Most Litigated Issues: Introduction

Internal Revenue Code (IRC or the 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 type of taxpayer affected. Through analysis of these issues, the National Taxpayer Advocate will, if appropriate, propose legislative recommendations to mitigate disputes that result in litigation.

TAS used commercial legal research databases to identify the ten most litigated issues in federal courts from June 1, 2007, through May 31, 2008.[1] 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:

- Gross income (IRC § 61 and related Code sections);
- 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);
- Accuracy-related penalty (IRC § 6662(b)(1) and (2));
- Civil damages for certain unauthorized collection actions (IRC § 7433);
- Failure to file penalty (IRC § 6651(a)(1)) and estimated tax penalty (IRC § 6654);
- Relief from joint and several liability for spouses (IRC § 6015);
- Frivolous issues penalty (IRC § 6673 and related appellate-level sanctions); and
- Family status issues (IRC §§ 2, 24, 32, and 151).

The ten Most Litigated Issues are the same ones identified in 2007,[3] but the order of the issues has shuffled slightly from the 2007 list. Gross income rose from second to first place due to a dramatic increase in the number of cases involving the issue of whether income earned in Antarctica should be excluded from gross income under IRC § 911.[4] The summons enforcement and trade or business expense issues also saw notable increases in litigation, with the latter rising from seventh to fourth place.[5]

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 2007 Annual Report to Congress 558-61.

4 Gross income cases increased from 112 in 2007 to 205 in 2008. *See* National Taxpayer Advocate 2007 Annual Report to Congress 558-61.

5 The summons enforcement issue had 109 cases in 2007 and 146 cases in 2008. Trade or business expenses had 77 cases in 2007 and 116 in 2008. *See* National Taxpayer Advocate 2007 Annual Report to Congress 558-61.

Once we identified the ten most litigated issues, TAS analyzed each issue in four sections: a summary of findings, description of present law, analysis of the litigated cases, and conclusion. Each case is listed in Appendix III, where we categorize the cases by type of taxpayer (*i.e.*, individual or business).[6] Appendix III also provides the citation for each case, indicates whether the taxpayer was represented at trial or argued the case *pro se* (without counsel), and lists the court's decision in each case.[7]

Beginning with the 2007 Annual Report to Congress, our office expanded the "Most Litigated Issues" section of this report by adding a new "Significant Cases" discussion before the comprehensive analysis of the ten issues. This discussion summarizes important judicial decisions that are not included in the top ten issues but were deemed significantly relevant to tax administration.

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 to appeal decisions of the trial court.[8]

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 (CDP), and relief from joint and several liability.[9]

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

6 Individuals filing Schedules C, E, or F were 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 *See* IRC § 7482, which provides that, in general, the United States Courts of Appeals (other than the United States Court of Appeals for the Federal Circuit) have exclusive 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(a)(3) (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).

9 IRC §§ 6214; 7476-7479; 6320; 6330; 6015.

10 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).

11 IRC § 7422(a).

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

Analysis of *Pro Se* Litigation

As in previous years, our analysis indicates that many taxpayers appeared before the courts *pro se*.[13] Table 3.1-01 lists the most litigated issues for the period June 1, 2007, through May 31, 2008, and identifies the number of cases, broken down by issue, in which taxpayers appeared *pro se*. As illustrated in the table below, the category of cases with the highest rate of *pro se* taxpayers are those involving family status issues, the frivolous issues penalty, and civil damages for certain unauthorized collection actions.

TABLE 3.1-01, *Pro Se* Cases by Issue

Most Litigated Issue	Total Number of Litigated Cases Reviewed	*Pro Se* Litigation	Percentage of *Pro Se* Cases
Gross Income	205	68	33%
Collection Due Process	179	104	58%
Summons Enforcement	146	108	74%
Trade or Business Expense	116	78	67%
Accuracy-Related Penalty	87	47	54%
Civil Damages for Certain Unauthorized Collection	78	60	77%
Failure to File and Estimated Tax Penalties	66	47	71%
Joint and Several Liability	50	27	54%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	49	45	92%
Family Status Issues	34	33	97%
Total	**1,010**	**617**	**61%**

Table 3.1-02 demonstrates our belief that overall, taxpayers have a higher chance of prevailing in litigation if they are represented. However, *pro se* taxpayers actually experienced a higher rate of success than represented taxpayers in litigation over gross income and civil damages for certain unauthorized collection actions. 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.

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

TABLE 3.1-02, 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**
Gross Income	68	8	12%	137	10	7%
Collection Due Process	104	8	8%	75	10	13%
Summons Enforcement	108	1	1%	38	8	21%
Trade or Business Expense	78	21	27%	38	10	26%
Accuracy-Related Penalty	47	8	17%	40	17	43%
Civil Damages for Certain Unauthorized Collection	60	8	13%	18	1	6%
Failure to File and Estimated Tax Penalties	47	5	11%	19	3	16%
Joint and Several Liability	27	5	19%	23	7	30%
Frivolous Issues Penalty (and analogous appellate-level sanctions)	45	8	18%	4	1	25%
Family Status Issues	33	2	6%	1	0	0%
Totals	**617**	**74**	**12%**	**393**	**67**	**17%**

Significant Cases

The purpose of this section is to summarize 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 *Knight v. Commissioner*, the Supreme Court held that a trust's or estate's miscellaneous itemized deductions are subject to the "two percent floor," unless it would be unusual or uncommon for those costs to be incurred by an individual holding the same assets as the trust or estate.[2]

Knight, the trustee of a trust holding marketable securities, paid $22,241 in investment advisory fees for the trust for the year. The Internal Revenue Code (IRC or Code) provides that individuals, trusts, and estates may take itemized deductions to the extent that they exceed two percent of adjusted gross income.[3] This two percent threshold is commonly referred to as the "two percent floor." The Code further provides that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate" are not subject to the two percent floor.[4] On the trust's return, Knight reported total income of $624,816 and deducted the fees in full.

On audit, the IRS disallowed the deduction for the portion of the fees that did not exceed two percent of the trust's adjusted gross income, and assessed a $4,448 deficiency. Knight petitioned the U.S. Tax Court on behalf of the trust, observing that his fiduciary duty under state law required him to obtain investment advisory services for the trust, and therefore to pay an investment advisory fee. Accordingly, he argued, the fees resulted from the fact that the taxpayer was a trust, and should be fully deductible. The Tax Court disagreed, finding that investment advisory fees are commonly incurred by individuals, and consequently, the fees were subject to the two percent floor.[5] The Second Circuit affirmed the Tax Court on the basis that an individual "could" incur investment advisory fees.[6]

The Second Circuit ruling exacerbated a conflict among the circuits. The Sixth Circuit had held that investment advisory fees paid by a trust were fully deductible, reasoning

1 When identifying the ten most litigated issues, TAS analyzed federal decisions issued during the period beginning on June 1, 2007, and ending on May 31, 2008. 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, 2008, because the issues involved in those cases are particularly important. We are also discussing one case that is included in one of the ten most litigated issues because the decision was rendered by the United States Supreme Court.

2 *Knight v. Comm'r*, 128 S. Ct. 782 (2008). In response to *Knight,* the IRS provided interim guidance regarding the deductibility of costs "bundled" as part of one commission or fee for taxable years beginning before January 1, 2008. *See* Notice 2008-32, 2008-11 I.R.B. 593.

3 IRC § 67(a) (individuals) and (e) (trusts and estates).

4 IRC § 67(e)(1).

5 *Rudkin Testamentary Trust v. Comm'r,* 124 T.C. 304 (2005), *aff'd,* 467 F.3d 149 (2d Cir. 2006), *aff'd sub nom*., 128 S. Ct. 782 (2008).

6 *William L. Rudkin Testamentary Trust v. Comm'r*, 467 F.3d 149, 155-56 (2d Cir. 2006), *aff'd sub nom*., 128 S. Ct. 782 (2008).

that because a trustee has a fiduciary duty to manage trust assets as a "prudent investor," investment-advisory fees are "necessary to" the trust's administration and "caused by" the fiduciary duty of the trustee.[7] In contrast, the Fourth and Federal Circuits previously held that such fees were subject to the two percent floor because they were "commonly" or "customarily" incurred by individuals.[8]

The Supreme Court ultimately affirmed the Second Circuit's decision, but rejected its test. The Supreme Court reasoned that the text of the Code required an inquiry into what expenses an individual holding the trust's or estate's assets "would" be likely to have incurred, *i.e.*, whether it would be "unusual" or "uncommon" for an individual to incur such fees.[9] Because it would not be unusual or uncommon for an individual holding the same assets as the trust to incur investment advisory fees, they were subject to the two percent floor.

In *Swallows Holding, Ltd. v. Commissioner*, the Third Circuit Court of Appeals held that where a statute required a taxpayer to file "in the manner prescribed" to obtain certain deductions, the term "manner" was sufficiently ambiguous that the IRS's regulation, which required the taxpayer to file within 18 months of the due date to obtain the deductions, was reasonable.[10]

Swallows Holding, Ltd. (Swallows Holding), a Barbados corporation, earned rental income from real property located in the U.S. In 1999, it filed tax returns in the U.S. for tax years 1993-1996, electing to claim deductions for taxes and other costs associated with a trade or business of leasing the real property.[11] The IRS denied these deductions on the basis that Swallows Holding's returns were more than 18 months late; and pursuant to Treas. Reg. § 1.882-4(a)(3)(i), a foreign corporation must file its return within 18 months of the due date for such expenses to be deductible.

Swallows Holding petitioned the Tax Court, arguing the regulation was an invalid exercise of the Secretary's rule-making authority.[12] In ruling in favor of Swallows Holding, the Tax Court focused on the language of IRC § 882(c)(2), which requires that foreign corporations file "in the manner prescribed by subtitle F."[13] The Tax Court found the plain meaning of "manner" did not include an element of time, and consequently, relying on the factors

7 *O'Neill v. Comm'r,* 994 F.2d 302, 304 (6th Cir. 1993), *nonacq.*, 1994-2 C.B. 1, *abrogated by, Knight v. Comm'r*, 128 S. Ct. 782 (2008).

8 *See Scott v. United States*, 328 F.3d 132, 140 (4th Cir. 2003); *Mellon Bank, N.A. v. United States*, 265 F.3d 1275, 1281 (Fed. Cir. 2001).

9 *Knight v. Comm'r*, 128 S. Ct. 782 (2008).

10 *Swallows Holding, Ltd. v. Comm'r*, 515 F.3d 162 (3d Cir. 2008).

11 Foreign corporations not engaged in a trade or business in the U.S. are subject to tax at a flat rate under IRC § 881(a)(1) of 30 percent of any amount received from sources within the U.S. Swallows Holding elected under IRC § 882(a)(1) to treat the income as "effectively connected" with a U.S. trade or business in order to claim certain tax deductions (*e.g.*, interest and taxes) that are otherwise unavailable to a foreign corporation that is not engaged in a trade or business in the U.S. *See Swallows Holding, Ltd. v. Comm'r,* 126 T.C. 96, 106-07 (2006), *vacated by* 515 F.3d 162 (3d Cir. 2008).

12 *Swallows Holding, Ltd. v. Comm'r,* 126 T.C. 96 (2006).

13 *Swallows Holding, Ltd. v. Comm'r,* 126 T.C. 96, 107 (2006).

in *National Muffler,*[14] held that the interpretive regulation promulgating the timely filing requirement (Treas. Reg. § 1.882-4(a)(3)(i)) was invalid.[15]

The Third Circuit upheld the regulation after applying the test set forth in *Chevron,* in large part, because the regulations had been subject to public comment, and vacated the Tax Court decision.[16] Pursuant to the *Chevron* test, agency regulations are entitled to deference unless they contradict an unambiguous statute or set forth an unreasonable construction of it. The court reasoned that the statutory term "manner" was ambiguous and the regulatory clarification, that it included a timely filing component, was reasonable. Therefore, at least in the Third Circuit, taxpayers may find it more difficult to successfully challenge Treasury Regulations promulgated after public comment.

In *Ballard v. Commissioner*, the Eleventh Circuit Court of Appeals ordered the Tax Court to adopt the special trial judge's report as the Tax Court opinion because the judge's findings were not manifestly unreasonable.[17]

The IRS alleged that the Ballards (husband and wife) and others engaged in a kickback scheme that generated unreported income, finding them liable for deficiencies and fraud penalties for tax years 1975-1982, 1984, and 1987. In 1994, after a five-week Tax Court trial, a special trial judge found the evidence insufficient to show the Ballards were responsible for a deficiency and had committed fraud. Pursuant to Tax Court procedure, the special trial judge submitted his written findings and opinions to a regular Tax Court Judge for review. On December 15, 1999, a Tax Court judge issued the opinion of the Tax Court, purporting to adopt the opinion of the special trial judge, but ruling in favor of the IRS.[18] After the Tax Court issued the opinion but before it entered the final order, the Ballards filed several motions requesting access to the special trial judge's initial findings. After the Tax Court denied these motions, the Ballards petitioned the Eleventh Circuit for a writ of mandamus, also seeking the report.

The Supreme Court ultimately heard the Ballards' case.[19] It disapproved of the Tax Court's practice of allowing the Tax Court judge to edit the special trial judge's report before it is

14 *National Muffler Dealers Association, Inc. v. United States,* 440 U.S. 472 (1979) (analyzing whether an interpretive regulation is valid based on whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose; relevant considerations are whether the regulation is a substantially contemporaneous construction of the statute, the length of time the regulation has been in effect, reliance placed upon it, consistency of administrative interpretation, and the degree of scrutiny Congress has devoted to regulation during subsequent reenactments of the statute).

15 *Swallows Holding, Ltd. v. Comm'r*, 126 T.C. 96, 130, 136-39 (2006). The court cited cases decided before the regulations were issued that held that the statutory term "manner," as used in a predecessor of IRC § 882, did not include a timely filing requirement.

16 *Swallows Holding, Ltd. v. Comm'r*, 515 F.3d 162, 168-72 (3d Cir. 2008) (citing *Chevron v. United States*, 467 U.S. 837 (1984)). According to the court, it applied the *Chevron* standard, in large part, because the regulations had been subject to "public comment, a move that is indicative of agency action that carries the force of law." *Id.*

17 *Ballard v. Commissioner,* 522 F.3d 1229 (11th Cir. 2008).

18 *Investment Research Associates, Ltd. v. Comm'r,* T.C. Memo. 1999-407, *aff'd sub nom., Ballard v. Comm'r,* 321 F.3d 1037 (11th Cir. 2003), *rev'd and remanded,* 544 U.S. 40 (2005).

19 *Ballard v. Comm'r*, 544 U.S. 40 (2005).

issued, vacated the earlier judgment, and remanded the case to the Eleventh Circuit.[20] The Court of Appeals for the Eleventh Circuit then remanded the case back to the Tax Court.[21] The Eleventh Circuit instructed the Tax Court to: (1) assign a new regular Tax Court Judge with no prior involvement to review the case, and (2) adopt the special trial judge's findings of fact unless "manifestly unreasonable."[22] The regular Tax Court Judge again rejected the special trial judge's findings and ruled against the Ballards.[23]

The Eleventh Circuit held that although it was a "close call," the regular Tax Court judge had conducted a nearly *de novo* review of the facts, which violated its instructions because the special trial judge's findings were not manifestly unreasonable.[24] Thus, the Eleventh Circuit ordered the Tax Court to adopt the special trial judge's original report as the opinion of the Tax Court.

In *Regents of the University of Minnesota v. United States*, the United States District Court for the District of Minnesota held that a hospital's medical residents' stipends were exempt from Federal Insurance Contributions Act (FICA) taxes because the residents were employed by the university (rather than the hospital where they performed services) and otherwise qualified for the student exemption to FICA.[25]

FICA taxes must generally be paid on all wages.[26] However, payments for services performed by certain students in the employ of a "school, college, or university" are not subject to FICA taxes.[27] In a similar case decided in 2003, the District Court for the District of Minnesota rejected the IRS's argument that the Mayo Clinic was not a "school, college, or university" within the meaning of the FICA statute because education was not its "primary purpose" and awarded a refund of FICA taxes withheld and paid on Mayo's medical residents' stipends.[28] In 2004, the IRS amended the FICA regulations, in part to make clear that an institution would not be considered a "school, college, or university" unless education was its "primary purpose."[29] In another related case brought by the Mayo Clinic, the District Court held the IRS's regulations to be invalid on the basis that the plain meaning of "school, college, or university," as set forth in the statute, was not ambiguous.[30]

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20 The Supreme Court observed: "The Tax Court's practice of not disclosing the special trial judge's original report, and of obscuring the Tax Court judge's mode of reviewing that report, impedes fully informed appellate review of the Tax Court's decision." *Id*. at 59-60.

21 *Ballard v. Comm'r*, 429 F.3d 1026 (11th Cir. 2005).

22 *Estate of Kanter v. Comm'r*, T.C. Memo. 2007-21 (the Ballards' case was consolidated with other participants in the kickback scheme).

23 *Id.*

24 *Ballard v. Commissioner*, 522 F.3d 1229 (11th Cir. 2008).

25 *Regents of the University of Minnesota v. United States*, 101 A.F.T.R.2d (RIA) 2008-1532 (D. Minn. 2008), *appeal docketed*, No. 08-2193 (8th Cir. May 28, 2008). There are a number of similar cases. *See, e.g., Ctr. for Family Med. v. United States*, 102 A.F.T.R.2d (RIA) 5623 (D. S.D.S.D. 2008).

26 *See* IRC § 3101 *et. seq.*

27 IRC § 3121(b)(10).

28 *United States v. Mayo Found. for Med. Educ. and Research*, 282 F. Supp. 2d 997 (D. Minn. 2003).

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

30 *Mayo Found. for Med. Educ. and Research v. United States*, 503 F. Supp. 2d 1164 (D. Minn. 2007), *appeal docketed*, No. 07-3242 (8th Cir. Sept. 28, 2007).

In this case, the IRS argued the residents were ineligible for the FICA exemption because they were employees of the hospital where they rendered services, rather than the university, and because they were not "enrolled and regularly attending classes"[31] or performing services "for the purpose of pursuing a course of study,"[32] as required to qualify for the exemption. The District Court rejected these arguments, finding the residents were common law employees of the university, were enrolled and regularly attending classes, and were performing services at the hospital for the purpose of pursuing a course of study. Thus, the court held they were eligible for the exemption and the IRS's regulations were invalid.

In *United States v. Clintwood Elkhorn Mining Co.*, the Supreme Court held that a taxpayer must file a timely administrative claim for refund or credit within the period provided by the Code, rather than the longer period provided in the Tucker Act, even if the taxpayer is seeking a refund of a tax that was determined to be unconstitutional.[33]

The taxpayer, a coal company, paid export taxes that were later determined to be unconstitutional under the Export Clause.[34] The issue was whether the taxpayer's claims for refund were timely. The Code provides: "No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax ... until a claim for refund or credit has been duly filed with the [IRS]."[35] The Code further provides that such administrative claims must be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever is later.[36] In contrast, the Tucker Act – which authorizes various claims against the government – provides a longer six-year period of limitations for filing a claim.[37]

The coal company did not file administrative claims within the period provided by the Code for its 1994-1996 taxes. Instead, it filed suit in the Court of Federal Claims, seeking refunds of those taxes, arguing its claim was timely because the longer period provided by the Tucker Act applied to refunds for taxes determined to be unconstitutional.

The Court of Federal Claims agreed with the taxpayer that the longer six-year period applied, and the Court of Appeals for the Federal Circuit affirmed the decision.[38] The

31 IRC § 3121(b)(10).

32 Treas. Reg. § 31.3121(b)(10)-2(c) (pre-Apr. 1, 2005).

33 *United States v. Clintwood Elkhorn Mining Co.*, 128 S. Ct. 1511 (2008).

34 The Export Clause provides that "No Tax or Duty shall be laid on Articles exported from any State." *See* U.S. Const. art. I, § 9, cl. 5. The export taxes were declared unconstitutional in *Ranger Fuel Corp. v. United States*, 33 F. Supp. 2d 466 (E.D. Va.1998).

35 IRC § 7422(a).

36 IRC § 6511(a).

37 28 U.S.C. § 2501 (stating that "[E]very claim of which the United States Court of Federal Claims has jurisdiction shall be barred unless the petition thereon is filed within six years after such claim first accrues.").

38 *Andalex Res., Inc. v. United States*, 54 Fed. Cl. 563 (2002), *aff'd sub nom., Clintwood Elkhorn Mining Co. v. United States*, 473 F.3d 1373 (Fed. Cir. 2007), rev'd, 128 S. Ct. 1511 (2008).

Supreme Court reversed, however, reasoning that the unambiguous plain language of the Code (IRC § 7422(a)) requires claims to be filed within the shorter period.

In *Pennoni v. United States*, the Court of Federal Claims held that a suit challenging the IRS's use of levy and garnishment to recoup an erroneous refund is an "illegal exaction" claim, rather than a refund claim under the Code, and is therefore subject to the longer statute of limitations provided by the Tucker Act.[39]

As the result of a stipulated decision, the IRS owed Lawrence Pennoni a refund of approximately $2,800 for the 1998 tax year, but sent him a check for approximately $80,000. After discovering its mistake, the IRS did not follow standard procedures for recovering erroneous payments: It did not file suit to recover the payment,[40] or timely reassess and collect the liability for the relevant tax year.[41] Instead, beginning on August 4, 2003, the IRS simply garnished Pennoni's wages and levied his bank account.

On December 15, 2006, Pennoni filed suit seeking to recover the wrongfully garnished and levied funds. The government filed a motion to dismiss, characterizing Pennoni's action as a refund suit under IRC § 7422, and arguing Pennoni had failed to file an administrative refund claim as required by IRC § 7422(a), and had also failed to bring his suit within the two-year limitations period applicable to refund suits.[42]

Pennoni maintained his action was not a tax refund suit subject to the Code's provisions, but was instead a claim for the return of an "illegal exaction." As such, he was not required to file an administrative refund claim and his suit was timely under the Tucker Act's six-year statute of limitations.[43]

The Court of Federal Claims agreed with Pennoni and denied the government's motion. It concluded the Code's refund suit provisions apply only to actions for the recovery of overpayments of tax and erroneous refunds recovered by the IRS via levy or garnishment do not constitute overpayments of tax.

In *Commissioner v. Dunkin*, the Ninth Circuit held that a retirement-eligible employee who continued to work must pay federal income tax on wages he

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39 *Pennoni v. United States*, 79 Fed. Cl. 552 (2007).

40 *See* IRC § § 7405 (providing for recovery of erroneous refunds by instituting a civil action) and 6532(b) (providing a period of limitation on suits by the government for the recovery of erroneous refunds).

41 *See* IRC § § 6501(a) (providing a period of limitation on assessment and collection) and 6502(a)(1) (providing a period limitation on collection).

42 *See* IRC § 6532(a) (providing a period of limitation on refund suits).

