]

TABLE 3.1.1, Success Rates in CDP Cases[45]

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

ISSUES LITIGATED

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

Procedural Rulings

Trout v. Commissioner

In *Trout v. Commissioner*,[48] the taxpayer filed a Tax Court petition challenging the IRS's determination to proceed with a levy action after the taxpayer defaulted on his OIC. The taxpayer and the IRS had entered an offer in 1997 compromising the taxpayer's 1989, 1990,

41 *Daniel v. Comm'r*, T.C. Memo. 2009-28; *Hall v. Comm'r,* T.C. Summ. Op. 2008-128; *Haubrich v. Comm'r*, T.C. Memo. 2009-45; *Mathia v. Comm'r*, T.C. Memo. 2009-120; *Santini Stone, LLC v. Comm'r*, T.C. Memo. 2009-64; *Select Steel Inc. v. Comm'r*, T.C. Summ.Op. 2008-79; *Wagenknecht v. U.S.*, 533 F.3d 412 (6th Cir. 2008).

42 *Baber v. Comm'r,* T.C. Memo. 2009-30; *Dailey v. Comm'r*, T.C. Memo. 2008-148; *Hall v. Comm'r,* T.C. Summ.Op. 2008-128; *Hoyle v. Comm'r*, 131 T.C. No. 13 (2008), 2008 WL 5156596 (U.S. Tax Ct. Dec. 3, 2008); *Urtekar v. Comm'r*, 302 Fed. Appx. 64 (3rd Cir. 2008); *Wagenknecht v. U.S.*, 533 F.3d 412 (6th Cir. 2008); *Wister v. Comm'r*, 296 Fed. Appx. 547 (9th Cir. 2008).

43 *Conn v. Comm'r*, T.C. Memo. 2008-186; *Dalton v. Comm'r*, T.C. Memo. 2008-165; *Daniel v. Comm'r*, T.C. Memo. 2009-28; *Haubrich v. Comm'r*, T.C. Memo. 2009-45; *Mathia v. Comm'r,* T.C. Memo. 2009-120; *Santini Stone, LLC v. Comm'r*, T.C. Memo. 2009-64; *Select Steel Inc. v. Comm'r,* T.C. Summ. Op. 2008-79.

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

45 Numbers have been rounded to nearest percentage.

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

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

48 131 T.C. No. 16 (2008), 2008 WL 5233280 (U.S. Tax Ct. Dec. 16, 2008).

1991, and 1993 income tax liabilities. Under the terms of the offer, the taxpayer was required to file and pay all his federal taxes on time for the five years following the signing of the OIC. The IRS defaulted the taxpayer's OIC because he failed to timely file his 1998 and 1999 returns. The taxpayer argued that the appeals officer abused his discretion by failing to reinstate the OIC because his failure to timely file his returns was an immaterial breach, not a default. The Tax Court analyzed the case by revisiting *Robinette v. Commissioner*.[49] The Tax Court clarified that OICs should be interpreted using the federal common law of contracts, rather than state contract law. The court looked to the Restatement of Contracts as a "good source" to determine the federal law of contracts.[50] In applying the restatement, the court held that the offer provision requiring the taxpayer to file his tax returns for five years is an express condition subject to strict performance. Accordingly, the Tax Court held the appeals officer did not abuse his discretion by defaulting the OIC because the taxpayer materially breached an express condition of the offer when he did not timely file his returns.[51]

Conn v. Commissioner

In *Conn v. Commissioner*,[52] a taxpayer timely filed a Tax Court petition seeking review of the IRS's determination to uphold its filing of NFTLs and a levy action for the 1993 tax year. The taxpayer sought to challenge the validity of his 1993 liability. When the IRS issued a joint notice of deficiency for the taxpayer's and spouse's 1993 tax year, the taxpayer was serving time in a federal penitentiary for embezzlement. The IRS should have sent the notice of deficiency to the residence of the taxpayer's spouse and a post office box at the penitentiary. The taxpayer's spouse received the deficiency notice, appealed it, and received relief under IRC § 6015 for the 1993 tax year. The taxpayer, on the other hand, claimed he never received the notice. The appeals officer determined the taxpayer was precluded from challenging the underlying liability because he had had a prior opportunity to contest the 1993 liability. The IRS argued the deficiency notice sent to the taxpayer's last known address was sufficient for purposes of IRC § 6330(c)(2)(B). However, the court found the IRS was mistaken, because receipt of the deficiency notice, not just mailing, is required to bar the taxpayer from challenging to the underlying liability in a CDP proceeding. The IRS could not prove the taxpayer received the deficiency notice, so the Tax Court held that the taxpayer did not have a prior opportunity to challenge the 1993 tax liability and remanded the case to Appeals.

49 123 T.C. 85 (2004) rev'd, 439 F.3d 455 (8th Cir. 2006).

50 *Trout*, 131 T.C. at *24.

51 In a concurring opinion, Judge Marvel posed that IRC § 6330(c)(1) appears to require that the IRS verify Internal Revenue Manual (IRM) procedures were followed before a determination to proceed with collection after defaulting an offer. *Id.* at *45.

52 T.C. Memo. 2008-186.

Santini Stone, LLC v. Commissioner

In *Santini Stone, LLC v. Commissioner*,[53] the taxpayer requested a hearing in response to the IRS's proposal to levy and its filing of the NFTL. The taxpayer's liability for payroll taxes and penalties for failing to file correct information returns under IRC § 6721 was provided for in the taxpayer's Chapter 11 bankruptcy plan. The IRS issued CDP notices to the taxpayer after receiving several dishonored checks. The taxpayer petitioned the court to challenge whether the terms of the plan barred the IRS from collecting the IRC § 6721 penalty, whether the IRS had credited payments according to the plan and abated all preconfirmation penalties, and whether the taxpayer's check was honored. The Tax Court placed the burden of proof on the taxpayer with respect to proving whether the check was honored. The IRS admitted at trial, however, that it improperly applied the payments and should have abated the penalties. Further, the Tax Court held that the IRC § 6721 penalty was limited to the obligations contained in the plan. Because the plan assigned no value to this penalty, the court found the appeals officer abused her discretion in determining to proceed with the collection of the IRC § 6721 penalty.

Wilson v. Commissioner

In *Wilson v. Commissioner*,[54] the Tax Court held that a notice of determination issued to a taxpayer who filed a late request for a CDP hearing is invalid. On July 19, 2003, the IRS issued a CDP levy notice with respect to the taxpayer's unpaid Trust Fund Recovery Penalties (TFRPs). The taxpayer did not request a CDP hearing until March 6, 2006, almost three years after the IRS issued its CDP notice. Thus, the taxpayer's hearing request was late. Appeals then conducted an equivalent hearing and issued a notice of determination, which the taxpayer appealed within 30 days. However, the Appeals case memorandum attached to the determination stated the taxpayer had received an equivalent hearing and could not petition the Tax Court because of his untimely hearing request. The Tax Court held the determination letter was internally inconsistent and invalid for purposes of the jurisdictional requirements of § 6330(d)(1), and it lacked jurisdiction to hear the taxpayer's case.

Appeals Impartiality

IRC §§ 6320(b)(3) and 6330(b)(3) require CDP hearings to be conducted by an "impartial" Appeals officer or employee – one "who has had no prior involvement with respect to the unpaid tax" before the first CDP lien or levy hearing. The National Taxpayer Advocate is concerned about a lack of independence of the Office of Appeals from other IRS functions.[55] In previous reports, the National Taxpayer Advocate has focused on cases where employees engage in *ex parte* communications that can compromise Appeals'

53 T.C. Memo. 2009-64.

54 131 T.C. No. 5 (2008), 2008 WL 4159711 (U.S. Tax Ct. Sept. 10, 2008).

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

independence. While *ex parte* communications remain a concern, the following case illustrates a problem facing taxpayers whose cases are handled by Appeals employees who have previously worked on the taxpayers' accounts.

Baber v. Commissioner

In *Baber v. Commissioner*,[56] the IRS filed NFTLs and sent the taxpayer a CDP lien notice with respect to the taxpayer's 1994, 1995, 1996, and 1997 tax liabilities. In response, the taxpayer timely requested a CDP hearing. The settlement officer assigned to handle the case previously served as an OIC specialist, who in 2000 had sent the taxpayer forms to apply for an offer to settle the same liabilities. Moreover, the settlement officer had supervised another employee who assisted the taxpayer with the OIC. At the time of the CDP hearing, the settlement officer did not recall her prior involvement with the petitioner. The taxpayer questioned whether the settlement officer was an impartial officer pursuant to IRC § 6320(b)(3). The Treasury Regulation's definition of "prior involvement" at the time of the hearing was that it included participation of the Appeals Officer in any hearing (other than a CDP hearing) the taxpayer may have had with respect to the unpaid tax and tax periods shown on the NFTL. Based on this definition, the IRS determined the appeals officer's prior consideration of an OIC involving the same tax liabilities did not preclude her from handling the CDP case.[57] However, the Tax Court rejected this interpretation as "impermissibly narrowing" the taxpayer's right to an impartial appeals officer and remanded the case to Appeals for a new hearing.

The Administrative Record

Hoyle v. Commissioner

In *Hoyle v. Commissioner*,[58] the Tax Court held that it has authority to consider IRC § 6330(c)(1) verification issues not raised during the hearing that should have been considered by the appeals officer. The taxpayer challenged the validity of his 1993 income tax liability, arguing that the IRS failed to mail him a notice of deficiency prior to assessing the liability. During the CDP hearing, the taxpayer contested the underlying liability and whether the IRS properly reflected offsetting overpayments in the lien amount. The appeals officer upheld the lien filing and determined the taxpayer was precluded from challenging his underlying liability because he had a previous opportunity to dispute it. The court held that it can review whether the appeals officer verified compliance with applicable law under IRC § 6330(c)(1) without regard to whether the taxpayer raised the issue at the administrative hearing. The court then found the IRS failed to establish the presumption of official regularity by providing a copy of Postal Service Form 3877 to prove it properly mailed the notice of deficiency to the taxpayer.[59] Further, the court was unwilling

56 T.C. Memo 2009-30.

57 Treas. Reg. § 301.6330-1(d)(2)(2004). Subsequent to the determination in this CDP hearing, the IRS amended the Treasury Regulations to adopt a broader definition of "prior involvement" consistent with this case. *See* Treas. Reg. § 301.6330-1(d)(2) A-D4 (2006).

58 131 T.C. No. 13 (2008), 2008 WL 5156596 (U.S. Tax Ct. Dec. 3, 2008).

59 Postal Form 3877 lists the specific name, address and date of an item sent by certified mail.

to accept the IRS's assertion that if the deficiency notice allegedly sent by the IRS was not returned as undeliverable, it meant that the taxpayer received it. The Tax Court held that because the record was unclear regarding what the appeals officer had relied upon to verify the validity of assessment, the court would remand the case, rather than hear the taxpayer's challenge to the underlying liability.

Dalton v. Commissioner

In *Dalton v. Commissioner*,[60] the taxpayers, a husband and wife, owned two parcels of property that they transferred to the taxpayer husband's father. Almost two years later, in 1985, the father placed these and an adjacent parcel he owned into a trust, naming himself as settler and trustee and the taxpayers' two sons as beneficiaries. The three parcels contained a vacation home for the trustee and his wife. Over the years, the trustee executed several transactions in favor of the beneficiaries. In 1993, he entered a home equity loan, which the taxpayer wife co-signed, for one of the sons. In 1996, the taxpayers' demolition business became financially distressed and could not pay its payroll taxes. After losing their home due to their business's failure, the taxpayers moved onto the trust property and began paying rent, debt service, maintenance, and other costs. In 1997, the IRS assessed TFRPs against the taxpayers for two quarters of their business's 1996 payroll taxes. In 1999, the trustee died and the taxpayer husband appointed his brother-in-law to serve as trustee. In 2004, the IRS issued CDP levy notices to the taxpayers and they requested a hearing. The taxpayers wanted an OIC to settle their tax liabilities. The appeals officer focused the hearing on whether the trust property should be included in determining whether to accept the taxpayers' OIC. During the hearing, the appeals officer obtained an opinion from the IRS Office of Chief Counsel on whether the trust property could be seized for the taxpayers' debt on nominee or alter ego theories. The opinion concluded that a nominee relationship existed under federal law between the taxpayers and the trust. The Tax Court found the appeals officer had incorrectly interpreted nominee principles; thus, the administrative record was incomplete with regard to whether the taxpayers held an interest or rights in the trust property sought to be reached under state law. The case was remanded to Appeals, so it could reconsider the IRS's claim that the taxpayers held an interest in the trust property under a nominee theory.

Imposition of Sanctions

One notable issue emerging from the review of CDP decisions is the extent to which the courts imposed sanctions on taxpayers for frivolous positions. IRC § 6673(a)(1) authorizes the Tax Court to impose sanctions when it appears that proceedings have been instituted primarily for delay.[61] Our analysis demonstrates that courts are trying to deter the filing of frivolous CDP hearing requests by imposing sanctions under IRC § 6673 or by warning taxpayers of the possible imposition of sanctions in the future. Of the 170 cases decided

60 T.C. Memo. 2008-165.

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

during the review period, the courts imposed sanctions in 22 cases – or almost 13 percent – and threatened IRC § 6673 sanctions in three additional cases.[62]

Pro Se Analysis

Pro se taxpayers, those without benefit of counsel, litigated 123 (or 72 percent) of the 170 cases brought before the courts, an increase from 58 percent in the previous year and 65 percent in 2007.[63] Table 3.1.2 shows the breakdown of *pro se* and represented cases and the decisions rendered by the court, indicating that approximately six percent of *pro se* taxpayers received some relief on judicial review while approximately 15 percent of represented taxpayers received full or partial relief.

TABLE 3.1.2, *Pro Se* and Represented Taxpayer Cases and Decisions

Court Decisions	*Pro Se* Taxpayers		Represented Taxpayers	
	Volume	Percentage of Total	Volume	Percentage of Total
Decided for IRS	116	94%	40	85%
Decided for Taxpayer	5	4%	2	4%
Split Decisions	2	2%	5	11%
Totals:	**123**		**47**	

CONCLUSION

CDP hearings continue to provide a critical means for taxpayers to challenge IRS collection actions. Given the important protection that CDP hearings offer, it should be of little surprise that CDP remains one of the most frequently litigated tax issues in the federal courts – a trend unlikely to change anytime soon. The cases reviewed illustrate the need for both taxpayers and the IRS to comply with the basic CDP requirements such as verification under IRC § 6330(c)(1), the need for an impartial appeals officer, timeliness of the CDP hearing request, and receipt of the notice of deficiency for purposes of challenging the underlying liability. The issue of what constitutes receipt of a notice of deficiency for purposes of challenging the underlying liability remains a developing issue as illustrated by the *Conn*[64] and *Hoyle*[65] cases discussed previously.

Because of the important role of CDP hearings in protecting taxpayer rights, taxpayers and their representatives will likely continue to pursue their CDP rights in court. However, the courts have demonstrated a decreasing tolerance for frivolous claims designed to stall the

62 *Maga v. Comm'r*, T.C. Memo. 2008-162; *Taylor v. Comm'r*, T.C. Memo. 2008-151; *Williams v. Comm'r*, T.C. Memo. 2008-173.

63 National Taxpayer Advocate 2008 Annual Report to Congress 486.

64 T.C. Memo. 2008-186.

65 131 T.C. No. 13 (2008), 2008 WL 5156596 (U.S. Tax Ct. Dec. 3, 2008).

collection process. The 2006 legislation designed to deter taxpayers from making frivolous arguments during the CDP process, along with the courts' trend of imposing sanctions, may reduce such arguments. The National Taxpayer Advocate will continue to monitor how this legislation plays out and its effect on the CDP process.

MLI #2

Summons Enforcement Under Internal Revenue Code Sections 7602, 7604, and 7609

SUMMARY

The IRS may examine any books, records or other data relevant to an investigation of a civil or criminal tax liability.[1] The IRS may serve a summons for this information directly on the individual who is the subject of the investigation or any third party who may possess relevant information.[2]

A person who has a summons served upon him or her may contest the legality of the summons if the government petitions a court to enforce it.[3] If the IRS serves a summons upon a third party, any person entitled to notice of the summons may challenge its legality by filing a motion to quash or by intervening in any proceeding regarding the summons.[4] Generally, the burden on the taxpayer to establish the illegality of the summons is formidable.[5] We reviewed 158 federal court opinions discussing issues related to IRS summons enforcement during the 12 months from June 1, 2008, through May 31, 2009. The party contesting the summons prevailed in full in only four of these cases, with one resulting in a split decision, two resulting in no decision, and the IRS prevailing in 151 of the 158 cases.

PRESENT LAW

The IRS has broad authority under Internal Revenue Code (IRC) § 7602 to issue a summons to examine a taxpayer's books and records or direct testimony under oath.[6] Further, the IRS may obtain information related to an investigation from a third party if, subject to the exceptions of IRC § 7609(c), it provides notice to those identified in the summons.[7] However, the IRS may not issue a summons *after* referring the matter to the Department of Justice (DOJ).[8] If the recipient of a summons fails to comply, the IRS may commence an action under IRC § 7604 in the appropriate United States District Court to compel production or testimony.[9] If the IRS files a petition to enforce the summons, the taxpayer may contest

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

2 IRC § 7602(a).

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

4 IRC § 7609(b).

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

6 *LaMura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985) (citing *U.S. v. Bisceglia*, 420 U.S. 141, 145-46 (1975)).

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

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

9 IRC § 7604.

the validity of the summons in that proceeding.[10] Also, if the summons is served upon a third party, any person entitled to notice may initiate a petition to quash the summons in an appropriate U.S. District Court, or may intervene in any proceeding regarding the enforceability of the summons.[11]

Generally, every person named in a third party summons is entitled to notice.[12] However, several exceptions may apply. First, the IRS is not required to give notice if the summons is issued to aid in the collection of "an assessment made or judgment rendered against the person with respect to whose liability the summons is issued."[13] This exception reflects congressional recognition of a difference between a summons issued where the IRS has made an assessment or obtained a judgment (and is attempting to determine, for example, whether the taxpayer has an account in a certain bank and whether the account has sufficient funds to pay the tax), and a summons issued in an attempt to compute the taxpayer's taxable income. Giving taxpayers notice in the former case would seriously impede the IRS's ability to collect the tax.[14] The courts have interpreted the "aid of collection" exception to apply only where the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned.[15] Second, for the same reason, a summons issued by an IRS criminal investigator in connection with a criminal investigation is also exempt from IRC § 7609 notice procedures if the summons is served on any person who is not a third party record keeper.[16]

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

- The investigation must be conducted for a legitimate purpose;
- The information sought must be relevant to that purpose;
- The IRS must not already possess the information; and
- All required administrative steps must have been taken.[18]

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

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

12 IRC § 7609(a)(1).

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

14 H.R. Rep. No. 94-658, at 310, *reprinted in* 1976 U.S.C.C.A.N. at 3206. *See also* S. Rep. No. 94-938, pt. 1, at 371-72, *reprinted in* 1976 U.S.C.C.A.N. at 3800-3801 (containing essentially the same language).

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

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

17 *Phillips v. Comm'r,* 99 A.F.T.R.2d (RIA) 3487 (D. Ariz. 2007).

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

The IRS bears the initial burden of establishing that these requirements have been met.[19] However, this burden is minimal, and the government need only introduce a sworn affidavit of the agent who issued the summons declaring that each of the *Powell* requirements has been satisfied.[20] The burden then shifts to the person contesting the summons to demonstrate that the IRS did not meet the requirements or that enforcement of the summons would be an abuse of process.[21]

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

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

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

ANALYSIS OF LITIGATED CASES

Summons enforcement has appeared as a Most Litigated Issue in the National Taxpayer Advocate's Annual Report to Congress every year since 2005. At that time, we reviewed only 44 cases but predicted the number would rise as the IRS became more aggressive in its enforcement initiatives. Our prediction was accurate, as the volume of cases grew to 101 in 2006, 109 in 2007, 146 in 2008, and 158 in 2009.[27] A detailed list of this year's cases appears in Table 2 in Appendix lll.

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

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

21 *Id.*

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

23 The work product doctrine protects against the discovery of documents and other tangible things prepared in anticipation of litigation. Fed. R. Civ. P. 26(b)(3).

24 IRC § 7525 extends the protection of the common law attorney-client privilege to federally authorized tax practitioners in federal tax matters. Criminal tax matters and communications regarding tax shelters are exceptions to the privilege. IRC § 7525 (a)(2), (b). The tax practitioner privilege is interpreted based on the common law rules of the attorney-client privilege. *U.S. v. BDO Seidman, LLP,* 337 F.3d 802, 810-12 (7th Cir. 2003); *petition for cert. denied Roes v. U.S.*, 540 U.S. 1178 (2004).

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

26 IRC § 7525(b); *Valero Energy Corp. v. U.S.*, 102 A.F.T.R.2d (RIA) 5916 (N.D. Ill. 2008), *motion granted by, in part, motion denied by, in part* 2008 U.S. Dist. LEXIS 75959 (N.D. Ill. 2008); *aff'd* by 2009-1 U.S.T.C. (CCH) ¶50,445 (7th Cir. 2009).

27 National Taxpayer Advocate 2008 Annual Report to Congress 488-94; National Taxpayer Advocate 2007 Annual Report to Congress 588-93; National Taxpayer Advocate 2006 Annual Report to Congress 582-88.

The IRS prevailed in full in 151 cases, while taxpayers prevailed in only four cases, and one case ended in a split decision. Attorneys represented taxpayers in 43 cases, while taxpayers appeared *pro se* (*i.e.,* without counsel) in the other 115. One hundred thirty-four cases involved individual taxpayers, while the remaining 24 cases involved business taxpayers (17 of which had representation). The arguments the litigants raised against IRS summonses generally fell into the following categories:

***Powell* Requirements:** Although we identified no cases in which the taxpayer successfully challenged the government's *prima facie* showing, taxpayers frequently argued that one or more of the *Powell* requirements had not been met. For example, a court found the IRS had the authority under IRC § 6031(e)(2) to investigate foreign partnerships to determine if any of the partnerships' gross income was derived from sources within the United States or was connected with trade or business conducted in the United States.[28] In addition, as long as the matter has not been referred to the DOJ, the IRS may issue a summons for the sole purpose of determining criminal liability.[29] Taxpayers argued the summonses were overly broad, but failed to support their claims with evidence that the information sought was irrelevant.[30] Taxpayers also claimed the IRS already possessed the requested documents, but courts have found that the IRS may seek documents directly from the summoned party, even where other sources provide similar information.[31] A court did not enforce a summons where the summoned party established that it did not presently possess the requested documents.[32]

Criminal Referral: Taxpayers argued that because the IRS issued the summons pursuant to a possible criminal investigation, the IRS violated the IRC § 7602(d) restriction on issuing a summons after referring the matter to the DOJ. However, the courts were careful to distinguish between a *referral* to the DOJ, which prevents the IRS from issuing a summons, and a criminal investigation by the IRS, which does not.[33] Additionally, the IRC § 7602(d) restriction on issuing a summons after DOJ referral applies only when the IRS has referred the taxpayer whose tax liabilities are under investigation to the DOJ. This restriction does not apply when summoning a third party whose own tax matter has been referred to the DOJ.[34]

28 *Clearwater Consulting Concepts, LLLP v. U.S.*, 102 A.F.T.R.2d (RIA) 5307 (D.V.I. 2008).

