

Federal Tax Procedure

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This publication is prepared in two versions for different uses. One version is designed for students. This student version has all of the text, but has no footnotes. I have presented in the text the key concepts and discussions I think students should learn in a law school class on tax procedure. Key code sections and cases are cited in text so that students can refer to them when appropriate. The other version of the publication is designed for practitioners. This is the same text but with extensive footnotes designed to provide the authority for the statements in the text and develop nuance beyond what I would expect students to know.

Users of this text may want to refer to an additional resource in conjunction with this text. On Mr. Townsend's blog site titled Federal Tax Procedure, there is a page titled [UH Law Tax Procedure Class Information](#). On that page, Mr. Townsend will discuss and provide appropriate links to materials related to the Tax Procedure class at UH Law School.

Mr. Townsend welcomes feedback from readers of this text, particularly any suggestions as to improvements for the text. Feedback can be given by email (jack@tjtaxlaw.com) or through comments on the Tax Procedure Blog.

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Thanks

My wife, Irene, is a great supporter. This publication would not exist without her love and encouragement.

My partner, Larry Jones, acts daily as a mentor as we share ideas for our practices and for our classes at the respective law schools which tolerate and sometimes even appreciate our teachings. He has also corrected some of the errors that slipped by me and has kept me from wandering too much.

Others have also contributed greatly. I can mention only a few.

My colleagues at the Department of Justice Tax Division where I started the practice of tax law gave me a solid foundation. At DOJ Tax, I was blessed to be influenced by giants -- like the late Professor Ernest Brown and John Murray, and others too numerous to mention. In addition, the people I dealt with at the IRS taught me a me a great deal about professionalism.

Since I entered private practice many years ago, I have continued to be inspired by my friends at the Tax Division and the IRS and have also been influenced by my colleagues in the private bar, many of whom are also giants and most of whom are friends, tolerating gracefully both my excesses and deficiencies.

I have finally been greatly influenced by my students over the years at the University of Houston School of Law; they gave me the encouragement and incentive to do my best and held me accountable, as I hope they will do with this edition of the book. My students have made me a better teacher and lawyer. I hope I also have contributed to their development as lawyers. I am reminded of a quote from Thomas Jefferson:

“He who receives an idea from me, receives instruction himself without lessening mine; as he who lights his taper at mine, receives light without darkening me.”

Finally, I have had substantial editorial assistance on this book from my former assistant, Merry Davis, and from my current assistants, Theresa Mickiewicz and Irene Townsend. They made this book better than I could have made it without them.

Thanks to all!

Jack Townsend

Table of Contents

Ch. 1. Purpose and Scope..		1
Ch. 2. Structure of the Federal Revenue Function.....		4
I. Legislative Branch..		4
A. House/Senate Roles in Tax Legislation.....		4
B. Statutes and Their Meanings.....		5
C. Committees and Committee Reports..		12
D. Floor Consideration..		13
E. Summaries of Proposed Legislation and Other Proposals to Congress.....		14
F. Conference Committees and Reports..		14
G. Subsequent Legislative History?..		15
1. The Oxymoron of Subsequent Legislative History..		15
2. But Then There’s the Blue Book.....		15
3. Even Less Formal Indications of Legislative Intent..		18
H. Technical Corrections Legislation.....		19
I. The Code and Uncodified Tax Legislation.....		20
1. General, Uncodified Laws..		20
2. Treaties..		20
J. Oversight Functions..		21
II. Executive Branch..		22
A. Treasury Department..		22
1. General.....		22
2. Assistant Secretary (Tax Policy)..		22
3. Treasury Inspector General For Tax Administration.....		23
4. Chief Counsel of IRS.....		23
B. IRS..		23
1. Overview.....		23
2. 1998 Restructuring Act..		24
3. Oversight Board..		26
4. Commissioner of Internal Revenue.....		27
5. Structure..		27
a. General.....		27
b. Civil Compliance Function..		28
(1) Examination Function..		28
(2) Collection Function.....		28
c. Appeals Function..		29
d. Criminal Investigation..		29
e. Chief Counsel..		30
f. Taxpayer Advocate.....		31
g. Representing Taxpayers With or Before the IRS.		31

	(1)	General; Circular 230.....	31
	(2)	Return Preparer Authority and the RPO.....	32
	(3)	Practitioner Discipline and OPR.....	34
	(4)	Form 2848; CAF and PTIN.....	40
	(5)	Other Miscellaneous OPR Regulation..	41
	h.	Service Centers.....	41
6.		IRS Rule Making Authority.....	41
	a.	Introduction (Including the APA).....	41
	b.	Regulations..	45
	(1)	Interpretive or Legislative.....	46
	(a)	Introduction.....	46
	(b)	Interpretive Regulations.....	46
	(c)	Legislative Regulations.....	47
	(d)	Blurring the Lines.....	48
	(2)	Final, Proposed and Temporary..	48
	(3)	Retroactivity of Regulations..	50
	(a)	Introduction.....	50
	(b)	Promulgated Regulations.....	51
	(c)	What About Temporary Regulations?	53
	(4)	Nonexistent or Phantom Regulations..	53
	c.	Notices (and Retroactivity)..	54
	d.	Revenue Rulings and Procedures..	56
	(1)	Revenue Rulings..	56
	(2)	Revenue Procedures..	58
	e.	Letter Rulings..	58
	(1)	Nature of the Letter Ruling..	58
	(2)	User Fees..	59
	(3)	Precedential Value..	59
	(4)	Retroactive Revocation.....	61
	(5)	Taxpayer Strategies for PLRs..	62
	f.	Technical Advice - TAMs and TEAMS.....	63
	g.	Internal Revenue Manual (“IRM”).....	63
	h.	AODs – IRS Positions on Decided Cases..	65
	i.	Miscellaneous Internal Positions.....	66
7.		Deference to IRS Interpretation of the Code.....	66
	a.	Statutory Interpretation - The <u>Chevron</u> Framework..	66
	b.	<u>Chevron</u> Applies to Internal Revenue Code Interpretation..	70
	c.	<u>Chevron</u> Applies to Both Legislative and Interpretive Regulations.....	70
	d.	<u>Chevron</u> ’s Application to Temporary Regulations.	71

e.	Recognizing Ambiguity in <u>Chevron</u> Step One..	71
f.	Determining Reasonableness / Unreasonableness in Step Two..	73
g.	Deference to Interpretations Other than By Regulation..	74
h.	Self-Serving Regulations Can Control Interpretation..	80
i.	Conclusion..	82
8.	Some other Issues of Deference..	83
a.	Interpretation of Interpretations..	83
b.	Procedural Regulations..	84
c.	Holding the IRS to Published Positions..	86
9.	Special Interpretive Considerations for Treaties..	86
10.	IRS Duty of Consistency..	87
a.	General..	87
b.	Competitive Issues - Examples..	88
(1)	The <u>IBM</u> Case..	88
(2)	Employee-Independent Contractor Issue..	89
c.	IRS Abuse and the 10 Deadly Sins..	91
C.	Department of Justice..	93
1.	Tax Division (“DOJ Tax”)..	93
2.	Office of the Solicitor General..	95
III.	Judicial Branch..	97
A.	Introduction..	97
B.	The Courts..	97
1.	Article III Courts..	97
2.	Article I Courts..	98
Ch. 3.	The Right to Know – FOIA and Privacy Act..	100
I.	Freedom of Information Act (“FOIA”)..	100
A.	The Theory of FOIA..	100
B.	General Rule - Governmental Information is Available..	100
C.	Key Exemptions from FOIA..	101
1.	Exemptions by Statutes Other than FOIA..	101
2.	Agency Deliberative Memoranda and Documents Unavailable in Litigation..	101
3.	Records for Law Enforcement Purposes..	102
D.	Procedural Aspects..	103
1.	General..	103
2.	The Redaction Process..	103
3.	Appeals and Judicial Review..	103
E.	Practical Uses of FOIA in a Tax Setting..	104
1.	Discovery of the Audit..	104
2.	Discovery in the Criminal Investigation..	105

3.	Other..	105
II.	Privacy Act..	106
Ch. 4.	Confidentiality and Disclosure of Return Information..	107
I.	Introduction..	107
II.	Definitions..	108
A.	Return Information..	108
B.	Taxpayer Return Information..	108
III.	General Rule - Return Information is Nondisclosable..	108
IV.	Exceptions – Must be Congressionally Approved..	108
A.	Taxpayer, Related Persons and Material Interest Disclosures..	109
B.	Tax Administration Disclosures..	111
1.	Disclosures Within the IRS..	111
2.	Criminal Tax Enforcement..	111
3.	Disclosures to DOJ for Civil Tax Litigation..	111
4.	Disclosures as Necessary for Audits and Investigations..	112
5.	Disclosures to State Tax Authorities..	114
6.	Disclosures in Judicial and Administrative Proceedings if Directly Related to the Resolution of the Issue in the Proceeding..	114
C.	NonTax Criminal Enforcement..	114
1.	Ex Parte Order or High Level Request Required..	114
2.	Exception for Crimes and Emergencies..	115
3.	Other..	115
D.	To Congress..	115
1.	Tax Committees and JCT..	115
2.	Other Committees..	115
E.	To the President..	116
F.	Tax-Exempt Organizations..	116
G.	Exchange of Information Under Treaties..	116
H.	Other Permitted Disclosures..	117
I.	Accounting for Disclosures and Annual Report on Disclosures..	118
V.	Some Issues Under § 6103..	119
A.	Information in the Public Record..	119
B.	What is Necessary to Be Disclosed..	120
C.	An IRS Workaround for Humane Purposes (The IRS as Good Guy)..	120
VI.	Penalties/Remedies for Wrongful Disclosure..	120
A.	Criminal Penalties..	120
B.	Civil Remedies..	121
VII.	Return Preparers Prohibited from Disclosing Return Information..	122
VIII.	Summary..	122
Ch. 5.	Returns..	123

I.	The Self-Assessment System..	123
II.	The Return...	124
A.	Return Filing Requirement..	124
	1. Returns to Report Tax Liabilities..	124
	2. Information Returns or Reports..	125
	a. General - the Concept..	125
	b. Commonly Encountered Information Returns..	126
	(1) W-2s and 1099s..	126
	(2) Currency Transaction Reports (“CTRs”)..	127
	(3) Foreign Bank Account Reports (“FBARs”).	128
	(4) Other..	136
B.	Certain Types of Elections Not on Returns..	137
	1. Introduction..	137
	2. S Corporation Elections..	137
	3. Check-The-Box on Entity Characterization..	138
C.	Jurat and Signature..	139
D.	What is a Return? ..	140
	1. General Requirements..	140
	2. Missing Elements..	141
	a. Honest and Reasonable Attempt to Satisfy..	141
	b. Missing Required Schedules..	143
	c. Disclaimer or Altered Jurat Returns..	143
	d. Failure to Identify the Taxpayer..	144
E.	Return Information to Address Noncompliance..	146
	1. General..	146
	2. Information Required For Special Compliance Initiatives.	146
	a. Offshore Compliance Information..	146
	(1) The General Compliance Problem..	146
	(2) Offshore Entity Reporting..	146
	(3) Offshore Financial Assets on 1040 Form	
	8938..	147
	b. Uncertain Tax Positions (“UTP”)..	149
	c. Disclosure of Aggressive Position..	151
F.	How is the Return Actually Filed?..	152
	1. Introduction..	152
	2. Hard Copy Filing..	152
	3. Computer Filing (E-Filing)..	152
III.	Amended Returns..	153
A.	General..	153
B.	Fraudulent Original Returns, Amended Returns and the Civil	
	Statute of Limitations..	155

	C.	Fraudulent Original Returns, Amended Returns and the Voluntary Disclosure Policy.....	156
	D.	Amended Returns Claiming Refunds and Audits..	156
IV.		Time for Filing Returns..	157
	A.	General.....	157
	B.	Extensions..	158
	1.	Income Tax..	158
	2.	Estate Tax..	159
V.		When Returns Are Filed..	160
	A.	General Rule - Date of Filing with IRS.....	160
	B.	Exception - Returns Filed Prior to Original Due Date..	160
	C.	Returns Filed After the Due Date During the Extension Period..	160
	D.	Timely-Mailing, Timely-Filing Rule.....	160
	1.	The Statutory Rule..	160
	2.	Common Law Mailbox Rules..	164
	a.	General.....	164
	b.	The Prison Mailbox Rule..	165
	E.	Review..	166
	F.	Timely-Mailing Timely-Filing Rule for Delinquent Original Returns Claiming Refunds.....	167
VI.		Assessment of Tax.....	167
VII.		Payment of Tax.....	168
	A.	General.....	168
	B.	Prepayments of Taxes.....	168
	1.	Withholding of Tax on Employees..	168
	2.	Estimated Taxes..	170
	a.	Individuals.....	170
	b.	Corporations..	171
	c.	Payment by Application of Overpayment..	171
	d.	Penalties.....	171
	3.	Withholding on Certain Payments..	171
	a.	Backup Withholding.....	171
	b.	Miscellaneous..	172
	C.	Extensions of Time to Pay Tax..	173
VIII.		Return Reporting in the Marital Relationship.....	174
	A.	Community Property States v. Separate Property States.....	174
	B.	Joint Returns and Joint Liability..	175
	1.	The Concept.....	175
	2.	Couples Eligible to File Joint Returns..	175
	3.	Requirements for a Joint Return..	176
	4.	Joint Returns Filed After Separate Returns..	176
	C.	Relief from Unjust Marital Tax Liability.....	177
IX.		Return Preparer Regulation and Penalties..	177
	A.	Introduction.....	177

B.	Who is a Tax Return Preparer?	178
C.	Basic Preparer Responsibilities and Penalties..	179
D.	Penalties for Unreasonable Positions, Negligence and Fraud..	179
1.	Unreasonable Positions...	179
2.	Willful or Reckless Conduct..	181
3.	Asserting and Contesting Preparer Penalties..	181
E.	Injunctions...	182
F.	Criminal Penalties...	182
G.	Practice Penalties..	182
X.	Appraiser Penalties...	183
XI.	Tax Compliance and the Tax Gap...	183
Ch. 6.	Statutes of Limitations...	185
I.	Introduction...	185
II.	Assessment...	186
A.	Introduction...	186
B.	The General Rule - Three Years..	186
C.	Exceptions to the General Three Year Statute..	187
1.	False Return or Attempted Evasion..	187
2.	No Return..	191
3.	Extension by Agreement..	191
a.	General...	191
b.	Forms for Extensions - 872 and 872-A..	192
c.	Procedures for Consents..	194
d.	Proof Issues Regarding Consents..	194
e.	Extension Strategies..	195
4.	Failure to Disclose Listed Transaction..	196
5.	Significant Omissions of Income..	196
a.	Six Year Statute for 25% Omissions...	196
(1)	The Exception to the General Rule..	196
(2)	Examples..	197
(3)	Disclosure To Avoid 6-Year Statute..	200
(4)	Burdens of Proof...	202
b.	\$5,000+ Omissions of Income from § 6038D Reportable Foreign Assets...	202
6.	Special Rules for Transfer Tax Returns...	203
a.	Gift Tax Returns...	203
b.	Estate Tax Returns...	204
7.	Requests for Prompt Assessment..	204
8.	Minimum Statute to Assess Tax Reported on Amended Return..	204
9.	Other Statutes..	204
D.	Suspensions by Deficiency Notice and Tax Court Petition...	205

	1.	General - Suspensions to Insure Right to Prepayment Remedy.....	205
	2.	Notice of Deficiency and No Tax Court Petition..	206
	3.	Notice of Deficiency and Tax Court Petition..	207
	4.	Waiver of Prohibitions on Assessment During Suspension Period.....	210
	E.	Exceptions -- No Statute of Limitations for Some Assessments....	210
	F.	IRS Erroneous Abatements.....	212
	G.	Special Rule for Assessment of Interest..	213
III.		Collections.....	213
IV.		Overpayments.....	216
	A.	What Are Overpayments? ..	216
	1.	Actual Overpayments (Herein of Refunds and Credits; Offsets).....	216
	2.	Constructive Overpayments..	218
	3.	Determination of Overpayment.....	220
	4.	Overpayment of Installments..	221
	B.	The Claim for Refund.....	221
	1.	The Role and Nature of the Claim..	221
	2.	Statute for Filing of the Claim for Refund.....	222
	a.	General.....	222
	b.	Interest Claims..	227
	c.	Adequacy of the Claim; Variance.....	228
	d.	Form for Claims.....	230
	(1)	IRS Prescribed Forms..	230
	(2)	Informal Claims..	230
	(3)	Waiver..	232
	(4)	Amendments..	233
	e.	Claims After Consent to Extend Statute.....	234
	3.	Overpayments in Tax Court Litigation..	235
	4.	The Payment/Deposit Distinction..	235
	a.	The Distinction..	235
	b.	Examples and Strategies..	236
	5.	Related Party Transactions..	239
	C.	The Refund Suit..	241
V.		Abatements of Erroneous Assessments.....	243
VI.		Erroneous Refund Remedies.....	243
	A.	Introduction; Rebate Refunds and Nonrebate Refunds.....	243
	B.	Rebate Refunds.....	244
	1.	Deficiency Procedures..	244
	2.	Erroneous Refund Suits.....	245
	3.	Offsets to Claims for Refund.....	246
	C.	Nonrebate Refunds.....	246
VII.		Smoothing the Harsh Effects of Statutes of Limitation..	247

A.	The Problem - Statutes of Limitation Can Be Harsh..	247
B.	The Protective Claim for Refund..	247
C.	General Equitable Principles..	248
D.	Equitable Recoupment..	251
E.	Duty of Consistency..	254
F.	Claim of Right Relief - § 1341..	258
G.	Mitigation Provisions of the Code..	259
1.	Introduction..	259
2.	Examples of Double Benefits Covered..	259
a.	Double Inclusion of Income..	259
b.	Double Deductions..	261
3.	Maintenance of an Inconsistent Position..	262
4.	Other Circumstances of Adjustment; Complications.	265
a.	Double Exclusions of Income..	265
b.	Double Disallowance of a Deduction or Credit..	267
c.	Other..	267
5.	Supplementary Reading for Mitigation Enthusiasts..	267
H.	Accounting Method Adjustments..	268
Ch. 7.	Interest..	270
I.	Introduction..	270
II.	When the Taxpayer Owes the Government.	270
A.	General..	270
1.	Interest on Underpayments..	270
2.	Underpayments of Required Prepayments..	271
3.	Erroneous Refunds..	271
B.	Underpayment Interest Rates..	271
1.	General..	271
2.	Large Corporate Underpayments (“Hot Interest”)..	271
3.	Deferred Estate Tax on Closely Held Business..	272
C.	Relief from the Accrual of Interest..	273
1.	General..	273
2.	Abatement of Interest Otherwise Due..	273
a.	Delays for Ministerial or Managerial Acts..	273
b.	Reliance on Written IRS Advice..	274
c.	Delay in Notification of Tax Liability..	274
3.	Delay in Assessment After Waiver of Restrictions..	275
4.	Prompt Payment Grace..	276
D.	Making and Contesting IRS Interest Calculations..	276
E.	Payments or Deposits to Stop the Running of Interest..	277
F.	Time For Assessment of Interest..	281
III.	When the Government Owes the Taxpayer..	281
A.	Overpayments..	281
1.	General Rule - Interest is Due..	281

	2.	No Interest Prior to the Tax Due Date..	282
	3.	IRS 45 Day Grace Period on Overpayments..	282
B.		Interest Rate..	283
	1.	General Overpayments...	283
	2.	Special Reduced Corporate Overpayment Rates..	283
	a.	General 1% Reduction (the “GATT Rate”)...	283
	b.	Reduction on “Large” Corporate Overpayments...	284
C.		Deposits..	285
D.		Interest on Judgment of Refund..	285
IV.		Miscellaneous Interest Issues...	286
A.		Interest on Penalties..	286
B.		Carrybacks and Carryforwards..	286
C.		Mutual Indebtedness, Setoffs and Interest Netting..	287
D.		Restricted Interest..	288
E.		Deficiency or Refund Interest Paid or Accrued...	289
F.		Contesting Interest Calculations..	289
G.		Who Really Does This Type of Work?..	290
Ch. 8.		Penalties...	292
I.		Introduction...	292
II.		Criminal Penalties...	295
A.		Introduction...	295
B.		The Sentencing Guidelines...	298
C.		Return Reporting Crimes..	299
	1.	Tax Evasion - § 7201...	299
	2.	False Return (Tax Perjury) - § 7206(1)...	300
	3.	Aiding or Assisting - § 7206(2)...	301
	4.	Failure to File Return - § 7203...	302
D.		Tax Administration Crimes...	302
	1.	Tax Evasion - § 7201...	302
	2.	Concealing Assets - § 7206(4)...	302
	3.	Impeding Administration - Section 7212(a)...	303
	4.	False Statements - 18 U.S.C. § 1001..	304
	5.	FBAR Violations (31 U.S.C. § 5324; 18 U.S.C. § 1001)...	304
E.		Conspiracy - 18 U.S.C. § 371..	304
F.		Miscellaneous Tax-Related Crimes...	305
	1.	General - Myriad of Other Tax Related Crimes..	305
	2.	Money Laundering - 18 U.S.C. §§ 1956 & 1957...	305
	3.	Some Other Representative Crimes..	306
G.		Voluntary Disclosure..	306
	1.	The General Voluntary Disclosure Programs..	306
	a.	General Description of the Programs...	307
	b.	IRS Voluntary Disclosure Policy...	310
	(1)	The “Practice.”...	310

	(2)	How Is Disclosure Made?	313
	(a)	The “Quiet Disclosure”.. .. .	313
	(b)	Noisy Disclosures... .. .	314
	(3)	Which Type of Disclosure is “Better”?. .. .	314
	(a)	DOJ Tax Disclosure Policy... .. .	315
c.		Does the Voluntary Disclosure Practice Confer Rights?.. .. .	316
d.		Timeliness, Truthfulness and Completeness.. .. .	317
e.		Taxpayer Cooperation.. .. .	318
f.		Events That Prevent Timeliness or Voluntariness.	319
g.		Special Voluntary Disclosure Initiatives... .. .	320
	(1)	Earlier Offshore Voluntary Compliance Initiative (and Related Audit Initiatives).. . . .	320
	(2)	Tax Shelter Initiatives.. .. .	320
	(3)	2009 Offshore Account Initiative... .. .	321
	(4)	2011 Voluntary Compliance Initiative (“OVDI”).. .. .	322
	(5)	Current Voluntary Disclosure for Offshore Accounts... .. .	322
	(6)	Opting Out of OVDP and OVDI (Including Extended OVDI).. .. .	324
H.		Statutes of Limitation... .. .	326
I.		Criminal Investigations and Prosecutions.. .. .	326
	1.	Introduction... .. .	326
	2.	The Usual Criminal Tax Investigation.. .. .	327
	a.	CI Investigation... .. .	327
	b.	DOJ Review Through Prosecution.. .. .	327
	c.	Taxpayer Conferences.. .. .	328
	3.	Unusual Processing of Criminal Tax Investigations.. .. .	328
	4.	Secrecy Rules in Criminal Tax Investigations.. .. .	329
	5.	Sentencing Guidelines Strategy... .. .	329
III.		Civil Penalties.. .. .	331
A.		Introduction... .. .	331
B.		Burden of Proof - General and § 7491(c).. .. .	331
C.		Fraudulent Return - § 6663.. .. .	332
D.		Fraudulent Failure to File Return - § 6651(f).. .. .	337
E.		Accuracy-Related Penalties - § 6662... .. .	339
	1.	Introduction to the Concepts... .. .	339
	2.	Penalty Base - Tax Understatement; Qualified Amended Return (“QAR”).. .. .	341
	3.	Negligence and Disregard of Rules and Regulations... .. .	343
	a.	Negligence.. .. .	343
	b.	Disregard of Rules and Regulations.. .. .	344

4.	Substantial Understatement Penalty	345
a.	Introduction	345
b.	Understatement Threshold and Preliminary Base.	345
c.	Reductions to the Penalty Base ..	345
	(1) Design of the Statute for Reductions	345
	(2) Substantial Authority and Reasonable Basis	346
	(3) Disclosure	347
d.	No Reduction for Tax Shelter Positions ..	348
5.	Substantial Valuation or Basis Misstatement Penalty	349
a.	Improper Valuation Claims	349
b.	Improper Basis Claims	349
c.	Error Thresholds for Penalty ..	350
d.	Section 482 Valuation Misstatements ..	350
e.	Parallel Estate and Gift Tax Penalties ..	351
f.	No Fault	351
6.	Undisclosed Foreign Financial Account Understatement.	351
7.	Other Accuracy Related Penalties	352
8.	Innocent Spouse Relief	352
9.	Reasonable Cause Exception	352
a.	General	352
b.	Reasonable Reliance on Tax Advisor ..	354
c.	Tax Shelters	356
	(1) General	356
d.	Other	356
10.	Penalties and Carryovers	357
F.	Failure to File Penalty	357
1.	Most Returns With Tax Due	357
2.	Information Returns	359
G.	Failure to Pay Penalty	360
1.	Failure to Pay Tax Reported on the Return	360
2.	Failure to Pay Estimated Taxes	363
H.	Frivolous Returns	364
I.	Refund Claims	365
1.	Refund Claims Without a Reasonable Basis ..	365
2.	Refund Claims Where No Tax Paid	366
J.	Penalties Applicable to Nontaxpayers (Enablers)	367
1.	Tax Shelter Related Penalties	367
2.	Aiding and Assisting Understatement of Tax.	367
K.	Penalty Administration	368
1.	Authority to Assess	368

	2.	Assessing Penalties..	369
	3.	Penalty Handbook...	369
	4.	IRS Goals in Penalty Administration..	369
	5.	Deadly Sins and Penalty Administration..	370
Ch. 9.		The IRS Compliance Function (Examination)...	372
	I.	Introduction...	372
	II.	Types of Examinations...	373
		A. Civil Examinations.	373
		1. Correspondence...	373
		2. Office Audits..	374
		3. Field Examinations...	374
		4. Unnecessary Examinations Prohibition..	374
		a. Unnecessary Examinations..	374
		b. Second Examinations..	375
		B. Criminal Investigations..	376
	III.	Selection for Audit..	376
		A. Computer Selection...	376
		1. DIF..	376
		B. Related Party Audits..	377
		C. Return Disclosures..	377
		D. Initiatives in Areas of Noncompliance..	377
		1. General...	377
		2. Offshore Initiative...	378
		3. High Wealth Taxpayer Compliance Initiatives..	378
		a. Global High Wealth Industry Group..	378
		E. Informants (the Whistleblower Program)...	378
		F. Information from State Agencies..	380
		G. Audits to Develop Compliance Initiatives (TCMP, NRP, etc.)...	381
		H. Audit Priorities..	383
		I. Audit Coverage and the Audit Lottery...	384
	IV.	IRS Players In the Process...	385
		A. Revenue Agent...	385
		B. Other Disciplines...	385
		C. Industry Experts...	385
		D. Counsel...	385
		E. National Office Players...	386
		F. CI Agent (“Special Agent”)..	386
	V.	Initiation of the Audit...	387
	VI.	IRS Information Gathering Process...	387
		A. Informal Requests...	387
		B. Information Document Requests (“IDR”)..	387
		C. Third Party Contacts..	387
		D. The IRS Administrative Summons..	389

1.	General.....	389
a.	The IRS Summons.....	389
b.	The Summons Power and the Powell Standards.. . . .	390
c.	Routine for Summonses.. . . .	392
d.	Summonses for Software Source Code.....	394
e.	Summonses in Criminal Investigations.....	394
2.	Third Party Summonses.....	395
a.	General Requirement of Notice to Party Being Investigated.. . . .	395
b.	Exceptions to Notice Requirement.. . . .	396
3.	The John Doe Summons.....	397
4.	The Designated Summons.. . . .	400
5.	Litigation Regarding Summonses.....	401
6.	Use Of IRS Summonses Under U.S. Tax Treaties.....	405
7.	Taxpayer Interviews.....	405
a.	Taxpayer Rights.. . . .	405
b.	Special Risks / Issues in Criminal Investigations....	406
8.	Representing the Taxpayer and a Summoned Witness.....	407
E.	Formal Document Requests.....	408
F.	Privileges at the Examination Level.. . . .	409
1.	Privileges to Withhold Information from the IRS.....	409
a.	Introduction.....	409
b.	Privileges in the Federal Universe Generally.....	410
c.	Attorney-client Privilege.. . . .	411
(1)	General.....	411
(2)	Client Communications for Legal Advice.. . . .	413
(3)	Reasonable Expectation of Confidentiality.	413
(4)	Client Identity Privilege.....	414
(5)	Attorney Communications to Client.....	415
(6)	Relationship to Legal Representation.....	416
(7)	Privilege and In-House Counsel.. . . .	417
(8)	Waiver.. . . .	421
d.	Federally Authorized Tax Practitioner Privilege (“FATP”).....	422
e.	Fifth Amendment Privilege.. . . .	424
(1)	Compulsory Testimonial Communications.	424
(2)	Documents.....	424
(a)	General - The Act of Production Doctrine.. . . .	424
(b)	<u>Hubbell</u> and the Act of Production.	425
(3)	Entity Records and the Act of Production.. . . .	432

	(4)	Other Issues.....	434
	(a)	Handwriting Exemplars.....	434
	(b)	Consent Directives to Foreign Banks.....	434
f.		Work Product Privilege.....	438
g.		Spousal Privileges.....	441
	(1)	General Justification for Spousal Privilege.	441
	(2)	Spousal Communications Privilege.....	441
	(3)	Spousal Immunity (aka Adverse Testimony Privilege).....	442
	(4)	Examples.....	443
h.		The Limits of Privileges - Tax Accrual Workpapers.....	444
	2.	Protecting Information Developed in the Audit (Kovel)....	449
G.		Financial Status Inquiries.....	453
H.		Search Warrants and Covert Activities.....	454
I.		International Evidence Gathering.....	454
	1.	Introduction.....	454
	2.	Prototypical U.S. International Tax Fraud.....	454
	3.	Tax Treaties and International Comity.....	455
	a.	Introduction.....	455
	b.	Double Tax Treaty Exchange of Information Provision.	456
	c.	OECD Convention on Tax Administrative Assistance.....	459
	d.	IRS Summons and the Hague Convention.....	461
	e.	Other Treaties.....	462
	(1)	MLATs.....	462
	(2)	TIEAs.....	462
	(a)	Caribbean Basin Initiative TIEAs....	464
	(b)	Other TIEAs.....	466
	f.	Letters Rogatory.....	466
	4.	Non-Treaty Techniques.....	467
VII.		Joint International Audits and Simultaneous Examinations.....	468
VIII.		IRS Methodology for Determining Additional Tax Liability.....	471
A.		Specific Items.....	471
B.		Indirect Methodologies.....	471
	1.	Net Worth Method.....	471
	2.	Bank Deposits and Expenditures Method.....	471
	3.	Others.....	472
	4.	General Problems with Indirect Methods.....	472
IX.		Settlement at Examination.....	472
X.		Closing Out the Examination.....	474

A.	General.....	474
B.	Substitute for Return..	475
C.	The Closing Agreement..	476
Ch. 10.	Appeals.....	480
I.	Appeals' Mission.....	480
II.	Settlement Authority..	481
III.	Tickets to Appeals.....	482
A.	The Usual Case – After Audit..	482
1.	30-Day Letter and Protest..	482
2.	After Filing a Tax Court Petition (“Docketed Appeal”)..	482
3.	Strategies as to Route to Appeals..	483
B.	Other Avenues to Appeals..	484
IV.	Examination's Rebuttal; Other Examination Communications with Appeals.....	485
V.	Taxpayer Discovery..	487
VI.	Conferences..	487
VII.	New Issues..	488
A.	Raised by Appeals.....	488
B.	Raised by the Taxpayer..	490
VIII.	Special Alternative Dispute Resolution-Type Procedures..	490
A.	General.....	490
B.	Alternative Dispute Resolution (“ADR”)..	491
IX.	Settlement in Appeals.....	493
A.	Issue by Issue Approach.....	493
B.	Effecting the Settlement - Form 870-AD..	494
Ch. 11.	Notice of Deficiency..	497
I.	The Notice of Deficiency and its Role in the System (A Reprise).....	497
A.	General.....	497
B.	What is a Notice of Deficiency?..	497
1.	A Deficiency.....	497
2.	The Notice..	498
a.	The Determination and Explanation.....	498
b.	Procedural Requirements..	498
(1)	The Date to File a Petition..	498
(2)	Notice of Taxpayer Advocate’s Contact Information.....	498
(3)	The Last Known Address Requirement.....	499
c.	Explanation of the Basis for the Deficiency..	503
d.	Consequences of Invalidity of the Notice..	505
3.	Prohibition on Assessment.....	507
a.	General - No Assessments..	507
b.	Exceptions to Prohibitions on Assessment..	507

	4.	Effects of Prepayments and Deposits on Notices.....	507
	5.	Rescinding Notices of Deficiency.....	508
	6.	Second Notices of Deficiency..	508
	C.	Non-Deficiency Cases..	510
II.		Jeopardy and Termination Assessments..	510
	A.	Introduction to the Issues.....	510
	B.	Jeopardy Assessments..	511
	C.	Termination Assessments.....	514
	D.	Comments on Procedures..	514
Ch. 12.		Litigation.....	515
	I.	Introduction.....	515
	II.	Choices of Courts..	515
	A.	United States Tax Court.....	515
		1. Introduction.....	515
		2. User Friendly Court..	517
		a. General.....	517
		b. Small Tax Case Procedure.....	518
		3. Attorneys for the IRS.....	518
		4. Court of Limited Jurisdiction and Authority.....	519
		5. Opinions and Decisions..	520
		6. Tax Court Pleadings.....	524
		7. New Matters..	526
		8. From Petition to Trial.....	527
		a. Appeals Office Review..	527
		b. Informal Discovery.....	528
		c. Formal Discovery..	528
		d. Expert Witnesses.....	529
		e. Other Limitations on Discovery..	529
		f. Alternative Dispute Resolution..	530
		g. Piggyback Agreements.....	531
		9. The Stipulation Process..	531
		10. PreTrial Memorandum.....	532
		11. The Trial..	532
		12. Briefing..	533
		13. Opinion and Decision..	533
		14. Appeals and Precedent.....	534
		a. Appellate Review.....	534
		b. Appellate Timing and Venue.....	535
		c. The <u>Golsen</u> Rule..	536
		15. Nondeficiency Jurisdiction of the Court.....	538
		a. Collection Due Process Proceedings..	539
		b. Declaratory Judgment..	539
		c. Employee - Independent Contractor Disputes.....	539

	d.	Disclosure Disputes.....	540
	e.	Partnership Proceedings..	540
	f.	Supplemental and Related Proceedings..	541
	g.	Recovery of Administrative Costs.....	541
	h.	Proceedings to Abate Interest..	541
B.		District Courts.....	541
	1.	The Judges.....	541
	2.	Types of Tax Litigation In District Courts.....	542
	3.	Refund Suits..	543
	a.	Prerequisites for Refund Suits.....	543
	b.	Claim for Refund and Variance..	545
	c.	The Full Payment Rule and its Mitigation.....	545
		(1) Claim for Refund Predicate.....	545
		(2) The Prepayment Rule.....	545
		(3) Mitigating the Prepayment Rule.....	546
		(a) Express Statutory Mitigation.....	546
		(b) Divisible Tax Mitigation.....	546
		(c) Judicial Interpretation Mitigation..	548
	d.	Jury Trial.....	549
	e.	Setoffs.....	549
		(1) The Setoff Concept..	549
		(2) Procedural Predicates for Setoffs in Refund Cases.....	550
		(3) Statutes of Limitations and Offsets.....	551
		(4) Venue for Refund Suits in District Courts.	553
	4.	Department of Justice Tax Division (“DOJ Tax”) Role..	553
	5.	Discovery..	554
C.		Court of Federal Claims.....	554
	1.	Nature of the Court.....	554
	2.	Refund Jurisdiction..	555
	3.	Court's Spin on the Prepayment (<u>Flora</u>) Rule.....	555
	4.	Appeals and Precedent.....	555
	5.	Discovery..	555
	6.	Trials..	556
D.		Bankruptcy Courts.....	556
III.		Miscellaneous Trial Related Matters Applicable to All Forums..	558
	A.	Recovery of Attorneys Fees & Costs from the Government - § 7430.....	558
		1. The Setting..	558
		2. Some Issues Regarding Recovery of Costs.....	559
		a. Eligible Taxpayers..	559
		b. Costs Recoverable.....	559
		(1) Administrative and Litigation Costs.....	559

	(2) Fees Paid by Third Party.....	559
	(3) Exception for Protracting Proceedings.....	560
c.	Prevailing Party (Position Substantially Justified).	560
	560
d.	Exhaustion of Administrative Remedies.....	561
e.	Amount of Attorneys Fees..	562
f.	Government Circuit Shopping..	563
g.	Sanctions for Litigation Abuses.....	564
h.	Qualified Offer (“QO”)..	565
	(1) General.....	565
	(2) Costs Covered..	566
	(3) Thoughts and Strategies.....	567
B.	Recovery of Costs from the Taxpayer - 28 USC 2412(b)..	568
C.	Burden of Proof (Including Presumption of Correctness)..	569
	1. Context and Concepts.....	569
	a. Context.....	569
	b. Burden of Production.....	570
	c. Burden of Persuasion..	570
	d. Shifting Burdens.....	571
	e. Presumptions.....	572
	f. The Limits of Burden of Proof.....	574
	2. The General Tax Rule - Taxpayer Bears the Burdens..	575
	3. The Key Cases and Nuances..	575
	4. The Presumption of Correctness.....	579
	5. What About Collection Suits? ..	580
	6. Exceptions to the General Rule.....	581
	a. Criminal Cases..	581
	b. Civil Fraud.....	582
	c. Omitted Income.....	582
	d. § 7491 - Real or Phantom Shift..	584
	(1) Taxpayer Has Done What's Right.....	584
	(2) Statistical.....	585
	(3) Penalties.....	586
	(4) Comments..	587
	e. The Strong Proof Rule.....	587
D.	Injunctions in Tax Litigation.....	590
	1. General Rule.....	590
	2. Exceptions..	591
	a. Failure to Issue a Notice of Deficiency..	591
	b. <u>Enochs v. Williams Packing</u> Exception.....	592
	c. Declaratory Judgments and Other Injunction	
	Substitutes.....	594
	Ch. 13. Assessment Procedures.....	596

I.	Introduction and a Review.....	596
II.	Assessment.....	598
A.	Procedures for Assessment..	598
B.	Effect of Assessment.....	600
1.	Assessment Does Not Determine Liability..	600
2.	Permits Collection Measures.....	602
III.	Erroneous Refunds.....	603
Ch. 14. Collection Procedures.....		604
I.	Introduction.....	604
II.	Notice and Demand for Payment..	607
III.	Payment Issues..	609
IV.	Administrative Follow-Throughs..	611
V.	The Tax Lien.....	612
A.	General “Secret” Lien Upon Assessment and Failure to Pay.	612
B.	The Filed Tax Lien..	613
C.	Lien is Not Self-Executing..	615
VI.	Statute of Limitations.....	615
VII.	Set-Offs..	616
A.	Statutory Right to Set-Off Overpayments / Refunds..	616
B.	General Equitable Right of Set-Off.....	618
C.	Procedural Issues..	619
VIII.	Administrative Levy and Judicial Enforcement..	619
A.	Administrative Levy and Sale..	619
1.	General Rules of Levies..	619
2.	Exemptions or Limitations on Levies..	624
3.	Notice of Levy and Sale of Levied Assets..	625
4.	Discovery of Levable Property.....	626
5.	Constitutional Limitations on Levies..	626
6.	Procedural Predicates to Levy.....	627
B.	Judicial Enforcement..	628
1.	Civil Collection Suits..	628
2.	Writ of Ne Exeat Republica - Constraining the Person..	629
IX.	Property Subject to Lien and Levy - the Taxpayer’s Property..	630
X.	Priority of Tax Liens.....	635
XI.	Third Party Claimant Sales and IRS Right of Redemption.....	638
XII.	Alternatives to Immediate Full Payment..	638
A.	Introduction.....	638
B.	Currently Not Collectible or Collection Suspense.....	639
C.	Installment Agreements.....	639
1.	Introduction.....	639
2.	Statutory or Guaranteed Agreements.....	640
3.	Streamlined Agreements..	641
4.	Online Payment Agreements.....	641