43 *See* 28 U.S.C. § 2501. Interestingly, according to the court, an "illegal extraction" includes money that was improperly paid in contravention of the Constitution. Thus, it appears that the period of limitations provided by the Tucker Act applies to some "illegal extraction" claims but not others. *See United States v. Clintwood Elkhorn Mining Co.*, 128 S. Ct. 1511 (2008) (holding that the shorter period of limitations provided by the Code (rather than the longer period provide by the Tucker Act) applied to a suit to recover a tax later declared unconstitutional).

used to reimburse his former spouse for her community property law interest in his pension benefits.[44]

When John Dunkin and his wife divorced in 1997, he was eligible to receive full pension benefits from the Los Angeles Police Department. Rather than retire, however, Dunkin chose to continue working.

Under California community property law, Dunkin's spouse was entitled to one-half of the retirement benefits Dunkin earned during the marriage. Although the state court did not award alimony to his former spouse, because Dunkin decided to delay retirement it ordered him to make so-called "Gillmore" payments to his former spouse in an amount equal to the benefits she would have received had he retired on the date of the divorce.[45]

In 2000, Dunkin used $25,511 of his wages to make the court-ordered Gillmore payments and deducted the payments as alimony on his return for that year. The IRS denied the deduction. The Tax Court determined Dunkin was entitled to exclude the $25,511 from his gross income.[46]

A majority of the Ninth Circuit panel disagreed with the Tax Court, concluding that Dunkin had to include the $25,511 in gross wages and was not entitled to an alimony deduction. The court reasoned that post-divorce wages, unlike actual distributions of pension benefits, are not community property under California law. Moreover, because Dunkin was required to make the court-ordered payments as long as he continued working, even if his ex-spouse remarried or died, the payments did not qualify as deductible alimony.[47]

In *Menard, Inc. v. Commissioner*, the Tax Court held that it had jurisdiction to consider an equitable recoupment defense and offset time-barred overpayments against deficiencies arising out of the same transaction, even though the Tax Court would not otherwise have jurisdiction over the type of tax overpayment at issue.[48]

In an earlier opinion, the Tax Court concluded that a portion of the amount that Menard, Inc. (Menard) paid to its president and chief executive officer and deducted as a compensation expense on its 1998 return was unreasonable and recharacterized it as a deemed

44 *Comm'r v. Dunkin,* 500 F.3d 1065 (9th Cir. 2007), *rev'g* 124 T.C. 180 (2005).

45 *See In re Marriage of Gillmore*, 29 Cal. 3d 418, 629 P.2d 1 (Cal. 1981).

46 *Comm'r v. Dunkin*, 124 T.C. 180 (2005), *rev'd*, 500 F.3d 1065 (9th Cir. 2007).

47 *See* IRC §§ 71; 215. If such payments are not deductible by the ex-husband and are income to the ex-wife, they may be taxed twice – once to the ex-husband when he earns them and again to the ex-wife when she receives them. In a strongly worded dissent, Judge Stephen Reinhardt commented that requiring Dunkin to pay income taxes on the part of his salary that he paid to his former wife as her community property interest in his pension benefits "defies reason, not to mention fairness." He also expressed policy concerns that the majority's holding may encourage divorced employees to retire "[a]t a time when the federal government is encouraging postponing retirement due to a looming Social Security shortfall, and police forces nationwide are facing officer shortages as officers retire at a younger and younger age and take (or divide) their pension benefits and go off to obtain higher paying jobs in private industry." *Comm'r v. Dunkin*, 500 F.3d 1065, 1072-74 (9th Cir. 2007).

48 *Menard, Inc. v. Comm'r,* 130 T.C. 54 (2008).

dividend.[49] The IRS's deficiency computation eliminated the compensation deduction, but did not give Menard credit for the hospital insurance tax it paid in connection with the putative compensation.[50]

The period for making an overpayment claim for 1998 had expired.[51] In addition, the Tax Court normally does not have deficiency jurisdiction over hospital insurance taxes.[52] However, IRC § 6214(b) expands the Tax Court's jurisdiction by allowing it to apply the doctrine of "equitable recoupment" to offset a deficiency against an overpayment arising out of the same transactions that would otherwise be time-barred.[53] The IRS argued the Tax Court's equitable recoupment jurisdiction did not extend to taxes that do not normally fall within the court's deficiency or overpayment jurisdiction.

The Tax Court disagreed with the IRS, holding that it had equitable recoupment jurisdiction to offset the hospital tax overpayment against the deficiency. The Tax Court reasoned that if Congress had intended to so limit its jurisdiction, it would have done so explicitly, and such a limit would be at odds with the purpose of the provision: to prevent an inequitable windfall due to inconsistent tax treatment of a single transaction under two different code provisions. Because Menard had previously deducted its hospital insurance payments, the Tax Court ruled it had to eliminate that deduction, compute its tax liability as if it paid a dividend to its president rather than compensation, and then offset the resulting deficiency by the amount of the hospital tax that it previously paid.

In *Jade Trading, LLC v. United States*, the Court of Federal Claims held that although it had jurisdiction to impose the negligence penalty in a partnership level proceeding, it did not have jurisdiction to consider the reasonable cause defenses of the partners.[54]

The Ervin brothers invested in a "Son of Boss" tax shelter[55] designed to generate an inflated outside basis in their interests in Jade Trading LLC (Jade). The Ervins then used this inflated basis in Jade to generate tax losses. The IRS issued a Final Partnership Administrative Adjustment (FPAA) asserting that the entire series of transactions should be disregarded

49 *Menard, Inc. v. Comm'r*, T.C. Memo. 2004-207.

50 *See* IRC §§ 3111(b); 3501.

51 Any claim for credit or refund must normally be made within three years from the time the return was filed or two years from the time the tax was paid, whichever is later. IRC § 6511(a).

52 *See* IRC § § 6213(a) (providing for deficiency jurisdiction); 6211(a) (limiting the Tax Court's deficiency jurisdiction to enumerated sections); 6512(b)(1) (providing for overpayment jurisdiction for years in which the Commissioner has issued a notice of deficiency and for specifically enumerated Code sections).

53 As a general rule, according to the Tax Court, a party claiming an equitable recoupment defense must show: (1) the overpayment or deficiency for which recoupment is sought by way of offset is barred by an expired period of limitation; (2) the time-barred overpayment or deficiency arose out of the same transaction, item, or taxable event as the overpayment or deficiency before the court; (3) the transaction item or taxable event has been inconsistently subject to two taxes; and (4) if the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one. *Menard, Inc. v. Comm'r,* 130 T.C. 54, 62-63 (2008) (citations omitted).

54 *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007). The same court later denied a motion for reconsideration. *Jade Trading, LLC v. United States*, 81 Fed. Cl. 173 (2008).

55 For a description of this shelter, *see* Notice 2000-44, 2000-2 C.B. 255.

for federal income tax purposes as lacking economic substance. It also asserted various penalties in the alternative, including the negligence and substantial understatement penalties.

Jade and the Ervin brothers brought a tax refund suit challenging the FPAA. The Court of Federal Claims agreed with the IRS, holding that the transaction lacked economic substance. It also affirmed the IRS's assertion of various penalties, including the negligence penalty. The court based its conclusion that the negligence penalty applied on the conduct of Jade, its managing member, and its tax matters partner, rather than on the conduct of any particular partner whose return reflected an understatement.

The court went on to hold that it had no jurisdiction to consider any reasonable cause exceptions to these penalties in a partnership-level proceeding under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) because such defenses would be unique to each partner. As a result, the only way for a partner to avoid these penalties based on a reasonable cause defense would be to pay the penalty and file an individual refund action.[56]

In a subsequent motion for reconsideration and clarification of the decision, Jade's tax matters partner argued the court erred in applying the negligence penalty at the partnership level because the partnership return was not inaccurate and did not report an understatement, and that the court improperly considered its behavior (rather than the taxpayers whose returns contained understatements) in applying the penalty.[57] The tax matters partner also argued that Treas. Reg. § 1.6221-1T (1999), which purported to limit the court's jurisdiction to consider a partner level defense, was invalid.[58] The court denied these motions.

In *Philadelphia Marine Trade Association-International Longshoremen's Association Pension Fund v. Commissioner*, the Third Circuit Court of Appeals held that even if a taxpayer did not use registered mail or other methods provided by IRC § 7502 to establish a presumption of timely filing, he or she may do so by establishing that he or she mailed a document early enough to allow for physical delivery by the due date, pursuant to the common law "mailbox rule."[59]

After the Philadelphia Marine Trade Association-International Longshoremen's Association Pension Fund (Fund) failed to make timely tax payments, the IRS assessed penalties and on June 25, 2001, levied on its funds to collect the penalties. According to the Fund, when it discovered the levy, it called the IRS and sent two letters requesting a refund, one on May

56 *See* IRC § 6230(c)(4).

57 *Jade Trading, LLC v. United States*, 81 Fed. Cl. 173 (2008).

58 *Id.* Practitioners representing clients who will be affected by the *Jade Trading* decision have expressed similar arguments and an interesting critique of the decision. *See* Thomas A. Cullinan and Julie P. Bowling, *This One Left Us Jaded*, 118 Tax Notes 422 (Jan. 21, 2008).

59 *Philadelphia Marine Trade Association-International Longshoremen's Ass'n Pension Fund v. Comm'r*, 523 F.3d 140 (3d Cir. 2008).

8, 2003, and one on June 13, 2003, but could not produce direct proof of mailing such as a registered mail receipt. The IRS did not keep the letters if it received them. However, various circumstantial evidence supported the Fund's contention that it mailed the letters to the IRS on the dates it claimed.

To be timely, the request for refund had to be filed by June 25, 2003.[60] The Fund argued that because it could establish based on circumstantial evidence that the letters were placed in the mail in time to be delivered before this deadline, the court should presume they were timely delivered pursuant to the common law "mailbox rule." Citing cases from the Second and Sixth Circuits,[61] the IRS argued that proof of registration received in connection with registered mail (and similar delivery confirmation services) provided by the statutory mailbox rule of IRC § 7502 is the exclusive type of evidence that can be used to establish a presumption that a document was delivered on or before a given date.[62] Because the Fund did not have such proof, the IRS reasoned, the claim could not be presumed to be timely pursuant to any mailbox rule.

The District Court agreed with the IRS,[63] but the Third Circuit Court of Appeals did not.[64] The Third Circuit held that the statutory mailbox rule supplemented (rather than supplanted) the common law mailbox rule, at least in cases where the taxpayer placed a document in the mail in time for the IRS to physically receive it before the due date. It reasoned that unlike the statutory rule, which requires the IRS to treat the postmark date as the filing date, expressly excusing delivery after the deadline, the common law mailbox rule is simply a presumption that items placed in the mail are delivered within ordinary timeframes, which helps taxpayers show that a document was actually physically delivered on or before the due date. As a result, it is not inconsistent for the two rules to coexist, especially because there is no legislative history suggesting that Congress intended to eliminate the common law mailbox rule when it enacted the statutory rule.

In *Fisher v. United States,* the Court of Federal Claims held the "open transaction doctrine" applied to allow a policyholder of a mutual life insurance company to recover tax basis in the policy when it received cash upon the company's demutualization, which constituted severance of the policyholders' rights to payment on death from their ownership rights in the insurance company.[65]

Prior to March of 2000, Sun Life Assurance Company (Sun Life), was a mutual life insurance company owned by its policyholders. A mutual insurance company's policy confers

60 IRC § 6511(a) (requiring taxpayers to file refund requests within three years from the time the return was filed or two years from the time the tax was paid, whichever is later).

61 *See, e.g., Deutsch v. Comm'r,* 599 F.2d 44 (2d Cir. 1979); *Miller v. United States,* 784 F.2d 728 (6th Cir. 1986).

62 IRC § 7502(a) and (c).

63 *Philadelphia Marine Trade Association-International Longshoremen's Ass'n Pension Fund v. Comm'r,* 98 A.F.T.R.2d (RIA) 5483 (E.D. Pa. 2006).

64 *Philadelphia Marine Trade Association-International Longshoremen's Ass'n Pension Fund v. Comm'r,* 523 F.3d 140 (3d Cir. 2008).

65 *Fisher v. United States,* 82 Fed. Cl. 780 (2008), *appeal docketed*, No. 09-5001 (Fed. Cir. Oct. 6, 2008).

ownership rights in the company, such as the right to vote and the right to dividends and liquidating distributions, if any, as well as typical insurance contract rights to payment on death of the insured. In 1990, a trust became a policyholder by purchasing a policy and beginning to pay annual premiums of $19,763 to Sun Life. In March of 2000, when Sun Life demutualized, it distributed shares of stock in exchange for the ownership rights of the policyholders, who could elect to immediately sell the stock (*i.e.*, receive cash in lieu of stock). Pursuant to an IRS private letter ruling, the basis of the stock would be the same as the basis in the ownership rights – "zero," according to the ruling.[66] Thus, any cash that policyholders elected to receive would be fully taxable, unreduced by the policyholders' cost basis in the policy. The trust elected to receive cash in lieu of stock. It reported the demutualization proceeds as income on its 2000 return, unreduced by any basis, paid the resulting tax, and filed a refund claim. The trust asserted the gain on the demutualization transaction should be offset by the trust's basis in the policy.

The IRS denied the claim. It reasoned that pursuant to Treasury Regulation § 1.61-6(a), the trust was required to allocate its basis in the policy among the ownership and contract rights in accordance with their relative values when acquired. Thus, the trust could not allocate any basis to the ownership rights unless it established that they were worth more than zero when acquired.

The trust argued it should be entitled to recover its basis pursuant to the common law "open transaction" doctrine instead, because the ownership rights acquired by policyholders were impractical or impossible to value.[67] If applicable, the doctrine would allow the trust to use its full basis in the policy to offset any gain on the demutualization payment.

The court agreed that the open transaction doctrine would apply if the ownership rights were impractical or impossible to value. At trial, an IRS expert testified the value of the policyholders' ownership rights was zero, while the trust's expert testified the rights were impractical or impossible to value. The court agreed with the trust's expert, holding that the "open transaction" doctrine applied.[68] Because the amount received by the trust was less than its cost basis in the insurance policy, the trust did not realize any income on the sale of the stock in question and, therefore, was entitled to a refund.

66 P.L.R. 200020048 (May 19, 2000).

67 *See, e.g.*, *Burnet v. Logan*, 283 U.S. 404 (1931); *Pierce v. United States*, 49 F. Supp. 324 (Ct. Cl. 1943).

68 The IRS expert concluded the rights should be valued at zero, in part, because the ownership rights were "neither separable [from other policy rights] nor alienable," Sun Life had not incurred any expenses in establishing those rights, and it was relatively unlikely that demutualization would occur at the time the rights were acquired. The court characterized this conclusion as an "illogical view" due, in part, to the fact that those rights were valued at more than $5.7 billion (Canadian) in connection with the demutualization. *Fisher v. United States*, 82 Fed. Cl. 780, 797 (2008), *appeal docketed*, No. 09-5001 (Fed. Cir. Oct. 6, 2008). We wonder if the court would have reached a different conclusion if the IRS's expert had valued the ownership components of the policy at an amount greater than zero. Such an approach would demonstrate that they were subject to a reasonable valuation.

MLI #1 Gross Income Under Internal Revenue Code Section 61 and Related Sections

Summary

When preparing tax returns, taxpayers must make 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] Common issues in the 205 cases decided between June 1, 2007, and May 31, 2008, that we reviewed include:

- Foreign earned income;
- Damage awards; and
- Disability and Social Security benefits.

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 broadly 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 205 opinions involving gross income issued by the federal courts between June 1, 2007, and May 31, 2008.[5] Gross income issues most often fall into two categories: what is included in gross income under IRC § 61 and what can be excluded under other statutory provisions. A detailed list of all cases appears in Table 1 of Appendix III. In 137 cases (nearly 67 percent) taxpayers were represented by attorneys, while the rest were *pro se*. Ten of the 137 represented taxpayers (about seven percent) prevailed in full or in part of their cases, while overall, taxpayers prevailed in full or in part in 18 of the 205 cases (about nine percent). *Pro se* taxpayers prevailed in eight of the 68 cases (about 12 percent).

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1 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 582-87.

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).

5 We reviewed federal cases involving IRC § 61 where the issue was whether the taxpayer had an item of unreported income or whether the taxpayer was entitled to exclude the item from gross income.

The vast majority of the cases we reviewed this year involved taxpayers failing to report items of income, including some that are specifically mentioned in IRC § 61 such as rents,[6] pensions,[7] and interest.[8] In the context of items that can be excluded from gross income, the following issues were commonly raised in the cases we analyzed.

Foreign Earned Income

In the 2007 Annual Report to Congress, we addressed one case in which the taxpayer argued that income he earned in Antarctica should be excluded from gross income under IRC § 911.[9] We mentioned this case last year because it served as the prelude to a number of cases addressing the identical issue this year. IRC § 911 permits a qualified taxpayer to elect to exclude foreign earned income, within statutory limits, earned while residing in a foreign country.[10] However, only a territory under the sovereignty of a foreign nation is considered a "foreign country."[11] Because the United States does not recognize a sovereign authority over Antarctica, it is not considered a foreign country qualifying for income exclusion under IRC § 911.[12] Taxpayers in at least 96 cases raised the issue of excluding income earned in Antarctica.[13] In all but three cases,[14] the taxpayers raising this argument were represented by the same attorney, and the IRS prevailed in all of the cases.[15]

The cases involving income earned in Antarctica significantly changed the gross income statistics included in this year's Annual Report. If not for the Antarctica cases, where only three taxpayers were not represented and the IRS prevailed in all 96 cases, the statistics for this year's Annual Report would more closely mirror the gross income case statistics in previous Annual Reports. Without the Antarctica cases, there would have been only 109 cases, taxpayers would have prevailed in full or in part in 18 cases (about 17 percent) and taxpayers would have been represented by counsel in 44 cases (about 40 percent).[16] We believe this year's numbers are an anomaly, as we have not identified any cases involving Antarctica falling within our timeframe of analysis for next year's Annual Report.

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6 IRC § 61(a)(5). *See, e.g., McGowan v. Comm'r*, T.C. Memo. 2008-125.

7 IRC § 61(a)(11). *See, e.g., Joubert v. Comm'r*, T.C. Memo. 2007-292.

8 IRC § 61(a)(4). *See, e.g., Callahan v. Comm'r*, T.C. Memo. 2007-301, *motion to vacate or revise decision denied* (May 9, 2008).

9 *See* National Taxpayer Advocate 2007 Annual Report to Congress 586-87 (discussing *Arnett v. Comm'r,* 473 F.3d 790 (7th Cir. 2007), *aff'g* 126 T.C. 89 (2006)).

10 IRC § 911.

11 Treas. Reg. § 1.911-2(h).

12 Rev. Rul. 67-52, 1967-1 C.B. 186.

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

14 *See, Brown v. Comm'r*, T.C. Summ. Op. 2007-166, *Macala v. Comm'r*, T.C. Summ. Op. 2008-7, and *Yamasaki v. Comm'r*, T.C. Memo. 2008-7.

15 *See, e.g., Hamann v. Comm'r*, T.C. Memo. 2007-246; *Minor v. Comm'r*, T.C. Memo. 2008-35.

16 *See* National Taxpayer Advocate 2007 Annual Report to Congress 582-87 (analyzing 112 cases with taxpayers prevailing in whole or in part in 14 cases (about 14 percent) and being represented by counsel in 36 cases (about 32 percent)); National Taxpayer Advocate 2006 Annual Report to Congress 575-81 (analyzing 106 cases with taxpayers prevailing in whole or in part in nine cases (about eight percent) and being represented by counsel in 31 cases (about 30 percent)); National Taxpayer Advocate 2005 Annual Report to Congress 488-97 (analyzing 108 cases with taxpayers prevailing in whole or in part in 25 cases (about 23 percent) and being represented by counsel in 48 cases (about 44 percent)).

Several other taxpayers raised issues involving foreign earned income.[17] In *Clark v. Commissioner*, the taxpayer resided in Scotland but was a U.S. citizen.[18] During the tax years at issue, the taxpayer worked for a shipping company and spent time at port and in international waters. The taxpayer argued that any income earned in international waters could be excluded from his gross income under IRC § 911. The U.S. Tax Court, using a similar rationale to its decisions in the Antarctica cases, held that to qualify for an exclusion, the income must be earned in a foreign country, defined as any territory or territorial waters under the sovereignty of a nation other than the United States. Because international waters are not under the sovereignty of any foreign country, income earned while in international waters is not foreign earned income for the purposes of IRC § 911. Clark further argued IRC § 911 should be read in conjunction with IRC § 863(c), which provides a special transportation income exception for income earned when the transportation begins or ends in the United States or one of its possessions. The court noted, however, that IRC § 863(c) does not generally apply to U.S. citizens, and even if it did, Clark's transportation neither began nor ended in the United States or one of its possessions. Thus, the court held that Clark owed tax on his income earned while working in international waters.[19]

Damage Awards

Taxation of damage awards spurs litigation every year.[20] Taxpayers in at least 17 cases raised this issue,[21] an increase over the seven cases that addressed damage awards last year.[22] In the 2007 Annual Report, all the damage award cases addressed the issue of excluding the award under IRC § 104(a)(2).[23] This year, we identified at least three cases in which taxpayers did not attempt to exclude the award under IRC § 104(a)(2), but nonetheless failed to report the settlement proceeds.[24]

In one of these cases, *Eckersley v. Commissioner*, the taxpayer worked for a company that purchased a life insurance policy on his life.[25] Under its contract with the taxpayer, the company was to make his wife the beneficiary. The taxpayer resigned from the company and the policy remained in the company's name. The couple sued the company and settled for an amount including the $500,000 in dispute in the Tax Court. The taxpayers argued

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17 *See Clark v. Comm'r*, T.C. Memo. 2008-71; *Langroudi v. Comm'r*, T.C. Summ. Op. 2007-156; *Rusten v. Comm'r*, T.C. Summ. Op. 2008-16.

18 *Clark v. Comm'r*, T.C. Memo. 2008-71.

19 *Id.*

20 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 582-87; National Taxpayer Advocate 2006 Annual Report to Congress 576-78; National Taxpayer Advocate 2005 Annual Report to Congress 489-90.

21 *See, e.g., Wright v. Comm'r*, T.C. Memo. 2007-278; *Polone v. Comm'r*, 505 F.3d 966 (9th Cir. 2007), *withdrawing and superseding* 479 F.3d 1019 (9th Cir. 2007), 449 F.3d 1041 (9th Cir. 2006) *withdrawn and superseded, aff'g* T.C. Memo. 2003-339, *writ of certiorari denied* (S. Ct. Mar. 24, 2008); *Phelps v. Comm'r*, T.C. Memo. 2008-86.

22 *See* National Taxpayer Advocate 2007 Annual Report to Congress 582-87.