29 *Hopkins v. IRS, et al.*, 103 A.F.T.R.2d (RIA) 1570 (10 Cir. 2009), *aff'g* 101 A.F.T.R.2d (RIA) 1906.

30 *Good Karma Trading, LLC v. U.S., et al.*, 102 A.F.T.R.2d (RIA) 6593 (D. Colo. 2008) (documents requested in the summons were "clearly related to the legitimate tax investigation and the factors which must be investigated" in pursuing that investigation).

31 *Bodensee Fund, LLC v. U.S.,* 102 A.F.T.R.2d (RIA) 6399 (D.N.J. 2008) (requesting essentially the same document from two separate sources allows the IRS to "double check" the records for consistency); *Clearwater Consulting Concepts, LLLP v. U.S.*, 102 A.F.T.R.2d (RIA) 5307 (D.V.I. 2008).

32 *U.S. v. Smith Barney*, 101 A.F.T.R.2d (RIA) 2669 (W.D. Pa. 2008) (Smith Barney provided affidavit testimony establishing where the documents would be kept in the ordinary course of business, attesting to the fact that the relevant files have been searched, twice, and stating that the originals were not located. The Court stated that "although the IRS has satisfied the *Powell* factors...judicial enforcement is not warranted under the circumstances...we find that Smith Barney does not presently possess the requested documents." The Court held that the IRS abused judicial process and did not enforce the summons).

33 *Hopkins v. IRS, et al.*, 103 A.F.T.R.2d (RIA) 1570 (10 Cir. 2009), *aff'g* 101 A.F.T.R.2d (RIA) 1906; *U.S. v. Barry,* 2009 U.S. Dist. LEXIS 19427 (M.D. Fla. 2009) (criminal referral made after IRS issued summons).

34 *Khan v. U.S.*, 103 A.F.T.R.2d (RIA) 1957 (E.D. Mich. 2009); *Khan v. U.S.*, 548 F.3d 549 (7th Cir. 2008), rev., *remanded* 537 F. Supp. 2d 944 (N.D. Ill. 2008).

Constitutional Arguments: Taxpayers asserted several generally unsuccessful constitutional arguments. For example, courts have stated that taxpayers cannot use the Fourth Amendment as a defense to a third-party summons.[35] Further, although taxpayers may have a valid Fifth Amendment claim regarding specific documents or testimony, the courts routinely rejected blanket assertions of a Fifth Amendment privilege.[36] Courts have also rejected taxpayers' First Amendment arguments,[37] with several courts stating that the First Amendment does not protect false commercial speech.[38] Courts have also rejected separation of powers[39] and violation of privacy rights arguments.[40] Finally, the courts found that where the taxpayer received notice and was given an opportunity to respond, there was no due process violation.[41]

Privilege: In *United States v. Richey*, the IRS sought enforcement of its summons for the work file of an appraiser who appraised the value of a conservation easement claimed as a charitable deduction by the taxpayers.[42] The appraiser prepared the appraisal at the direction of the taxpayers' law firm to aid the attorney in providing legal advice to the firm's clients.[43] The court held that the notes in the work file were protected by the attorney-client privilege.[44] The court also held that the attorney prepared the work file in anticipation of future litigation over the value of the conservation easement and thus could also receive work-product protection.[45] The court also noted that the IRS would have an opportunity to conduct discovery regarding the final appraisal report if the taxpayers filed a claim for refund.[46]

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35 *Hibben v. U.S.*, 103 A.F.T.R.2d (RIA) 1403 (E.D. Mo. 2009), *citing Ryan v. Bilby,* 764 F.2d 1325, 1328-29 (9th Cir. 1985); *Maehr v. U.S.*, 102 A.F.T.R.2d (RIA) 6370 (D.N.M. 2008)

36 *U.S. v. Dornstadter*, 103 A.F.T.R.2d (RIA) 426 (S.D. Ala. 2009); *U.S. v. Dornstadter*, 103 A.F.T.R.2d (RIA) 427; *U.S. v. Scambos*, 102 A.F.T.R.2d (RIA) 7151 (W.D. Va. 2008), *aff'd by U.S. v. Scambos,* 2009 U.S. App. LEXIS 5705 (4th Cir. 2009); *U.S. v. Trenk*, 2009 U.S. Dist. LEXIS 15333 (D.N.J. 2009), *hearing on reconsideration by* 103 A.F.T.R.2d (RIA) 1071 (D.N.J. 2009); *U.S. v. Bosset*, 101 A.F.T.R.2d (RIA) 2633 (M.D. Fla. 2008); *U.S. v. Gonzales*, 531 F.3d 1198 (10th Cir. 2008), *aff'g* D.C. No. MC-07-17-BB (D.N.M. 2007); *U.S. v. Navarro*, 304 Fed. Appx. 908 (2nd Cir. 2008); *U.S. v. Rutherford*, 555 F.3d 190 (6th Cir. 2008), *reversing U.S. v. Rutherford*, 2007 U.S. Dist. LEXIS 42351 (E.D. Mich. 2007); *U.S. v. Schaal*, 2008 U.S. Dist. LEXIS 106238 (E.D. Wisc. 2008); *Superior Trading, LLC v. U.S., et al.*, 102 A.F.T.R.2d (RIA) 7276 (M.D. Pa. 2008).

37 *Mottahedeh v. U.S.*, 2009 U.S. Dist. LEXIS 43802 (S.D. Fla. 2009); *Connemara Trading, LLC v. U.S.*, 2008 U.S. Dist. LEXIS 108731 (N.D. Fla. 2008).

38 *Pragovich v. U.S.*, 102 A.F.T.R.2d (RIA) 5188 (C.D. Ill. 2008); *Pragovich v. U.S.*, 102 A.F.T.R.2d (RIA) 5418 (M.D. Pa. 2008); *Pragovich v. U.S.*, 102 A.F.T.R.2d (RIA) 5764 (S.D. Ill. 2008); *Pragovich v. U.S.*, 2008 U.S. Dist. LEXIS 102209 (N.D. Ind. 2008), *adopted by* 103 A.F.T.R.2d (RIA) 696 (N.D. Ind. 2009); *Pragovich v. U.S.*, 102 A.F.T.R.2d (RIA) 5260 (D. Haw. 2008), *adopted by, petition denied by, objection overruled* by 102 A.F.T.R.2d (RIA) 5263 (D. Haw. 2008); *Pragovich v. U.S.*, 2008 U.S. Dist. LEXIS 80604 (M.D. Fla. 2008); *Pragovich v. U.S.*, 102 A.F.T.R.2d (RIA) 7098 (D. Ariz. 2008) (all rejecting a third-party promoter's argument that the IRS issued the summons for the improper purpose of chilling promoter's first amendment rights).

39 *Connemara Trading, LLC v. U.S.*, 2008 U.S. Dist. LEXIS 108731 (N.D. Fla. 2008).

40 *Cox v. U.S. et al.,* 102 A.F.T.R.2d (RIA) 5695 (D. Idaho 2008).

41 *Cox v. U.S. et al.*, 102 A.F.T.R.2d (RIA) 5695 (D. Idaho 2008); *U.S. v. Elmes*, 532 F.3d 1138 (11th Cir. 2008), *aff'g* 99 A.F.T.R.2d (RIA) 1653 (S.D. Fla. 2007); *Superior Trading, LLC v. U.S., et al.*, 102 A.F.T.R.2d (RIA) 7276 (M.D. Pa. 2008); *Howa Trading, LLC, et al. v. U.S., et al.*, 101 A.F.T.R.2d (RIA) 2504 (W.D.N.C. 2008), *objection overruled by, adopted by, petition denied by, motion granted by, stay denied by* 2008 U.S. Dist. LEXIS 96738 (W.D.N.C. 2008).

42 *U.S. v. Richey*, 103 A.F.T.R.2d (RIA) 1228 (D. Idaho 2009).

43 *Id.*

44 *Id.*

45 *Id.*

46 *Id.*

The identity of a taxpayer's client is not protected from the attorney-client privilege, however.[47] In addition to attorney-client privilege, taxpayers may utilize the taxpayer-client privilege under IRC § 7525 or work-product as defenses to summons enforcement.[48] The tax practitioner-client privilege provides that the "same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and a federally authorized tax practitioner."[49] Such privilege exists to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.[50] The communication must be made for the purpose of obtaining tax advice from a federally authorized tax practitioner.[51] The privilege does not apply to communications in connection with the promotion of the direct or indirect participation of a taxpayer in any tax shelter, however.[52]

Under the tax shelter exception, the tax practitioner privilege does not apply to "any written communication between a federally authorized tax practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter."[53] A tax shelter is defined as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax."[54]

One court upheld the tax shelter exception to the tax practitioner privilege under IRC § 7525.[55] In *Valero Energy Corp. v. United States*, the court held that the scope of the "tax shelter promotion" did not limit the tax shelter exception to "communications aimed at selling or marketing pre-packaged tax shelter products."[56] The exception also applied to a person who organizes or assists in organizing a tax shelter.[57]

47 *U.S. v. Diblasi*, 2008 U.S. Dist. LEXIS 93128 (W.D.N.Y. 2008); *U.S. v. Waage*, 102 A.F.T.R.2d (RIA) 6406 (S.D. Cal. 2008) (billing records with complete client names or a key to translate the client codes listed on the privilege log, to identify client names was not protected by attorney-client privilege).

48 *Valero Energy Corp. v. U.S.*, 102 A.F.T.R.2d (RIA) 5916 (N.D. Ill. 2008), *motion granted by, in part, motion denied by, in part* 2008 U.S. Dist. LEXIS 75959 (N.D. Ill. 2008), *aff'd by* 2009-1 U.S.T.C. (CCH) ¶50,445 (7th Cir. 2009); *U.S. v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009), *rev'g* 507 F. Supp. 2d 138 (D.R.I. 2007), *vacated and rehearing granted by* 560 F.3d 513 (1st Cir. 2009). (An *en banc* First Circuit held that tax accrual work papers are not subject to work product protection.).

49 IRC § 7525(a)(1).

50 *Id. See also Valero Energy Corp. v. U.S.*, 102 A.F.T.R.2d (RIA) 5916 (N.D. Ill. 2008), *motion granted by, in part, motion denied by, in part* 2008 U.S. Dist. LEXIS 75959 (N.D. Ill. 2008), *aff'd by* 2009-1 U.S.T.C. (CCH) ¶50,445 (7th Cir. 2009).

51 *Valero Energy Corp. v. U.S.*, 102 A.F.T.R.2d (RIA) 5916 (N.D. Ill. 2008), *motion granted by, in part, motion denied by, in part* 2008 U.S. Dist. LEXIS 75959 (N.D. Ill. 2008), *aff'd by* 2009-1 U.S.T.C. (CCH) ¶50,445 (7th Cir. 2009).

52 IRC § 7525(b); *Valero Energy Corp. v. U.S.*, 102 A.F.T.R.2d (RIA) 5916 (N.D. Ill. 2008), *motion granted by, in part, motion denied by, in part*, 2008 U.S. Dist. LEXIS 75959 (N.D. Ill. 2008), *aff'd by* 2009-1 U.S.T.C. (CCH) ¶50,445 (7th Cir. 2009).

53 IRC § 7525(b); *Valero Energy Corp. v. U.S.*, 102 A.F.T.R.2d (RIA) 5916 (N.D. Ill. 2008), *motion granted by, in part, motion denied by, in part* 2008 U.S. Dist. LEXIS 75959 (N.D. Ill. 2008), *aff'd by* 2009-1 U.S.T.C. (CCH) ¶50,445 (7th Cir. 2009).

54 IRC § 6662(d)(2)(C)(ii).

55 *Valero Energy Corp. v. U.S.*, 102 A.F.T.R.2d (RIA) 5916 (N.D. Ill. 2008), *motion granted by, in part, motion denied by, in part* 2008 U.S. Dist. LEXIS 75959 (N.D. Ill.2008), *aff'd by* 2009-1 U.S.T.C. (CCH) ¶50,445 (7th Cir. 2009).

56 *Id.*

57 *Id.*

The IRS prevailed in 79 of the 84 cases initiated by filing motions to quash the summonses, in part because the courts lacked jurisdiction to hear the cases. The courts dismissed these cases for lack of jurisdiction for the following reasons:

Lack of Jurisdiction Due to Procedural Requirements: The United States is immune from suit unless Congress has expressly waived its sovereign immunity.[58] Since a motion to quash is a suit against the United States, a court has jurisdiction only when Congress has expressly waived sovereign immunity.[59] When a taxpayer wishes to challenge an IRS summons issued to a third party, federal law sets forth the exclusive method by which a taxpayer may proceed.[60] A taxpayer may initiate a proceeding in the U.S. District Court in which the third party resides, no later than 20 days from the date the notice of summons was given.[61] Accordingly, the courts have strictly construed IRC § 7609 when determining if sovereign immunity has been waived.[62]

For example, a court dismissed a *pro* se taxpayer's motion to quash for lack of jurisdiction because the taxpayer filed the motion eight days after the 20-day limitation period had expired.[63] Courts have also dismissed motions to quash where the taxpayer named improper party defendants such as the IRS or an IRS auditor.[64] A court also held that it lacked subject matter jurisdiction over a petition to quash a third party tax summons, where the third party neither resided nor was found within jurisdiction of the district court.[65] Courts have also dismissed motions to quash because the IRS had not yet attempted to enforce an administrative summons.[66]

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

59 *Boudreau v. U.S.*, 2008 U.S. Dist. LEXIS 108232 (E.D. Wash. 2008), *adopted by, complaint dismissed at, petition dismissed by Boudreau v. U.S.*, 2008 U.S. Dist. LEXIS 98522 (E.D. Wash. 2008).

60 26 U.S.C. § 7609(b)(2)(A); *Justin v. U.S., et al.*, 2009 WL 755191 (D.D.C. 2009) (Administrative Procedure Act did not create a cause of action for taxpayer to challenge United States' issuance of administrative summonses); *Bank of O'Fallon v. U.S. et al.*, 102 A.F.T.R.2d (RIA) 5213 (S.D. Ill. 2008) (federal interpleader statute does not waive sovereign immunity).

61 26 U.S.C. § 7609(b)(2)(A); *Justin v. U.S., et al.*, 2009 WL 755191 (D.D.C. 2009); *Bank of O'Fallon v. U.S. et al.*, 102 A.F.T.R.2d (RIA) 5213 (S.D. Ill. 2008).

62 *Boudreau v. U.S.*, 2008 U.S. Dist. LEXIS 108232 (E.D. Wash. 2008), *adopted by, complaint dismissed at, petition dismissed by Boudreau v. U.S.*, 2008 U.S. Dist. LEXIS 98522 (E.D. Wash. 2008).

63 *Boudreau v. U.S.*, 2008 U.S. Dist. LEXIS 108232 (E.D. Wash. 2008), *adopted by, complaint dismissed at, petition dismissed by Boudreau v. U.S.*, 2008 U.S. Dist. LEXIS 98522 (E.D. Wash. 2008). *See also Guardian Trust Co. v. U.S.*, 2009 U.S. Dist. LEXIS 35878 (S.D. Fla. 2009); *Guardian Trust Co. v. U.S.*, 103 A.F.T.R.2d (RIA) 593 (S.D. Fla. 2009) (taxpayers filed untimely objection to third-party summons, four months after entry of the court order enforcing the summons, and two months after the third party complied with the summons).

64 *Maxwell v. IRS,* 2009 U.S. Dist. LEXIS 39854 (M.D. Tenn. 2009), *motion to vacate denied, sanctions allowed by, dismissed by* 2009 U.S. Dist. LEXIS 42798 (M.D. Tenn. 2009); *Maxwell v. IRS*, 2009 U.S. Dist. LEXIS 42788 (M.D. Tenn. 2009), *motion to vacate denied, sanctions allowed by, dismissed by* 2009 U.S. Dist. LEXIS 42798 (M.D. Tenn. 2009); *Zdun, et al., v. Henderson*, 103 A.F.T.R.2d (RIA) 438 (9th Cir. 2009), *aff'g* D.C. No. CV-06-06072-TMC (D. Or. 2006), *petition for cert. filed* Apr. 14, 2009; *Stambaugh v. U.S.*, 103 A.F.T.R.2d (RIA) 333 (S.D. Cal. 2009); *Loppnow v. U.S.*, 2009 U.S. Dist. LEXIS 41468 (E.D. Mo. 2009).

65 *McCammon v. U.S.*, 584 F. Supp. 2d 193 (D.D.C. 2008); *McCammon v. U.S.*, 569 F. Supp. 2d 78 (D.D.C. 2008); *McCammon v. U.S.*, 568 F. Supp. 2d 73 (D.D.C. 2008), *stay denied* 588 F. Supp. 2d 43 (D.D.C. 2008), *appeal dismissed* 2009 U.S. App. LEXIS 1635 (D.C. Cir. 2009); *McCanna v. IRS, et al.*, 2008 U.S. Dist. LEXIS 106779 (D.N.M. 2008) (IRS did not establish that financial institutions were located in the District of New Mexico); *Fisher v. U.S.*, 2009 U.S. Dist. LEXIS 54201 (W.D. Wash. 2009) (court also denied taxpayer's motion to transfer venue).

66 *Holman v. IRS, et al.*, 2009 U.S. Dist. LEXIS 45826 (D. Conn. 2009); *Holman v. IRS, et al.*, 2009-2 U.S.T.C. (CCH) ¶50,457 (D. Conn. 2009); *Jewell v. U.S.*, 102 A.F.T.R.2d (RIA) 5259 (E.D. Ark. 2008); *Pragovich v. U.S.*, 102 A.F.T.R.2d (RIA) 6148 (D. Colo. 2008).

Lack of jurisdiction due to notice requirements: Courts denied several motions to quash because the party contesting the summons was not entitled to notice of the summons due to one of the IRC § 7609(c) exceptions, and therefore lacked standing to contest the validity of the summons.[67] For example, a court dismissed a taxpayer's challenge to a summons based upon lack of jurisdiction when it upheld a summons issued to the taxpayer's church pursuant to a criminal investigation.[68] The court reasoned that IRC § 7609(c)(2)(E), pertaining to waiver of sovereign immunity, did not apply to a church that was not a third-party record-keeper within the definition of IRC § 7603(b)(2).[69] Finally, the court held that it lacked jurisdiction for injunctive relief.[70]

Lack of jurisdiction due to no actual controversy: The courts dismissed motions to quash with respect to two taxpayers because the IRS withdrew the summonses, leaving no ripe case or controversy.[71]

CONCLUSION

The IRS may issue a summons to obtain information needed to determine the correctness of a tax return, determine if a return should have been filed, determine a taxpayer's tax liability, or collect a liability.[72] Accordingly, the IRS may request documents and testimony from taxpayers who have failed to provide that information to the IRS voluntarily. Taxpayers and third parties continue to contest IRS summonses, but rarely succeed due to the significant burden of proof and strict procedural requirements. It appears that as the IRS employs a more aggressive enforcement policy, it will continue to rely heavily on the summons enforcement tool, and we expect the courts will continue to see increased numbers of these cases.

67 *Taylor v. U.S. et al.*, 102 A.F.T.R.2d (RIA) 6227 (5th Cir. 2008), *aff'g* USDC No. 1:07-CV-680 (W.D. Tex. 2007); *Waller v. U.S.*, 102 A.F.T.R.2d (RIA) 7173 (9th Cir. 2008), *aff'g* D.C. No. CV-06-00617-KJD/GWF (D. Nev. 2006).

68 *Taylor v. U.S. et al.*, 102 A.F.T.R.2d (RIA) 6227 (5th Cir. 2008), *aff'g* D.C. No. 1:07-CV-680 (W.D. Tex. 2007).

69 *Id.*

70 *Id.*

71 *U.S. v. Cathcart,* 102 A.F.T.R.2d (RIA) 5949 (2nd Cir. 2008), *vacated and remanded* 2006 U.S. Dist. Lexis 26727 (S.D.N.Y. 2006); *U.S. v. Griggs,* 2008 U.S. Dist. LEXIS 105374 (D. Ariz. 2008), *later proceeding at* 2008 U.S. Dist. LEXIS 108149 (D. Ariz. 2008); cases consolidated (taxpayer had filed suit against U.S., IRS, and Revenue Officer), 103 A.F.T.R.2d (RIA) 922 (D. Ariz. 2009).

72 IRC § 7602(a).

MLI #3

Trade or Business Expenses Under Internal Revenue Code Section 162 And Related Sections

SUMMARY

The deductibility of trade or business expenses is perennially among the ten most litigated tax issues in the federal courts. We identified 112 cases that included a trade or business expense issue and were litigated between June 1, 2008, and May 31, 2009. The courts affirmed the IRS position in the majority (approximately 65 percent) of cases, while taxpayers prevailed about five percent of the time.[1] The remaining cases resulted in split decisions.

PRESENT LAW

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

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

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

1 The IRS prevailed in full in 73 of the 112 cases, while taxpayers prevailed in full in only six cases.

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

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

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

What is an ordinary and necessary expense?

IRC § 162(a) requires a trade or business expense to be both "ordinary and necessary" in relation to the taxpayer's trade or business in order to be deductible. In *Welch v. Helvering*, the Supreme Court stated that the words "ordinary" and "necessary" have different meanings, both of which must be satisfied for a taxpayer to benefit from the deduction.[5] The Supreme Court describes an "ordinary" expense as customary or usual and of common or frequent occurrence in the taxpayer's trade or business.[6] The Court describes a "necessary" expense as one that is appropriate and helpful for development of the business.[7]

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

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

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

Determining whether to deduct expenditures under IRC § 162(a) or to capitalize them under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach to applying principles of capitalization and deductibility.[12]

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

IRC § 162(a) requires an expense to be "paid or incurred during the taxable year" to be deductible. The Code also requires a taxpayer to maintain books and records that substantiate income, deductions, and credits – including adequate records to substantiate deductions claimed as trade or business expenses.[13] If a taxpayer cannot substantiate deductions by documentary evidence (*e.g.*, invoice, paid bill, or canceled check) but can establish that he

5 290 U.S. 111, 113 (1933).