	5.	Negotiated Agreements.....	641
D.		Offers in Compromise (“OICs”).....	642
	1.	Concept and Goals of the Program.....	642
	2.	OIC as Contract; Acceptance..	643
	3.	Bases for Compromise..	643
	a.	General.....	643
	b.	Doubt as to Collectibility..	643
	c.	Doubt as to Liability.....	644
	d.	Special Circumstances - Effective Tax Administration.....	644
	4.	Independent Review.....	645
	5.	Administrative Procedures.....	645
	6.	IRS Counsel Review.....	645
	7.	Collateral Agreements.....	646
	8.	Litigation Regarding OICs.....	646
	a.	Compliance with Accepted OICs.....	646
	b.	IRS Rejection of an OIC..	647
	9.	Other Aspects of OICs.....	647
E.		Audit Reconsideration.....	648
F.		Bankruptcy.....	648
	1.	Introduction.....	648
	2.	The Automatic Stay.....	649
	3.	Determination of Tax Liability.....	649
	4.	Discharge of Tax Liability.....	649
	a.	Corporate Taxes.....	649
	b.	Individual Taxes.....	649
	c.	Trust Fund Tax and Penalty.....	653
	d.	What Must Happen for a Discharge of Federal Tax.....	653
	e.	Discharge and the Federal Tax Lien.....	653
	5.	Priority Rules.....	655
	6.	Miscellaneous.....	655
XIII.		Protection from Collection Abuses -- Appeals and Judicial Remedies..	656
A.		Introduction.....	656
B.		Collection Appeals Program (“CAP”).....	656
C.		Collection Due Process (“CDP”).....	657
	1.	Introduction.....	657
	2.	Types of CDP Review.....	658
	a.	General.....	658
	b.	Notice of Tax Lien.....	659
	c.	Notice of Intent to Levy.....	660
	d.	Taxpayer Otherwise in Compliance.....	661
	e.	Collection Suspended; Effect on Statute of Limitations.....	661

	f.	Matters That May Be Considered.....	662
	g.	Miscellaneous Features of the Hearings.....	664
	h.	Disposition of Hearing..	665
	3.	Judicial Review by the Tax Court.....	665
	4.	Retained Jurisdiction..	667
	5.	Jeopardy.....	667
	6.	Equivalent Hearing (“EH”).....	667
	D.	NonTaxpayer Remedies.....	668
	1.	Wrongful Levy..	668
	2.	Other Remedies.....	669
	E.	Fair Tax Collection Practices.....	670
	F.	Monetary Damages for Unauthorized Collection Action..	671
	G.	Release of Filed Tax Liens..	671
	H.	Taxpayer Advocate Assistance..	673
XIV.		Outsourcing the Collection Function..	673
XV.		Innocent Spouse Relief.....	674
	A.	Introduction.....	674
	B.	Joint Liability Relief.....	675
	1.	Basic Relief - § 6015(b).....	675
	a.	a joint return and tax understatement; .	675
	b.	understatement due to other spouse’s items; .	676
	c.	spouse claiming relief did not know or have reason to know; .	676
	d.	imposing tax would be inequitable; and.	678
	e.	election for relief by 2 years from first collection activity..	679
	2.	Special Relief for Spouses Who Are Separated, Divorced or Living Apart - § 6015(c).....	680
	3.	Equitable Relief - § 6015(f)..	681
	4.	Disqualifiers.....	684
	a.	Closing Agreement or Offer in Compromise.....	684
	b.	Fraudulent Transfers.....	684
	c.	Res Judicata and Collateral Estoppel.....	684
	5.	Collection Issues..	685
	a.	Statutes of Limitations Issues..	685
	b.	Community Property Issues..	685
	6.	Judicial Review.....	686
	7.	The Culpable Spouse..	687
	8.	Miscellaneous Issues.....	687
	C.	Separate Liability Relief For Community Property Items.....	688
XVI.		Collection from Third Parties.....	690
	A.	Property Titled to Others (Nominee and Transferee Liability)....	690
	1.	The Problem..	690
	2.	Nominee, Alter Ego, Agent and Related Concepts..	691

	a.	The Issue..	691
	b.	Nominee and Agent..	691
	c.	Alter Ego..	693
	d.	Other Theories..	694
	e.	Protections Against and Remedies for Wrongful Collection Activity..	694
	3.	Transferee Liability and Special Statutory Procedure.. . . .	695
	a.	General..	695
	b.	Transferee Liability Under § 6901..	698
B.		Liability for Trust Fund Taxes - the Trust Fund Recovery Penalty (“TFRP”)	704
	1.	Introduction..	704
	a.	Withholding Taxes a/k/a Trust Fund Taxes..	704
	b.	Trust Fund Recovery Penalty (TFRP) - § 6672..	707
	2.	Elements of Liability..	710
	a.	Parsing the Elements of the Statute..	710
	b.	Gravamen - Control of Financial Decisions..	710
	c.	Willfulness..	713
	d.	Reasonable Cause..	714
	e.	Exception for Unpaid Volunteers to Charities..	716
	3.	Administrative Procedures..	718
	a.	Audits and Appeals..	718
	b.	Assessments and Predicates..	719
	c.	Statute of Limitations..	720
	4.	IRS Policy to Collect Only Once..	721
	5.	Collection Due Process..	724
	6.	Litigating the TFRP..	724
	a.	The Traditional Procedure - The Refund Suit..	724
		(1) Procedural Predicates..	724
		(2) The Litigation..	728
		(3) Counterclaims and Other Parties..	728
	b.	The CDP Alternative Procedure..	729
	7.	Bankruptcy and the TFRP..	730
	8.	Planning for the TFRP..	731
	9.	Contribution Among Responsible Persons..	732
	10.	Summary..	733
C.		Section 3505 Liability	736
D.		Special Collection Mechanisms for Tax Liabilities of Estates And Donees	736
	1.	The Problem..	736
	2.	Beneficiary and Donee Liability for Estate or Gift Tax Under § 6324..	737
	a.	Lien on Property Transferred..	737
	b.	Personal Liability..	739

c.	Relationship to 6901..	741
3.	Executor under 31 U.S.C. § 3713...	741
E.	Transfers By Disclaimer or Renunciation..	742
F.	IRS Use of State Law..	742
G.	Constitutional Protections..	743
XVII.	International Aspect of Collection of U.S. Tax from NonResidents..	743
XVIII.	International Aspects of Collection of Foreign Country Tax.....	744
A.	The Revenue Rule.....	744
B.	Alternatives Consistent with the Revenue Rule.....	745
1.	Custodian Subject to U.S. Process.....	745
2.	Compulsory Process Against the U.S. Taxpayer.....	745
C.	Cracks in the Revenue Rule.....	746
1.	Treaties..	746
2.	Pasquantino and Extensions..	747
Ch. 15.	Partnerships and S Corporations.....	748
I.	Introduction.....	748
II.	Partnerships..	750
A.	Entities Subject to Procedures.....	750
B.	Partners Subject to the Procedures.....	751
C.	Rule of Consistency in Partner Return Reporting..	751
D.	Unified Partnership Level Proceedings for Partnership Items..	752
E.	Statutes of Limitation.....	756
F.	Tax Matters Partner.....	759
G.	Notice to Partners.....	760
H.	Partner Participation in Proceedings..	760
I.	Settlements.....	760
J.	Conclusion of Audit - 60-Day Letter & Appeal. .	761
K.	Conclusion of Audit (or Appeal, If Taken) - FPAA.....	761
L.	Judicial Remedies..	762
M.	Conclusion of Unified Proceedings..	763
1.	Partnership Items.....	763
2.	Affected Items.....	763
3.	Penalties.....	764
N.	The Oversheltered Partner Return.....	764
O.	A Reprise..	765
III.	Large Partnerships.....	765
IV.	S Corporations..	766
Ch. 16.	Overpayments..	767
I.	Introduction.....	767
II.	Overpayment Issues Previously Addressed..	767
A.	Role of the Claim for Refund.....	767
B.	Interest.....	767

C.	Statutes of Limitation.....	767
D.	Who May Seek Return of the Overpayment?.....	767
III.	Tentative Refunds on Carrybacks and Claim of Right.....	768
IV.	Joint Committee Review of Large Refunds..	770
Ch. 17.	Miscellaneous..	774
I.	Nonfiler Initiatives..	774
II.	Tax Protestor and Tax Defier Initiatives..	775
III.	Lower Hanging Fruit - Global High-Wealth Returns; Foreign Accounts.777.....	
IV.	Alternative Dispute Resolution and Other Nontraditional Resolution Techniques.....	777
A.	Traditional ADR.....	777
B.	Other Quasi-ADR.....	778
1.	Advance Pricing Agreements (“APAs”).....	778
2.	Pre-Filing Agreements..	780
3.	Compliance Assurance Process (“CAP”).....	780
V.	Tax Shelters.....	781
A.	Introduction - The Compliance Problem.....	781
B.	Congressional Initiatives..	785
1.	Introduction.....	785
2.	Increasing the Promoter Penalty – Upping the Ante.....	786
3.	Tightening the Registration and Reporting Requirements.	788
a.	“Reportable Transactions.”	788
b.	Registration.	789
c.	Taxpayer Reporting..	789
d.	Penalties.....	790
e.	Extended Statute of Limitations..	791
f.	List Maintenance Requirement.....	791
g.	Injunctions.....	791
h.	FATP Privilege Denied.....	791
4.	Denying Interest Deductions..	792
5.	Codifying Economic Substance with A Strict Liability Penalty..	792
6.	Congressional Investigations.....	793
C.	Administrative Initiatives.....	795
1.	Strategic Study Initiatives..	795
a.	Office of Tax Shelter Analysis.....	795
b.	Abusive Shelters Initiative.....	795
2.	Abusive Shelters and the States.....	795
3.	Audits and Summonses..	796
4.	Designation for Litigation..	797
5.	Mandatory IDRs about Listed Transactions..	798

6.	Disclosure Initiatives.....	798
7.	Penalties.....	798
a.	Civil Penalties..	798
b.	Criminal Penalties.....	798
8.	Circular 230 and OPR Initiatives..	798
D.	Judicial Initiatives.....	799
1.	Judicial Enforcement of Summonses..	799
2.	Statute of Limitations Issues..	800
a.	Introduction - the 3-Year and 6-Year Statutes..	800
b.	Unlimited Statute for Fraudulent Tax Shelters.....	800
c.	Statute Extension for Summons Noncompliance.....	801
3.	Grand Jury Investigations.....	802
4.	Conclusion.....	803
VI.	Transfer Pricing.....	803
VII.	Industry Issue Resolution (“IIR”) Program.....	807
VIII.	Remedies for IRS Employee Misconduct.....	808
A.	Introduction.....	808
B.	Remedies Against the United States.....	809
1.	Federal Tort Claims Act (“FTCA”).....	809
2.	Remedies for Wrongful Return Information Disclosures.	810
3.	Reckless, Intentional or Negligent Disregard of Code and Regulations..	810
4.	Recovery of Attorneys Fees.....	810
C.	Remedies Against Government Employees (<u>Bivens</u>).....	811
Ch. 18.	Trends in Enforcement Efforts.....	812
I.	General.....	812
II.	Sources.....	812
III.	Trends.....	812
Ch. 19.	Ethics, Malpractice and Tax Procedure.....	813
I.	Introduction.....	813
II.	Ethical Issues in Planning.....	813
III.	Ethical Issues in Return Preparation.....	813
IV.	Ethical Issues with Amended Returns.....	816
V.	Ethical Issues in the Audit.....	817
A.	Closing the Statute Gambit.....	817
B.	Statement 1999-1.....	818
C.	Conflicts of Interest in Audits.....	819
VI.	Ethical Issues in Litigation.....	820
VII.	Ethical Issues in Collections.....	820
VIII.	A Reminder on IRS Disbarment.....	821
IX.	A Brief Note on Malpractice.....	821

APPENDIX A - RESOURCES.....	822
APPENDIX B - INTEREST AND PENALTY EXAMPLES.....	824
APPENDIX C - ACRONYMS, INITIALISMS & SHORT-HANDISMS.	825
APPENDIX D - ON FOOTNOTES.	828

Ch. 1. Purpose and Scope.

This book is written for a law school course in federal tax procedure. Federal tax procedure is important:

“The procedural aspects of the tax laws are of overriding importance in many controversies,” one commentator has noted, “eclipsing or making moot substantive issues such as the allowance of deductions or credits, recognition or deferral of income, and methods of accounting.” Theodore D. Peyser, *627-3rd Tax Management Portfolio, “Limitations Periods, Interest on Underpayments and Overpayments, and Mitigation”* at 1 (2010). At times, the questions spawned by these procedures take on an almost “metaphysical” cast, Baral v. United States, 528 U.S. 431, 436 (2000), like “when is taxable income taxed?” The ontology needed to solve such abstruse inquiries comes not from philosophical tomes, but from Chapters 63 through 66 of the Internal Revenue Code of 1986, which supply interfused rules mapping the contours of commonly-used, but frequently-misunderstood, tax concepts such as “assessment,” “deposit,” and “overpayment.”¹

I “publish” the book in pdf format. There are two pdf versions: a version without footnotes which I refer to as the student version; and a version with footnotes which I refer to as the practitioner version. For the course, I encourage my students to use the student edition (i.e., no footnotes). The footnotes are distracting and are not needed for the course as I teach it. I would have footnoted the following, but I want all students to read it: the following is from the transcript of the oral argument in Cuno v. DaimlerChrysler, Inc., 545 U.S. 1165 (2006):²

Mr. Enrich: In a footnote in Flast [v. Cohen], the Court specifically says, “Having now decided that there's Establishment Clause standing, we can also reach the free-exercise question without discussing whether there would be independent standing.”

Justice Scalia: I had not recollected that footnote. I will -- I will find it. I don't read footnotes, normally.

Regardless of whether Justice Scalia’s practice is good or bad (actually I like to read and write footnotes),³ I have attempted to put in the text the material that I believe a student should know for this class. Accordingly, the student edition has no footnotes; using that edition, the student will not

¹ Principal Life Insurance Company v. United States, 95 Fed. Cl. 786, 788 (2010).

² As reported in the Tax Prof Blog reported on 3/20/06 and the Wall Street Journal Law Blog on 3/20/06.

³ In earlier versions of this text, I had a long – too long – digression on footnotes in this footnote. I decided to move that diversion into Appendix D to this text. Appendix D is not required nor, for most, even suggested reading. But having penned it to my suiting, I was reluctant to just discard it altogether.

be tempted to read the footnotes. (I do wonder, however, whether Justice Scalia's admission is a suggestion that footnotes in his opinions should not be read; you don't have to wonder for this class since the student edition has no footnotes.)

For those who enjoy the distraction of footnotes, by all means take advantage of the footnoted version. In the footnotes, I present more detail and citations to authority that will be more useful to practitioners than to students. I repeat, however, that I strongly encourage my students for this class not to be tempted to use the footnoted version. For readers using the footnoted version of this text, I caution that even my more detailed footnotes cannot fully discuss all the nuances, much less present those nuances correctly. For the practitioner requiring more detail, I recommend Michael Saltzman and Leslie Book, IRS Practice and Procedure (Thomsen Reuters 2015).⁴ Professor Book and some colleagues publish the very helpful Procedurally Taxing Blog.

My principal focus is on the Internal Revenue Code. I want the student to read the Code Sections cited in the text. Students should access the Code routinely and test what I say against the Code's commands. I cite in the footnotes many Code sections and subsections that are not important for the class to know or read. I follow a similar practice for case citations, but include in the text only the case citations of key cases that the student should know by name. Where I cite a case in the text, the student should try to remember the case name, for it has become a term of art in tax procedure practice. I will sometimes ask the student to read the case cited. I have a lot more case citations and discussions in the footnotes, but the student will not have the footnotes and thus not be tempted to divert his or her attention away from the text.

Helpful discussion and links for class information may be found at the following site:

<http://federaltaxprocedure.blogspot.com/p/uh-law-tax-procedure-class-information.html>

Finally, acronyms and similar short-hand reference techniques (all of which I lump under the term acronyms)⁵ are ubiquitous in the practice of tax law, as in life itself. They are perhaps

⁴ I was the principal author of Chapter 12 of the 2015 edition of this treatise, titled Criminal Penalties and the Investigation Function.

⁵ Purists on the English language often articulate a difference between acronyms and initialisms – both based on the same short-hand techniques (most often the initial letters of the series of words) as follows: An initialism is a word made up of initial letters that are pronounced separately as letters rather than as a word (e.g. IRS or FBI); an acronym is a word that is also made up of initial letters that are spoken as a word rather than separate letters (e.g., NATO). See University of Chicago Press, Chicago Manual of Style 15.3, Some Definitions (Online Edition as of 3/8/07). Similar short-hand techniques are encountered and may be variations on the theme – e.g., FBAR (for foreign bank account reports studied in this class) and FinCen for the Financial Crimes Enforcement Network. For ease of reference and at the risk of offending purists, I refer in this book to all such techniques herein as acronyms. I am not a purist in the English language, as the reader will conclude from my occasional abuse of the language in this text.

overused,⁶ but I can't solve that problem in this class. I will use acronyms relevant to this class and will define each acronym at least when first I use it. I have a list of acronyms (as defined) in Appendix C.

⁶ In Nat'l Ass'n of Regulatory Util. Comm'rs v. United States DOE, 680 F.3d 819, 820 n. 1 (D.C. Cir. 2012), the Court expressed frustration with the overuse of obscure acronyms in the parties' briefs. Said the Court:

We also remind the parties that our Handbook of Practice and Internal Procedures states that "parties are strongly urged to limit the use of acronyms" and "should avoid using acronyms that are not widely known." Brief-writing, no less than "written English, is full of bad habits which spread by imitation and which can be avoided if one is willing to take the necessary trouble." George Orwell, "Politics and the English Language," 13 *Horizon* 76 (1946). Here, both parties abandoned any attempt to write in plain English, instead abbreviating every conceivable agency and statute involved, familiar or not * * *.

Ch. 2. Structure of the Federal Revenue Function.

Revenue is the life blood of Government and society as we know it. As Justice Holmes famously said: “Taxes are what we pay for civilized society.”⁷ All taxpayers,⁸ of course, do not place the same value on civilized society; dealing with that difference in attitude is a large part of what this class is about. That taxes are a significant component of our Government and society, however, cannot be seriously questioned.

The revenue function of our federal government is massive and engages each of the three branches of Government -- the legislature, the executive and the courts. The criminal aspects of the revenue function also addresses another branch of Government – the grand jury -- which the Supreme Court describes as “an institution separate from the courts, over whose functioning the courts do not preside.”⁹ We shall touch on the grand jury lightly in this course which is designed to deal principally with civil procedural aspects of the tax system.¹⁰

I. Legislative Branch.

A. House/Senate Roles in Tax Legislation.

The Constitution provides (Article I, § 7): “All Bills for raising Revenue shall originate in the House of Representatives; but the Senate may propose or concur with amendments as on other Bills.” This provision is referred to as the Origination Clause.¹¹

⁷ Compania de Tabacos v. Collector, 275 U.S. 87, 100 (1927) (dissenting).

Taxes even have important religious aspects. Jesus famously said that we should “Give to Caesar what is Caesar's, and to God what is God's.” Matthew 22:21 (New International Version).

⁸ I use the term taxpayer in this text in a sense broader than just those who actually pay tax, but also usually include in the term those persons who owe taxes without regard to whether they paid them. Thus, for example, a total tax scofflaw may not pay any tax and not file any return, even though he owes tax and is required to file. That person will usually be referred to as a taxpayer.

⁹ United States v. Williams, 504 U.S. 36, 47 (1992).

¹⁰ There are many good texts on the grand jury. I refer often to Paul S. Diamond, Federal Grand Jury Practice and Procedure (Juris Publishing, Inc. 5th ed. 2012, with pocket supplements). For more discussion of the grand jury in the context of the tax system, readers might also want to refer to my book on Tax Crimes which is downloadable free from my web site and to a publication which I co-authored with Larry Campagna, Steve Johnson and Scott Schumacher, Tax Crimes (Lexis Nexis 2015).

¹¹ For good articles on history, application and interpretation of the Origination Clause, see Rebecca M. Kysar, the Shell Bill' Game: Avoidance and the Origination Clause, 91 Wash. U. L. Rev. 659 (2014); and Michael W. Evans, “A Source of Frequent and Obstinate Altercations”: The History and Application of the Origination Clause, 105 Tax Notes 1215 (Nov. 29, 2004).

B. Statutes and Their Meanings.

Assuming proper origination, the two houses of Congress pass a bill, and the President signs it into law. The executive and judicial branches then implement the statute in their respective spheres of constitutional authority. I address those branches below. But first I want to discuss some aspects of the legislative process that bear upon how the executive and judicial branches apply the statute through a process of interpretation.

Some jurists – Justice Scalia the most visible – give primacy to the statutory text and are reluctant to look beyond the statutory text (for example, to the legislative history) for assistance in determining how the statutory text should be interpreted.¹² They may discern what they often call the “plain meaning” to statutory text; in such cases, they profess to give little or no credence to broader legislative context, including legislative history (such as Committee Reports), because, they reason, only the statutory text was enacted by Congress and the text means what they believe it plainly says.¹³ This approach to statutory interpretation is often called textualism.¹⁴ If context is relevant at all to textualists, it is internal context (i.e., context within the statute itself rather than context determined from sources external to the statute) and perhaps the context of what the legislative words would mean to the hypothetical reasonable person versed in the English language as of the date of enactment (thus, for example, permitting resort to a contemporaneous dictionary). Other jurists find that broader legislative context assists in interpreting text and are willing to look to that broader context, most immediately the legislative history, to determine how the enacted text

¹² Justice Scalia’s impact in the debate in terms of influencing others to the same position has been questioned. See David S. Law and David Zaring, Law Versus Ideology: The Supreme Court and the Use of Legislative History, 51 Wm. and Mary L. Rev. 1653, 1659 (2010). Other authors conclude from smaller and perhaps less sophisticated samplings that Justice Scalia has had a significant impact, if not so much on other Justices on the Supreme Court then in the lower courts. *Id.* 1671-1672, 1682. Professors Law and Zaring, however, question the sophistication of the prior analyses to address the determinants in the use of legislative history.

¹³ Earlier in his career while on the D.C. Circuit Court of Appeals, Justice Scalia so pronounced by quoting a marvelous floor dialog between Senator Armstrong and Senator Dole, then Chair of the Finance Committee, in which Senator Dole denied having written or even read or even knowing whether any Senator wrote or even read the Committee Report and denied that the Report had been voted on by the Committee. Hirschey v. F.E.R.C., 250 U.S. App. D.C. 1, 777 F.2d 1, 7 n.1 (D.C. Cir. 1985) (Scalia, J., concurring) (quoting 128 Cong. Rec. S8659 (daily ed. July 19, 1982)). Senator Armstrong concluded the dialog with the following comment: “[F]or any jurist, administrator, bureaucrat, tax practitioner, or others who might chance upon the written record of this proceeding, let me just make the point that this is not the law, it was not voted on, it is not subject to amendment, and we should discipline ourselves to the task of expressing congressional intent in the statute.”

¹⁴ See <http://en.wikipedia.org/wiki/Textualism> (also containing a fair general description of the concept and noting the difference between textualism, of which Justice Scalia is a proponent, and strict construction, of which Justice Scalia is not a proponent).

should be interpreted.¹⁵ This approach to interpretation has different iterations that go by the terms intentionalism, purposivism and the practical reason (or dynamic) method.¹⁶

I will use an oversimplified example to illustrate the differences. If Congress uses the term white in a statute but, in a definitions section of the statute, Congress defines white to include gray, then the statute itself would require that the word white include gray. All approaches to

¹⁵ Citing Justice Breyer as its most visible champion, two authors say that this mode of interpretation “cite[s] legislative history for the innocuous reason that it is a useful aid to interpreting statutes that lack clear meaning.” David S. Law and David Zaring, Law Versus Ideology: The Supreme Court and the Use of Legislative History, 51 Wm. and Mary L. Rev. 1653, 1658 (2010). Professors Law and Zaring summarize more nuance in Justice Breyer’s approach as follows (p. 1660, footnotes omitted):

To consider legislative history, he [Justice Breyer] has argued, is akin to “find[ing] out the purpose of an action taken by a group” by “ask[ing] some of the group’s members about it”: given a purposive approach to statutory interpretation, it is sensible and unobjectionable to consider legislative history. Nor, in his view, must the use of legislative history be confined to discerning the purpose of an enactment. It can also help judges to “avoid[] an absurd result,” “explain[] specialized meanings,” “choos[e] among reasonable interpretations of a politically controversial statute,” and even “illuminate drafting errors that courts should correct”-as the Court itself has demonstrated on various occasions.

¹⁶ The issue also has constitutional ramifications, since the Constitution is but a “super-statute.” When are sources outside the Constitution relevant to the search for constitutional text meaning? Any number of cases could be discussed to develop this issue, but I refer to one as an example. In Crawford v. Washington, 541 U.S. 36 (2004), the Court struggled with the application of the Confrontation Clause. In the context, presented, the Court handily found “The Constitution’s text does not alone resolve this case.” Thereupon, the Court launched into the history of the Clause – its context or even “legislative history” in a broader sense – to resolve the case. In a constitutional context, the Court often repairs to the Constitution’s principal contextual documents – James Madison’s notes of the convention (which are somewhat analogous to legislative history) and the Federalist Papers (somewhat like legislative history since they framed the debate in some of the state constitutional conventions approving the Constitution) – for guidance. See Hans W. Baade, “Original Intent” in Historical Perspective: Some Critical Glosses, 69 Tex. L. Rev. 1001, 1003-5 (1991). The same type of inquiry is required for legislation, although the sources of relevant context may be different.

The Constitutional interpretation variation of this debate has been forcefully addressed in retired Justice Souter’s commencement address at Harvard University on May 27, 2010. I recommend Justice Souter’s address, for it is powerful in the important context of constitutional interpretation that every lawyer should be familiar with, but also offers insight into some of the principal issues in the statutory interpretation debate. Justice Souter’s address may be viewed at: <http://news.harvard.edu/gazette/story/2010/05/text-of-justice-david-souters-speech/>.

interpretation would interpret the statutory text white as including gray.¹⁷ However, if, that definition were not in the statute but was used in the committee reports to explain the legislation and also discussed without objection on the respective Houses' floors immediately before passage of each bill, so that any reasonable person would conclude that the legislators intended white to include gray, still a textualist might say that white in the statute still does not mean gray because white is white and gray is not white. The other approaches might find a way to achieve Congress' intended purpose. This stark a contrast is not usually encountered. More often, to use the same metaphor, it would be whether the use of the statutory term white includes off-white. A textualist might say that white is white and is not off-white and if Congress meant white to include off-white, it would - certainly should - have said so in the statute. Another textualist might say, however, that off-white is still white, and Congress did say white without differentiating shades of white. Seizing on the potential for at least some ambiguity in the statute text (i.e., is off-white included in the term white?), the other interpretive approaches might use the legislative history to interpret the word white to include off-white or not include off-white. Indeed, even a textualist who takes the second interpretation (off-white is still a variation of white and thus included) might find comfort for that interpretation (although not support) in the legislative history. And, of course, a textualist who believes that it is plain that white does not include off-white might be comforted in that conclusion if the legislative history confirmed that plain meaning.

This debate is a variation of a theme introduced early to law students in the famous sound bite from Justice Oliver Wendell Holmes in a federal tax case:

¹⁷ Although not directly in point, I can't resist offering up this from a case that has become somewhat of a legend. In United States v. Byrnes, 644 F.2d 107, 112 n. 9 (2d Cir. 2007), the Court addressed the momentous issue of the definition of birds in applying the perjury statute and offered this from a sister jurisdiction:

n9 For a liberal construction of the term "birds," by a Canadian court see Regina v. Ojibway, 8 Criminal Law Quarterly 137 (1965-66) (Op. Blue, J.), holding that an Indian who shot a pony which had broken a leg and was saddled with a downy pillow had violated the Small Birds Act which defined a "bird" as "a two legged animal covered with feathers." The court reasoned that the statutory definition "does not imply that only two-legged animals qualify, for the legislative intent is to make two legs merely the minimum requirement.... Counsel submits that having regard to the purpose of the statute only small animals 'naturally covered' with feathers could have been contemplated. However, had this been the intention of the legislature, I am certain that the phrase 'naturally covered' would have been expressly inserted just as 'Long' was inserted in the Longshoreman's Act.

"Therefore, a horse with feathers on its back must be deemed for the purpose of this Act to be a bird, a fortiori, a pony with feathers on its back is a small bird." Id. at 139.

A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used.¹⁸

Holmes' observation segues nicely into a statement by another revered jurist, Learned Hand, in a tax case:

The literal meaning of the words of a statute is seldom, if ever, the conclusive measure of its scope. Except in rare instances statutes are written in general terms and do not undertake to specify all the occasions that they are meant to cover; and their "interpretation" demands the projection of their expressed purpose, upon occasions, not present in the minds of those who enacted them. . . .¹⁹

Still, as noted, the plain meaning enthusiasts continue to have considerable sway in the interpretation process.²⁰ Maybe plain meaning enthusiasts really mean something different than literal meaning

¹⁸ Towne v. Eisner, 245 U.S. 418, 425 (1918). There are any number of tax cases illustrating the concept that words and nuances of their interpretations can vary "in color and content according to the circumstances." For example, as we discuss later in the text, the Internal Revenue Code and other Codes refer to a tax "return." As interpreted the simple and ubiquitous "return" does not mean the same thing in all contexts. See In re Payne, 431 F.3d 1055, 1059 (7th Cir. 2005), Posner, J, ("All the cases cited to us make sense and are consistent if 'return' can vary with context; nonsense results if 'return' must bear the same meaning everywhere."); and Conforte v. Commissioner, 692 F.2d 587, 591 (9th Cir. 1982) (acknowledging "the possibility that the same word could have a different meaning in different parts of the code," and concluding that "where, as here, a word could well have a different meaning in different statutory contexts, a purpose-oriented approach should be used when interpreting the meaning of the word as it is used in different sections of the Code.")

¹⁹ Gilbert v. Commissioner, 248 F.2d 399, 411 (2nd Cir. 1957) (dissenting). In more flowing terms, Judge Learned Hand delivered up another good statement of the concept in Helvering v. Gregory, 69 F.2d 809, 810 (2^d Cir. 1934), aff'd. as Gregory v. Helvering, 293 US 465 (1935), that leading tax case where the Supreme Court took his lead in imposing the ubiquitous business purpose requirement, as follows: "[T]he meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create."

I hope the reader of this footnote also reads Justice Souter's commencement address at Harvard, cited in an earlier footnote, dealing with similar phenomena in constitutional interpretation. See also Peter Ludlow, The Living Word (NYT Opinionator Blog 4/22/12), at <http://opinionator.blogs.nytimes.com/2012/04/22/the-living-word/>, noting that words in the constitution, just as words in any writing or speech are "undetermined and dynamic and thus 'living organisms.'"

²⁰ Perhaps the high water mark of this mode of interpretation in the tax area is Gitlitz v. Commissioner, 531 U.S. 206, 220 (2001) (where the Court sustained a taxpayer benefit that was plainly not intended by Congress, stating "Because the Code's plain text permits the taxpayers here

and really mean something more like “plain-to-me” meaning. In any event, this debate on interpretation is one that is not unique to federal taxation, but you must be aware of it as a student of federal taxation.²¹

I note that much tax planning – egregiously illustrated in the abusive tax shelters – is based on a textualist reading of statutes and cases and the hope that, should the IRS discover the plan and test it, the court called upon to review the planning will base its decision on a textualist reading as well, so that the planning will prevail despite its conflict with sound tax policy in the overall context of the Code. Sometimes, tax planners and their clients doing things they shouldn’t are lucky enough to draw jurists of a textual bent and are rewarded; sometimes not. And this often turns upon the jurist’s approach to statutory interpretation.²²

The issue of the proper touchstones for interpretation arises in many recurring contexts. In a tax setting, it most frequently arises with respect to legislative history. The legislative history is the course of congressional consideration in identifying the need for legislation, drafting or revising the legislation, and then enacting the legislation. The principal sources of legislative history are the committee reports which I discuss below. Other sources include committee hearings, statements made on the floor of Congress in debating the legislation, and submissions to Congress by the executive branch. There is a long and substantial history of judicial use of legislative history in

to receive these benefits, we need not address this policy concern.”). Gitlitz was a startling result; thankfully its mode of analysis is absent from subsequent Supreme Court tax cases and in the lower courts’ tax cases. See Lawrence Zelman, Response: the Court and the Code: a Response to the Warp and Woof of Statutory Interpretation, 58 Duke L.J. 1783 (2009) (noting that the result was absurd).

²¹ See Noel B. Cunningham and James R. Repetti, Textualism and Tax Shelters, 24 Va. Tax Rev. 1 (2004). One of the leading proponents of a “plain meaning” interpretation of statutes which eschews legislative history is Alex Kozinski who wrote an article aptly named Should Reading Legislative History Be an Impeachable Offense?, 31 Suffolk L. Rev. 807 (1998). For a good general introduction to the plain meaning debate, but focusing on state courts see Steve R. Johnson, Use and Abuse of “Plain Meaning”, State Tax Notes 831 (9/22/2008). Most jurists and scholars, however, tend to use legislative history to a greater or lesser degree, and do so particularly in the tax area where the Code is so complex and contextual terms are the norm rather than the exception. The eminent Judge Learned Hand fell in the latter camp, reasoning that statutes “should be construed, not as theorems of Euclid, but with some imagination of the purposes which lie behind them.” Lehigh Valley Coal Co. v. Yensavage, 218 F. 547, 553 (2d Cir. 1914).

²² This paragraph of the text was inspired by a statement made in a draft article, Henry M. Ordower, The Culture of Tax Avoidance, 55 Saint Louis University Law Journal xx, 2010 (draft viewed at SSRN-id1596684), as follows: “Tax planning often enjoys and is likely to continue to enjoy the protection of textualist judicial decisions.”

statutory interpretation, particularly in the tax area, however much the textualists may decry it.²³ In this regard, the Supreme Court has noted:

We have noted that “the true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part.”²⁴

Still, the polar extremes of textualism and intentionalism offer a convenient model for analysis of how the various courts approach the interpretation of tax statutes specifically. I cite two studies on the use of legislative history. The first is a study of Supreme Court opinions over a very long period (1953-2006) using statistical techniques and analysis to draw conclusions.²⁵ The authors’ findings include: use of legislative history is driven by a combination of legal and ideological factors, with legal factors (e.g., length and complexity of the statute,²⁶ frequency of amendment,²⁷ age of the statute (new and old statutes prompting reference to legislative history), etc.) having the most influence. Still ideological factors do have some influence: (i) “liberal Justices are generally more likely than conservative Justices to cite legislative history;” (ii) “Justices are more likely to consult legislative history when they are ideologically sympathetic to the purposes of the enacting Congress;” and (iii) as to ideological influence:

[T]he propensity of Justices to cite legislative history is significantly correlated with the ideology of the Justices themselves: liberal Justices are more likely than conservative Justices to use it. In addition, the fact that a Justice is of the same ideological bent as the legislators who enacted the statute increases the likelihood that he or she will turn to legislative history. At the same time, however, the fact that

²³ See Cunningham and Repetti, Textualism & Tax Shelters, 24 Va. Tax Rev. 1, 10 (2004) (“Nevertheless, for over one hundred years the courts have been willing to look at the legislative history of a statute to clarify ambiguities, and to avoid applying the law in ways that produce unintended results.”; the authors discuss Holy Trinity Church v. United States, 143 U.S. 457, 472 (1892) and cite Maureen B. Cavanaugh, Order in Multiplicity: Aristotle On Text, Context, and the Rule of Law, 79 N.C. L. Rev. 577, 587 (2001); William N. Eskridge, Jr., The New Textualism, 37 UCLA L. Rev. 621, 626-627 (1990).

²⁴ Commissioner v. Engle, 464 U.S. 206, 223 (1984) (quoting Helvering v. Morgan's, Inc., 293 U.S. 121, 126 (1934)).

²⁵ David S. Law and David Zaring, Law Versus Ideology: The Supreme Court and the Use of Legislative History, 51 Wm. and Mary L. Rev. 1653 (2010).

²⁶ The authors cite the Internal Revenue Code as one of the more complex statutes, requiring a reading level of 22.53 on the Fleish-Kinkaid scale measuring text complexity. *Id.* 1699-1701. The authors conclude that complexity is a factor tending toward the use of legislative history. This may be just another way of saying the plain meaning is usually discernible only where the statutes are less complex.

²⁷ The Internal Revenue Code is the most amended (p. 1702), a factor that might tend toward more use of legislative history. I presume this relates to being sure that the interpretation is appropriate to the complex setting within the Code.

a liberal Justice cites legislative history in a particular opinion does not render it more likely that the opinion in question will arrive at a liberal outcome.

Finally, we reject the oft-expressed hypothesis that Justice Scalia's vocal criticism of legislative history helps to explain the overall decline in legislative history usage since the Burger Court. The decline is more likely attributable to the overall rightward shift in the composition of the Court, for which no single Justice can be assigned either credit or blame. Liberal Justices who were inherently predisposed to use legislative history have, on the whole, been replaced by conservative Justices who are not. Controlling for such factors as the ideology of each Justice, we found no evidence that Justice Scalia has influenced the legislative history usage of other members of the Court.²⁸

I should caution that this study analyzes interpretation of the gamut of statutes and is not limited to tax statutes (although tax statutes were a significant component of the data set). It is often felt that use of legislative history for interpreting tax statutes may not fit within mainstream analyses simply because, Justice Scalia aside, there is a long tradition of using legislative history for interpreting tax statutes. The notion may be that tax statutes are more bipartisan (perhaps in earlier years) and expertise driven, so as to make the legislative history are more reliable guide to what the text means (or should mean).²⁹

The other study focuses on interpreting tax statutes by the lower courts.³⁰ This study draws broad conclusions from a study of 10 cases where the literal meaning of the text of the statute was demonstrably at odds with the intentions of the drafters. The study determined that, with surprising consistency, the Tax Court adopted an intentionalist approach but the courts of appeals adopted a textualist or plain meaning approach. A general tendency of the Tax Court to adopt an intentionalist approach is perhaps not surprising, since it is a tax specialty court more attuned to the nuances and needs of a comprehensive tax system governing a complex economy. Courts of appeals and the Supreme Court for that matter tend to lack that tax background and approach and often focus more narrowly on the text in order to apply some plain meaning, perhaps justified in part on the notion that the public at large must deal with the statute in a generalist sort of way and structure transactions without the detailed nuances that might be available by going beyond the text of the statute.

²⁸ Id., at p. 1659; see also Nicholasa R. Parrillo, Leviathan and Interpretive Revolution: The Administrative State, the Judiciary, and the Rise of Legislative History, 1890-1950, 123 Yale L.J. 266, 270-271 (2013).

²⁹ Id. at p. 1669-70, citing James J. Brudney & Corey Ditslear, The Warp and Woof of Statutory Interpretation: Comparing Supreme Court Approaches in Tax Law and Workplace Law, 58 Duke L.J. 1231 (2009) and a predecessor article by the same authors. Professors Brudney and Ditslear concluded a significant use prior to Justice Blackmun's death because of his disproportionate involvement in tax opinions based on his private practice experience in tax but a decline afterward.

³⁰ See David E. Shores, Textualism and Intentionalism in Tax Litigation, 61 Tax Law. 53 (2007).

C. Committees and Committee Reports.

Substantive consideration of tax bills in each house is principally through the committee having jurisdiction over taxes. In the House of Representatives, the **Ways and Means Committee** considers tax legislation; in the Senate, the **Finance Committee** considers tax legislation. Each committee considers proposed tax legislation³¹ and makes recommendations in the form of bills sent to the floor of their respective houses for floor debate and action. Each committee draws on the expertise of the staff of the prestigious and relatively nonpartisan Joint Committee on Taxation (“JCT”), discussed below, which gives each committee’s actions a degree of technical expertise often not present in other areas of legislation.³²

Each Committee's recommendations in the form of a bill are usually accompanied by a **Committee Report**. The Committee Report explains the bill – the problems that the Committee drafted the bill text to solve and an explanation of how the text will apply to solve the problems. As suggested above, whether and how useful Committee Reports are in interpreting the legislation is a disputed topic that frequently engages the courts and legal pundits. Given the legislative process where the substantive consideration and comment on pending legislation is principally (sometimes exclusively) in the Committee, it should not be surprising that courts looking beyond the statute for meaning tend to give significant weight to the Committee Reports.³³ Courts have frequently used legislative history to assist in the interpretation of the Internal Revenue Code, although there will be occasional complaints such as that Congress passed the statute not the Committee Report.

The committees also hold hearings on significant legislation. The materials submitted and transcripts from this process may be helpful in understanding context but they rarely are persuasive of themselves because, unlike the Committee Reports, they rarely reflect anything that could be called a consensus.

As mentioned, the **Joint Committee on Taxation** (“JCT”),³⁴ a joint congressional committee with representatives of the Ways and Means and Senate Finance Committees, is significantly

³¹ It is reported that, unlike some other committees, the Committee Members of the House Ways and Means Committee and Senate Finance Committee “rarely consider statutory language when discussing a tax bill” but rather make decisions based on general concepts that are reduced to writing or refined by the Committee staff. Michael Livingston, Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes, 69 Tex. L. Rev. 819, 833 (1991), cited in Cunningham and Repetti, 19-20 as an argument against the textualist approach.