23 National Taxpayer Advocate 2007 Annual Report to Congress 582-87.

24 *See Eckersley v. Comm'r*, T.C. Memo. 2007-282, *appeal docketed,* No. 08-70934 (9th Cir. Feb. 25, 2008); *Messina v. Comm'r*, 232 Fed. Appx. 254 (4th Cir. 2007), *superseding* 219 Fed. Appx. 328 (4th Cir. 2007), *aff'g in part and vacating and remanding in part* T.C. Memo. 2006-107; *Halliburton v. Comm'r*, T.C. Summ. Op. 2007-203.

25 *Eckersley v. Comm'r*, T.C. Memo. 2007-282, *appeal docketed* No. 08-70934 (9th Cir. Feb. 25, 2008).

the entire amount should be taxable to them as capital gain income rather than ordinary income. The court determined the taxpayers had no basis in the insurance policy, nor did the policy have any cash value, and in exchange for the $500,000, the company received nothing more than the extinguishment of the taxpayers' claim to the policy. The court held that based on these factors, the settlement income was ordinary income, not capital gain.[26]

The remaining 14 cases identified this year that addressed damage awards all challenged the IRS's determination that the taxpayers' awards were not excludible from gross income under IRC § 104(a)(2).[27] Under IRC § 104(a)(2), any award other than punitive damages is excludible from gross income if the award is compensation for damages resulting from a physical injury or sickness.[28] It makes no difference whether the award is received by suit or settlement agreement, or whether the award is paid as a lump sum or in periodic payments, because all such awards are excludible unless they represent punitive damages.

Congress amended IRC § 104(a)(2) in 1996, to clarify the conditions under which a damage award may be excluded from income, making an award excludible only if the damages are received on account of personal physical injury or physical sickness.[29] Prior to 1996, the word "physical" did not appear in the statute. The change in law was effective for amounts received after enactment on August 20, 1996,[30] but not for amounts received under a written, binding agreement, court decree, or mediation award in effect (or issued on or before) September 13, 1995.[31] The legislative history to the 1996 amendment 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."[32]

Taxpayers in the 14 cases addressing taxation of damage awards under IRC § 104(a)(2) all argued that all or part of the damage award was received on account of physical injury or physical sickness and should be excluded from gross income. The IRS prevailed in full or in part in all cases addressing the characterization of the damage award under IRC § 104(a)(2). We identified one case where the taxpayer prevailed in part.[33]

In *Wright v. Commissioner*, the court overturned the determination of the IRS that the taxpayer's award was not excludible under IRC § 104(a)(2).[34] The award occurred before

26 *Eckersley v. Comm'r*, T.C. Memo. 2007-282, *appeal docketed* No. 08-70934 (9th Cir. Feb. 25, 2008).

27 *See, e.g., Phelps v. Comm'r*, T.C. Memo. 2008-86; *Pettit v. Comm'r*, T.C. Memo. 2008-87.

28 IRC § 104(a)(2).

29 Pub. L. No. 104-188, § 1605(a).

30 Pub. L. No. 104-188, § 1605(d)(1).

31 Pub. L. No. 104-188, § 1604(d)(2).

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

33 *Wright v. Comm'r*, T.C. Memo. 2007-278.

34 *Id.*

the 1996 change in the law, and is thus governed under the pre-1996 version of IRC § 104(a)(2). Wright entered a settlement agreement with his former partners that provided in part for a damage award for personal injuries suffered. The IRS determined the award was fully includible in gross income and contended that although the settlement provided a portion of the award was for personal injuries, the actual dispute was purely a business matter, and therefore did not meet the requirement that the action be based in tort or tort type rights to be excludible from gross income under IRC § 104(a)(2). The court disagreed with the IRS, determining that the portion of the award intended for emotional distress was in the plain language of the settlement agreement; it was not added at the last minute to achieve favorable tax treatment, but had been part of the settlement negotiations from the beginning, and it was undeniable that Wright suffered emotional distress as a result of the actions of his former partners. The court held for Wright in part, excluding the portion of the damage award specifically allocated to personal injuries from gross income under IRC § 104(a)(2).[35]

Disability and Social Security Benefits

Taxpayers continue to litigate the issue of the characterization of Social Security and other disability benefits because portions of these benefits may be excludible from gross income. In *Connors v. Commissioner*, the taxpayer argued the disability benefits he received were excludible under IRC §§ 105 and 104(a)(3).[36] IRC § 105 provides that amounts received from a disability plan that are attributable to employee contributions are excludible from gross income.[37] IRC § 104(a)(3) provides that amounts received from accident or health insurance that are attributable to employee after-tax contributions are excludible from gross income.[38] The Court of Appeals for the Second Circuit upheld the finding of the Tax Court that Connors' disability insurance premium payments were made either by his employer or with pre-tax dollars, and therefore benefits from the policies were not excludible from gross income.[39]

Conclusion

Taxpayers consistently litigate many of the same gross income issues year after year due to the complex nature of what is and is not gross income and what can or cannot be excluded. The characterization of disability benefits and the nature of damage awards frequently cause confusion. The increase in cases litigating the issue of damage awards could suggest that *Murphy v. Commissioner*, discussed in detail in the 2006 and 2007 Annual Reports to

35 *Wright v. Comm'r*, T.C. Memo. 2007-278

36 *Connors v. Comm'r*, 2008 U.S. App. LEXIS 10632 (2d Cir. 2008), *aff'g* T.C. Memo. 2006-239.

37 IRC § 105.

38 IRC § 104(a)(3).

39 *Connors v. Comm'r*, 2008 U.S. App. LEXIS 10632 (2d Cir. 2008), *aff'g* T.C. Memo. 2006-239. *See also* Tuka v. Comm'r, 120 T.C. 1 (2003), aff'd, 85 Fed. Appx. 875 (3d Cir. 2003) (exclusion under IRC § 104(a)(3) is available only to employees who make after-tax contributions to insurance premiums).

Congress,[40] did not help to resolve the confusion surrounding the treatment of settlement and damage awards.[41]

The increase in the number of cases litigating gross income issues can be attributed almost entirely to the Antarctica foreign earned income cases. We expect future case numbers to be similar to those of previous years, as it appears no more Antarctica cases have been filed.

40 *See, e.g.*, National Taxpayer Advocate 2006 Annual Report to Congress 575-81; National Taxpayer Advocate 2007 Annual Report to Congress 582-87.

41 *Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007), *rev'g* 460 F.3d 79 (D.C. Cir. 2006), *aff'g* 362 F.Supp. 2d 206 (D. D.C. 2005), *vacated*, 2007-1 U.S.T.C. (CCH) ¶ 50,228 (D.C. Cir. 2006), *reh'g en banc denied*, 2007 U.S. App. LEXIS 22173 (D.C. Cir. Sept. 14, 2007), *writ of certiorari denied*, No. 05-5139 (S. Ct. Apr. 22, 2008). In *Murphy*, the taxpayer entered into a $70,000 settlement agreement for an employment discrimination suit. The agreement allocated $45,000 to "emotional distress and mental anguish" and the remaining $25,000 to "injury to professional reputation." The taxpayer included the entire $70,000 in gross income and later initiated a refund suit. After a lengthy legal battle, substantial adverse commentary, and a conclusion that IRC § 104(a)(2) was unconstitutional, the Court of Appeals for the District of Columbia Circuit ultimately held that the tax on compensatory damages was an excise tax on an involuntary conversion transaction (*i.e.*, Murphy had to surrender part of her mental health and reputation in return for monetary damages), and as such was not subject to the constitutional requirements for a tax on "income." Consequently, Murphy's entire $70,000 settlement award was not excludible from gross income.

MLI #2 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 Office of Appeals of the IRS's decision to file a lien or its proposal to undertake a levy action. In other words, a CDP hearing gives taxpayers an opportunity for meaningful hearings in front of independent appeals officers before the IRS deprives them of property. 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' determination provided that they timely request the CDP hearing and timely petition the court.[3] Generally, the IRS stays collection action during the CDP hearing process 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. This year continues the trend, with the courts issuing at least 179 opinions during the review period of June 1, 2007, through May 31, 2008.[5] Some critics have argued the CDP process stalls the IRS collection process and allows taxpayers to raise frivolous arguments. However, the CDP process serves an important function by providing taxpayers with a forum to raise legitimate issues before the IRS deprives them of property. The opinions reviewed this year support this view. Many of these decisions provide useful guidance on substantive issues. Where taxpayers attempted to use the CDP 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, Pub. L. No. 105-206, § 3401, 112 Stat. 685 (1998).

2 Internal Revenue Code (IRC) §§ 6320(c); 6330(c).

3 IRC §§ 6320(a)(3)(B); 6330(a)(3)(B). These provisions set forth the time requirements for requesting a CDP hearing. IRC §§ 6320(c); 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,[6] or of a proposed levy action.[7] 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.[8] The hearing allows taxpayers an opportunity to raise issues relating to the collection of the subject tax, including:

- Appropriateness of collection actions;[9]
- Collection alternatives such as an installment agreement, offer in compromise, posting a bond, or substitution of other assets;[10]
- Appropriate spousal defenses;[11]
- 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;[12] and
- Any other relevant issue relating to the unpaid tax, the lien, or the proposed levy.[13]

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

Procedural Collection Due Process Requirements

Procedurally, the IRS must provide notice to the taxpayer of the lien filing and its intent to levy. The IRS must provide the NFTL to the taxpayer not more than five business days after the day of filing the notice of the lien,[15] and must provide the notice of intent to levy to taxpayers at least 30 days before the day of the levy.[16] Further, the IRS must notify the taxpayer of his or her right to a CDP hearing after the filing of the NFTL and before any levy action can take place. In the case of a lien, the IRS must provide the CDP hearing notice to the taxpayer not more than five business days after the filing of the NFTL, and must inform the taxpayer of his or her right to request a CDP hearing within the 30-day period

6 IRC § 6320.

7 IRC § 6330.

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

9 IRC §§ 6330(c)(2)(A)(ii); 6320(c).

10 IRC §§ 6330(c)(2)(A)(iii); 6320(c).

11 IRC §§ 6330(c)(2)(A)(i); 6320(c).

12 IRC §§ 6330(c)(2)(B); 6320(c).

13 IRC §§ 6330(c)(2)(A); 6320(c).

14 IRC §§ 6330(c)(4); 6320(c).

15 IRC § 6320(a)(2). The NFTL can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail to the taxpayer's last known address.

16 IRC § 6331(d)(2). *Id.*

that begins on the expiration of the fifth business day after the filing of the NFTL.[17] In the case of a levy, the CDP hearing notice must be provided to the taxpayer no fewer than 30 days before the first levy and must inform the taxpayer of his or her right to request a hearing within 30 days from the date the notice is sent.[18]

Requesting a Collection Due Process Hearing

Under both lien and levy procedures, the taxpayer must return a signed, written request for a CDP hearing within the applicable period for requesting a hearing.[19] 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 but with no judicial review.[20] Regulations that took effect in November 2006 require taxpayers to provide in writing their reasons for requesting a CDP hearing (preferably using Form 12153, *Request for a Collection Due Process or Equivalent Hearing*); the failure to provide the basis for the hearing may result in a denial of a face-to-face hearing.[21] The regulations also provide that untimely requests are no longer automatically treated as requests for an equivalent hearing, and eliminate the availability of equivalent hearings if the taxpayer does not request a hearing within a certain time. The period for requesting an equivalent hearing after the filing of an NFTL is one year from the end of the five-business-day period following the filing of the notice,[22] while the period for requesting an equivalent hearing with respect to a levy is one year from the date the IRS issued the CDP notice.[23]

Conduct of a Collection Due Process 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.[24] Collection activity is also suspended throughout any judicial review of Appeals' determination, unless the

17 IRC §§ 6320(a)(2) and (a)(3)(B).

18 IRC §§ 6330(a)(2) and (a)(3)(B). The CDP hearing 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.

19 IRC §§ 6330(a)(3)(B); 6320(a)(3)(B); Treas. Reg. §§ 301.6320-1(c); 301.6330-1(c).

20 Treas. Reg. §§ 301.6320-1(i); 301.6330-1(i).

21 Treas. Reg. §§ 301.6320-1(c)(2) Q&A-D8; 301.6330-1(c)(2) Q&A-C1; 301.6330-1(d)(2) Q&A-D8. The regulations require the IRS to provide the taxpayer an opportunity to "cure" any defect in a timely filed hearing request, including providing a reason for the hearing. In conjunction with issuing 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). Additionally, IRC §§ 6320(b)(1) and 6330(b)(1) were recently amended to require taxpayers to include, in writing, in their CDP hearing request the grounds for requesting the hearing. *Id.*

22 Treas. Reg. § 301.6320-1(i)(2) Q&A-17.

23 Treas. Reg. § 301.6330-1(i)(2) Q&A-17.

24 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)).

underlying tax liability is not at issue and the IRS can demonstrate to the court good cause to resume collection activity.[25]

CDP hearings are informal. When a taxpayer requests CDP hearings with respect to both a lien and a proposed levy, the IRS Appeals office will attempt to conduct one hearing.[26] The Office of Appeals presumptively establishes telephonic CDP hearings, so it is incumbent on the taxpayer to request a face-to-face hearing.[27] Courts have determined that, depending on the circumstances, a CDP hearing need not be face-to-face with the Appeals office, but can take place by telephone or by an exchange of correspondence.[28] The CDP regulations clarify when the IRS will grant a face-to-face hearing and state that taxpayers who provide non-frivolous reasons for opposing the IRS collection action will ordinarily be offered, but not guaranteed, a face-to-face conference.[29] Taxpayers making only frivolous arguments or only requesting collection alternatives for which they cannot qualify are not entitled to a face-to-face conference.[30]

The CDP hearing is to be held by an impartial officer from the Appeals function of the IRS, who is barred from engaging in *ex parte* communication with IRS personnel regarding the substance of the case.[31] The officer must also be an individual who has had "no prior involvement" in the case.[32] In addition to the issues described above, which the taxpayer is permitted to address in the CDP hearing, the Appeals officer must verify that the requirements of all applicable laws and administrative procedures have been satisfied for the IRS to proceed with collection activity.[33] 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.[34]

On December 6, 2006, Congress passed the Tax Relief and Health Care Act of 2006 (TRHCA).[35] Section 407 of the TRHCA significantly 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

25 IRC §§ 6330(e)(1) and (e)(2).

26 IRC § 6320(b)(4).

27 Appeals Letter 3855 schedules a conference call, but provides information on the availability of a face-to-face conference. *See also* Treas. Reg. §§ 301.6320-1(d)(2) Q&A-D6, D8; 301-6330-1(d)(2) Q&A-D6, D8.

28 *Katz v. Comm'r,* 115 T.C. 329, 337-38 (2000) (finding that telephone conversations between the taxpayer and the Appeal officer constituted a hearing as provided in IRC § 6320(b)). *See, e.g., Simien v. IRS*, 99 A.F.T.R.2d (RIA) 495 (W.D. La. 2007); *Industrial Investors v. Comm'r*, T.C. Memo. 2007-93.

29 Treas. Reg. §§ 301.6320-1(d)(2) Q&A-D7; 301.6330-1(d)(2) Q&A D7.

30 *Id.*

31 IRC §§ 6320(b)(1); 6320(b)(3); 6330(b)(1); 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).

32 IRC §§ 6320(b)(3); 6330(b)(3).

33 IRC §§ 6330(c)(1); 6320(c).

34 IRC §§ 6330(c)(3)(C); 6320(c).

35 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, provides the first published list of frivolous positions.

of federal tax laws.[36] Section 407 also amended IRC § 6702 to create a new frivolous submission penalty that applies to frivolous CDP hearing requests.[37] 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."[38]

Section 407 also amended IRC §§ 6320(b)(1) and 6330(b)(1) to require taxpayers to include within their CDP hearing requests the grounds for requesting the hearing in writing.[39] Section 6330(c)(4) was amended to provide that an issue may not be raised at a hearing if the issue is based on a position identified as frivolous by the IRS or reflects a desire to delay or impede the administration of federal tax laws.[40] These provisions were passed to assist the IRS in combating the problems associated with the submission of frivolous documents.[41]

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."[42] 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.[43]

Judicial Review of Collection Due Process Determination

Within 30 days of the Appeals determination, the taxpayer may petition the United States Tax Court for judicial review of IRS Appeals' determination.[44] Where the validity of the tax liability is properly at issue in the CDP hearing, the court will review the amount of the tax

36 IRC § 6330(g).

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

38 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).

39 IRC §§ 6320(b)(1); 6330(b)(1).

40 IRC § 6330(c)(4).

41 S. Rep. No. 109-336, at 49 (2006).

42 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.

43 IRC § 6330(h).

44 IRC §§ 6330(d)(1); 6320(c). 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.

liability on a *de novo* basis.[45] Where the appropriateness of the collection action is at issue, the court will review the IRS's administrative determination for abuse of discretion.[46]

Analysis of Litigated Cases

CDP was one of the most litigated tax issues in the federal court system between June 1, 2007, and May 31, 2008. We reviewed 179 CDP court opinions, a 17.5 percent decrease from the 217 cases in last year's analysis. Moreover, the 179 decided cases do not reflect the full measure of CDP litigation because not all CDP cases result in court opinions. Some cases are resolved through pre-litigation settlements while other taxpayers do not pursue litigation after filing a petition with the court, resulting in dismissal of the action prior to the court issuing an opinion. Other cases are disposed of by unpublished order. Table 2 in Appendix lll provides a detailed list of the 179 CDP opinions reviewed, including specific information about the issue(s) considered, the types of taxpayers involved, and the outcomes of the cases.

Litigation Success Rate

Taxpayers prevailed in 15 of the 179 cased reviewed (approximately eight percent), and prevailed in part in an additional three cases.[47] Of those cases in which the courts found for the taxpayer in whole or in part, the taxpayers appeared *pro se* in eight cases[48] and were represented in the remaining ten.[49]

Table 3.2.1 compares litigation success rates in CDP cases reported in the 2003 through 2008 Annual Reports to Congress.[50]

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

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

47 *Graham v. Comm'r,* T.C. Memo. 2008-129; *Ulloa v. U.S.*, 100 A.F.T.R.2d (RIA) 6119 (N.D.N.Y. 2007); *Wagenknecht v. Comm'r*, 509 F.3d 729 (6th Cir. 2007).

48 *Butti v. Comm'r,* T.C. Memo. 2008-82; *Callahan v. Comm'r*, 130 T.C. No. 3 (2008); *Golub v. Comm'r*, T.C. Memo. 2008-122; *Kennedy v. Comm'r*, T.C. Memo. 2008-33; *Kuykendall v. Comm'r*, 129 T.C. No. 9 (2007); *Perkins v. Comm'r,* T.C. Memo. 2008-103; *Ulloa v. U.S.*, 100 A.F.T.R.2d (RIA) 6119 (N.D.N.Y. 2007); *Wagenknecht v. U.S.*, 509 F.3d 729 (6th Cir. 2007).

49 *Blosser v. Comm'r,* T.C. Memo. 2007-323; *Cotler v. Comm'r,* T.C. Memo. 2007-283; *Downing v. Comm'r*, T.C. Memo. 2007-291; *Ellison v. Comm'r,* 101 A.F.T.R.2d (RIA) 1661 (S.D. W. Va. 2008); *Graham v. Comm'r*¸ T.C. Memo. 2008-129; *Imarah v. Comm'r,* T.C. Memo. 2008-137; *Samuel v. Comm'r*, T.C. Memo. 2007-312; *Don Johnson Motors, Inc. v. U.S.*, 532 F. Supp. 2d 844 (S.D. Tex. 2007); *Lofgren Trucking Service, Inc. v. Comm'r,* 508 F. Supp. 2d 734 (D. Minn. 2007); *Shelter Mutual Insurance v. Gregory*, 2008 U.S. Dist. Lexis 1963 (M.D. Tenn.).

50 See National Taxpayer Advocate 2007 Annual Report to Congress 569, Table 1, for 2003, 2004, 2005, 2006, and 2007 statistics.

TABLE 3.2.1, Success Rates in CDP Cases

Court Decision	2003 Percentage	2004 Percentage	2005 Percentage	2006 Percentage	2007 Percentage	2008 Percentage[51]
Decided for IRS	96%	95%	89%	90%	92%	90%
Decided for Taxpayer	1%	4%	8%	8%	5%	8%
Split Decision[52]	3%	1%	3%	2%	3%	2%
Neither[53]	N/A	N/A	N/A	N/A	Less than 1%	N/A

Issues Litigated

The cases discussed below are those which 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 examine the CDP process and look for opportunities for improvement, both in its application and execution.

Procedural Rulings

Leahy v. Commissioner

In *Leahy v. Commissioner*,[54] the taxpayers filed a Tax Court petition under the small tax case procedures[55] seeking judicial review of a notice of determination concerning a notice of intent to levy. The total unpaid balance the IRS sought to collect in the notice of determination was over $50,000. The taxpayers contended that because they disputed only a portion of the total of the unpaid tax liability, which was less than $50,000, they were eligible for small tax case procedures.[56] Section 7463(f)(2) provides that a CDP case may be conducted under "S case" procedures with respect to "a determination in which the unpaid tax does not exceed $50,000." Applying IRC § 7463(f)(2), the court in *Leahy* held that for a case to qualify for small tax case procedures under IRC § 7463(f)(2), the total amount of "unpaid tax," including interest and penalties, cannot exceed $50,000 as of the date of the notice of determination.[57] The court also concluded the fact that the taxpayers disputed only a portion of the amount at issue is irrelevant; it is the amount that the IRS seeks to collect in

51 Numbers have been rounded to nearest percentage.

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

53 A "neither" decision refers to a case where the court's decision was not in favor of either party. 129 T.C. 71 (2007).

54 129 T.C. 71 (2007).

55 Small tax cases, often referred to as "S" cases, as discussed in IRC § 7463, are limited to certain types of cases involving $50,000 or less. Small tax cases are typically less formal in nature than a regular Tax Court case and often result in speedier disposition of the case. Decisions entered in small tax cases, however, are not appealable.

56 *Leahy v. Comm'r*, 129 T.C. 71 at 72.