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

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

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

9 IRC § 162(a).

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

11 IRC § 167.

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

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

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*.[14] The court held that the taxpayer's business expense deductions were not adequately substantiated, but "the [Tax Court] should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent."[15]

The *Cohan* rule may not be utilized in 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. Travel expenses;
2. Entertainment, amusement, or recreation expenses;
3. Gifts; or
4. Certain "listed property."[16]

A taxpayer must substantiate a claimed IRC § 274(d) expense with adequate records or sufficient evidence to corroborate the taxpayer's statement establishing the amount, time, place, and business purpose of the expense.[17]

Who has the burden of proof in a substantiation case?

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

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

14 39 F.2d 540 (2d Cir. 1930).

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

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

17 Treas. Reg. § 1.274-5T(b).

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

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

ANALYSIS OF LITIGATED CASES

Trade or business expenses have been one of the ten most litigated tax issues in the federal courts since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.[20] For this year's report, we reviewed 112 cases involving various trade or business expense issues that were litigated in federal courts from June 1, 2008, through May 31, 2009. Table 3 in Appendix III contains a list of the main issues in those cases. Table 3.3.1 (below) categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category. In *Cook v. Commissioner*,[21] for example, the taxpayer raised three distinct trade or business expense issues, so *Cook* appears in three categories in Table 3.3.1.

TABLE 3.3.1, Trade or Business Expense Issues in Cases Reviewed

Issue	Type of Taxpayer	
	Individual	Business (including sole proprietors)
Substantiation of expenses, including application of the *Cohan* rule[22]	19	58
Profit objective[23]	0	10
Ordinary and necessary trade or business expenses[24]	3	0
Personal vs. business expenses[25]	10	8
Business expenses vs. capital expenditures[26]	0	4
Education expenses[27]	2	2
Did the taxpayer establish the carrying on of a trade or business?	0	24

Approximately 71 percent of the taxpayers litigating trade or business deduction issues represented themselves (*pro se*). In terms of percentage, taxpayers represented by counsel fared little better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in approximately 34 percent of litigated cases (11 of 32), while *pro se*

20 See National Taxpayer Advocate 1998-2008 Annual Reports to Congress.

21 T.C. Memo. 2008-182, *appeal docketed*, No. 09-1501 (4th Cir. Apr. 28, 2009).

22 IRC § 6001 and Treas. Reg. § 1.6001-1 require a taxpayer to maintain books and records that substantiate income, deductions, and credits. Treas. Reg. § 1.162-17 provides guidance regarding maintaining adequate records to substantiate deductions claimed as trade or business expenses in connection with the performance of services as an employee. The *Cohan* rule allows courts to estimate certain expenses not properly substantiated. *See Cohan v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930).

23 IRC § 183(a) provides that no deduction attributable to an activity engaged in by an individual or an S corporation shall be allowed if such activity is not engaged in for profit.

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

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

26 Under IRC § 263(a), generally no deduction is allowed for capital expenditures, where capital expenditures include any amount paid for permanent improvements made to increase the value of any property. Under IRC § 195(a), startup expenditures generally cannot be deducted unless a taxpayer makes an expense/amortization election according to IRC § 195(b). Taxpayers who made the election may generally deduct up to $5,000 of startup expenditures in the tax year in which an active trade or business begins and amortize any excess expenditures over 180 months. The $5,000 deduction is reduced by a dollar for every dollar that total start-up expenditures exceed $50,000. *See* IRC § 195(b)(1)(A), (B).

27 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.

taxpayers received partial relief in approximately 35 percent of litigated cases (28 of 80). Only one of the *pro se* taxpayers received full relief.

Individual Taxpayers

None of the 25 decisions involving individual taxpayers was issued as a regular opinion of the Tax Court.[28] Twenty-five of the 112 cases analyzed were litigated by individual taxpayers, and all but two appeared *pro se*. One of the individual taxpayers received full relief, although nine of the 25 cases resulted in split decisions. The most prevalent issue was the substantiation of the claimed trade or business expense deductions, which appeared in 18 cases. For example, in *Alami v. Commissioner*,[29] a split decision, the Tax Court denied numerous deductions claimed by the taxpayers (a husband and wife) for lack of substantiation. These deductions included expenses for union dues, a computer, cell phone, Internet service, uniform maintenance, and depreciation. With respect to the union dues, the Internet, uniform maintenance, and depreciation, the court found that the taxpayers had either not properly substantiated the items or there was not sufficient evidence in the record to provide an estimate under the *Cohan* rule. The Tax Court denied the computer and Internet deductions because the taxpayers had not complied with the strict substantiation requirements of IRC § 274(d). However, the court did allow the taxpayers to deduct tool expenses, which were estimated under the *Cohan* rule.

In a number of cases, the IRS disallowed deductions for various expenses claimed by airline mechanics who had to work at different locations throughout the country or risk being laid off. For example, in *Wilbert v. Commissioner*,[30] the Court of Appeals for the Seventh Circuit affirmed the Tax Court's decision denying travel expense deductions claimed by the taxpayer. In this case, a mechanic received a "bump" notice with a choice between being laid off and bumping other employees and moving to different cities to continue working. The airline gave the taxpayer no end dates for his positions in these cities and no longer required him to perform any services whatsoever in his home city where he initially worked. The IRS denied the deductions because the taxpayer was not "away from home" in the pursuit of a trade or business.[31] The Tax Court, in upholding the IRS's denial of deductions, concluded there was no business reason for the taxpayer to maintain a family residence in his hometown and that he kept it for purely personal reasons. The Seventh Circuit affirmed the Tax Court and held that, absent a business purpose, the taxpayer was not entitled to deductions to travel to work when he could have moved to that area.

28 Tax Court reported decisions fall into three categories: regular decisions, memorandum decisions, and small tax case ("S") decisions. The regular decisions of the Tax Court include cases which have some new or novel point of law, or in which there may not be general agreement, and therefore have the most legal significance. In contrast, memorandum decisions generally involve fact patterns within previously settled legal principles and therefore are not as significant. Finally, "S" case decisions (for disputes involving $50,000 or less) are not appealable and, thus, have no precedential value. *See* IRC § 7463(b). *See also* U.S. Tax Court Rules of Practice and Procedure, Rules 170-175. All but two of the cases involving individual taxpayers were "S" cases.

29 T.C. Memo. 2009-42.

30 553 F.3d 544 (7th Cir. 2009), *aff'g* T.C. Memo. 2007-152. *Wilbert* is the only appellate court decision involving an individual taxpayer.

31 *See* IRC §§ 162(a)(2) and 262(a).

Business Taxpayers

Eighty-seven of the 112 litigated trade or business expense cases involved business taxpayers. These taxpayers had less success than individual taxpayers in obtaining a favorable outcome, receiving full or partial relief in approximately 33 percent of cases (29 of 87) compared to 40 percent for individuals (ten of 25). Notably, however, five business taxpayers obtained full relief, while only one individual taxpayer prevailed in full. In five favorably decided cases, business taxpayers were represented by counsel.

As with individual taxpayers, substantiation of expenses was the most prevalent issue,[32] and in some instances the courts denied business taxpayers' deductions for failure to substantiate.[33] On the other hand, courts allowed business taxpayers' trade or business expense deductions that were properly substantiated.[34] In an interesting decision, *Barrow v. Commissioner*,[35] the Tax Court allowed the taxpayer to claim deductions for the business use of an airplane because the IRS had lost the substantiation records the taxpayer submitted. In other cases, however, where taxpayers did not have contemporaneous records but nonetheless demonstrated that they incurred business expenses, the courts permitted taxpayers to claim a reasonable amount of deductions through application of the *Cohan* rule.[36]

Another common issue litigated by business taxpayers was the question of whether the business expense deductions were attributable to a legitimate "for profit" activity constituting an actual trade or business. In *Fadeley v. Commissioner*,[37] the taxpayer (a retired Oregon Supreme Court justice) and his wife were involved in farming activities at their home. The taxpayer spent ten to 20 hours a week working on the farm and raised several animals for their meat. However, the taxpayer did not sell this meat, nor did he keep separate books and records for the farming activity. The Tax Court found the activity did not constitute a trade or business. The court noted that in addition to the above facts, the farm did not turn a profit, and therefore the court upheld the IRS's denial of the Schedule F business expense.

Similarly, the courts upheld the IRS's denial of trade or business expenses claimed by taxpayers who engaged in gambling activity because the taxpayers failed to establish they were carrying on a trade or business.[38] However, in one case, *Miller v. Commissioner*,[39] the Tax Court found that the taxpayer's horse-breeding activity was undertaken with a profit objective and therefore constituted a trade or business. The Tax Court employed a

32 Substantiation of expenses issue appeared in 56 of 87 cases involving business taxpayers.

33 *See, e.g., Alemasov v. Comm'r,* 103 A.F.T.R.2d (RIA) 1336 (9th Cir. 2009), *aff'g* T.C. Memo. 2007-130; *Arnold v. Comm'r*, T.C. Memo. 2008-228.

34 *See, e.g., Chaney v. Comm'r*, T.C. Memo. 2009-55; *Griggs v. Comm'r,* T.C. Memo. 2008-234, *appeal filed* (5th Cir. July 6, 2009).

35 T.C. Memo. 2008-264. *Barrow* is a split decision. The taxpayer prevailed on the airplane expense substantiation issue but was denied deductions for other expenses.

36 *See, e.g., Rodriguez v. Comm'r,* T.C. Memo. 2009-22.

37 T.C. Memo. 2008-235.

38 *See, e.g., Hastings v. Comm'r*, T.C. Memo. 2009-69; *Merkin v. Comm'r,* T.C. Memo. 2008-146.

39 T.C. Memo. 2008-224.

nine-factor test to evaluate whether the horse-breeding was conducted with a profit objective.[40] After thoroughly examining these nine factors, the Tax Court held that the taxpayer had indeed demonstrated that he bred horses with the intent of making a profit.

Several cases explored the issue of whether a business expense is currently deductible or must be capitalized.[41] For example, in *LOAD, Inc. v. Commissioner*,[42] the Ninth Circuit Court of Appeals affirmed the Tax Court and held that taxpayers' costs relating to manufactured homes placed on retail lots were not deductible under IRC § 162 and instead had to be capitalized under IRC § 263A. Similarly, in *Wellpoint, Inc. v. Commissioner*,[43] the Tax Court held that the taxpayer's claimed business expense deductions for settlement payments, as well as legal and professional expenses, were improper and should have been capitalized.

CONCLUSION

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

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

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

41 See discussion *supra* in the "Present Law" section.

42 559 F.3d 909 (9th Cir. 2009), *aff'g* T.C. Memo. 2007-51.

43 T.C. Memo. 2008-236, *appeal docketed*, No. 09-3163 (7th Cir. Aug. 21, 2009).

MLI #4

Gross Income Under Internal Revenue Code Section 61 and Related Sections

SUMMARY

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.[1] For this report, we reviewed 109 cases decided between June 1, 2008, and May 31, 2009. Some gross income issues in these cases include:

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

PRESENT LAW

Internal Revenue Code (IRC) § 61 broadly defines gross income as "all income from whatever source derived."[2] The U.S. Supreme Court has defined gross income as any accession to wealth.[3] However, over time, Congress has carved out numerous exceptions and exclusions to this definition.[4]

ANALYSIS OF LITIGATED CASES

We analyzed 109 opinions involving gross income issued by the federal courts between June 1, 2008, and May 31, 2009. Gross income issues most often fall into two categories: (1) what is included in gross income under IRC § 61, and (2) what can be excluded under other statutory provisions. A detailed list of all cases appears in Table 4 of Appendix III.

In 35 cases (32 percent), taxpayers were represented, while the rest were *pro se* (without counsel). Five of the 35 represented taxpayers (about 14 percent) prevailed in full or in part in their cases while *pro se* taxpayers prevailed in just one case. Overall, taxpayers prevailed in full or in part in six of 109 cases (less than six percent). The vast majority of the cases this year involved taxpayers failing to report items of income, including some specifically

1 *See, e.g.*, National Taxpayer Advocate 2008 Annual Report to Congress 470-75.

2 IRC § 61(a).

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

4 *See, e.g.*, IRC §§ 104 (compensation for injuries or sickness), 105 (amounts received under accident and health plans), and 108 (income from discharge of indebtedness).

mentioned in IRC § 61 such as wages,[5] interest,[6] and pensions.[7] In the context of items that can be excluded from gross income, the following issues were raised in the cases we analyzed.

Damage Awards

Taxation of damage awards continues to generate litigation. This year, at least seven taxpayers (or six percent of the cases reviewed) challenged the inclusion of damage awards in their gross income. IRC § 104(a)(2) specifies that damage awards are taxable as gross income unless the award was received "on account of personal physical injury or physical sickness."[8] Congress added the "physical injury or physical sickness" requirement to IRC § 104(a)(2) in 1996.[9] Prior to 1996, the word "physical" did not appear in the statute. The legislative history to the 1996 amendments to IRC § 104(a)(2) provides that "[i]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness...[but] emotional distress is not considered a physical injury or physical sickness."[10] Thus, damage awards for emotional distress are not considered as received on account of physical injury or physical sickness, even if the injury is emotional distress resulting in "insomnia, headaches, [or] stomach disorders."[11]

This year in *Sanford v. Commissioner,* the taxpayer petitioned the United States Tax Court to have her damage award from a sexual harassment and sex discrimination suit excluded from her gross income.[12] The taxpayer suffered physical symptoms, including asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression, attributable to the psychiatric problems the harassment and discrimination caused. Although the court recognized these as "physical symptoms," it held the award represented damages for sexual harassment, discrimination based on sex, and failure of the employer to take appropriate corrective action. Thus, the physical symptoms were not the basis of the award. Because the origin of the claim determines whether the award is included as gross income,[13] and the origin of the taxpayer's claim was not physical, the Tax Court held that the award was appropriately taxed.[14]

5 IRC § 61(a)(1). *See, e.g., Callahan v. Comm'r*, 103 A.F.T.R.2d (RIA) 2400 (7th Cir. 2009), *aff'g* T.C. Memo. 2007-301.

6 IRC § 61(a)(4). *See, e.g., Baker v. Comm'r*, T.C. Memo. 2008-247.

7 IRC § 61(a)(11). *See, e.g., Wagenknecht v. Comm'r*, T.C. Memo. 2008-288.

8 IRC § 104(a)(2).

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

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

11 H.R. Conf. Rep. No. 104-737, at 301 (1996).

12 *Sanford v. Comm'r,* T.C. Memo. 2008-158.

13 *See Comm'r v. Schleier,* 515 U.S. 323 (1995) (holding that for damages to be excludible under IRC § 104(a)(2), the underlying cause of action must be based in tort or tort-type rights).

14 *Sanford v. Commissioner*, T.C. Memo. 2008-158.

In another case, *Stadnyk v. Commissioner*, the taxpayer argued that her physical detention should satisfy the "physical injury" requirement in IRC § 104(a)(2).[15] A local bank had incorrectly stamped a check from the taxpayer as "NSF" for insufficient funds, causing the recipient of the check (an auto dealership) to file a criminal complaint against the taxpayer for issuing a worthless check. Consequently, the taxpayer was arrested, physically restrained against her will, and subjected to police procedures. The taxpayer filed a complaint against the bank and the dealership, receiving $49,000 from the bank in settlement. The Tax Court held that the settlement award was based upon tort or tort-type rights; although the bank did not initiate the criminal proceedings against the taxpayer, the bank's erroneous stamping of the check precipitated the arrest and the bank was compensating the taxpayer because of the trauma she suffered as a result of the criminal proceedings.

On the question of whether the taxpayer's physical restraint and physical detention constituted "physical injuries" within the meaning of IRC § 104(a)(2), the court acknowledged that "[b]eing subjected to police arrest procedures may cause physical discomfort. However, being handcuffed or searched is not a physical injury for purposes of section 104(a)(2). Nor is the deprivation of personal freedom a physical injury for purposes of section 104(a)(2)."[16] Consequently, the settlement proceeds were not excludible under IRC § 104(a)(2).

As illustrated by both these cases, the question of when damage awards can be excluded from taxable income continues to confuse taxpayers. Even when taxpayers seek legal advice before filing a complaint for damages or accepting settlement proceeds, they may not understand how to characterize the damages in the complaint in order for them to be excludable under IRC § 104(a)(2), or may be confused about the proper tax treatment of the proceeds. For example, in *Stadnyk*, the taxpayer's attorney informed the taxpayer and her family that her settlement proceeds would not be taxed. It was not until the taxpayer received Form 1099-MISC, *Miscellaneous Income*, from the bank that she realized her settlement would be taxed.[17] It is clear from this and other cases we reviewed that many questions remain as to how "physical" is to be defined under IRC § 104(a)(2).

Foreign Earned Income

In the 2008 Annual Report to Congress, we highlighted 96 cases in which taxpayers raised the issue of excluding income earned in Antarctica under IRC § 911.[18] IRC § 911 permits taxpayers to exclude earned income, within statutory limits, earned while residing in a foreign country.[19] Only a territory under the sovereignty of a foreign nation is considered a

15 *Stadnyk v. Comm'r*, T.C. Memo. 2008-289, *appeal filed* (6th Cir. Apr. 10, 2009).

16 *Id.*

17 *Id.*

18 *See, e.g., Booth v. Comm'r*, T.C. Memo. 2007-253; *Charpenteir v. Comm'r*, T.C. Memo. 2007-314.

19 IRC § 911.

"foreign country."[20] The Tax Court determined that Antarctica does not qualify as a foreign country under IRC § 911, and the IRS prevailed in all 96 cases.

These Antarctica cases significantly inflated the number of gross income cases in the 2008 Annual Report. This year, it appears the issue has been resolved, as we did not locate any cases involving Antarctica that were decided between June 1, 2008, and May 31, 2009. We did, however, locate three cases where taxpayers argued income should be excluded from gross income under IRC § 911. In at least one case, taxpayers asserted that income earned in international airspace should be excluded.[21] For example, in *Rogers v. Commissioner*, two married taxpayers argued that the wages the wife earned as a flight attendant for American Airlines, while residing in Taiwan, qualified as foreign earned income.[22] The Tax Court reasoned that wages earned in international airspace are taxable because "[i]nternational airspace – like international waters – is not under the sovereignty of a government other than the United States."[23] International airspace is not a "foreign country" for purposes of IRC § 911. The wife's income earned while in flight through international airspace was therefore taxable. It is the responsibility of each taxpayer working in such a profession to calculate the percentage of wages allocable to service rendered in international airspace and to pay taxes on that income.[24] While taxpayers did not litigate a significant number of cases over foreign earned income this year, IRC § 911 may continue to raise questions from Americans working abroad.

Discharge of Indebtedness

In five cases we reviewed this year, taxpayers disputed the IRS's determination that cancellation of indebtedness was taxable income. The IRS prevailed in all cases. Generally, a taxpayer must include cancellation of indebtedness in gross income.[25] However, in certain circumstances, cancellation of indebtedness income may be excluded. IRC § 108(a) provides that a taxpayer may exclude income from the discharge of indebtedness if the discharge occurs in a bankruptcy case, when the taxpayer is insolvent, or if the indebtedness is qualified farm or business real estate debt or qualified principal residence indebtedness.[26]

The burden of proof is on the taxpayer to show that any of the exceptions in IRC § 108(a) apply.[27] For example, in *Hill v. Commissioner*, the taxpayer had cancellation of debt income from a credit card debt that was forgiven by the credit card company.[28] The taxpayer did not dispute the amount of the debt, and offered no evidence that he qualified

20 Treas. Reg. § 1.911-2(h).

21 *Rogers v. Comm'r*, T.C. Memo. 2009-111.

22 *Id.*

23 *Id.*

24 *Id.*

25 IRC § 61(a)(12).

26 IRC § 108(a).

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

28 *Hill v. Comm'r*, T.C. Memo. 2009-101.

for any of the exceptions in IRC § 108.[29] Consequently, the taxpayer was required to include the cancellation of indebtedness income in his gross income.[30]

Another exclusion for cancellation of indebtedness income involves gifts. In this regard, IRC § 102(a) excludes from gross income the value of property acquired by gift. Thus, if the discharge of a debt constitutes a gift from the creditor to the debtor, the debtor has no income as a result of that discharge. In *Plotinsky v. Commissioner*, the taxpayer argued the cancellation of his student loan debt should be excluded from his gross income because the discharge of debt was a "gift" from Key Bank/American Education Services through its loan consolidation service.[31] The Tax Court held the discharge of debt was not a gift because the discharge was contingent upon the taxpayer's on-time monthly payments and was not made out of "detached and disinterested generosity."[32] Consequently, the amount of the taxpayer's consolidated student loan that was discharged was not excludable from gross income under IRC § 102.

With the rising cost of advanced education, many graduates are faced with enormous student loan balances. IRC § 108(f) provides that an individual's gross income does not include discharge of a student loan if the discharge occurred in exchange for the individual's service for a certain period of time in a certain profession. Thus, many loan repayment assistance programs have emerged as a means of relieving the debt burden of some graduates.[33] These programs provide repayment or forgiveness to graduates entering specific types of employment, usually in the public sector. As the number of graduates taking advantage of these types of programs grows, we may see an increase in IRC § 108(f) litigation, as graduates may not be aware of the tax consequences of the loan forgiveness, or the IRS questions whether a particular loan forgiveness program fits the parameters of IRC § 108(f).

Qualified Scholarships

In *United States v. Detroit Medical Center*, the United States Court of Appeals for the Sixth Circuit addressed the issue of whether stipends earned by Detroit Medical Center residents were taxable or could be excluded from gross income pursuant to IRC § 117.[34] IRC § 117 provides that gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in IRC § 170(b)(1)(A)(ii) (which generally describes a school, college, or university). An individual is a candidate for a degree within the meaning of IRC § 117 if he or she is pursuing studies to meet the requirements for an academic or professional degree conferred by

29 *Hill v. Comm'r*, T.C. Memo. 2009-101.

30 *Id.*

31 *Plotinsky v. Comm'r*, T.C. Memo. 2008-244.

32 *Id.* (citing *Comm'r v. Duberstein*, 363 U.S. 278 (1960)).

33 *See, e.g.*, The College Cost Reduction and Access Act (allowing for the cancellation of certain student loan debt under certain conditions when the individual has been working in a public service job for a certain length of time). Pub. L. No. 110-84, § 401, 121 Stat. 784, 800 (2007).

34 *Detroit Medical Center, U.S. v.*, 557 F.3d 412, *aff'g in part and vacating in part* 98 A.F.T.R.2d (RIA) 7995 (E.D. Mich. 2006).

colleges or universities. The term "scholarship" is used broadly to include an amount paid for the benefit of a student, whether an undergraduate or a graduate, to aid such individual in pursuing his or her studies. The term "qualified scholarship" refers to "any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses."[35] In general, taxpayers cannot exclude from gross income an amount received that represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship.[36] Payments excludable under IRC § 117 must be "relatively disinterested 'no-strings' educational grants, with no requirement of any substantial *quid pro quo* from the recipients."[37] Thus, a scholarship conditioned upon the performance of substantial past, present, or future services by the recipient represents "payment for services" and is therefore not excludable from gross income.