³² See James J. Brudney and Corey Ditslear, The Warp and Woof of Statutory Interpretation: Comparing Supreme Court Approaches in Tax Law and Workplace Law, 58 Duke L. J. 1231, 1246-1247 (2009)

³³ See e.g., Garcia v. United States, 469 U.S. 70, 76 (1984) (holding that the most “authoritative source for finding the Legislature's intent lies in the Committee Reports”).

³⁴ The JCT is authorized and empowered by Subtitle G of the Code (§§ 8001 ff.).

involved in the process. The following is a succinct summary of its role by a former Chief of Staff of the JCT:³⁵

The JCT is a bipartisan committee of ten members of the House and Senate tax-writing committees, and exists principally to provide justification for its staff. The committee does not report legislation, and rarely convenes hearings or performs other traditional functions of a legislative committee. The staff of the JCT — currently including about 50 economists, lawyers, and accountants — assists every member of Congress at each stage of the tax legislative process, and provides a source of tax expertise that is independent of the executive branch. The staff is nonpartisan rather than bipartisan; unlike staff supporting most other Congressional committees (including certain joint committees), the JCT staff is not affiliated with any party and is not separated into majority and minority party staff members.

Although the staff serves all of Congress, its principal duty is to be a policy advisor to the chairs, ranking members, and other members of the tax-writing committees. In this role, the staff helps to develop, analyze, and evaluate many tax policy options for those committees and assists with all of the legislative tasks necessary for enactment of a bill. In addition, the staff provides the official revenue estimates used by Congress for all proposed tax legislation. The staff also reviews all tax refunds in excess of \$2 million³⁶ and monitors the administration of the tax laws by the IRS. Occasionally, the staff performs tax-related investigations, such as examining President Nixon's tax returns and the tax positions of the Enron Corp. The JCT and its chief of staff are given direct access to otherwise confidential tax return information and permitted to delegate that access to others.

D. Floor Consideration.

After being reported out of the committee, the full House of Representatives and Senate will consider and, in some cases, debate the recommendations prior to approving the text of the bills. Those deliberations are legislative history also, but discerning consensus of understanding from floor statements or record insertions by individual legislators is problematic. Sometimes, in the past at least, if the comments on the floor were made by the Chairman of the tax committee in that house, the comments have been considered particularly persuasive.³⁷ Or sometimes, by de facto consensus of the legislators, there may be an orchestrated dialog – referred to as a colloquy – during the floor consideration designed to put a spin on the statutory language that, due to circumstances, may be

³⁵ George K. Yin, James Couzens, Andrew Mellon, The "Greatest Tax Suit in the History of the World," and the Creation of the Joint Committee on Taxation and its Staff, 66 Tax L. Rev. 787 (2013).

³⁶ § 6405.

³⁷ See, e.g., Walt Disney Productions v. United States, 480 F.2d 66, 68 (9th Cir. 1973), cert. denied 415 U.S. 934 (1974).

considered authoritative.³⁸ But generally, floor discussions are not considered authoritative in and of themselves because there is usually no confirmation that the statements reflect a consensus.

E. Summaries of Proposed Legislation and Other Proposals to Congress.

The committees in their deliberations and the senators or representatives in their floor discussions may also consider summaries of the proposed text of the bills prepared by the Joint Committee on Taxation. These summaries are in the legislative history but it is sometimes unclear what use the committees or the full houses actually made of the summaries, so the extent to which a court might consider them authoritative is heavily dependent upon the particular circumstances.³⁹

Similarly the text may have originally been presented as proposed legislation by the Treasury Department on behalf of the administration along with discussion of the purposes and effect of the text, if enacted. Those discussions are helpful background but, again, it may be difficult to determine that they represented a consensus of the legislators.

Finally, proposals considered by the tax writing committees may come from other sources or other sources / interests may become involved in the consideration in a way that does not get into the more direct forms of legislative history. What is the value, if any, of those sources in any attempt to determine what it is that Congress did? The answer appears to be virtually none when those efforts were not made a formal part of the legislative history.⁴⁰

F. Conference Committees and Reports.

If the House and Senate Bills differ, as is likely at least for some of the provisions of major tax legislation, the differences are worked out in “conference” through a Conference Committee comprised of representatives from the House and the Senate tax writing committees. The **Conference Committee** resolves the differences and agrees upon a single bill that is then presented to the Senate and House of Representatives for passage. The Conference Committee also produces

³⁸ For a particularly thoughtful discussion by the former chair of the House Ways and Means Committee on the use of colloquies as interpretive aids of congressional intent as to the text of a statute, see Glass v. Commissioner, 87 T.C. 1087, 1168-69 (1986).

³⁹ The issue of the use of summaries was addressed but hardly resolved in Robinson v. Commissioner, 119 T.C. 44 (2002), in the context of JCT summaries for the Conference Committee. I discuss the Conference Committee below, but the role of such JCT summaries apply equally to all committees involved in the tax writing process.

⁴⁰ For example in United States v. G-I Holdings, Inc. (In re G-I Holdings, Inc.), 369 B.R. 832 (D. N.J. 2007), in a bankruptcy proceeding with a large amount of taxes in issue, the taxpayer sought to introduce the affidavit of a lobbyist involved in the process of “encouraging” the Congressional powers to be to insert a favorable effective date provision the language of which apparently did not achieve its goal. The purpose of the affidavit was to give the court some pertinent “legislative history” that would permit it to interpret the provision in its favor. The Court was not amused or, perhaps, appreciative, and denied the maneuver. The Court reasoned that the testimony in the affidavit was not legislative history and not helpful to the court in interpreting the statute.

a report — the **Conference Committee Report** — that serves the same function of the committee reports earlier mentioned — i.e., it states publicly the Conference Committee’s reasons for resolving the differences (or at least the reasons the Committee will state publicly) and thus may aid in the interpretation of the text of the bill finally enacted. The Conference Committee Report is legislative history,⁴¹ and as to the matters approved by the Conference Committee is quite persuasive (at least for those courts who give weight to legislative history).⁴²

As with the two houses acting independently, the hearings and considerations preceding the Conference Committee’s action will also be legislative history but suffer the same uncertainties noted above in terms of their use in interpreting the statutory text ultimately enacted.

G. Subsequent Legislative History?

1. The Oxymoron of Subsequent Legislative History.

After legislation is enacted, Congress or, more usually, a committee or member may state in a committee or on the floor of the House he serves an interpretation of the previously enacted legislation. Are these statements properly considered in interpreting the statute? Consider the following from Justice Scalia in top form:

The legislative history of a statute is the history of its consideration and enactment. “Subsequent legislative history” -- which presumably means the post-enactment history of a statute's consideration and enactment -- is a contradiction in terms. The phrase is used to smuggle into judicial consideration legislators' expressions not of what a bill currently under consideration means . . . but of what a law previously enacted means.⁴³

2. But Then There’s the Blue Book.

After a major revenue act or at the end of each Congress, the Staff of the **Joint Committee on Taxation** (“JCT”), a congressional joint committee of House and Senate members with a deep and prestigious staff to assist the Senate and House of Representatives on tax legislation, will usually produce a Staff General Explanation of the legislation. This Staff General Explanation is often referred to as the “**Blue Book**.” The Blue Book states the JCT Staff’s understanding of the legislation that was passed based upon the legislative history. At least in recent times, the content

⁴¹ E.g., Robinson v. Commissioner, 119 T.C. 44 (2002).

⁴² See Nestle Purina Petcare Co. v. Commissioner, 594 F.3d 968 (8th Cir. 2010) (citing Sierra Club v. Clark, 755 F.2d 608, 615 (8th Cir. 1985) which quoted Demby v. Schweiker, 671 F.2d 507, 510 (D.C. Cir. 1981) (“Because a ‘conference report represents the final statement of terms agreed to by both houses, next to the statute itself it is the most persuasive evidence of congressional intent.”)).

⁴³ Sullivan v. Finkelstein, 496 U.S. 617, 631 (1990) (Scalia, J., concurring). I cover below the effect of the IRS’s subsequent interpretation of its own authoritative interpretation (e.g., a regulation) which is comparable to a form of subsequent legislative history.

of the Blue Book hews closely to the language of the statute and legislative history (such as the committee reports leading to the legislation). Most of the Blue Book's explanation of the legislation thus might be viewed as a virtual cut and paste compilation of the statute and legislative history.⁴⁴ It has thus been said that the purpose of the Blue Book is to "to provide a single, comprehensive source of legislative history for major tax acts."⁴⁵

But, in order to be a unified, comprehensive source, the Blue Book sometimes – perhaps more in the past – is not just a cut and paste but a description of the statute and legislative history in words other than the statute and legislative history. In stating its understanding in words different than the statute and legislative history, the Staff may add nuance or interpretations perhaps not compelled by the legislative history. Therein lies the rub. The Blue Book is not itself legislative history; that nuance and those interpretations are not legislative history. When the Blue Book differs, even subtly, from the actual legislative history, the issue is whether the departure has some authority because of the key vantage point of the Staff of the Joint Committee in the legislation process.⁴⁶ Some courts are wary of the Blue Book where it goes beyond parroting or paraphrasing the statute or the direct legislative history;⁴⁷ of course, when all the Blue Book does is parrot the actual legislative history, the actual legislative history is the source for interpretation and is real legislative history.

⁴⁴ A JCT staff member explained to me this process of closely hewing to the actual legislative history and where the legislative history did not address an issue that, in the Staff's view, should be addressed, it might note in the Blue Book the need for technical corrections, a process whereby actual legislation is subsequently enacted to correct problems in the statute.

⁴⁵ Livingston, What's Blue and White and Not Quite as Good as a Committee Report: General Explanations and the Role of 'Subsequent' Tax Legislative History, 11 Am. J. Tax Pol'y 91, 98 (Spring 1994).

⁴⁶ My understanding is that, in the past, the Administration and private interests would lobby subtly for favorable interpretations.

⁴⁷ E.g., Federal National Mortgage Association v. United States, 379 F.3d 1303, 1309 (Fed. Cir. 2004) ("As a post-enactment explanation, the Blue Book interpretation is entitled to little weight. Jones v. United States, 526 U.S. 227, 238, 143 L. Ed. 2d 311, 119 S. Ct. 1215 (1999)."); and Exxon Mobil Corporation v. Commissioner, 689 F.3d 191, 201 (2d Cir. 2012) (quoting and stated its "agreement"). For a thoughtful exposition of this view, see AD Global Fund LLC v. United States, 67 Fed. Cl. 657, 677- 678 (2005), aff'd 481 F.3d 1351 (Fed. Cir. 2007).

Although not legislative history, courts, even those which on occasion express concern about the role of the Blue book, rely upon the Blue Book as some indication of what Congress intended.⁴⁸ As one court reasoned:

[A]s other federal courts around the country have noted, the Blue Book, as an interpretation of the statute by experts involved in the drafting process and very familiar with the problems being addressed, plainly has some value, particularly where the statute is ambiguous and the only available legislative history is limited to expressing broad policy goals. Where, as here, the explanation offered by the Blue Book accords both with the explicit statements of broad Congressional intent and with the most logical and consistent reading of somewhat ambiguous statutory provisions, that explanation is entitled to some weight.⁴⁹

The Supreme Court (Justice Scalia for a unanimous Court) weighed in on the issue as follows:

Woods contends, however, that a document known as the “Blue Book” compels a different result. See General Explanation of the Economic Recovery Tax Act of 1981 (Pub. L. 97-34), 97 Cong., 1st Sess., 333, and n. 2 (Jt. Comm. Print 1980). Blue Books are prepared by the staff of the Joint Committee on Taxation as commentaries on recently passed tax laws. They are written after passage of the legislation and therefore do not inform the decisions of the members of Congress who vot[e] in favor of the law. We have held that such post-enactment legislative history (a contradiction in terms) is not a legitimate tool of statutory interpretation.” While we have relied on similar documents in the past, our more recent precedents disapprove of that practice. Of course the Blue Book, like a law review article, may be relevant to the extent it is persuasive. But the passage at issue here does not persuade. It concerns a situation quite different from the one we confront: two

⁴⁸ See Kikalos v. Commissioner, 190 F.3d 791, 798 (7th Cir. 1999) (“This [Blue Book] gloss on the meaning of the statute does not carry the same weight as legislative history, but in view of its authorship, it is nonetheless ‘highly indicative of what Congress did, in fact, intend.’” (Citations omitted).) See also Michael Livingston, What's Blue and White and Not Quite as Good as a Committee Report: General Explanations and the Role of “Subsequent” Tax Legislative History, 11 Am. J. Tax Pol'y 91, 103 (1994) (“Courts have almost uniformly been willing to consult the Blue Book.”); see also Michael Livingston, Congress, the Courts and the Code: Legislative History and the Interpretation of Tax Statutes, 69 Tex. L. Rev. 819, 885-886 (1991). For lively debate over the role of the blue book, see Robinson v. Commissioner, 119 T.C. 44 (2002), particularly the concurrence of Judge Thornton. For reliance on a nontax Blue Book, see Fed. Power Comm'n v. Memphis Light, Gas & Water Div., 411 U.S. 458, 472 (1973) (describing Blue Book under consideration in that case as “compelling contemporary indication” of congressional intent).

⁴⁹ Sequa Corp. v. United States, 350 F.Supp. 2d 447, 454 (S.D. N.Y. 2004) (case citations and quotations omitted for readability)..

separate, non-overlapping underpayments, only one of which is attributable to a valuation misstatement.⁵⁰

I ask readers to consider whether the two explanations of the uses of the Blue Book are consistent.

In a tough interpretive issue, you should be prepared to exploit a Blue Book interpretation that is in your favor and defend against a Blue Book interpretation that is not in your favor.

Finally, Blue Books are also used to identify potential areas in which the legislative language may not have achieved or fully achieved Congress' intent for the legislation and thus provides a roadmap for potential "technical corrections" legislation (which we discuss below) or for the IRS to address in Regulations under the IRS rule-making authority (also discussed below).⁵¹

3. Even Less Formal Indications of Legislative Intent.

Occasionally, the Chairs of the tax writing committees spotting a potential for ambiguity have written the IRS to provide an indication of the legislative intent of recently passed legislation; this interpretation may be important to the IRS in interpreting the statute by regulation or other authoritative guidance.⁵² It is most unclear what, if any, deference a court would give to such indications of the legislative intent outside the legislative history,⁵³ but, as we shall note, the IRS's adoption of the spin in authoritative pronouncements might itself be entitled to deference thus,

⁵⁰ United States v. Woods, ___ U.S. ___, ___, 134 S. Ct. 557, 568 (2013) (case citations and quotations omitted for readability).

⁵¹ Marc J. Gerson, Technically Speaking: The Art of Tax Technical Corrections, 114 Tax Notes 927 (2007).

⁵² In Tualatin Valley Builders Supply, Inc. v. United States, 522 F.3d 937, 941 (9th Cir. 2008), the Court cited:

[A] Congressional Letter [from each chairman of the respective tax writing committees to Treasury shortly after the enactment of the legislation] (stating that "it is the intent of Congress that such revocation be made in such manner as prescribed by the Secretary" and "[w]e trust that this letter provides sufficient clarification so that guidance can be issued in a manner that fully reflects Congressional intent").

The IRS then issued a Notice consistent with the scope of the authority indicated in both the statute and the cited letters.

⁵³ The Tualatin opinion (preceding footnote) mentions the letter and then considers it in the Chevron / Skidmore deference analysis as somehow supporting the IRS's exercise of rule making authority. I discuss Chevron / Skidmore deference below, so defer further consideration on the issue just now, but do note that, as legislative history, I suspect that most courts would view this type of post hoc interpretation with less than great deference, if any. Of course, if the issue is whether the IRS's exercise of specifically delegated authority (as the statute clearly did in the Tualatin case) was reasonable, then perhaps the statements of the chairs of the committees writing the delegation that the interpretation is reasonable might be considered on the reasonableness of the exercise of the delegation and perhaps that is what the Tualatin court did.

perhaps, bootstrapping the non legislative history into controlling effect. I am sure that this whole exercise would make Justice Scalia apoplectic.

Finally, in a hotly contested case, the taxpayer sought to introduce testimony from staff members of the Senate Finance Committee and even a lobbyist that the purpose of a particular statute was to provide relief to this taxpayer. The purpose of course was to give the district court a taxpayer-friendly assist in its interpretation of the statute. The attempt failed.⁵⁴

H. Technical Corrections Legislation.

Because of the frequency and complexity of tax legislation, glitches and unintended consequences are inevitable. Glitches are not a major problem to the extent that they can be addressed effectively in the Blue Book or via the IRS rule-making authority. However, if the statutory language itself needs a fix, the fix often comes via a “technical corrections” process that results in corrective legislation.⁵⁵ That process is defined as:

A technical correction [is] legislation that is designed to correct errors in existing law in order to fully implement the intended policies of previously enacted legislation. The principal factor in determining whether a provision is technical is the original intent of the underlying legislation. Once it is determined that the existing statute does not properly implement legislative intent, and that the proposed change conforms to and does not alter the intent, the provision is deemed to be technical.⁵⁶

Precisely how the perceived problem is fixed depends upon how best Congress perceives that it is implementing the original intent of the legislation being fixed. Nevertheless, the following are key features of the technical corrections legislation:

⁵⁴ The saga for the Senate staff testimony is discussed in several Tax Notes discussions. See Jeremiah Coder, In Unusual Twist, Company Seeks Sealed Congressional Staffer Testimony, 2009 TNT 77-3; Corporation Asks Court to Seal Finance Committee Staff Statements, 2009 TNT 77-12; Government Files Opposition to Brief in G-I Holdings Case, 2009 TNT 86-15. That testimony could not be used because Congress’ permission is required, and Congress did not permit. The saga for the lobbyists’ testimony is discussed in United States v. G-I Holdings, Inc. (In re G-I Holdings, Inc.), 369 B.R. 832, 837 (D.N.J. 2007). The court rejected the use of the proffered lobbyist’s testimony. The court’s reasoning is sound, and echoes the concerns that such tenuous history of sources for legislation is too remote to indicate that it was the legislators’ intent.

⁵⁵ For good general discussion of the process, see Marc J. Gerson, Technically Speaking: The Art of Tax Technical Corrections, 114 Tax Notes 927 (2007).

⁵⁶ Gerson, *supra*, quoting Joint Committee on Taxation, “Overview of Revenue Estimating Procedures and Methodologies Used by the Staff of the Joint Committee on Taxation” (JCX-1-05).

- The fix is generally retroactive to the effective date of the legislation that is being corrected.⁵⁷
- The fix is deemed to be revenue neutral because it is merely implementing the original intent which was previously scored.

I. The Code and Uncodified Tax Legislation.

1. General, Uncodified Laws.

Most legislation affecting the federal tax law is “codified” in the Internal Revenue Code (the current iteration of the Code being the Internal Revenue Code of 1986 (“the Code”), as amended after 1986, which is codified at 26 U.S.C. The Code is the great compendium of the tax law. By great, I refer to size more than grand design, but there is a grand design (imperfectly implemented).

Tax legislation may also be “off the books” – by which I mean in this context not codified into the Internal Revenue Code, Title 26. This often troubles practitioners who would prefer a comprehensive grand design and “one-stop shopping” via the Internal Revenue Code. Practicing tax law requires that the practitioner be diligent to at least consider the possibility that there may be extra-Code legislation that affects what he or she is doing. Most good compendiums of the tax law with analysis will lead the practitioner to the extra-Code legislation. We shall cover a couple of instances of this type of noncodified legislation in these materials.⁵⁸

2. Treaties.

Normally, tax laws are created and modified in the ways described earlier. Under the Constitution, however, treaties with foreign countries are the law of the land.⁵⁹ Although the precise parameters of that mandate may be unclear, for present purposes they are given a status that is the co-equal of legislation. Among other things, this means that the later in time trumps the earlier.

Taxes may be dealt with in any type of treaty, but tax issues are usually addressed in special types of treaties. For example, a common type of treaty among countries – particularly developed

⁵⁷ Gerson, *supra*, citing cases sustaining retroactivity (United States v. Carlton, 512 U.S. 26 (1994); Wiggins v. Commissioner, 904 F.2d 311 (5th Cir. 1990) and Bethlehem Steel Corp. v. United States, 270 F.3d 135 (3d Cir. 2001) (overriding a closing agreement)).

⁵⁸ See e.g., Section 530 of the Revenue Act of 1978, which we discuss later in this text, is noncodified legislation giving taxpayers certain relief in the ongoing problem of characterizing service provides as employees or independent contractors. Section 530 is well known in the tax community because of its frequent reference in cases and administrative rulings. See also Bruecher Found. Servs. v. United States, 2010 U.S. App. LEXIS 12598 (5th Cir. Tex. 2010) (saying that Section 530 is “codified as a note to 26 U.S.C. § 3401”). See also McGee v. Commissioner, 123 T.C. 314 (2004) (discussing uncodified requirement that IRS give notice upon initiation of collection activity that of innocent spouse relief claims to start a critical statute of limitations). McGee v. Commissioner, 123 T.C. 314, 317-318 (2004).

⁵⁹ U.S. Const.art. VI, § 1, cl. 2.

countries – is a type commonly referred to as a double tax treaty⁶⁰ which is designed to avoid, to the extent reasonable, double taxation on commerce between the treaty states. Tax treaties have not created taxes (although conceivably they could), but tax treaties figure prominently in the application of the tax laws. Two good examples come readily to mind. First, U.S. corporations paying dividends to foreigners are subject must withhold for income tax up to 30%, but many of our treaties allow a significantly reduced or zero treaty rate. Second, U.S. tax law prescribes a regime for taxing foreign corporations doing business in the U.S., but treaties may require a regime different from the one required by statute.⁶¹

Treaty effects on the Code will not appear in the Code itself. Practitioners must be cognizant that this form of “off the books” equivalent of legislation.

In terms of process as to how these treaties come into existence, they are shaped both by the executive branch which negotiates the treaties and by the legislative branch – specifically the Senate – which must advise and consent to the treaties. In that process, as noted, the executive branch negotiates the treaty and submits it to the Senate along with a Treasury Explanation of the Treaty. In the Senate, the treaty is referred to the Senate Foreign Relations Committee which considers the treaty and, if approved, sends it to the Senate along with a committee report explaining what the Foreign Relations Committee believes it has approved and why it approved it. The Senate then votes on the treaties and, if approved, they “enter into force” – treaty speak for become effective.

J. Oversight Functions.

In addition to its role in passing substantive tax legislation, Congress serves an important oversight function with the IRS. In this oversight role, Congress reviews whether the IRS is working efficiently and in the best interests of the citizens of the United States.⁶² Just as any other role it serves, this oversight role can become politicized, for, after all, it is conducted by politicians whose political ambitions and motives may interfere with any imperative to get it right. (See my discussion below, p. 24, regarding the 1998 legislation which demonstrates, in my mind, the worst excesses of politicized abuse of the oversight function of Congress; although politicized abuse of oversight during the Obama years has rivaled that in 1998.)

⁶⁰ The more precise title for U.S. double tax treaties is “Convention Between the United States of America and [The Other Treaty State] for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes.”

⁶¹ National Westminster Bank, PLC v. United States, 512 F.3d 1347 (Fed. Cir. 2008). See also Richard L. Reinhold & Catherine A. Harrington, What NatWest Tells Us About Tax Treaty Interpretation, 119 Tax Notes 169 (2008).

⁶² For example, in a particularly prominent case, a House subcommittee investigated IRS improprieties. See United States v. Payner, 447 U.S. 727, 733 n. 5 (1980), citing Oversight Hearings into the Operations of the IRS before a Subcommittee of the House Committee on Government Operations (Operation Tradewinds, Project Haven, and Narcotics Traffickers Tax Program), 94th Cong., 1st Sess. (1975).

A prominent example of an oversight role for Congress was a Senate subcommittee investigation into the role of professional firms – accounting firms, law firms, banking firms and investment firms – in the U.S. tax shelter industry. The investigation was by the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs.⁶³ The investigation resulted in dramatic hearings and dramatic reports of mischief and perhaps illegality in these components of the tax shelter industry.⁶⁴ The hearings and initial report was followed – and influenced, no doubt – by the largest criminal indictment in history wherein 19 individuals related to KPMG promoted shelters were indicted. Subsequently the same subcommittee conducted a major investigation into off shore tax evasion.⁶⁵

II. Executive Branch.

A. Treasury Department.

1. General.

The **Treasury Department** is authorized to administer and enforce the Internal Revenue Code.⁶⁶ Within the Treasury Department, the IRS is the principal administrator and enforcer of the tax laws. Other components of Treasury, however, play certain key tax roles in administration of the Internal Revenue Code.

2. Assistant Secretary (Tax Policy).

Treasury's **Office of the Tax Policy** is managed by the **Assistant Secretary of Treasury (Tax Policy)** and serves the following key functions: (1) assists in development and implementation of federal tax policies and programs; (2) provides official estimates of all government receipts for the President's budget, for fiscal policy decisions, and for Treasury cash management decisions; (3) develops and reviews regulations and rulings to administer the tax code; (4) negotiates tax treaties for the United States; (5) provides economic and legal policy analysis for domestic and international tax policy decisions; and (6) prepares reports of tax policy issues mandated by Congress or the administration.

⁶³ When the investigation started and had its first hearings and minority report, the Committee was named the Committee on Governmental Affairs. Before the Subcommittee Report in 2005, the Committee had been renamed as indicated in the text.

⁶⁴ The investigation produced two reports. The first, a minority staff report gunned by the minority leader, Senator Carol Levin, was released contemporaneously with the highly touted hearings on November 18 & November 20, 2003. The Staff Report is titled U.S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professionals and is subtitled “Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2. The second report, a full committee report, is titled The Role of Professional Firms in the U.S. Tax Shelter Industry, and was published on February 8, 2005.

⁶⁵ See Report of the Permanent Subcommittee on Investigations, Tax Havens Banks and Tax Compliance (July 17, 2008).

⁶⁶ § 7801(a).

The Office of Tax Policy has a significant staff and, because of its key high level role is considered a great opportunity for Government service for the best and brightest. The Office of Tax Policy is organized into the following functional offices:

Office of the Benefits Tax Counsel
Office of the International Tax Counsel
Office of the Tax Legislative Counsel
Office of Tax Analysis

3. Treasury Inspector General For Tax Administration.

The **Treasury Inspector General for Tax Administration** (“TIGTA”) is a Treasury function outside the IRS established by the 1998 Restructuring Act to provide independent oversight of IRS activities.⁶⁷ TIGTA investigates misconduct of IRS employees but its more visible role is to conduct audits, investigations, and evaluations of IRS programs and operations (including the Oversight Board); to evaluate the adequacy and security of IRS technology; and to review a limited sample of the IRS's assertion of privileges to deny requests under the Freedom of Information Act (“FOIA”) and the Privacy Act. In addition, TIGTA studies compliance with key facets of the 1998 Restructuring Act.⁶⁸

TIGTA reports are often useful to practitioners for understanding the operations of the IRS.

4. Chief Counsel of IRS.

The IRS **Chief Counsel**, a Presidential appointee, is the IRS's top lawyer.⁶⁹ The Chief Counsel is a Treasury officer with duties in the IRS as designated by the Secretary of Treasury. The Chief Counsel is a very important person within the IRS, having principal responsibility for the legal function in the IRS. I shall deal more with Chief Counsel's function within the IRS below.

B. IRS.

1. Overview.

The IRS, a branch of Treasury, is the principal component of Treasury charged with the administration of the tax laws. I hope that, even as a relative novice to the tax law, you have some sense of the magnitude of the task assigned to the IRS. The following statistics from the IRS Data Book for 2013⁷⁰ should reinforce the magnitude of the task:

⁶⁷ See TIGTA's web site <http://www.treas.gov/tigta/> which is probably worth poking around from time to time.

⁶⁸ § 7803(d).

⁶⁹ § 7803(b)(1).

⁷⁰ See <http://www.irs.gov/pub/irs-soi/11databk.pdf>.

- The IRS collected \$2.855 trillion of revenue, and refunded over \$364 billion dollars, for a net revenue collection of almost \$2.490 trillion.⁷¹

- The IRS processed over 240 million tax returns, excluding information returns such as W-2s and 1099s.⁷²

Managing the function obviously requires a large bureaucracy. The 2013 Data Book reports that the IRS had over 84,000 full-time permanent employees during the year 2013.⁷³ These employees and the functions they serve are organized with a pyramid structure typical of large organizations.⁷⁴

Managing the function requires frequent points of contact between the public and the agency. To assist the many IRS players involved in their mission, the IRS has adopted the following mission statement:

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.⁷⁵

The articulated goal views taxpayers as customers to be serviced; in this model, the broad goal is for satisfied customers. Obviously, the concept of customer service and customer satisfaction needs to be considered in context. No person who is investigated and prosecuted for a tax crime is going to feel like a customer or feel well served or satisfied. Nor will any person who is sent a large tax bill or who, owing the IRS, is subject to enforced collection measures equate those actions with customer service. But given a different view of its role as servant of the taxpayers (which means, of course, doing all of those things to ensure that everyone pays his or her fair share of the cost of government), the focus on customer service has begun to ripple through the management plans and thinking of the IRS. Whether customer service was ever absent from the IRS is doubtful, but the focus on it may lead to improvements in the public perception of the role of the IRS.

2. 1998 Restructuring Act.

After highly publicized and politicized hearings into alleged IRS abuses, Congress passed the IRS Restructuring and Reform Act of 1998 (“1998 Restructuring Act”).⁷⁶ Prior to this act, the IRS had functioned under the general supervision of Treasury through a Commissioner of Internal

⁷¹ 2013 Data Book, Table 1.

⁷² 2013 Data Book, Table 2.

⁷³ 2013 Data Book, Table 30.

⁷⁴ Large organizations require a pyramid structure (the issue being how steep the outside walls of the pyramid must/should be), with “headquarters” centralized functions (usually in Washington), intermediate functions (at various levels and geographically dispersed), and local front line functions where the public (and their tax representatives) interface with the IRS.

⁷⁵ <http://www.irs.gov/irs/article/0,,id=98141,00.html>.

⁷⁶ Pub. L. No. 105-206, 112 Stat. 685, 722 (July 22, 1998).

Revenue appointed by the President. The key institutional management function dictated by the 1998 Restructuring Act was to create an **Oversight Board** within the Treasury Department. At the time of the consideration of the 1998 Restructuring Act, the Commissioner had announced certain major management reorganizations to mitigate or eliminate problems which Congress was addressing itself and features of this plan were enacted into law. I shall first discuss the Oversight Board and then cover the new management structure.

The engine that fueled the Act was a highly publicized and politicized Senate Finance Committee (“SFC”) hearing into alleged IRS abuse. Prior to those hearings, a blue ribbon panel had recommended significant changes to the IRS, but the SFC hearings so politicized the issues that I believe Congress lost its ability or desire to act rationally and in the best interests of the country.⁷⁷ The politicians on the Committee set about a path of slandering an agency that was, in fact, serving the country a lot better than those politicians asserted solely for political gain.⁷⁸ Those politicians unfairly brought discredit upon an agency that fairly – not perfectly – served a critical role in the operation of democracy as we know it. Further, those politicians passed legislation that, on balance, created far more problems than it solved.⁷⁹ Beyond the specifics of the legislation, the hearings and public ill-will fueled by the hearings sent shock waves throughout the IRS and, in some major respects, debilitated it from serving its critical mission. The combination of events put the IRS in massive turmoil, at great expense to the country. A subsequent investigation by Congress’ own semi-independent investment authority, the Government Accountability Office (often initialized “GAO”),⁸⁰ determined that the SFC’s politically charged allegations of IRS abuse were in major part false.⁸¹ In short, for political gain, Congress trashed and I think substantially damaged a fine agency

⁷⁷ See, for similar conclusion, the comments of Chris Rizek, a key player with Treasury’s Tax Legislative Counsel who drew two lessons from the process (Jeremiah Coder, IRS Restructuring Anniversary Conference Recalls Political Limits on Policy, 2008 TNT 140-3 (7/21/2008):

First, a consensus bill can take on a life of its own in a charged political atmosphere, leading to “bad judgments.” It’s not a good way to make policy, he said. Second, the no-brainer is that “tax policy is best made by the tax policy professionals,” he said.

⁷⁸ Professor Bryan Camp, as astute observer of the tax legislation and the administrative process, observed that Congress’ 1998 fulminations became “one might say hysterical” and “worked itself into a lather” over the wrong problem. See Bryan T. Camp, Theory and Practice in Tax Administration, 29 Va. Tax Rev. 227, 270 (2009).

⁷⁹ As stated, this is the author’s opinion, but other more recognized and astute observers of the process also share the opinion. See Mortimer Caplin, The Tax Lawyer’s Role in the Way the American Tax System Works, 106 Tax Notes 697 (Feb. 7, 2005).

⁸⁰ This office was formerly known as the Government Accounting Office.

⁸¹ GAO Special Report on Tax Administration: Investigation of Allegations of Taxpayer Abuse and Employee Misconduct Raised at Senate Finance Committee’s IRS Oversight Hearings (5/24/99), unofficially reproduced at 2000 TNT 80-13 (4/25/00). Keep in mind that the GAO is Congress’ investigator and managed to produce a report that, in its conclusions, was nothing short of a criticism of the hearings. See also Leandra L. Lederman, Of Taxpayer Rights, Wrongs, and a Proposed Remedy, 87 Tax Notes 1133, 1135-36 (May 19, 2000); and Amy Hamilton, A Look at Taxpayer Attitudes on the Fifth Anniversary of IRS Reform, 2003 TNT 140-4 (7/22/03) (“Cohen

that served this country well; just as any large organization, it needed fixes but most of the problems Congress imagined were nonexistent and its solutions to the nonexistent problem were inappropriate.

3. Oversight Board.

The IRS is a Treasury agency with lines of authority through the Commissioner of Internal Revenue to the Secretary of the Treasury. An Oversight Board, however, has certain functions with respect to IRS administration, management, conduct, direction and supervision of the execution and application of the internal revenue laws.⁸² The Board has the following specific responsibilities:

1. review and approve the IRS's strategic plans and operational functions (such as modernization, outsourcing, training, and education).
2. recommend candidates for appointment as IRS Commissioner, as well as recommend whether the Commissioner should be removed.
3. review the Commissioner's selection, evaluation and compensation of senior executives.
4. review and approve any major reorganization of the IRS.
5. participate in the IRS budget preparation process.

The Oversight Board is expressly denied certain responsibilities.⁸³ Generally, these are responsibilities for tax policy and certain specific organizational functions (such as specific examinations or personnel actions) that would be micro-managing rather than overseeing.

The Board is composed of nine members.⁸⁴ Seven members are appointed by the President and confirmed by the Senate. Of this seven, one must be a full time federal employee or a representative of IRS employees. The other two members are ex officio (by virtue of the office they hold) and are the Commissioner and the Treasury Secretary (or his or her Deputy). The President appoints the other Board members with the advice and consent of the Senate. The Board members serve staggered five-year terms. The Board positions are not full time positions, but the Board is

[former IRS Commissioner] said that nearly everyone now agrees that the 1998 Senate Finance Committee hearings into alleged IRS abuses of taxpayers were 'grossly unfair.' Jeff Trinca, who served as chief of staff of the National Commission on Restructuring the IRS, called the hearings 'a circus added at the end of a year of a lot of hard work.'"); Mortimer Caplin's article in the preceding footnote; and Bryan T. Camp, "The Evil That Men Do Lives After Them", 2004 TNT 144-34 (7/27/04).

⁸² § 7802(c). The Board was created by the 1998 Restructuring Act.

⁸³ § 7802(c)(2).

⁸⁴ § 7802(b).

to be a working group rather than just an advisory group. The Board members are paid \$30,000 per year, with the Chair person being paid \$50,000 per year.⁸⁵

4. Commissioner of Internal Revenue.

The **Commissioner of Internal Revenue** is a Presidential appointee confirmed by the Senate. The Commissioner heads the vast IRS bureaucracy.⁸⁶ Historically, the Commissioner has been a leading tax practitioner, most often a tax lawyer. Because of the perception that tax practitioners may not be the best managers, the statute now requires that the person appointed have “demonstrated ability in management.”⁸⁷ Tax practitioners are not necessarily excluded, but the field is much broader now. The current Commissioner is John Koskinen. When the Commissioner position is not filled by a duly appointed and approved person, a senior IRS official will serve as Acting Commissioner.

The Commissioner's duties are set forth very broadly to manage the internal revenue function (including its relationship to foreign countries through the treaty program) and assist in recommending the Chief Counsel.⁸⁸

5. Structure.

a. General.

The IRS is organized into four major operating divisions aligned generally by types of taxpayer. Each division is then organized along functional lines, based upon the perception that a functional approach can better serve taxpayers. The purpose of the functional structure is to organize all levels based on groups of taxpayers with similar needs. The plan eliminates all regional and district level functions (although the various divisions will certainly have regional and district level functions within their respective areas of focus).

The IRS has four civil compliance operating divisions: **(1) Wage and Investment (“W&I”)**, **(2) Small Business and Self-Employed (“SB/SE”)**, **(3) Large Business and International (“LB&I”)**⁸⁹ **(4) Tax Exempt and Governmental Entities (“TE/GE”)**. The IRS has a separate **Appeals Office** function that serves generally to hear taxpayer appeals from decisions made by these four civil compliance operating divisions. The IRS also has a **Criminal Investigation** division that conducts criminal investigations and makes referrals to the DOJ Tax Division for criminal prosecution or grand jury investigation. Various other functions within the IRS that are not necessarily related to taxpayers fitting neatly within these descriptions will either be placed within

⁸⁵ § 7802(e)(1).

⁸⁶ § 7803.

⁸⁷ § 7803(a)(1)(A).

⁸⁸ § 7803(a)(2).

⁸⁹ This division was formerly known as the Large and Medium Size Business Division (“LMSB”). The name was changed in the summer of 2010 to reflect the division’s major emphasis on international matters in a globalized economy.

one of the divisions or elsewhere in the organization. For example, the Tax Treaty function and Advance Pricing Agreement function will be in the Large and Mid-Size Business function, because most (but certainly not all) of the taxpayers needing those services would otherwise be in that Division.

In Appendix A, I link to an IRS organizational chart.

I will present these divisions by the functions they serve:

b. Civil Compliance Function.

(1) Examination Function.

The examination function determines whether taxes in addition to those reported by the taxpayer are due and owing and, if so, sets in process procedures for assessing and collecting the taxes. This is often referred to as the audit function. The office handling this function is sometimes referred to as “Examination.” Most practitioners’ principal interface with the Examination function will be in IRS audits. As indicated from the IRS’s functional structure, audits will be handled by the “business” division that covers the particular taxpayer. Dealing with the examination function will be a significant area of your practice as a tax practitioner. I discuss examinations in more detail below. The examination function is served by each of the civil compliance division.

(2) Collection Function.

Historically, the IRS's examination function has been different than its collection function. Some IRS personnel would perform the examination function to determine whether the taxpayer owed more tax than the taxpayer reported voluntarily. Personnel performing the examination function were historically called Revenue Agents. Different IRS personnel would then perform the function of collecting the tax from the taxpayer, subject to any appeal and litigation rights the taxpayer may have. Persons performing the collection function were historically called Revenue Officers, or colloquially, Collections Officers. The collection function may be analogized to accounts receivable or bill collection function in a business organization. Usually, the personnel involved in the examination function were not concerned with collection, and the personnel involved in the collection function were not concerned with whether the taxpayer really the tax they were charged with collecting.

Part of the focus of the new IRS is to resolve both the examination function and collection function in the least number of steps. This means that persons previously involved in determining the amount of the correct liability (the historical examination function) may be involved at that stage in also determining how and when the IRS collects from the taxpayer. Similarly, where personnel are involved in a collection function and the taxpayer asserts some defense that he or she may not owe the amount the IRS seeks to collect, the IRS collection officer may become more actively involved in the examination function, at least by assisting the taxpayer get to the right office for help on that issue. I address the IRS’s implementation of the collection function below in Chapter 14.

The bottom line at this point, however, is that the IRS has a huge collection function -- taxpayers in the aggregate owe large liabilities that, for one reason or another, they have not paid. Just as any creditor, the IRS has an incentive to see if it can take action to encourage collection of the amounts owed. I deal with collection procedures below in some detail in Chapter 14.

The collection function is performed by each of the civil compliance divisions with respect to taxpayers within the scope of that division's service.

c. Appeals Function.

The IRS has an internal Appeals function designed to offer a semi-independent review of determinations by the IRS civil compliance functions (such as audits and collection actions). The Appeals function is handled by the IRS Appeals Office. (I often refer to this office as simply "Appeals" or "IRS Appeals".) Organizationally, Appeals is separate from the examination and collection functions, and various administrative and statutory procedures are designed to assure Appeals' independence.⁹⁰ Generally, the taxpayer and the tax practitioner go to Appeals for an independent review and resolution of positions taken by the examination or collection functions of the IRS. Dealing with the Appeals function will be a significant part of your practice as a tax practitioner. I discuss Appeals and practice in that office in more detail below (pp. 480 ff.)

d. Criminal Investigation.