57 *Leahy v. Comm'r*, 129 T.C. 71 at 72 (citing *Schwartz v. Comm'r*, 128 T.C. 6 at 12).

the Notice of Determination that controls. Thus, the case was not eligible for small tax case status.[58]

Downing v. Commissioner

In *Downing v. Commissioner*,[59] a taxpayer filed a Tax Court petition seeking review of the IRS determination to uphold its filing of an NFTL for the 1995 and 1999 tax years. The taxpayer claimed he never received the notice of intent to levy and right to a CDP hearing notice previously issued to him for the 1995 and 1999 tax years because the IRS sent the notice to the wrong address. Between the filing of the original return and the notice of intent to levy, the taxpayer submitted a Form 2848, *Power of Attorney and Declaration of Representative*, which directed the IRS to contact him at his address and not at the address of his accountant. The IRS, however, continued to send notices to the taxpayer's accountant. The court found the IRS should have known of the address change, and thus, the notice of intent to levy was invalid as it was not sent to the taxpayer's last known address. Because the notice of intent to levy was invalid, the court found the taxpayer did not have a prior opportunity to challenge the merits of the underlying liabilities, and therefore could challenge them in the CDP proceeding.[60] The Tax Court then found the 1995 tax liability was improperly assessed because no statutory notice of deficiency was issued prior to assessment, and thus, the notice of determination sustaining the filing of the NFTL was invalid with respect to the 1995 tax year.[61]

Imarah v. Commissioner

In *Imarah v. Commissioner*,[62] the taxpayers filed a Tax Court petition seeking review of the IRS determination to uphold its filing of an NFTL for the 1996 and 1998 tax years. The taxpayers claimed that the 1996 and 1998 tax liabilities had been discharged in bankruptcy, and hence the filing of the NFTL was improper. During the CDP hearing, the appeals officer refused to consider the dischargeability issue on the grounds that the taxpayers had a prior opportunity to address this issue in the bankruptcy court, and thus, the taxpayers were precluded from raising this issue as it was a challenge to the underlying liability.[63] The Tax Court disagreed with the IRS, finding that dischargeability was an issue concerning the appropriateness of the collection action, not the underlying tax liability, and thus, the appeals officer erred in not addressing this issue during the CDP proceeding. The Tax Court then concluded the taxpayers' 1996 and 1998 income tax liabilities were in fact discharged, and consequently, the Tax Court did not sustain the IRS's determination to proceed with collection.[64]

58 *Leahy v. Comm'r*, 129 T.C. at 76.
59 T.C. Memo. 2007-291 (2007).
60 *Id.*
61 *Id.*
62 T.C. Memo. 2008-137 (2008).
63 *Id.* at 21.
64 *Id.*

Baltic v. Commissioner

In *Baltic v. Commissioner*,[65] the taxpayers requested a CDP hearing in response to the IRS filing an NFTL against them. At the CDP hearing, the taxpayers requested an offer in compromise based on doubt as to liability (OIC-DATL). The appeals officer refused to consider the OIC-DATL, finding the taxpayers had already had an opportunity to challenge the underlying liability and were thus precluded from challenging the liability during the CDP proceeding. The appeals officer, however, informed the taxpayers that another IRS office would consider the OIC-DATL separately and that a third office would consider the taxpayers' amended return during the audit reconsideration process.[66] The appeals officer issued a notice of determination, finding that the IRS should postpone levy action until the IRS decided whether to accept the OIC-DATL and finished its audit reconsideration, but that the filing of the NFTL would be sustained. The taxpayers petitioned the Tax Court to challenge the appeals officer's determination not to consider the OIC-DATL during the CDP process. The Tax Court held that an OIC-DATL is a challenge to the underlying tax liability and that the IRS did not abuse its discretion in sustaining the filing of the NFTL because the taxpayers had a prior opportunity to challenge their liability when they received the statutory notice of deficiency.[67]

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. As noted in this report and previous reports, the National Taxpayer Advocate is concerned about the lack of independence of the Office of Appeals from the IRS compliance function, which can impair Appeals' ability to act impartially.[68] In previous reports, the National Taxpayer Advocate has focused on cases where employees engage in inappropriate *ex parte* communications that can compromise Appeals' independence. While *ex parte* communications remain a concern, the following case illustrates a slightly different problem facing taxpayers whose cases are reviewed by IRS Appeals employees who have previously worked on cases brought by the taxpayers.

Cox v. Commissioner

In *Cox v. Commissioner*,[69] the IRS sent the taxpayer a Notice of Intent to Levy to collect the taxpayer's 2001 and 2002 tax liabilities, and in response the taxpayer requested a CDP hearing. The appeals officer assigned to handle the case was the same officer who had worked on the taxpayer's prior CDP case involving collection of the taxpayer's 2000 tax liability.

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65 129 T.C. 178 (2007).

66 *Id.* at 180.

67 *Id.* at 184.

68 *See* 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*).

69 514 F.3d 1119 (10th Cir. 2008), *rev'g* 126 T.C. 237 (2006).

The taxpayer objected to this officer handling the subsequent case, claiming the appeals officer had impermissible "prior involvement" because during the course of the first case, he had reviewed the taxpayer's 2001 and 2002 tax returns to evaluate possible collection alternatives.[70] Relying on the Treasury Regulation's definition of "prior involvement,"[71] the IRS determined the appeals officer was not precluded from handling the subsequent case, and the Tax Court upheld this determination.[72]

The taxpayer appealed to the United States Court of Appeals for the Tenth Circuit. In the time between the Tax Court ruling and the appeal to the Tenth Circuit, the IRS modified the regulations under IRC § 6330 to clarify that an appeals officer was deemed to have "prior involvement" only in situations where the officer had considered the identical liability (same type of tax and same tax period) in a prior non-CDP matter.[73] The Tenth Circuit reversed the Tax Court's decision, holding that the appeals officer's review of the taxpayer's 2001 and 2002 tax liabilities during the first proceeding constituted prohibited "prior involvement" under IRC § 6330(b)(3) and the definitions of "prior involvement" contained in the 2004 regulations and as clarified in the 2006 regulations were invalid as these regulations were inconsistent with the intention of the statute.[74]

The Administrative Record

Giamelli v. Commissioner

In *Giamelli v. Commissioner*,[75] the Tax Court held that it did not have the "authority to consider IRC § 6330(c)(2) issues that were not raised before the Appeals Office."[76] In *Giamelli*, the taxpayer and his wife filed a joint federal income tax return in 2001 and failed to pay the tax due at the time of filing. The IRS assessed the tax due and also filed an NFTL. In response to the filing of the NFTL, the taxpayer requested a CDP hearing and during that proceeding argued that he should be allowed to enter into an installment agreement with the IRS for the 2001 tax year. The IRS rejected the proposed agreement after the taxpayer failed to make estimated tax payments in subsequent years. Shortly after the CDP hearing, the taxpayer died, and his estate sought to challenge the determination to reject the installment agreement and the amount of the 2001 tax liability. The Tax Court held that since the taxpayer did not challenge the amount of the 2001 liability during the CDP hearing, the estate could not challenge the underlying liability in the Tax Court proceeding.[77]

70 *Cox v. Comm'r*, 514 F.3d 1119 (10th Cir. 2008); IRC § 6330(b)(3) guarantees taxpayers a right to an appeals officer who has had "no prior involvement with respect to the unpaid tax specified before the first hearing under this section or section 6320."

71 Treas. Reg. § 301.6330-1(d)(2) (2004).

72 *Cox v. Comm'r,* 126 T.C. 237 (2006).

73 Treas. Reg. § 301.6330-1(d)(2) Q&A -D4 (2006) provides that "Prior involvement exists only when the taxpayer, the tax and the tax period at issue in the CDP hearing also were at issue in the prior non-CDP matter, and the Appeals officer or employee actually participated in the prior matter." *Id.*

74 *Cox v. Comm'r*, 514 F.3d 1119, 1127 (10th Cir. 2008).

75 129 T.C. 107 (2007).

76 *Id.* at 115.

77 *Id.* at 115-16.

Perkins v. Commissioner

In *Perkins v. Commissioner*,[78] the taxpayer and his wife filed joint returns for tax years 1995 and 2000. The IRS assessed the taxes owed for those years. For the 1999 tax year, the taxpayer was due a refund, which he sought to have applied to his liabilities for 1995 and 2000. The IRS determined the 1999 refund claim was not timely filed and thus the taxpayer was not entitled to a refund for that year. The taxpayer then inquired as to whether his medical disability would suspend the limitations period for filing a refund claim under IRC § 6511(h), which suspends the period of limitations for filing a refund claim for any period of time that the taxpayer is financially disabled. The appeals officer concluded that IRC § 6511(h) did not apply because the taxpayer was not disabled at the time the 1999 return was filed. The Tax Court found the appeals officer had incorrectly interpreted the requirements for suspension of the statute of limitations under IRC § 6511(h); thus, the administrative record was incomplete with regard to whether the taxpayer had met the requirements of this provision. The case was remanded to Appeals so it could reconsider the taxpayer's claim that his 1999 refund claim was timely as a result of the application of IRC § 6511(h).

Imposition of Sanctions

One notable issue emerging from the review of CDP decisions during the time period is the extent to which the courts imposed sanctions on taxpayers for frivolous positions. Section 6673(a)(1) authorizes the Tax Court to impose sanctions when it appears that proceedings have been instituted primarily for delay.[79] Our analysis of decisions 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 179 cases decided during the review period, the courts imposed sanctions in 14 cases – or over seven percent – and threatened IRC § 6673 sanctions in three additional cases.[80]

Pro Se Analysis

One hundred and four (or 58 percent) of the 179 cases litigated were brought before the courts by the taxpayer *pro se*. This is a decrease from 65 percent in the previous year and 73 percent in 2006.[81] Table 3.2.2 shows the breakdown of *pro se* and represented taxpayer cases and the decisions rendered by the court, indicating that approximately eight percent of *pro se* taxpayers received some relief on judicial review while approximately 13 percent of represented taxpayers received full or partial relief from their CDP appeals.

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78 T.C. Memo. 2008-103.

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

80 *Anderson v. Comm'r*, T.C. Memo. 2007-265; *McGowan v. Comm'r*, T.C. Memo. 2008-125; *Moore v. Comm'r*, T.C. Memo. 2007-200.

81 National Taxpayer Advocate 2007 Annual Report to Congress 569.

TABLE 3.2.2, *Pro Se* and Represented Taxpayer Cases and Decisions

Court Decisions	*Pro Se* Taxpayers		Represented Taxpayers	
	Volume	Percentage of Total	Volume	Percentage of Total
Decided for IRS	96	92%	65	87%
Decided for Taxpayer	6	6%	9	12%
Split Decisions	2	2%	1	1%
Totals	**104**		**75**	

Conclusion

CDP hearings continue to provide a critical means for taxpayers to challenge IRS attempts to deprive them of property. 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 that is not likely 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 the need for the notice of determination to be sent to the taxpayer's last known address, the need for an impartial appeals officer, and the role of the administrative record. The issue of what constitutes a challenge to the underlying liability remains a developing issue as illustrated by the *Imarah*[82] and *Baltic*[83] 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 taxpayers making frivolous claims designed to stall the collection process. The new legislation designed to deter taxpayers from making frivolous arguments during the CDP process, along with the courts' trend of imposing sanctions, may reduce the number of reported decisions discussing only frivolous arguments. The National Taxpayer Advocate will continue to monitor how this legislation plays out and its effect on the CDP process.

82 T.C. Memo 2008-137 (2008).

83 129 T.C. No. 19 (2007).

MLI #3

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 the legality of the summons by filing a motion to quash or by intervening in any proceeding regarding the summons.[4] Generally, the burden on the taxpayer to establish the illegality of the summons is formidable.[5] We reviewed 146 federal court opinions discussing issues related to IRS summons enforcement during the 12 months from June 1, 2007, through May 31, 2008. The party contesting the summons prevailed in full in only three of these cases, while six cases resulted in split decisions.

Present Law

The IRS has broad authority under 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 the

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-I.R.S.*, 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, 145-146 (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.

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 371-372, *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 *Powell* requirements or that enforcement of the summons would be an abuse of process.[21]

A taxpayer may also allege that the information requested by the IRS 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 to 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, and 146 in 2008. A detailed list of this year's cases appears in Table 3 in Appendix lll.

The IRS prevailed in full in 137 cases, while taxpayers prevailed in only three cases; six cases resulted in split decisions. Attorneys represented taxpayers in 38 cases, while taxpayers

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).

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

26 IRC § 7525(b); *Valero Energy Corp. v. U.S.*, 100 A.F.T.R.2d (RIA) 6473 (N.D. Ill. 2007).

appeared *pro se* (*i.e.*, without counsel) in the other 108 cases. One hundred fourteen cases involved individual taxpayers, while the remaining 32 involved business taxpayers. Twenty of the represented taxpayers were business taxpayers. Arguments raised by litigants against IRS summonses generally fell into the following categories:

- ***Powell* Requirements:** Although we reviewed 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 that assisting a foreign tax investigation was a legitimate purpose and the IRS does not need to establish the good faith of the requesting country so long as the IRS itself acted in good faith and complied with applicable statutes.[27] In addition, so 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.[28] Taxpayers also argued the summonses were overbroad or ambiguous but failed to substantiate their claims with evidence the information sought was irrelevant.[29] Taxpayers also claimed the IRS already possessed the requested documents, but were unable to provide sufficient evidence to refute the IRS agent's affidavit to the contrary.[30]
- **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 issuance of a summons, and a criminal investigation by the IRS, which does not.[31] Generally, courts accepted the testimony of the IRS agents who issued the summonses concerning whether the IRS had made criminal referrals to the DOJ.[32] One court, however, granted a motion to quash six summonses issued to the taxpayers' lawyer when the government only provided testimony regarding whether a referral had been made to the DOJ with respect to the taxpayers, and refused to disclose if a DOJ referral was made with respect to the lawyer. The court held the prohibition against issuing a summons if a DOJ referral is in effect applied, not only to the taxpayers, but to the lawyer.[33]
- **Constitutional Arguments:** Taxpayers also asserted several generally unsuccessful constitutional arguments. For example, the courts rejected the argument that the Fourth Amendment requires the IRS to establish probable cause to issue a summons,

27 *U.S. v. Hiley*, 100 A.F.T.R.2d (RIA) 6224 (S.D. Cal. 2007).

28 *Hopkins v. I.R.S.*, 101 A.F.T.R.2d (RIA) 1906 (D.N.M. 2008), *appeal docketed*, No. 08-2127 (10th Cir. June 6, 2008).

29 *U.S. v. Bright*, 100 A.F.T.R.2d (RIA) 5905 (D. Haw. 2007), *adopting* 100 A.F.T.R.2d (RIA) 6109 (D. Hawaii 2007), *reh'g denied*, 100 A.F.T.R.2d (RIA) 6615 (D. Haw. 2007).

30 *Bodensee Fund, LLC v. U.S. Dept. of Treasury-I.R.S.*, 101 A.F.T.R.2d (RIA) 2092 (E.D. Pa. 2008) (requesting essentially the same document from two separate sources allows the IRS to "double check" the records for consistency).

31 *Hennessy v. C.I.R.*, 100 A.F.T.R.2d (RIA) 7055 (E.D. Mich. 2007), *adopting* 100 A.F.T.R.2d (RIA) 5130 (E.D. Mich. 2007); *Hopkins v. I.R.S.*, 2008 WL 2079151 (D.N.M. 2008), *appeal docketed*, No. 08-2127 (10th Cir. June 6, 2008).

32 *Hopkins v. I.R.S.*, 101 A.F.T.R.2d (RIA) 1906 (D.N.M. 2008), *appeal docketed*, No. 08-2127 (10th Cir. June 6, 2008); *Speelman v. U.S.*, 2008 WL 148935 (S.D. Ohio 2008).

33 *Khan v. U.S. ex rel. I.R.S.*, 537 F. Supp. 2d 944 (N.D. Ill. 2008), *appeal docketed,* No. 08-1743 (7th Cir. Mar. 27, 2008).

and recognized that a taxpayer has no Fourth Amendment right in information sought by the IRS from a third party.[34] Also, 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.[35] Finally, the courts found that where the taxpayer received notice and was given an opportunity to respond, there was no due process violation.[36]

- **Privilege:** Generally, taxpayers were most successful when arguing privilege as a bar to disclosure of the summoned information. For example, in *United States v. Textron*, the IRS issued a summons seeking all of the taxpayer's "tax accrual work papers," and the taxpayer moved to quash the summons on the grounds that the attorney-client and work product privileges protected the materials from disclosure.[37] The papers at issue consisted of a list of items that in counsel's opinion might be challenged by the IRS because they involved unsettled areas of the law, and also counsel's opinion as to the taxpayer's chances of prevailing with respect to each item if the matter was ever litigated. The court held that while the attorney-client privilege applies to tax accrual work papers, the privilege was waived when the documents were disclosed to the taxpayer's independent auditors.[38] Further, the work product privilege does not apply to documents prepared in the ordinary course of business or that would have been created in essentially the same form irrespective of anticipated litigation. The court found, however, that the work papers were protected from disclosure by the work product privilege as the work papers were prepared in anticipation of litigation.[39]

  In *Regions Financial Corp. v. United States*, the taxpayer successfully argued the work product privilege applied to documents containing the legal analysis of the tax implications of a corporate transaction that the taxpayer felt might result in litigation.[40] Also, a court partially granted a taxpayer's motion to quash a summons on the grounds that the requested documents were confidential communications between the taxpayer and a federally authorized tax practitioner, and were therefore protected by the tax practitioner privilege.[41]

The IRS prevailed in 28 of the 54 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:

34 *Palmer v. U.S.*, 101 A.F.T.R.2d (RIA) 623 (E.D. Tenn. 2008); *Bandy v. U.S.*, 101 A.F.T.R.2d (RIA) 1916 (D. Kans. 2008).

35 *U.S. v. Benoit*, 101 A.F.T.R.2d (RIA) 2167 (9th Cir. 2008); *U.S. v. Bowers*, 259 Fed. Appx. 89 (10th Cir. 2007); *U.S. v. Rinehart*, 539 F. Supp. 2d 1334 (W.D. Okla. 2008) (granting IRS petition to enforce subject to specific assertions of taxpayer's Fifth Amendment privilege).

36 *U.S. v. Benoit*, 101 A.F.T.R.2d (RIA) 2167 (9th Cir. 2008).

37 *U.S. v. Textron, Inc.*, 507 F. Supp. 2d 138 (D.R.I. 2007), *appeal docketed*, No. 07-2631 (1st Cir. Oct. 31, 2007).

38 *Id.*

39 *Id.*

40 *Regions Financial Corp. v. U.S.*, 101 A.F.T.R.2d (RIA) 2179 (N.D. Ala. 2008).

41 *Valero Energy Corp. v. U.S.*, 100 A.F.T.R.2d (RIA) 6473 (N.D. Ill. 2007) (recognizing that the tax shelter privilege exception only applies were tax avoidance is a "significant purpose," not just "one of the purposes" of a transaction).

- **Lack of Jurisdiction Due to Procedural Requirements:** The United States is immune from suit unless Congress has expressly waived its sovereign immunity.[42] Since a motion to quash is a suit against the United States, a court has jurisdiction only when Congress has expressly waived the sovereign immunity of the United States.[43] Accordingly, the courts have strictly construed IRC § 7609 when determining if sovereign immunity has been waived.[44] For example, a court denied a motion to quash for lack of jurisdiction because the taxpayer filed by regular mail instead of registered or certified mail as required by statute.[45] Also, a court dismissed a *pro se* taxpayer's motion to quash because the motion was filed two days after the 20-day limitation period had expired.[46]
- **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.[47] For example, the U.S. Court of Appeals for the Ninth Circuit dismissed a motion to quash as it related to the taxpayer's wife because the wife was not entitled to notice of the summonses.[48]
- **Lack of jurisdiction due to no actual controversy:** The courts dismissed motions to quash with respect to two taxpayers because the IRS withdrew the contested summons, leaving no ripe case or controversy.[49] Because the motions were dismissed, the taxpayers never received rulings regarding the validity of the summons. If the IRS issues another summons, the taxpayer will be required to file another motion to quash to contest the validity of the new summons.[50]

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.[51] 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

Most Litigated Issues

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

43 *Huffman v. U.S.*, 100 A.F.T.R.2d (RIA) 7089 (S.D. Fla. 2007).

44 *Luongo v. U.S.*, 2008 WL 1326953 (M.D. Fla. 2008).

45 *Id*.

46 *Neuger v. U.S.*, 2008 WL 697342 (D. Colo. 2008).

47 *Grant v. Comm'r*, 100 A.F.T.R.2d (RIA) 5327 (E.D. Ky. 2007) (taxpayer not entitled to notice because summons was issued in aid of collection); *Daniel v. U.S.*, 101 A.F.T.R.2d (RIA) 1541 (D. Ariz. 2008) (taxpayer not entitled to notice because summons was issued as part of a criminal investigation meeting requirements of IRC § 7609(c)(2)(E)).

48 *Stewart v. U.S.*, 511 F.3d 1251 (9th Cir. 2008).

49 *Thompson v. U.S.*, 100 A.F.T.R.2d (RIA) 2007-6133; *Thompson v. U.S.*, 2007 WL 1891167 (D.D.C. 2007); *Tift v. Comm'r*, 101 A.F.T.R.2d (RIA) 2008-2645 (W.D. Wash. 2008).

50 *Thompson v. U.S.*, 100 A.F.T.R.2d (RIA) 6133 (S.D. Ohio 2007).

51 IRC § 7602(a).

IRS continues its 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.[52]

52 For a more detailed discussion of IRS collection enforcement actions, see Most Serious Problem, *The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulties, supra*.

MLI #4

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

Summary

The deductibility of trade or business expenses is perennially among the ten most litigated tax issues in the federal courts. We identified 116 cases that included a trade or business expense issue and were litigated between June 1, 2007, and May 31, 2008. The courts affirmed the IRS position in nearly three-fourths of the 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 a facts and circumstances analysis. 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 of business" comes from common law, where the concepts have been developed and refined by the courts.[3] The United States Supreme Court has interpreted "trade or business" for purposes of IRC § 162 to mean an activity conducted "with continuity and regularity" and with the primary purpose of earning income or making a profit.[4]

What is an ordinary and necessary expense?

IRC § 162(a) requires a trade or business expense to be both "ordinary and necessary" in relation to the taxpayer's trade or business in order to be deductible. In *Welch v. Helvering,*

1 The IRS prevailed in full in 85 of the 116 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 Regulation provisions. *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).

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 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 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 is unable to substantiate deductions by documentary evidence (*e.g.*, invoice, paid bill, or canceled check) but can establish that he or she had some deductible business expenditures, the courts may opt to employ the *Cohan* rule to grant the taxpayer a reasonable amount of deductions.

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

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

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

8 176 F.2d 815, 817 (6th Cir. 1949).

9 IRC § 162(a).

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

11 IRC § 167.

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

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

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

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

1. Traveling expenses;
2. Entertainment expenses;
3. Gifts; or
4. Certain "listed property."[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) (citation 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] We reviewed 116 cases involving various trade or business expense issues that were litigated in federal courts from June 1, 2007, through May 31, 2008. Table 4 in Appendix III contains a detailed listing of those cases. Table 3.4.1 (below) categorizes the main trade or business expense issues raised by taxpayers in the cases reviewed. Cases involving more than one issue are included in more than one category. In *Lebloch v. Commissioner,*[21] for example, the taxpayer raised four distinct trade or business expense issues, so *Lebloch* appears in four categories in Table 3.4.1.

TABLE 3.4.1, Trade or Business Expense Issues in Cases Reviewed

Issue	Type of Taxpayer	
	Individual	Business (including sole proprietors)
Substantiation of expenses, including application of the *Cohan* rule[22]	29	46
Profit objective[23]	0	19
Ordinary and necessary trade or business expenses[24]	4	18
Personal vs. business expenses[25]	16	12
Travel, entertainment and gift expenses[26]	15	6
Medical and dental expenses[27]	7	4
Business expenses vs. capital expenditures[28]	2	3
Compensation expenses[29]	0	6
Self-employed health insurance deduction[30]	0	2
Education expenses[31]	2	2

20 *See* National Taxpayer Advocate 1998-2007 Annual Reports to Congress.