In applying the terms of IRC § 117, the court in *Detroit Medical* held that the stipends paid to the residents were not used for tuition or related expenses, and the residents were not in pursuit of degrees at the time of payment.[38] In addition, the hospital extracted a *quid pro quo* from the residents in return for the stipends, as residents were required to provide patient care and teaching/supervision services for other residents.[39] As a result, the stipends were not excludable from gross income.[40] This case also involved the issue of whether stipends received by medical residents constitute "wages" for purposes of the Federal Insurance Contributions Tax Act (FICA), an area of the law where there have been many cases litigated recently.[41]

CONCLUSION

Taxpayers consistently litigate many of the same gross income issues year after year due to the complex nature of what constitutes gross income. This report has highlighted some of the main areas of confusion under IRC § 61. For example, the characterization of damage awards for mental distress may cause confusion. We discuss the treatment of these awards in our Legislative Recommendation section, *supra*.

35 IRC § 117(b)(1).

36 IRC § 117(c)(1).

37 *Bingler v. Johnson*, 394 U.S. 741, 751 (1969).

38 *Detroit Medical Center, U.S. v.*, 557 F.3d 412, *aff'g in part and vacating in part* 98 A.F.T.R.2d (RIA) 7995 (E.D. Mich. 2006).

39 *Id.*

40 *Id.*

41 For a discussion of the FICA issue, see *Significant Cases, supra.*

MLI #5

Accuracy-Related Penalty Under Internal Revenue Code Section 6662

SUMMARY

Internal Revenue Code (IRC) §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if under § (b)(1), a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if under § (b)(2), an underpayment of tax exceeded a computational threshold called a substantial understatement. IRC § 6662(b) also authorizes the IRS to impose three other accuracy-related penalties.[1] However, during our review period of June 1, 2008, through May 31, 2009, taxpayers litigated these other penalties less frequently than the negligence and substantial understatement penalties; therefore, this analysis does not address the three other accuracy-related penalties.

PRESENT LAW

The amount of an accuracy-related penalty equals 20 percent of the portion of the underpayment attributable to the taxpayer's negligence or disregard of rules or regulations or a substantial understatement.[2]

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

Negligence

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

1 IRC § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement for income taxes; IRC § 6662(b)(4) authorizes a penalty for any substantial overstatement of pension liabilities; and IRC § 6662(b)(5) authorizes a penalty for any substantial valuation understatement of estate or gift taxes.

2 IRC § 6662(b)(1) (negligence) and IRC § 6662(b)(2) (substantial understatement).

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

4 IRC § 6664(c)(1).

to the underpayment.[5] Strong indicators of negligence include instances where a taxpayer failed to report income on a tax return that a payor reported on an information return as defined in IRC § 6724(d)(1),[6] or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return.[7] The IRS can also consider various other factors in determining whether the taxpayer's actions were negligent.[8]

Substantial Understatement

In general, an "understatement" is the difference between (1) the correct amount of tax and (2) the amount of tax the taxpayer reported on the return, reduced by any rebate.[9] Understatements are generally reduced by the portion of an understatement attributable to (1) an item for which the taxpayer had substantial authority; or (2) any item if the taxpayer adequately disclosed the relevant facts affecting the item's tax treatment in the return or in an attached statement, and the taxpayer had a reasonable basis for the tax treatment of the item.[10] For individuals, the understatement of tax is substantial if it exceeds the greater of $5,000 or ten percent of the correct amount of tax.[11] For corporations (other than S corporations or personal holding companies), an understatement is substantial if it exceeds the lesser of ten percent of the tax required to be shown on the return or $10,000,000.[12]

For example, if the correct amount of tax should have been $10,000 and the individual taxpayer reported $6,000, the substantial understatement penalty under IRC § 6662(b)(2) would not apply because although the $4,000 shortfall is more than the ten percent test ($1,000 is ten percent of $10,000), it is less than the fixed $5,000 threshold. Conversely, if the same individual taxpayer reported a tax of $4,000, the substantial understatement penalty would apply because the $6,000 shortfall is more than $1,000 (ten percent of $10,000), and is also greater than $5,000.

Reasonable Cause

The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.[13] A reasonable cause determination takes into account all of the pertinent facts and circumstances.[14] Generally,

5 Treas. Reg. § 1.6662-3(b)(1).

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

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

8 These factors include the taxpayer's history of noncompliance; the taxpayer's failure to maintain adequate books and records; actions taken by the taxpayer to ensure the tax was correct; and whether the taxpayer had an adequate explanation for underreported income. Internal Revenue Manual (IRM) 4.10.6.2.1 (May 14, 1999).

9 IRC § 6662(d)(2)(A).

10 IRC § 6662(d)(2)(B). No reduction is permitted, however, for any item attributable to a tax shelter. *See* IRC § 6662(d)(2)(C)(i).

11 IRC § 6662(d)(1)(A)(i) and (ii).

12 IRC § 6662(d)(1)(B)(i) and (ii).

13 IRC § 6664(c)(1).

14 Treas. Reg. § 1.6664-4(b)(1).

the most important factor is the extent of the taxpayer's effort to determine the proper tax liability.[15]

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process[16] and through its Automated Underreporter (AUR) computer system.[17] Before a taxpayer receives a notice of deficiency, he or she has opportunities to engage the IRS on the merits of the penalty.[18] Once the IRS concludes an accuracy-related penalty is warranted, it must follow the same deficiency procedures that it follows with other assessments, *i.e.*, IRC §§ 6211-6213.[19] Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to petition the United States Tax Court.[20] Alternatively, taxpayers may seek judicial review through refund litigation.[21] Under certain circumstances, a taxpayer can request an administrative appeal of IRS collection procedures (and the underlying liability) through a Collection Due Process (CDP) hearing.[22]

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.[23] The IRS must first present sufficient evidence to establish that the

15 *Id*.

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

17 The AUR is an automated program that the IRS utilizes to identify discrepancies between amounts that taxpayers reported on a tax return and amounts that payers reported via Form W-2, Form 1099, and other information returns. *See* IRM 4.19.2 (Sept. 1, 2008). IRC § 6751(b)(1) provides that IRS employees must have written supervisory approval before assessing any penalty. However, IRC § 6751(b)(2)(B) allows an exception for situations where the IRS can calculate a penalty automatically "through electronic means." The IRS interprets this exception as allowing it to use its AUR system to propose the substantial understatement and negligence components of the accuracy-related penalty without human review. If a taxpayer responds to an AUR-proposed assessment, then at that point, the IRS first involves its employees to determine whether the penalty is appropriate. If the taxpayer does not respond timely to the notice, then the computers automatically convert the proposed penalty to an assessment. *See* National Taxpayer Advocate 2007 Annual Report to Congress 259 ("Although automation has allowed the IRS to more efficiently identify and determine when such underreporting occurs, the IRS's over-reliance on automated systems rather than personal contact has led to insufficient levels of customer service for taxpayers subject to AUR. It has also resulted in audit reconsideration and tax abatement rates that are significantly higher than those of all other IRS examination programs").

18 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 IRS Appeals, during which time he or she may raise issues related to the deficiency, including the reasonable cause exception. If the issue is not resolved after the 30 day letter, the IRS sends a statutory notice of deficiency ("90 day letter") to the taxpayer. *See* IRS Pub. 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree* (Jan. 1999); IRS Publication 3498, *The Examination Process* (Nov. 2004).

19 IRC § 6665(a)(1).

20 IRC § 6213(a). Note that a taxpayer has 150 days instead of 90 to petition the Tax Court if the IRS sent the notice of deficiency to the taxpayer at an address outside the United States.

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

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

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

penalty is warranted. The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.[24]

ANALYSIS OF LITIGATED CASES

For the period from June 1, 2008, through May 31, 2009, we identified 101 cases where taxpayers litigated the negligence, disregard of rules or regulations, or substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 83 cases (82 percent), the taxpayers prevailed in full in 14 cases (14 percent), and three cases (three percent) resulted in split decisions. Finally, one case (one percent) was indeterminate because the court remanded it for further consideration. Thus, taxpayers prevailed partially or fully in 17 percent of the penalty disputes.

Taxpayers appeared *pro se* (without representation) in 60 of the 101 cases (59 percent). *Pro se* taxpayers convinced the court to dismiss or reduce the penalty in ten (17 percent) of their cases.[25] Represented taxpayers achieved full or partial relief from the penalty in seven (17 percent) of their cases. Taxpayers with representation achieved approximately the same success rate as those who appeared *pro se*.

In some cases, the court ruled on the accuracy-related penalty without specifying whether subsection (b)(1) or (b)(2) applied. Where possible, in Table 5 of Appendix III, we indicate which subsection was at issue. The analysis of reasonable cause is the same regardless of which subsection is at issue. Therefore, we have combined our analysis of reasonable cause for the negligence and substantial understatement cases.

Reasonable Cause

Adequacy of Records and Substantiation of Deductions for Reasonable Cause and as Proof of Taxpayer's Good Faith

Taxpayers are required to maintain records sufficient to establish the amount of gross income, deductions, and credits claimed on a return.[26] Where taxpayers prevailed in a reasonable cause defense, the reasonable cause and good faith argument was most frequently based on the adequacy of taxpayers' records. For example, in *Aref v. Commissioner*,[27] because the taxpayer maintained proper business records to substantiate his expenses (even though his substantiating documentation did not precisely correspond with the dollar amounts of the claimed expenses), the court determined the taxpayer acted reasonably and in good faith.

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24 IRC § 7491(c).

25 In determining the taxpayer success rates, we included those cases that were split between the taxpayer and the IRS because the taxpayer achieved a reduction in penalties. We excluded the one case that was remanded (taxpayer appeared with representation) as the case was sent back to the Tax Court for a determination of whether the taxpayer's reliance on a tax professional was reasonable and in good faith. *See Green v. Comm'r*, 312 Fed. Appx. 929 (9th Cir. 2009), *aff'g and remanding* T.C. Memo. 2007-39.

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

27 T.C. Memo. 2009-118.

In other cases, the courts held that taxpayers did not show good faith in attempting to comply with tax laws, and had no reasonable cause when presenting inadequate records or insufficient substantiation. For example, in *Sanderlin v. Commissioner*,[28] the Tax Court sustained the IRS's denial of miscellaneous deductions and imposition of accuracy-related penalties because the taxpayer did not keep adequate records. The taxpayer, a licensed practical nurse, shredded receipts and other records of her deductions after entering them into a computer program. The court found the taxpayer was negligent in not keeping records to substantiate her deductions as required by IRC § 6001.

Reliance on Advice of Tax Professional for Reasonable Cause

Reliance on a tax professional was the second most commonly litigated element of reasonable cause. To qualify for reliance on a tax professional under the reasonable cause exception for accuracy-related penalties, the taxpayers established three factors: (1) they provided all necessary information to the tax professional; (2) the tax professional was competent with sufficient expertise; and (3) the taxpayers relied in good faith on the tax professional's opinion or tax return preparation.[29]

Cases in which taxpayers successfully claimed reasonable reliance on a tax professional include:

- An estate tax case where an attempt to establish a valid family limited partnership to minimize estate taxes failed. Even so, the court found the negligence penalty was not warranted, given that the estate's executor reasonably relied on estate planning professionals and provided relevant information in a good faith attempt to minimize the estate's tax liability.[30]
- A settlement award case, where the taxpayer did not suffer physical injury and therefore should have reported receipt of a settlement payment as income.[31] The court held the taxpayer reasonably and in good faith relied on statements by two attorneys and a mediator that the award would not be taxed. Although these three individuals had no particular expertise in tax law, the court noted that two of them were disinterested parties and that "reasonable persons could disagree as to whether additional advice was required in this instance."[32]
- A tax shelter case, where loans to partners lacked economic substance and were therefore disregarded for tax purposes. The court held the taxpayer had requested detailed

28 T.C. Memo. 2008-209.

29 *Neufeld v. Comm'r*, T.C. Memo. 2008-79; *Neonatology Associates, P.A. v. Comm'r,* 115 T.C. 43, 99 (2000) (citations omitted); Treas. Reg. § 1.6664-4(c)(1).

30 *Estate of Hurford v. Comm'r*, T.C. Memo. 2008-278. In another estate case, *Estate of Lee v. Commissioner*, the court found that although the estate did not qualify for a marital deduction (as determined in a case previously decided by partial summary judgment), the executor, a municipal court judge, reasonably and in good faith relied on a competent tax attorney to prepare the estate tax return. *Estate of Lee v. Comm'r,* T.C. Memo. 2009-84.

31 IRC § 104(a)(2) provides that damage awards are included in gross income unless the award was received "on account of personal physical injury or physical sickness." For a detailed discussion of this case and the IRC § 104(a)(2) analysis, see Most Litigated Issue, *Gross Income Under IRC § 61 and Related Sections, supra.*

32 *Sytadnyk v. Comm'r*, T.C. Memo. 2008-289, *appeal filed* (6th Cir. Apr. 10, 2009).

tax advice from qualified accountants and tax attorneys and provided them with access to all pertinent documentation. Therefore, the taxpayer's reliance was reasonable and in good faith.[33]

Examples of cases in which taxpayers unsuccessfully claimed reliance on a tax professional for the manner in which they reported (or failed to report) items on their returns include:

- A settlement award case, where the taxpayer failed to include a damage award in gross income. Although the taxpayer testified that she consulted a tax professional, she failed to specify when she received advice from the tax professional, what advice she received, or that she provided the tax professional with all necessary information.[34]
- An unreported income case, where the taxpayer failed to report gambling winnings. Although the taxpayer engaged the services of a competent tax professional, the taxpayer failed to demonstrate that she provided necessary and accurate information and her reliance was in good faith. The court noted that the taxpayer had a duty to examine her tax return to ensure that all items of income were included and had conceded that she failed to do so.[35]
- A case involving the taxpayers' use of trusts to claim deductions for personal living expenses and depreciation of their residence. In upholding the decision of the Tax Court that the taxpayers were liable for the accuracy-related penalty, the United States Court of Appeals for the Ninth Circuit found the taxpayers failed to demonstrate they had actually received, and in good faith relied upon, the advice of competent tax professionals. In reaching this conclusion, the Ninth Circuit noted that the taxpayers had consulted with one attorney who was not a tax specialist and had apparently sought the advice of two tax professionals who the taxpayers did not call as witnesses at their trial.[36]

In the lone remand case that we examined, *Green v. Commissioner*,[37] the Ninth Circuit Court of Appeals remanded a case to the Tax Court to determine whether a taxpayer's reliance on a tax professional was indeed reasonable. The taxpayer had received a jury award from an employer-retaliation lawsuit, but did not include the award in her gross income based on the advice of the attorney who represented her at trial, and the advice of a tax professional. The Tax Court had found the taxpayer liable for the substantial understatement component of the accuracy-related penalty because although she proved the tax professional was competent, she failed to demonstrate that she provided necessary and accurate information and relied in good faith on the professional's advice. The Ninth Circuit disagreed, and held that the Tax Court failed to take into consideration all factors in determining whether the

33 *Klamath Strategic Investment Fund v. U.S.*, 568 F.3d 537 (5th Cir. 2009), *aff'g* 472 F. Supp. 2d 885 (E.D. Tex. 2007).

34 *Sanford v. Comm'r*, T.C. Memo. 2008-158.

35 *Qi v. Comm'r*, T.C. Memo. 2008-200.

36 *Kierstead v. Comm'r,* 103 A.F.T.R.2d (RIA) 2119 (9th Cir. 2009), *aff'g* T.C. Memo. 2007-158.

37 312 Fed. Appx. 929 (9th Cir. 2009), *aff'g and remanding* T.C. Memo. 2007-39.

taxpayer's reliance was reasonable, including the advice of the attorney who represented the taxpayer in her employer-retaliation lawsuit. The Ninth Circuit ordered the Tax Court to consider whether the taxpayer's reliance was reasonable "in light of the totality of the circumstances," and allowed the Tax Court to consider new testimony or evidence in doing so.

Although reliance on a tax professional may be evidence of acting with reasonable cause and good faith, it does not necessarily entitle the taxpayer to escape liability for accuracy-related penalties. In *New Phoenix Sunrise Corporation v. Commissioner*,[38] a tax shelter case, the court upheld the accuracy-related penalty because although the taxpayer relied on tax professionals for advice, such reliance was not reasonable. The court focused on the fact that the tax firm providing the advice possessed a clear conflict of interest because it both promoted a tax shelter and wrote opinions regarding the use of the shelter.

Other Circumstances for Reasonable Cause

Tax Sophistication of the Taxpayer

A taxpayer's education and sophistication in business and tax issues are facts taken into account when determining whether a taxpayer acted with reasonable cause and in good faith.[39] For taxpayers with special knowledge or experience in tax law, courts often sustained the penalty because the taxpayers should have known better. For example, the Tax Court held that taxpayers sophisticated in business or tax matters lacked reasonable cause and did not act in good faith in the following instances:

- A retired certified public accountant (CPA) attempted to deduct as alimony court-ordered payments of attorneys' fees he paid to his ex-wife's attorney. The Tax Court held that given the taxpayer's knowledge and experience, his failure to consult a tax professional in claiming the deduction showed a lack of reasonable cause and good faith.[40]
- An educated and sophisticated banker at a large national bank failed to include an arbitration award from his former employer in gross income. The Tax Court found the taxpayer failed to exercise diligence and should have sought the advice of a tax professional.[41]
- A former IRS agent tried to deduct as business expenses items that were clearly personal and failed to keep proper records. In imposing the penalty, the Tax Court simply noted that the taxpayer "should have known better."[42]
- A CPA who owned a tax return preparation business attempted to deduct his son's college tuition, home improvements, health club dues, and vacations as business expenses

38 132 T.C. No. 9 (2009), 2009 WL 960213 (U.S. Tax Ct. Apr. 9, 2009).

39 Treas. Reg. § 1.6664-4(b)(1).

40 *Stedman v. Comm'r*, T.C. Memo. 2008-239. Similarly, in *Good v. Comm'r*, T.C. Memo. 2008-245, the Tax Court found that the taxpayer, who was a CPA and a partner in an accounting firm, failed to show the he acted with reasonable cause and in good faith in claiming disabled access tax credits and related deductions.

41 *Bachmann v. Comm'r*, T.C. Memo. 2009-51.

42 *Langer v. Comm'r*, T.C. Memo. 2008-255, *appeal docketed*, No. 09-3593 (8th Cir. Oct. 27, 2009).

even though the items were clearly personal in nature. The court upheld the penalty, stating that "[n]o one, and especially not an accountant and trained tax-preparer, would believe that it is appropriate to deduct expenses for a personal vacation as a business expense."[43]

In contrast, taxpayers without specialized tax knowledge achieved better results. For example, the Tax Court in *Robertson v. Commissioner*[44] found that the taxpayers (a husband and wife) reasonably and in good faith relied on a tax professional with respect to complex partnership tax questions that arose in relation to their ownership of a limited liability company. The taxpayers, who were unsophisticated, convinced the court they had provided the tax professional with all necessary information and diligently attempted to obtain records that had been destroyed for reasons beyond their control.

Taxpayers Facing Complex Issues

The court found reasonable cause to dismiss the penalty when taxpayers litigated a complex issue. For example, in *Ocmulgee Fields, Inc. v. Commissioner*,[45] the court upheld the IRS's determination that a like-kind exchange transaction entered into by a corporate taxpayer was not eligible for nonrecognition treatment under IRC § 1031 because the taxpayer failed to demonstrate that the principal purpose of the transaction was not tax avoidance. However, the court found that because the taxpayer acted reasonably and in good faith in relying on a competent tax professional, who made reasonable assumptions in interpreting a complex provision of the IRC, the taxpayer did not have to pay the penalty.

Penalties in Settlement Award Cases

We identified several cases in which taxpayers contested whether settlement payments could be excluded from gross income pursuant to IRC § 104(a)(2), and in each one, the court found the taxpayer's settlement award should have been included in gross income.[46] However, the court did not always penalize the taxpayer's failure to report this income. For example, in *Stadnyk v. Commissioner*,[47] the court held that taxpayers were not liable for an accuracy-related penalty because they reasonably and in good faith relied on two attorneys and a mediator who informed them the settlement payment would not be subject to tax. Similarly, in *Shelton v. Commissioner*,[48] the court found the taxpayers were not liable for the penalty since they reasonably relied on advice from an IRS employee who stated the damage award might be excludible from income, and because the taxpayers genuinely believed the settlement was for physical injury and therefore excludible.

43 *United States v. Lovlie*, 2008 U.S. Dist. LEXIS 85458 (D. Minn. 2008).

44 T.C. Memo. 2009-91.

45 132 T.C. No. 6 (2009), 2009 WL 884535 (U.S. Tax Ct. Mar. 31, 2009), *appeal filed* (11th Cir. June 29, 2009).

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

47 T.C. Memo. 2008-289.

48 T.C. Memo. 2009-116.

On the other hand, the court sometimes found taxpayers liable for the penalty for failing to report settlement payments as income. For example, in *Moulton v. Commissioner*,[49] the court upheld the penalty where the taxpayer signed a mediation agreement saying that he would be liable for all applicable taxes, and received a Form W-2, *Wage and Tax Statement*, characterizing the settlement payment as wages, but failed to seek professional tax advice and include the award in income. Also, in *Sanford v. Commissioner*,[50] the court found the taxpayer liable for the penalty where she claimed she had sought the advice of a tax professional regarding the proper treatment of the settlement payment but failed to prove she gave all necessary information to the professional or demonstrate what advice she received. The court also noted that the tax professional did not testify at the taxpayer's trial.

Tax Shelter Penalty Litigation

We also encountered several cases in which accuracy-related penalties were disputed in the context of tax shelters. In most cases, the court upheld the penalty asserted by the IRS. For example, in *Stobie Creek Investments, LLC v. United States*,[51] the court found a partnership, because of the conduct of its managing partner, did not act with reasonable cause and in good faith and was therefore liable for the penalty. The court focused on the fact that the managing partner failed to inquire whether the transactions the partnership entered into had a business purpose independent of tax considerations.

Where there is a conflict of interest with the preparer rendering tax advice, reliance on such preparer may not be reasonable. As discussed above, in *New Phoenix Sunrise Corporation v. Commissioner*[52] the court found a corporate taxpayer liable for the penalty because its reliance on a tax professional was not done with reasonable cause and in good faith. The court emphasized that the taxpayer could not successfully argue that it had relied on the opinion of a tax professional where that tax professional also promoted the tax shelter.