Criminal Investigation serves the tax administration function of investigating tax crimes and referring cases to DOJ Tax for criminal prosecution or for further grand jury investigation. This office, often referred to as "CI" or "CID,"⁹¹ is independent of the four operating civil compliance divisions described above.

CI was substantially re-vamped after a blue-ribbon study published in 1999 by a panel headed by William Webster, who previously served as a federal trial and appellate judge and FBI director.⁹² This panel issued a report, commonly referred to as the Webster Report, recommending that CI refocus its mission to undergird the tax system rather than being distracted to help the government's other nontax criminal enforcement priorities. As a result of the Webster Report, the IRS has significantly shifted its criminal investigation resources away from nontax priorities toward tax priorities, particularly in the legal income area.⁹³

⁹⁰ I discuss later the more important of these procedures. An example of such a procedure is the statutory requirement that generally prohibits ex parte communications between the Appeals Office and the examination function as to an appeal. Rev. Proc. 2000-43, 2000-43 I.R.B. 1.

⁹¹ The office formerly was named Criminal Investigation Division, hence the acronym CID. The name was shorted to Criminal Investigation, hence CI. Many experienced practitioners continue to use the former acronym.

⁹² Webster Commission, Review of the Internal Revenue Service's Criminal Investigation Division (April 1999) from William H. Webster and the Criminal Investigation Division Review Task Force (often referred to as the "Webster Report").

⁹³ I cover this in some detail in my Tax Crimes book.

e. **Chief Counsel.**

The **Chief Counsel** is the IRS's top lawyer.⁹⁴ The Chief Counsel's summary job description is:

(m) Chief Counsel (Counsel) - Provides legal interpretation and represents the IRS with complete impartiality, so that taxpayers know the law is being applied with integrity and fairness. The Chief Counsel reports to the Commissioner of Internal Revenue on tax matters and reports to the Treasury General Counsel on other matters.⁹⁵

The Chief Counsel of the IRS supervises approximately 1,500 attorneys.

The Chief Counsel's Office plays a central role in the administration of the Federal tax laws. Its attorneys provide the IRS guidance on the correct interpretation of the tax laws, represent the IRS in litigation, and provide all other legal support the IRS needs to carry out its mission.⁹⁶ For example, the Chief Counsel's Office drafts regulations, rulings, and other published legal guidance; handles tens of thousands of cases per year in the U.S. Tax Court and bankruptcy courts and works closely with the Department of Justice on other tax litigation in other Federal courts; and provides specific legal advice and determinations to taxpayers and to various IRS offices both before and after taxes are filed.

Attorneys within the office of Chief Counsel are organized along the functional lines in the current IRS organization. The four civil compliance divisions thus have Chief Counsel attorneys assigned to them to provide legal assistance in serving their functions. For example, they may help in framing requests for information or documents. Organizationally, the attorneys still report to Chief Counsel, but they serve the operating divisions to which they are assigned. In addition, Chief Counsel attorneys are assigned to the IRS's office of Criminal Investigation (“**CI**”) where they will assist IRS criminal investigation agents (historically referred to as “**Special Agents**”) and serve the CI function.

Tax practitioners, particularly lawyers, most often encounter attorneys from the Chief Counsel's office when litigating cases in the Tax Court. Chief Counsel's attorneys represent the IRS in the Tax Court. By contrast, in the other courts in which tax cases may be litigated (the district courts and the Court of Federal Claims), the IRS is represented by attorneys from the Tax Division of the Department of Justice (I usually refer to the Tax Division as “**DOJ Tax**”).⁹⁷

⁹⁴ § 7803(b).

⁹⁵ IRM 1.1.1.3(2)(m) (03-01-2006); for a more detailed statement of the Chief Counsel's duties and the structure of the office of Chief Counsel, see IRM 1.1.6 (07-20-2005).

⁹⁶ § 7803(b)(2); IRM 1.1.6 (07-20-2005).

⁹⁷ In the past, IRS attorneys have been designated Special Assistant United States Attorneys (SAUSAs) to handle certain matters in bankruptcy courts, but apparently that program has ended. See Keith Fogg, End of SAUSA Program at Chief Counsel's Office (Procedurally Taxing Blog 6/3/15).

f. Taxpayer Advocate.

The IRS has a taxpayer advocate function to represent taxpayer interests when the system fails or the taxpayer or taxpayer's representative is being treated inappropriately and the normal procedures do not resolve the matter.⁹⁸ The office is headed by the **National Taxpayer Advocate** ("NTA") who reports directly to the Commissioner. The National Taxpayer Advocate is appointed by the Secretary of the Treasury after consultation with the Commissioner and the Oversight Board. The NTA heads the Taxpayer Advocate Service ("TAS"). The office's principal functions are:

- (1) to assist taxpayers resolve problems with the IRS; and
- (2) to identify taxpayer problem areas in dealing with the IRS and to propose changes in the administrative practices and legislative changes to mitigate the problems.⁹⁹

The NTA's office is in Washington at the IRS. The TAS has local offices in each state staffed by local IRS employees and headed by a Local Taxpayer Advocate ("LTA"). These offices are independent of the other local IRS functions and report to the NTA.¹⁰⁰

The TAS may assist taxpayers in many ways. Basically, this function is designed as a failsafe, to operate when there is a breakdown or hardship resulting from administration of the IRS's other functions. The office is not designed to make the taxpayer happy, but rather to ensure that the administrative processes are fair and appropriate, and to provide a remedy when the normal processing produces a bad result. I discuss below a typical use of the TAS to deal with collection inequities.¹⁰¹

g. Representing Taxpayers With or Before the IRS.

(1) General; Circular 230.

Tax practitioners serve a critical role in the tax system. They prepare returns, advise as to expected tax consequences of contemplated transactions and advise as to how the transactions should be reported on returns, they assist taxpayers in defending against IRS compliance efforts, including audits and collections. In a sense, they are on the front-lines of taxpayer compliance with the system. They can abuse their roles. As we shall see in this course, there are disincentives in the way of monetary penalties, criminal penalties and other civil liabilities that may apply to abusive practice as a tax practitioner. I deal here with the authority and ability to practice before the IRS and the IRS's ability to sanction for inappropriate behavior.

⁹⁸ § 7803(c). A good summary of the Taxpayer Advocate function is contained in IRS Publication 1546.

⁹⁹ § 7803(c)(2).

¹⁰⁰ § 7803(c)(4).

¹⁰¹ See pp. 673 ff.

The IRS has two offices that deal with practice before the IRS. These are the Office of Professional Responsibility (“OPR”) and the Return Preparer Office (“RPO”).¹⁰² The IRS explains their roles as:

The Office of Professional Responsibility generally has responsibility for matters related to practitioner conduct and exclusive responsibility for discipline, including disciplinary proceedings and sanctions. The Return Preparer Office is responsible for matters related to the authority to practice, including acting on applications for enrollment and administering competency testing and continuing education.¹⁰³

For this purpose, practice before the IRS is:

- Communicating with the IRS for a taxpayer regarding the taxpayer's rights, privileges, or liabilities under laws and regulations administered by the IRS.
- Representing a taxpayer at conferences, hearings, or meetings with the IRS.
- Preparing and filing documents, including tax returns, with the IRS for a taxpayer.
- Providing a client with written advice which has a potential for tax avoidance or evasion.¹⁰⁴

The regulatory guidelines for practitioners are set forth in Treasury Department Circular 230¹⁰⁵ which OPR enforces.¹⁰⁶

I will break down my discussion by the two offices – OPR and RPO – that regulates the practitioners. I start first with RPO.

(2) Return Preparer Authority and the RPO.

Return preparers were historically not subject to regulation except as criminal or civil sanctions for misconduct. Specifically, persons serving only as return preparers were not subject to requirements for licensing, certification, minimum education, experience, or other credentials. The result was that the tax preparer community was and is populated by the full range of professionals, from the highly ethical and competent to the highly unethical and incompetent.

¹⁰² Acronyms are bad enough, but when closely related concepts are just the inverse of each other, well there is bound to be confusion.

¹⁰³ IRS Publication 947 (2012), visited on the web at <http://www.irs.gov/publications/p947/ar02.html> (9/23/12).

¹⁰⁴ Id.

¹⁰⁵ 31 C.F.R. Part 10. Circular 230 is promulgated under 31 U.S.C. § 330 which authorizes the Secretary of the Treasury to regulate the practice of representatives of persons and the admission to practice of representatives before the IRS, requiring that they demonstrate good character, a good reputation and necessary qualifications, and competence. The Regulations establishing who may practice before the IRS were sustained under the Chevron analysis in Wright v. Everson, 543 F.3d 649 (11th Cir. 2008).

¹⁰⁶ Circular 230, subpart A.

In 2009, the IRS began focusing on what actions might be appropriate to bring more professionalism to the tax preparer community and issued a comprehensive review of return preparers, making certain recommendations, including testing, continuing education, and tax compliance checks. As a result of IRS study and input from the public, the IRS proposed regulations to require the registration of return preparers for individual income tax returns (Forms 1040 and its iterations).¹⁰⁷ A return preparer is defined as an individual who is compensated for preparing or assisting in the preparation of all or substantially all of a tax return or claim for refund. As thus defined, a return preparer may include persons normally thought of as tax advisors if they are significantly involved in the presentation of an item on a return.¹⁰⁸ The return preparers who register will receive an identifying number, known as a Preparer Tax Identification Number (“PTIN”).¹⁰⁹ Return preparers registering may be subject to both an initial tax-compliance check and subsequent periodic checks, which could include a review of a preparer's history of compliance with personal and business tax filing and payment obligations. The PTIN must be included on the returns with the signing return preparer’s signature.¹¹⁰ Return preparers who do not supply the PTIN on the return will be subject to penalty.¹¹¹ Return preparers must renew their registrations every 3 years. Return preparers will be subject to testing, continuing education, and Circular 230 guidance, which will be forthcoming in the future.

The Return Preparer Office (“RPO”) regulates the return preparer registration and authorization requirements. The RPO is relatively new and hence has not flanged out its role in the system. However, the RPO states that its strategic goals are:

- Register and promote a qualified tax professional community.
- Improve the compliance and accuracy of tax returns prepared by tax preparers.
- Engage stakeholders to create an environment that fosters compliance and program improvement.¹¹²

Although OPR (discussed in the next section) has historically handled practitioner misconduct investigations, RPO has been delegated some authority to make initial or preliminary investigations for alleged unethical preparer conduct coming principally from external complaints.¹¹³

¹⁰⁷ Prop. Reg. § 1.6109-2. See the NPRM REG-134235-08, 2010-16 IRB 596, published in 75 F.R. 14539-14545, and informally published at 2010 TNT 57-9. The PTIN requirement was sustained in Brannen v. United States, 682 F.3d 1316 (11th Cir. 2012).

¹⁰⁸ See § 6694(f) and Regs. § 301.7701-15(b)(2)(i). For other regulation of tax advisors, see generally David Weisbach and Brian Gale, The Regulation of Tax Advice and Tax Advisors, 130 Tax Notes 1279 (Mar. 14, 2011).

¹⁰⁹ PTINs are not new, but they will now be mandatory.

¹¹⁰ Prop. Reg. § 1.6109-2(a).

¹¹¹ § 6695(c).

¹¹² IRS website titled Return Preparer Office (RPO) At-a-Glance, [http://www.irs.gov/Tax-Professionals/Return-Preparer-Office-\(RPO\)-At-a-Glance](http://www.irs.gov/Tax-Professionals/Return-Preparer-Office-(RPO)-At-a-Glance) (viewed 9/23/12).

¹¹³ Jeremiah Coder, Hawkins Explains RPO Investigative Authority, 2012 TNT 184-5 (9/21/12).

Apparently the role is just to do preliminary investigations with any further development or sanctions being conducted or imposed by OPR.

The district court for the District of Columbia and, on appeal, the Court of Appeals for the D.C. Circuit held that the IRS had no authority to regulate return preparers.¹¹⁴ The holding is controversial. Regulation of preparers is needed and will occur, but may now require legislation.

(3) Practitioner Discipline and OPR.

The IRS Office of Professional Responsibility (“OPR”) regulates discipline and sanctions for misconduct related to tax practitioners’ practice before the IRS. Lawyers and CPAs, by virtue of their state licenses, are automatically entitled to practice before the IRS.¹¹⁵ Others, referred to as Enrolled Agents, may qualify to practice by taking an examination.¹¹⁶ There are also other limited categories of persons authorized to practice in special areas, such as Enrolled Actuaries.¹¹⁷ Generally, in practice, you most often will encounter attorneys, CPAs and Enrolled Agents practicing before the IRS. All persons so authorized are potentially subject to the disciplinary supervision of the OPR pursuant to Circular 230. The class of persons covered is broader than return preparers subject to the registration requirements noted above.

Historically, practice before the IRS so as to be subject to Circular 230, including its responsibilities and its sanctions, has been the affirmative representation of a taxpayer before the IRS.¹¹⁸ This includes representation of taxpayers in audits and other compliance efforts before the IRS, although it does not include representation in a court (e.g., Tax Court) proceeding where the practitioner has contact with IRS personnel.¹¹⁹ Representation subject to Circular 230 does not now include tax planning.

Although I will not expect you to know the rules of Circular 230 for the examination in this class, you will certainly need to know them if you practice before the IRS. Accordingly, I shall state

¹¹⁴ Loving v. IRS, 917 F. Supp. 2d 67 (D.D.C. 2013), aff’d 742 F.3d 1013 (D.C. Cir. 2014).

¹¹⁵ Circular 230, § 10.3(a) and (b).

¹¹⁶ Circular 230, § 10.3(c).

¹¹⁷ Circular 230, § 10.3(d) and (e).

¹¹⁸ Circular 230, § 10.2(d) provides:

(d) Practice before the Internal Revenue Service comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings.

¹¹⁹ Persons practicing before any court are subject to regulation in that practice by the court.

certain of these rules so that you can get a feeling for the types of rules to which you will be subject as a practitioner. I think most of these rules should be self evident to the ethical and qualified tax practitioner; nevertheless, since the practice is not limited that qualified and ethical practitioners, a guidebook is necessary so that they can know the rules even if they choose to skirt them.¹²⁰

1. The practitioner must cooperate with the Office of Professional Responsibility in any investigation into potential misconduct by the practitioner or by another practitioner. The practitioner may assert privileges to such cooperation where they are applicable.

2. The practitioner who knows that his or her client has not complied with the internal revenue laws must advise the client of the noncompliance.

3. The practitioner must exercise due diligence in return preparation and in making representations (oral or written) to the IRS and to the client.

4. The practitioner must not unreasonably delay the prompt disposition of any matter before the IRS.

5. The practitioner must not “knowingly directly or indirectly” –

- a. Employ or accept assistance from any person who is under disbarment or suspension from practice before the IRS.
- b. Accept employment as associate, correspondent, or subagent from, or share fees with, any person under disbarment or suspension from practice before the IRS.
- c. Accept assistance from any former government employee where provisions of these regulations or any federal law would be violated.

6. The practitioner should not engage in disreputable conduct, including the following:

- a. Committing any criminal offense under the revenue laws, or committing any offense involving dishonesty or breach of trust;
- b. Knowingly giving, or participating in the giving of, false or misleading information in connection with federal tax matters;
- c. Soliciting employment by prohibited means as discussed in § 10.30 of T.D. Circular 230;
- d. Willful failure to file a tax return, evading or attempting to evade any federal tax or payment, or participating in such actions;
- e. Misappropriating, or failing to properly and promptly remit, funds received from clients for payment of taxes;
- f. Directly or indirectly attempting to influence the official action of IRS employees by the use of threats, false accusations, duress, or coercion, or by offering gifts, favors, or any special inducements;

¹²⁰ I owe a debt to my ethics professor at the University of Virginia Law School, A. J. G. Priest for the concept that a qualified and ethical practitioner will be able to intuit the right conduct from just being qualified and ethical. Think about all of the guidance to conduct in the text and, I hope, that is the way you would practice anyway.

g. Being disbarred or suspended by the District of Columbia or any state, possession, territory, commonwealth, or any federal court, or any body or board of any federal agency;

h. Knowingly aiding and abetting another person to practice before the IRS during a period of suspension, disbarment, or ineligibility (maintaining a partnership so that a suspended or disbarred person can continue to practice before the IRS is presumed to be a violation of this provision);

i. Contemptuous conduct in connection with practice before the IRS, including the use of abusive language, making false accusations and statements knowing them to be false, or circulating or publishing malicious or libelous matter; and

j. Giving a false opinion knowingly, recklessly, or through gross incompetence; or following a pattern of providing incompetent opinions in questions arising under the federal tax laws.¹²¹

Circular 230 most prominently deals with tax shelter opinions. I shall deal with these amendments below in discussing the overall phenomenon of tax shelters and compliance with the tax laws (pp. 798 ff.).

Although not free from doubt, the current thinking appears to be that OPR must bring an action to penalize a practitioner within five years of the act on which the desired penalty is based.¹²²

In 2004, Congress authorized (i) sanctions, including monetary penalties, against a practitioner who is incompetent or disreputable, who fails to comply with the regulations prescribed under section 330, or who, with intent to defraud, willfully and knowingly misleads or threatens a client or potential client and (ii) monetary penalties against an employer, firm, or other entity, if the practitioner was acting on its behalf in connection with the prohibited conduct giving rise to the penalties and the employer, firm, or other entity knew, or reasonably should have known, of the prohibited conduct.¹²³ The monetary penalties cannot exceed the gross income from the penalized conduct.¹²⁴

¹²¹ For more information on practice before the IRS, see IRS Publication 947, Practice Before the IRS and Power of Attorney.

¹²² See Jeremiah Coder, OPR Restricted to 5-Year Time Limit in Failure to File Cases, 131 Tax Notes 1220 (June 20, 2011) (“In decisions posted to the OPR website on June 15, the appellate authority held that 28 U.S.C. 2462 bars OPR from charging practitioners with disreputable conduct under Circular 230 section 10.51 when a failure to file, or failure to timely file, their personal tax returns involves years further back than five years,” citing Director, Office of Professional Responsibility v. Baldwin, No. 2010-08 (June 15, 2011) and Director, Office of Professional Responsibility v. Hernandez, No. 2010-09 (June 15, 2011)). See Director v. Navatsyk, Decision and Order on Default (11/5/10), reprinted at 2011 TNT 148-11.

¹²³ 31 U.S.C. § 330.

¹²⁴ For the IRS preliminary guidance on this new authority, see Notice 2007-39, 2007-20 IRB 1243.

The IRS provides a useful summary of discipline under the Circular 230 regulations as follows:¹²⁵

The disciplinary sanctions to be imposed for violation of the regulations are:

Disbarred from practice before the IRS -- An individual who is disbarred is not eligible to represent taxpayers before the IRS.

Suspended from practice before the IRS -- An individual who is suspended is not eligible to represent taxpayers before the IRS during the term of the suspension.

Censured in practice before the IRS -- Censure is a public reprimand. Unlike disbarment or suspension, censure does not affect an individual's eligibility to represent taxpayers before the IRS, but OPR may subject the individual's future representations to conditions designed to promote high standards of conduct.

Monetary penalty -- A monetary penalty may be imposed on an individual who engages in conduct subject to sanction or on an employer, firm, or entity if the individual was acting on its behalf and if it knew, or reasonably should have known, of the individual's conduct.

Disqualification of appraiser -- An appraiser who is disqualified is barred from presenting evidence or testimony in any administrative proceeding before the Department of the Treasury or the IRS.

Under the regulations, attorneys, certified public accountants, enrolled agents, enrolled actuaries, and enrolled retirement plan agents may not assist, or accept assistance from, individuals who are suspended or disbarred with respect to matters constituting practice (i.e., representation) before the IRS, and they may not aid or abet suspended or disbarred individuals to practice before the IRS.

Disciplinary sanctions are described in these terms:

Disbarred by decision after hearing, Suspended by decision after hearing, Censured by decision after hearing, Monetary penalty imposed after hearing, and Disqualified after hearing -- An administrative law judge (ALJ) conducted an evidentiary hearing upon OPR's complaint alleging violation of the regulations and issued a decision imposing one of these sanctions. After 30 days from the issuance of the decision, in the absence of an appeal, the ALJ's decision became the final agency decision.

¹²⁵ Announcement 2013-34, 2013-23 IRB 1207.

Disbarred by default decision, Suspended by default decision, Censured by default decision, Monetary penalty imposed by default decision, and Disqualified by default decision -- An ALJ, after finding that no answer to OPR's complaint had been filed, granted OPR's motion for a default judgment and issued a decision imposing one of these sanctions.

Disbarment by decision on appeal, Suspended by decision on appeal, Censured by decision on appeal, Monetary penalty imposed by decision on appeal, and Disqualified by decision on appeal -- The decision of the ALJ was appealed to the agency appeal authority, acting as the delegate of the Secretary of the Treasury, and the appeal authority issued a decision imposing one of these sanctions.

Disbarred by consent, Suspended by consent, Censured by consent, Monetary penalty imposed by consent, and Disqualified by consent -- In lieu of a disciplinary proceeding being instituted or continued, an individual offered a consent to one of these sanctions and OPR accepted the offer. Typically, an offer of consent will provide for: suspension for an indefinite term; conditions that the individual must observe during the suspension; and the individual's opportunity, after a stated number of months, to file with OPR a petition for reinstatement affirming compliance with the terms of the consent and affirming current eligibility to practice (i.e., an active professional license or active enrollment status).

Suspended indefinitely by decision in expedited proceeding, Suspended indefinitely by default decision in expedited proceeding, Suspended by consent in expedited proceeding -- OPR instituted an expedited proceeding for suspension (based on certain limited grounds, including loss of a professional license for cause, and criminal convictions).

OPR has authority to disclose the grounds for disciplinary sanctions in these situations: (1) an ALJ or the Secretary's delegate on appeal has issued a decision on or after September 26, 2007, which was the effective date of amendments to the regulations that permit making such decisions publicly available; (2) the individual has settled a disciplinary case by signing OPR's "consent to sanction" form, which requires consenting individuals to admit to one or more violations of the regulations and to consent to the disclosure of the individual's own return information related to the admitted violations (for example, failure to file Federal income tax returns); or (3) OPR has issued a decision in an expedited proceeding for indefinite suspension.

Announcements of disciplinary sanctions appear in the Internal Revenue Bulletin at the earliest practicable date. The sanctions announced below are alphabetized first by the names of states and second by the last names of individuals. Unless otherwise indicated, section numbers (e.g., § 10.51) refer to the regulations.

The administrative procedure whereby practitioners are disciplined has been summarized as including the following stages:¹²⁶

- **Pre-Hearing Phase.** OPR typically gets cases by referral from the operating divisions who have, at least preliminarily, investigated sufficiently determine that referral is warranted. If OPR determines the referral has merit, it notifies the practitioner and requests a response. After OPR does such further investigation as it deems appropriate, including (1) if it determines no further action is warranted, it can close the matter, (2) resolve the matter by agreement with the practitioner as to an appropriate sanction; or (3) issue a complaint that leads to an administrative hearing.
- **Administrative Hearing.** This hearing is started by the issuance of the complaint. The practitioner must answer or suffer default decision. For contested matters, an Administrative Law Judge (“ALJ”) from outside the IRS will preside. The hearing will include such proceedings as the ALJ determines to be appropriate, but it is a trial like process where evidence in the form of documents and witnesses are considered. OPR bears the burden of proof, with the level of proof required determined by the sanctions. If the sanction is censure or suspension for less than 6 months, the burden is preponderance of the evidence; for more serious sanctions, the burden of proof is clear and convincing. When the record is complete, the ALJ renders a decision.
- **Treasury Review.** Either party may appeal to the Treasury. A delegate of the Secretary of Treasury serves as the Appellate Authority. The Appellate Authority performs this function de novo and with the full authority of the Secretary of the Treasury and the Internal Revenue Service (as the charging agency). The Appellate Authority may increase, decrease or affirm the sanction proposed by the ALJ. After the delegate makes his or her decision, the practitioner has a right to judicial review.
- **Judicial Review.** The practitioner may petition a U.S. district court for review. The standard of review is similar to the Treasury review. Fact findings are deferentially reviewed, thus subject to reversal only if not supported by substantial evidence. Fact findings based on witness credibility determinations are entitled to great deference, as they are in the normal appeals process. Determinations of law are reviewed de novo, but the agency’s determinations of law may require some level of deference as further discussed below.

¹²⁶ See ABA Tax Section Comments on Disciplinary Procedures of the Office of Professional Responsibility (12/8/05), reproduced at 2005 TNT 236-18. For a more detailed guide, see Rita A. Cavanagh and Paul Hynes, Navigating an OPR Disciplinary Proceeding, 127 Tax Notes 789 (May 17, 2010).

In addition to the conditions and potential sanctions from the regulation of practice, practitioners are subject to civil and criminal penalties which we shall cover later in this book.

Finally, CPAs and attorneys must comply with the ethical requirements of their respective professions in all of their practice, including before the IRS and otherwise representing taxpayers with respect to tax matters. I shall not go into these in this book because it would divert us from the focus of this text and all readers should have other opportunities to study those rules.¹²⁷

(4) Form 2848; CAF and PTIN.

The key to representing a taxpayer before the IRS is for the IRS to have authority to discuss the taxpayer's tax matters with the representative. We discuss elsewhere the privacy rules imposed upon the IRS in § 6103. The IRS is prohibited by law from discussing taxpayer return information except in certain narrow situations, the pertinent one here being where the taxpayer has authorized an eligible representative to represent the taxpayer before the IRS. This is usually done through a **Form 2848** which identifies the taxpayer, identifies the representative, and states the scope of the authority given to the representative.

As I mentioned above, lawyers and CPAs by virtue of their state licenses, are automatically entitled to practice before the IRS. Others, referred to as Enrolled Agents, may qualify to practice by taking an examination.¹²⁸ There are other categories, but, generally, in practice, you most often encounter attorneys, CPAs and Enrolled Agents practicing before the IRS.

On the Form 2848, the representative must identify his eligibility and provide the representative's **CAF** number which is a unique identifying number for the eligible IRS representative¹²⁹ and **PTIN** if the representative has a PTIN. I have discussed PTINs above. The CAF is a different number generally assigned first when the taxpayer files the first Form 2848. You will be expected to know the Form 2848 for this class.

Once a Form 2848 is filed, the IRS must generally deal with the taxpayer through the representative and provide the representative a copy of all notices or written communication required to be given the taxpayer, unless restricted by the taxpayer.¹³⁰ However, if the representative is deemed unreasonably uncooperative, an IRS agent may request bypass authority – in the form of a Bypass Order that should be given to both the taxpayer and the representative – to deal directly with the taxpayer.¹³¹

¹²⁷ A good introduction may be found in Jay A. Soled, Third-Party Civil Tax Penalties and Professional Standards, 2004 Wis. L. Rev. 1611, 1625-1628 (2004).

¹²⁸ Circular 230, § 10.3(c).

¹²⁹ See generally IRS Publication 947, Practice Before the IRS and Power of Attorney.

¹³⁰ 26 C.F.R. § 601.506(a).

¹³¹ 26 C.F.R. § 601.506(b) (allowing agent to request permission from his supervisor to bypass representative and contact taxpayer directly when representative “has unreasonably delayed or hindered an examination . . . by failing to furnish, after repeated request, non-privileged

(5) Other Miscellaneous OPR Regulation.

The foregoing are the principal types of regulation you will encounter in your practice. The IRS, however, does have much broader regulatory authority. Because OPR is authorized under Title 31, OPR can jurisdiction is not limited to tax and, indeed, may cover many of the programs that the IRS administers, such as Healthcare.¹³²

h. Service Centers.

The principal operational function with which you will deal as a practitioner is the Service Center. The IRS has 10 Service Centers around the country. The Service Center serving Houston, other Texas districts and some contiguous states is the Austin Service Center. The principal roles of the Service Center in terms of what the practitioner sees are as follows: (1) Taxpayers file tax returns with the Service Center, which is set up to accept mass filings; returns are not filed in the local IRS offices; (2) the Service Center processes the returns to catch obvious errors (return not signed or otherwise facially deficient), enters return data into the computer, performs computer matching of the items on the return with information the IRS has from other sources (such as Forms 1099 and W-2's), and “scores” the returns for audit potential; (3) the Service Center makes the assessments required by the returns or by audits; (4) having made an assessment, the Service Center generates the notice and demand for the taxpayer to pay the taxes thus assessed (if not paid already); and (5) the Service Center has a problems resolution office to assist taxpayers in resolving problems with respect to their dealings with the Service Center.

6. IRS Rule Making Authority.

a. Introduction (Including the APA).

Administrative agencies make rules in the exercise of their congressionally delegated responsibilities. In the tax area, these rules may affect taxpayers in matters of interpretation, procedural administration of the tax laws and in other areas. I discuss the IRS rule making authority and practices in general order of authority.¹³³

I discuss the range of IRS rule making via the various types of pronouncements it makes. In the course of discussing these pronouncements, I cover the rules that have historically guided courts in the weight to give these pronouncements in the interpretation of the tax laws. I then conclude this section with a discussion of the Supreme Court’s opinions in Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) and its progeny, which have signaled a broad – but not unlimited – role for deference to agency interpretation.

information necessary to the examination”).

¹³² Jeremiah Coder, Hawkins Explains Expanding OPR Jurisdiction, 2010 TNT 123-1 (6/28/10).

¹³³ An excellent article updating a prior article is found at Mitchell Rogovin and Donald L. Korb, The Four R's Revisited: Regulations, Rulings, Reliance and Retroactivity in the 21st Century: A View from Within, 46 Duq. L. Rev. 323 (2008).

Before launching into IRS-specific rule making, students need to know the APA background. The IRS is a rule-making administrative body subject to the Administrative Procedure Act (“APA”).¹³⁴ Tax lawyers may not have to become administrative law / APA experts, but they do have to know a good deal about the APA. The following is a good introduction:

Pursuant to APA sec. 553, in promulgating regulations through informal rulemaking an agency must (1) publish a notice of proposed rulemaking in the Federal Register, n9 see APA sec. 553(b); (2) provide "interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation", id. subsec. (c); and (3) "[a]fter consideration of the relevant matter presented, * * * incorporate in the rules adopted a concise general statement of their basis and purpose", id. These requirements do not apply to interpretive rules, see id. subsec. (b)(A), or when an agency for good cause finds -- and incorporates its findings in the rules issued -- that "notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest", id. para. (B).

n9 The notice of proposed rulemaking must include "(1) a statement of the time, place, and nature of public rule making proceedings; (2) reference to the legal authority under which the rule is proposed; and (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved." APA sec. 553(b).¹³⁵

The notice to the public and opportunity to comment by the affected persons is designed to involve those persons in the process, improve the quality of the rule making, encourage compliance by listening to regulated parties’ needs and to assist judicial review.¹³⁶ Rule for this purpose is defined as:

the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency * * *¹³⁷

¹³⁴ 5 U.S.C. section 551 ff. Beside the APA framework for regulations, there is another framework established by Executive Order EO 12866. Under EO 12866, the Office of Information and Regulatory Affairs (“OIRA”), a branch of the Office of Management and Budget, “carries out several important functions, including reviewing Federal regulations, reducing paperwork burdens, and overseeing policies relating to privacy, information quality, and statistical programs.” Treasury believes its regulations – except on rare occasions – do not require OIRA review; others disagree and, as with the application of the APA itself to tax regulations, there is some controversy in the practitioner community as to OIRA review of tax regulations. See Jeremiah Coder, Why Treasury Regulations Are Rarely "Significant", 136 Tax Notes 867 (Aug. 20, 2012).

¹³⁵ Altera Corp. v. Commissioner, 145 T.C. ___, ___ No. 3 (2015).

¹³⁶ Altera Corp. v. Commissioner, 145 T.C. ___, ___ No. 3 (2015).

¹³⁷ 5 U.S.C. § 551(4).

As we shall see, the IRS publishes a number of different forms of rule-making from regulations, some of which are clearly subject to the APA notice and comment, to less formal rules (such as Revenue Rulings, Notices, etc.) which have historically not been subject to formal APA notice and comment, although less formal notice and opportunities to comment are sometimes offered. The question is which of these forms of rule-making are subject to the APA?¹³⁸

The IRS is an administrative agency, just like other administrative agencies. It therefore should be and is subject to the APA rules applicable to other agencies, except to the extent specifically exempted by statute. Over the years some practitioners, scholars and courts – including the Supreme Court – have given signals that some have read as giving the IRS a special place in the administrative universe. These signals have been interpreted as “tax exceptionalism,” a notion that tax is just different. The claim of tax exceptionalism has nuances in many potential APA contexts, but the one most prominently addressed in a related context was whether IRS rule-making by regulation was subject to the same judicial deference as the courts gave other agency rule-making by regulation. After equivocating on that issue, the Supreme Court in **Mayo Foundation for Medical Research v. United States**, 562 U.S. 44 (2011) rejected the notion of tax exceptionalism for judicial deference to agency rule-making. I discuss Mayo below under deference,¹³⁹ but for the present discussion, it would appear that, extrapolating from Mayo to the APA generally, the APA would apply to the IRS the same way it applies to other agencies.

In terms of the APA requirement of notice and comment, agency rules may be divided into two universes: (1) **legislative rules** and (2) **non-legislative rules**, commonly called **interpretive rules** (those interpreting a statute rather than imposing a rule).¹⁴⁰ Legislative rules are those promulgated within a congressional grant of authority to make the rules.¹⁴¹ Legislative rules, which

¹³⁸ There are any number of good treatments of the administrative context for agency rule making. For this discussion, I have relied principally upon Leslie Book, A New Paradigm for IRS Guidance: Ensuring and Enhancing Participation, 12 Fla. Tax Rev. 517 (2012).

¹³⁹ See subsection 7. Deference to IRS Interpretation of the Code p. 66.

¹⁴⁰ Interpretive rules are also called interpretative rules; the current trend / fashion is to use the shorter version, interpretive. Perez v. Mortg. Bankers Ass'n, ___ U.S. ___, 135 S. Ct. 1199, 1204 n. 1 (2015) (“The latter [interpretive] is the more common phrasing today, and the one we use throughout this opinion.”) I use interpretive except in quotes. The APA uses “interpretative.”

In federal agency settings, there may be a third set of rules, procedural rules, which do not interpret a statute but simply establish procedures in the administration of the statute. In the IRS universe, published the Revenue Procedure (referred to as Rev. Proc. is perhaps the best known example, but the Internal Revenue Manual (“IRM”) is another good example. Generally, agencies have the right to set procedural rules, subject to due process limitations.

¹⁴¹ See generally IRM 32.1.1.2.8 (09-23-2011), How to Determine If a Rule Is Interpretative or Legislative, providing somewhat cryptically “2. If Congress simply provided end result, without any guidance as to how to achieve the desired goal, then regulations promulgated to achieve that goal are considered to be legislative.”

must be adopted in regulations, require notice and comment.¹⁴² Interpretive rules adopted in regulations (or elsewhere), simply interpret the statute, and do not require notice and comment.¹⁴³ Legislative rules promulgated by regulation within the scope of the statutory authority delegated are the law.¹⁴⁴ Historically, by contrast, interpretive rules – whether by regulation or otherwise – have had some lesser force.¹⁴⁵ But, the force of at least some types of interpretive rules has gained some traction under the concept of **deference** under which courts give some levels of deference to interpretive rules adopted by administrative agencies. To the extent that such deference controls the interpretation of a statute within the agency’s authority to administer, it is said that the interpretation is the law. Hence, as I shall note below in discussing deference,¹⁴⁶ there has been some blurring of the crisp distinction between legislative rules which determine the law and interpretive rules which, under the concept of deference, determine the law.¹⁴⁷

And, although there is a blurring, the APA regulatory review and the Chevron deference review (discussed below) may not produce different results in particular cases. Both would permit the regulation intended by the agency as law to be rejected if the agency acted unreasonably. See Altera Corp. v. Commissioner, 145 T.C. ___ No. 3 (2015), which was decided on July 27, just as I was finalizing this text.¹⁴⁸ Other than to state the glittering generality from the case on this point, I have not had time to digest it. I will try to provide additional analysis of my Federal Tax Procedure Blog and links to other analyses.

Beyond regulations, the question is what forms of other pronouncements by the IRS, if any, might be subject to the APA’s rule-making regime and what deference should be accorded them?

¹⁴² There is an exception to the notice and comment requirement where the agency ‘an agency, for good cause, finds that notice and public comment are “impracticable, unnecessary, or contrary to the public interest” and incorporates the good cause finding and a brief statement of the reasons therefore in the rule it issues. 5 U.S.C § 553(b)(B).’ IRM 32.1.5.4.7.5.1 (09-30-2011), Administrative Procedure Act.

¹⁴³ 5 U.S.C. § 553(b)(A) (2000). 5 U. S. C. §553(b)(A) (also APA § 4(b)(A)); see Perez v. Mortgage Bankers Ass'n, ___ U.S. ___, ___, 135 S. Ct. 1199, 1203-1204 (2015). IRM 32.1.1.2.8 (09-23-2011), How to Determine If a Rule Is Interpretative or Legislative, says that interpretive rules include rules filling gaps left by Congress are interpretive (interpretative in the terms of the IRM). This too is a cryptic explanation of the concept interpretive rules.

¹⁴⁴ Perez v. Mortgage Bankers Ass'n, ___ U.S. ___, ___, 135 S. Ct. 1199, 1203 (2015).

¹⁴⁵ In Perez v. Mortgage Bankers Ass'n, ___ U.S. ___, ___, 135 S. Ct. 1199, 1204 (2015), the Court said (internal quotes omitted) that interpretive rules “do not have the force and effect of law.”

¹⁴⁶ See 7. Deference to IRS Interpretation of the Code, p. 66.

¹⁴⁷ In Altera Corp. v. Commissioner, 145 T.C. ___, ___ n10, No. 3 (2015).

¹⁴⁸ An early comment is Patrick J. Smith (Guest Blogger), A Massive Loss and a Huge Rebuke for the IRS from the Tax Court in Altera Decision (Procedurally Taxing Blog 7/28/15), where he concludes: “I have noted in my articles that the Supreme Court’s decision in Judulang v. Holder makes clear that State Farm [the APA case] and Chevron step two are essentially equivalent, and the Tax Court in Altera reached the same conclusion.”

I don't think the rules are quite so crisply developed for agency rules generally because the need for pervasive rule-making is less exacerbated in other agencies that deal with less universal administrative needs than the IRS. Put simply, the needs of the tax system for some form of rule-making are simply greater or more pervasive, particularly ordinary taxpayers, than other agencies.

So, first, we will look at the types of IRS rule-making pronouncements and then address the APA concerns after developing more on the concept of the type of deference that these pronouncements should be given by the courts.

b. Regulations.

Regulations are the most authoritative form of published guidance issued by the IRS. Regulations fall into two broad classes – those that relating to substantive tax law and those relating to administration of the tax law.¹⁴⁹ Regulations receive the greatest consideration within the IRS of any of its guidance formats and, unlike other formats, are generally subject to a process of notice and public comment prior to becoming final.¹⁵⁰ Even after the Regulation becomes final, the Regulations can be amended, replaced or simply repealed. “Interested persons” may petition the IRS to issue, amend or repeal regulations.¹⁵¹

¹⁴⁹ Title 26 regulations are numbered with a prefix that give an indication of which category they fall in. Income tax regulations have a prefix – e.g. § 1.61, with the 1 indicating an income tax regulation and the number following the dot indicating the related Code Section. Similarly estate tax regulations have a 20 prefix, procedure and administrative regulations have a 301 or 601 prefix.

¹⁵⁰ Technically, under the Administrative Procedure Act (“APA”), public notice and comment prior to promulgation is required only for legislative regulations (as opposed to interpretive regulations) that I discuss later in this section of the text. 5 U.S.C. § 553(b)(A) (2000). 5 U. S. C. §553(b)(A) (also APA § 4(b)(A)); see Perez v. Mortgage Bankers Ass'n, ___ U.S. ___, ___, 135 S. Ct. 1199, 1203-1204 (2015). However, the IRS has historically used in the notice and comment procedure for all regulations, whether legislative or interpretive under the APA. See Banker's Life & Cas. Co. v. United States, 142 F.3d 973, 978 (7th Cir. 1998).

¹⁵¹ Reg. 601.601(c).

(1) Interpretive or Legislative.

(a) Introduction.