21 T.C. Memo. 2007-145.

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 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 IRC § 162(a)(2) allows a deduction for ordinary and necessary business-related expenses for traveling "while away from home in the pursuit of a trade or business"; entertaining clients and customers; and giving gifts to customers, employees, and others with whom they have a business relationship. A taxpayer's "home" for purposes of IRC § 162(a)(2) is his or her principal place of business. *See Kroll v. Commissioner*, 49 T.C. 557, 561-62 (1968) (citations omitted). *See also* IRS Fact Sheet FS-2007-10, Jan. 2007.

27 IRC § 213(a) allows a deduction for a portion of medical and dental expenses not compensated by insurance or otherwise, which exceeds seven and half percent of the taxpayer's adjusted gross income. Qualified medical expenses are not subject to the two-percent floor on miscellaneous itemized deductions under IRC § 67(b).

Over two-thirds of the taxpayers litigating trade or business deduction issues represented themselves (*pro se*). In terms of percentage, represented taxpayers did not fare any better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in approximately 26 percent of litigated cases (ten of 38), while *pro se* taxpayers received partial relief in approximately 26 percent of litigated cases (20 of 78). Only one of the *pro se* taxpayers received full relief.

Individual Taxpayers

Thirty-four of the 116 cases analyzed were litigated by individual taxpayers, over three-quarters of whom appeared *pro se*.[32] None of these taxpayers received full relief, although 14 of the 34 cases resulted in split decisions. The most prevalent issue was the substantiation of the claimed trade or business expense deductions, which appeared in 29 cases. For example, in *Boltinghouse v. Commissioner*,[33] the taxpayer failed to provide consistent and credible documentation to satisfy the strict substantiation requirements of IRC § 274(d). His claims for transportation and travel expenses, entertainment and business meals, and business gifts were denied for lack of strict substantiation, as well as failure to provide proof that such expenses were not reimbursed by his employer.[34] The court partly allowed claimed deductions for medical and dental expenses, but not for vitamins because they were not prescribed medications.[35] Consequently, this case ended in a split decision.

None of the 34 decisions involving individual taxpayers was issued as a regular opinion of the Tax Court.[36] In the only appellate court decision involving individual taxpayers, *Cargill v. Commissioner*,[37] the Court of Appeals for the Eleventh Circuit affirmed the Tax Court's

28 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

29 IRC § 162(a)(1) allows a trade or business expense deduction for a "reasonable allowance for salaries or other compensation for personal services actually rendered."

30 Under IRC § 162(l), a self-employed taxpayer may deduct the cost of medical insurance premiums under certain conditions. A self-employed taxpayer may not deduct the cost of medical insurance premiums, however, if he or she is eligible to participate in a subsidized health plan of another employer or of the spouse's employer. *See* IRC § 162(l)(2)(B).

31 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.

32 Individual taxpayers were represented by counsel in only seven of the 34 cases.

33 T.C. Memo. 2007-32, *appeal dismissed*, No. 08-1195 (4th Cir. Apr. 24, 2008). This case illustrates the typical outcome in a substantiation case where the taxpayer has failed to provide adequate records for travel, meal, and other miscellaneous expenses that cannot be estimated under the *Cohan* rule and are subject to the strict substantiation requirements of IRC § 274(d).

34 Fifteen of 34 cases involved travel, entertainment, and gift expenses issues.

35 *See* IRC § 213(a). Medical and dental expenses issues were raised in seven cases involving individual taxpayers.

36 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. In addition, "S" case decisions (for disputes involving $50,000 or less) are not appealable and, thus, have no precedential value. *See generally* IRC §§ 7459 and 7463(b). *See also* U.S. Tax Court Rules of Practice and Procedure, Rules 170-175.

37 272 Fed. Appx. 756 (11th Cir. 2008).

order dismissing the taxpayer's petition for redetermination of a deficiency involving claimed itemized deductions and business expenses not properly substantiated. The taxpayer failed to provide any substantiation to support the claimed deductions and expenses on her unsigned joint return. Even during the Tax Court proceedings, the taxpayer failed to produce any evidence that she was entitled to those deductions. As a result, the appellate court did not find an abuse of discretion in the Tax Court's prior dismissal of the case.

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.[38] For example, in *Bogue v. Commissioner*, an airline mechanic received a "bump" notice with a choice between being laid off or bumping other employees and moving to different cities to continue working. The airline gave the taxpayer no end date for his positions in these cities and no longer required him to perform any services whatsoever in his home city where his post of duty was initially located. The IRS denied the deductions because the taxpayer was not "away from home" in the pursuit of a trade or business.[39] The Tax Court 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. Consequently, the Tax Court upheld the IRS's denial of the taxpayer's deductions because he did not have a tax home in the tax year at issue.[40]

Business Taxpayers

Eighty-two of the 116 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 21 percent of cases (17 of 82) compared to 41 percent for individuals (14 of 34). Notably, however, six business taxpayers obtained full relief, while none of the individual taxpayers 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,[41] and in some instances, the courts denied business taxpayers' deductions for failure to substantiate.[42] 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

38 *See, e.g., Bogue v. Comm'r*, T.C. Memo. 2007-150; *Farran v. Comm'r,* T.C. Memo. 2007-151. *Bogue* involved vehicle, lodging, and meals expenses as well as expenses for Internet access, safety glasses and safety shoes, uniform cleaning, and cellular telephone, while *Farran* involved expenses for vehicle, lodging, meals, Internet access, uniform cleaning, tools, depreciation of tools, personal property taxes, job searching, supplies, parking, publications, cellular telephone, and education mileage. *See also McKeown v. Comm'r*, T.C. Summ. Op. 2007-95; *Riley v. Comm'r*, T.C. Memo. 2007-153; *Stephens v. Comm'r*, T.C. Summ. Op. 2007-94; *Stockwell v. Comm'r*, T.C. Memo. 2007-149; *Wasik v. Comm'r,* T.C. Memo. 2007-148; and *Wilbert v. Comm'r,* T.C. Memo. 2007-152.

39 *See* IRC §§ 162(a)(2) and 262(a).

40 *Bogue* resulted in a split decision. The Tax Court denied deductions for miscellaneous unsubstantiated expenses while allowing estimated amounts of deductible cleaning expenses under the *Cohan* rule. *See Bogue v. Comm'r*, T.C. Memo. 2007-150; *Cohan v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930).

41 Substantiation of expenses issue appeared in 46 of 83 cases involving business taxpayers.

42 *See, e.g., Arnold v. Comm'r*, T.C. Memo. 2007-168; *Osborne v. Comm'r*, T.C. Memo. 2008-40; *Sita v. Comm'r,* T.C. Memo. 2007-363.

Cohan rule.[43] At least one taxpayer prevailed on appeal when the Tax Court denied certain deductions associated with the taxpayer's unincorporated car racing business. For example, in *Maciel v. Commissioner*,[44] the IRS refused to permit deductions associated with the unincorporated businesses of a taxpayer who did not report any income from these businesses and pled guilty to tax evasion in a separate criminal proceeding. The Tax Court summarily determined the taxpayer failed to substantiate claimed business deductions. The United States Court of Appeals for the Ninth Circuit reversed the decision because the taxpayer did substantiate some of his expenses with adequate records.[45]

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 *Smith v. Commissioner*,[46] the taxpayers were involved in dog breeding, cow and dairy farming, and horse breeding activities, and claimed deductions for expenditures related to these businesses.[47] The IRS disallowed the deductions on the grounds that these activities were not conducted for profit under IRC § 183. The Tax Court used a nine-factor test to analyze each of these activities.[48] Based on all facts and circumstances, the court upheld the IRS determination for the taxpayers' horse and dog breeding activities. The court concluded these activities were not for profit because the taxpayers failed to maintain adequate records or develop business plans for them, and used losses from the activities to offset their large incomes from other sources. However, the court found the cow and dairy farm was for profit activity for purposes of IRC § 183(a) because the taxpayer who engaged in this activity approached the operation in a businesslike manner. The taxpayer gained expertise in breeding cows through extensive study and spent an average of 20 to 30 hours per week on the activity. In addition, the Tax Court found that, unlike the horse and dog breeding, the cow and dairy farm was more business than pleasure oriented. Consequently, the court allowed deductions related to the farm activity under IRC § 162(a).

Although none of the 82 business taxpayer cases was issued as a regular opinion of the Tax Court, five cases resulted in appellate court decisions and one case led to a decision of the

43 *See, e.g.*, *Tash v. Comm'r*, T.C. Memo. 2008-120.

44 489 F.3d 1018 (9th Cir. 2007), *rev'g in part* T.C. Memo. 2004-28.

45 489 F.3d at 1029.

46 T.C. Memo. 2007-368, *appeal docketed*, No. 08-72402 (9th Cir. May 23, 2008).

47 This case consolidated related petitions of three married couples related by blood and marriage – the parents and their children's families.

48 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. All facts and circumstances are to be taken into account and no single factor or group of factors is determinative. *See Indep. Elec. Supply, Inc. v. Commissioner*, 781 F.2d 724, 726-727 (9th Cir. 1986), *aff'g. Lahr v. Commissioner*, T.C. Memo. 1984-472; *Golanty v. Commissioner*, 72 T.C. 411, 425-426 (1979), *aff'd. in unpublished opinion*, 647 F.2d 170 (9th Cir. 1981); *see also* Treas. Reg. § 1.183-2(b).

United States Supreme Court.[49] In *Knight v. Commissioner*,[50] the Supreme Court settled the long-standing split of authority regarding the applicability of the two percent adjusted gross income limitation to the deductibility of investment fees by trusts. In this case, the trust claimed deductions for the full amount of the investment advisory fees incurred by the trust to satisfy the trustee's fiduciary obligation of prudent investment. The IRS allowed a deduction only for the portion of the fees that exceeded two percent of the trust's adjusted gross income according to IRC § 67(a). The trustee appealed, arguing the full amount of the investment advisory fees is deductible under the IRC § 67(e)(1) exception to the IRC § 67(a) two-percent floor.[51] The Supreme Court upheld the Tax Court and the Court of Appeals for the Second Circuit, holding that the deductibility of the fees paid by the trust is limited to fees in excess of the two-percent floor, since IRC § 67(e)(1) exception only allows full deductibility if the costs would not have been incurred had the property not been held in trust.

Another important case, *BB&T Corp. v. United States*, involved business expense deductions in a tax shelter transaction.[52] The United States Court of Appeals for the Fourth Circuit upheld the decision of the district court denying the corporate taxpayer's deduction for rent and related expenses under IRC § 162(a)(3)[53] associated with the company's participation in a lease-in/lease-out (LILO) transaction.[54] The financial services company entered into a LILO transaction of manufacturing equipment with the manufacturer that owned the equipment and claimed rent expense deductions. The court upheld disallowance of the rental deduction because the rent was not in substance an ordinary and necessary business expense, but rather a device through which the taxpayer duplicated deductible expenses.

Conclusion

Taxpayers continued to challenge IRS denials of trade or business expense deductions, and represented taxpayers again fared better than their *pro se* counterparts. 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 highly fact-specific.

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49 *See BB&T Corp. v. U.S.*, 523 F.3d 461 (4th Cir. 2008); *E. J. Harrison & Sons, Inc. v. Comm'r,* 270 Fed. Appx. 667 (9th Cir. 2008); *Green v. Comm'r*, 507 F.3d 857 (5th Cir. 2007); *Kanofsky v. Comm'r*, 101 A.F.T.R.2d (RIA) 1501 (3d Cir. 2008); *Maciel v. Comm'r*, 489 F.3d 1018 (9th Cir. 2007). *See also Knight v. Comm'r*, 128 S. Ct. 782 (2008).

50 128 S. Ct. 782 (2008). For a detailed discussion of this case, see Most Litigated Issues, *Significant Cases, supra.*

51 IRC § 67(e)(1) excepts from the two-percent floor of IRC § 67(a) expenses incurred by a trust that could not have been incurred if the property were held by an individual.

52 *See BB&T Corp. v. U.S.*, 523 F.3d 461 (4th Cir. 2008), *reh'g en banc denied* (4th Cir. June 27, 2008).

53 IRC § 162(a)(3) allows a deduction for "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." *Id.*

54 In this LILO transaction, a manufacturer owned and used the equipment and retained, in substance, all of the rights it possessed in the equipment before the transaction and during the term of the lease. The rights that the manufacturer transferred to the taxpayer under the lease were identical to the rights that the corporate taxpayer transferred back to the manufacturer under the sublease. *See BB&T*, 523 F.3d 461, 465-470.

Many of the analyzed 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. By helping self-employed and small business taxpayers understand these requirements, the IRS will encourage compliance and minimize litigation. The IRS may stop or substantially limit the abuse of business expense deductions by vigorously litigating tax shelter and sham transaction cases.

MLI #5

Accuracy-Related Penalty Under Internal Revenue Code Sections 6662(b)(1) and (2)

Summary

Internal Revenue Code (IRC) §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if, under § (b)(1) a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if under § (b)(2) an underpayment of tax exceeded a computational threshold called a substantial understatement. IRC § 6662(b) also authorizes the IRS to impose three other accuracy-related penalties.[1] However, during our review period of June 1, 2007, through May 31, 2008, 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 the accuracy-related penalty equals 20 percent of the portion of the underpayment that is attributable to the taxpayer's negligence or disregard of rules or regulations or a substantial understatement.[2] For example, if a taxpayer wrongly reports a handful of income tax items, some errors may be justifiable mistakes while others might be the result of negligence. The 20 percent penalty would apply only against the underpayment attributable to negligence.

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]

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 the internal revenue laws, including a failure to keep adequate books and records or to substantiate items that gave rise to the underpayment.[5] Strong indicators of negligence include instances where a

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

2 IRC § 6662(a).

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

4 IRC § 6664(c)(1).

5 Treas. Reg. § 1.6662-3(b)(1).

taxpayer failed to report income on a tax return that a payer reported on an information return, as defined in IRC § 6724(d)(1),[6] or the taxpayer 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 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 taxpayer reported $6,000, the substantial understatement penalty 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 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] The most important factor is the extent of the taxpayer's effort to determine the proper tax liability.[15]

6 IRC § 6724(d)(1) cross-references other subsections that define various 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; 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).

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).

15 Treas. Reg. § 1.6664-4(b)(1).

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, *i.e.*, IRC §§ 6211-6213, that it follows with other assessments.[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 U.S. Tax Court.[20] Alternatively, taxpayers may seek judicial review through refund litigation.[21] Generally later, in response to IRS collection actions, *e.g.*, a notice of intent to levy, the taxpayer may under certain circumstances 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 penalty is warranted. The burden of proof then shifts to the taxpayer to establish any exception to the accuracy-related penalty, such as reasonable cause.[24]

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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. IRC § 6751(b)(1) provides that IRS employees must have written supervisory approval before assessing any penalty. However, IRC § 6751(b)(2)(B) provides an exception for situations where the IRS is able to calculate a penalty automatically "through electronic means." The IRS interprets the exception language as allowing the IRS 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 IRS computers automatically convert the proposed penalty to an assessment. *See* National Taxpayer Advocate 2007 Annual Report to Congress 277 ("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 Publication 5, *Your Appeal Rights and How to Prepare a Protest if You Don't Agree* (Rev. Jan. 1999); IRS Publication 3498, *The Examination Process* (Rev. Nov. 2004).

19 IRC § 6665(a)(1).

20 IRC § 6213(a).

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; IRC § 7422(a); *Flora v. U.S.*, 362 U.S. 145 (1960) (requiring full payment of tax liabilities as a precondition 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."

24 IRC § 7491(c).

Analysis of Litigated Cases

For the period from June 1, 2007, through May 31, 2008, we identified 87 cases where taxpayers litigated the negligence or disregard of rules or regulations or the substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 61 cases (70 percent), the taxpayers prevailed in full in 22 cases (25 percent), and three cases (three percent) resulted in split decisions. Finally, one case (one percent) was indeterminate because it was remanded for further consideration. Thus, taxpayers prevailed partially or fully in 29 percent of the penalty disputes.

Taxpayers appeared *pro se* (without representation) in 47 of the 87 cases (54 percent). *Pro se* taxpayers convinced the court to dismiss or reduce the penalty in 17 percent of their cases.[25] In contrast, represented taxpayers achieved full or partial relief from the penalty 43 percent of the time. Thus, representation appears to be a major factor in the outcome of penalty litigation.[26]

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 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

Reasonable cause and good faith were proven most frequently by the adequacy of taxpayers' records. For example, in *Bigler v. Commissioner*,[27] because the taxpayer kept detailed records and his bookkeeping was generally accepted and complied with industry standards, the court determined that the taxpayer acted reasonably and in good faith. Even though the taxpayer erred in his computation of tax, his accounting practices helped to establish that he had reasonable cause and acted in good faith.

In other cases, the court 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. In *Agbaniyaka v. Commissioner*,[28] the Tax Court sustained

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, and excluded the one case which was remanded (taxpayer appeared *pro se*) as the case was remanded to the tax court for a determination of whether the taxpayer's reliance on experts was in good faith. *See Thompson v. Comm'r*, 100 A.F.T.R.2d (RIA) 5792 (2d Cir. 2007), *vacating and remanding* T.C. Memo. 2003-174, *cert. denied* (June 16, 2008).

26 Taxpayers achieved some relief in eight of the 47 *pro se* litigated cases, whereas 17 of the 40 represented taxpayers achieved success (including split decisions). Similarly, 32 percent of the taxpayers who convinced the court to dismiss or reduce the penalty were *pro se*, while 68 percent of the taxpayers who won full or partial relief were represented.

27 T.C. Memo. 2008-133.

28 T.C. Memo. 2007-300.

the IRS's denial of business and educational deductions and imposition of accuracy-related penalties because the taxpayer did not keep adequate records. Even though the taxpayer held a master's degree in accounting with a concentration in tax, he failed to keep records establishing trade and business expenses under IRC § 162. The taxpayer failed to keep records of business expenses such as continuing education classes, travel receipts, depreciation schedules, and calculations of the cost of goods sold. The court held that the taxpayer's lack of record keeping amounted to negligence.

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 to accuracy-related penalties, the taxpayers established three factors: (1) they provided all necessary information to the professional; (2) the tax professional was competent with sufficient expertise; and (3) the taxpayers actually relied in good faith on the professional's opinion or tax return preparation.[29]

Three examples of where taxpayers successfully claimed reasonable reliance on a tax professional include:

1. Although the taxpayer's accountant mischaracterized the taxpayer as a sole proprietor rather than the landlord of a bar for several years, the court found reasonable cause and that the taxpayer acted in good faith by providing correct information to the accountant who made an understandable error.[30]
2. Even though a taxpayer failed to report alimony payments from her ex-husband in her gross income, the court found she reasonably and in good faith relied on the advice of her tax and divorce attorneys, who erroneously determined the payments were not alimony.[31]
3. Although a taxpayer failed to report all of his gambling winnings on his tax returns, the taxpayer proved he acted in good faith and reasonably relied on his tax preparer by demonstrating that he provided documents and records supporting his gambling winnings and losses to his tax preparer.[32]

Three examples where taxpayers unsuccessfully claimed reliance on a tax professional include:

1. The taxpayer failed to present evidence of the tax preparer's competence;[33]

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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 *Monk v. Comm'r,* T.C. Memo. 2008-64.

31 *Perkins v. Comm'r*, T.C. Memo. 2008-41.

32 *Gagliardi v. Comm'r*, T.C. Memo. 2008-10.

33 *See G. Kierstead Family Holdings Trust v. Comm'r*, T.C. Memo. 2007-158 (taxpayers failed to show that the attorney they relied on was competent); *Tash v. Comm'r*, T.C. Memo. 2008-120 (taxpayer provided no evidence establishing tax preparer as a competent tax professional); *Burkley v. Comm'r*, T.C. Summ. Op. 2008-20 (tax preparer was unfamiliar with software and was not an accountant).

2. The taxpayer failed to provide the preparer with all of the necessary documentation for the tax return;[34] and
3. The court found the taxpayers did not rely in good faith on their preparer's advice and failed to oversee the preparer; the taxpayers signed their tax return without examining it or discussing it with the preparer.[35]

Although reliance on a tax professional may be evidence of reasonable cause or acting in good faith, it does not entitle the taxpayer to an exception from accuracy-related penalties. In *Oria v. Commissioner*,[36] the court upheld the accuracy-related penalty because the taxpayer knew his S corporation was making payments to his CPA so the CPA could make accounting entries to inflate the corporation's expenses and reduce the taxpayer's salary for his income taxes. The court held a reasonably prudent person would not rely on the advice of a person with a financial interest in that advice, and therefore the taxpayer's reliance on his CPA was not reasonable cause for the understatement of taxes.

Other Circumstances for Reasonable Cause

Tax Sophistication of the Taxpayer

A taxpayer's education and sophistication relating to business and tax issues is of great concern to the court. For taxpayers with special knowledge or experience in tax law, the court sustained the penalty because the taxpayers should have known better. For example, the court held that taxpayers sophisticated in tax matters lacked reasonable cause and did not act in good faith in the following instances:

- A taxpayer with a master's degree in accounting with a concentration in taxation negligently failed to keep adequate records and receipts for his business-related deductions, including travel, continuing education, and union dues.[37]
- A former tax auditor for the IRS tried to deduct an uncollectible personal settlement as an IRC § 165(c) casualty loss.[38]
- A licensed attorney and former IRS employee failed to report income received as part of a settlement paid by a former employer. The Tax Court found the taxpayer failed to make a reasonable inquiry into whether his decision not to include the settlement in his gross income was correct. Therefore, the court held that the taxpayer failed to act with reasonable cause and in good faith.[39]

34 *See King v. Comm'r*, 100 A.F.T.R.2d (RIA) 6481 (11th Cir. 2007) (taxpayers failed to provide their accountants with records and receipts); *Muller v. Comm'r*, T.C. Summ. Op. 2007-207 (taxpayer did not tell tax preparer about IRA withdrawal); *Prudhomme v. Comm'r*, T.C. Memo. 2008-83 (taxpayers failed to provide information regarding the sale of their S corporation to their tax preparer).

35 *Neufeld v. Comm'r*, T.C. Memo. 2008-79.

36 T.C. Memo. 2007-226.

37 *Agbaniyaka v. Comm'r*, T.C. Memo. 2007-300.

38 *Green v. Comm'r*, T.C. Memo. 2007-217.

39 *MacMurray v. Comm'r*, T.C. Summ. Op. 2007-118.

In contrast, taxpayers without specialized tax knowledge achieved better results. For example, the Tax Court in *Thompson v. Commissioner*[40] disallowed the accuracy-related penalty imposed on a taxpayer who incorrectly deducted education expenses. The court found the taxpayer, an aeronautical engineer, acted reasonably in purchasing tax software to help him prepare his return. Additionally, in *Dawson v. Commissioner*,[41] the court found the taxpayers, a building inspector and a registered nurse, reasonably attempted to comply with their reporting requirements by offsetting their gambling winnings with gambling losses. The taxpayer's use of "logic" sufficed for the court.