However, in *Klamath Strategic Investment Fund v. United States*,[53] an appellate court upheld a lower court ruling that the taxpayer's reliance on tax professionals was reasonable and in good faith. In this case, although loans to partners in a partnership were found to lack economic substance, the court found the taxpayers had requested detailed tax advice from qualified accountants and tax attorneys and provided them with access to all pertinent documentation. Therefore, the taxpayers' reliance was reasonable and in good faith.

49 T.C. Memo. 2009-38.

50 T.C. Memo. 2008-158.

51 82 Fed. Cl. 636 (2008).

52 132 T.C. No. 9 (2009), 2009 WL 960213 (U.S. Tax Ct. Apr. 9, 2009), *appeal filed* (6th Cir. Oct. 19, 2009).

53 568 F.3d 537 (5th Cir. 2009), *aff'g* 472 F. Supp. 2d 885 (E.D. Tex. 2007).

CONCLUSION

In the cases reviewed for this report, the court most often sustained the IRS's determination of a deficiency or a portion of the deficiency, but occasionally overruled the IRS on the issue of the accuracy-related penalty. The court dismissed or reduced the penalty in 17 percent of the cases. Taxpayers who had representation were no more successful in contesting the penalty than those who were *pro se*.

The results indicate that the courts find reasonable cause where taxpayers make a legitimate effort to determine the correct amount of tax, even though the taxpayers are wrong on the underlying tax issue. In finding reasonable cause, the preeminent factors were whether the taxpayer relied on a competent tax professional and had adequate records for claimed deductions. The courts also weighed the breadth and sophistication of the taxpayer's tax knowledge and novelty of the substantive legal issues.

The IRS should consider issuing guidance clarifying the appropriate tax treatment of settlement award payments, as there appears to be genuine taxpayer confusion about how to treat such payments. This guidance would go a long way in addressing accuracy-related penalties stemming from this confusion.

Finally, the IRS should consider reviewing cases where the court did not agree with the IRS's determination to impose the penalty and incorporate the court's rationale into training and Internal Revenue Manual provisions for its employees. As a result, the accuracy-related penalty will not be at issue when cases go to trial on an underpayment of tax, thereby lessening the burden on taxpayers, the government, and the courts.

MLI #6

Frivolous Issues Penalty Under Internal Revenue Code Section 6673 and Related Appellate-Level Sanctions

SUMMARY

During the 12 months between June 1, 2008, and May 31, 2009, the federal courts issued decisions in at least 49 cases involving the Internal Revenue Code (IRC) § 6673 "frivolous issues" penalty, and at least 13 cases involving an analogous penalty at the appellate level.[1] These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal.[2] In four of the 34 cases where IRC § 6673 was at issue in the United States Tax Court or a United States District Court, taxpayers escaped liability for the penalty but were warned that they could face sanctions for similar conduct in the future.[3] Similarly, we identified one case at the appellate level where the court did not impose a sanction under IRC § 7482(c)(4) or any other authority, but did warn the taxpayer that similar future conduct will result in a sanction.[4] Nonetheless, we include these cases in our analysis to illustrate what conduct will and will not be tolerated by the courts.

PRESENT LAW

The U.S. Tax Court is authorized to impose a penalty against a taxpayer if the taxpayer institutes or maintains a proceeding primarily for delay, takes a frivolous position in a proceeding, or unreasonably fails to pursue available administrative remedies.[5] The maximum penalty is $25,000.[6] In some cases, the IRS requests that the Tax Court impose the penalty;[7] in other cases, the Tax Court exercises its discretion, *sua sponte*,[8] to impose the penalty.

1 In five cases, the U.S. Courts of Appeals both affirmed the imposition of the IRC § 6673 penalty and addressed the issue of an additional sanction against the taxpayer for filing a frivolous appeal. Thus, the total number of cases we identified as involving frivolous claims is 57.

2 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.

3 *See, e.g., Maga v. Comm'r*, T.C. Memo. 2008-162.

4 *See U.S. v. Clampitt*, 281 Fed. Appx. 337 (5th Cir. 2008).

5 IRC § 6673(a)(1)(A), (B), and (C).

6 IRC § 6673(a)(1).

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

8 *"Sua sponte"* means without prompting or suggestion. Thus, for conduct that it finds particularly offensive, the Tax Court can choose to impose a penalty under IRC § 6673 even if the IRS has not requested the penalty. *See, e.g., Boggs v. Comm'r*, T.C. Memo. 2008-81, *aff'd*, 569 F.3d 235 (6th Cir. 2009). In this case, the Tax Court imposed a penalty of $10,000 because the court had repeatedly warned the taxpayers that their position was frivolous. The taxpayers argued they had no income, just a return of human capital. On appeal, the U.S. Court of Appeals for the Sixth Circuit affirmed the Tax Court's decision, and imposed an additional sanction of $8,000.

Taxpayers who institute an action pursuant to IRC § 7433[9] in a U.S. District Court for damages against the United States could be subject to a maximum penalty of $10,000 if the court determines the taxpayer's position in the proceedings is frivolous or groundless.[10] In addition, IRC § 7482(c)(4),[11] § 1927 of Title 28 of the U.S. Code,[12] and Rule 38 of the Federal Rules of Appellate Procedure[13] (among other laws and rules of procedure) authorize federal courts to impose penalties against taxpayers or attorneys for raising frivolous arguments or using litigation tactics primarily to delay the collection process. Because the sources of authority for imposing appellate-level sanctions are numerous and some of these sanctions may be imposed in non-tax cases, this report focuses primarily on the IRC § 6673 penalty. However, the table of cases presented in Table 6 of Appendix III lists 13 tax cases in which U.S. Courts of Appeals considered sanctions under other authorities.

ANALYSIS OF LITIGATED CASES

We analyzed 49 opinions issued between June 1, 2008, and May 31, 2009 that addressed the IRC § 6673 penalty. Thirty-four of these opinions were issued by the Tax Court and 15 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 position in all 15 cases. A detailed list of all cases appears in Table 6 of Appendix III.

In 28 cases, the Tax Court imposed penalties under IRC § 6673, with the amounts ranging from $1,000 to the maximum of $25,000. We identified only three cases that involved business taxpayers (*i.e.*, a corporation, partnership, trust, or a taxpayer filing a Form 1040, *U.S. Individual Income Tax Return*, with a Schedule C, E, or F). Three taxpayers were represented by attorneys; all others appeared *pro se*. The taxpayers in these cases presented a wide variety of arguments that the courts have generally rejected on numerous occasions. Upon encountering these arguments, the courts almost invariably cited the language set forth in *Crain v. Commissioner:*

> We perceive no need to refute these arguments with somber reasoning and copious citation of precedent; to do so might suggest that these arguments have some colorable merit. The constitutionality of our income tax system – including the role played

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

10 IRC § 6673(b)(1).

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

12 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.

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

within that system by the Internal Revenue Service and the Tax Court – has long been established.[14]

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

- **Citizens of certain states are not subject to income taxes:** At least four taxpayers argued that as residents of various "sovereign," "compact," or "independent" states, they are not subject to income taxes imposed by the United States government.[15]
- **IRS forms and notices violate the Paperwork Reduction Act because they do not display a valid Office of Management and Budget (OMB) Control Number:** In at least five cases, taxpayers argued the IRS forms and notices they received violated the Paperwork Reduction Act (PRA).[16] Under the PRA, OMB is given authority to review an agency collection of information and to assign a control number to each collection of information it approves.[17] If a collection of information does not display a current control number or fails to state that the request for information is not subject to the PRA, the PRA provides that a person cannot be subject to a penalty for the failure to maintain or provide information.[18] These taxpayers argued that because certain IRS forms and notices do not contain OMB control numbers, the PRA protects them from any penalties for failure to comply with the IRS's request for information. The courts have consistently rejected such arguments.[19]
- **Only income earned from the United States government is taxable:** Taxpayers in at least five cases presented arguments that only federal government employees or those who earn income from the United States government are subject to the income tax.[20]
- **Constitutional arguments:** At least three taxpayers argued that the income tax violates their constitutional rights, they are not citizens as defined by the 14th or 16th Amendments, or that the 16th Amendment as a whole is unconstitutional.[21]

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

15 *See, e.g., Cobin v. Comm'r*, T.C. Memo. 2009-88.

16 *See, e.g., Schneller v. Comm'r*, T.C. Memo. 2008-196. *See also Ford v. Pryor*, 552 F.3d 1174 (10th Cir. 2008), *aff'g U.S. v. Ford*, 514 F.3d 1047 (D.N.M. 2007).

17 44 U.S.C. §§ 3502, 3504, 3507(a).

18 44 U.S.C. § 3512.

19 *See U.S. v. Dawes*, 951 F.2d 1189, 1191-93 (10th Cir. 1992) (citations omitted).

20 *See, e.g., Wagenknecht v. Comm'r*, T.C. Memo. 2008-288, *appeal docketed*, No. 09-1355 (6th Cir. Mar. 24, 2009).

21 *See, e.g., Cummings v. Comm'r*, T.C. Memo. 2008-184, *appeal filed,* No. 08-2472 (6th Cir. Oct. 8, 2008).

CONCLUSION

Taxpayers in the cases analyzed this year presented the same arguments raised and repeated year after year, which the courts routinely and universally reject.[22] The taxpayer avoided the IRC § 6673 penalty in only four of the cases where the IRS requested the penalty, demonstrating the willingness of the courts to impose a penalty when the taxpayer makes frivolous arguments or institutes a case merely for delay. Where the IRS has not requested the penalty, the court may raise the issue *sua sponte* and in many cases imposes the penalty or cautions the taxpayer that similar future behavior will result in a penalty.[23] Finally, the U.S. Courts of Appeals have shown their willingness to uphold the penalties imposed by the Tax Court without fail in the cases analyzed for the period between June 1, 2008, and May 31, 2009, and will often impose further appellate-level sanctions on taxpayers who assert frivolous arguments.

22 *See, e.g.*, National Taxpayer Advocate 2008 Annual Report to Congress 533-36.

23 *See, e.g., Cobin v. Comm'r*, T.C. Memo. 2009-88.

MLI #7

Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under Internal Revenue Code Section 7403

SUMMARY

Internal Revenue Code (IRC or "Code") § 7403 authorizes the United States to file a civil action in a United States District Court against a taxpayer who has refused or neglected to pay any tax, to enforce the federal tax lien or to subject any of the delinquent taxpayer's property to the payment of the tax. We identified 61 opinions issued between June 1, 2008, and May 31, 2009, that involved civil actions to enforce federal tax liens under IRC § 7403. The courts affirmed the position of the United States in the majority of cases. Taxpayers prevailed in only six cases and four cases resulted in split decisions. This is the first year that civil actions to enforce federal tax liens under IRC § 7403 have appeared as a Most Litigated Issue in the National Taxpayer Advocate's Annual Report to Congress.

PRESENT LAW

IRC § 7403 specifically authorizes the United States to enforce a federal tax lien with respect to a taxpayer's delinquent tax liability, or to subject any property, right, title, or interest in the property of the delinquent taxpayer to the payment of tax liability, by initiating a civil action in the appropriate United States District Court against a taxpayer who has refused or neglected to pay any tax.[1] All persons holding liens or claiming any interest in the taxpayer's property should be named as parties to the action.[2] The nature of a taxpayer's legal interest in the property subject to a lien is determined by the law of the state where the property is located.[3] However, once it is determined that a delinquent taxpayer has an interest in the property, federal law controls whether the property is exempt from attachment.[4]

The U.S. District Court may order that the property be sold by an officer of the court and the proceeds applied to the delinquent tax liability.[5] However, the court is not required to authorize a forced sale under all circumstances and may exercise limited equitable discretion.[6] In cases where the forced sale involves the interests of nondelinquent third parties, a U.S. District Court should consider the following four factors when determining whether the property should be sold:

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

2 IRC § 7403(b).

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

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

5 IRC § 7403(c).

6 *Rodgers*, 461 U.S. at 711.

1. The extent to which the government's financial interests would be prejudiced if they were relegated to a forced sale of the partial interest of the delinquent taxpayer;
2. Whether the innocent third party with a separate interest in the property, in the normal course of events, has a legally recognized expectation that the property would not be subject to a forced sale by the delinquent taxpayer or his or her creditors;
3. The likely prejudice to the third party in personal dislocation costs and inadequate compensation; and
4. The relative character and value of the nonliable and liable interests held in the property.[7]

The IRS may bid at the sale of the property when it holds a first lien.[8] However, the amount of the bid is limited to the amount of the lien, plus selling expenses.[9] If any of the taxpayer's other creditors institute an action to foreclose their lien on the property which is subject to the federal tax lien, and the United States is not a party, the United States may intervene as if it had originally been joined as a proper party[10] and may remove the case to the U.S. District Court if such action was instituted in a state court.[11] However, junior federal tax liens may be effectively extinguished in a foreclosure and sale under state law, even if the United States is not a party to the proceeding.[12] The Code also specifically authorizes the court to appoint a receiver to enforce the lien and, upon the government's certification that it is in the public interest, the court may appoint a receiver with all powers of a receiver in equity to preserve and operate the property prior to sale.[13]

ANALYSIS OF LITIGATED CASES

We reviewed 61 opinions entered between June 1, 2008, and May 31, 2009, in civil actions to enforce federal tax liens. Table 7 in Appendix III contains a detailed list of those cases. Although in the majority of cases taxpayers represented themselves (*pro se*), representation did not negatively impact the outcome in cases litigated under IRC § 7403.[14] Taxpayers with representation received full or partial relief in six cases, while *pro se* taxpayers received full or partial relief in four cases.

7 *Rodgers*, 461 U.S. at 709-11.

8 IRC § 7403(c).

9 *Id.*

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

11 28 U.S.C. § 1444. However, if the application of the IRS to intervene is denied, the adjudication will have no effect upon the federal tax lien on the property. IRC § 7424.

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

13 IRC §§ 7403(d) and 7402(a).

14 Twenty-five of 61 taxpayers were represented by counsel. Of those 25 cases, the IRS prevailed in 19, four cases resulted in victories for taxpayers, and two cases ended in split decisions.

The issue of whether it was appropriate to foreclose the federal tax lien against the taxpayer's real property was the most prevalent issue. It was considered in 44 cases,[15] with the government prevailing in 39 of these cases.[16] A typical case is *United States v. McMahan,*[17] in which the government filed an action to foreclose its tax liens and sell the taxpayers' real property to which the liens had attached. First, the court determined the taxpayers had failed to show that tax liabilities assessed against them were incorrect, and had not paid the assessed tax liabilities.[18] Consequently, the federal tax liens attached to all of the taxpayers' property.[19] Second, the court established that the assessments were made within the applicable statute of limitations period and after notice and demand.[20] Finally, the court ordered foreclosure of the valid federal tax liens against the taxpayers' real property. The proceeds from the forced sale were applied to satisfy the taxpayers' delinquent tax liability.[21]

However, in *United States v. Cochran,*[22] the court denied the government's motion for summary judgment, finding an issue of material fact existed with respect to the amount of the taxpayers' liability.[23] Similarly, the court in *United States v. Hoklin*[24] issued a split decision, finding the collection period had expired with regard to the first two tax years at issue but remained open with respect to the four later tax years.

Because federal tax liens attach to any property, right, title, or interest in the property of the delinquent taxpayer,[25] the courts allowed foreclosure of liens against taxpayers' water rights,[26] stock,[27] interest in settlement proceeds in Chapter 7 bankruptcy,[28] interest in a

15 *See, e.g., U.S. v. Barr*, A.F.T.R.2d (RIA) 6078 (E.D. Mich. 2008); *U.S. v. Bruner,* 102 A.F.T.R.2d (RIA) 7246 (W.D. Ark. 2008); *U.S. v. Langkand*, 102 A.F.T.R.2d (RIA) 5873 (D. Minn. 2008); *U.S. v. Marlatt,* 102 A.F.T.R.2d (RIA) 5699 (D. Or. 2008).

16 In two cases, the United States Courts of Appeals affirmed the trial court's decision in favor of the government. **See U.S. v. Gomes,** 292 Fed. Appx. 570 (9th Cir. 2008), *aff'g*, No. CV-06-00161-ECR/VPC (D. Nev. May 17, 2007); *U.S. v. Rupe*, 308 Fed. Appx. 777 (5th Cir. 2009).

17 102 A.F.R.2d (RIA) 7183 (S.D. Tex. 2008), *recons. denied by* 102 A.F.T.R.2d (RIA) 7393 (S.D. Tex. 2008), *mot. for stay denied by* 2009 U.S. Dist. LEXIS 5813 (S.D. Tex. 2009) and 103 A.F.T.R.2d (RIA) 690 (S.D. Tex. 2009). *See also U.S. v. Palhang*, 102 A.F.T.R.2d (RIA) 6662 (S.D. Miss. 2008), *recons. denied by* 102 A.F.T.R.2d (RIA) 6924 (S.D. Miss. 2008).

18 Tax deficiency assessments determined by the IRS carry a presumption of correctness, and this presumption imposes upon the taxpayer the burden of proving that the assessment is erroneous. *See, e.g., U.S. v. Janis*, 428 U.S. 433, 440 (1976); *Bar L Ranch, Inc. v. Phinney,* 426 F.2d 995, 998-99 (5th Cir. 1970).

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

20 *See generally* IRC § 6501. The taxpayers executed a Form 872, *Consent to Extend the Time to Assess Tax*, thereby extending by one year the time in which the government could make a timely assessment. *McMahan*, 102 A.F.R.2d (RIA) 7183 (S.D. Tex. 2008).

21 *McMahan*, 102 A.F.R.2d (RIA) 7183 (S.D. Tex. 2008).

22 102 A.F.T.R.2d (RIA) 5239 (S.D. Ind. 2008), *motion to dismiss denied by* 2008 U.S. Dist. LEXIS 100346 (S.D. Ind. 2008).

23 *Cochran,* 102 A.F.T.R.2d (RIA) 5239 (S.D. Ind. 2008), *motion to dismiss denied by* 2008 U.S. Dist. LEXIS 100346 (S.D. Ind. 2008).

24 102 A.F.T.R.2d (RIA) 5071 (D. Minn. 2008).

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

26 *U.S. v. Little*, 2008 U.S. Dist. LEXIS 93467 (E.D. Cal. 2008).

27 *Hirko v. U.S.*, 103 A.F.T.R.2d (RIA) 1326 (E.D.N.Y. 2009).

28 *In re Marine Energy Sys. Corp.*, 2009 Bankr. LEXIS 1273 (D.S.C. 2009).

royalty contract,[29] and personal property.[30] However, the court denied foreclosure of the tax lien against the undistributed assets of a taxpayer that were being held by a trustee.[31]

In a number of cases, the courts considered the equitable factors under the United States Supreme Court decision in *United States v. Rodgers*.[32] For example, in *United States v. Vogt*,[33] the court applied the *Rodgers* factors and denied the IRS's motion for summary judgment to foreclose tax liens and sell the delinquent taxpayer's interest in a property. In that case, the court concluded there were issues of material facts concerning the non-liable spouse's dislocation costs. The court in *United States v. Tanchak*[34] issued a split decision, refusing to foreclose the tax liens that attached to the taxpayer's interest in real property (which he held by tenancy by the entireties with his non-liable wife), but requiring the taxpayer to pay one-half of the imputed rental value of the property to the government until the delinquent tax liability was satisfied. In contrast, in *United States v. Guthery*,[35] the court foreclosed and sold property that the taxpayer and his non-liable spouse held as tenants by the entireties. The court rejected the wife's argument that under the *Rodgers* factors, the court should not order the sale. The court found it was equitable to sell the property, given that the couple's residence was also subject to foreclosure due to the taxpayer and the non-liable spouse defaulting on a promissory note and a mortgage.[36] Similarly, in *United States v. Ramirez*,[37] after evaluating the *Rodgers* factors, the court ordered the foreclosure of the federal tax liens that attached to the real property held jointly by a delinquent taxpayer and her non-liable spouse. Although the foreclosure and sale would result in forced dislocation and inadequate compensation for the husband, the court concluded the government's interest in prompt and certain collection of delinquent taxes outweighed any prejudice to the nondelinquent third party.

Another common issue litigated by the government was foreclosure of federal tax liens against the taxpayer's property titled in the name of a nominee.[38] For example, in *Key*

29 *Kish v. Rogers,* 101 AFTR.2d (RIA) 2635 (S.D. Tex. 2008).

30 *U.S. v. Reed*, 103 A.F.T.R.2d (RIA) 1390 (N.D. Iowa 2009), *granting summary judgment*, 102 A.F.T.R.2d (RIA) 6784 (N.D. Iowa 2008). The subject personal property included a 1974 GMC truck, a 2001 Ford pickup, a 2004 Toyota Sequoia, a 1947 Indian Chief motorcycle, a 2002 Indian Chief motorcycle, and a 1991 Harley-Davidson motorcycle.

31 *U.S. v. Butler*, 103 A.F.T.R.2d (RIA) 1636 (W.D. Tex. 2009). The court held that the IRS cannot possess a greater right to property than the taxpayer himself, relying on *U.S. v. Durham Lumber Co.*, 363 U.S. 522, 525-26 (1958).

32 461 U.S. 677.

33 102 A.F.T.R.2d (RIA) 6224 (N.D. Ind. 2008), *recons. denied by* 102 A.F.T.R.2d (RIA) 6655 (N.D. Ind. 2008), *vacated by* 2009 U.S. Dist. LEXIS 38972 (N.D. Ind. 2009).

34 103 A.F.T.R.2d (RIA) 779 (D.N.J. 2009).

35 103 A.F.T.R.2d (RIA) 1708 (M.D. Fla. 2009).

36 The wife could not claim an expectation that her separate interest in the property would not be subject to a forced sale outside the tax lien foreclosure under IRC § 7403. *Guthery*, 103 A.F.T.R.2d (RIA) 1708 (M.D. Fla. 2009).

37 103 A.F.T.R.2d (RIA) 2116 (S.D. W. Va. 2009), *judgment entered by* 2009 U.S. Dist. LEXIS 51535 (S.D. W. Va. 2009). *See also U.S. v. Barr,* 102 A.F.T.R.2d (RIA) 6078 (E.D. Mich. 2008) (same).

38 *See, e.g., U.S. v. Fields*, 103 A.F.T.R.2d (RIA) 1271 (S.D. Miss. 2009); *Key Bank Nat. Ass'n v. Van Noy*, 2008 WL 4646045 (D. Or. 2008); *U.S. v. Lena*, 101 A.F.T.R.2d (RIA) 2593 (S.D. Fla. 2008), *summary judgment granted by* 103 A.F.T.R.2d (RIA) 2488 (S.D. Fla. 2009); *U.S. v. Reed*, 103 A.F.T.R.2d (RIA) 1390 (N.D. Iowa 2009), *granting summary judgment*, 102 A.F.T.R.2d (RIA) 6784 (N.D. Iowa 2008); *U.S. v. Lang*, 102 A.F.T.R.2d (RIA) 5367 (S.D. Cal. 2008), *recons. denied by* 103 A.F.T.R.2d (RIA) 2153 (S.D. Cal. 2008).