I discuss here the historical distinction between legislative and interpretive. Whether the distinction continues to be meaningful in a tax context under APA analysis and how so is an open issue. In Altera Corp. v. Commissioner, 145 T.C. ___, No. 3 (2015), decided just as this text was finalized, the Court said:

n10 We have previously referred to regulations issued pursuant to specific grants of rulemaking authority as legislative regulations and regulations issued pursuant to Treasury's general rulemaking authority, under sec. 7805(a), as interpretive regulations. See, e.g., Tutor-Saliba Corp. v. Commissioner, 115 T.C. 1, 7 (2000). Because the terms "legislative" and "interpretive" have different meanings in the administrative law context, see Hemp Indus. Ass'n v. DEA, 333 F.3d 1082, 1087 (9th Cir. 2003), we will refer to regulations issued pursuant to specific grants of rulemaking authority as specific authority regulations and regulations issued pursuant to Treasury's general rulemaking authority, under sec. 7805(a), as general authority regulations.

I did not have time to fully consider Altera in finalizing the text, so I will have to pick up that discussion in the next edition and, in the interim, on my Federal Tax Procedure Blog. The following discussion is based on the historical distinction between interpretive and legislative regulations.

(b) Interpretive Regulations.

Interpretive regulations interpret the law. In the context of the Code, at least historically, they are regulations promulgated under the general grant of authority in § 7805(a) (authority to “prescribe all needful rules and regulations for the enforcement” of the Code) or under some other specific grant in a Code section to interpret. These regulations sometimes just state what the Code section says explicitly; sometimes they paraphrase the Code section, without adding any interpretation to it. More commonly, these regulations add interpretations that state how the IRS will apply the Code section. In this case, they interpret statutory text that may not otherwise be clear from the text alone. Interpretive regulations often interpolate or extrapolate a rule that the statutory text or extrinsic sources of Congress’ intent do not necessarily command. For example, in enacting legislation Congress may not have considered the detailed implementation of the statute as to which of several different choices are possible; in order to make administration feasible, some choice as to interpretation must be made. The IRS may attempt to fill gaps (interpolate) or even go beyond (extrapolate) in its interpretive regulations. I discuss below the issue of the proper deference that courts must give to IRS interpretations in the regulations.

(c) Legislative Regulations.

Legislative regulations go beyond interpretation and establish the rules within the parameters set by Congress.¹⁵² The constitutional theory is that the agency is not legislating – a power reserved to Congress – if all it does is act within reasonable parameters set by Congress. These are called legislative regulations because, provided the regulation is within those parameters Congress established, the regulations are the law and do not merely interpret the law. The Code is shot through with many such grants of authority. The quintessential example is the consolidated return regulations. In very sparse statutory text,¹⁵³ Congress granted the IRS the authority to determine the rules that apply to consolidated returns. The IRS did so in hundreds of pages of Regulations, setting forth detailed, sometimes mind-numbing, rules that are the law despite the fact that they have never been expressly approved by Congress.¹⁵⁴

The IRS, of course, does have limits in promulgating legislative regulations. In the consolidated return area where courts generally defer to the regulations, a court has rejected the IRS legislative regulation as outside the scope of the authority.¹⁵⁵ In that case, the court found the IRS unable to make a persuasive argument that the benefit the IRS sought to deny to the taxpayer in the regulations was in some rational way related to the problems of filing a consolidated return which were the *raison d'etre* for the Congressional grant of legislative regulation authority. In the court's view, the IRS's fallback position that, if the taxpayer wanted the benefit of the consolidated return regulations (which the taxpayer must elect into), then the taxpayer “must take the bitter with the sweet.” Turning that cute thought on the IRS, the Court held that there is no requirement that the taxpayer be burdened by an invalid regulation outside the scope of the authority granted simply to elect the proper benefits of the consolidated return.

¹⁵² Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843-844 (1984) (“If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.”)

¹⁵³ § 1502 provides:

The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

¹⁵⁴ One author has noted that there are several hundred grants of specific authority. Kristin E. Hickman, Coloring Outside the Lines: Examining Treasury's (Lack Of) Compliance with Administrative Procedure Act Rulemaking Requirements, 82 Notre Dame L. Rev. 1727, 1735 (2007). The other grants of authority are less ambitious in scope than the consolidated return regulations. *Id.*

¹⁵⁵ Rite Aid Corp. v. United States, 255 F.3d 1357 (Fed. Cir. 2001). The Government's petition for panel and en banc rehearing were denied. 2001 U.S. App. LEXIS 23207.

(d) Blurring the Lines.

The distinction I have noted between legislative and interpretive regulations is a traditional distinction and important distinction in administrative law, including the APA. There has been a blurring of the distinction, at least for some purposes, under the Supreme Court's decision in Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) and its progeny.¹⁵⁶ I deal in more detail with the changes wrought by Chevron in the area of administrative deference to agency interpretation as to the meaning of the law and therefore defer further consideration here.¹⁵⁷ At this point, suffice it to say that for present purposes understanding the distinction is critical.

(2) Final, Proposed and Temporary.

For tax regulations, the process,¹⁵⁸ very generally, involves the following steps: (i) the IRS starts a regulations project on the Code section involved; (ii) a proposal is developed from the project and reviewed and revised, as appropriate, by the IRS's managers of the project, in conjunction with input from the Treasury Office of Tax Policy and internal reviews within appropriate offices of the IRS; (iii) unless there is good cause for immediate effectiveness of the regulation, the Treasury gives public notice of the proposed regulation and opportunity for comment by publishing the proposed regulation in the Federal Register (technically, in APA jargon, a Notice of Proposed Rulemaking ("NPRM"));¹⁵⁹ and (iv) after receiving and considering the comments, the

¹⁵⁶ Boeing Co. v. United States, 537 U.S. 437, 447-450 (2003) ("Even if we regard the challenged regulation as interpretive because it was promulgated under § 7805(a)'s general rulemaking grant rather than pursuant to a specific grant of authority, we must still treat the regulation with deference."); See Kristin E. Hickman, Coloring Outside the Lines: Examining Treasury's (Lack Of) Compliance with Administrative Procedure Act Rulemaking Requirements, 82 Notre Dame L. Rev. 1727 (2007). A colleague, influenced by the Chevron analysis (discussed in the immediately cited articles) would distinguish differently than I state in the text. He makes the distinction between regulations which, under the deference regime commencing with Chevron, set the law and those that are merely the Commissioner's argument or position, entitled to weak, if any, deference. Steve R. Johnson, Intermountain and the Importance of Administrative Law in Tax Law, 128 Tax Notes 837 (Aug. 23, 2010). I am not ultimately persuaded, but caution that Steve makes a good case and I am an older lawyer perhaps too steeped in traditional thinking on this subject to change my ways now.

¹⁵⁷ See 7. Deference to IRS Interpretation of the Code, p. 66.

¹⁵⁸ The process is described in many works, but for good summaries, see Kristin E. Hickman, Coloring Outside the Lines: Examining Treasury's (Lack Of) Compliance with Administrative Procedure Act Rulemaking Requirements, 82 Notre Dame L. Rev. 1727, 1735 (2007) (noting some apparent inconsistencies in the IRS implementation of the rulemaking authority); and Phillip Gall, Phantom Tax Regulations: The Curse of Spurned Delegations, 56 Tax Lawyer 413, 416-417 (2003).

¹⁵⁹ APA § 553(b) provides a good cause exception to the notice and comment requirement where the agency finds it to be "impracticable, unnecessary, or contrary to the public interest."

IRS withdraws or, more likely, modifies (sometimes with an additional notice and comment period) and finalizes the Regulation.¹⁶⁰ Legislative regulations must be adopted under this procedure. Interpretive regulations may be adopted under the procedure; the IRS usually uses the procedure for interpretive regulations. Regulations that go through the procedure and are promulgated are said to be “**Final Regulations**,” and may be amended by a similar process.

Proposed Regulations advise the public of the IRS's positions that it intends to adopt as final Regulations, subject to such adjustments as appropriate after notice and comment. They are not authoritative until they become final, particularly if they change a rule stated in an existing final or Temporary Regulation.¹⁶¹

Where circumstances justify issuing more immediately applicable authoritative regulatory guidance, the IRS can issue **Temporary Regulations** that become applicable immediately without completion of the notice and comment period under the APA. **Section 7805(e)** requires the IRS to contemporaneously issue the Temporary Regulations as Proposed Regulations and requires that the Temporary Regulations expire within 3 years of the date of issuance. In other words, Temporary Regulations are designed to be a temporary expedient to provide a working rule but to require that the normal Regulations process go forward expeditiously. The need for expediency creates a tension with the APA which imposes a process built on the fundamental value that regulations will better serve the public if there is advance notice and comment to provide the best assurance that all constituencies views are considered.¹⁶²

Some courts accord Temporary Regulations the same weight accorded final regulations.¹⁶³

¹⁶⁰ The adoption of the final regulation is published in the Federal Register. The IRS formalizes the adoption by what is called a Treasury Decision (“T.D.”)

¹⁶¹ Mitchell Rogovin and Donald L. Krob, The Four R’s Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within, 46 Duquesne L. Rev. 323, 328 (2008).

¹⁶² In conferring deference to regulations (deference being a large topic discussed below in the text), the Supreme Court has relied upon notice and comment to Proposed Regulations before the regulation becomes final. See e.g., Mayo Foundation for Medical Research v. United States, 562 U.S. 44, 57-58 (2011) (deferring to the regulation, emphasizing that the regulation had received notice and comment, “a consideration identified . . . as a significant sign that a rule merits Chevron deference.”) This tension has been noted by scholars. See Kristin E. Hickman, A Problem of Remedy: Responding to Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements, 76 Geo. Wash. L. Rev. 1153, 1158-60 (2008). As indicated, we will return to the deference topic later in the text.

¹⁶³ Callaway v. Commissioner, 231 F.3d 106, 107 n. 1 (2d Cir. 2000) (citing E. Norman Peterson Marital Trust v. Commissioner, 78 F.3d 795, 98 (2d Cir. 1996); and Truck & Equipment Corp. of Harrisonburg v. Commissioner, 98 T.C. 141, 149 (1992)).

(3) Retroactivity of Regulations.

(a) Introduction.

I introduce the topic of retroactivity of regulations by discussing first retroactivity of statutes and retroactivity of judicial interpretation of statutes.¹⁶⁴

Retroactivity of statutes and/or interpretations of statutes, is a multifaceted issue.¹⁶⁵ Criminal statute retroactivity violates the Ex Post Facto prohibition of the Constitution.¹⁶⁶ Economic legislation, including tax legislation, is not subject to the Ex Post Facto Clause, but there are other constitutional restraints of uncertain scope.¹⁶⁷ Even beyond constitutional requirements, prudential considerations rather than constitutional considerations have dominated Congress' consideration of whether to apply tax legislation retroactively.¹⁶⁸ It is not the norm to have tax legislation apply retroactively.¹⁶⁹

Congress will sometimes enact retroactive tax legislation. Retroactivity is usually directed to curing a particular serious problem that Congress believes is in the existing law. For example, in United States v. Carlton,¹⁷⁰ Congress passed a law retroactively taking away the benefit of a

¹⁶⁴ Judicial interpretation retroactivity is often called adjudicatory retroactivity.

¹⁶⁵ There are many good treatments of the issues subsumed in the concept of retroactivity. Interesting discussions of the issue may be found in the following articles relating to one aspect of the equities of retroactive tax legislation: Louis Kaplow, An Economic Analysis of Legal Transitions, 99 Harv. L. Rev. 511, 551-52 (1986) (urging that retroactive application of laws may be desirable in some cases); Michael Graetz, Legal Transitions: The Case for Retroactivity in Income Tax Revision, 126 U. Pa. L. Rev. 47, 66 (1977).

¹⁶⁶ Article I, § 9. In a tax setting, this would mean that a judicial or administrative interpretation of a Code provision that is not clear on its face (e.g., that is a choice among reasonable alternatives under the second step of Chevron (which is discussed in more detail below)) could not be applied retroactively to establish the requirement of clear violation of a known legal duty as required by Cheek v. United States, 498 U.S. 192 (1991) or, in a slightly different setting, James v. United States, 366 U.S. 213 (1961). Further development of these issues is beyond the scope of this text on tax procedure.

¹⁶⁷ See generally Jill E. Fisch, Retroactivity and Legal Change: an Equilibrium Approach, 110 Harv. L. Rev. 1055 (1997); and Bernard W. Bell, In Defense of Retroactive Laws (reviewing Daniel E. Troy's Retroactive Legislation), 78 Texas L. Rev. 235 (1999).

¹⁶⁸ Jill E. Fisch, Retroactivity and Legal Change: an Equilibrium Approach, 110 Harv. L. Rev. 1055, 1073-1074 (1997).

¹⁶⁹ Indeed, the Supreme Court has determined that, without a clear expression of congressional intent to have legislation apply retroactively, the rule of interpretation is that the legislation will not apply retroactively. Landgraf v. USI Film Prods., 511 U.S. 244, 270 (1994); and Bernard W. Bell, Legislative History Without Legislative Intent: The Public Justification Approach to Statutory Interpretation, 60 Ohio St. L.J. 1, 28 (1999).

¹⁷⁰ 512 U.S. 26 (1994).

deduction originally designed to encourage Employee Stock Option Plans (“ESOPs”). The taxpayer planned the transaction based on the law extant at the time he undertook the transaction. The Supreme Court rejected constitutional challenge to retroactivity, relying on its curative effect and short period of retroactivity. The Court did suggest that there are constitutional restraints on Congress’ ability to legislate retroactively, but blessed reasonable retroactivity.

Usually, considerations of fairness will compel Congress to make tax legislation retroactive only to the date a tax committee first announced its interest in changing the law and the news release to that effect will often say that the legislation is expected to be so retroactive. Sometimes the date may be retroactive to any earlier date when the executive branch proposes a legislative fix to Congress.

(b) Promulgated Regulations.

One of the historical concerns about interpretive regulations was whether they could apply retroactively, the same type of concern for adjudicative retroactivity (the issue of whether a Supreme Court definitive interpretation of an uncertain statute enacted years earlier is retroactive to the date the statute was enacted). There are no constitutional constraints on adjudicative retroactivity.¹⁷¹ So, when interpretive regulations, like judicial decisions, merely interpret the law, is there or should there be any constitutional or prudential constraints on retroactivity?

In Manhattan General Equipment Co. v. Commissioner, 297 US 129, 135 (1936), the Supreme Court explained the concept of retroactive application of regulations:

The statute defines the rights of the taxpayer and fixes a standard by which such rights are measured. The regulation constitutes only a step in the administrative process. It does not and could not alter the statute. It is no more retroactive in its operation than is a judicial determination construing and applying a statute to the case at hand.

Thus, an interpretive regulation in theory merely interprets the statute and, if it does so properly, the interpretation has historically generally been effective as of the effective date of the statute that it interprets.¹⁷²

However, as noted above, interpretive regulations may do more than just interpret the law. Sometimes they pick among choices of interpretation and thereby become the authoritative

¹⁷¹ Jill E. Fisch, Retroactivity and Legal Change: an Equilibrium Approach, 110 Harv. L. Rev. 1055, 1075-1077 (1997).

¹⁷² Indeed, for this reason, a correct interpretation is retroactive even if the IRS had adopted an interim incorrectly interpreting the law and the taxpayer had relied upon the incorrect interpretation. See Dickman v. Commissioner, 465 U.S. 330, 343 (1984). See generally, Mitchell Rogovin and Donald L. Krob, The Four R’s Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within, 46 Duquesne L. Rev., 323, 329 (2008).

interpretation. Certainly a policy argument can be made that, until that choice of interpretation was made in the regulation, it is unfair to apply the interpretation retroactively for, during that period prior to adoption of the regulation, taxpayers had to make choices as to which they had no guidance. On the other hand, since alternative choices were available from the enactment of the statute to the announcement of the Regulation, it cannot be said that a taxpayer reasonably relied upon any particular choice that had not yet been adopted, so the case for harm from an unadopted interpretation that is never adopted may be questionable.

Because of prudential concerns (as opposed to constitutional constraints), § 7805(b) provides that “no temporary, proposed, or final regulation * * * shall apply to any taxable period ending before the earliest of the following dates:”

- (1) if issued within 18 months of the date of the statute, then to the date of the statute;¹⁷³
- (2) if issued later than 18 months, then the earliest of the following dates: (a) the date the final regulation was published; (b) the date on which any Proposed or Temporary Regulation was published; and (c) the date on which any notice substantially describes the contents of the expected Proposed, Temporary or Final Regulation;¹⁷⁴
- (3) if necessary “to prevent abuse,” with no limitation as to the date of retroactivity;¹⁷⁵
- (4) “to correct a procedural defect in the issuance of any prior regulation,” with no indication as to the date of retroactivity;¹⁷⁶
- (5) if “relating to internal Treasury Department policies, practices, or procedures,” with no limitation as to the date of retroactivity.¹⁷⁷

Even where the IRS could apply the Regulations retroactively, it may determine to apply the Regulations prospectively.¹⁷⁸

The case for retroactivity of legislative regulations is much weaker. Hence, the APA, which generally applies to legislative regulations rather than interpretive regulations, permits retroactivity only to 30 days before promulgation of the regulation, unless it is (1) a substantive rule which grants an exception or relieves a restriction, (2) an interpretive rule or statement of policy, or (3) “as otherwise provided by the agency for good cause found and published with the rule.”¹⁷⁹

Now, I have just stated the law on retroactivity under the traditional legislative / interpretive regime that may or may not continue to apply under Chevron after Mayo Foundation said there was

¹⁷³ § 7805(b)(2).

¹⁷⁴ § 7805(b)(1).

¹⁷⁵ § 7805(b)(3).

¹⁷⁶ § 7805(b)(4).

¹⁷⁷ § 7805(b)(5).

¹⁷⁸ § 7805(b)(7); see the Rogovin and Korb article in the preceding footnote.

¹⁷⁹ 5 U.S.C. § 553(d).

no distinction between the two – in effect both legislative and interpretive regulations now state the law. I will presume that that interpretation in Mayo Foundation does not upset the application of § 7805(b). Certainly, if retroactive tax legislation can be a problem, then retroactive regulations with the force of law can be a problem. Section 7805(b) would not cure that problem.¹⁸⁰

(c) What About Temporary Regulations?

Temporary Regulations by definition have not gone through any notice and comment process which seems to have been an important reason that regulations are given great deference under pre-Chevron and post-Chevron interpretive regimes. One could argue – and some have – that given the deference required for regulations, Temporary Regulations should not be entitled to the deference. If, as in some cases I treat in the Chevron deference discussion below, the IRS’s interpretation wins only because it is in the regulation, should the interpretation prevail during the period when the interpretation was only in a Temporary Regulation? I think that, if the interpretation is ultimately promulgated into a notice and comment regulation, then there are strong arguments for giving it authoritative treatment in the interim. The more difficult issue is what if the Temporary Regulation itself is retroactive and attempts to change the law for periods prior to the issuance of the Temporary Regulation. “Ay, there’s the rub.”¹⁸¹ I defer further discussion until we embark on the still evolving journey of Chevron.

(4) Nonexistent or Phantom Regulations.

Congress will sometimes direct the IRS to issue regulations to flesh out the statutory scheme. The direction may be for either interpretive regulations or legislative regulations. For any number of reasons, the IRS may not get around to promulgating the required regulations for long periods and in some cases not at all.¹⁸² How do the IRS and the courts resolve cases which should be subject to such regulations if they existed? Should the courts create, in effect, the court’s own “phantom” regulation to resolve the case based on the policies reflected in the statute? Should the IRS do so to resolve particular cases administratively? One author surveying the cases has concluded:

¹⁸⁰ Robert R. Gunning, Back from the Dead: The Resurgence of Due Process Challenges to Retroactive Tax Legislation, 47 Duq. L. Rev. 291 (2009) (proposing “a presumptive line be drawn at the year preceding the legislative session in which the subject tax law is enacted.”).

¹⁸¹ William Shakespeare, Hamlet (circa 1600), in the famous “To be or not to be” soliloquy.

¹⁸² A classic example is § 385, enacted in 1969. Section 385 authorizes – but does not direct – the IRS to promulgate regulations to adopt a test for distinguishing between corporate debt and equity. The courts had developed general rules which were so squishy in application that they were difficult for taxpayers, the IRS and the courts to apply. Congress punted to the IRS the authority to make the rules. The IRS tried but finally realized that it could not do that in a way that might not create more problems than it solved. The IRS has yet to promulgate regulations. Taxpayers, the IRS and the courts are left with the same squishy rules as before.

Over the past several decades, the lower courts have had numerous occasions to interpret statutory delegations, with many of the cases decided in the U.S. Tax Court. Though the decisions are hardly a model of consistency, the courts have generally treated statutory delegations as self-executing, even in the absence of implementing regulations. To give the statute effect, the reviewing court invokes “phantom regulations,” deciding the case in accordance with the interpretation it believes the Secretary might offer were he to issue regulations. Though the courts sometimes express discomfort with doing the Secretary’s job for him, they believe that doing so is consistent with Congress’s intent.¹⁸³

Would it make a difference if the statute is “taxpayer-friendly” but does contemplate that the IRS will flesh out the benefit? Can the IRS deny the benefit intended by the statute by simply not promulgating the Regulations? Would it make a difference if the statute is “taxpayer-unfriendly” so that it is the IRS’s ox that is gored by the absence of Regulations? Would there be some equity in creating phantom “taxpayer-friendly” regulations but not “taxpayer-unfriendly” regulations?

Moreover, in planning transactions, the practitioner must extrapolate his or her best guess as to what regulation might be when and if the IRS adopts it and what the courts might do if the IRS does or does not adopt a regulation. Further discussion of this phenomenon is beyond the scope of this introductory procedure book, but the student and practitioner should be aware of this phenomenon.

c. Notices (and Retroactivity).

The IRS issues “Notices” that are less formal than Regulations. These notices are used to provide quicker notice to the public than allowed by the other forms of pronouncement.

A notice, which is published in the Internal Revenue Bulletin and compiled annually in the Cumulative Bulletin, contains guidance that involves substantive interpretations of the Code or other provisions of law. Topics can include changes to forms or to other previously published materials, solicitation of public comments on issues under consideration, and advance notice of rules to be provided in regulations when the regulations may not be published in the immediate future. Increasingly, notices have served as a critical component of the Service's efforts to combat abusive tax avoidance transactions, as they have been used to identify transactions about which the Service has concerns. Given the rapid pace of developments in this area, notices have proven particularly useful for quickly disseminating information that allows taxpayers to understand exactly which transactions will be of interest to the Service, including so-called “listed

¹⁸³ Amandeep S. Grewal, Substance Over Form? Phantom Regulations and the Internal Revenue Code, 7 *Houston Bus. & Tax J.* 42, 45 (2006); see generally also Phillip Gall, Phantom Tax Regulations: The Curse of Spurned Delegations, 56 *Tax Lawyer* 413 (2003).

transactions” and “transactions of interest,” both of which are “reportable transactions” under section 6011.¹⁸⁴

For example, the IRS may use the Notice format to alert the public that certain types of tax shelters will not sustain the tax benefits hawked by promoters.¹⁸⁵ These do not have any formal status as interpretations of the substantive provisions of the Code, but merely state the IRS’s interpretation of the law and that it intends to enforce that interpretation.¹⁸⁶

The IRS has sometimes used this Notice procedure to caution the public that it will issue a Regulation to deal with the identified abuses.¹⁸⁷ The ultimate regulation may be made retroactive to the date of such Notice.¹⁸⁸ The purpose of such Notices is to chill the behavior that the IRS thinks is abusive or contrary to a balanced interpretation of the statutes – e.g., in the case of so-called abusive corporate tax shelters, to discourage corporate tax directors from investing in such corporate tax shelters -- and to put the public on notice earlier than it could do so through the regulations process. Many have argued that the IRS's propensity to use such Notices is itself abusive, and the IRS seems to have curbed the frequency of their use after Congress expressed some concerns also.

The IRS also uses Notices to provide guidance in complex areas of the law where the public needs prompt guidance. For example, the IRS has used notices to flesh out the 1980 Foreign Investment in Real Property Tax Act (often referred to as “FIRPTA”). A practitioner commenting on the state of FIRPTA advised that:

[I]t is crucial to consult all notices, regulations, and the IRC. Notices are especially important, Bracuti said, because the notices sometimes change the rules.¹⁸⁹

Notice the order chosen by this practitioner. Many lawyers would reverse the order – treating the Code as the best authority, regulations thereafter (under Chevron almost like the Code) and notices falling a distant third. But, in terms of day to day practice for a practitioner solving practical

¹⁸⁴ Mitchell Rogovin and Donald L. Korb, The Four R's Revisited: Regulations, Rulings, Reliance and Retroactivity in the 21st Century: A View from Within, 46 Duq. L. Rev. 323, 339-340 (2008).

¹⁸⁵ E.g., IRS Notice 97-24, 1997-1 C.B. 43; IRS Notice 2000-44, 2000-2 C.B. 255.

¹⁸⁶ In Stobie Creek Invs., L.L.C. v. United States, 82 Fed. Cl. 636, 671 (2008), the Court of Federal Claims described IRS notices as “press releases stating the IRS's position on a particular issue and informing the public of its intentions”.

¹⁸⁷ For example, in the tax shelter arena that drew the IRS’s angst in the late 1990s and early 2000s, the IRS frequently issued Notices to warn taxpayers and influence them to comply with the IRS interpretive view of the law.

¹⁸⁸ § 7805(b)(1)(C). See Cemco Investors, LLC v. United States, 515 F.3d 749 (7th Cir. 2008).

¹⁸⁹ Consulting IRS Notices Key to Avoiding FIRPTA Traps, Practitioner Says, 2009 TNT 177-10 (9/15/09), citing comments of Guy Bracuti, a principal at KPMG.

problems without concern for the boundaries of the law, the practitioner quite properly noted that notices are very, very important. In this regard, an IRS participant at the same meeting noted:

Asked if the IRS might issue a comprehensive set of regulations that combine all of the notices issued to date relating to FIRPTA transactions, Besecky declined to make a specific regulation prediction, but did say that he thought that some issues, such as REITs, “need attention.” He added there are aspects of FIRPTA that haven't been updated in 25 years.¹⁹⁰

So, however questionable Notices may be from an administrative law purist's standpoint, they do serve an important function in notifying taxpayers and practitioners as to important matters that should be considered in planning transactions.

The IRS also has adopted a procedure to advise the public of so-called “transactions of interest.”¹⁹¹ In these notices, the IRS advises the public that it was aware of the transactions, has some interest in them in terms of possibly designating them as listed transactions, and intends to consider further whether they should be identified as tax avoidance transactions. When the IRS has enough information to make an informed decision as to whether the transaction described is a tax avoidance type transaction, its options include: (i) removing the transaction from the transactions-of-interest category in published guidance, (ii) designating the transaction as a listed transaction, or (iii) providing a new category of reportable transaction. In the meantime, the designation as a transaction of interest make the transaction reportable until that characterization is removed.

d. Revenue Rulings and Procedures.

(1) Revenue Rulings.

“A **Revenue Ruling** is an official interpretation by the Service that has been published in the Internal Revenue Bulletin. Revenue Rulings are issued only by the National Office and are published for the information and guidance of taxpayers, Internal Revenue Service officials, and others concerned.”¹⁹² IRS rulings regarding substantive tax law appear in Revenue Rulings.¹⁹³ Revenue Rulings promote uniformity of interpretation within the IRS and permit taxpayers to rely on them “in determining the tax treatment of their own transaction” without having to “request specific rulings applying the principles of a published revenue ruling to the facts of their particular cases.”¹⁹⁴ Taxpayers may rely upon the Revenue Ruling without seeking a private letter ruling

¹⁹⁰ Id.

¹⁹¹ Regs. § 1.6011-4(b)(6). The most recent list of transactions of interest is published at Notice 2009-55; 2009-31 IRB 1.

¹⁹² Reg. 601.601(d)(2)(i)(a).

¹⁹³ Reg. 601.601(d)(2)(v).

¹⁹⁴ Reg. 601.601(d)(2)(v)(e). See also Rev. Proc. 89-14, 1989-1 C.B. 814, at section 7.01(5); see Mitchell Rogovin and Donald L. Krob, The Four R's Revisited: Regulations, Rulings,

(which is discussed below), and, even though the IRS has the power to change a position in a Revenue Ruling retroactively,¹⁹⁵ the IRS will not generally make a change in position retroactively even if a particular taxpayer was not aware of it or did not rely upon it.¹⁹⁶

The usual format for a Revenue Ruling is to state an assumed set of facts (often, but not always, based upon a real fact situation of which the national office is aware) and state the IRS's opinion as to what the substantive legal result should be.¹⁹⁷

Revenue Rulings are issued under the authority of § 7805(a). Revenue Rulings are not issued with public notice and comment opportunity via the Federal Register as are regulations, but there is a multi-stage administrative procedure for issuance of Revenue Rulings, including review within both the IRS and Treasury. **Revenue Rulings** are issued by the IRS periodically in the **Internal Revenue Bulletin** (“**I.R.B.**”), a bi-weekly IRS publication, and compiled twice a year into the **Cumulative Bulletin**, an IRS publication.¹⁹⁸

Within the IRS, Revenue Rulings are used as authority and binding on IRS agents in audits.¹⁹⁹ This means that, if the Revenue Ruling supports the taxpayer, the agent has no leeway to make a different audit determination. If, however, the Revenue Ruling supports the adjustment the agent proposes, he should follow the Revenue Ruling. This does not mean that the taxpayer loses, for the taxpayer can go to Appeals which can settle based on litigating hazards regardless of the Revenue Ruling and, if unsuccessful in Appeals, eventually litigate where the outcome is not controlled by the Revenue Ruling.

Reliance, and Retroactivity in the 21st Century: A View From Within, 46 Duquesne L. Rev. 323, 331 (2008).

¹⁹⁵ Dixon v. United States, 381 U.S. 68 (1965).

¹⁹⁶ Rogovin & Korb, *supra*, pp. 335-336.

¹⁹⁷ Reg. 601.201(a)(2) and 601.601(d)(2)(i)(a).

¹⁹⁸ Mitchell Rogovin and Donald L. Krob, The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within, 46 Duquesne L. Rev. 323, 330(2008) (citing Treas. Reg. § 601.601(d)(2) (1987)); focusing on the interpretive authority of revenue rulings, revenue procedures and notices but providing a good review of what they are in the regulatory landscape, see Kirstin E. Hickman, IRB Guidance: The No Man's Land of Tax Code Interpretation, 2009 Mich. St. L. Rev. 239 (2009).

¹⁹⁹ Reg. 601.601(d)(2)(v)(d). See generally Rev. Rul. 53-2, 1953-1 C.B. 484.

Occasionally in litigation, the IRS has taken positions that contradict or appear to contradict a Revenue Ruling; in those cases the Courts appeared quite willing to hold the IRS to the Revenue Ruling.²⁰⁰ As a result, the IRS will not take positions in litigation contrary to Revenue Rulings.²⁰¹

More often, however, in litigation, it is the taxpayer seeking to avoid the position the IRS asserted in a Revenue Ruling. Then, the issue of whether the Revenue Ruling is just one lawyer's opinion or is entitled to deference becomes important. We address later the deference that courts accord to interpretations in Revenue Rulings (pp. 74 ff), but for now suffice it to say that Revenue Rulings are usually accorded no deference in the interpretation of the Code or may be given a very weak form of deference – called Skidmore deference – that permits the Revenue Ruling to affect the interpretation applied by the court only if the court believes the position in the Revenue Ruling is persuasive (in which case, one might conclude, for a persuasive position what affect does the Revenue Ruling serve?).

(2) Revenue Procedures.

Revenue Procedures are IRS publications advising the public of internal management and procedural matters.²⁰² They thus differ from Revenue Rulings which advise the public of IRS substantive law positions. For example, the IRS uses Revenue Procedures to advise the public about detailed requirements for requests for private letter rulings (discussed immediately below). In this sense, they act as “check lists” that taxpayers and practitioners follow in order to seek private letter rulings. Like Revenue Rulings, Revenue Procedures are published in the Internal Revenue Bulletins and Cumulative Bulletins.

e. Letter Rulings.

(1) Nature of the Letter Ruling.

A **letter ruling** (also referred to as “**private letter ruling**” or “**PLR**”) is a ruling issued to a taxpayer as to the application of the tax law to a transaction (1) that the taxpayer contemplates

²⁰⁰ See e.g., Rauenhorst v. Commissioner, 119 T.C. 157 (2002) (holding that the Revenue Ruling is a concession by the IRS, avoiding the necessity of determining the application of the law to the facts); and McLendon v. Commissioner, 135 F.3d 1017 (5th Cir., 1998); see also IRS CC-2002-043, 2002 WTD 223-29 (cautioning IRS attorneys in light of Rauenhorst to follow published guidance.)

²⁰¹ CC-2003-014, published at 2003 TNT 93-7 (instructing IRS attorneys to not take positions inconsistent with public positions in “final guidance,” defined as “final regulations, temporary regulations, revenue rulings, revenue procedures.”)

²⁰² Rogovin & Korb, pp. 336-337; see Reg. 601.601(d)(2)(i)(b) (“[a] ‘Revenue Procedure’ is a statement of procedure that affects the rights or duties of taxpayers or other members of the public under the Code and related statutes or information that, although not necessarily affecting the rights and duties of the public, should be a matter of public knowledge.”)

undertaking or (2) that the taxpayer has undertaken and needs guidance in order to file the return.²⁰³ By far the bulk of the rulings are issued in the first category – contemplated transactions – where the taxpayer needs certainty or “comfort” as to the tax consequence before entering into the transaction. Letter rulings are requested from and issued by the National Office of the IRS.

The letter ruling is not a position of the IRS; rather, it is just a ruling approved by two attorneys at the IRS – a “line” or docket attorney and his immediate superior – as to the tax consequences of the transaction in question.²⁰⁴ (I am sure that those attorneys vet their positions with appropriate personnel within the IRS, but the point for present purposes is that the process is relatively informal.)

Usually, the taxpayer is engaged in the process leading to the ruling, at least sufficiently to insure that the legal issues are developed from the taxpayer’s perspective. If the IRS makes a preliminary decision to deny the ruling request, the IRS will notify the taxpayer and offer the opportunity to withdraw the ruling request. Based on my anecdotal evidence, most taxpayers withdraw the request rather than force the IRS to issue an unfavorable PLR.²⁰⁵

(2) User Fees.

The IRS charges so-called “user fees” to taxpayers requesting PLRs. The fees are provided in a periodic Revenue Procedure, the latest being Rev. Proc. 2015–8, IRB 2015-1 (1/2/15). That procedure, applying to certain requests other than PLRs, generally requires a fee of \$10,000.²⁰⁶

(3) Precedential Value.

A PLR is issued to a specific taxpayer for a specific transaction. It is given far less formal review than, for example, Regulations, Revenue Rulings and Revenue Procedures. It is not intended to be an IRS statement of generally applicable position but is intended to permit the taxpayer to whom it is rendered to rely upon the ruling in completing or reporting the transaction involved in the request. Notwithstanding that it is not intended as a formal statement of IRS position, the IRS has used PLRs internally for consideration in reaching positions in other cases. Because of

²⁰³ The procedures for letter rulings are published periodically in Revenue Procedures. The IRS also periodically issues Revenue Procedures identifying issues for which it will not issue private rulings. The IRS numbering system for private letter rulings is a series of digits with the year first, the numerical week in the year next and the next digits being the sequentially issued rulings during that week. Thus, a PLR issued in the 2nd week of 2009 would have the following prefix: 200902. The final digits will be the sequential number of the PLR as issued during that week.

²⁰⁴ Jasper L. Cummings, Chief Counsel Legal Advice Questions and Answers, 2004 TNT 46-48 (3/9/04).

²⁰⁵ In Anonymous v. Commissioner, 134 T.C. 13 (2009), the taxpayer declined to withdraw the request and then complained about the IRS’s decision to issue the unfavorable ruling and make it public as required for PLRs (see in the text below). Strange indeed.

²⁰⁶ ¶ 6.

congressional concerns about a secret body of law, § 6110(a) directs the IRS to make a “written determination and any background file document relating to such written determination” open for public inspection. A written determination includes a “ruling, determination letter, technical advice memorandum, or Chief Counsel advice.” § 6110(b)(1). I discuss the latter forms of IRS determination below, but focus in this section on private letter rulings. Before making PLRs public, the IRS is required to excise taxpayer specific information (the excision process is referred to as “redaction”). § 6110(c).²⁰⁷

Many tax publishers publish PLRs and other of the more informal written determinations as the IRS makes them available. In a tax practice, these PLRs and other written determinations made public under § 6110 must be consulted in researching tax issues, particularly with respect to transactions, return reporting and litigation. One obvious use is in helping a client determine whether he or she should seek a PLR. Why would a taxpayer need to seek a PLR if there is an outstanding unrevoked PLR that confers the benefits the taxpayer seeks? The taxpayer’s ability to rely upon a PLR issued to another taxpayer is circumscribed. Recognizing the relatively informal genesis of such written determinations (including PLRs), Congress provided in § 6110(k)(3):

(3) Precedential status. Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent. * * * *

The statutory prohibition is straight-forward and would seem to preclude the use of PLRs either by taxpayers or courts in interpreting the tax law in a way that is contrary to the interpretation derived from traditional tools of statutory interpretation. Not so fast, however. Now that PLRs (and other determinations) are published by the IRS, the positions tend to be influential in the development of the law.²⁰⁸ Particular contexts will present a nuanced opportunity to use PLRs in an outcome determinative way despite § 6110(k)(3)’s apparent meaning.²⁰⁹ Indeed, as I note below, the Supreme

²⁰⁷ The IRS must engage the taxpayer to whom the ruling is addressed in the process of determining what portion of the determination will be disclosed and the Code provides administrative and judicial processes for resolution of disputes as to the disclosures to be made. § 6110(f)(1). In Anonymous v. Commissioner, 134 T.C. 13 (2009), the anonymous taxpayer sought to enjoin the IRS from disclosing an unfavorable PLR or, alternatively, redact certain terms that allegedly identified the taxpayer. The Tax Court held that the Court had no authority to prohibit the public release of the PLR, but held for future decision whether certain terms that might identify the taxpayer should be redacted.

²⁰⁸ See Yehonatan Givati, Resolving Legal Uncertainty: the Unfulfilled Promise of Advance Tax Rulings, 29 Va. Tax Rev. 137, 158-161 (2009) (noting de facto effect from publication, including IRS duty of consistency); and Judy S. Kwok, The Perils of Bright Lines: Section 6110(k)(3) and the Ambiguous Precedential Status of Written Determinations, 24 Va. Tax Rev. 863, 884 & 907 (2005).

²⁰⁹ See e.g., Rowan Cos. v. United States, 452 U.S. 261, 261-262 (1981); Hanover Bank v. Commissioner, 369 U.S. 672, 686-687 (1962); Estate of Cristofani v. Commissioner, 97 T.C. 74, 84 n.5 (1991); Woods Inv. Co. v. Commissioner, 85 T.C. 274, 281 n.15 (1985).

Court may have breathed new life into this issue in the Chevron²¹⁰ line of cases where deference may be given to administrative interpretations other than Regulations, particularly if they evidence long-standing interpretations. I will return to this issue in discussing the Supreme Court's decision in Chevron and its progeny and implications below (pp. 66 ff.).

Finally, in a rare decision prior to § 6110(k)(3), involving facts where a PLR improperly gave a taxpayer a competitive advantage, the Court of Claims appellate division (the predecessor to the Court of Appeals for the Federal Circuit) permitted reliance in a backhanded way. See **International Business Machines Corp. v. United States**, 343 F.2d 914 (Ct. Cl. 1965), cert. denied, 382 US 1028 (1966),²¹¹ discussed below at p. 88. I say IBM is a rare case because taxpayers frequently seek to bootstrap reliance on a PLR via the IBM case, but rarely succeed.²¹²

(4) Retroactive Revocation.

One serious issue that has arisen is whether letter rulings may be revoked retroactively. The ruling may be revoked if the taxpayer has made material misstatements of fact in the process of requesting and obtaining a ruling. The taxpayer has no credible complaint, since the taxpayer misstated the facts. Where, however, the letter ruling appears to have been improvidently granted because the IRS wrongly interpreted the law and later changes its interpretation of the law (whether in response to subsequent cases or otherwise), the case for retroactive revocation is murkier.

The black letter law is that the Commissioner's correction of a legal error retroactively is permitted.²¹³ The theory is that an incorrect interpretation is a nullity. Obviously, however, where a taxpayer in good faith has requested and received a specific ruling and then relied upon the ruling in completing a transaction, retroactive revocation can be viewed as unfair and inequitable. Generally, therefore, the IRS exercises its discretion and revokes only prospectively.²¹⁴ By contrast, in those less common cases where the PLR issues after the fact as to a completed transaction, the case against retroactivity is less compelling and the revocation will generally be retroactive.²¹⁵

But what about a business taxpayer who is competitively disadvantaged during that earlier period when his competitor to whom the PLR was issued benefits from nonretroactivity? I shall return to this issue in a specific context below in discussing the IBM case discussed below at p. 88.