Complex Issues or Extraordinary Circumstances

The court found reasonable cause to dismiss the penalty when taxpayers litigated a complex issue or were victims of extraordinary circumstances. In *Tateosian v. Commissioner*,[42] the court upheld the IRS's determination that the payments received by the taxpayer were taxable retirement income, not exempt disability payments. However, the court held the taxpayer was not liable for the accuracy-related penalty due to the complex nature of the state retirement laws, compounded by a confusing change in the taxpayer's pension.

Similarly, in *Langroudi v. Commissioner*,[43] the Tax Court sustained the IRS's determination that the tax convention between the United States and Belgium did not apply to the taxpayer's income earned as an anesthetist trainee. However, the court held the taxpayer was not liable for the accuracy-related penalty because the complex nature of the tax treaty caused his tax deficiencies.

Finally, reasonable cause may exist in the extraordinary circumstances in the life of the taxpayer. In *Smith v. Commissioner*,[44] the Tax Court found the taxpayer's life circumstances constituted reasonable cause for failing to report income received from a settlement. After the taxpayer received a small settlement, he lost his job, became temporarily homeless, and suffered expensive health issues for which he had no insurance. The court found these circumstances, coupled with the taxpayer's education level, knowledge, and experience, constituted reasonable cause.

Taxpayers Who Deducted Personal Expenses

The court sustained the accuracy-related penalty in instances where a taxpayer deducted personal expenses. For example, in *Berryman v. Commissioner*,[45] the court sustained the penalty under IRC § 6662(b)(1) because the taxpayers' deductions showed a disregard for the rules and regulations. The taxpayers deducted items such as cat litter, golf balls, college

40 T.C. Memo. 2007-174.

41 T.C. Summ. Op. 2008-17.

42 T.C. Memo. 2008-101.

43 T.C. Summ. Op. 2007-156.

44 T.C. Summ. Op. 2007-106.

45 T.C. Summ. Op. 2007-138.

football tickets, and satellite TV, which the taxpayers claimed related to their association with a direct marketing company that sells health and wellness products.

Son of Boss Litigation

After a decade, Son of Boss[46] tax shelters are finding their way to court. The IRS has assessed negligence and substantial understatement penalties (IRC § 6662(b)(1) & (2)) in most, if not all, Son of Boss cases. The courts, however, came out very differently on Son of Boss cases during our review period. In *Jade Trading, LLC v. Commissioner,*[47] the Court of Federal Claims upheld the IRS's imposition of IRC § 6662 penalties because the transactions yielded tax benefits that were "too good to be true" and a reasonably prudent person, acting as the "tax matters partner," would not have supported such substantial tax losses from a fictional transaction. Additionally, the court found the tax deficiencies met the substantial understatement standard of IRC § 6662(b)(2) in the alternative.

The United States District Court reached a different opinion in *Sala v. United States.*[48] The court found the disputed transaction had legitimate business purposes other than the favorable tax consequences, and therefore the taxpayer was entitled to a full refund of taxes, interest, and penalties. The IRS also sought to offset the taxpayer's refund with an accuracy-related penalty that was never assessed. The court held the government could not assess the penalty because the taxpayer had filed a qualified amended return.[49]

Conclusion

In the cases reviewed for this report, the court often sustained the IRS's determination of a deficiency or a portion of the deficiency, but from time to time the court overruled the IRS on the accuracy-related penalty. The court dismissed or reduced the penalty in 29 percent of the cases. Further, taxpayers who had representation were more than twice as successful in contesting the penalty as were those who were *pro se*.

The results indicate that the court finds 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

46 Son of Boss transactions were designed to inflate the basis of a partnership interest through the partner's contribution of offsetting short-term options. The partner would write and sell a call option and use the proceeds to purchase a counterpart put option. The partner would then contribute the put option to the partnership as an asset and take a higher basis in the partnership. The partner would contribute the call option but take advantage of the classification of call options as contingent obligations so the partner would not have to treat the call as a liability which ordinarily would decrease the partner's basis under IRC § 752(b). The partner would encounter a substantial loss when the put option expired. The net result would be that the partner would recognize this loss to offset a substantial prior or future gain. *See* IRS Notice 00-44, 2000-2 C.B. 255; *Kligfeld Holdings v. Comm'r,* 128 T.C. 192 (2007).

47 100 A.F.T.R.2d (RIA) 7123 (Fed. Cl. 2007), *reconsideration denied by* 101 A.F.T.R.2d (RIA) 1411 (2008).

48 552 F. Supp. 2d 1167 (D. Colo. 2008), *motion for new trial denied*, 102 A.F.T.R.2d (RIA) 5292 (2008).

49 *See* Treas. Reg. § 1.6664-2(c)(2). The underpayment for purposes of assessing the accuracy-related penalty does not include the underpayment reported on a "qualified amended return," which is filed after the due date for the taxable year and before the earliest of (1) the date the IRS first contacts the taxpayer to examine the return; (2) the date that the promoter of a shelter transaction upon which the taxpayer relied on his tax return is contacted by the IRS; (3) the date on which the IRS serves a summons for any activity upon which the taxpayer received a tax benefit for the taxable year; or (4) the date on which the IRS announces a settlement initiative for an abusive transaction for which the taxpayer has received a tax benefit.

whether the taxpayer relied on a competent tax professional and whether the taxpayer had adequate records for claimed deductions. The court also weighed the breadth and sophistication of the taxpayer's tax knowledge, novelty of the substantive legal issues, and extraordinary circumstances.

The IRS should review cases where the court rejected the penalty and incorporate the court's rationale into training and Internal Revenue Manual provisions for its employees. Thereafter, the accuracy-related penalty will not be at issue when cases go to trial on an understatement of tax, thereby lessening the burden on taxpayers, the government, and the court.

MLI #6

Civil Damages for Certain Unauthorized Collection Actions Under Internal Revenue Code Section 7433

Summary

Internal Revenue Code (IRC or the "Code") § 7433 establishes jurisdiction for the United States District Courts, and in certain circumstances the bankruptcy courts, to hear cases for damages sustained in connection with the wrongful collection of any federal tax because an IRS employee recklessly or intentionally, or by reason of negligence, disregarded any provision of the IRC, any IRS regulations, or certain provisions of the Bankruptcy Code. We identified 78 opinions issued between June 1, 2007, and May 31, 2008, that involved a claim for damages for unauthorized collection action under IRC § 7433. The courts affirmed the IRS position in the majority of cases. Taxpayers prevailed in six cases, while three cases resulted in split decisions.

Present Law

IRC § 7433 allows a taxpayer to seek monetary damages in United States District Court in connection with the collection of federal tax if an IRS employee recklessly or intentionally, or by reason of negligence, disregarded any provision of the Code or IRS regulations.[1] An action under IRC § 7433 is the taxpayer's exclusive remedy for recovering damages for wrongful collection resulting from the IRS employee's reckless, intentional, or negligent[2] disregard of such provisions and regulations.[3] A taxpayer may bring suit under IRC § 7433 if the IRS does not follow the rules for proper communication with the taxpayer in connection with the collection of tax in violation of the Fair Debt Collection Practices Act.[4] A taxpayer may also bring suit under IRC § 7433 in connection with the failure to follow the statutory requirements for sale of seized property under IRC § 6335.[5]

A taxpayer may bring an action under IRC § 7433 in a bankruptcy court for pecuniary damages if the IRS willfully violates the automatic stay[6] or discharge[7] provisions of the Bankruptcy Code and any applicable regulations.[8] Notwithstanding § 105 of the

1 IRC § 7433.

2 Taxpayers may bring damage actions for negligent disregard of the Code or regulations that occurred after July 22, 1998. The prior version of IRC § 7433 did not provide a remedy for negligent actions by IRS employees. *See* IRC § 7433(a), prior to amendment by the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3102(a)(1)(A) (July 22, 1998).

3 IRC § 7433(a) and (e)(2). In certain circumstances, taxpayers also can obtain a damage award for the IRS's failure to release a lien. *See* IRC § 7432.

4 IRC § 6304(c).

5 IRC § 6335(e)(4).

6 *See* 11 U.S.C. § 362.

7 *See* 11 U.S.C. § 524.

8 *See* IRC § 7433(e)(1); Treas. Reg. § 301.7433-2.

Bankruptcy Code, an IRC § 7433 damage action is the exclusive remedy for pecuniary damages resulting from such violations.[9]

A taxpayer may recover the actual, direct economic damages sustained as a proximate result of intentional, reckless, or negligent actions of the IRS employee and costs of the action. Economic damages are capped at $100,000 for negligent actions and $1,000,000 for reckless or intentional actions, plus the costs of the action.[10] However, the damages awarded to a taxpayer will be reduced by the amount that reasonably could have been mitigated.[11]

The statutory period for bringing a suit for damages under IRC § 7433 is two years after the right of action accrues.[12] Before bringing a suit, the taxpayer must first exhaust administrative remedies.[13] Treasury Regulations provide that administrative remedies are considered exhausted on the earlier of the date the IRS renders a decision on a properly filed administrative claim for actual, direct economic damages, or if the IRS has not acted on the claim, six months from the date the claim is filed.[14] However, the regulations provide an exception if a taxpayer files an administrative claim in the last six months before the two-year limitations period expires. In such cases, a taxpayer may file the suit at any time from the date when the administrative claim is properly filed and before the limitations period expires.[15]

The regulations establish comprehensive procedures for filing an administrative claim.[16] Such claims must be filed with the IRS Area Director, Attn: Compliance Technical Support Manager, of the area in which the taxpayer resides[17] and must include the following information:[18]

- The taxpayer's name, taxpayer identification number, current address, current home and work telephone numbers, and any convenient times to be contacted;
- The detailed grounds of the claim for damages, including copies of all substantiating documentation and correspondence with the IRS;

9 *See* IRC § 7433(e)(2)(A); Treas. Reg. § 301.7433-2(a)(2); 11 U.S.C. § 105.

10 *See* IRC § 7433(b); Treas. Reg. §§ 301.7433-1 and 301.7433-2.

11 *See* IRC § 7433(d)(2).

12 IRC § 7433(d)(3); Treas. Reg. §§ 301.7433-1(g) and 301.7433-2(g). The regulations provide that a right of action accrues at the time when the taxpayer has had a reasonable opportunity to discover all essential elements of a possible cause of action. *See* Treas. Reg. §§ 301.7433-1(g)(2) and 301.7433-2(g)(2).

13 *See* IRC § 7433(d)(1); Treas. Reg. §§ 301.7433-1(d) and 301.7433-2(d) (actions for the violation of the bankruptcy rules).

14 *See* Treas. Reg. §§ 301.7433-1(d)(i), (ii) and 301.7433-2(d)(i), (ii).

15 *See* Treas. Reg. §§ 301.7433-1(d)(2) and 301.7433-2(d)(2).

16 *See* Treas. Reg. §§ 301.7433-1(e) and 301.7433-2(e).

17 *See* Treas. Reg. §§ 301.7433-1(e)(1) and 301.7433-2(e)(1) (in actions for violation of bankruptcy rules, the administrative claim must be filed with the Chief, Local Insolvency Unit, for the judicial district in which the taxpayer filed the underlying bankruptcy case giving rise to the alleged violation).

18 *See* Treas. Reg. §§ 301.7433-1(e)(2) and 301.7433-2(e)(2) (in actions for violation of bankruptcy rules, the administrative claim must also include the location of the bankruptcy court in which the underlying bankruptcy case was filed and the case number of the case in which the violation occurred).

- A description of the taxpayer's damage-related injuries associated with the claim, including copies of all available substantiating documentation and evidence;
- The amount of the damages, including any reasonably foreseeable future damages related to the claim; and
- The taxpayer's signature or the signature of the duly authorized representative.[19]

Analysis of Litigated Cases

We reviewed 78 cases involving damages for unauthorized collection actions that were litigated between June 1, 2007, and May 31, 2008. Table 6 in Appendix III contains a detailed list of those cases.

Although most taxpayers litigating damages for wrongful collection activity represented themselves (*pro se*), representation did not negatively impact the outcome in cases litigated under IRC § 7433.[20] Taxpayers with representation received full relief in only one case, while *pro se* taxpayers received full or partial relief in eight cases.[21] Exhaustion of administrative remedies, which was litigated in 50 cases, was the most common issue. In 42 of the 50 cases where the issue was raised, the government prevailed.[22] As the court stated in *Hallinan v. United States, pro se* taxpayers filed numerous "boilerplate" complaints in the United States District Court for the District of Columbia alleging violation of IRC § 7433, and many of these "nearly identical" filings were dismissed for failure to exhaust administrative remedies.[23] In four of these cases, taxpayers prevailed on procedural grounds based on the recent United States Supreme Court decision in *Jones v. Bock*,[24] which held that failure to exhaust administrative remedies is an affirmative defense rather than a pleading requirement, and thus, taxpayers "are not required to specially plead or demonstrate exhaustion in their complaints."[25]

For example, in *Olender v. U.S.*, a taxpayer received a letter from the IRS stating that the taxpayer had exhausted all available administrative remedies and should file a civil action for

19 A duly authorized representative is an attorney, certified public accountant, or an enrolled preparer, permitted to represent the taxpayer before the IRS in a good standing, who has a written power of attorney executed by the taxpayer. *See* Treas. Reg. §§ 301.7433-1(e)(2)(v) and 301.7433-2(e)(3); Treas. Cir. 230 § 10.3 (Sept. 26, 2007) (for the definition of enrolled preparers).

20 Eighteen of 78 taxpayers were represented by counsel. Of those 18 cases, the IRS prevailed in 17, and only one resulted in a victory for a taxpayer.

21 *Pro se* taxpayers prevailed in five cases and three cases resulted in split decisions.

22 In one case, the Court of Appeals affirmed the trial court's decision in favor of the government. *See Dorn v. U.S.*, 249 Fed. Appx. 164 (11th Cir. 2007), *aff'g, per curiam*, 99 A.F.T.R.2d (RIA) 1495 (M.D. Fla. 2007), *petition for cert. filed,* No. 07-1445, 76 USLW 3630 (May 12, 2008).

23 *See Hallinan v. U.S.*, 498 F. Supp. 2d 315, 317 (D.D.C. 2007), *appeal dismissed*, 2007 U.S. App. LEXIS 28445 (D.C. Cir. Dec. 4, 2007); *Bennett v. U.S.*, 530 F. Supp. 2d 340, 343 (D.D.C. 2008), *denying reconsideration*, 462 F. Supp. 2d 35 (D.D.C. 2008). *See also Eleson v. U.S.*, 518 F. Supp. 2d 279, 283 (D.D.C. 2007); *Lutz v. U.S.,* 100 A.F.T.R.2d (RIA) 5114 (D.D.C. 2007); *Rae v. U.S.*, 530 F. Supp. 2d 127, 131 (D.D.C. 2008); *Wesselman v. U.S.*, 498 F. Supp. 2d 326, 328 (D.D.C. 2007).

24 549 U.S. 199 (2007).

25 *See Scott v. U.S.*, 275 Fed. Appx. 21 (D.C. Cir. 2008), *remanded per curiam,* 100 A.F.T.R.2d (RIA) 5876 (D.D.C. 2007), *petition for reh'g filed*, No. 07-5310 (D.C. Cir. June 9, 2008). *See also Lindsey v. U.S.*, 532 F. Supp. 2d 144, 149 (D.D.C. 2008); *prior action*, 448 F. Supp. 2d 37 (D.D.C. 2006), *dismissed with prejudice,* 100 A.F.T.R.2d (RIA) 5220 (D.D.C. 2007); *Pollinger v. U.S.*, 539 F. Supp. 2d 242 (D.D.C. 2008), *dismissed without prejudice*, No. 06-1885 (D.D.C. Apr. 16, 2008); *Shane v. U.S.*, 101 A.F.T.R.2d (RIA) 449 (D.D.C. 2008).

damages if he wanted to take further action.[26] Based on the statement the IRS made in the letter, the court found the taxpayer had exhausted his administrative remedies and could recover the costs of the action and any actual economic damages incurred as a proximate result of an IRS employee's actions.[27]

Another common issue litigated by taxpayers was the question of whether the alleged improper IRS conduct arose from activities other than collection.[28] For example, in *Henry v. United States*, the U.S. Court of Appeals for the Seventh Circuit affirmed the district court's dismissal of the taxpayer's claims relating to the IRS's improper assessment of the taxpayer's 1999 tax liability.[29] In that case, the taxpayer sued the IRS and its employees, alleging he was entitled to damages stemming from the issuance of a purportedly fraudulent notice of deficiency. The district court dismissed the suit on other grounds, and the taxpayer appealed. The appellate court concluded that a taxpayer can only recover damages under IRC § 7433 with respect to improper tax collection, but not with respect to improper tax assessment.[30]

Nine of the 78 cases involved a statute of limitations issue. For example, in *Eastman v. United States*, the court considered the issue of whether the taxpayer's action commenced after the applicable statutory period had expired.[31] Generally, a taxpayer may not commence an action under IRC § 7433 before the IRS acts on the administrative claim or six months after the date an administrative claim is filed, whichever is earlier.[32] Although the taxpayers in *Eastman* did not commence their action within either of these periods, the court held the action was still timely because under the applicable regulations, if an administrative claim is filed during the last six months of the two year period for filing suit, as was the case in *Eastman*, the taxpayer may file an action after the administrative claim is filed and before the period of limitations expires.[33]

26 *Olender v. U.S.*, 100 A.F.T.R.2d (RIA) 6047 (M.D. Fla. 2007), *summary judgment granted,* 101 A.F.T.R.2d (RIA) 2519 (M.D. Fla. 2008). The court dismissed the taxpayer's prior complaint because the taxpayer "presented no evidence that he exhausted administrative remedies as required by IRC § 7433(d)(1) and Treas. Reg. § 301.7433-1(d)(1)." *See Olender v. U.S.*, 97 A.F.T.R.2d (RIA) 2196 (M.D. Fla. 2006).

27 *Olender v. U.S.*, 100 A.F.T.R.2d (RIA) 6047 (M.D. Fla. 2007), *summary judgment granted*, 101 A.F.T.R.2d (RIA) 2519 (M.D. Fla. 2008). The court noted that "the Internal Revenue Service cannot explicitly deny further administrative action to the [taxpayer] and then claim administrative remedies have not been exhausted." Id.

28 This issue was raised in 20 of 78 cases. The statute does not provide a cause of action for wrongful tax assessment or other actions that are not specifically related to the collection of tax. *See* IRC § 7433(a) and (e).

29 *Henry v. U.S.,* 101 A.F.T.R.2d (RIA) 2098 (7th Cir. 2008).

30 *Id.* The court also stated that a notice of deficiency merely informs the taxpayer of the amount of the liability and always precedes enforcement, while collection, by contrast, enforces an assessed liability. *See Henry v. U.S.*, 101 A.F.T.R.2d (RIA) 2098 (7th Cir. 2008) (citing *Murray v. Comm'r,* 24 F.3d 901, 903 (7th Cir. 1994); see also IRC § 6213(a).

31 *Eastman v. U.S.*, 101 A.F.T.R.2d (RIA) 1566 (W.D. Ark. 2008).

32 Treas. Reg. §§ 301.7433-1(d)(2)(i), (ii) and 301.7433-2(d)(2)(i), (ii).

33 *Eastman v. U.S.*, 101 A.F.T.R.2d (RIA) 1566 (W.D. Ark. 2008). The government claimed that the taxpayer did not exhaust his administrative remedies before filing the petition although the regulations contain an exception to this requirement if an administrative claim is filed during the last six months of the two year statute of limitations. *Id. See also* Treas. Reg. §§ 310.7433-1(d)(2); 310.7433-1(g).

In another case, *Cox v. United States*,[34] the taxpayers filed suit seeking damages under IRC § 7433 to recover damages for the profits and dividends they allegedly lost as a result of the IRS's improper collection actions. The court concluded the action was untimely and subject to dismissal, as it was commenced more than two years after the alleged improper collection took place.[35]

Three cases involved damage claims stemming from alleged violations of certain bankruptcy procedures.[36] The predominate issue in these three cases was exhaustion of administrative remedies. In *In re Abate*,[37] the United States District Court for the District of New Jersey vacated the bankruptcy court's holding to compel the return of the tax refund seized by the IRS in violation of the bankruptcy discharge and automatic stay provisions of the Bankruptcy Code, because the taxpayer had failed to exhaust his administrative remedies.[38]

In *Cherbanaeff v. United States*,[39] the taxpayers sought damages under IRC § 7433 alleging the IRS had wrongfully levied their Social Security benefits after the statutory period for collection had expired and the IRS had violated the bankruptcy discharge injunction. The Court of Federal Claims dismissed the IRC § 7433 claims, finding the taxpayers' claims involving the alleged wrongful levy needed to be brought in district court and the claims stemming from alleged violations of the bankruptcy discharge injunction needed to be brought in bankruptcy court.[40]

In *Acacia Corporate Mgmt., LLC v. United States*,[41] a corporation filed suit alleging, among other things, that it was entitled to damages under IRC § 7433 stemming from alleged wrongful collection actions the IRS had taken against two individuals who had owned assets that the corporation subsequently acquired. The court dismissed the IRC § 7433 claims, finding the corporation lacked standing to sue for damages because only a taxpayer, and not a third party, can sue for damages under IRC § 7433.[42]

Conclusion

This is the second year that the issue of damages for unauthorized collection actions under IRC § 7433 has appeared in the National Taxpayer Advocate's Annual Report to Congress. The increase in these cases is due in large part to the filing of the series of nearly identical complaints dismissed for failure to exhaust administrative remedies, which were

34 *See Cox v. U.S.*, 101 A.F.T.R.2d (RIA) 991 (E.D. Cal. 2008).

35 *See Id.*

36 IRC § 7433(e).

37 *In re Abate*, 101 A.F.T.R.2d (RIA) 1806 (D.N.J. 2008), *vacating* No. 05-19745, 2007 Bankr. LEXIS 2139 (Bankr. D.N.J. May 29, 2007).

38 *Id.*

39 98 A.F.T.R.2d (RIA) 6772 (S.D.Miss. 2006).

40 *See Cherbanaeff v. U.S.*, 77 Fed. Cl. 490 (2007), *appeal docketed*, No. 2007-5166 (Fed. Cir. Aug. 29, 2007), *appeal dismissed*, 253 Fed. Appx. 23 (Fed. Cir. 2007), *appeal reinstated*, 257 Fed. Appx. 275 (Fed. Cir. 2007); *see also* IRC § 7433(e)(1); Treas. Reg. § 301.7333-2.

41 101 A.F.T.R.2d (RIA) 772 (E.D. Cal. 2008).

42 *Id.*

apparently inspired by templates found on the Internet. Although the cases discussed herein were dismissed primarily on procedural grounds, it is unclear whether taxpayers will continue to file these complaints in such high numbers. The courts' routine rejection of the arguments contained in these complaints may curtail them in the future.