Bank Nat. Ass'n v. Van Noy,[39] a foreclosure action was initiated by a third party creditor against a taxpayer who defaulted on a line of credit. The creditor named the United States as a co-defendant because a junior federal tax lien attached to the subject property. The United States brought a cross-claim against the taxpayer's real property titled in a nominee corporation. The court determined the corporation was the *alter ego* or nominee of the taxpayer,[40] and the transfer of the subject property from the taxpayer to the nominee corporation for no consideration constituted a fraudulent transfer under state law. Consequently, the court ordered the foreclosure of the real property held by the nominee, finding that valid federal tax liens attached to the real property and primed certain third party creditor lien interests.[41]

In two cases, the government intervened in state court proceedings and removed the actions to the appropriate federal district courts. In *Norem v. Norem*,[42] the court ordered foreclosure of federal tax liens attached to property that had been transferred into receivership according to a divorce decree. In *Kish v. Rogers*,[43] which arose from a small claims suit, the court appointed a receiver to enforce a valid tax lien against the taxpayer's interest in a royalty contract under IRC § 7403(d).

In *United States v. Ligas*,[44] the United States Court of Appeals for the Seventh Circuit reversed the district court and remanded with instructions to dismiss the lien enforcement action on procedural grounds for lack of personal service. The government never properly served the taxpayer, although the district court granted multiple extensions of time to effectuate service.[45]

39 2008 WL 4646045 (D. Or. 2008).

40 The court applied the *Towe* factors to determine nominee status: (1) whether the nominee paid no consideration or inadequate consideration; (2) whether the property was placed in the name of the nominee in anticipation of litigation or liabilities; (3) whether there is a close relationship between the transferor and the nominee; (4) whether the parties to the transfer failed to record the conveyance; (5) whether the transferor retained possession; and (6) whether the transferor continues to enjoy the benefits of the transferred property. *Towe Antique Ford v. IRS*, 791 F. Supp. 1450, 1454 (D. Mon. 1992), *aff'd*, 999 F.2d 1387 (9th Cir.1993).

41 The United States perfected its tax liens against the taxpayer and the nominee before the judgment creditor liens of certain third parties were recorded against the real property.

42 101 A.F.T.R.2d (RIA) 2511 (N.D. Tex. 2008).

43 101 A.F.T.R.2d (RIA) 2635 (S.D. Tex. 2008).

44 549 F.3d 497 (7th Cir. 2008), *rev'g* 98 A.F.T.R.2d (RIA) 7155 (N.D. Ill. 2006).

45 The government asserted that if the case was dismissed for lack of personal jurisdiction, it could not be refilled because the statute of limitations had expired. After giving the government about 15 months to serve the delinquent taxpayer, the district court dismissed the government's complaint for failure to serve process. After the district court dismissed the action, the taxpayer asked the court to extinguish the liens. The district court treated taxpayer's motion as a request for affirmative relief that waived his prior objection to personal jurisdiction and on that basis reinstated the government's complaint. Ligas, 549 F.3d at 498.

CONCLUSION

It is unclear what has caused the increase in the number of published opinions issued in lien foreclosure cases. However, increased lien filing and enforcement in recent years,[46] combined with the current economic downturn, may have contributed to taxpayers opposing more vigorously the sale of their property in these district court proceedings.[47] The government's need to sustain the current level of revenue and collect delinquent tax liability during a recession may increase the number of these actions in the future.

46 During the past decade, IRS filings of notices of federal tax lien increased 457 percent, from about 168,000 in fiscal year (FY) 1999 to over 768,000 in FY 2008. IRS, Statistics of Income Data Book, Table 16, Delinquent Collection Activities, 2008.

47 See Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent The Spirit Of The Law, Fail To Promote Future Tax Compliance, And Unnecessarily Harm Taxpayers, supra.*

MLI #8

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 60 decisions issued by the federal court system from June 1, 2008, to May 31, 2009, regarding the addition to tax under Internal Revenue Code (IRC) § 6651(a)(1) for failure to timely file a tax return, or the addition to tax under IRC § 6654 for failure to pay estimated income tax.[1] The phrase "addition to tax" is commonly referred to as a penalty, so we will refer to these two additions to tax as the failure to file penalty and the estimated tax penalty. Twenty cases involved imposition of the estimated tax penalty in conjunction with the failure to file penalty, five cases involved only the estimated tax penalty, and the remaining 35 cases involved only the failure to file penalty.

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

PRESENT LAW

Under IRC § 6651(a)(1), a taxpayer that fails to file a tax return on or before its due date (including extensions) will be subject to a five percent penalty for each month or partial month the return is late, up to a maximum of 25 percent, unless such failure is due to reasonable cause and not willful neglect.[4] The penalty is based on the amount of tax due, minus any credit the taxpayer is entitled to receive or payment made by the due date.[5] The failure to file penalty applies to income, estate, gift, and certain excise tax returns.[6] To establish reasonable cause, the taxpayer must show that he or she exercised ordinary business care and prudence but was still unable to file by the due date.[7]

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

2 IRC § 6651(a)(1).

3 IRC § 6654(e).

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

5 IRC § 6651(b)(1).

6 IRC § 6651(a)(1).

7 Treas. Reg. § 301.6651-1(c)(1).

IRC § 6654 imposes a penalty on any underpayment of a required installment of estimated tax by an individual.[8] There are four required installments per taxable year, and each amount is generally 25 percent of the taxpayer's total required annual payment.[9] The required annual payment is the lesser of 90 percent of the tax for the current taxable year or 100 percent of the tax shown on the taxpayer's return for the previous taxable year.[10] The IRS will determine the amount of the penalty by applying the underpayment rate according to IRC § 6621 to the amount of the underpayment for the period of the underpayment.[11] The estimated tax penalty applies to income tax returns of individuals and certain estates and trusts.[12] To avoid the estimated tax penalty, the taxpayer has the burden of proving one of the following exceptions applies:

- The tax due is less than $1,000;[13]
- The taxpayer has no tax liability for the preceding taxable year and was a citizen or resident of the United States throughout the preceding taxable year;[14]
- The IRS determines that by reason of casualty, disaster, or other unusual circumstances the imposition of the penalty would be against equity and good conscience;[15] or
- The taxpayer retired after reaching age 62 or became disabled in the taxable year for which estimated payments were required or in the taxable year preceding such year, and the underpayment was due to reasonable cause and not willful neglect.[16]

In any court proceeding, the IRS has the initial burden of production to provide sufficient evidence regarding the appropriateness of the failure to file penalty and the estimated tax penalty.[17] If the IRS meets this burden, the taxpayer may produce evidence to establish any exception to the penalty.[18]

ANALYSIS OF LITIGATED CASES

We analyzed 60 opinions issued between June 1, 2008, and May 31, 2009, where the failure to file penalty or the estimated tax penalty was in dispute. All but ten of these cases were litigated in the United States Tax Court. A detailed list of these cases appears in Table 8 in Appendix III. Fifty-six cases involved individual taxpayers and four involved businesses

8 IRC § 6654(a) and (b).

9 IRC § 6654(c) and (d)(1).

10 IRC § 6654(d)(1).

11 IRC § 6654(a)(1) – (3).

12 IRC § 6654(a) and (l).

13 IRC § 6654(e)(1).

14 IRC § 6654(e)(2).

15 IRC § 6654(e)(3)(A).

16 IRC § 6654(e)(3)(B).

17 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001) (quoting 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).

18 *Higbee v. Comm'r*, 116 T.C. 438, 447 (2001).

(including individuals engaged in self-employment or partnerships). Of the 46 cases in which taxpayers appeared *pro se*, or without counsel, taxpayers prevailed in full in only two cases, and five cases resulted in split decisions. Of the 14 cases in which taxpayers appeared with representation, only two were resolved in the taxpayer's favor.

Failure to File Penalty

A common basis for the courts ruling against taxpayers was the lack of evidence that the failure to file was due to reasonable cause. In fact, in 40 of the 60 cases analyzed, the taxpayers 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.[19] For illness or incapacity to constitute reasonable cause, the taxpayer must show incapacitation to such a degree that he or she could not file a return on time.[20] A court also may allow a taxpayer who is caring for another person to establish reasonable cause if providing the care prevents the taxpayer from filing on time.[21]

One court determined reasonable cause did not exist where a taxpayer claimed his wife's illness prevented him from filing a return, but he engaged in other business ventures during her period of illness.[22] In addition, while a court may be sympathetic to a taxpayer's medical condition, if the condition was not present at the time the return was due, it does not constitute reasonable cause. For example, in *Kantor v. Commissioner*, the taxpayers (husband and wife) argued that they were unable to file their 2000 joint tax return because the husband underwent drug rehabilitation from September 2001 through February 2002.[23] The taxpayers did not file their 2000 return until nearly 21 months after the husband's February, 2002 release from a drug program.[24]

Mistaken Belief as to Filing Obligation: Often, taxpayers mistakenly believe they are not required to file returns. If a taxpayer's mistaken belief about the filing requirement is based on an incomplete or flawed reading of the law, the taxpayer does not have reasonable cause. For example, in *McWhorter v. Commissioner*, the taxpayer believed he was an employee, rather than an independent contractor.[25] As a result, the taxpayer mistakenly assumed that the company for which he was providing services

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

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

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

22 *Ruggeri v. Comm'r*, T.C. Memo. 2008-300.

23 *Kantor v. Comm'r*, T.C. Memo. 2008-297.

24 *Id.*

25 *McWhorter v. Comm'r*, T.C. Memo. 2008-263.

was withholding taxes from the remuneration he received, and therefore, he had no obligation to file a return. The Tax Court concluded that the taxpayer was an employee; however, the failure of the employer to withhold taxes that should have been withheld from the taxpayer's wages was not an excuse for the taxpayer's failure to file a return.[26]

Reliance on Agent: The Supreme Court, in *United States v. Boyle*, held that taxpayers have a nondelegable duty to file a return on time, and a taxpayer's reliance on an agent does not excuse a failure to file.[27] Where a taxpayer is effectively disabled from fulfilling its obligations because of "circumstances beyond its control," a taxpayer may, however, succeed with a reasonable cause argument.[28] When a taxpayer (a private school) failed to timely file employment tax returns and argued the failure was due to criminal embezzlement by its bookkeeper, the court concluded that reasonable cause did not exist, noting that the bookkeeper was not in charge of the taxpayer's financial affairs in general and that the bookkeeper did not have the capacity to disable the taxpayer's operations.[29]

A taxpayer may establish reasonable cause if the taxpayer can prove that he reasonably relied on a professional tax advisor or that the taxpayer made a good-faith effort to ascertain return filing requirements.[30] In order to reasonably rely on the advice of a tax professional, the taxpayer must present evidence of the tax professional's expertise and that the taxpayer provided such professional with all necessary and accurate information.[31] Consistent with the *Boyle* line of reasoning, the Tax Court did not find reasonable cause where an executor was completely disengaged from preparation of the estate tax return and relied entirely on an estate attorney to handle all aspects of preparing and filing the return.[32] The Tax Court also rejected a reasonable cause claim when taxpayers (a husband and wife) relied on their accountant who had falsely informed them that he had filed a second request for extension of time to file their return, and that the IRS would extend the due date.[33]

Although an executor has a nondelegable duty to file the estate tax return on time, in at least one case the Tax Court determined that the executor of a deceased taxpayer's estate did establish reasonable cause for the failure to file when the executor relied on

26 *McWhorter v. Comm'r*, T.C. Memo. 2008-263.

27 469 U.S. 241, 252 (1985). *See also Guterman v. Comm'r*, T.C. Memo. 2008-283 (taxpayers could not establish reasonable cause by claiming that their certified public accountant suffered from an illness and was unable to complete their 2004 joint return in a timely manner).

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

29 *St. Paul Cathedral School v. U.S.*, 102 A.F.T.R.2d (RIA) 7212 (E.D. Wash. 2008).

30 *Cobaugh v. Comm'r*, T.C. Memo. 2008-199 ("Petitioner's failure to make a good-faith effort to verify the [professional advisor's] credentials or the legitimacy of his advice established that petitioner's reliance on [such professional] was neither reasonable nor in good faith").

31 *Linmar Property Management Trust v. Comm'r*, T.C. Memo. 2008-219 (the court rejected the taxpayer's reasonable cause argument that he reasonably relied on the advice of a tax professional who told the taxpayer that he did not have sufficient income to mandate the filing of a return because the taxpayer never provided the professional with all necessary information to determine filing requirement).

32 *Baccei v. U.S.*, 102 A.F.T.R.2d (RIA) 5801 (N.D. Cal. 2008), *modifying* 101 A.F.T.R.2d (RIA) 2717 (N.D. Cal. 2008).

33 *Wyatt v. Comm'r*, T.C. Memo. 2008-253 (*citing U.S. v. Boyle*, 469 U.S. 241, 249 (1985)).

an attorney's advice.[34] In *Estate of Lee v. Commissioner*, the estate attorney advised the executor (who was a judge), that the attorney would request a second six-month extension of time to file the return.[35] The executor questioned the attorney on such advice, and the attorney assured him it was correct.[36] The executor accepted the attorney's advice and authorized her to request a second extension.[37] Unknown to the executor at that time, the attorney had never before requested a second extension of time to file a federal estate tax return,[38] nor had she researched whether such an extension could be requested.[39] Nonetheless, the Tax Court concluded that the executor had acted diligently as to fulfilling his obligation to file the estate tax return and therefore reliance on the attorney was reasonable.[40]

"Zero Return" Filers and Other Frivolous Arguments: Under the longstanding four-part test articulated in *Beard v. Commissioner*, for a document to be a valid return it must: (1) purport to be a return; (2) be signed under penalties of perjury; (3) contain sufficient data to calculate the tax liability; and (4) represent an honest and reasonable attempt to satisfy the requirements of the tax laws.[41] Each year, some taxpayers claim they have no obligation to pay taxes by filing returns reporting zero income when they have earned substantial wages accurately reported on a Form W-2, *Wage and Tax Statement*.[42] A "zero return" does not constitute a tax return for purposes of the failure to file penalty of IRC § 6651(a)(1).[43] In addition, any departure from the jurat above the signature block provided in IRS forms invalidates a document purporting to be a return under the *Beard* test.[44] In the 55 cases we reviewed where the IRS had asserted the failure to file penalty, the courts also imposed a frivolous issue penalty in ten cases because the taxpayers presented frivolous arguments.[45]

One taxpayer argued the failure to file penalty was improper because she believed she had "negative income."[46] The Tax Court determined that the taxpayer received income in excess of her deductions and exemptions for the years at issue, and her mistakes as to, or ignorance of, the law did not constitute reasonable cause.[47]

34 *Estate of Lee v. Comm'r*, T.C. Memo. 2009-84.

35 *Id.*

36 *Id*

37 *Id*

38 *Id.*

39 *Id*

40 *Id*

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

42 *See, e.g., Smith v. Comm'r*, T.C. Summ. Op. 2009-52; *Hodsdon v. Comm'r*, T.C. Summ. Op. 2008-85.

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

44 *Green v. Comm'r*, T.C. Memo. 2008-130.

45 See Most Litigated Issue: *Frivolous Issues Penalty Under Internal Revenue Code Section 6673 and Related Appellate-Level Sanctions, supra.*

46 *Briseno v. Comm'r*, T.C. Memo. 2009-67.

47 *Id.*

The Tax Court rejected a taxpayer's argument that no one told him he was required to file a return and that the IRC did not require such filing.[48] Likewise, the Tax Court rejected a taxpayer's argument that the failure to file was due to the death of his tax preparer, because the taxpayer could not provide the name of the preparer.[49]

Miscellaneous Arguments: The Tax Court rejected the taxpayers' argument that they were unable to timely file their joint return because of a criminal investigation and incarceration of one spouse.[50] Courts have held that incarceration alone does not constitute reasonable cause for purposes of the addition to tax for failure to file.[51]

One taxpayer and his spouse argued that they had reasonable cause for filing their 2001 and 2002 returns late because of the hurricanes in Florida, where the return preparer's office was located.[52] The Tax Court, in rejecting the taxpayers' argument, held that the disaster declarations issued by the Federal Emergency Management Administration (FEMA) relating to Tropical Storms Allison and Gabriel during 2001 for certain areas of Florida did not cover the county where the preparer's office was.[53] The Tax Court also noted that FEMA issued a disaster declaration for Hurricane Isabelle, the alleged cause for the late filing for the 2002 tax year, covering the state of North Carolina, but not covering any portion of South Carolina where the taxpayers resided at the time of filing their joint return.[54] Moreover, the due date of the taxpayers' 2002 return, due under extension, occurred more than a month before the FEMA declaration.[55]

The one constant theme throughout the cases we reviewed is that the existence of reasonable cause in any given case depends on all the facts and circumstances of the case.[56]

Estimated Tax Penalty

Courts routinely found taxpayers liable for the IRC § 6654 estimated tax penalty when the Commissioner proved the taxpayers had a tax liability, had no withholding credits, and did not make any estimated tax payments for that year, and the taxpayer offered no evidence to refute the Commissioner's evidence.[57]

The IRS has the burden of production under IRC § 7491(c) to produce evidence that a taxpayer was required to make an annual payment under IRC § 6654(d)(1)(B). In all six of

48 *Rodriguez v. Comm'r*, T.C. Memo. 2009-92.

49 *Id*

50 *Kohn v. Comm'r*, T.C. Memo. 2009-117, *appeal filed* (8th Cir. Aug. 27, 2009).

51 *See, e.g., Thrower v. Comm'r*, T.C. Memo. 2003-193; *Krause v. Comm'r*, T.C. Memo. 1991-13.

52 *Robertson v. Comm'r*, T.C. Memo. 2009-91. The taxpayers also alleged reasonable cause because their return preparer faced extraordinary circumstances due to a federal investigation of the return preparer's business activities, and the Tax Court rejected this argument as well.

53 *Robertson v. Comm'r*, T.C. Memo. 2009-91.

54 *Id.*

55 *Id.*

56 IRM 20.1.1.3.1(1) (Feb. 22, 2008).

57 *See, e.g., Brennan v. Comm'r*, T.C. Memo. 2009-77; *McWhorter v. Comm'r*, T.C. Memo. 2008-263.

the cases where the taxpayers prevailed on the estimated tax penalty for some or all of the years at issue, their success was a result of the IRS failing to meet its burden of production regarding the appropriateness of the penalty. For example, in *Bannister v. Commissioner*, the Tax Court held that the Commissioner failed to introduce evidence showing whether a taxpayer filed a return for the preceding year and the amount of tax shown on that return, thereby not satisfying the burden of production because "it is impossible to determine whether the taxpayer had a required annual payment."[58]

CONCLUSION

The United States tax system relies on taxpayers voluntarily filing accurate returns and paying their taxes. Penalties attempt to establish fairness in the system by imposing an additional cost on the noncompliant taxpayer. The penalties for failure to file and failure to pay estimated tax were implemented to encourage voluntary compliance and deter noncompliance.[59]

The IRS should determine whether these penalties positively influence compliance as intended. Congress should again consider the National Taxpayer Advocate's recommendation of a one-time abatement of the failure to file penalty for taxpayers who comply with their filing obligations, but in an untimely manner.[60] This proposal would broaden the definition of reasonable cause by providing the IRS the authority to abate a late filing penalty for inadvertent taxpayer mistakes, while still encouraging the IRS's goal of voluntary compliance.

58 *Banister v. Comm'r,* T.C. Memo. 2008-201, *appeal filed*, No. 09-70775 (9th Cir. Mar. 10, 2009).

59 *See* Policy Statement 20-1 (formerly P-1-18), Internal Revenue Manual (IRM) 1.2.20.1.1 (June 9, 2004). *See also United States v. Boyle,* 469 U.S. 241, 245 (1985) ("Congress' purpose in the prescribed civil penalty was to ensure timely filing of tax returns to the end that tax liability will be ascertained and paid promptly.").

60 *See* National Taxpayer Advocate 2001 Annual Report to Congress 188. A provision to waive the failure to file penalty for first-time unintentional minor errors was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003. See H.R. 1528, 108th Cong. § 106 (2003). Although the IRS has provided for a one-time administrative waiver of the failure to file penalty in IRM 20.1.1.3.5.1 (Feb. 22, 2008), the National Taxpayer Advocate continues to recommend a statutory waiver similar to IRC § 6656(c).

MLI #9

Family Status Issues Under Internal Revenue Code Sections 2, 24, 32, and 151

SUMMARY

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

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

We reviewed 48 federal court opinions issued between June 1, 2008, and May 31, 2009. This is the first time in four years that we have observed an increase in the number of opinions in family status cases. Over the past three years, the figure has declined, from 46 in the National Taxpayer Advocate's 2006 Annual Report to Congress[5] to 41 in the 2007 report[6] and 34 in 2008.[7] Many of these opinions cover multiple family status issues, with the determination of one often affecting others. For example, a denial of the dependency exemption will lead to the summary denial of the child tax credit and may impact eligibility for head of household filing status.

PRESENT LAW

Uniform Definition of Qualifying Child

Before 2005, the Internal Revenue Code (IRC) contained multiple definitions of a "child" for purposes of filing status, deductions, and tax credits associated with dependent children.[8] These family status provisions potentially affect 85.5 million taxpayers and 82.9 million

1 Internal Revenue Code (IRC) § 2(b).

2 IRC § 24.

3 IRC § 32.

4 IRC § 151.

5 National Taxpayer Advocate 2006 Annual Report to Congress 555.

6 National Taxpayer Advocate 2007 Annual Report to Congress 634.

7 National Taxpayer Advocate 2008 Annual Report to Congress 537.

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

children.[9] Effective for tax years after December 31, 2004, the Working Families Tax Relief Act (WFTRA)[10] established a uniform definition of a qualifying child (UDOC) with respect to five family status provisions: head of household filing status, the child tax credit, the child and dependent care credit, the EITC, and the dependency deduction.[11] The intent of the UDOC legislation was to bring about some uniformity for the vast majority of taxpayers who had to meet multiple tests to determine if they were eligible to claim an exemption, credit, or filing status under the basic family status provisions.[12] Under UDOC, a dependent must be either a "qualifying child" or a "qualifying relative."[13] 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, an individual must meet four tests to be claimed as a qualifying child under UDOC.