²¹⁰ Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).

²¹¹ Nonacq. AOD 2012-02; 2012-40 IRB 1.

²¹² E.g., Bookwalter v. Brecklein, 357 F.2d 78 (8th Cir. 1966).

²¹³ See Automobile Club v. Commissioner, 353 US 180 (1957); cf. Dixon v. United States, 381 US 68, 73 (1965); and Dickman v. Commissioner, 465 U.S. 330, 343 (1984).

²¹⁴ Reg. § 601.201(l)(5) provides that a PLR issued with respect to a proposed transaction that is relied upon in good faith will generally not be revoked retroactively. See also, Emily Cauble, Detrimental Reliance on IRS Guidance, 2015 Wis. L. Rev. 421, 440 (2015).

²¹⁵ Reg. § 601.201(l)(9) (“taxpayers will not be afforded protection against retroactive revocation . . . since they will not have entered into the transactions in reliance on the rulings.”).

(5) Taxpayer Strategies for PLRs.

When should the taxpayer seek a PLR?²¹⁶ There are two extremes that set the parameters to this question.

First, the practitioner may know in advance that the IRS will not rule favorably. Obviously, the effort will be futile if the taxpayer is reasonably certain the IRS will issue a negative ruling. Not only will it waste time and resources to generate and process, but the PLR will alert the IRS to the transaction. While it is true that the IRS may not then correlate the matter with a return in which the taxpayer takes the position, there is still that possibility. For this reason, if the IRS is considering a negative response, the taxpayer may have an opportunity to withdraw the request, and the taxpayer should strongly consider taking that opportunity.

Second, the practitioner may know in advance that IRS approval is a virtual certainty. Many transactions, particularly in the reorganization area, will seek so-called “comfort rulings.” The transactions are so large that, although it may be clear to the practitioner that the transaction will qualify for the tax-beneficial treatment, the taxpayer and the practitioner would like the comfort of advance assurance from the IRS that it does qualify.

Then there are the cases between the two extremes where the taxpayer and his practitioner will have to assess the burdens and benefits of placing the transaction on the IRS’s radar screen. There is no easy answer to the question, but the goal is to make sure that there is some reasonable prospect that the IRS will issue a favorable ruling. Otherwise, it will usually be better just to take a return reporting position (so long as that can be taken ethically and without unacceptable penalty risk), and see if it works.

What should the taxpayer do with a negative private ruling? The taxpayer has been put on notice that the IRS does not agree with the position the taxpayer sought. What risks then will the taxpayer assume if he takes the rejected position on a return? Keep in mind that the IRS’s position in a negative ruling is simply the IRS’s position, and the IRS’s position may be wrong. Nevertheless, if the taxpayer were to take the position on the tax return without disclosing the negative position, this would almost certainly be a negative factor to the taxpayer’s attempt to avoid a penalty that might otherwise be asserted under the facts.²¹⁷

²¹⁶ See generally Burgess J.W. Raby and William L. Raby, When Is a Practitioner's Opinion Preferable to Requesting a Ruling from the IRS?, 2003 TNT 199-33 (10/15/03).

²¹⁷ For example, in Roco v. Commissioner, 121 T.C. 160 (2003), discussed below at p. 353, the Court held that a taxpayer who applied for and then withdrew a private letter ruling request after being advised informally by the IRS attorney assigned to the request that the ruling would be negative and then took the position he desired on the return without any disclosure was subject to the accuracy related penalty.

f. Technical Advice - TAMs and TEAMs.

During the course of an audit, an agent may seek to support an adjustment on the basis of an issue as to which the law may not be clear. The agent may seek advice from the local District Counsel who is usually not a specialist in the substantive issue involved. Alternatively, the agent may seek a “**Technical Advice**” (“TAM”) from the National Office and obtain a definitive (at least internally definitive) position on the issue. Technical Advice is designed to resolve legal issues, not factual issues.²¹⁸ The taxpayer may even initiate the process for technical advice.²¹⁹ The taxpayer will be involved in the process because it requires that the IRS and the taxpayer agree upon the facts, at least sufficiently for the National Office to render its legal position. The taxpayer will have the opportunity to “brief” his position, so that the National Office will have that input in reaching its decision.

Practitioners should be familiar with the TAM process and may want to invoke the consideration of a TAM in appropriate cases where the agent may be adopting a position that the practitioner does not believe will be adopted by the National Office.

The IRS has developed an alternative to the TAM, known as the Technical Expedited Advice Memorandum (“**TEAM**”).²²⁰ This process provides TAM-quality advice to the field in a shorter time frame.²²¹

g. Internal Revenue Manual (“IRM”).

The IRS internally publishes an **Internal Revenue Manual** (“IRM”) which is a large compilation of internal administrative procedures. Most of the IRM has been made public on the IRS website²²² and is easily searchable with search engines such as Google. In addition, some private services republish the IRM. Some portions of the IRM are not made public, however. The IRM is quite useful for determining authorities and proper procedures within the IRS. Most practitioners believe that handy access to the IRM is important in a tax controversy practice.

Does the taxpayer have any relief if the IRS violates the IRM and thereby potentially harms the taxpayer? In **United States v. Caceres**,²²³ the Supreme Court held that, where the IRS violated the IRM by monitoring conversations without the DOJ approval required by the IRM, the resulting evidence need not be excluded in a criminal prosecution. The Court reasoned that the IRM did not and was not intended to grant rights to the taxpayers, but to regulate the internal conduct of the agency. Furthermore, no due process issue was implicated because the target had not reasonably

²¹⁸ The procedures for technical advice are set forth in Revenue Procedures updated periodically by the IRS. See Rev. Proc. 2014-2, 2014-1 IRB 90.

²¹⁹ See Policy P-4-82, IRM 1.2.1.13.1.25 (Approved 07-25-1967).

²²⁰ IRM 33.2 Requests for Technical Advice and Technical Expedited Advice.

²²¹ Id.

²²² <http://www.irs.gov/irm/>.

²²³ 440 U.S. 741 (1979).

relied upon the rule. Accordingly, while the taxpayer may have some type of general complaint about administrative irregularity, that was not a personal right violation requiring the extreme remedy of exclusion in a criminal prosecution. The Caceres holding (sometimes referred to as the Caceres doctrine) has been applied in a myriad of contexts to prevent taxpayers from obtaining benefits from IRS procedural irregularities. Nevertheless, where IRM procedures are grounded in constitutional protections, Courts may take protective action.

Example: It is common knowledge (even among moderately sophisticated criminals) that, in a questioning in a **custodial** setting (such as incident to an arrest), Miranda²²⁴ requires that the person questioned first be given certain warnings as to his or her rights. Those warnings include, for example, the right to remain silent and to engage an attorney. If the warnings were not given, or even if the Government cannot prove the warnings were given, the evidence obtained in the interrogation may not be used in prosecuting that person. Normally in IRS investigations (whether civil or criminal), IRS agents will try to interview taxpayers in a **noncustodial** setting. Technically, Miranda does not apply because the taxpayer is not in custody. But Miranda concerns may nevertheless be raised because Miranda is bottomed on the undue influence that might be brought to bear in a custodial setting. Somewhat analogous influences might exist in an IRS noncustodial interview where trained IRS personnel line up against unsophisticated taxpayers. Accordingly, in recognition of the underpinnings of Miranda, the IRM requires IRS **Special Agents** (agents who conduct tax criminal investigations) to give a modified Miranda warning before interviewing (or, more precisely, interrogating) a taxpayer. The concern reflected in the IRM requirement is just an extension of the concern giving rise to Miranda and the recognition that a court might be willing to extend Miranda if some warnings are not given. For this reason, IRS criminal agents travel in pairs (two agents coming to an interview is not a good sign) in order to be able to prove from two witnesses that the modified Miranda warning was given and to prove any admissions the taxpayer may make in the interview.

The problem comes, however, in an interview conducted by an IRS agent (which for this discussion we will call a civil agent) who does not have the special training given IRS criminal agents regarding noncustodial interviews and thus does not give the modified Miranda warning. The IRM requires that, upon receiving firm indications of fraud, the civil agent should consult with his manager and the Fraud Technical Advisor and, if they concur there are such indicators, conclude his or her civil audit activity and refer the matter to the IRS's criminal investigation function (CI, as noted above).²²⁵ Many civil agents, however, like to press further, functioning in some type of criminal investigative capacity beyond the scope of their civil responsibilities (or perhaps a Rambo style) in the hope that they can nail the taxpayer. They may have a firm indication of fraud, but think that they can just press forward and then serve up to CI a case complete with damaging taxpayer admissions. The agent will then interview the taxpayer, armed, as best he can, to exploit the advantage. Needless to say, in this scenario, the civil agent does not give the modified Miranda warnings which often would result in a taxpayer refusing to cooperate further and seek legal counsel. There has been much litigation over whether, in this context, the taxpayer's admissions or even

²²⁴ Miranda v. Arizona, 384 U.S. 436 (1966).

²²⁵ IRM 25.1.2 Recognizing and Developing Fraud.

document production at such an interview can be used against the taxpayer, but the trend is to permit the prosecution to use the fruits of such interviews.²²⁶ Sometimes the issue is posed as to whether the civil agent misled the taxpayer as to the nature of the civil agent's further inquiries, on the theory that Government agents should not be allowed to mislead and the remedy is to deprive the Government of the fruits of the deception; in such cases relief may be available, despite Carceres.²²⁷

h. AODs – IRS Positions on Decided Cases.

When the IRS loses a legal issue in court, the IRS may prepare a document called an **Action on Decision** (“AOD”) stating whether the IRS will follow the decision in other cases.²²⁸

The recommendation in every AOD will be summarized as acquiescence, acquiescence in result only, or nonacquiescence.

A. Acquiescence means that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. It does not indicate approval or disapproval of the reasons assigned by the court for its conclusions.

B. Acquiescence in result only means that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. It also indicates disagreement or concern with some or all of the reasons assigned by the court for its conclusions.

C. Nonacquiescence signifies that, although the decision was not appealed or was not reviewed by the Supreme Court, the Service does not agree with the holding of the court and will not follow it nationwide in disposing of other cases. With respect to opinions of an appellate court, the Service generally will follow the holding in cases appealable to that circuit due to the binding nature of the opinion on lower courts even when the office concludes that the opinion is erroneous. The AOD may include a statement that the holding will not be followed in future cases in the circuit if the case can be distinguished on the facts. Any decision to not follow circuit court

²²⁶ See e.g. United States v. Rutherford, 555 F.3d 190, 196-197 (6th Cir. 2009) (“Nearly every other federal court to address this issue has held the IRS’s violation of internal policy does not of its own force infringe upon a person’s constitutional rights, thus requiring suppression of evidence.”).

²²⁷ United States v. Tweel, 550 F.2d 297 (1977). Tweel seems to be limited now to some showing of affirmative deception by the agent. See United States v. Carriles, 541 F.3d 344 (5th Cir. 2008); and United States v. Stringer, 521 F.3d 1189 (9th Cir. 2008), both of which are nontax cases, but discuss the same point in case of other agency investigations.

²²⁸ See IRM 36.3.1 Actions on Decision.

precedence in that circuit is a strategic decision, which can only be made after consultation with the Department of Justice Tax Division.²²⁹

AODs are published in the **IRB** and the Cumulative Bulletin.

i. Miscellaneous Internal Positions.

The IRS has a number of other documents internally prepared that may serve as authority or precedent for various legal actions within the IRS. These include for example any form of **Chief Counsel** advice that conveys legal positions that the IRS should adopt.²³⁰ These inquiries may arise in audits and, unlike technical advice, the taxpayer is not involved in the process and may not even be aware that the agent sought or received the advice. Accordingly, these types of advice (with appropriate excisions of taxpayer specific information) are made public and, like letter rulings, are published by tax publishers.²³¹

7. Deference to IRS Interpretation of the Code.

a. Statutory Interpretation - The Chevron Framework.

The issue I address in this section is how the IRS's various types of interpretations of the Code affect the courts' interpretation of statutes.²³² Are courts bound or influenced by the IRS interpretation of the Code its administers? If not bound, but influenced, how exactly does that influence work? And, in either case, when are the courts bound or influenced?

²²⁹ IRM 36.3.1.4 (03-14-2013), Drafting an AOD.

²³⁰ See CC- 2004-012, reproduced at 2004 TNT 35-25 (2/23/04), addressing questions regarding how the Office of Chief Counsel renders legal advice, including when legal advice should be provided in writing and the effect of provisions requiring the release of documents to the public on the decision to provide legal advice. For a discussion of CC-2004-012, see Jasper L. Cummings, Chief Counsel Legal Advice Questions and Answers, 2004 TNT 46-48 (3/9/04).

²³¹ § 6110.

²³² This issue is significantly affected by the Supreme Court's decision in Chevron and Mead discussing agency interpretation. These decisions and related Supreme Court decisions on interpretation of tax regulations specifically have drawn a plethora of scholarly and lower court comment. For your further reading I cite only Kristin E. Hickman, The Need for Mead: Tax Exceptionalism in Judicial Deference, 90 Minn. L. Rev. 1537 (2006) and Noel B. Cunningham and James R. Repetti, Textualism and Tax Shelters, 24 Va. Tax Rev. 1, 45-50 (2004), both of which have abundant references to those comments. In an earlier version of this text, I attempted copious footnote references, but realize that that is just repetitive of easily accessible references in articles such as the foregoing. Accordingly, I shall not attempt such redundant footnoting except where I feel that the point I make may not be discussed the way I would like it in those easily accessible materials.

The point of departure in current jurisprudence for deference to administrative agency interpretation is the Supreme Court’s 1984 opinion in **Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.**,²³³ which was not a tax case. Prior to Chevron, the Supreme Court clearly gave great deference to tax regulations.²³⁴ In **National Muffler Dealers Association v. United States**,²³⁵ the culmination of deference jurisprudence in tax cases prior to Chevron, decided just five years before Chevron, the Supreme Court held that deference to a tax regulation was required if the regulation “implements the congressional mandate in some reasonable manner,” with the “choice among reasonable interpretations * * * for the Commissioner, not the courts.”²³⁶ Chevron signaled even more deference than National Muffler, although for many years it was unclear whether Chevron had replaced National Muffler in tax interpretation, and the lower courts waxed with more length than eloquence over that issue.²³⁷ As I will note, the Supreme Court rejected the notion that tax was different, holding that the Code is subject to Chevron analysis. **Mayo Foundation for Med. Educ. & Research, 562 U.S. 44 (2011)** (hereafter “Mayo Foundation”). So it is important to focus on Chevron and the trajectory of Chevron jurisprudence through the present in the administrative world generally and in the tax world specifically.

Chevron involved an agency environmental regulation interpreting a statutory term that was ambiguous. The regulation was granted pursuant to general agency authority, at least as interpreted by the Court, much in the way that the IRS is explicitly given general interpretive authority under § 7805(a)). The Court established a “two-step” inquiry. **The First Step inquires whether the meaning of the statute is plain and unambiguous?** An alternative way to say this is whether the meaning of the statute is “clear” and needs no interpretation either by the courts or the agency. If so, the regulation is irrelevant because the plain or clear meaning of the statute itself pre-empts the interpretive field. A regulation inconsistent with the clear (or plain or unambiguous) meaning is invalid. **The Second Step, reached only if the text is determined to be not clear (or not plain or not unambiguous) in the First Step, is whether the agency interpretation is unreasonable?** Under this Second Step, the agency’s interpretation in the regulations is given deference so long as

²³³ 467 U.S. 837 (1984).

²³⁴ An early precedent in this historical deference was United States v. Correll, 389 U.S. 299, 307 (1967), where the Court deferred to an interpretation in a predecessor of a Revenue Ruling (not a formal regulation), but stated its deference as being in the context of a regulation. Correll thus is frequently cited as the standard for regulations. This historical curiosity is probably of no continuing significance after Chevron, to which we turn quickly in the text.

²³⁵ 440 U.S. 472 (1979).

²³⁶ Pp. 476-7.

²³⁷ I suspect that, in only a very small subset of cases, Chevron would command a different result than National Muffler, so much of the pre-Mayo Foundation angst in the lower courts over whether Chevron trumped National Muffler was probably academic in a real sense. The underpinnings of the argument the Internal Revenue Code is just different from other codes and laws and thus subject to an interpretive regime other than Chevron was sometimes referred to as “tax exceptionalism.” See Patrick J. Smith, Life After Mayo: Silver Linings, 131 Tax Notes 1251 (June 20, 2011) (at par. IV deconstructing the not uncommon notion – or hope – of many tax lawyers that tax was just special and thus subject to special rules).

it is not arbitrary, capricious or manifestly contrary to the statute it seeks to interpret (I generally just truncate this litany to “unreasonable”).²³⁸ This gives the IRS authority to interpret and determine the law where in the conceptual space between clear statutory text and an interpretation that is unreasonable under the statutory text. This two-step inquiry is very important; students, practitioners and scholars must know the steps instinctively;²³⁹ I encourage readers of this text to commit them to memory – at least the formulation of the steps.

The jurisprudential basis for the Chevron analysis, particularly Step Two, is a presumption that “a statute’s ambiguity constitutes an implicit delegation from Congress to the agency to fill in the statutory gaps.”²⁴⁰

Chevron ushered in a new way of thinking about and new authority for the modern administrative state. I will address some of the issues and cases that arose after Chevron, but let me quote here a statement from the Chief Counsel of the IRS after a victory based on the permutations of Chevron:

The thesis behind Chevron deference is based on agency competence and integrity. The relevant opinions focus on the agency's knowledge of the subject matter, the agency's ability to consider secondary and tertiary effects on stakeholders and the regulatory system writ large, and the agency's ability to consult at length with affected internal and external parties. We recognize that all of this implies the need to make choices based on wise public policy.²⁴¹

This thesis of implicit delegation from Congress to the agency supports the general rule of deference announced in Chevron. However, as the Supreme Court held King v. Burwell, ___ U.S. ___, 2015 U.S. LEXIS 4248 (2015), this general rule may not apply in “extraordinary cases” where a Court believes that Congress did not intend to delegate interpretive authority to the agency. In King, the IRS had interpreted statutory language in the Affordable Care Act, a health care statute,

²³⁸ This formulation is set forth in the Court’s direct foray into Chevron jurisprudence in the tax context. Mayo Foundation v. United States, 562 U.S. 44 (2011).

²³⁹ Sometimes the steps are conflated or ignored at the extremes. In his dissent in United States v. Home Concrete, ___ U.S. ___ n. 1, 132 S.Ct. 1836, 1846 n.1 (2012), Justice Scalia pithily observed (case and law review citation omitted):

“Step 1” has never been an essential part of Chevron analysis. Whether a particular statute is ambiguous makes no difference if the interpretation adopted by the agency is clearly reasonable -- and it would be a waste of time to conduct that inquiry. The same would be true if the agency interpretation is clearly beyond the scope of any conceivable ambiguity. It does not matter whether the word “yellow” is ambiguous when the agency has interpreted it to mean “purple.”

²⁴⁰ King v. Burwell, ___ U.S. ___, 2015 U.S. LEXIS 4248 (2015) (quoting FDA v. Brown & Williamson Tobacco Corp., 529 U. S. 120, 159 (2000)).

²⁴¹ William J. Wilkins, Chief Counsel of the IRS, quoted in Irving Salem, Mayo Dissected: Some Dragons Slain, Some Still Breathing Fire, 130 Tax Notes 1327 (Mar. 14, 2011).

with certain key duties delegated to the IRS. As to those duties, the Court found the text was ambiguous. **But**, finding the text’s centrality to the purpose of the Act presented “a question of deep ‘economic and political significance’” and outside the IRS’s traditional tax administration expertise, the Court declined to presume an implicit delegation to the IRS and, instead, interpreted the statute using the normal tools of statutory interpretation without any deference to the IRS interpretation.²⁴² We mention this exception to the general rule of Chevron deference for completeness of the limits of Chevron deference. Notwithstanding the King v. Burwell exception, in my view, rarely would income tax regulations or other interpretations within the IRS’s historic tax administration function invoke the exception. Even where those regulations or interpretations are important, even very important, they rarely exist in a context of “deep economic and political significance” outside the IRS’s traditional expertise in which it can be concluded that Congress did not intend to delegate interpretive authority to the IRS.²⁴³

Many questions lingered after Chevron and subsequent Supreme Court cases have clarified some of the issues. I address here only seven. First, does Chevron replace National Muffler as the standard for testing tax administrative interpretations? Second, does Chevron apply only to legislative regulations or are interpretive regulations included? Third, does Chevron apply to Temporary Regulation issued without notice and comment? Fourth, how is ambiguity determined in Step One? Fifth, how is reasonableness / unreasonableness determined in Step Two? Sixth, did the Court’s deferential attitude in Chevron and one of its later cases, United States v. Mead Corp., 533 U.S. 218 (2001), signal a general willingness to apply some form of Chevron deference to agency rulemaking less formal than regulations? Seventh, is Chevron deference required for agency interpretations where they may be viewed as self-serving – i.e., to change the interpretation in a prior case that the IRS thinks is wrong or to affect the outcome of a pending dispute with one or more taxpayers?²⁴⁴

²⁴² By pre-empting the Chevron analysis and directly interpreting the ambiguous statutory text, the Court insured that its interpretation will stand absent reversal by the Supreme Court itself, because, by taking away implicit delegation to the IRS, there is nothing left for the IRS to interpret under Chevron. From a practical perspective, a change in administration cannot result in an IRS change by amended regulation in the interpretation.

²⁴³ Notwithstanding this comment, I am sure that litigants will invoke the exception early and often when inveighing against IRS regulations and other interpretations that might otherwise be entitled to Chevron or some lesser deference.

²⁴⁴ In a sense, all regulations or other IRS pronouncements deemed to have some authority are self-serving because, they attempt to resolve uncertainty in the statute in an agency friendly way. The problem comes when the IRS has not anticipated the uncertainty and thus has not clarified it by regulation by the time the uncertainty appears in audit or even litigation or even after litigation that the IRS has lost. A regulation promulgate at that time particularly smacks of being self-serving if the IRS seeks to resolve the uncertainty in its favor.

b. Chevron Applies to Internal Revenue Code Interpretation.

In Mayo Foundation, the Supreme Court held that Chevron replaced National Muffler as the standard for deference. Writing for all justices (except Justice Kagan who did not participate), Justice Roberts forcefully deconstructs any notion of tax exceptionalism as follows:

Aside from our past citation of National Muffler, Mayo has not advanced any justification for applying a less deferential standard of review to Treasury Department regulations than we apply to the rules of any other agency. In the absence of such justification, we are not inclined to carve out an approach to administrative review good for tax law only. To the contrary, we have expressly “[r]ecogniz[ed] the importance of maintaining a uniform approach to judicial review of administrative action.” Dickinson v. Zurko, 527 U.S. 150, 154 (1999). See, e.g., Skinner v. Mid-America Pipeline Co., 490 U.S. 212, 222-223 (1989) (declining to apply “a different and stricter non-delegation doctrine in cases where Congress delegates discretionary authority to the Executive under its taxing power”).

The principles underlying our decision in Chevron apply with full force in the tax context. Chevron recognized that “[t]he power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.” 467 U.S., at 843 (internal quotation marks omitted). It acknowledged that the formulation of that policy might require “more than ordinary knowledge respecting the matters subjected to agency regulations.” *Id.*, at 844 (internal quotation marks omitted). Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes. Cf. Bob Jones Univ. v. United States, 461 U.S. 574, 596 (1983) (“[I]n an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems”). We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to Chevron to the same extent as our review of other regulations.²⁴⁵

c. Chevron Applies to Both Legislative and Interpretive Regulations.

In Mayo Foundation, the Court held that the Chevron inquiry “does not turn on whether Congress's delegation of authority was general or specific.” General or specific are administrative law synonyms for interpretive or legislative.²⁴⁶

²⁴⁵ 562 U.S. 44, 55-56.

²⁴⁶ 562 U.S. 44, 57.

d. Chevron’s Application to Temporary Regulations.

As noted earlier, the APA imposes a process that places a premium on notice and comment, as a predicate step to final regulations. Indeed, in conferring deference to regulations, the Supreme Court has relied in part on notice and comment as meriting Chevron deference.²⁴⁷ The need for expedient guidance on issues that affect many taxpayers, however, has resulted in the IRS’s use of Temporary Regulations issue before notice and comment. So the question is what deference, if any, is due Temporary Regulations? I don’t think this question has been answered, so I can pose it as a question only. Would it make any difference if, as required by statute, when the Temporary Regulations are issued, similar Proposed Regulations are issued and, after notice and comment with appropriate amendments, the Proposed Regulations are finalized before the resolution of any issue governed by the Temporary Regulations?

e. Recognizing Ambiguity in Chevron Step One.

The analytical framework established by Chevron requires the two-step analysis. Although I urged the reader to commit the two-step analysis to memory, I repeat it here for emphasis. In Step One, the inquiry is whether the statutory text is ambiguous as to the point addressed in the agency interpretation. The agency may interpret only if the statutory text is ambiguous. If the statutory text is not ambiguous, the text governs. Only if the text is ambiguous will the agency interpretation that clarifies the ambiguity be given deference. In terms of the steps, only if the Step One inquiry reveals ambiguity in the text will the Step Two inquiry be made. That inquiry in Step Two is whether the administrative agency interpretation is unreasonable. If the agency interpretation is not unreasonable, then the agency interpretation governs. If the agency interpretation is unreasonable, the agency interpretation does not govern and the court will interpret under traditional tools of statutory interpretation.

Focus on Step One. How is that Step processed? Traditional tools of statutory interpretation are used to determine whether the text is ambiguous.²⁴⁸ The Supreme Court elucidated:

In determining whether Congress has specifically addressed the question at issue, a reviewing court should not confine itself to examining a particular statutory provision in isolation. The meaning -- or ambiguity -- of certain words or phrases may only become evident when placed in context. It is a “fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme.” A court must therefore

²⁴⁷ See Mayo Foundation for Medical Research v. United States, 562 U.S. 44,57-58 (2011) (emphasizing that the regulation to which it conferred Chevron deference had been promulgated after notice and comment, “a consideration identified . . . as a significant sign that a rule merits Chevron deference.”).

²⁴⁸ FDA v. Brown & Williamson , 529 U.S. 129 (2000).

interpret the statute “as a symmetrical and coherent regulatory scheme,” and “fit, if possible, all parts into an harmonious whole.”²⁴⁹

Can legislative history be used to show that the statute is ambiguous in Step One or can it only be used in Step Two to show whether the agency interpretation is or is not reasonable after the statute is found ambiguous?²⁵⁰ In Chevron, the Court seemed to use legislative history in the Step One inquiry, but the Supreme Court has not been consistent on this issue in later cases. The quote above would suggest that legislative history could be used,²⁵¹ but many observers see this issue as still uncertain.²⁵²

There is a more subtle and larger issue regarding interpretation in the first step – what is the jurist’s, scholar’s or interpreter’s approach to statutory interpretation generally? Justice Scalia addressed this subtlety early on in the Chevron saga:

I cannot resist the temptation to tie this lecture into an impenetrable whole, by observing that where one stands on this last point -- how clear is clear -- may have much to do with where one stands on the earlier points of what Chevron means and whether Chevron is desirable. In my experience, there is a fairly close correlation between the degree to which a person is (for want of a better word) a “strict constructionist” of statutes, and the degree to which that person favors Chevron and is willing to give it broad scope. The reason is obvious. One who finds more often (as I do) that the meaning of a statute is apparent from its text and from its relationship with other laws, thereby finds less often that the triggering requirement for Chevron deference exists. It is thus relatively rare that Chevron will require me to accept an interpretation which, though reasonable, I would not personally adopt. Contrariwise, one who abhors a “plain meaning” rule, and is willing to permit the apparent meaning of a statute to be impeached by the legislative history, will more frequently find agency-liberating ambiguity, and will discern a much broader range of “reasonable” interpretation that the agency may adopt and to which the courts

²⁴⁹ FDA v. Brown & Williamson Tobacco Corp., supra 132-133 (citations omitted).

²⁵⁰ In the second step, “Chevron devotes approximately 40 percent of its opinion to a searching examination of congressional intent;” Irving Salem, Third Circuit Ignored the Clear Intention of Congress in Swallows, 124 Tax Notes 265 n. 3 (July 20, 2009).

²⁵¹ Ronald M. Levin, A Blackletter Statement of Federal Administrative Law, 54 Admin. L. Rev. 1, 37 (2002) (Emphasis supplied) (hearkening to the “traditional tools of statutory interpretation” benchmark, the author concludes that “[f]or most judges, these tools include examination of the text of the statute, dictionary definitions, canons of construction, statutory structure, legislative purpose, and legislative history.”).

²⁵² Jeremiah Coder, Use of Legislative History Uncertain After Home Concrete, Officials Say, 2012 TNT 119-4 (6/20/12).

must pay deference. The frequency with which Chevron will require that judge to accept an interpretation he thinks wrong is infinitely greater.²⁵³

Finally, some scholars feel that Step One and Step Two are often conflated, with Step Two being the outcome determinative test of deference to the regulation.²⁵⁴

f. Determining Reasonableness / Unreasonableness in Step Two.

I noted above that, under the Second Step, the agency's interpretation in the regulations is given deference so long as it is not arbitrary, capricious or manifestly contrary to the statute it seeks to interpret.²⁵⁵ For convenience, I truncate this litany to giving deference if not unreasonable; a purist might not like that because the other words – specifically arbitrary and capricious carry a stronger flavor than unreasonable, but I ask the reader to accept this convention just for convenience; I do note, however, that the test, so nominated, is not whether the agency interpretation is reasonable; it is whether the agency interpretation is unreasonable; conceptually there may be some ground between reasonable and unreasonable where the interpretation is neither reasonable nor unreasonable, in which case the agency interpretation is entitled to Chevron deference.²⁵⁶

²⁵³ Antonin Scalia, Judicial Deference to Administrative Interpretations of Law, 1989 Duke L.J. 511 (1989). I cannot resist noting that Justice Scalia's pungent question of "how clear is clear," has an overtone – perhaps undertone – of Bill Clinton's renowned claim that "It depends upon what the meaning of the word "is" is." See Wikipedia Entry on Impeachment of Bill Clinton, http://en.wikipedia.org/wiki/Impeachment_of_Bill_Clinton.

²⁵⁴ Steve R. Johnson, Preserving Fairness in Tax Administration in the Mayo Era, 32 Va. Tax Rev. 268, 284-285 (2012):

[W]hen Chevron does apply, its two steps appear to be collapsing into a single "reasonableness" inquiry based on the APA's "arbitrary or capricious" standard. Chevron's first step - whether the statute itself clearly answers the question at issue - never had any outcome-determinative significance independent of Chevron's second step - whether the agency's position reasonably interprets the statute. A regulation contrary to a clear statute can never be reasonable. Thus, step one will never invalidate a regulation that would not also be invalidated under step two.

Therefore, all of Chevron boils down to step two, which increasingly is being conflated with "arbitrary or capricious" interpreted as "unreasonable."

²⁵⁵ This formulation is set forth in the Court's foray into Chevron jurisprudence in the tax context. Mayo Foundation v. United States, 562 U.S. __ (2011).

²⁵⁶ This may be conceptualized like the ground between proof of a fact's existence or nonexistence by a preponderance of the evidence. The party bearing the burden of persuasion as to the existence of the fact will lose unless the evidence shows the existence of the fact is more likely than not. There is ground where the trier of fact would be in equipoise as to the existence or nonexistence of the fact; in that case, the party bearing the burden of persuasion as to the existence of the fact will lose. Stating that in the negative, if party bears the burden of proving that a fact does not exist, that party loses if the trier is in a state of equipoise. Now, focusing on the Chevron test for an agency interpretation, the party seeking to avoid the agency interpretation must establish that

The reviewing court will similarly bring to bear all of the legislative indications of Congress' intent (including legislative history) in addressing the question as to whether the agency interpretation is unreasonable. In doing this, the court will engage in a similar process to review under the Administrative Procedure Act, which the Supreme Court described in language paralleling its deference approach in Chevron:

This case requires us to decide whether the BIA's policy for applying § 212(c) in deportation cases is “arbitrary [or] capricious” under the Administrative Procedure Act (APA), 5 U. S. C. § 706(2)(A).ⁿ⁷ The scope of our review under this standard is “narrow”; as we have often recognized, a court is not to substitute its judgment for that of the agency. Agencies, the BIA among them, have expertise and experience in administering their statutes that no court can properly ignore. But courts retain a role, and an important one, in ensuring that agencies have engaged in reasoned decision making. When reviewing an agency action, we must assess, among other matters, whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment. That task involves examining the reasons for agency decisions--or, as the case may be, the absence of such reasons. See *FCC v. Fox Television Stations, Inc.*, 556 U. S. 502, 515, 129 S. Ct. 1800, 173 L. Ed. 2d 738 (2009) (noting “the requirement that an agency provide reasoned explanation for its action”).

ⁿ⁷ The Government urges us instead to analyze this case under the second step of the test we announced in Chevron U.S.A. Inc. v. NRDC, 467 U. S. 837 (1984), to govern judicial review of an agency's statutory interpretations. Were we to do so, our analysis would be the same, because under Chevron step two, we ask whether an agency interpretation is arbitrary or capricious in substance. But we think the more apt analytic framework in this case is standard “arbitrary [or] capricious” review under the APA.²⁵⁷

g. Deference to Interpretations Other than By Regulation.

What does Chevron and its progeny tell us about the deference to be accorded agency interpretations other than regulations – Revenue Rulings and Revenue Procedures, for example?

The Supreme Court gave some guidance on this question in United States v. Mead Corporation.²⁵⁸ The Court addressed deference issues in the context of a customs ruling letter. The customs ruling letter has some features of a private letter ruling (“PLR”) which is issued by the IRS to a taxpayer to advise of the treatment the IRS will give a stated transaction. It also has some

the interpretation is unreasonable; that party loses if the court finds the interpretation reasonable or is in a state of equipoise as to whether it is reasonable.

²⁵⁷ Judulang v. Holder, ___ U.S. ___, ___, 132 S.Ct. 476, 483-484 (2011) (most case citations and quotation marks omitted for easier readability.)

²⁵⁸ 533 U.S. 218 (2001).

features of a published Revenue Ruling in the tax arena.²⁵⁹ The customs ruling letter and the PLR are issued without any notice and comment to the public. Customs ruling letters may be published but need only be made available for public inspection. PLRs are made available for public inspection,²⁶⁰ and published regularly by several private tax publishers. Customs ruling letters may not be relied upon by other persons, and, similarly, PLRs may not be relied upon by other taxpayers.

The Court held that customs ruling letters are not entitled to Chevron deference. The Court reasoned that Chevron deference arises only where it appears that Congress delegated authority (either explicitly or implicitly) to the agency to make rules with the force of law and the agency interpretation in issue was promulgated in the exercise of such authority. Regulations authorized by Congress are the classic type of agency interpretation entitled to Chevron deference. The Court could not find that the customs letter rulings were issued by the agency in the exercise of its delegated authority to promulgate rules with the force of law.²⁶¹ But, the Court held, agency interpretations not qualifying for Chevron deference might still be entitled to some deference. The Court held that agency interpretations such as the customs ruling letter might qualify for Skidmore²⁶² deference, a type of lesser deference originally articulated in the Supreme Court's 1944 opinion in Skidmore v. Swift & Co.²⁶³ In Mead, The Court reasoned:

To agree with the Court of Appeals that Customs ruling letters do not fall within Chevron is not, however, to place them outside the pale of any deference whatever. Chevron did nothing to eliminate Skidmore's holding that an agency's interpretation may merit some deference whatever its form, given the "specialized experience and broader investigations and information" available to the agency, 323 U.S. at 139, and given the value of uniformity in its administrative and judicial understandings of what a national law requires, *id.*, at 140. See generally Metropolitan Stevedore Co. v. Rambo, 521 U.S. 121 (1997) (reasonable agency

²⁵⁹ In Omohundro v. United States, 300 F.3d 1065, 1067 (9th Cir. 2002), the Court found that the Customs ruling "is closely akin to an IRS revenue ruling" and because the two were analogous, "we are required to apply Mead's standard of review to an IRS revenue ruling." The Court did not mention Correll.

²⁶⁰ § 6110.

²⁶¹ The Court said:

It is difficult, in fact, to see in the agency practice itself any indication that Customs ever set out with a lawmaking pretense in mind when it undertook to make classifications like these. Customs does not generally engage in notice-and-comment practice when issuing them, and their treatment by the agency makes it clear that a letter's binding character as a ruling stops short of third parties; Customs has regarded a classification as conclusive only as between itself and the importer to whom it was issued, 19 CFR § 177.9(c) (2000), and even then only until Customs has given advance notice of intended change, §§ 177.9(a), (c). Other importers are in fact warned against assuming any right of detrimental reliance. § 177.9(c).

²⁶² Skidmore v. Swift & Co., 323 U.S. 134 (1944).

²⁶³ 323 U.S. 134 (1944).

interpretations carry “at least some added persuasive force” where Chevron is inapplicable); Reno v. Koray, 515 U.S. 50 (1995) (accorded “some deference” to an interpretive rule that “does not require notice and comment”); Martin v. Occupational Safety and Health Review Comm’n, 499 U.S. 144, 157 (1991) (“some weight” is due to informal interpretations though not “the same deference as norms that derive from the exercise of . . . delegated lawmaking powers”).

There is room at least to raise a Skidmore claim here, where the regulatory scheme is highly detailed, and Customs can bring the benefit of specialized experience to bear on the subtle questions in this case: [classification distinctions omitted]. A classification ruling in this situation may therefore at least seek a respect proportional to its “power to persuade,” Skidmore, supra, at 140; see also Christensen, 529 U.S. at 587; id., at 595 (STEVENS, J., dissenting); id., at 596-597 (BREYER, J., dissenting). Such a ruling may surely claim the merit of its writer's thoroughness, logic and expertness, its fit with prior interpretations, and any other sources of weight.

So, Skidmore seems to stand somewhere between no deference and Chevron deference. What does it mean that deference is accorded by the power to persuade? If the position set forth is intrinsically persuasive (including the indicated touchstones of thoroughness and consistency),²⁶⁴ does it need any deference in order to carry the day? Presuming the Court meant something in paying homage to Skidmore deference, perhaps it means that a court must give slight tilt in favor of an agency interpretation when it does not rise to the level required for Chevron deference.

What does Mead tell us about the other types of pronouncements? The Court said:

It is, of course, true that the limit of Chevron deference is not marked by a hard-edged rule. But Chevron itself is a good example showing when Chevron deference is warranted, while this is a good case showing when it is not. Judges in other, perhaps harder, cases will make reasoned choices between the two examples, the way courts have always done.²⁶⁵

Mead made clear that regulations promulgated with notice and comment are not the only types of agency pronouncements entitled to Chevron deference.²⁶⁶ The Court said that, if the agency has been granted authority (either explicitly or implicitly) to make interpretations and is acting pursuant to that authority, then its interpretations will be entitled to Chevron deference. Where those conditions are not present, Skidmore deference may apply.

²⁶⁴ The consistency may be both internal (which affects the persuasiveness) and over time (which would also affect persuasiveness). Webber v. Commissioner, 144 T.C. ___, ___ No. 7 (2015).

²⁶⁵ Mead, p. 237 fn. 18.

²⁶⁶ See Barnhart v. Walton, 535 U.S. 212, 221 (2002).

Let's go back to Revenue Rulings? In the usual context where the taxpayer seeks to avoid the application of a Revenue Ruling and the IRS seeks to apply it, courts have adopted varying approaches.²⁶⁷ Let's address that issue under the Chevron/Mead approach. Are Revenue Rulings entitled to Chevron deference? It is true that they are not subject to notice and comment, the hallmark of the traditional regulation. But a regulation is not required for Chevron deference.²⁶⁸ Can it be said as to Revenue Rulings, as the Court said in Mead, that: "It is difficult, in fact, to see in the agency practice itself any indication that Customs ever set out with a lawmaking pretense in mind when it undertook to make classifications like these?" Certainly, the IRS does provide guidance via Revenue Rulings. On the other hand, in issuing Revenue Rulings, the IRS purports only to state its position with respect to the assumed fact pattern and does not purport to be issuing an interpretation binding on taxpayers.²⁶⁹ Should therefore only Skidmore deference apply?²⁷⁰ I think it is a close case that can ultimately go either way, although the tilt now seems to be in favor of the more limited Skidmore deference.²⁷¹

²⁶⁷ The Tax Court has historically taken the position that Revenue Rulings are not binding. Frazier v. Commissioner, 111 T.C. 243, 248 (1998); N. Ind. Pub. Serv. Co. v. Commissioner, 105 T.C. 341, 350 (1995), affd. 115 F.3d 506 (7th Cir. 1997). Some Circuits take a similar position, e.g., Stubbs, Overbeck & Associates, Inc. v. United States, 445 F.2d 1142, 1146-7 (5th Cir. 1971) ("A ruling is merely the opinion of a lawyer in the agency and must be accepted as such. It may be helpful in interpreting a statute, but it is not binding on the Secretary or the courts."). Other courts have given some deference to Revenue Rulings.