MLI #7

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 66 decisions issued by the federal court system from June 1, 2007, to May 31, 2008, 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. The Tax Court remanded one case to determine a preliminary issue not addressed in the original hearing. Eight of the cases resulted in split decisions. Thirty-five cases involved imposition of the estimated tax penalty in conjunction with the failure to file penalty, three cases involved the estimated tax penalty without the failure to file penalty, and the remaining 28 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. 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 year or 100 percent of the tax shown on the taxpayer's return for the previous 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:

- The tax due is less than $1,000;[13]
- The taxpayer has no tax liability for the preceding 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 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 66 opinions issued between June 1, 2007, and May 31, 2008, where the failure to file penalty or the estimated tax penalty was in dispute. All but four of these cases were litigated in the United States Tax Court. A detailed list of these cases appears in Table 7 in Appendix III. Forty-three cases involved individual taxpayers and 23 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 47 cases in which taxpayers appeared *pro se*, or without counsel, five cases resulted in split decisions, and the Tax Court remanded one for a rehearing. Of the 19 cases in which taxpayers appeared with representation, none were resolved in the taxpayer's favor, and only three ended in split decisions.

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 34 of the 66 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 a return on time.[21] However, the court disallowed reasonable cause and found willful neglect where a taxpayer engaged in other business ventures during a claimed period of illness.[22] Similarly, where the taxpayer's medical condition and treatment do not affect the taxpayer's ability to file a return for a different tax year, the court will not find reasonable cause.[23] We found no cases in which a taxpayer successfully established reasonable cause because of a medical illness.
- **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 and flawed reading of a tax code provision, the taxpayer does not have reasonable cause.[24] A taxpayer may not rely on the mistaken assumption that tax withholdings relieved the taxpayer from filing a return because he or she owed no further tax.[25] A court also declined to find reasonable cause where the taxpayer argued that she mistakenly relied on an alleged agreement with her spouse to include her on a joint return.[26]

19 *See, e.g., Harbour v. Comm'r*, T.C. Memo. 1991-532 (the taxpayer's coma occurring the month before the due date of his tax return was a 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 *See Tomlinson v. Comm'r,* T.C. Summ. Op. 2007-210 (the taxpayer's care of her dependent brother was not sufficient for reasonable cause when the taxpayer engaged in other business activities and the care ended several months prior to the extended due date of the return).

22 *McClain v. Comm'r*, T.C. Summ. Op. 2007-175.

23 *Kopty v. Comm'r*, T.C. Memo. 2007-343, *appeal docketed*, No. 08-1171 (D.C. Cir. Apr. 30, 2008).

24 *Ballmer v. Comm'r*, T.C. Memo. 2007-295.

25 *Joubert v. Comm'r*, T.C. Memo. 2007-292.

26 *Conner v. Comm'r*, T.C. Summ. Op. 2007-131.

- **Reliance on Agent:** The Supreme Court, in *United States v. Boyle*, held that taxpayers have a non-delegable duty to file a return on time, and a taxpayer's reliance on an agent does not excuse a failure to file.[27] Thus, a taxpayer's failure to file due to criminal embezzlement by a bookkeeper was not reasonable cause.[28] 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.[29] Similarly, the court rejected a taxpayer's reasonable cause claim when the taxpayer failed to show he relied on professional advice regarding the duty to file despite the court recognizing the reasoned advice of a professional might establish reasonable cause.[30]
- **"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.[31] Some taxpayers claim 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*.[32] A "zero return" does not constitute a tax return for purposes of the failure to file penalty of IRC § 6651(a)(1).[33] 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.[34] In addition to the failure to file penalty, the courts imposed a frivolous issue penalty on 12 of the 24 taxpayers who presented frivolous arguments.[35]
- **Overpayment of previous tax liability:** One taxpayer argued the failure to file penalty was improper because he was entitled to a refund for an overpayment of tax for the previous year.[36] He argued the refund was sufficient to cover his liability and therefore he was not required to file a return.[37] However, because the taxpayer submitted his claim for the refund after the three-year limitation established by IRC § 6511(b)(2)(A), the Tax Court remanded the issue to the IRS Office of Appeals to determine whether the taxpayer was entitled to a suspension of that time limit.[38]

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27 469 U.S. 241, 252 (1985).

28 *A Better Plumbing Service, Inc. v. U.S.*, 533 F. Supp. 2d 1233, 1244 (N.D. Ga. 2008) (reliance on corporate agent may only be reasonable cause where the agent makes it objectively impossible for the taxpayer to meet its obligations).

29 *Estate of Zlotowski v. Comm'r*, T.C. Memo. 2007-203.

30 *New York Guangdong Finance, Inc. v. Comm'r*, T.C. Memo. 2008-62 at 11.

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

32 *Cabirac v. Comm'r*, T.C. Memo. 2008-142 (also holding that the failure to pay penalty under section 6651(a)(2) is inapplicable to a zero return when the IRS does not prepare a substitute for return (SFR) in accordance with IRC § 6020(b)); *Phillips v. Comm'r*, T.C. Memo. 2008-9.

33 *Phillips v. Comm'r*, T.C. Memo. 2008-9 at 3.

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

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

36 *Perkins v. Comm'r*, T.C. Memo. 2008-103.

37 *Id.* at 4.

38 *Perkins v. Comm'r*, T.C. Memo. 2008-103 at 9.

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.[39] Although the court recognized that it lacked jurisdiction to rule on the issue, the Tax Court in *Alston v. Commissioner* indicated a taxpayer would be subject to the estimated tax penalty if he or she failed to make a required installment even if the taxpayer's total payments exceeded his or her total tax liability.[40] In six of the cases where the taxpayers prevailed on the estimated tax penalty, their success was a result of the IRS either conceding the issue or failing to produce evidence that the taxpayer filed a return for the preceding year and had a corresponding liability.

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.[41]

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 penalty for taxpayers who comply with their filing obligations, but in an untimely manner.[42] 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.

39 *See Bray v. Comm'r*, T.C. Memo. 2008-113.

40 T.C. Summ. Op. 2007-155 at 2 n.9.

41 *See* Policy Statement 20-1 (formerly P-1-18), Internal Revenue Manual (IRM) 1.2.20.1.1 (Aug. 28, 2007); *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.").

42 *See* National Taxpayer Advocate 2001 Annual Report to Congress 188. This provision was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003. *See* H.R. 1528, 108th Cong. § 106 (2003). Although the IRS has provided for a one-time administrative waiver of the 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 #8

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[1] or tax due. Joint and several liability enables 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. IRC § 6015(b) provides "traditional" relief for deficiencies. IRC § 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. IRC § 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 50 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2007, and May 31, 2008. Procedural issues and the merits of the taxpayer's claim were frequent subjects of litigation. Although the cases produced no substantive changes in the law, the court continued to resolve jurisdictional questions stemming from passage of the Tax Relief and Health Care Act of 2006 (TRHCA).[3] TRHCA amended IRC § 6015(e) to provide that the U.S. Tax Court has jurisdiction in stand-alone cases[4] to review IRC § 6015(f) determinations where no deficiency has been asserted.[5] The number of cases involving procedural issues has diminished this year. This decrease is likely due to the passage of TRHCA expressly providing that the Tax Court has jurisdiction to decide IRC § 6015(f) cases where no deficiency had been asserted.

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." The terms are nearly identical, but there are sometimes semantic differences. Compare IRC § 6211 (defining "deficiency" as the excess of the taxpayer's correct liability over the amount shown on the return, adjusted for other assessments and rebates) with IRC § 6662(d)(2)(A) (defining "understatement" as the excess of the amount of tax required to be shown on the return over the amount of the tax imposed which is shown on the return, reduced by any rebate).

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.

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

4 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.

5 TRHCA also modified IRC § 6015(e)(1)(B), the provision regarding collection restrictions, to include IRC § 6015(f) claims. As a result, the IRS is now prohibited by law from pursuing certain collection activity against taxpayers who request relief only under IRC § 6015(f), and the period of limitations on collection is likewise suspended while the collection restrictions remain in effect. If, however, an IRC § 6015 claim was filed before the December 20, 2006, effective date of the amendment, the period of limitations on collection will be suspended beginning on December 20, 2006, and not from the date the claim was originally filed. Notice CC-2007-13 (June 8, 2007).

In response to several recent district court decisions which did not allow a taxpayer to raise IRC § 6015 as a defense, the National Taxpayer Advocate proposed in the 2007 Annual Report to Congress that IRC § 6015 be amended to, among other things, clarify that taxpayers may raise relief from joint and several liability as an affirmative defense in any proceeding brought under any provision of Title 26 or in any case under Title 11 of the United States Code.[6] The issue of whether a taxpayer can raise IRC § 6015 as a defense in district court proceeding remains the subject of litigation and is discussed in several case summaries below.[7]

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;
2. There was an understatement of tax[8] attributable to erroneous items[9] of the nonrequesting spouse;
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[10] with respect to him or her.

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6 National Taxpayer Advocate 2007 Annual Report to Congress 466. *See also United States v. Boynton*, 99 A.F.T.R.2d (RIA) 920 (S.D. Cal. 2007) (holding that the district court only has jurisdiction to consider an IRC § 6015 claim in the context of a refund suit and exclusive jurisdiction for review of the claim lies with the Tax Court in all other circumstances); *United States v. Cawog*, 97 A.F.T.R.2d (RIA) 3069 (W.D. Pa. 2006), *appeal dismissed* (3d Cir. July 5, 2007) (holding that exclusive jurisdiction to review an IRC § 6015 determination lies with the Tax Court and refusing to allow the taxpayer to raise the defense in the foreclosure action).

7 *United States v. Bucy*, 100 A.F.T.R.2d (RIA) 6666 (S.D. W. Va. 2007) (holding that IRC § 6015(f) could not be raised as a defense in a suit to reduce assessment to judgment); *United States v. Wilson*, 100 A.F.T.R.2d (RIA) 6849 (E.D. Ark. 2007) *appeal docketed* No. 08-1242 (8th Cir. Jan. 29, 2008) *appeal dismissed* (Feb. 27, 2008) (holding that IRC § 6015 could not be raised as a defense in an erroneous refund suit); *Walker v. United States*, 101 A.F.T.R.2d (RIA) 1013 (D.N.J. 2008) (holding that the taxpayer is not entitled to raise IRC § 6015 as a defense in a quiet title action because a taxpayer cannot challenge the validity of the underlying tax liability in this type of proceeding).

8 There is an understatement of tax when the amount of tax required to be shown on the return is greater than the amount of tax actually shown on the return. *See* IRC §§ 6015(b)(3); 6662(d)(2)(A).

9 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).

10 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).

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 him or her.[11]

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.[12] Additionally, relief is not available for amounts attributable to fraud, fraudulent schemes, or certain transfers of disqualified assets.[13]

Equitable Relief Under IRC § 6015(f)

IRC § 6015(f) provides that the Secretary may relieve a taxpayer from liability for both deficiencies and underpayments[14] where the taxpayer demonstrates that:

1. Relief under IRC § 6015(b) or (c) is unavailable;
2. Taking into account all the facts and circumstances, it would be inequitable to hold the taxpayer liable for the underpayment or deficiency; and
3. The election was made within two years after the IRS began collection activities[15] with respect to the taxpayer.

Revenue Procedure 2003-61 lists some of the factors the IRS considers in determining whether equitable relief is appropriate.[16] These factors include marital status, economic hardship, knowledge or reason to know, legal obligations of the nonrequesting spouse, significant benefit to the requesting spouse, compliance with income tax laws, and abuse. Unlike IRC § 6015(b) and (c), which relieve taxpayers from liability for deficiencies

11 See note 10, *supra*, for a discussion of what constitutes "collection activity" under IRC § 6015.

12 IRC § 6015(c)(3)(C).

13 IRC §§ 6015(c)(4); 6015(d)(3)(C).

14 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).

15 Treas. Reg. § 1.6015-5(b). See note 10, *supra*, for a discussion of what constitutes "collection activity" under IRC § 6015.

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

in tax, IRC § 6015(f) provides equitable relief from liability for both deficiencies and underpayments.

Rights of Nonrequesting Spouse

The individual with whom the requesting spouse filed the joint return is generally referred to as a "nonrequesting spouse." IRC § 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.[17] 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 Appeals.[18] However, the Appeals decision is the final decision with respect to the nonrequesting spouse. The nonrequesting spouse does not have the right to petition the Tax Court in response to the IRS's administrative determination regarding IRC § 6015 relief.[19] If, however, 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.[20] The nonrequesting spouse may intervene to dispute or support the requesting spouse's claim for relief.[21] The nonrequesting spouse who has intervened in the Tax Court proceeding, however, has no standing to appeal the Tax Court's decision to the United States Court of Appeals.[22]

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 to speed processing.[23] After reviewing the request, the IRS issues a final notice of determination, granting or denying relief in whole or in part. The taxpayer has 90 days from the date the IRS mails this notice to file a petition with the Tax Court.[24] However, the taxpayer can still petition the court if he or she does not receive a final notice of determination within six months of filing Form 8857.[25] The taxpayer may also raise relief from joint and several liability in a collection due process (CDP) proceeding,[26] a deficiency proceeding,[27]

17 IRC § 6015(h)(2).

18 Rev. Proc. 2003-19, 2003-5 C.B. 371 (Feb. 3, 2003).

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

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

21 *Id.*

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

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

24 IRC § 6015(e)(1)(A)(ii).

25 IRC § 6015(e)(1)(A)(i)(II).

26 IRC §§ 6320(c); 6330(c)(2)(A)(i).

27 IRC § 6213; *Corson v. Comm'r*, 114 T.C. 354, 363 (2000).

a bankruptcy proceeding,[28] or a refund suit.[29] The issue of whether relief from joint and several liability can be raised as a defense in various district court proceedings has been the subject of litigation that will be discussed later.

Analysis of Litigated Cases

We analyzed 50 opinions issued between June 1, 2007, and May 31, 2008. Forty-two cases were decided in the Tax Court, two were decided in the Court of Appeals for the Ninth Circuit, and the Sixth and Seventh Circuits each decided one case. Finally, three cases were decided in U.S. District Courts and one in the Bankruptcy Court. Seventy-six percent of the cases (38 of 50) were decided in favor of the IRS, 22 percent (11 of 50) in favor of the taxpayer and two percent (one of 50) ended in split decisions. In 54 percent (27 of 50) of the cases, the taxpayers were *pro se* (*i.e.*, they represented themselves). The nonrequesting spouse intervened in ten percent of the cases (five of 50).

Seventy-two percent of the cases (36 of 50) involved an analysis of whether to grant relief, a 15 percent increase from last year. Thirty-four percent (17 cases) involved procedural issues, with 76 percent (13 of 17) of these cases decided in favor of the IRS and 24 percent (four of 17) in favor of the taxpayer (including one case where only the intervenor opposed granting relief and that was dismissed for failure to prosecute).[30]

Of the 36 cases decided on the merits, 72 percent (26 of 36) were decided in favor of the IRS, 25 percent (nine of 36) in favor of the taxpayer, and in three percent (one case) the court split its decision. See Table 8 in Appendix lll for a detailed breakdown of the cases.

Procedural Issues

This year saw a reduction in the number of cases involving procedural issues.[31] Last year, the issue of whether the Tax Court has jurisdiction to review IRC § 6015(f) determinations in stand-alone proceedings was frequently litigated.[32] This year, the procedural issues were more diverse. The courts addressed questions such as whether the court may consider evidence introduced at trial which was not part of the administrative record,[33] the extent of

28 11 U.S.C.A. §§ 502, 505(a)(1). *See, e.g.*, *Hinckley v. United States*, 256 B.R. 814 (Bankr. M.D. Fla. 2000).

29 IRC § 7422.

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

31 In the 2007 report, 43 percent of the cases involved procedural issues whereas only 34 percent of the cases in this year's report are procedural in nature. *See* National Taxpayer Advocate 2007 Report to Congress 629.

32 In the 2007 report, 60 percent of the procedural cases addressed the Tax Court's ability to hear stand-alone IRC § 6015(f) cases. *See* National Taxpayer Advocate 2007 Report to Congress 626-633.

33 *See, e.g.*, *Porter v. Comm'r*, 130 T.C. No.10 (2008) (holding that the Tax Court may consider evidence introduced at trial which was not included in the administrative record in reviewing denial of IRC § 6015(f) relief).

the rights of intervening spouses,[34] and whether IRC § 6015 could be raised as an affirmative defense in proceedings outside the Tax Court.[35]

Porter v. Commissioner

In *Porter v. Commissioner*,[36] the Tax Court held that in determining whether a taxpayer is eligible for relief under IRC § 6015(f) the court may consider evidence introduced at trial which was not included in the administrative record.[37] In this case, the IRS issued a notice of determination denying the taxpayer's request for relief under IRC § 6015(f), and the taxpayer filed a Tax Court petition seeking review of the determination under IRC § 6015(e). The IRS argued the Tax Court should limit the record to only the evidence considered by the IRS when it made its IRC § 6015(f) determination. The court disagreed, finding that the Administrative Procedure Act, [38] which limits the scope of judicial review to the administrative record, was not applicable to Tax Court proceedings, including IRC § 6015 proceedings. Further, the court found 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 court concluded the use of this term meant that Congress intended the court to have *de novo* review authority for IRC § 6015 cases. Although a case involving this issue is pending in the U.S. Court of Appeals for the 11th Circuit, no Court of Appeals has yet ruled on this issue.[39]

Green v. Commissioner

In *Green v. Commissioner*,[40] the Tax Court held that it lacked jurisdiction under IRC § 6015(e) to review a denial of IRC § 6015(f) claim for tax years for which the liability was paid in full prior to December 20, 2006. As discussed previously, TRHCA[41] 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

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34 *See, e.g., Edwards v. Comm'r*, T.C. Summ. Op. 2007-193 which involved a tax year before the effective date of TRHCA (holding that the Tax Court does not have jurisdiction to review the IRS's decision to grant IRC § 6015 relief to the electing spouse in a stand-alone proceeding and that the non-electing spouse is only afforded a right to notice and an opportunity to intervene once the electing spouse has initiated a proceeding in court under IRC § 6015(e)); *Fain v. Comm'r*, 129 T.C. 89 (2007) (holding that a nonrequesting spouse's right to intervene survives death).

35 *See, e.g., U.S. v. Bucy*, 100 A.F.T.R.2d (RIA) 6666 (S.D. W. Va. 2007) (holding that the taxpayer was not entitled to raise IRC § 6015(f) as a defense in a suit to reduce assessment to judgment because he had not raised the IRC § 6015(f) claim administratively prior to commencement of suit); *Walker v. U.S.*, 101 A.F.T.R.2d (RIA) 1013 (D.N.J. 2008) (holding that the taxpayer was not entitled to raise IRC § 6015 as a defense in a quiet title action because the taxpayer cannot normally challenge the validity of the underlying tax liability in this type of proceeding); *Waggoner v. U.S.*, 100 A.F.T.R.2d (RIA) 6426 (Bankr. N.D. Tex. 2007) (holding that the taxpayer could not use an innocent spouse defense to counter a motion to vacate a default judgment).

36 130 T.C. No.10 (2008).

37 This holding is consistent with the Tax Court's prior holding in *Ewing v. Comm'r*, 122 T.C. 32 (2004), *vacated on jurisdictional grounds*, 439 F.3d 1009 (9th Cir. 2006).

38 5 U.S.C. §§ 551-559, 701-706 (2000).

39 *See Neal v. Comm'r*, T.C. Memo. 2005-201, *appeal docketed*, No. 06-14357-JJ (11th Cir. Aug. 10, 2006).

40 T.C. Memo. 2008-28.

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

added). The amendment, however, applies only with respect to liability for taxes arising or remaining unpaid on or after December 20, 2006. The Tax Court, therefore, cannot review IRC § 6015(f) determinations where the liability arose and was paid before that date.[42] Consequently, in *Green*, because the IRS never issued a notice of deficiency and the taxpayer's liabilities did not arise or remain unpaid on or after December 20, 2006, the Tax Court lacked jurisdiction over the taxpayer's claim.

United States v. Wilson

In *United States v. Wilson*,[43] the government filed suit against a husband and wife, seeking recovery of an erroneous refund. The wife, among other things, argued she was entitled to the refund as an innocent spouse under IRC § 6015(f). The court concluded that in a suit to recover an erroneous refund under IRC § 7405, a taxpayer could not raise IRC § 6015(f) because IRC § 6015 relief is only available with respect to an "unpaid tax or deficiency" and in this case the government does not attempt to collect or reduce to judgment any unpaid tax or deficiency, but rather seeks a judgment to recover its erroneous payment of a refund.

Walker v. United States

In *Walker v. United States*,[44] the district court held that in a quiet title action filed against the United States under 28 U.S.C. §§ 1346(a)(1) and 2410(a)(1), the taxpayer may contest the procedures followed by the IRS in filing its tax liens but may not contest the underlying tax liability.[45] Thus, the court did not have jurisdiction to consider the taxpayer's request for relief under IRC § 6015 as such a request pertains directly to the underlying tax liability.

United States v. Bucy

In *United States v. Bucy*,[46] the District Court for the Southern District of West Virginia held the taxpayer was not entitled to relief under IRC § 6015 because the taxpayer provided no evidence to support a claim under IRC § 6015(b) or (c). The court also held that the exclusive means of seeking equitable relief under IRC § 6015(f) is for the taxpayer to file a timely claim with the IRS and if the claim is denied to seek review of the claim in the Tax Court in a stand-alone proceeding where jurisdiction is predicated on IRC § 6015(e). The court did not address the fact that the statutory language of IRC § 6015(e)(1)(A) expressly provides that jurisdiction under IRC § 6015(e) is not exclusive, but rather is "[i]n addition to any other remedy provided by law." In contrast, the Tax Court held in *Thurner v.*

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42 *See Bock v. Comm'r*, T.C. Memo. 2007-41; *Smith v. Comm'r*, T.C. Memo. 2007-117. *See also* Notice CC- 2007-13 (June 8, 2007) (providing procedures for Chief Counsel attorneys handling cases affected by the new legislation).

43 100 A.F.T.R.2d (RIA) 6849 (E.D. Ark. 2007) *appeal docketed*, No. 08-1242 (8th Cir. Jan. 29, 2008), *appeal dismissed* (Feb. 27, 2008).

44 101 A.F.T.R.2d (RIA) 1013 (D.N.J. 2008).

45 *See Elias v. Connett*, 908 F.2d 521, 527 (9th Cir. 1990) (holding that in a quiet title action where jurisdiction is predicated on 28 U.S.C. § 2410, a taxpayer cannot collaterally attack the merits of the tax assessment); *Pollack v. United States,* 819 F.2d 144, 145 (6th Cir. 1987) (holding that in an action under 28 U.S.C. 2410, the parties cannot challenge the underlying liability).

46 100 A.F.T.R.2d (RIA) 6666 (S.D. W. Va. 2007).