1. **Relationship Test.** The child must be the taxpayer's child (including an adopted child, stepchild, or eligible foster child), brother, sister, stepbrother, stepsister, or 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.[14]
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.[15]
3. **Age Test.** The child must be under a certain age, depending on the tax benefit claimed, to be a qualifying child.[16]
4. **Support Test.** The child cannot provide more than half of his or her own support during the year.[17]

9 IRS Compliance Data Warehouse, Individual Returns Transaction File for Tax Year 2007.

10 The Working Families Tax Relief Act, Pub. L. No. 108-311, § 201, 118 Stat. 1166, 1169 (2004).

11 Further, UDOC applies to determining whether a taxpayer qualifies for an income inclusion under IRC § 129.

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

13 IRC § 152(a).

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

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

16 IRC § 152(c)(1)(C).

17 IRC § 152(c)(1)(D).

Qualifying Relative

An individual who does not meet the requirements for a qualifying child may still be claimed as a dependent if he or she meets the requirements for a qualifying relative. Again, 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, 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.[18]
2. **Gross Income Test.** An individual must have gross income below the amount allowed for a personal exemption for the taxable year.[19]
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.[20]
4. **Not a Qualifying Child.** In general, an individual may not be a qualifying child of the taxpayer or of any other taxpayer for the taxable year.[21] IRS Notice 2008-5 provides additional guidance as to when an individual is a qualifying relative.[22]

The taxpayer can claim a personal exemption deduction for a dependent who meets the tests of a qualifying relative.[23]

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

19 IRC § 152(d)(1)(B).

20 IRC § 152(d)(1)(C).

21 IRC § 152(d)(1)(D).

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

23 IRC §§ 152(d); 151(c).

Tie-Breaker Rule

Sometimes a child meets the tests to be a qualifying child for more than one person. However, only one taxpayer can claim that child as a qualifying child. If multiple taxpayers meet the test with respect to the same qualifying child, they may decide among themselves who will claim the child. If they cannot agree and more than one taxpayer files a return claiming the child, the IRS will use the tie-breaker rules explained in the table below to determine which taxpayer will be allowed to claim the child.[24] Until 2005, these tie-breaker rules applied only to a qualifying child for the EITC, but they now cover the five family status provisions mentioned earlier. Generally, the same taxpayer is entitled to all of the applicable family status benefits with respect to the same qualifying child – or to put it another way, generally taxpayers may not "split the baby" and divide the family status benefits among themselves.[25] Table 3.9.1 below describes how the tie-breaker rule applies.

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

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

Special Rule for Divorced or Separated Parents

A child will be treated as being the qualifying child or qualifying relative of his or her noncustodial parent if all of 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 for the year 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 releases the claim to the dependency exemption in a written declaration that the noncustodial parent attaches to the noncustodial parent's tax return.[26]

24 IRC § 152(c)(4).

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

26 IRC § 152(e); Notice 2006-86, 2006-2 C.B. 680. *See also* Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents* (used to release the dependency exemption to the noncustodial parent). The custodial parent may, in lieu of Form 8332, use a similar written statement that meets the requirements of the form. Treas. Reg. 1.152-4(e)(1) requires that the declaration include an unconditional statement that the custodial parent will not claim the child as a dependent for the years covered by the declaration.

A custodial parent is the parent having custody of the child for the greater part of the calendar year;[27] the other parent is the noncustodial parent.[28] The special rule for divorced or separated parents allows the noncustodial parent to claim the dependency exemption and child tax credit; it does not allow the noncustodial parent to claim head of household filing status, the credit for child and dependent care expenses, or the EITC. Only the custodial parent can claim the child as a qualifying child for these three tax benefits.

Further, the statute does not define "custody." When a child resides with one parent for part of the day and the other parent for the rest of the day, it can be difficult to calculate how much time is spent in the custody of each parent. Under regulations published on July 2, 2008, the custodial parent is the one who resides with the child for the greater number of nights during the calendar year.[29] The regulations also adopt the rule enunciated by the united States Tax Court in *King v. Commissioner*,[30] that the IRC § 152(e) special rules for divorced or separated parents also apply to parents who were never married to each other.[31]

ANALYSIS OF LITIGATED CASES

Most of the cases litigated during this period were small Tax Court cases.[32] A majority of the cases discussed address factual disputes and not novel issues of law.

Pro Se Analysis

Taxpayers were represented by counsel in only three of the 48 cases litigated this year, even though many cases were highly fact-specific and involved a complicated web of statutory provisions. Out of 48 cases, only six taxpayers prevailed in full and those taxpayers appeared *pro se*. It appears that many taxpayers did not understand the complex family status provisions or know what evidence to submit; thus, the assistance of counsel might have affected the courts' rulings. A detailed list of all family status cases analyzed appears in Table 9 in Appendix III.

Cases Decided Where UDOC Applied

As expected, because UDOC has become operative only recently, the number of cases where UDOC was applied greatly increased since 2008. This year UDOC applied in 27 of the 48 cases reviewed, or more than half. UDOC appears to have made the analysis of the issues easier for the court by the establishment of one definition of a "qualifying child" with respect to head of household filing status, the child tax credit, the EITC, and the dependency

27 IRC § 152(e)(4)(A).

28 IRC § 152(e)(4)(B).

29 Treas. Reg. § 1.152-4(d)(1).

30 121 T.C. 245 (2003).

31 Treas. Reg. § 1.152-4(b)(2)(C).

32 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 in these cases cannot be appealed or cited as precedent. *See* IRC § 7463.

deduction. Not only does the UDOC seem to simplify the court's analysis, but it reduces the burden on taxpayers who only need to establish the existence of a "qualifying child" under one standard, rather than several under prior law.

However, in most cases, UDOC does not seem to lead to a different outcome for the taxpayer than the previous law. For example, in *McLain v. Commissioner*,[33] the IRS determined a deficiency for both 2004 (before UDOC was effective) and 2005. For both years, the court decided the legitimacy of the taxpayer claiming a dependency exemption deduction, head of household filing status, and EITC. The court disallowed each of these claims, applying the law for 2004 and 2005 separately when analyzing the dependency exemption deduction and head of household filing status, but denying the claims for each year. Although the outcome did not change, the analysis under UDOC seemed to be easier for the court and was a simpler, more straightforward application of the law.

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

We reviewed 23 cases involving head of household status, with three taxpayers prevailing on this issue in full and one taxpayer prevailing on this issue for two out of the three years that were being challenged.[34] In many cases, the taxpayer was confused about the eligibility requirements for the various family status provisions.[35] However, the taxpayer did succeed in a few circumstances. For example, in *Aref v. Commissioner*,[36] the IRS did not question the taxpayer's entitlement to head of household filing status in the statutory notice of deficiency, but the IRS did raise this issue as a new matter at trial. Therefore, under Tax Court Rule 142(a), the IRS had the burden of proof. Thus, the IRS had to prove the taxpayer was not entitled to head of household filing status.[37] Because the IRS was not able to establish the total cost of maintaining the household or that petitioner did not provide over half of the cost, the IRS failed to meet its burden, and the taxpayer prevailed.

However, in many cases the taxpayer did not understand the eligibility requirements necessary to be allowed the head of household filing status. For example, in *Eubanks v. Commissioner*,[38] the taxpayer claimed head of household status under the theory that his girlfriend's son was a qualifying child. The court disallowed the filing status, finding that the son was not a qualifying child under IRC § 152(c). This case is typical of the cases reviewed.

33 T.C. Summ. Op. 2008-122.

34 *Briseno v. Comm'r*, T.C. Memo. 2009-67.

35 *Contreras v. Comm'r*, T.C. Summ. Op. 2009-55.

36 T.C. Memo 2009-118.

37 Tax Court Rule 142(a). "The burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in the answer, it shall be upon the respondent."

38 T.C. Summ. Op. 2009-36.

Child Tax Credit

We reviewed 33 cases involving the child tax credit; taxpayers prevailed in full on this issue in three cases. In one case, the taxpayer prevailed on the issue two out of the three years the credit was challenged.[39] To claim the child tax credit, the taxpayer must be able to claim the child as a dependent on his or her tax return, and the child must meet the requirements of IRC § 152(c).[40] In *Leonard v.* Commissioner,[41] the taxpayer was not eligible for the child tax credit because the dependents claimed by the taxpayer did not meet the relationship test under IRC § 152(c)(2), *i.e.*, they were not the qualifying children or qualifying relatives of the taxpayer.[42]

In *Pavia v. Commissioner*,[43] the taxpayer was able to receive the child tax credit for the 2005 year. In order to receive the credit, the taxpayer must show that the dependents meet the qualifying children requirements under IRC § 152(c), including the support test under IRC § 152(c)(1)(D), which was the main issue in this case. The taxpayer lived with her sister and her sister's two children in 2005. The taxpayer testified to the total amount of support received by the claimed dependents (her sister's two children) and the sources of the support. The expenses of the household and support of the claimed dependents were provided by the taxpayer, the taxpayer's sister, public aid (in the form of food stamps), and Medicaid. Further, neither of the claimed dependents provided over half of their own support. Therefore, the support test was met, and the taxpayer was entitled to the child tax credit.

Earned Income Tax Credit

We reviewed 20 cases involving the EITC during the reporting period, with two taxpayers prevailing on this issue. Taxpayers appeared *pro se* in 19 of the 20 cases. Several recurring themes appear throughout the EITC cases.

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

In *Eubanks v. Commissioner*,[44] the taxpayer was denied the EITC because: (1) his girlfriend's child was not a qualifying child as defined in IRC § 32(c)(3)(A); (2) the taxpayer was not an eligible individual as defined in IRC § 32(c)(1)(A)(i); and (3) the taxpayer's income exceeded the adjusted gross income limitation of IRC § 32(c)(1)(A)(ii).

39 *Briseno v. Comm'r*, T.C. Memo. 2009-67.

40 *Scott v. Comm'r*, T.C. Summ. Op. 2008-135.

41 T.C. Summ. Op. 2008-141.

42 *Id.*

43 T.C. Memo. 2008-270.

44 T.C. Summ. Op. 2009-36.

Dependency Exemption – IRC §151

We reviewed 42 cases involving the dependency exemption, with four taxpayers prevailing in full and one taxpayer prevailing for two of the three years the dependency exemption was challenged. Taxpayers appeared *pro se* in all but two of these cases.

In *Hahn v. Commissioner*,[45] the taxpayers (husband and wife) filed a joint return for 2005, claiming the husband's son from a prior marriage as a dependent. Under the husband's divorce decree, the mother of the son had primary custody. The taxpayers did not attach a Form 8332, *Release of Claim to Exemption for Child of Divorce or Separated Parents*, to the return. Therefore, the taxpayers would only be entitled to the dependency exemption if they could show that the husband's son resided with the taxpayers for more than one-half of the taxable year, making the husband the custodial parent. None of the evidence introduced at trial, including the taxpayers' testimony, supported a finding that the son resided with the taxpayers for more than half of any month in 2005. Therefore, the court disallowed the dependency exemption.

In *Halbin v. Commissioner*,[46] the taxpayer filed a return for 2004 claiming her 26-year-old son as a dependent. During 2004, the son became incapacitated as a result of a serious automobile accident. Due to his extensive injuries, the son resided with his parents (taxpayer and taxpayer's husband) in 2004. Both the taxpayer and her husband testified credibly that they paid 100 percent of their son's expenses, including grocery and medical bills, that their son did not work, and he had no other source of income in 2004. Thus, the testimony established that the taxpayer provided all of the son's support during 2004. Because the taxpayer could meet the support test, and all other requirements, she was entitled to a dependency exemption for her son.

CONCLUSION

Family status provisions still seem to be a confusing area for taxpayers. Over the past few years, the number of family status cases we have reviewed has declined significantly. We reviewed 34 cases in the 2008 Annual Report to Congress,[47] down from 41 in the 2007 report[48] and 46 in 2006.[49] However, this year the number of family status cases has risen to 48.[50] It is not clear what caused the increase. The National Taxpayer Advocate will continue to monitor the number of family status cases if the increase in these decisions is only an aberration or indicates a trend.[51]

45 T.C. Summ. Op. 2009-41.

46 T.C. Memo. 2009-18.

47 National Taxpayer Advocate 2008 Annual Report to Congress 537.

48 National Taxpayer Advocate 2007 Annual Report to Congress 634.

49 National Taxpayer Advocate 2006 Annual Report to Congress 555.

50 National Taxpayer Advocate 2008 Annual Report to Congress 537.

51 One possible explanation for this increase could be IRS correspondence examinations. *See* National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 94; National Taxpayer Advocate 2008 Annual Report to Congress 243.

This increase in family status cases supports the National Taxpayer Advocate's contention that these provisions of the tax code still contain 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 adversely affect the outcomes of their cases. In an effort to build on the improvements made by UDOC and reduce the complexity of these provisions even more, the National Taxpayer Advocate proposed a legislative recommendation in her 2005 Annual Report to Congress on how to restructure the requirements governing these provisions to make them easier for taxpayers to understand, thereby reducing complexity.[52] The National Taxpayer Advocate updated her 2005 recommendation in the 2008 Annual Report to Congress, once again highlighting the importance of creating a less complex and convoluted tax system.[53]

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

53 National Taxpayer Advocate 2008 Annual Report to Congress 363.

MLI #10

Relief from Joint and Several Liability Under Internal Revenue Code Section 6015

SUMMARY

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

Internal Revenue Code (IRC) § 6015 provides three avenues for relief from joint and several liability. Section 6015(b) provides "traditional" relief for deficiencies. Section 6015(c) also provides relief for deficiencies for certain spouses who are divorced, separated, widowed, or not living together, by allocating the liability between each spouse. Section 6015(f) provides "equitable" relief from both deficiencies and underpayments, but only applies if a taxpayer is not eligible for relief under IRC § 6015(b) or (c). A taxpayer generally files Form 8857, *Request for Innocent Spouse Relief*, to request relief.

We reviewed 42 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2008, and May 31, 2009. Most significantly, courts addressed three important procedural issues this year: The period of time within which a taxpayer may request relief under IRC § 6015 (f); the evidence the U.S. Tax Court can consider when reviewing an IRC § 6015 determination; and the standard by which the Tax Court reviews IRC § 6015(f) determinations. An additional three cases reiterated that taxpayers in community property states are not entitled to refunds of taxes paid with community property even if they obtain relief under IRC § 6015 with respect to those taxes. Finally, the Tax Court noted that the issue of whether IRC § 6015 can be raised as a defense in a collection suit persists.

PRESENT LAW

Traditional Innocent Spouse Relief Under IRC § 6015(b)

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

1. A joint return was filed;

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

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

2. There was an understatement of tax attributable to erroneous items of the nonrequesting spouse;[3]
3. Upon signing the return, the requesting spouse did not know or have reason to know of the understatement;
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.[4]

Allocation of Liability Under IRC § 6015(c)

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

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

This election allocates to each joint filer that portion of the deficiency on the joint return attributable to each filer as calculated under the allocation provisions of IRC § 6015(d). A taxpayer is ineligible to make an election under IRC § 6015(c) if the IRS demonstrates that, at the time he or she signed the return, the requesting taxpayer had "actual knowledge" of any item giving rise to the deficiency.[5] Additionally, relief is not available for amounts attributable to fraud, fraudulent schemes, or certain transfers of disqualified assets.[6] Finally, no credit or refund is allowed as a result of relief granted under IRC § 6015(c).[7]

Equitable Relief Under IRC § 6015(f)

IRC § 6015(f) provides that the Secretary may relieve a taxpayer from liability for both deficiencies and underpayments[8] where the taxpayer demonstrates that:

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

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

5 IRC § 6015(c)(3)(C).

6 IRC § 6015(c)(4),(d)(3)(C).

7 IRC § 6015(g)(3).

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

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.

The regulations under IRC § 6015(f) require the taxpayer to make an election for relief under IRC § 6015(f) within two years after the IRS initiates collection activity with respect to the taxpayer. The Tax Court, however, recently held in *Lantz v. Commissioner*,[9] discussed in more detail, *infra*, that this regulation is invalid, and the government has appealed this decision to the United States Court of Appeals for the Seventh Circuit.

Revenue Procedure 2003-61 lists some of the factors the IRS considers in determining whether equitable relief is appropriate.[10] These factors include marital status, economic hardship, knowledge or reason to know, legal obligations of the nonrequesting spouse, significant benefit to the requesting spouse, compliance with income tax laws, and abuse.

Rights of Nonrequesting Spouse

The individual with whom the requesting spouse filed the joint return is generally referred to as a "nonrequesting spouse." Section 6015 has conferred certain rights on the nonrequesting spouse. The nonrequesting spouse must be notified and given an opportunity to participate in any administrative proceedings concerning a claim under IRC § 6015.[11] And, if during the administrative process full or partial relief is granted to the requesting spouse, the nonrequesting spouse can file a protest and receive an administrative conference in the IRS Appeals function.[12] However, the nonrequesting spouse does not have the right to petition the Tax Court in response to the IRS's administrative determination regarding IRC § 6015 relief.[13] Similarly, if the requesting spouse files a Tax Court petition, the nonrequesting spouse must receive notice of the proceeding and has an unconditional right to intervene in the Tax Court proceeding, either to dispute or support the requesting spouse's claim for relief.[14] However, an intervening spouse has no standing to appeal the Tax Court's decision to the United States Court of Appeals.[15]

Judicial Review

Taxpayers seeking relief under IRC § 6015 generally file Form 8857, *Request for Innocent Spouse Relief*, which the IRS revised in June 2007 to reduce taxpayer mistakes and speed processing.[16] After reviewing the request, the IRS issues a final notice of determination

9 132 T.C. No. 8 (2009), 2009 WL 928241 (U.S. Tax Ct. Apr. 7, 2009), *appeal docketed* No. 09-3345 (7th Cir. Sept. 17, 2009).

10 Rev. Proc. 2003-61, 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1 C.B. 447.

11 IRC § 6015(h)(2).

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

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

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

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

16 *See* IRS Form 8857, *Request for Innocent Spouse Relief, Instructions* (June 2007).

granting or denying relief in whole or in part. The taxpayer has 90 days from the date the IRS mails the notice of determination to file a petition with the Tax Court.[17] The Tax Relief and Health Care Act of 2006 (TRHCA) amended IRC § 6015(e) to expressly provide that the Tax Court has jurisdiction in stand-alone cases to review IRC § 6015(f) determinations, even where no deficiency has been asserted.[18]

ANALYSIS OF LITIGATED CASES

We analyzed 42 opinions issued between June 1, 2008, and May 31, 2009, including 37 cases in the Tax Court, one each in the Courts of Appeals for the Fifth, Sixth, Ninth, and Eleventh Circuits, and one in a U.S. District Court. Fifty-five percent of the cases (23 of 42) were decided in favor of the IRS, 38 percent (16 of 42) in favor of the taxpayer (including three cases in which only the intervenor opposed granting relief), and seven percent (three of 42) ended in split decisions. In 57 percent (24 of 42) of the cases, the taxpayers were *pro se* (*i.e.*, they represented themselves). The nonrequesting spouse intervened in 24 percent of the cases (ten of 42).

Seventy-nine percent of the cases (33 of 42), approximately the same percentage as last year, involved an analysis of whether to grant relief. Thirty-one percent (13 cases) involved procedural issues,[19] with 46 percent (six of 13) of these cases decided in favor of the IRS and 54 percent (seven of 13) in favor of the taxpayer.

Of the 33 cases decided on the merits, 52 percent (17 of 33) were decided in favor of the IRS, 39 percent (13 of 33) in favor of the taxpayer, and in nine percent (three cases) the court split its decision. See Table 10 in Appendix III for a detailed breakdown of the cases.

Procedural Issues

In previous years, the issue of whether the Tax Court has jurisdiction in a stand-alone proceeding to review IRC § 6015(f) determinations where no deficiency had been determined was frequently litigated.[20] The passage of TRHCA in 2006 clarified the prior ambiguity regarding the scope of the Tax Court's authority to review IRC § 6015(f) claims in stand-alone cases. Thus, not surprisingly, few of the cases reviewed this year involved the scope

17 IRC § 6015(e)(1)(A)(ii).

18 Pub. L. No. 109-432, Div. C, § 408(a), (c), 120 Stat. 2922, 3061-62 (2006). The filing of a Tax Court petition in response to the final notice of determination or after the IRC § 6015 claim is pending for six months is often referred to as a stand-alone proceeding because jurisdiction is predicated on IRC § 6015(e) and not deficiency jurisdiction under IRC § 6213. Prior to the passage of TRHCA, there was much litigation concerning the scope of the Tax Court's jurisdiction under IRC § 6015(e) to review IRC § 6015(f) determinations. The National Taxpayer Advocate, in her 2001 Annual Report to Congress, submitted a legislative recommendation, *Judicial Review of Determinations Made Under IRC § 6015(f)*, to amend IRC § 6015(e) to clarify that taxpayers have the right to petition the Tax Court to challenge determinations in cases seeking relief under IRC § 6015(f) alone. In 2006, two appellate courts held that the Tax Court lacked jurisdiction in a stand-alone proceeding to review an IRC § 6015(f) determination where no deficiency had been determined. *Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), *rev'g* 118 T.C. 494 (2002), *vacating* 122 T.C. 32 (2004) and *Bartman v. Comm'r*, 446 F.3d 785446 F.3d 785 (8th Cir. 2006). Shortly thereafter, the Tax Court issued an opinion in which it reversed its prior position and adhered to the holdings of these two appellate decisions. *See Billings v. Comm'r*, 127 T.C. 7 (2006).

19 These percentages do not add up to 100 percent because some cases involved more than one issue.

20 For example, 60 percent of the procedural cases in the period June 1, 2006, through May 31, 2007, addressed the Tax Court's jurisdiction to hear stand-alone IRC § 6015(f) cases. *See* National Taxpayer Advocate 2007 Report to Congress 626-33.

of the Tax Court's jurisdiction under IRC § 6015(e).[21] The courts, however, addressed other procedural questions, such as whether a Treasury regulation that imposed a two-year time limit within which to elect relief under IRC § 6015(f) was valid, whether the Tax Court may consider evidence introduced at trial that was not part of the administrative record, and what is the appropriate standard of review in Tax Court cases reviewing denials of relief under IRC § 6015(f).

Lantz v. Commissioner

In *Lantz v. Commissioner*,[22] the Tax Court considered the validity of Treas. Reg. § 1.6015-5(b)(1), which requires the requesting spouse to make an election for relief under IRC § 6015(f) within two years after the IRS initiates collection activity against the requesting spouse. The court held that the regulation was not entitled to judicial deference because it failed the test articulated by the Supreme Court in *Chevron*,[23] noting:

> [T]he Supreme Court created a two prong test: (1) If Congress has directly spoken to the precise question at issue, the court is to give effect to the unambiguously expressed intent of Congress: If the statute is ambiguous, then the court is to continue to the second prong: (2) If the statute is ambiguous with respect to the specific issue, the court is to determine whether the regulation is a permissible construction of the statute.[24]

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

Because the request for IRC § 6015(f) was not time-barred, the court concluded it would need to conduct further proceedings to determine whether the taxpayer is entitled to relief on the merits. In response to the *Lantz* opinion, the IRS issued Chief Counsel Notice 2009-012, which directs Chief Counsel attorneys not to file motions for summary judgment in other docketed Tax Court cases arguing that the petitioner's claim for relief under IRC § 6015(f) was untimely, but to raise the issue during litigation whenever appropriate (*e.g.*, in the pre-trial memo, at trial, and on brief), noting the IRS's disagreement with the

21 *See Kollar v Comm'r*, 131 T.C. No. 12 (2008), 2008 WL 5000107 (U.S. Tax Ct. Nov. 25, 2008), and *Pollock v. Comm'r*, 132 T.C. No. 3 (2009), 2009 WL 349743 (U.S. Tax Ct. Feb. 12, 2009), discussed *infra*.