²⁶⁸ E.g., Kornman & Assoc. Inc. et al. v. United States, 527 F.3d 443, 453 (5th Cir. 2008) ("notice-and-comment rulemaking is not the sine qua non of Chevron deference"), citing Mead.

²⁶⁹ Perhaps this is a quibble, but the Treasury Regulations define a revenue ruling as "an official interpretation by the [IRS] . . . published for the information and guidance of taxpayers, [IRS] officials, and others concerned." 26 C.F.R. § 601.601(d)(2)(i)(a) (2004). To guide is not to bind.

²⁷⁰ In United States v. Cleveland Indians Baseball Co., 532 U.S. 200, 220 (2001), the Supreme Court had expressly declined to decide whether revenue rulings were entitled to deference because the rulings in question expressed the longstanding reasonable interpretation of its own regulations.

²⁷¹ Kornman & Assoc., Inc. et al. v. United States, 527 F.3d 443, 455-456 (5th Cir. 2008) (consistent with other circuits, adopting Skidmore deference for revenue rulings). See Patrick J. Smith, Life After Mayo: Silver Linings, 131 Tax Notes 1251 (June 20, 2011); and Leandra Lederman, The Fight Over "Fighting Regs" and Judicial Deference in Tax Litigation, 92 B.U.L. Rev. 643, 666-669 (2012). Some argue for stronger deference. Ryan C. Morris, Substantially Deferring to Revenue Rulings After Mead, 2005 B.Y.U.L. Rev. 999 (2005) (arguing for a stronger form of deference); and others survey the law and see a no-man's land of uncertainty as to precisely the force of these types of pronouncements. Kirstin E. Hickman, IRB Guidance: The No Man's Land of Tax Code Interpretation, 2009 Mich. St. L. Rev. 239 (2009).

For that reason (at least I suppose), DOJ Tax has announced that it will not assert Chevron deference for Revenue Rulings.²⁷² It logically follows that the IRS will not assert Chevron deference for lesser authority IRS pronouncements (such as PLRs and other written determinations). Practitioners should not be lulled, however, because Skidmore deference may carry the day for the IRS.

Let's consider Revenue Rulings and Revenue Procedures, the most formal forms of pronouncement short of Regulations. Here is my best cut to date as to the deference rules based on the assumption that Revenue Rulings and, by extension, Revenue Procedures are not entitled to full bore Chevron deference:

Substantive interpretations of the law in Revenue Rulings should receive Skidmore deference. Procedural rules in Revenue Procedures should be given at least Skidmore deference and perhaps even Chevron deference; substantive interpretations of the statute stated or assumed in Revenue Procedures should be given Skidmore deference only if it is clear that the IRS intended to state a substantive interpretation of the law as opposed to merely guiding agents on administratively processing audits.²⁷³

For lesser forms of IRS pronouncements, Chevron will clearly not apply, but the Courts will have to address the issue of Skidmore deference. Of course, keep in mind that Skidmore deference is only available if the reasoning is stated in the pronouncement and the reasoning is persuasive. If the interpretation in such lesser rulings provides no reasoning, the IRS can always assert in the

²⁷² Marie Sapirie, DOJ Won't Push Chevron Deference for Revenue Rulings, 2011 TNT 90-7 (5/16/11). Thus, in Webber v. Commissioner, 144 T.C. ___, ___ n12 No. 7 (2015), the Court noted that, under its Golsen rule looking to the precedent in the Court of Appeals to which appeal would be taken, the Ninth Circuit had not yet decided whether revenue rulings were entitled to Chevron or Skidmore deference, but that the Tax Court would apply Skidmore because that was what the IRS urged.

²⁷³ See Exxon Mobil Corp. v. Commissioner, 689 F.3d 191, 200 (2d Cir. 2012) (joining other courts rejecting Skidmore deference for a Revenue Procedure applying the interest netting statute that incorporate a substantive interpretation of the statute to require that both periods of limitation be open for netting; Skidmore was rejected not because Skidmore could or should not apply to such a substantive interpretation in a Revenue Procedure but because the Revenue Procedure stated no reasoning for the interpretation; Skidmore requires reasoning for deference); and Corbalis v. Commissioner, 142 T.C. 46 (2014). See also Kathryn Sedo and Katrina Wessbecker, Should Courts Ever Give Deference to Revenue Procedures?, 134 Tax Notes 225 (Jan. 9, 2012) (arguing that Skidmore deference rather than Chevron deference is more appropriate for revenue procedures, particularly those that may state substantive rules). For an illustration of Revenue Procedures that some have interpreted as stating an interpretation of the law as opposed to just providing agent guidance as to when to raise the issue, see my Federal Tax Procedure Blog entry, [Are Revenue Procedures Influential In Interpreting the Law: Of Profits / Carried Interests and Administrative Billion Dollar Largess](#) (9/7/12).

subsequent context in which it arises and presumably if the newly asserted reasons are persuasive, they have a good chance of carrying the day.

What deference, if any, should be accorded to agency interpretations advanced for the first time in litigation? Chevron is based on the policy that Congress has delegated to the agency the power to make interpretations and that considered agency interpretations, particularly those subject to notice and comment, pursuant to that delegation should be given deference. I have noted that the process involved in promulgating regulations insures that the interpretations are forced through a process that should result in generally better-considered interpretations. Other agency interpretations, such as revenue rulings, have some lesser process – but process nonetheless – designed to give some institutional consideration to the positions and thus are entitled to at least Skidmore deference. Litigating positions, however, do not have even these institutional protections. Litigating positions may well be good interpretations, but that is not necessarily because the process is designed to make them so. Indeed, even in tax cases where the positions are supposed to be coordinated with the overarching goals of consistent nationwide tax enforcement, litigating positions are often ad hoc, solely for the purpose of prevailing in the particular case at hand, often without concern for whether it is good policy or a balanced interpretation of the statutory or the overall legislative scheme of which it is part. There is a conflict as to whether such litigating positions are entitled to Skidmore deference.²⁷⁴

What about litigating positions interpreting regulations which are ambiguous in their interpretation of the statute? The litigating interpretations appear to qualify for Skidmore deference.²⁷⁵

What about Revenue Ruling or Revenue Procedure issued during the pendency of litigation? As noted, Revenue Rulings have a more formal level of institutional process than litigating positions. The courts are still struggling to determine how to deal with this issue. I think that they should qualify for Skidmore deference.

²⁷⁴ This split involves subtle distinctions beyond the scope of the text or this footnote. The split is discussed in Bradley George Hubbard, Deference to Agency Statutory Interpretations First Advanced in Litigation? The Chevron Two-Step and the Skidmore Shuffle, 80 U. Chi. L. Rev. 447 (2013). In part relevant to the IRS, Mr. Bradley breaks the authority into two categories – litigating position interpretations of the statute asserted in (i) Government amicus briefs where the Government is not a party and (ii) in Government litigant briefs. He asserts that the extant authority is that (i) amicus briefs qualify for Skidmore deference and (ii) there is a split as to whether Skidmore deference applies in Government litigant briefs. Mr. Bradley argues that both types of litigating positions should qualify for Skidmore deference.

²⁷⁵ Decker v. Northwest Environmental Defense Center, ___ U.S. ___, 133 S. Ct. 1326 (2013) (see particularly Justice Roberts' concurring opinion, joined by Justice Alito, and Justice Scalia's dissent presenting a full-throated attack on Seminole Rock and Auer.)

h. Self-Serving Regulations Can Control Interpretation.

In a sense, all regulations are self-serving – they are intended to give the imprimatur of authority to the IRS’s interpretation of the statute. But sometimes they are particularly self-serving such as when they seek to reverse a court’s – even the Supreme Court’s – interpretation of the statute or when they are promulgated to affect a dispute the IRS is already having with a taxpayer or taxpayers. Can or should Chevron deference apply?

The Supreme Court appeared to resolve the fourth question – as to whether an agency interpretation issued after a contrary court interpretation may, in effect, trump the court interpretation. In National Cable & Telecommunications Association v. Brand X Internet Services, 545 U.S. 967 (2005), Justice Thomas for the majority synthesized the holding of Chevron as follows:

In Chevron, this Court held that ambiguities in statutes within an agency's jurisdiction to administer are delegations of authority to the agency to fill the statutory gap in reasonable fashion. Filling these gaps, the Court explained, involves difficult policy choices that agencies are better equipped to make than courts. If a statute is ambiguous, and if the implementing agency's construction is reasonable, Chevron requires a federal court to accept the agency's construction of the statute, even if the agency's reading differs from what the court believes is the best statutory interpretation. (Citations omitted.)

Then moving to whether an agency interpretation can trump an earlier court decision, Justice Thomas said:

A contrary rule would produce anomalous results. It would mean that whether an agency's interpretation of an ambiguous statute is entitled to Chevron deference would turn on the order in which the interpretations issue: If the court's construction came first, its construction would prevail, whereas if the agency's came first, the agency's construction would command Chevron deference.

Justice Thomas then concluded: “A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion.” Further emphasizing the point, Justice Thomas states: “Only a judicial precedent holding that the statute unambiguously forecloses the agency's interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.”²⁷⁶ Brand X thus grants (or recognizes) the IRS’s (or any agency’s) authority to change the prior judicial interpretation so long as the agency interpretation is not absolutely foreclosed as a reasonable

²⁷⁶ Justice Scalia in typical pungent fashion disagreed in dissent: “When a court interprets a statute without Chevron deference to agency views, its interpretation (whether or not asserted to rest upon an unambiguous text) is the law.” The result, he urged unsuccessfully, is that the agency then cannot change that interpretation by mere interpretation otherwise entitled to Chevron deference.

interpretation of an otherwise ambiguous statute. In other words, if in order to resolve the case at hand, the prior judicial opinion applies an interpretation that it thinks best resolves the case but is not necessarily commanded as the only reasonable interpretation of the statute, the prior judicial opinion does not foreclose an agency from adopting an interpretation otherwise that is a different reasonable interpretation and qualify that interpretation for Chevron deference.

As to self-serving interpretations to affect a current dispute with a taxpayer where a court has not definitively spoke, in Mayo, the Court held:

And we have found it immaterial to our analysis that a "regulation was prompted by litigation." *Id.*, at 741. Indeed, in United Dominion Industries, Inc. v. United States, 532 U.S. 822, 838 (2001), we expressly invited the Treasury Department to "amend its regulations" if troubled by the consequences of our resolution of the case.

Of course, under the Brand X analysis (not affected by Mayo Foundation), everything turns upon whether the prior judicial opinion effectively forecloses other reasonable interpretations of the statute, thus not permitting the analysis to go beyond Chevron's Step One. (Remember that the regulations interpretation is entitled to deference only if Step Two is reached.) The Supreme Court addressed this issue in United States v. Home Concrete, ___ U.S. ___, 132 S.Ct. 1836 (2012). Without getting into the weeds of the technical details (but see the footnote),²⁷⁷ the Supreme Court had earlier interpreted statutory text in the 1939 Internal Revenue Code to have a particular meaning that foreclosed the application of an extended period of limitations on assessment beyond the normal 3-year period. That statutory text was carried forward into the 1954 Code and then into the 1986 Code. Same language interpreted in the prior case. The IRS desired the longer statute of limitations and adopted regulations to interpret the language in a manner differently than the earlier Supreme Court case had interpreted the same language. The courts of appeals were split on the issue of whether the regulations were valid under Chevron. The Supreme Court resolved the circuit conflict by holding that the IRS could not overturn that earlier Supreme Court interpretation because "there is no longer any different construction that is consistent with Colony and available for adoption by the agency."²⁷⁸ This Supreme Court decision is a plurality decision except that it did draw a majority on the key holding that I have described.

²⁷⁷ The legal background is the rule that a 25% omission of gross income increases the statute of limitations for assessment from three years to six years. § 6501(e). The question is whether artificially increasing basis that results in an understatement of net gain can result in a 25% omission. In Colony Inc. v. Commissioner, 357 U.S. 28 (1958), the Supreme Court held under the 1939 Code iteration of the statute that the 25% rule related to net gain as reduced by overstated basis thus precluding an extended statute in a situation where basis was overstated. Some of the cases held that the Colony interpretation is a compelled interpretation in Step One, thus precluding the IRS from adopting a different interpretation by regulation. The other cases held that the interpretation adopted in Colony was is not a compelled interpretation in Step One, thus permitting the IRS to adopt an interpretation by regulation a reasonable interpretation different than Colony.

²⁷⁸ United States v. Home Concrete & Supply, LLC, ___ U.S. ___, ___, 132 S. Ct. 1836, 1843 (U.S. 2012).

I think that Home Concrete tells us that, generally, a Supreme Court interpretation cannot be trumped by a subsequent regulation. I think there could conceptually be some Supreme Court interpretations that would not have the pre-emptive effect, but the IRS is unlikely to be aggressive in this area and will likely default to a position that it will not challenge a Supreme Court interpretation.²⁷⁹ As to lower court – circuit and district courts – interpretations, I think Brand X still applies full bore, so that IRS regulations can trump if they pass Chevron muster. Specifically, Step One requires the Court reviewing the regulations’ interpretation to find that there is ambiguity in the statute. In that exercise, while Supreme Court interpretations have the power to foreclose ambiguity, lower court interpretations do not.

i. Conclusion.

I remind the reader that the concept, however formulated, is deference only. The IRS interpretation does not necessarily control, even in the strongest form of Chevron deference.

There will be more developments in the near future, but it seems that the trend in our administrative state will be to give more deference to these pronouncements that are less formal than regulations. In the meantime, you must understand that the ramifications of “the Chevron revolution” in an administrative environment such as tax are enormous and have occupied the time and energies of courts and legal pundits for years now. At the great risk of oversimplifying, I offer the following from a law review article:

The primary virtue of the Chevron revolution has been the resultant shift of policymaking inherent in statutory interpretation from the courts to administrative agencies like Treasury and the Service. In the civil context, the Chevron and Skidmore deference doctrines allow the courts to avoid interfering in tax policy decision making but still act as a check against arbitrary and capricious agency actions.²⁸⁰

²⁷⁹ See Shamik Trivedi, Wilkins Comments on Regulatory Process Following Home Concrete, 2012 TNT 94-2 (5/15/12) (Wilkins is Chief Counsel of the IRS and thus a major player in the regulations adoption and application processes); see also William J. Wilkins, Implications of Home Concrete, 31 ABA Section of Taxation Newsletter 25, 27 (Summer 2012)

I say that, yes, it is something special when the Supreme Court has interpreted a statute first. * * * [M]ost of the time a case gets to the Supreme Court, there is some ambiguity, particularly when there has been a Circuit split. I sense that the Court is reluctant to say that any ambiguity remains after the highest Court in the land interprets the statute.

But, what if the Supreme Court specifically acknowledges the statute is ambiguous and the opinions are quite fractured as to the interpretation? If the construct is that Congress assigned to the agency the authority to clarify ambiguity, why should it matter that the Supreme Court did it first (except, of course, the Supreme Court determines what deference is and, of course, the Supreme Court wants the agency to defer to it, except when it says it will defer to the agency).

²⁸⁰ Kristin E. Hickman, Of Lenity, Chevron and KPMG, 26 Va. Tax Rev. 905, 932 (2007). For another discussion of the intersection of lenity and Chevron, see Elliott Greenfield, A

8. Some other Issues of Deference.

a. Interpretation of Interpretations.

What happens if the Regulation is ambiguous? Can the IRS interpret the Regulation in a Revenue Ruling or other IRS pronouncement and confer deference upon the interpretation? The answer appears to be yes, unless the interpretation is unreasonable or inconsistent with the regulation.²⁸¹ This type of deference is often referred to as Seminole Rock or Auer deference for the cases in it was applied, Auer being more recent.²⁸² One court has thus noted that an agency's interpretation of its own ambiguous regulations is entitled to even "broader than deference to the agency's construction of a statute," reasoning that "in the latter case the agency is addressing Congress's intentions, while in the former it is addressing its own."²⁸³ Indeed, it appears that the agency's interpretation of its own interpretation is entitled to deference even if advanced for the first time in the litigation before the court giving it deference.²⁸⁴

Lenity Exception to Chevron Deference, 58 Baylor L. Rev. 1 (2006).

²⁸¹ United States v. Cleveland Indians Baseball Co., 121 S.Ct. 1433, 1445 (2001) (giving "substantial judicial deference" to the IRS's reasonable longstanding interpretation of its own regulations); Bowles v. Seminole Rock & Sand Co., 325 U.S. 410, 414 (1945) (an agency's interpretation of its own regulation is entitled to "controlling weight unless it is plainly erroneous or inconsistent with the regulation"); United States v. Mead Corp., 533 U.S. 218, 246 (2001) (Scalia, J., dissenting) ("[T]he Court leaves untouched today[] [the principle] that judges must defer to reasonable agency interpretations of their own regulations."); American Express v. United States, 262 F.3d 1376 (Fed. Cir. 2001) (see particularly authorities there cited); Cinema '84 et al v. Commissioner, 294 F.3d 432 (2d Cir. 2002); and Texaco, Inc. v. United States, 528 F.3d 703 (9th Cir. 2008) (citing Morales v. Sociedad Espanola de Auxilio Mutuo y Beneficencia, 524 F.3d 54, 57 (1st Cir. 2008)).

²⁸² Bowles v. Seminole Rock & Sand Co., 325 U.S. 410, 414 (1945); Auer v. Robbins, 519 U.S. 452, 461 (1997).

²⁸³ Cathedral Candle Co. v. U.S. Int'l Trade Comm'n, 400 F.3d 1352, 1363-64 (Fed. Cir. 2005). In Kaufman v. Shulman, 687 F.3d 21 (1st Cir. 2012), in rejecting the IRS's interpretation of a regulation, the court said the issue was not whether the IRS is entitled to deference in its interpretations (a point it seems to have conceded), but whether the interpretation was unreasonable and thus loses because, even with deference, it cannot prevail. Kaufman is just a reminder that, throughout the deference discussion, deference is not blind allegiance.

²⁸⁴ See Talk America, Inc. v. Michigan Bell Telephone Company, ___ U.S. ___, 131 S. Ct. 2254 (2011) (citing Auer v. Robbins, 519 U.S. 452, 461 (1997) and Chase Bank USA, N.A. v. McCoy, 562 U.S. 195, 209-210 (2011); Kennedy v. Plan Administrator for Dupont Sav. & Inv. Plan, 555 U.S. 285, 296 n. 7 (2009) ("Nor does the fact that the interpretation is stated in a legal brief make it unworthy of deference, as '[t]here is simply no reason to suspect that the interpretation does not reflect the agency's fair and considered judgment on the matter in question.' (Citing Auer v. Robbins, 519 U.S. 452, 462 (1997).); and Abbott Laboratories v. United States, 573 F.3d 1327 (Fed. Cir. 2009) (holding also, however, that "Comments by government litigating counsel on appeal addressing peripheral issues are not entitled to deference." (P. 1332.))

However, a decision in a nontax case suggests that there is considerable controversy among the Supreme Court Justices as to the application of the rule that an agency interpretation of its regulation is entitled to deference and, if so, the scope of the deference.²⁸⁵

b. Procedural Regulations.

The Chevron analysis appears to give the IRS more authority or latitude in adopting regulations that apply procedural rules to the statute. The IRS provides procedural rules both in Regulations and in other less official publications (e.g., Rev. Proc.'s and in the IRM). The same question is presented as to whether those procedural rules are subject to deference. I focus here on procedural regulations. In terms of the considerations underlying deference, procedural regulations have a key distinction from substantive regulations – under the APA, procedural regulations are not subject to notice and comment. Sometimes the line between substance and procedure may be blurred, but I think it helpful here to just state the extremes of the continuum between substantive regulations and procedural regulations.

Judge Posner in the unanimous opinion gave the IRS wide leeway to impose a deadline, amounting to statute of limitations, for equitable claims for innocent spouse relief under § 6015(f).²⁸⁶ I discuss the innocent spouse provisions below (beginning on p. 674), so I won't get into the details of the provision; suffice it to say that Congress provided three different bases for innocent spouse relief but provided a deadline (like a statute of limitations) for only two but not for the third which is a general fall back grant of innocent spouse relief based on the IRS's discretion as to the equities (§ 6015(f)). The IRS by regulation imposed a 2-year deadline on this third basis for relief. The Tax Court, in a reviewed opinion, had held the regulation invalid.²⁸⁷ The Seventh Circuit reversed, sustaining the regulation.²⁸⁸ The key steps in Judge Posner's reasoning for present purposes are (case and statute citations omitted):

- Appellate review of pure legal rulings by the Tax Court, as by a district court, is plenary, and administrative regulations issued pursuant to authority delegated by Congress must be upheld unless unreasonable. [citing Chevron]
- Given the predilection in Anglo American jurisprudence for the repose offered by a statute of limitations, courts tend to borrow a statute of limitations to grant repose even where the statute provides no such limitations period. (I deal with this phenomenon in discussing statutes of limitation below.)
- Then the punchline holding:

²⁸⁵ Perez v. Mortgage Bankers Ass'n, ___ U.S. ___, 135 S. Ct. 1199 (2015) (see separate concurring opinions of Alito, Scalia and Thomas); see also Decker v. Northwest Environmental Defense Center, ___ U.S. ___, 133 S. Ct. 1326 (2013) (see Justice Roberts' concurring opinion, joined by Justice Alito, and Justice Scalia's dissent).

²⁸⁶ Lantz v. Commissioner, 607 F.3d 479 (7th Cir. 2010)

²⁸⁷ Lantz v. Commissioner, 132 T.C. 131 (2010), rev'd 607 F.3d 479 7th Cir. 2010).

²⁸⁸ Lantz v. Commissioner, 607 F.3d 479 (7th Cir. 2010)

Agencies, in contrast, being legislative as well as adjudicatory bodies, are not bashful about making up their own deadlines. And because they are not bashful, and because it is as likely that Congress knows this as that it knows that courts like to borrow a statute of limitations when Congress doesn't specify one, the fact that Congress designated a deadline in two provisions of the same statute and not in a third is not a compelling argument that Congress meant to preclude the Treasury Department from imposing a deadline applicable to cases governed by that third provision. Whether the Treasury borrowed the two-year limitations period from subsections (b) and (c) or simply decided that two years was the right deadline is thus of no consequence; either way it was doing nothing unusual.

* * * *

The arguments against the Tax Court's interpretation of subsection (f) as barring a fixed deadline may not be conclusive, though they are powerful. But federal income taxation is immensely complex, and Congress does not have the time or the knowledge to formulate comprehensive rules for its administration. It delegates expansive authority to the Treasury, which promulgates regulations only after long and painstaking consideration. The delegation in section 6015(f) is express, and the cases are legion that say that Treasury regulations are entitled to judicial deference --all the more so if "issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision." Remember that subsection (f) provides that "under procedures prescribed by the [Treasury]" an innocent spouse may be granted equitable relief under that subsection, while subsection (h) provides that "the [Treasury] shall prescribe such regulations as are necessary to carry out the provisions of [section 6015]" in general.

The Third Circuit thereafter reversed another Tax Court case, lining up with the Seventh Circuit on this issue.²⁸⁹

The interpretive point I explore here is well illustrated in the cases. I should note that the issue presenting the context of the interpretive point – whether the limitations period adopted by regulation for § 6015(f) relief is valid – has been mooted by an IRS announcement that it will no longer abide by the rule (and will revoke the regulation).²⁹⁰

²⁸⁹ Mannella v. Commissioner, 631 F.3d 115 (3d Cir. 2010).

²⁹⁰ Notice 2011-70, 2011-32 IRB 1.

c. Holding the IRS to Published Positions.

Related to the issue of deference is whether the IRS may be held to taxpayer favorable interpretations that it has published in a format inviting taxpayers to rely upon the interpretations. Some courts appear willing to treat the IRS as bound in a case on theories of concession or even fairness without seeming to address the question of whether the interpretation is the proper interpretation of the law.²⁹¹ For this reason, the IRS Chief Counsel has directed IRS attorneys not to take positions inconsistent with published guidance.²⁹² That policy position is not technically binding upon DOJ Tax, but is likely to be followed by DOJ Tax.²⁹³

9. Special Interpretive Considerations for Treaties.

I noted above that treaties may constitute a form of “off the books” tax legislation – meaning, in this context, outside the federal Codes, including Title 26. The question I address here only briefly is what are the interpretive sources for tax treaties and, correspondingly, does the IRS / Treasury interpretations have any special role or deference in the interpretation of tax treaties.

This is a large, very large subject. But, a few short comments, most in terms of raising issues. A treaty is, after all, a contract intended to implement the shared expectations of the treaty partners.²⁹⁴ Contracts are generally interpreted to effect the shared expectations of the parties as evidence by the text. I don’t think it is yet settled precisely what is or should be the role of the interpretations of the treaty stated by the U.S. executive branch both before and after the Senate consideration of the treaty and by the Senate itself in approving the treaty. Some of these interpretations if made preceding or during the Senate consideration of the treaty (including the executive branch definitive analysis of the treaty submitted to the Senate Foreign Relations Committee), are the functional equivalent “legislative” history which some courts might find helpful in ascertaining the intent of the parties. Further, it is possible that the Senate may adopt or act on an interpretation of the treaty text that is different, at least in its nuances, than the treaty partner’s interpretation. Is it the treaty as understood – even reasonably understood – by the treaty partner or as understood by the Senate in giving its constitutionally mandated approval that governs in U.S. courts? Does the broad constitutional authority given the executive over foreign affairs give it some

²⁹¹ See e.g., Rauenhorst v. Commissioner, 119 T.C. 157 (2002) (holding that the Revenue Ruling is a concession by the IRS, avoiding the necessity of determining the application of the law to the facts); and McLendon v. Commissioner, 135 F.3d 1017 (5th Cir., 1998).

²⁹² IRS CC-2002-043, reproduced at 2002 TNT 206-13.

²⁹³ Tax Notes reports the following: “When asked about Justice Department litigation, Williams responded that while Justice attorneys are not bound by an IRS Chief Counsel notice, ‘they have a public duty to follow the same rule.’” Sheryl Stratton, *IRS Litigators Bound by IRS Rulings, Chief Counsel Says*, 2002 TNT 205-1.

²⁹⁴ Some statutory interpretation models buy into the notion of shared expectations of the legislators but where more than two parties are involved – particularly the mob of the two houses of the U.S. Congress – discerning a shared expectation of the individuals may be difficult indeed. Still, I think, that is a primary goal of statutory interpretation, so I am not sure that treaty interpretation is conceptually different than statutory interpretation.

special say entitled to deference in treaty interpretation by U.S. Courts? Finally, the treaty language may have some judicial interpretation history either in U.S. courts or even in foreign courts that might be helpful and, in the case of U.S. courts, even precedential; when should those trump? At this point, I think it would be too distracting to the intended purpose of this text to go further into this interpretive issue; so I use the footnote here to cite readers to further reading materials.²⁹⁵

10. IRS Duty of Consistency.

a. General.

The IRS should administer the tax law in a way that treats similarly situated taxpayers similarly.²⁹⁶ In a system as complex and involving millions of taxpayers and hundreds of millions, probably billions, of returns and filings, consistency is the goal but cannot be achieved perfectly. The large question addressed here is whether one taxpayer can avoid paying taxes (or penalties or interest thereon) that he or she owes simply because another taxpayer does not. The answer to that question has to be no. Taxpayers avoid paying – in some cases evade – taxes they owe every day, and the system would grind to a halt if all taxpayers were relieved of their obligation to pay. So I hope the student knows that one taxpayer's nonpayment of tax does not relieve another taxpayer of the duty to pay. That is and has to be the general rule.²⁹⁷

General rules are general rules, and there may be exceptions in some very egregious situations. However, given the reason for the general rule, I hope you can see that the exceptions will be narrow and circumscribed indeed. I deal here with two special areas in which there are exceptions. Note how narrow the exceptions are and how they involve competitive factors beyond just one taxpayer avoiding tax that others have to pay.

Before moving to the examples, I do want you to consider that there are myriad ways in which lack of consistency among taxpayers may be presented. The most obvious way is that many taxpayers are treated differently because they claim a benefit they are not entitled to and are never audited. Or, the IRS may audit a taxpayer and, even if the agent spots the issue, for some reason the

²⁹⁵ See e.g., Robert Thornton Smith, Tax Treaty Interpretation by the Judiciary, 49 Tax Law. 845 (1996); John A. Townsend, Tax Treaty Interpretation, 55 Tax Law. 219 (2001) (arguing for deference); and Richard L. Reinhold & Catherine A. Harrington, What NatWest Tells Us About Tax Treaty Interpretation, 119 Tax Notes 169 (2008), available at 119 Tax Notes 169 (Lexis). Focusing on potential executive branch deference in treaty interpretation, see Michael S. Kirsch, The Limits of Administrative Guidance in the Interpretation of Tax Treaties, 87 Tex. L. Rev. 1063 (2009).

²⁹⁶ For a good introduction to the problems discussed in this section, see Steve R. Johnson, An IRS Duty of Consistency: The Failure of Common Law Making and a Proposed Legislative Solution, 77 Tenn. L. Rev. 563 (2010).

²⁹⁷ See Steve R. Johnson, An IRS Duty of Consistency: The Failure of Common Law Making and a Proposed Legislative Solution, 77 Tenn L. Rev. 563 (2010). Professor Johnson makes legislative recommendations offering some limited remedies to inconsistency in more egregious cases.

agent erroneously does not make the good adjustment. Or, one taxpayer may apply for a private letter ruling and gets the favorable ruling, but another taxpayer is audited and the IRS requires that taxpayer to pay tax on the same issue. Or, in litigation, the judge or the jury relieves one taxpayer of tax but, where the case is not precedent, the IRS, another judge or another jury imposes the tax on a taxpayer. These are just examples of the way the issue can be presented.

b. Competitive Issues - Examples.

(1) The IBM Case.

Can the taxpayer complain about more favorable tax treatment given to a competitor? Allowing the taxpayer seeking the private letter ruling to obtain a benefit ultimately contrary to the law while denying that benefit to others, particularly competitors where the erroneous benefit gives a competitive advantage, has at least the appearance of unfairness. The Court of Claims – the predecessor to the current Court of Appeals for the Federal Circuit – addressed this issue in 1966 in **International Business Machines Corp. v. United States**.²⁹⁸ One of IBMs competitors in the highly competitive computer business had sought and obtained a ruling that ultimately proved to be based on an incorrect interpretation of law. Shortly thereafter, IBM learned of the ruling and sought one for itself. After over two years consideration / reconsideration of the issue, the IRS simply denied IBM's requested ruling and revoked the ruling to the competitor **but** revoked prospectively only. During the interim before prospective revocation (about 2 ½ years), the competitor had a substantial advantage over IBM, which had not sought a ruling and was taxed on the basis of the correct interpretation of law. In a fairness / equity based decision, the court required the IRS to refund the taxes during the period to IBM. The technical basis for the ruling was that (i) § 7805(b) authorizes IRS interpretations to be applied prospectively (thus implicitly permitting the IRS to apply wrong interpretations prior to a prospective application date), and (ii) that the IRS's refusal to make prospective the ruling it gave IBM was an abuse of discretion because of the favorable interpretation that the competitor secured in the interim before its ruling was revoked prospectively.

IBM illustrates the tensions in this area. Certainly IBM had equities in its favor, and the Court responded. But, can it be that the IRS, by making an incorrect interpretation of law as to one taxpayer, determines the law -- in effect overrides the will of Congress by adopting the incorrect interpretation -- for all taxpayers during the periods the incorrect interpretation is outstanding? That concept is disturbing indeed.²⁹⁹ And, would it make any difference whether the incorrect interpretation were adopted on audit as opposed to in a private letter ruling? The bottom-line competitive result is the same – one competitor achieves a competitive advantage because of the inconsistent application of the tax law. The implications of IBM are startling and far-reaching indeed. Probably for this reason, IBM is generally considered *sui generis* -- that is, limited to its facts; and similar relief is virtually never given and even when a court recognizes any continuing

²⁹⁸ 343 F.2d 914 (Ct. Cl. 1965), cert. denied, 382 US 1028 (1966), nonacq. AOD 2012-02; 2012-40 IRB 1.

²⁹⁹ See e.g., Merck & Co., Inc. v. United States, 652 F.3d 475, 487 (3d Cir. 2011) (3d Cir. 2011) (citing Hostar Marine Transp. Sys., Inc. v. United States, 592 F.3d 202, 210 (1st Cir. 2010)).

validity limits it to situations where the taxpayer requested and was denied a PLR for beneficial treatment that a competitor was granted.³⁰⁰ Nevertheless, in a large dollar case, even long shots must be pursued vigorously.³⁰¹

(2) Employee-Independent Contractor Issue.

Another area where you may encounter concerns about the competitive effect of different tax interpretations to common fact patterns is the classification of service providers as employees or independent contractors. Persons who engage such service providers have one set of tax responsibilities if the service providers are employees (withholding income tax and employee's share of FICA and paying over the withheld tax to the IRS, along with the employer's share of FICA and reporting the wages to the IRS and the taxpayer on Form W-2) and another, much more limited and less costly, set of tax responsibilities if the service providers are independent contractors (principally just to provide the IRS and the taxpayer the information on Form 1099). The difference between an employee and an independent contractor is determined under a common law test that uses multiple factors and produces uncertain results in a broad spectrum of cases.

The IRS generally prefers persons engaging service providers to treat them as employees because the employer will, in effect, become the collection agent for the IRS and the social security system through withholding. The service providers in many businesses where the characterization as employee or independent contractor is close often prefer being treated as independent contractors, because they have much greater chance of dropping outside the IRS's collection system or because they prefer not to be subject to withholding. The employers of such service providers will often prefer to treat the service providers as independent contractors because their costs are lower as they, in effect, benefit from the fact that the service providers are willing to work for less because they do not pay their full share of income and self-employment taxes. Furthermore, by treating the service provider as an independent contractor, the business owner may be able to exclude that person from costly benefits otherwise provided to employees. (That is not exactly a tax issue, but it is a cost that may attend the business owner treating the service provider as an employee.) Thus, from both the business owner and service provider perspective, it is often preferable to treat the service provider as an independent contractor, albeit for different reasons.

From time to time, the IRS will audit a business owner's position as to the alleged independent contractors. This may occur either as part of a routine audit or as part of an

³⁰⁰ E.g., Baker v. United States, 748 F.2d 1465, 1469 n.9 (11th Cir. 1984) ("taxpayers who have not requested or received private letter rulings from the IRS will not succeed on a claim of discriminatory treatment because other taxpayers have received private letter rulings on the tax consequences of the same activities").

³⁰¹ Students desiring to pursue this issue further are referred to Lawrence Zelenak, Should Courts Require the Internal Revenue Service to be Consistent?, 40 Tax L. Rev. 411 (1985) (arguing that they should). An aggressive pursuit of a large dollar claim in the setting of a hokey tax shelter, might however evoke a judicial response of "chutzpah" with respect to some of the peripheral claims that gild the lily of the basic IBM claim. See e.g., Merck & Co., Inc. v. United States, 652 F.3d 475, 488 (3d Cir. 2011) (3d Cir. 2011).

industry-wide initiative. For example, there have in the past been industry-wide initiatives as to the treatment of service providers in the dry wall construction business. Obviously, if the business owner has wrongly characterized his service providers as independent contractors a retroactive tax bill for the withholding and employee's share of FICA can be staggering -- i.e., it could put the business owner out of business and certainly would put him at a competitive disadvantage if his competitors or some substantial portion of them successfully treated their service providers as independent contractors.

For this reason after giving up on developing a test that would give business owners greater certainty as to the proper characterization of their service providers, Congress enacted special legislation to address the competitive issue. In late 1970s, Congress prohibited the IRS from issuing regulations and rulings on the status of workers. Further, Congress enacted so-called **§ 530 relief** that prohibits the IRS from recharacterizing service providers from independent contractor status to employee status if the following conditions are present: (1) the business owner did not treat an individual as an employee for any period and filed all returns consistently; and (2) the business owner had a reasonable basis for treating the service provider as an independent contractor.³⁰² Reasonable basis includes the following:

(A) judicial precedent or published rulings, whether or not relating to the particular industry or business in which the taxpayer is engaged, or technical advice, a letter ruling, or a determination letter pertaining to the taxpayer; or

(B) a past Internal Revenue Service audit (not necessarily for employment tax purposes) of the taxpayer, if the audit entailed no assessment attributable to the taxpayer's employment tax treatment of individuals holding positions substantially similar to the position held by the individual whose status is at issue (a taxpayer does not meet this test if, in the conduct of a prior audit, an assessment attributable to the taxpayer's treatment of the individual was offset by other claims asserted by the taxpayer); or

(C) long-standing recognized practice of a significant segment of the industry in which the individual was engaged (the practice need not be uniform throughout an entire industry).³⁰³

A taxpayer who fails to meet any of the three "safe havens" may nevertheless be entitled to relief if the taxpayer can demonstrate, in some other manner, a reasonable basis for not treating the

³⁰² Section 530 relief is an independent statute and is not part of the Internal Revenue Code. Tax lawyers use the term Section 530 as if it has independent meaning. Inexperience tax lawyers may go looking for it in the Code. It's not there. The reference is to Section 530 of the Revenue Act of 1978. The section is not codified, although it continues to apply.

³⁰³ Rev. Proc. 85-18, 1985-1 C.B. 581.

individual as an employee. “Reasonable basis” should be construed liberally in favor of the taxpayer.³⁰⁴

The IRS had for years taken the position that the filing requirement for § 530 relief required timely filing of informational returns, although the statute does not impose the timely requirement. The IRS’s interpretation was set forth as a general rule in a Revenue Procedure; an earlier specific application denying relief was included in a Revenue Ruling where the filing was not made until an audit commenced.³⁰⁵ The Tax Court, however, held that the statute itself did not impose a timely filing requirement and, applying the Skidmore analysis, the IRS pronouncements did not qualify for deference because they failed to articulate a persuasive rationale for denying relief as a general rule in all cases of late filing.³⁰⁶ The Court concluded that the IRS’s expansive application of the nonstatutory requirement would impose a penalty in addition to the regular late filing ad valorem penalty (discussed below in the penalty chapter). If there is no requirement of timely filing, taxpayers subject to an IRS audit on the issue can meet the filing requirement simply by filing delinquent Forms 1096 and 1099. The Fifth Circuit held in an unpublished opinion that the untimely filing must be before the employment taxes are assessed against “employer.”³⁰⁷

c. IRS Abuse and the 10 Deadly Sins.

We will discuss the IRS’s examination and collection functions in later chapters. These are the principal contacts the IRS has with the taxpayer. We will see that, in pursuing these functions, IRS officials are given significant powers. These powers work well and appropriately most of the time, but they can be misused. In hearings leading to the 1998 Restructuring Act, the Republican majority on the Senate Finance Committee trotted out taxpayers and IRS agents who testified as to alleged IRS abuses against taxpayers. After enactment of the 1998 Restructuring Act, studies of these witnesses’ charges showed most of them to be untrue or unverifiable, casting doubt upon the SFC majority’s extrapolation from those charges that abuse was rampant in the IRS. (It is not and never was.) Nevertheless, in the heat of political passion immediately after the charges were made before a complicitous Senate Finance Committee, Congress enacted legislation outside the Code (i.e., not codified in the Code) but still the law.³⁰⁸ That legislation provides:

³⁰⁴ H.R. Rep. No. 95-1748, 95th Cong., 2d Sess. 5 (1978), 1978-3 (Vol. 1) C.B. 629, 633. For case granting this relief, see Penno Trucking Inc. v. Commissioner, unpublished (6th Cir. 2008), unofficially reported at 2008 TNT 194-75, reversing the Tax Court on this issue (T.C. Memo 2007-66).

³⁰⁵ Rev. Proc. 85-18, 1985-1 C.B. 518; Rev. Rul. 81-224, 1981-2 C.B. 197.

³⁰⁶ Medical Emergency Care Associates, S.C. v. Commissioner, 120 T.C. 436 (2003).

³⁰⁷ Bruecher Found. Servs. v. United States, 2010 U.S. App. LEXIS 12598 (5th Cir. 2010) (Unpublished opinion); see Hale E. Sheppard, Must Taxpayers File “Timely” Forms 1099 to Obtain Code Sec. 530 Relief? Unexpected Answers from a Recent Worker-Classification Case, Taxes - the Tax Magazine 55 (May 2013) (a very thorough article on the specific issue, but with good background on § 530).

³⁰⁸ § 1203 of the 1998 Restructuring Act.