Commissioner[47] that *res judicata* barred the taxpayer from raising IRC § 6015 as a defense in the Tax Court proceeding because the taxpayer could have raised IRC § 6015 as a defense in a prior collection suit. These decisions, if read together, would preclude this taxpayer from raising relief under IRC § 6015(f) as a defense at all, as the district court contends it lacks the authority to consider the defense and it must raised in Tax Court, while the Tax Court contends *res judicata* would bar consideration of the defense in Tax Court as the defense could have been raised in the collection suit. The National Taxpayer Advocate disagrees with the *Bucy* decision and believes a taxpayer should be able to raise relief under IRC § 6015 as a defense in a collection suit, and has thus recommended that Congress enact legislation to clarify that a taxpayer can raise this defense in a collection suit.[48]

Petrane v. Commissioner

In *Petrane v. Commissioner*,[49] the taxpayer filed a Tax Court petition seeking review of the IRS's denial of her IRC § 6015 claim under IRC § 6015(e) and requesting that the proceeding be conducted under IRC § 7463 as a "small tax case."[50] The total amount of tax, penalty, and interest for which the taxpayer sought relief did not exceed $50,000 for any single year, but the total tax, penalty, and interest at issue for all the years did exceed $50,000.

IRC § 7463(f)(1) provides that if a petitioner files "a petition to the Tax Court under IRC § 6015(e) in which the amount of relief sought does not exceed $50,000" the case may be heard as a small tax case. The IRS argued and the Tax Court agreed that the dollar limitation in IRC § 7463(f)(1) references an aggregate amount rather than an amount determined by reference to a discrete taxable year. Accordingly, the Tax Court held that for a case under IRC § 6015(e) to come within the dollar limitation prescribed in IRC § 7463(f)(1), "the amount of paid and unpaid tax, interest, and penalties, including accrued but unassessed interest and penalties, for which relief is sought" must not exceed the $50,000 threshold, and the date the petition is filed is the date on which the amount of aggregate relief should be calculated. Because the taxpayer's aggregate tax liability in *Petrane* for the years at issue on the date of the petition exceeded $50,000, the case did not qualify as a small tax case under IRC § 7463(f)(1).

Review on the Merits

While the courts considered many factors in determining the appropriateness of relief on the merits under IRC § 6015, the most significant 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'

Most Litigated Issues

47 121 T.C. 43 (2003).

48 National Taxpayer Advocate 2007 Annual Report to Congress 466.

49 129 T.C. 1 (2007).

50 Small tax cases, often referred to as "S" cases, as discussed in IRC § 7463, are limited to certain types of cases involving $50,000 or less. Proceedings in "S" cases are less formal than in a regular Tax Court case, and as a result often lead to speedier disposition of the case. "S" case decisions are not appealable.

analyses.[51] Actual or constructive knowledge was a factor in 30 of the 38 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 continue to be jointly and severally liable for the tax that must 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. Adoption of such a proposal would eliminate the need for innocent spouse relief and the attendant inquiry into a spouse's knowledge.[52]

Conclusion

The passage of the TRHCA amendments, which provided the Tax Court with jurisdiction to review IRC § 6015(f) determinations in stand-alone cases where no deficiency has been asserted, decreased the amount of litigation regarding procedural issues in this area. The procedural issue of whether the court can look beyond the administrative record in reviewing IRC § 6015(f) determinations will continue to generate litigation, as a U.S. Court of Appeals has yet to consider the issue.

Further, the alarming trend of restricting a taxpayer's ability to raise IRC § 6015 as a defense in district court proceedings continued, as evidenced by the three district court decisions that prohibited the taxpayer from raising IRC § 6015 as a defense. Last year, in response to several similar district court decisions limiting the taxpayer's ability to raise innocent spouse relief, the National Taxpayer Advocate proposed that IRC § 6015 be amended to, among other things, clarify that taxpayers may raise relief from joint and several liability as an affirmative defense in district court proceedings.[53] In light of the increasing number of district court opinions that preclude taxpayers from raising innocent spouse relief as a defense, passage of the legislative correction proposed in the 2007 Annual Report may be the only means of ensuring that taxpayers can raise innocent spouse relief as a defense when engaged in tax litigation with the government in district court cases.

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51 *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).

52 National Taxpayer Advocate 2005 Annual Report to Congress 407.

53 National Taxpayer Advocate 2007 Annual Report to Congress 466.

MLI #9

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

Summary

During the 12 months between June 1, 2007, and May 31, 2008, the federal courts issued decisions in at least 45 cases involving the Internal Revenue Code (IRC) § 6673 "frivolous issues" penalty and at least nine cases involving an analogous penalty at the appellate level.[1] These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal.[2] In 12 of the 38 cases involving IRC § 6673, the United States Tax Court decided not to impose the penalty but warned taxpayers they could face sanctions in the future for similar conduct.[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 the court 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 Court exercises its discretion, *sua sponte*,[8] to impose the

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 49.

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., Anderson v. Comm'r*, T.C. Memo. 2007-265, *appeal docketed* (1st Cir. Jan. 22, 2008).

4 *See Dunn v. IRS*, 99 A.F.T.R.2d (RIA) 3464 (E.D. Mich. 2007).

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* Internal Revenue Manual (IRM) 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.*, IRM 35.10.2 (Aug. 11, 2004).

8 *"Sua sponte"* is a term that means without prompting or suggestion. Thus, for conduct that the Tax Court finds particularly offensive, the court can choose to impose a penalty under IRC § 6673 even if the IRS has not requested that the penalty be imposed. *See, e.g., Boggs v. Comm'r,* T.C. Memo. 2008-81. In this case, the Tax Court imposed a penalty of $10,000 because the court had repeatedly warned the taxpayers that position was frivolous. Taxpayers argued that they had no income, just a return of human capital.

penalty. 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 list of cases in Table 9 of Appendix lll includes nine cases we identified in which U.S. Courts of Appeals considered sanctions under other authorities.

Analysis of Litigated Cases

We analyzed 45 opinions issued between June 1, 2007, and May 31, 2008, which addressed the IRC § 6673 penalty. Thirty-eight of these opinions were issued by the Tax Court and seven by U.S. Courts of Appeals on appeals brought by taxpayers who sought review of the Tax Court's imposition of the penalty. Notably, the Courts of Appeals sustained the Tax Court's imposition of the penalty in all of the seven cases they decided. A detailed listing of all cases is presented in Table 9 of Appendix lll. In 26 cases, the Tax Court imposed a penalty under IRC § 6673, with the amounts ranging from $1,000 to $25,000. We identified only four cases that involved business taxpayers (*i.e.*, a taxpayer filing a Form 1040, *U.S. Individual Income Tax Return*, with a Schedule C, E, or F). Four taxpayers were represented by attorneys; all other taxpayers 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

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9 IRC § 7433(a) allows taxpayers a cause of action against the IRS, as follows:

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

10 IRC § 6673(b)(1).

11 IRC § 7482(c)(4) provides that the United States Courts of Appeals and the United States Supreme Court have the authority to impose a penalty in any case where the Tax Court's decision is affirmed 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 of the appellee.

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

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

- **Citizens of certain states are not part of the United States:** At least two taxpayers argued the states in which they reside are not part of the United States, and therefore they are not U.S. residents subject to income taxes.[15]
- **IRS forms and notices violate the Paperwork Reduction Act:** Several taxpayers argued the forms and notices they received (or allegedly received) violated the Paperwork Reduction Act.[16]
- **Failure to prosecute:** Taxpayers in at least four cases failed to prosecute the case and were assessed the frivolous issues penalty for instituting a suit for the purposes of delay.[17]
- **IRS forms do not display a valid Office of Management and Budget (OMB) control number:** At least four taxpayers argued that tax forms were invalid because they do not display an OMB control number.[18]
- **Income is a return of human capital:** In *Boggs v. Commissioner*, the taxpayers argued that depreciation of human life in exchange for labor hours should be treated similarly to depreciation on machinery allowed for corporations.[19] As such, the taxpayer argued that income is a private contract in exchange for the loss of hours of life and not taxable under the 16th Amendment.[20] At least two other taxpayers made similar arguments based on the theory that income is a return of human capital or an exchange for the depreciation of the human body.[21]
- **Income earned is not taxable income:** Taxpayers in at least 11 cases argued that they did not have any taxable income based on their interpretation of the IRC or the Constitution. In *Connolly v. Commissioner*, the taxpayer argued he was not engaged in the trade or business of cotton or distilled spirits in the tax years in question and therefore he had no taxable income because only the revenue made from involvement

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

15 *See, e.g., Williamson, et. al., U.S. v.*, 244 Fed. Appx. 900 (10th Cir. 2007), *aff'g* 97 A.F.T.R.2d (RIA) 810 (D.N.M. 2005).

16 *See, e.g., Moore v. Comm'r*, T.C. Memo. 2007-200.

17 *See, e.g., Long v. Comm'r*, T.C. Memo. 2008-1.

18 *See, e.g., Colorado Mufflers Unlimited, Inc. v. Comm'r*, T.C. Memo. 2007-222.

19 *Boggs v. Comm'r*, T.C. Memo. 2008-81.

20 *Id.*

21 *See, e.g., Richards v. Comm'r*, 101 A.F.T.R.2d (RIA) 1637 (10th Cir. 2008).

in those trades or businesses is taxable.[22] The taxpayer in *Rhodes v. Commissioner* asserted that compensation in exchange for services is not taxable under the 16th Amendment to the Constitution unless it is apportioned [23]

- **The income tax is unconstitutional:** At least two cases presented the argument that the income tax is unconstitutional or that the 16th Amendment as a whole is unconstitutional.[24]

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.[25] The taxpayer avoided the IRC § 6673 penalty in only seven 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 the purpose of delay. Where the IRS has not requested the penalty, the court often raises the issue *sua sponte* and in many cases chooses to impose the penalty or caution the taxpayer that similar future behavior will result in a penalty.[26] 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, 2007, and May 31, 2008, and will often impose further appellate level sanctions on taxpayers who assert frivolous arguments.

22 *Connolly v. Comm'r*, T.C. Memo. 2008-95.

23 *Rhodes v. Comm'r*, T.C. Memo. 2007-206, *appeal docketed*, No. 08-60093 (5th Cir. Jan. 22, 2008), *appeal dismissed* (Apr. 9, 2008).

24 *See Williamson, et. al., U.S. v.*, 244 Fed. Appx. 900 (10th Cir. 2007), *aff'g* 97 A.F.T.R.2d (RIA) 810 (D.N.M. 2005); *Richards v. Comm'r,* 101 A.F.T.R.2d (RIA) 1637 (10th Cir. 2008).

25 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 599-603.

26 *See, e.g., Boggs v. Comm'r,* T.C. Memo. 2008-81.

MLI #10 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 34 federal court opinions issued between June 1, 2007, and May 31, 2008. Over the past two years, the number of family status cases has declined. For example, in the National Taxpayer Advocate's 2007 Annual Report to Congress, we reviewed 41 family status cases[5] and the 2006 Annual Report covered 46 cases.[6] Many of these cases included multiple family status issues, with the determination of one issue often affecting others. For example, a denial of the dependency exemption will lead to the summary denial of the child tax credit and may jeopardize 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.[7] These family status provisions potentially affect 81.4 million taxpayers and 79.6 million children.[8] Effective for tax years after December 31, 2004, the Working Families Tax Relief

1 Internal Revenue Code (IRC) § 2(b).

2 IRC § 24.

3 IRC § 32.

4 IRC § 151.

5 National Taxpayer Advocate 2007 Annual Report to Congress 660.

6 National Taxpayer Advocate 2006 Annual Report to Congress 555.

7 *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).

8 IRS Compliance Data Warehouse, Individual Returns Transaction File for Tax Year 2006.

Act (WFTRA)[9] 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.[10] 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.[11] Under UDOC, a dependent must be either a "qualifying child" or a "qualifying relative."[12] 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 descendant of one of these relatives. An adopted child includes a child lawfully placed with a taxpayer for legal adoption even if the adoption is not final. An eligible foster child is any child placed with a taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.[13]
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.[14]
3. **Age Test.** The child must be under a certain age, depending on the tax benefit claimed, to be a qualifying child.[15]
4. **Support Test**. The child cannot provide more than half of his or her own support during the year.[16]

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.

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

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

11 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.

12 IRC § 152(a).

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

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

15 IRC § 152(c)(1)(C).

16 IRC § 152(c)(1)(D).

1. **Relationship Test.** The individual must be:
   - A child or a descendant of a child;
   - A brother, sister, stepbrother, or stepsister;
   - The father or mother, or an ancestor of either;
   - A stepfather or stepmother;
   - A son or daughter of a brother or sister of the taxpayer;
   - A brother or sister of the father or mother of the taxpayer;
   - A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or an individual (other than the spouse) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.[17]
2. **Gross Income Test.** An individual must have gross income below the amount allowed for a personal exemption for the taxable year.[18]
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.[19]
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.[20] IRS Notice 2008-5 provides additional guidance as to when an individual is a qualifying relative.[21]

The taxpayer can claim a personal exemption deduction for a dependent who meets the tests of a qualifying relative.[22]

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.[23] Until 2005, these tie-breaker

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17 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.

18 IRC § 152(d)(1)(B).

19 IRC § 152(d)(1)(C).

20 IRC § 152(d)(1)(D).

21 *See* Notice 2008-5, 2008-2 I.R.B. 1. The purpose of this notice is to clarify that an individual is not a qualifying child of "any other taxpayer" if the individual's parent (or other person with respect to whom the individual is defined as a qualifying child) is not required by IRC § 6012 to file an income tax return and (i) does not file a return, or (ii) files solely to obtain a refund of withheld taxes. Therefore, if an individual is not a qualifying child of anyone else and meets all other requirements of IRC §§ 151 and 152, the individual would be considered a qualifying relative, and the taxpayer could claim the qualifying relative as a dependent.

22 IRC §§ 152(d); 151(c).

23 IRC § 152(c)(4).

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.[24]

TABLE 3.10.1, 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.[25]

A custodial parent is the parent having custody of the child for the greater part of the calendar year.[26] The noncustodial parent is the other parent.[27] 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.

24 *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.

25 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.

26 IRC § 152(e)(4)(A).

27 IRC § 152(e)(4)(B).

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.[28] The regulations also adopt the rule enunciated by the Tax Court in *King v. Commissioner*[29] that the IRC § 152(e) special rules for divorced or separated parents also apply to parents who were never married to each other.[30]

Analysis of Litigated Cases

Most of the cases litigated during this period were small Tax Court cases.[31] 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 one of the 34 cases litigated this year, even though many cases were highly fact-specific and involved a complicated web of statutory provisions. Out of all the cases, only one taxpayer prevailed in full and that taxpayer 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 10 in Appendix III.

Cases Decided Where UDOC Applied

For the first time since Congress enacted UDOC, courts are applying this definition when determining family status issues. UDOC applied in six of the 34 cases we reviewed.[32] UDOC appears to have made the analysis of the issues easier for the court by establishing one definition of a "qualifying child" with respect to head of household filing status, the child tax credit, the EITC, and the dependency 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.

For example, in *Worota v. Commissioner*,[33] a case governed by UDOC, the *pro se* taxpayer's three relatives moved from Ethiopia to the United States and lived with the taxpayer in his

28 Treas. Reg. § 1.152-4(d)(1).

29 121 T.C. 245 (2003).

30 Treas. Reg. § 1.152-4(b)(2)(C).

31 In certain tax disputes involving $50,000 or less, taxpayers may elect to have their cases 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.

32 *See Felix v. Comm'r*, T.C. Memo 2008-96; *Harris v. Comm'r*, T.C. Summ. Op. 2007-202; *Holmes v. Comm'r*, T.C. Summ. Op. 2008-47; *Marshall v. Comm'r*, T.C. Summ. Op. 2008-31; *Ruben v. Comm'r*, T.C. Summ. Op. 2008-38; and *Worota v. Comm'r*, T.C. Summ. Op. 2008-52.

33 T.C. Summ. Op. 2008-52.

apartment from June 1, 2005, through December 31, 2005. The taxpayer claimed a dependency exemption, the EITC, and the child tax credit for the relatives on his 2005 return. Under UDOC, in order for the taxpayer to establish entitlement to these family status provisions, he had to establish that the relatives were either qualifying relatives or qualifying children under IRC § 152. The IRS contended the relatives did not meet the IRC § 152 residency requirement because they did not intend to stay in the United States. The court, however, found that although the relatives returned to Ethiopia in 2006, the U.S. residency requirement was met because at the time the relatives lived with the taxpayer, they did in fact intend to become U.S. citizens. The court further found that each of the relatives met all of the tests to be either a qualifying child or a qualifying relative under IRC § 152, and therefore, the taxpayer was entitled to all three family status provisions.

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

We reviewed 12 cases involving head of household status, with no taxpayers prevailing on this issue. In many cases, the taxpayer was confused about the eligibility requirements for the various family status provisions. For instance, in *Buah v. Commissioner*,[34] the taxpayer claimed head of household filing status, even though she was married at the end of the tax year. The court found the taxpayer ineligible for head of household filing status because the law dictates that a taxpayer cannot be married at the close of the taxable year to be eligible.[35] In *Felix v. Commissioner*,[36] the taxpayer claimed head of household filing status but failed to provide any evidence to establish that her home was the principal place of abode of the child for more than half of the taxable year, which is an eligibility requirement. The Tax Court, therefore, denied the taxpayer head of household filing status.

Child Tax Credit

We reviewed 18 cases involving the child tax credit; two taxpayers prevailed on this issue with respect to one of the tax years at issue. To claim the child tax credit, the taxpayer must be able to claim the child as a dependent on his or her tax return.[37] In *Kore v. Commissioner*,[38] the taxpayer was granted the child tax credit in 2003 but not 2004, because the taxpayer was entitled to claim his nephew as a dependent in 2003, but not in 2004.[39] In another case, the Tax Court denied the child tax credit because the taxpayer's income exceeded the dollar limits set forth in IRC § 24(b)(1).[40]

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34 T.C. Summ. Op. 2007-183.

35 *Buah v. Comm'r*, T.C. Summ. Op. 2007-183.

36 T.C. Memo. 2008-96.

37 *Kore v. Comm'r*, T.C. Summ. Op. 2007-109.

38 T.C. Summ. Op. 2007-109.

39 *Kore v. Comm'r*, T.C. Summ. Op. 2007-109.

40 *Kold-Warren v. Comm'r*, T.C. Summ. Op. 2007-197.

Earned Income Tax Credit

We reviewed 14 cases involving the EITC during the reporting period, with one taxpayer prevailing on this issue. Taxpayers appeared *pro se* in all 14 cases. Several themes appear throughout the EITC cases.

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

In *Anderson v. Commissioner*,[41] the court held that the taxpayer, who was married at the close of 2004, was not eligible for the EITC for 2004 because a married taxpayer must file a joint return to be eligible for the credit unless an exception is met.[42] An exception is available under IRC § 7703(b), where a married person living apart from his or her spouse will not be considered married for the purposes of entitlement to the EITC if the taxpayer, among other things, can establish that he or she was entitled to claim a dependency exemption for his or her dependent and if the taxpayer's home was the principal place of abode for the dependent for more than half of the year. In this case, the taxpayer could not establish that these requirements were met and was thus considered married at the close of the taxable year and ineligible for the EITC.

Dependency Exemption – IRC § 151

We reviewed 27 cases involving the dependency exemption, with two taxpayers prevailing. Taxpayers appeared *pro se* in all of these cases except one, with the IRS prevailing in the single case where the taxpayer was represented.[43]

In *Boltinghouse v. Commissioner*,[44] the Tax Court denied the dependency exemption deduction under IRC § 152(a) for the *pro se* taxpayer's daughter, who claimed a dependency exemption for herself on her own tax return. The court denied the exemption because the taxpayer failed to maintain and provide sufficient records establishing the total amount of support he provided to his daughter in the year in question.[45] The court further held that the taxpayer, who is divorced, did not qualify for the special rule for divorced parents under

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41 T.C. Memo. 2008-37.

42 *See* IRC § 32(d).

43 *Ward v. Comm'r*, T.C. Summ. Op. 2008-54.

44 T.C. Memo. 2007-324.

45 *See Boltinghouse v. Comm'r*, T.C. Memo. 2007-324. Note that UDOC has modified the support test. Under UDOC, a taxpayer may claim a dependency exemption for a child if the child has not provided more than half of his or her own support. *See* IRC § 152(c)(1)(D).

IRC § 152(e) because the child was not in the custody of one or both the child's parents for more than half of the calendar year.[46]

To determine what constitutes "custody" for purposes of IRC § 152(e), the Treasury Regulations provide that we must look to state law.[47] A child is treated as residing with neither parent if the child is emancipated under state law.[48] The National Taxpayer Advocate is concerned that the special rule for divorced parents under IRC § 152(e) is dependent upon the state law definition of custody. However, under UDOC, the taxpayer may be able to claim a dependency exemption for his college-bound daughter if she meets the requirements of a qualifying relative under IRC § 152(d)(1).

In *Chamberlain v. Commissioner*,[49] the Tax Court held the taxpayer was not entitled to a dependency exemption because he failed to attach a valid Form 8332, *Release of Claim to Exemption for Child of Divorce or Separated Parents*, to his return. The court held a non-custodial parent is only entitled to the exemption when he or she attaches a valid form to the return. The court also found the IRS's past acceptance of returns that did not conform to this requirement did not estop the IRS from disallowing the dependency exemption in the tax year before the court.[50] Estoppel is only available as a defense where the IRS committed fraud and the taxpayer relied on the fraud to his or her detriment.[51]

Conclusion

Family status provisions still seem to be a confusing area for taxpayers. However, over the past few years, the number of family status cases has dropped significantly. We reviewed 34 cases this year, down from 41 in the 2007 Annual Report[52] and 46 in the 2006 report.[53] This decline seems to indicate that UDOC may be having a positive impact. Additionally, it will be interesting to see if the new rules surrounding custody of a child will also help simplify family status provisions for taxpayers.[54]

Although these changes are a step in the right direction, and seem to have a positive effect, the family status 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

46 *See Boltinghouse v. Comm'r*, T.C. Memo. 2007-324; IRC § 152(e)(1)(B).

47 *See* Treas. Reg. §1.152-4(d)(1).

48 *See* Treas. Reg. §1.152-4(c).

49 T.C. Memo. 2007-178.

50 Estoppel precludes a person from asserting a fact or a right or prevents one from denying a fact.

51 *See Chamberlain v. Comm'r*, T.C. Memo. 2007-178.

52 National Taxpayer Advocate 2007 Annual Report to Congress 660.

53 National Taxpayer Advocate 2006 Annual Report to Congress 555.

54 *See* Treas. Reg. § 1.152-4(b)(2)(C).

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 complexity of these provisions even more, the National Taxpayer Advocate made 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.[55] The National Taxpayer Advocate has updated her 2005 recommendation in this report, once again highlighting the importance of creating a less complex and convoluted tax system.[56]

55 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 and head of household filing status 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.

56 *See* Legislative Recommendation, *Tax Reform for Families, supra.*