22 132 T.C. No. 8 (2009), 2009 WL 928241 (U.S. Tax Ct. Apr. 7, 2009), *appeal docketed* No. 09-3345 (7th Cir. Sept. 17, 2009).

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

24 *Lantz v. Comm'r*, 132 T.C. No. 8 at 13 (2009).

holding in *Lantz*. Where the IRS's denial of IRC § 6015(f) relief was based solely on the two-year rule, without consideration of the merits of the claim for relief, Chief Counsel attorneys are directed to refer the case to the Cincinnati Centralized Innocent Spouse Operations (CCISO) unit for consideration of the merits of the IRC § 6015(f) claims, and to proceed in newly-docketed cases only after CCISO had made a determination on the merits.[25] On June 26, 2009, pursuant to the parties' agreement, the Tax Court entered its decision in *Lantz* that no income tax was due from the taxpayer after application of IRC § 6015(f) and that she had overpaid her tax for the year in issue. As discussed *supra*, the IRS appealed that decision.

Shortly after the *Lantz* decision, the Tax Court decided *Mannella v. Commissioner*,[26] in which it allowed the taxpayer's IRC § 6015(f) claim made after the two-year period in the regulation. The Tax Court also held, however, that taxpayer's request for IRC § 6015(b) and (c) relief began when the IRS properly sent separate notices (*i.e.*, IRC § 6330 notices) to the taxpayer and to her husband that included information about how to request relief under IRC § 6015.[27] The taxpayer was precluded from electing relief under IRC § 6015(b) or (c) even if her husband signed for the IRC § 6330 notice addressed to her and did not inform her of it, and even if she did not actually receive the notice. As the court noted, according to the regulations pertaining to notice and opportunity for hearing (a collection due process or CDP hearing) prior to levy, "Actual receipt is not a prerequisite to the validity of the CDP Notice [also known as the IRC § 6330 notice]."[28] The court concluded: "Once the required notice was mailed to petitioner's last known address, nothing in the Internal Revenue Code, regulations, or public law required that respondent take additional steps to effect delivery."[29]

Neal v. Commissioner – Scope of Review in Tax Court

In *Neal v. Commissioner*,[30] the United States Court of Appeals for the 11th Circuit, relying on the Tax Court's decisions in *Ewing v. Commissioner*,[31] and *Porter v. Commissioner*,[32] held the Tax Court may consider evidence outside the administrative record when reviewing an IRC § 6015(f) claim in a stand-alone proceeding. In earlier cases, the Tax Court found that the Administrative Procedure Act,[33] which limits the scope of judicial review to the

25 Notice CC-2009-012 (Apr. 17, 2009).

26 132 T.C. No. 10 (2009), 2009 WL 981710 (U.S. Tax Ct. Apr. 13, 2009).

27 Section 3501(b) of the IRS Restructuring and Reform Act of 1998, Pub. L .No. 105-206, 112 Stat. 685, 770 (1998), requires the IRS to include a notice to taxpayers of their right to request relief under IRC § 6015 with Publication 1 and any other "collection-related notices." An IRC § 6330 notice is a collection- related notice.

28 Sec. 301.6330-1(a)(3), A-A9, Proced. & Admin. Regs.

29 *Mannella v. Comm'r*, 132 T.C. No. 10 at 11 (2009).

30 557 F.3d 1262 (11th Cir. 2009), *aff'g* T.C. Memo. 2005-201.

31 *Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), *rev'g* 118 T.C. 494 (2002), *vacating* 122 T.C. 32 (2004).

32 130 T.C. 115 (2008) (*Porter I*). In Porter I, the Tax Court denied the IRS's motion *in limine* (*i.e.*, as a preliminary matter) which sought to preclude the taxpayer from offering evidence not already contained in the administrative record.

33 5 U.S.C. §§ 551-559, 701-706 (2000).

administrative record, was not applicable to Tax Court proceedings, including IRC § 6015 proceedings. Further, the Tax Court found that the use of the word "determine" in IRC § 6015 is similar to the use of the word "redetermination" in IRC § 6213(a) under which it is unquestioned that the court conducts trials *de novo* (*i.e.*, considers evidence introduced at trial which was not included in the administrative record). The Tax Court concluded that the use of this term meant that Congress intended the court to have *de novo* review authority for IRC § 6015 cases. The appellate court affirmed the Tax Court's holding and also its conclusion that the taxpayer in *Neal* was entitled to relief under IRC § 6015(f).

Porter v. Commissioner (Porter II) – Standard of Review in Tax Court

In *Porter v. Commissioner (Porter II)*,[34] the Tax Court decided that in view of congressional expansion, in TRHCA,[35] of the Tax Court's jurisdiction to determine the appropriate relief available under IRC § 6015(f) in stand-alone cases, reconsideration of the standard of review in IRC § 6015(f) cases was warranted. The Tax Court then held that it would henceforth review IRS denials of relief under IRC § 6015(f) using a *de novo* standard of review, rather than, as in the past, an abuse of discretion standard of review. Under a *de novo* standard of review, the court considers the facts of the case anew and determines whether it is inequitable to hold the requesting spouse liable for the unpaid tax or deficiency. Under an abuse of discretion standard, the court reviews the IRS's denial of relief and overturns that determination only where it is shown to be arbitrary, capricious, or without sound basis in fact, and the requesting spouse bears the burden of proving that the Commissioner abused his discretion in denying relief.[36] The Tax Court noted that it had always reviewed claims for relief under IRC § 6015(b) and (c) *de novo*, and in view of TRHCA's direction that the Tax Court determine the appropriate relief available under subsections (b), (c), and (f), there was no longer any reason to apply a different standard of review under subsection (f) than under subsections (b) and (c). The IRS did not appeal the Tax Court's decision, but in Notice CC-2009-021 (June 30, 2009), the Office of Chief Counsel announced its disagreement with *Porter I* and *II* and instructed Chief Counsel attorneys to, among other things, continue to raise the scope and standard of review arguments whenever appropriate.

Kollar v. Commissioner and Pollock v. Commissioner

In *Kollar v. Commissioner*[37] and *Pollock v. Commissioner*,[38] the Tax Court dealt with two jurisdictional issues that arose as a consequence of TRHCA. TRHCA amended IRC § 6015(e)(1) to provide for Tax Court review "[i]n the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply, *or in the case of an individual who requests equitable relief under subsection (f)*." (emphasis

34 132 T.C. No. 11 (2009), 2009 WL 1098488 (U.S. Tax Ct. Apr. 23, 2009). *Porter II* is a continuation of the same case that produced the 2008 holding (*Porter I*, *see supra* note 32) that Tax Court review of denials of relief under IRC § 6015(f) is not limited to the administrative record.

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

36 *Jonson v. Comm'r*, 118 T.C. 106, 125, *aff'd*, 353 F.3d 1181 (10th Cir. 2003).

37 131 T.C. No. 12 (2008), 2008 WL 5000107 (U.S. Tax Ct. Nov. 25, 2008).

38 132 T.C. No. 3 (2009), 2009 WL 349743 (U.S. Tax Ct. Feb. 12, 2009).

added). The amendment, however, applies only with respect to liability for taxes arising or remaining unpaid on or after December 20, 2006. In *Kollar*, the requesting spouse sought relief from accrued interest owed with respect to her 1996 income tax which was paid in full prior to December 20, 2006. Noting that "taxes" includes unpaid interest, the Tax Court held that it had jurisdiction pursuant to IRC § 6015(e) to review the IRS's denial of the requesting spouse's IRC § 6015(f) claim even though the requesting spouse only sought relief from unpaid interest.

In *Pollock*, in April 2006, the IRS sent the requesting spouse a notice of determination denying her request for relief under IRC § 6015(f) and advising her that she had 90 days to file a Tax Court petition if she wanted to seek judicial review in the Tax Court of this determination.[39] The requesting spouse did not file a petition within the 90-day period.

In September of 2006, the Department of Justice filed a collection suit seeking, among other things, to foreclose its lien on a residence the requesting spouse obtained as part of her divorce settlement, to satisfy, in whole or in part, the joint debt for which the requesting spouse sought relief and a Trust Fund Recovery Penalty (TFRP) assessed against the requesting spouse's former husband.[40] By the time the Commissioner moved for summary judgment against the taxpayer in district court in 2007, TRHCA had been enacted, giving the Tax Court jurisdiction under IRC § 6015(e) to review all IRC § 6015(f) determinations. The requesting spouse attempted to raise IRC § 6015(f) as a defense in the district court action. The district court invoked the doctrine of equitable tolling,[41] stayed the case against the taxpayer in district court, and gave the taxpayer 30 days to file a Tax Court petition challenging the IRC § 6015 determination. The requesting spouse accordingly filed a petition.

As a preliminary matter, the Tax Court questioned the parties' assumption that IRC § 6015(f) could not be raised as a defense to a collection action in district court, noting the difference in views among various courts on that issue.[42] In prior reports,[43] the National Taxpayer Advocate pointed out that the combination of a district court refusing to allow

39 As discussed *supra* note 18, in April of 2006, there was conflicting law regarding whether the Tax Court had jurisdiction to review the requesting spouse's claim. As a resident of Florida, the requesting spouse's appeal would lie in the Court of Appeals for the Eleventh Circuit, which had never addressed this jurisdictional issue.

40 Pursuant to IRC § 6672, the IRS may assess a TFRP against any person responsible for collecting, accounting for, and paying delinquent employment taxes who willfully fails to collect and pay them.

41 The doctrine of equitable tolling permits a court to interrupt, or toll, the running of the period within which it may enforce certain rights. A statute of limitations may be equitably tolled unless it would be inconsistent with the particular terms of the relevant statute. *Young v. U.S.*, 535 U.S. 43, 49 (2002). If a deadline is jurisdictional, however, a court may not use equitable tolling to extend it. *Cooley v. Dir., Office of Workers' Comp. Programs,* 895 F.2d 1301, 1303 (11th Cir. 1990) citing *Shendock v. Dir., Office of Workers' Comp. Programs,* 893 F.2d 1458, 1466 (3d Cir. 1990).

42 *Pollock v. Comm'r,* 132 T.C. No. 3 at 8 (2009). The National Taxpayer Advocate, in her 2008 Annual Report to Congress, noted the same difference in views among the courts, and identified a disturbing trend of restricting a taxpayer's ability to raise IRC § 6015 as a defense in district court proceedings. National Taxpayer Advocate 2008 Annual Report to Congress 524.

43 National Taxpayer Advocate 2007 Annual Report to Congress 549; National Taxpayer Advocate 2008 Annual Report to Congress 524. In her 2007 Annual Report to Congress, the National Taxpayer Advocate proposed a legislative recommendation to clarify that taxpayers may raise IRC § 6015 as a defense in any proceeding brought under Title 26.

taxpayers to raise IRC § 6015 as a defense in a collection suit,[44] and the Tax Court's position that a taxpayer is barred by the doctrine of *res judicata* from raising IRC § 6015 relief in the Tax Court proceeding if the defense could have been raised in a prior collection suit,[45] may operate to foreclose a taxpayer from having a forum for seeking IRC § 6015 relief. Although the *Pollock* case presents a problem different than the one identified in the earlier report because *res judicata* did not bar the defense in the Tax Court (so the taxpayer could seek a refund), the *Pollock* case illustrates the inequity of not allowing the taxpayer to raise her IRC § 6015 defense in the district court proceeding which may result in her losing her home to foreclosure.

The Tax Court in *Pollock* held that it did not have jurisdiction, in spite of the district court's stay of proceedings, to permit the taxpayer to petition the Tax Court. The doctrine of equitable tolling did not apply to the 90-day period for filing a Tax Court petition because the 90-day period is a jurisdictional requirement. Therefore, the taxpayer could not take advantage of the enlarged jurisdiction conferred upon the Tax Court by TRHCA because she ran afoul of a different jurisdictional requirement – that the requesting spouse file a Tax Court petition in response to a notice of determination within 90 days. In its final footnote, the Tax Court noted that "Perhaps not all hope is lost—the Commissioner conceded at oral argument that if [the taxpayer] filed a refund action in District Court after her home was seized and sold, [she] could try to make her case that she is an innocent spouse." Instead, the taxpayer, on May 21, 2009, filed an appeal with the United States Court of Appeals for the Eleventh Circuit for review of the Tax Court's decision.

Ordlock v. Commissioner, Karp v. Commissioner, and Gray v. United States

Another category of cases decided this year highlights the difficulties faced by taxpayers who reside in community property states, and whose predicament the National Taxpayer Advocate has long recognized. In the 2005 Annual Report to Congress, the National Taxpayer Advocate recommended repeal of the rule of *Poe v. Seaborn*[46] that each spouse is taxed on one-half of community property.[47] She recommended requiring the IRS to exhaust efforts to collect against assets under the liable spouse's control before collecting against assets under the nonliable spouse's control, unless such efforts would be futile.

In *Ordlock v. Commissioner*,[48] the requesting spouse, who resided in California, was granted relief by the IRS pursuant to IRC § 6015(b) because the understatement of tax was attributable to the erroneous items of the nonrequesting spouse. In determining whether a taxpayer is entitled to innocent spouse relief, which includes whether an erroneous items on a joint return are attributable to the nonrequesting spouse, the operation of community

44 *See U.S. v. Bucy*, No. 5:06-00387, 2007 WL 3377240 (S.D. W. Va. Nov. 6, 2007), holding that the exclusive procedure for seeking equitable relief under IRC § 6015(f) in a stand-alone case is for the taxpayer to first obtain an IRS determination and then request review of denial of the claim in Tax Court.

45 *See Thurner v. Comm'r,* 121 T.C. 43 (2003).

46 282 U.S. 101 (1930).

47 National Taxpayer Advocate 2005 Annual Report to Congress 409.

48 533 F.3d 1136 (9th Cir. 2008), *aff'g* 126 T.C. 47 (2006).

property laws are suspended.[49] The tax reported on the joint return had already been paid, and except for one instance, payments had been made from community property. The requesting spouse sought a refund of part of those payments pursuant to IRC § 6015(g)(1). In this case of first impression, the U.S. Court of Appeals for the Ninth Circuit held that state law regarding ownership interests in property is not set aside for purposes of calculating the amount of a refund due an innocent spouse. Under California community property law, the individual debts of one spouse may be collected out of community assets. Therefore, the innocent spouse was not entitled to any refund of any of the payments that were determined to be made from community property even though she was not liable for the tax.

Karp v. Commissioner [50] was decided shortly after the Ninth Circuit affirmed the Tax Court decision in *Ordlock*. The taxpayer in *Karp* also resided in California, and the tax shown on her joint returns was paid from community property. Relying on *Ordlock*, the Tax Court held that the taxpayer could not obtain a refund, even if she were entitled to relief under IRC § 6015.[51]

The taxpayer in *Gray v. United States*[52] resided in Texas, also a community property state. Like the taxpayers in *Ordlock* and *Karp*, the requesting spouse in *Gray* was entitled to relief under IRC § 6015. However, the IRS offset refunds the couple claimed on tax returns for subsequent years to the year in which innocent spouse relief had been granted.[53] Texas law characterizes some community property as sole management community property, and provides that the IRS can only reach half of the nonliable spouse's sole management community property.[54] Because overpayments in later years were based in part on the innocent spouse's income and associated wage withholdings, the IRS had offset part of the innocent spouse's sole management community property against the liable spouse's tax. The IRS agreed that it could only reach half of the overpayments attributable to the nonliable spouse's sole management community property and that the innocent spouse was entitled to a refund of any amounts it had applied to the liable spouse's tax in excess of that amount. However, application of this rule required a calculation of the innocent spouse's

49 IRC § 6015(a).

50 T.C. Memo. 2009-40.

51 The IRS determined that the requesting spouse was entitled to partial relief under IRC § 6015(c) and not under IRC § 6015(b) or (f). As discussed *supra*, refunds are not available when relief is granted under IRC § 6015(c). IRC § 6015(g)(3). The taxpayer therefore sought review of the IRS's determination, requesting a refund if the court found that she was entitled to relief under IRC § 6015(b) or (f).

52 553 F.3d 410 (5th Cir. 2008), *aff'g* No. H-05-3530, 2007 WL 1300464 (S.D. Tex. May 3, 2007).

53 When the IRS offsets a refund due on a joint tax return to collect tax owed by one of the spouses, an injured spouse claim arises, and the injured spouse generally seeks relief by filing Form 8379, *Injured Spouse Claim and Allocation*. The requesting spouse in *Gray* filed a claim for relief as an injured spouse; the IRS did not dispute entitlement to injured spouse relief, but disputed the amount of relief. *See* Brief of Appellee at 3, *Gray v. U.S.*, No. 07-20592 (5th Cir. Mar. 24, 2008). The appellate court referred to the proceedings as "an 'innocent spouse' action to recover portions of tax overpayments applied to [the requesting spouse's] separate tax liability." *Gray*, 553 F.3d 410 at 411 (5th Cir. 2008), *aff'g* No. H-05-3530, 2007 WL 1300464 (S.D. Tex. May 3, 2007).

54 Texas law, in this respect, produces a more favorable outcome for the taxpayer than was possible under California community property law which does not recognize this category of community property. However, as the National Taxpayer Advocate noted in the 2005 Annual Report to Congress at 420, creditors in Texas other than the IRS cannot generally reach the sole management community property of the nonliable spouse at all; in this respect the IRS is in a more favorable position than other creditors in Texas.

share of the tax liability. The taxpayer argued that her tax should be calculated as if she had filed a separate return and that if, for example, her earnings accounted for 20 percent of the community total, she should be responsible for 20 percent of the tax. The IRS, relying on Revenue Ruling 2004-74 argued, and the court agreed, that in Texas, as in California, a spouse is liable for the tax on 50 percent of community income even if she files a separate return.[55] Therefore, the innocent spouse was responsible for that amount and the amount of her refund was reduced accordingly. The court agreed with the IRS's method of calculating the innocent spouse's tax.

The National Taxpayer Advocate, in the 2005 Annual Report to Congress, identified the inequities that arise from the interaction of community property law and federal tax law. In her legislative recommendation, *Another Marriage Penalty - Taxing the Wrong Spouse*,[56] the National Taxpayer Advocate recommended that the IRS be prohibited from levying on a nonliable spouse's wage, pension, disability and similar payments, that the IRS be subject to the same collection exemptions that apply to other creditors under state law, and that the IRS exhaust reasonable collection efforts under the liable spouse's control before collecting against the nonliable spouse's assets. In the absence of remedial measures, the cases of *Ordlock*, *Karp*, and *Gray* demonstrate some of the inequities that result when community property law is applied to federal tax collection.

Reiief on the Merits

While the courts considered many factors in determining the appropriateness of relief on the merits under IRC § 6015, the most significant factor was whether the requesting taxpayer had actual or constructive knowledge of the tax deficiency. All three avenues for relief contain a knowledge element or factor, making it the linchpin in most of the courts' analyses.[57] Actual or constructive knowledge was a factor in 32 of the 33 decisions on the merits. These cases suggest that determining what a taxpayer knew or should have known will continue to generate a significant amount of controversy as long as joint filers are taxed on their combined incomes and remain jointly and severally liable for the tax required to be shown on the return. The National Taxpayer Advocate has proposed legislation that would eliminate joint and several liability for joint filers in the first instance and would tax each spouse only on his or her own income.[58] Adoption of such a proposal would eliminate the need for innocent spouse relief and the attendant inquiry into a spouse's knowledge.

55 Rev. Rul. 2004-74, 2004-2 C.B. 84.

56 National Taxpayer Advocate 2005 Annual Report to Congress 407, 428-29.

57 *See* IRC § 6015(b)(1)(C); § 6015(c)(3)(C); Rev. Proc. 2003-61, 2003-2 C.B. 296 §§ 4.02(1)(b) and 4.03(2)(a)(iii).

58 National Taxpayer Advocate 2005 Annual Report to Congress 407.

CONCLUSION

This year the courts addressed several important procedural issues concerning IRC § 6015(f). First, the Tax Court held that the Treasury regulation which imposed a two-year time period within which a requesting spouse must elect relief under IRC § 6015(f) was invalid.[59] The issue is now being considered in an appeal by the government to the United States Court of Appeals for the Seventh Circuit. Second, the Tax Court and the United States Court of Appeals for the Eleventh Circuit held that in reviewing denials of relief under IRC § 6015, the Tax Court is not limited to considering matter already in the administrative record.[60] Third, the Tax Court held, based in part on the passage of TRHCA, that it will no longer apply the "abuse of discretion" standard in reviewing denials of relief under IRC § 6015, but will review such denials *de novo*.[61] The IRS has indicated that it does not agree with either of these holdings and will continue to raise the scope and standard of review arguments whenever appropriate.[62] Fourth, several courts reiterated that taxpayers who are entitled to relief from joint liability under IRC § 6015 may not obtain refunds of amount paid toward the joint liability to the extent the payment was made with community property.[63] Last, the Tax Court noted that the issue of whether IRC § 6015 can be raised as a defense in a collection suit remains unresolved.[64]

59 *Lantz v. Comm'r,* 132 T.C. No. 8 (2009), 2009 WL 928241 (U.S. Tax Ct. Apr. 7, 2009), *appeal docketed* No. 09-3345 (7th Cir. Sept. 17, 2009).

60 *Neal v. Comm'r,* 557 F.3d 1262 (11th Cir. 2009), *aff'g* T.C. Memo. 2005-201.

61 *Porter II,* 132 T.C. No 11 (2009), 2009 WL 1098488 (U.S. Tax Ct. Apr. 23, 2009).

62 Notice CC-2009-021 (June 30, 2009).

63 *Ordlock v. Comm'r*; 533 F.3d 1136 (9th Cir. 2008), *aff'g* 126 T.C. 47 (2006); *Karp v. Comm'r*, T.C. Memo. 2009-40; *Gray v. Comm'r*, 553 F.3d 410 (5th Cir. 2008), *aff'g* No. H-05-3530, 2007 WL 1300464 (S.D. Tex. May 3, 2007).

64 *Pollock v. Comm'r*, 132 T.C. No. 3 (2009), 2009 WL 349743 (U.S. Tax Ct. Feb. 12, 2009). *See* Legislative Recommendation, *Allow Taxpayers to Raise Relief Under Internal Revenue Code Sections 6015 and 66 as a Defense in Collection Actions, infra.*