The IRS must terminate an IRS employee if there is a final administrative or judicial determination that the employee committed any act or omission in performing official duties.³⁰⁹ The following list of 10 items – the 10 Deadly Sins – may result in employee termination:³¹⁰

(1) willful failure to obtain the required approval signatures on documents authorizing the seizure of a taxpayer's home, personal belongings, or business assets;

(2) providing a false statement under oath with respect to a material matter involving a taxpayer or taxpayer representative;

(3) with respect to a taxpayer, taxpayer representative, or other employee of the Internal Revenue Service, the violation of (A) any constitutional right or (B) any civil right established under certain specified statutes, such as the Civil Rights Acts;

(4) falsifying or destroying documents to conceal mistakes made by any employee with respect to a matter involving a taxpayer or taxpayer representative;

(5) assault or battery on a taxpayer, taxpayer representative, or other employee of the Internal Revenue Service, but only if there is a criminal conviction, or a final judgment by a court in a civil case, with respect to the assault or battery;

(6) violations of the Code, regulations, or policies of the Internal Revenue Service (including the IRM) for the purpose of retaliating against, or harassing, a taxpayer, taxpayer representative, or other employee of the Internal Revenue Service;

(7) willful misuse of the provisions of § 6103 (the confidentiality provisions for tax return information)³¹¹ for the purpose of concealing information from a Congressional inquiry;

(8) willful failure to file any required federal tax return, unless such failure is due to reasonable cause and not to willful neglect;³¹²

(9) willful understatement of federal tax liability, unless such understatement is due to reasonable cause and not to willful neglect;³¹³ and

³⁰⁹ § 1203(a).

³¹⁰ § 1203(b).

³¹¹ We shall study these provisions below.

³¹² The phrase “due to reasonable cause and not to willful neglect” is a term of art used in the penalty provisions generally applicable to all taxpayers. Taxpayers generally are subject to civil tax penalties for negligent or other conduct that fails to meet this standard. IRS employees are subject also to termination from employment.

³¹³ See the preceding footnote.

(10) threatening to audit a taxpayer for the purpose of extracting personal gain or benefit.

Items (8) and (9) relate to IRS employees' conduct in filing their own tax returns. Items 1 - 6 and 10 relate to conduct affecting other taxpayers, which was the principal target of Congress' attention. Item 7 relates to potential abuse of Congress by withholding information from it.

Although the general rule is that the listed infractions require termination of employment, the Commissioner may make a nondelegable determination that mitigating factors exist and not terminate the employee.

Congress further required investigations into abuses. The GAO, the investigative arm of Congress, studied the specific abuses alleged in the hearings leading to this legislation (and, by the way, for the most part, either could not verify or found the allegations to be false). In addition, TIGTA (pp. 23 ff.) studies these issues on an ongoing basis and periodically reports to Congress. The reports to date indicate some abuse in the IRS (a not surprising finding given its size), but hardly indicate that they are widespread. For the reason that such abuses are not and never were widespread in the IRS and the chilling effect the statute has on legitimate enforcement efforts (i.e., IRS employees fearing the statute forego legitimate administrative actions), some thoughtful observers have called for its repeal.³¹⁴

C. Department of Justice.

1. Tax Division ("DOJ Tax").

DOJ Tax is responsible for litigating tax cases in all courts except the United States Tax Court.³¹⁵ You will recall that the IRS Chief Counsel's office handles the litigation in the Tax Court. DOJ litigates tax cases in the District Courts (including the bankruptcy courts), the Court of Federal Claims, the Courts of Appeals, and the Supreme Court, as well as in the state courts when federal tax issues arise there as they do in rare cases.

DOJ Tax trial level activities are divided functionally between civil and criminal. Civil litigation is handled by civil sections – four **Civil Trial Sections** handling the litigation in district

³¹⁴ E.g., Mortimer Caplin, The State of IRS Administration and Our Tax System in General, 103 Tax Notes 473 (2004) and 2004 TNT 81-32 (4/27/04).

³¹⁵ President Franklin D. Roosevelt by executive order (EO 6166 6/12/33) transferred to DOJ "functions of prosecuting in the courts of the United States claims and demands by, and offenses against, the Government of the United States and of defending claims and demands against the Government exercised by an agency or officer." Tax disputes are included in the scope of this order, but the responsibility for Tax Court litigation remains with the IRS as noted above. Within the DOJ, the responsibility for tax litigation is with the Tax Division but, as noted below in the text, the Solicitor General has the responsibility for approving all Government appeals from adverse trial level decisions (including tax cases both in the Tax Court and elsewhere) and for handling all Government cases (including tax cases) in the Supreme Court.

courts in four geographical areas of the country and one **Court of Federal Claims Section** handling litigation in that court which handles over civil claims against the Government. Criminal activities, including both criminal litigation and grand jury investigations, are handled by the Criminal Enforcement Section (“CES”), which has four branches serving specific geographical areas of the country. DOJ Tax appellate level functions (that is, handling tax cases in the various courts of appeals and in the Supreme Court) are handled by the descriptively named **Appellate Section**. All tax appeals are handled by the Appellate Section, including appeals from trials handled by DOJ Tax in all courts except the Tax Court and trials handled by the IRS in the Tax Court.

DOJ Tax is headed by an **Assistant Attorney General** (“AAG”) who is a presidential appointee traditionally recruited from the private bar, usually as a reward for assistance in the political success of the President or some powerful politician who can influence the presidential appointment process. The AAG might have had government experience in the past, but it is not the practice to appoint someone to the position directly from government service. Usually, however, a senior DOJ Tax official (referred to as a Deputy Assistant Attorney General) will serve as Acting AAG during periods when the AAG's office is vacant. The Deputy AAGs will usually include one chosen from private practice and one from career DOJ Tax officials. The Deputy AAGs are not presidential appointees, but are chosen by the AAG or, in an AAG vacancy, by a DOJ official above that level..

Once a civil **or** criminal case is referred to DOJ Tax, DOJ Tax has the exclusive authority to compromise the case; prior to that referral, the IRS has exclusive authority to compromise. Section 7122(a).³¹⁶ However, as to DOJ Tax’s exclusive authority to settle, it must be kept in mind that the model is somewhat like attorney (DOJ Tax) and client (IRS). This is not a perfect fit because the attorney-client model would require the lawyer (DOJ Tax) to comply with the client’s (IRS’s decisions). The statutory structure does not fit this model, for DOJ Tax can operate from a different perspective and therefore need not always follow the client’s wishes or instructions. Suffice it to say, however, that the DOJ Tax will seek the IRS’s views and will make a different

³¹⁶ Isley v. Commissioner, 141 T.C. No. 11 (2013) (holding that Section 7122(a) requires DOJ approval to compromise the tax liability for the period(s) of referral, at least during the period that DOJ either directly or through the courts had continuing responsibility; in that case, it was the continuing requirement in the judgement in the criminal case to file returns and pay taxes during the period of supervised release that required DOJ approval); United States v. Jackson, 2013 U.S. App. LEXIS 1674 (3d Cir. 2013) (with discussion of authority as to the IRS’s lack of authority to settle after referral to DOJ Tax, even after the case is referred back to the IRS). See [IRS Has No Authority To Settle Cases Referred to DOJ Tax Even After They Are Returned \(Federal Tax Crimes Blog 8/3/13\)](#), discussing Jackson; and [IRS authority to settle after referral to DOJ Tax \(Federal Tax Crimes Blog 11/11/13\)](#), discussing Isley. For a comparison of DOJ Tax’s broad compromise authority with the authority of IRS attorneys in tax litigation, see [Keith Fogg, Contrasting the Compromise Standards between the Chief Counsel, IRS and the Department of Justice in Litigated Cases \(Procedurally Taxing Blog 6/23/15\)](#).

decision only in the rare case that DOJ Tax feels that the priorities from its perspective dictate a decision different than the one preferred by the IRS.³¹⁷

2. Office of the Solicitor General.

The **Solicitor General** of the United States (“SG”) has two key roles in tax litigation. First, and most prominently, the office of the SG handles all representation of the United States before the Supreme Court. The SG’s office thus files all papers (including petitions for writ of certiorari and briefs on the merits) and makes all oral arguments in the Supreme Court. (An exception is that high level political appointees, such as the AAG are sometimes given the opportunity to argue one case in their area of responsibility.)³¹⁸ In tax cases, the initial draft of briefs, petitions and other pleadings in the Supreme Court will usually be substantially prepared by the DOJ Tax Appellate Section and may be substantially commented upon by the various tax constituencies in the IRS and DOJ Tax. The final draft of those papers, however, are revised as appropriate (including substantially rewritten, if appropriate) by the SG's office. Second, the SG must approve all government appeals in tax cases.

Within the SG's office, there is a “tax assistant” -- i.e., an Assistant SG who handles most of the tax cases that come to the SG's office. The SG is usually not a tax lawyer, and therefore relies substantially on the tax assistant. There has been one instance in which the SG was a lawyer of some renown in the tax universe -- Erwin Griswold, who was former tax professor and Dean at Harvard Law School and a giant in the tax profession.

The SG's office is the crème de la crème and usually beyond political influence. These qualities have been carefully cultivated over the years and have given the office of the Solicitor General substantial influence at the Supreme Court. This is particularly illustrated in the tax area. The SG will carefully limit the times during any given term that the United States will either petition the Supreme Court for certiorari or acquiesce in a taxpayer's petition for writ of certiorari. It is said that the Supreme Court, disliking tax cases, has a tolerance for about only four to six tax cases per term, and the SG is careful to serve up only the ones in which his unique perspective of tax and Supreme Court priorities tells him that the Court may grant certiorari.

The SG's understanding of the limits of the Supreme Court's interest in tax cases was illustrated to me when I was a relatively fledgling lawyer in the Appellate Section. I handled and

³¹⁷ Before the referral when the IRS has exclusive authority to settle, the IRS usually will not ask DOJ Tax for its advice, but in cases where seeking the DOJ Tax advice is appropriate, the IRS will do so but likely, because of the secrecy rules will have to make some form of referral so that the facts underlying the advice can be shared with DOJ Tax. Perhaps that will not be a full bore referral that would transfer exclusive authority to DOJ Tax to settle the case (but, quite frankly, I have not researched this issue enough to do anything than raise the issue).

³¹⁸ One exception to the statement of which I am aware is that Ernest J. Brown, formerly professor of law at Harvard Law School, was an attorney in the DOJ Tax Appellate for many years after he retired from Harvard. He was permitted to argue a case for the SG’s Office before the Supreme Court. See Commissioner v. First Sec. Bank, 405 U.S. 394 (1972).

lost a case in a court of appeals where there was in my judgment a clear conflict among the circuits. The issue involved the application of the mitigation provisions of the Code designed to mitigate the harsh effects of the statute of limitations. (We cover the mitigation provisions at pp. 259 ff.) Suffice it to say at this point that they have a threshold complexity that courts have difficulty crossing but, when understood, are logical and beautiful. In any event, as I said, there did appear to be a conflict among the circuits and, at the time, a conflict was almost guaranteed certiorari material. I therefore recommended that the United States seek certiorari in the case. The SG (Dean Griswold whom I mentioned in two paragraphs up) himself nixed the recommendation, noting in handwriting on my recommendation that (and this is a paraphrase but pretty close to the actual quote) “We can't take a mitigation case to the Supreme Court, for they will never understand it.”

Although instances of political influence in the SG's office are rare, one such instance is prominent in the tax law history. In the mid to late 1970s, the IRS began revoking the tax exempt status of organizations that practiced some forms of racial discrimination. The revocations were not based on a specific Code provision denying tax exempt status for racially discriminatory practices, but rather upon evolving judicial interpretations that were excluding organizations practicing racial discrimination from the general definition of charitable organizations for some purposes. The Code definition of tax-exempt organizations relied on those general evolving law definitions of charitable organizations. The otherwise charitable organizations such as schools which desired to continue their discriminatory practices -- often in the name of claimed religion beliefs -- challenged this administrative denial of tax exempt status. Two such cases in which the IRS had succeeded in denying tax exempt status at the Circuit Court level finally reached the Supreme Court in the early 1980's.³¹⁹ By that time, President Reagan had been elected with a substantial boost from the South where there were significant constituencies favoring some forms of racial discrimination, and religious schools were their poster children. The President directed the SG's office to disavow the position the Government had earlier asserted successfully in the court of appeals, thus agreeing that the organizations qualified for tax exempt status even if they racially discriminated. Because the SG had recused himself on the case, the lot fell to the Acting SG, who felt strongly that the White House was wrong on the merits and on its attempt to influence the SG's office. The Acting SG agreed that the President was constitutionally entitled to direct the position taken by the Executive Branch, however mistaken and misguided it may be. But, the Acting SG agreed to put his name on the brief espousing a position he thought was wrong, only if he was project in a footnote that he did not agree with the position advocated in the brief. That Acting SG's action was gutsy and shows a remarkable degree of independence, because the President could have fired him and replaced him with someone willing to do his bidding without a distracting footnote slap at the blatant political move. (There would undoubtedly have been a number of political sycophants who would have volunteered; but the political flack from such conduct would have been serious, since it would have

³¹⁹ While with the Government, I handled one of the cases at the trial level to decision, and the Government prevailed. Goldsboro Christian Schools v. United States, 436 F. Supp. 1314 (ED NC 1977). I handled the other case involving Bob Jones University, the case that ended up in the Supreme Court, until I left DOJ Tax in 1977; it was completed at the trial level by another DOJ Tax attorney and the Government lost at the trial level. Bob Jones University v. United States, 468 F. Supp. 890 (D SC1978), rev'd 639 F.2d 147 (4th Cir. 1980), Fourth Circuit aff'd 461 U.S. 574 (1983).

echoed President's Nixon's command to fire the Special Prosecutor which the Attorney General and Deputy Attorney General resigned rather than perform with a resulting public forestorm that participated greatly in Nixon's fall.) Perceiving the interference in the SG's office, the Supreme Court invited a prominent DC attorney to file an amicus brief in support of the decisions rendered by the Fourth Circuit that stripped the schools of their tax exempt statuses. So, President Reagan got his way but lost in the Supreme Court.³²⁰ President Reagan's advisors certainly knew the position would fail, so the net effect was that President Reagan played to an important constituency at the cost of improperly influencing the SG's office and irritating the Supreme Court. In the political equation, that apparently was a reasonable price to pay. Fortunately such episodes are rare, very rare at least up to W's administration where the pervasiveness of politically motivated appointments may have reached into the SG's office as well as other offices in DOJ.

III. Judicial Branch.

A. Introduction.

The Judicial Branch of Government is the ultimate forum for resolution of issues created by the IRS administration of the tax laws. In the context of the focus of this course, we will see it when the taxpayer asks a court to review some action taken by the IRS – whether it is the assertion of additional tax due and owing (by deficiency notice), the denial of a claim for refund, improper administrative action (such as wrongful levy), etc.

B. The Courts.

1. Article III Courts.

Article III of the Constitution establishes the Judicial Branch of our Government. Judicial functions may be performed outside Article III (the prominent examples for present purposes being the Court of Federal Claims and the Tax Court), but generally the ultimate judicial function is handled by courts created under Article III of the Constitution. The key features of Article III courts are that the judges have lifetime tenure and, at the trial level, may impanel juries to find facts. The Article III Courts are the **United States District Courts**, the **United States Courts of Appeals**, and the **United States Supreme Court**. I hope that by now you understand the key features and roles of these courts in our judicial system. They serve the same roles in the tax system.

United States District Courts will have United States Magistrate Judges, who are not Article III Judges, but who are judicial officers assisting the District Courts in the management of the cases, performing many of the functions that the District Courts would otherwise have to perform. Bankruptcy judges, who are also not Article III judges, function under the auspices of the District Court and will sometimes resolve tax issues. For this class, I will expect you to know only the role of the District Court Judges.

³²⁰ See Bob Jones University v. United States, 461 U.S. 574 (1983).

I mentioned above the SG's understanding of the limits of the Supreme Court's interest in tax cases. Consider also the following: First, in explaining a practice among Justice Rehnquist's clerks, Judge Roberts, the current Chief Justice succeeding Justice Rehnquist, is quoted as saying of past practice when he was clerk:

Justice Rehnquist let the clerks decide who would handle which case. They used a system similar to the NFL draft, but with a twist. The clerks could use a vote to claim a case or to reject one, all before knowing whether Justice Rehnquist would be assigned to write the majority opinion or decide to write a concurrence or dissent. A clerk who did not vote carefully . . . "could get stuck with a lot of tax cases."³²¹

And also consider that, when the Supreme Court does take important tax case, it is apt to create great mischief.³²²

2. Article I Courts.

The other types of independent courts that we have are Article I Courts – i.e., courts created under the Article I legislative authority of the Congress rather than under Article III judicial authority. The key differences from Article III courts are that Article I judges do not have lifetime tenure and may not impanel juries to resolve disputed facts. The Article I courts pertinent to this class are the United States Court of Federal Claims and the United States Tax Court.

The **United States Court of Federal Claims** is a court that has jurisdiction over various types of claims against the Government, including tax claims. Generally, in tax matters, the Court of Federal Claims has jurisdiction over tax refund suits.³²³

The **United States Tax Court** is an independent court within the executive branch created by the legislative (hence, by exercise of the Article I legislative power) but operating under the

³²¹ Adam Liptak and Todd S. Purdum, As Clerk for Rehnquist, Nominee Stood Out for Conservative Rigor, Washington Post Web Edition (7/31/05).

³²² Charles I. Kingson, How Tax Thinks, 37 Suffolk U. L. Rev. 1031 (2004) (critiquing two leading Supreme Court cases: Frank Lyon Co. v. United States, 435 U.S. 561 (1978) and Commissioner v. Brown, 380 U.S. 563 (1965)); see also Charles I. Kingson, Confusion Over Tax Ownership, 93 Tax Notes 409 (Oct. 8, 2001) (critiquing the same). I also cite Gitlitz v. Commissioner, 531 U.S. 206 (2001) as a prime example of Supreme Court's mischief in this area. See René Matteotti, Struggling With Words in Tax Jurisprudence -- A Plea for an Equal Treatment Mode of Analysis in Construing Tax Statutes, 2005 TNT 130-30. My quip, not much of an overstatement, is that tax cases are too important to let the Supreme Court decide them.

³²³ Congress conferred jurisdiction on the Claims Court in the Tucker Act, now 28 U.S.C. § 1491, which authorizes the court in relevant part "to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress. " The remedy most often invoked in this court is the refund remedy authorized elsewhere. As to the jurisdiction, including tax refund jurisdiction, conferred by the Tucker Act, see Ontario Power Generation v. United States, 369 F.3d 1298, 1301 (Fed. Cir. 2004).

Executive Branch; they do exercise the judicial power of the U.S. beyond that required for Article III courts.³²⁴ The Tax Court has jurisdiction over tax related claims only.³²⁵ Generally, the Tax Court has jurisdiction to redetermine deficiencies proposed by the IRS and resolve certain other disputes with the IRS. The Tax Court is the principal court in which tax controversies are litigated.

Each Article I court, like the Article III courts, has jurisdictional prerequisites which must be satisfied; I shall deal with those in more detail below (pp. 515 ff.).

Article I courts, although in some ways subject to certain powers in the Executive (such as removal),

³²⁴ Kuretski v. Commissioner, 755 F.3d 929 (D.C. Cir. 2014) (rejecting the argument that the President's power of removal of Tax Court judges violated the separation of powers feature for the judicial power; in other words, the judicial power of the U.S. is not strictly confined to the Article III courts, citing Freytag v. Commissioner, 501 U.S. 868, 889 (1991)). See William R. Davis, Tax Court Judge Highlights Court's Independence, 2014 TNT 184-16 (9/23/14).

³²⁵ Congress created the Tax Court in § 7441, and has provided a number of remedies that may be pursued in the Tax Court, such as petitions to redetermine deficiencies and collection due process proceedings. See Freytag v. Commissioner, 501 U.S. 868 (1991), establishing that the Tax Court is a court with the judicial power which is not limited to Article III courts. The Supreme Court relied upon authority holding the predecessor to the Court of Federal Claims, also an Article I court, to have been constitutionally given the judicial power. On this point, Justice Scalia authored a vigorous dissent.

Ch. 3. The Right to Know – FOIA and Privacy Act.

I. Freedom of Information Act (“FOIA”).

A. The Theory of FOIA.

Information is the engine of democracy. FOIA³²⁶ is a congressional judgment that citizens should know the operations of Government and should have a formalized procedure to obtain that information.³²⁷ Accordingly, much of the information that shows how the Government works is available to citizens under FOIA. In a tax setting, FOIA permits taxpayers to learn much about IRS operations through FOIA and specifically to discover through FOIA much of what the IRS knows about the taxpayer. Accordingly, FOIA operates as a form of discovery unrelated to specific litigation.

B. General Rule - Governmental Information is Available.

Consistent with the purpose of FOIA to have an informed citizenry, the general rule is that governmental information is available. All the citizen has to do is to ask the Government agency.

FOIA provides a judicial remedy if a federal agency improperly withholds agency records. **United States DOJ v. Tax Analysts**, 492 U.S. 192 (1989) is illustrative. In that case, Tax Analysts, an organization that provides subscribers summaries of tax developments and copies of documents reflecting same, obtained under FOIA from the DOJ Tax a summary record of tax decisions that were rendered by the courts in which DOJ Tax represented the IRS. DOJ Tax represents the IRS in all courts except the Tax Court. Tax Analysts initially would use the summary records to obtain copies of the decisions from all of the courts -- i.e., the district courts, the courts of appeals, the Supreme Court, the predecessor of the Court of Federal Claims, and any other courts, including state courts in which the DOJ Tax represented the IRS. I hope you can appreciate that it was inconvenient to deal with the clerks of all these various courts when DOJ Tax had the decisions in a central location. Tax Analysts made FOIA requests for DOJ Tax's copies of the decisions, which DOJ Tax Division regularly receives as a party litigant. DOJ Tax resisted, urging in the final analysis that FOIA should not be used to obtain documents otherwise publicly available simply for the convenience of the requester. The Supreme Court handily found that the opinions met the requirements for disclosure -- i.e., they were agency records and DOJ Tax had improperly withheld them.

There is no requirement under FOIA that the agency create records or that it use its powers (such as summonses or of persuasion) to obtain records that it does not have. The requirement is that it produce records that it does otherwise have.

³²⁶ 5 U.S.C. § 552.

³²⁷ See NLRB v. Robbins Tire & Rubber Co., 437 U.S. 214, 242 (1978).

FOIA is not the same as discovery in litigation. In litigation, discovery requires relevance to the pending dispute.³²⁸ FOIA is based on the imperative of an informed citizenry. Thus, the requester under FOIA need not state a reason for the request. The reason is irrelevant.

C. Key Exemptions from FOIA.

FOIA provides exemptions that permit the agency (here the IRS) to withhold information when countervailing public interests are involved. When the agency relies upon the exceptions, the agency must prove its entitlement to assert the exceptions.

The key exemptions that you will face as a tax practitioner are as follows:

1. Exemptions by Statutes Other than FOIA.

FOIA exempts information that may or must be withheld by statute.³²⁹ **Section 6103**, discussed in Chapter 4, prohibits the IRS from disclosing tax return information of a taxpayer. That information may be disclosed to the taxpayer involved, but the information generally may not be disclosed to persons other than the taxpayer involved or, in some cases, persons in close nexus to the taxpayer. Thus, I cannot obtain via FOIA request the return information of my neighbor, business colleague or enemy. Despite FOIA, the IRS is exempt from responding to requests for tax return information of another taxpayer. I cover in more detail the limitations of § 6103 below the next chapter (pp. 107 ff.).

2. Agency Deliberative Memoranda and Documents Unavailable in Litigation.³³⁰

This exemption protects pre-decision deliberative process documents that would not be available in discovery in litigation.³³¹ The exemption's purpose is to avoid the chilling effect that threat of disclosure would bring to such pre-decisional processes. The proper functioning of Government, it is felt, is best shown by the documents and information reflecting the decision that is made. While the pre-decisional deliberative considerations might be helpful to an informed citizenry, on balance, Congress felt that the system would work better if the predecision deliberative documents were not subject to FOIA.

³²⁸ FRCP Rule 26(b)(1) (“Parties may obtain discovery regarding any matter, not privileged, that is **relevant** to any party’s claim or defense * * *.” (Emphasis supplied).) The other judicial forums for relevant litigation (tax litigation) have the same relevance requirement for discovery. Court of Federal Claims Rule 26(b)(1); and Tax Court Rule 70(b).

³²⁹ § 552(b)(3).

³³⁰ § 552(b)(5).

³³¹ NLRB v. Sears, Roebuck & Co., 421 U.S. 132, 149 (1975).

As interpreted, the exemption covers information that would be subject to three evidentiary privileges in litigation: the deliberative process privilege, the attorney-client privilege and the attorney work-product privilege.³³²

An example of a predecision document is a memorandum of the recommendations or opinions on legal or policy matters of Government personnel involved in making a decision but who do not make the final decision.³³³ In a prominent case,³³⁴ an individual of some public notoriety (the Reverend Sun Myung Moon) was considered for criminal prosecution. The IRS recommended prosecution, so that the matter came under the jurisdiction of the DOJ Tax. Within DOJ Tax, the responsibility for approving or declining prosecution is normally with the Chief of the Criminal Enforcement Section (“CES”). However, the Chief of CES reports to and is subject to the direction of a Deputy Assistant Attorney General for the DOJ Tax, who is in turn subject to the direction of the Assistant Attorney General for DOJ Tax. It appeared that the Chief of CES had decided that Rev. Moon not be prosecuted, but that decision was overruled by the Assistant Attorney General who authorized prosecution. The Court held that the memorandum of the Chief of CES was predecisional and thus not subject to disclosure under FOIA.

I discuss the attorney-client privilege and work product privileges below in the context of privileges potentially applicable in an IRS examination (audit or criminal investigation) process. Suffice it to say here that, if the documents within the scope of the FOIA request are subject to those privileges, they may be asserted by the IRS as an exemption to FOIA disclosures.

3. Records for Law Enforcement Purposes.³³⁵

This exemption generally exempts agencies from disclosing a significant portion of its criminal investigation files, including in the case of the IRS criminal tax investigations. Still, purely fact based documents and other information may be discoverable in IRS criminal investigations despite this exemption. Many practitioners routinely file FOIA requests in criminal investigations in the hope that something of value will be learned. The worst that can happen is that the IRS will say no. But it might not say no or it might release documents for which it arguably could have asserted an exemption and did not.

An important category of law enforcement documents exempt from disclosure are documents that might identify a confidential informant. Because of the importance of the general rule requiring open disclosure of government operations, the Supreme Court has held that an agency does not qualify for withholding agency records simply by chanting informant's exception when it does not want to disclose. The agency must prove that the informant gave the information under circumstances where the informant was given express assurances of confidentiality or the circumstances indicate that such assurances were necessarily assumed by the agency and the

³³² Burka v. HHS, 87 F.3d 508, 516 (D.C. Cir. 1996).

³³³ Vaughn v. Rosen, 523 F.2d 1136, 1143-44 (D.C. Cir. 1975).

³³⁴ Heggestad v. United States Department of Justice 182 F.Supp.2d 1 (D. D.C. 2000).

³³⁵ § 552(b)(7).

informant.³³⁶ The Court refused to assume that, merely because a citizen gave information to the FBI, there was an assurance, express or implied, of confidentiality.

D. Procedural Aspects.

1. General.

Each agency is required to adopt regulations and procedures for handling FOIA requests. The IRS has done so at Regs. § 601.702. The following are some of the key items in those regulations:

- For items of more general interest, the IRS maintains a FOIA Reading Room at the IRS National Headquarters. This would include items that are not taxpayer specific or have had the taxpayer specific information redacted. Tax publications often routinely print this information (or some selected subset of it).
- The form of the specific request is set forth.³³⁷ This information includes the IRS office to which the request is to be directed.
- Procedures for appeal of a decision to withhold all or part of any record.

2. The Redaction Process.

When the agency asserts exemptions from disclosure, it will often do so by “**redacting**” (i.e., blacking out) the portion of the document qualifying for the exemption or, where the entire document qualifies for the exemption, withholding the document altogether. If the agency handles the matter properly, it will advise the requester of which documents have been withheld and the exemption relied upon and, as to documents provided subject to redaction, which exemptions justify the specific redactions. Often, however, the agency will paint in broad strokes -- for example, saying that 40 documents have been withheld based on the informant's privilege. In those cases (and often even where the agency even provides a more particular identification of the documents (such as memo to Joe Blow from Sam Spade dated 1/1/94)), the requester will have no way of assessing whether the agency properly asserted an exemption.

The redaction process is the same that is used in discovery in civil litigation or pursuant to compulsory process (such as the IRS summons or a grand jury subpoena, that I cover later in this text). By redacting, the person seeking the information in the documents is given the portion that is not exempt from disclosure without disclosing the portion that is.

3. Appeals and Judicial Review.

The requester then may pursue an administrative appeal within the agency and, if still dissatisfied (usually because she is unable to assess the propriety of the exemption asserted), the

³³⁶ United States DOJ v. Landano, 508 U.S. 165 (1993).

³³⁷ Regs. § 601.702(c)(4).

requester can seek judicial review of the claim(s) for exemption. In that judicial review, the Government may provide, if it has not done so during the administrative consideration, a so-called Vaughn index.³³⁸ The index is the FOIA equivalent of a privilege log in civil litigation. The index should provide as much description as possible of the withheld documents without disclosing the information claimed to be exempted from disclosure. The Government will then, usually, file a motion for summary judgment and submit declarations³³⁹ of agency personnel asserting the basis for the claimed exemptions. Some or all of the declarations and attachments may be submitted in camera, if necessary to preserve the exemption claimed pending resolution by the court. The Government may produce voluntarily or upon order of the court the underlying documents for in camera inspection for the court to rule upon the validity of the claimed exemptions. The court will then rule.

The requester or the Government may then appeal to the Court of Appeals and then to the Supreme Court via the certiorari process.

Obviously, throughout this court process, the requester is operating blindfolded. The requester does not know whether an exemption is claimed properly. The requester thus must file his initial complaint and appeals without the usual due diligence required to determine whether the suit or the appeal has a basis in the underlying merits. The system contemplates that the requester has a right to a trial level consideration and an appeals consideration to have the courts test whether the exemption was properly claimed, even if the requester does not know whether it was properly claimed.

E. Practical Uses of FOIA in a Tax Setting.

1. Discovery of the Audit.

Many practitioners routinely file a FOIA request during the course of or at the conclusion of an IRS audit or criminal investigation.³⁴⁰ Alternatively, by carefully watching the agent's activities and keeping in communication (including asking questions), the practitioner may already know what is in the agent's files. Another alternative in a civil examination is to ask the IRS Appeals Officer for access to the files and, usually (local practice should confirmed), the information

³³⁸ The name is from a leading case, Vaughn v. Rosen, 484 F.2d 820 (D.C. Cir. 1973). For a case discussing the role served by the Vaughn index in insuring an adequate judicial review, see Batton v. Evers, 598 F.3d 169 (5th Cir. 2010).

³³⁹ Declarations are an affidavit-equivalent for Government employees.

³⁴⁰ See Charles P. Rettig, FOIA Requests: A Look into the IRS Examination File, 128 Tax Notes 877 (Aug. 23, 2010) (arguing that “The information received will almost always justify the limited effort required to submit a FOIA request.” and that “If not requested, the information will not be forthcoming. If requested, the responsive information may be the key to a favorable resolution.”)

otherwise available under FOIA will be provided informally.³⁴¹ One problem with waiting to ask the Appeals Officer is that any new information discovered will not have been addressed in the protest for a non-docketed appeal or in the petition for a docketed appeal. Of course, the taxpayer can always make supplemental submissions or arguments to address any new matters finally discovered on review of the files, but in many cases it will be strategically better to know about the information before taking a position in the protest in a non-docketed case or the petition in a docketed case.

2. Discovery in the Criminal Investigation.

Criminal investigators keep the fruits of the investigation close to the vest. Practitioners will often have less assurance that they know what is in the agent's files. FOIA requests are often made to obtain discovery. However, a key exception under FOIA is with regard to investigatory records and enforcement proceedings,³⁴² as well as the confidential informant exception. A FOIA request thus may not produce the sensitive matters, but may give important information, nevertheless, particularly in clues that might be derived from the exceptions asserted.

Remember in this context to request the IRS's records and, if DOJ Tax was involved in the investigation (a process we discuss below), DOJ Tax's records also.

3. Other.

The foregoing are the practical uses of FOIA for the ordinary practitioner. However, FOIA and a related provision -- § 6110 -- have been extraordinarily useful to tax practitioners generally to obtain access to so-called "hidden law" of the IRS. For example, I discussed in Chapter 2 private letter rulings (PLRs) issued by the IRS National Office to individual taxpayers requesting them. The rulings may contain key IRS interpretations and policy decisions as to law and procedure. FOIA was used early as a fulcrum for access to these documents, and § 6110 now specifically requires that the IRS disclose determination letters (of which private letter rulings are a class), subject to redaction of taxpayer specific information. There is thus some overlap between FOIA and § 6110.

FOIA continues to be available for documents not within the scope of § 6110 (either actually or because the IRS takes the position otherwise). The IRS, of course, redacts the taxpayer specific information so that there are no prohibited return disclosures and the taxpayer's identity is, at least theoretically, not obtained. Similarly, other types of internal guidance documents, however denominated (such as Chief Counsel Memoranda, Field Service Advice, Litigation Memoranda, etc.), which meet the requirements of FOIA documents have been required to be produced, again

³⁴¹ See Kathleen David, Ex Parte Rule Working Smoothly; Little Change Seen in Practice, Cycle Time, 151 DTR G-7 (2001) ("It is the IRS's position that the administrative record -- the file forwarded to Appeals when a taxpayer protests a proposed adjustment -- is not an ex parte communication, but that if a taxpayer wants a copy of any document in the file it should be provided* * * *").

³⁴² § 552(b)(7)(A).

stripped of taxpayer specific information. Publishers such as Tax Analysts regularly request and obtain such documents and publish them for private practitioners.

There are, of course, continuing but narrowing disputes with the IRS as to which of its otherwise internal documents must be disclosed under FOIA.

II. Privacy Act.

The Privacy Act³⁴³ generally regulates an agency's disclosure of information about a citizen. In summary,³⁴⁴ the Privacy Act:

- Permits an individual to have access to records containing personal information on him for purposes of inspection, copying, and, with certain exceptions including tax records, correction;
- Makes known to the American public the existence and characteristics of all “systems of records” of Federal agencies containing information about individuals;
- Limits availability of records containing personal information to agency employees who need to access them in the performance of their duties;
- Requires agencies to keep an accurate accounting of disclosures and make such an accounting available to the individual;
- Requires agencies to publish in the Federal Register the routine disclosures that are made of their information outside of the agency (“routine uses”) and establish procedures for access;
- Provides a civil remedy for individuals who have been denied access to their records or whose records have been used or disclosed in contravention of the Act.

There is substantial overlap in tax matters with § 6103 of the Code, and the courts are not consistent on whether § 6103 pre-empts the Privacy Act.³⁴⁵ Accordingly, I ask you to focus on § 6103 (next chapter) for purposes of this course.

³⁴³ 5 U.S.C. § 552a.

³⁴⁴ This summary is verbatim from a summary in Treasury Dept. Office of Tax Policy, Report to The Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions (October 2000), pp. 29-30.

³⁴⁵ Cases holding that § 6103 pre-empts the privacy act in the areas of overlap include Lake v. Rubin, 62 F.3d 113 (D.C. Cir. 1998), cert. denied, 526 U.S. 1070 (1999); Cheek v. United States, 703 F.2d 271 (7th Cir. 1983); and Gardner v. United States, 213 F.3d 735 (D.C. Cir. 2000).

Ch. 4. Confidentiality and Disclosure of Return Information.

I. Introduction.

Management of our tax system requires that the IRS have a significant amount of information regarding a taxpayer. Not only will the IRS have the taxpayer's returns, but the IRS will have significant additional information, particularly information developed in an audit. Societally, we have determined that most of this information is the type of information that should be confidential. Why is that? Because Congress was concerned that the critical revenue function of Government would be jeopardized if citizens were not **generally** assured that the information the IRS gathers about them would not be broadcast outside the agency.³⁴⁶ (The devil is in the word “generally,” because the exceptions are many; first, more on the background of the confidentiality rules.)

At one time, the IRS was a “lending library” to other government agencies, state and federal. The worst form of this problem was brought to light as a sidelight of the now infamous Watergate scandal. The congressional hearings showed that President Nixon (as well as some other Presidents before him) had used or attempted to use the IRS to serve political agendas -- by obtaining return information to use against enemies (real or perceived) and causing the IRS to target enemies (real or perceived).³⁴⁷ Less egregious to Congress but still troublesome was the fact that the IRS would make return information available to other government agencies -- state and federal -- for any number of purposes having nothing to do with the revenue function or with any other identified national priority. Congress determined that this floodgate of information to other agencies was harmful to the critical revenue function of the IRS and the Code. Congress believed that taxpayers would be less willing to report and pay voluntarily and would be less cooperative in audits if the information thus provided were too freely available. Accordingly, after Watergate in the mid-70s, Congress substantially revised § 6103 to provide taxpayers more assurance that, except in specific Congressionally approved instances, the information the IRS gathers about taxpayers will not be disclosed. **[Note to Students regarding reading § 6103: don't read it in its entirety; read only the specific subsections cited in the text below.]**

As we will see below, the enforcement mechanism for the confidentiality rules are (1) significant felony criminal penalties for a person wrongfully disclosing return information and (2) potentially significant civil damages (including punitive damages) that a taxpayer may recover from the United States for wrongful disclosures. First I turn to the legal parameters and thereafter discuss the punishments and remedies.

³⁴⁶ See S. Rep. No. 94-938, 94th Cong., 2d Sess. Pp. 317-317(1976).

³⁴⁷ Joint Committee on Taxation, Study of Present-law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998, Volume. 1: Study of General Disclosure Provisions (JCS-1-00), pp. 3-4 (January 28, 2000) (hereafter referred to as “JCT Confidentiality and Disclosure Study”).

II. Definitions.

The statute defines key terms in § 6103(b). Some are self-evident, but some are not. For example, § 6103(b) defines return as you would expect to cover the submissions a taxpayer makes on a return (or an attached schedule).³⁴⁸ Other key definitions that may not be so intuitive are:

A. Return Information.

“Return Information” is virtually everything the IRS has about the taxpayer. This includes the return, results of audit activities, private letter ruling requests and virtually everything else other than information that might otherwise be return information but which cannot be associated with a particular taxpayer.³⁴⁹

B. Taxpayer Return Information.

Taxpayer return information is return information under the foregoing definition which has been filed with or furnished to the IRS by the taxpayer.³⁵⁰ For example, a taxpayer return itself is taxpayer return information, whereas an affidavit submitted by a third party during the audit of the taxpayer's return is not taxpayer return information. The latter, of course, is return information; it is just not taxpayer return information as defined because the taxpayer did not submit it.

It is important to focus on the concept of return information and its nexus to a taxpayer. For example, if a tax shelter promoter is investigated, the information gathered may be the return information of the tax shelter promoter and the return information of a taxpayer who invested in the shelter.³⁵¹

III. General Rule - Return Information is Nondisclosable.

The general rule is that return information may not be disclosed. § 6103(a). As noted, return information is defined to include the return and virtually all information the IRS has about a taxpayer, including information developed in an audit and other information gathered by the IRS about a taxpayer. § 6103(b).

IV. Exceptions – Must be Congressionally Approved.

Congress provided many exceptions to the general rule of nondisclosability. Some may think that the exceptions, which seem to go on endlessly in the Code, swamp the general rule. Basically, the exceptions represent congressional judgments that, as important as is the general rule,

³⁴⁸ § 6103(b)(1).

³⁴⁹ § 6103(b)(2).

³⁵⁰ § 6103(b)(3).

³⁵¹ Solargistic Corp. v. United States, 921 F.2d 729 (7th Cir. 1991); Millennium Mktg. Gp., LLC v. United States, 2010 WL 1768235 (S.D. Tex. 2010).

there are some areas in which there must be exceptions. The key exceptions that you will encounter as a tax practitioner are as follows:

A. Taxpayer, Related Persons and Material Interest Disclosures.

The IRS must disclose the taxpayer's return to the taxpayer or the taxpayer's authorized representative.³⁵² The IRS generally "may" also disclose return information to the taxpayer or his or her representative unless it determines that the disclosure would "seriously impair Federal tax administration."³⁵³ Thus, to take an example, the IRS **may** disclose such return information developed in a criminal investigation to the taxpayer or his or her representative but is not compelled to disclose it.

The representative of the taxpayer must have written authority of the taxpayer to receive return information from the IRS. The taxpayer grants the authority by a power of attorney – **Form 2848** we discussed above (which is the form for general representation of the taxpayer with respect to the tax form and periods indicated on the document) or the more limited **Form 8821**, Tax Information Authorization ("TIA").

The IRS may also disclose return information to certain persons having some relationship to the taxpayer.³⁵⁴ These relationships are based upon some need to know grounded in tax administration considerations. The IRS may also withhold in these cases also if the disclosure would "seriously impair Federal tax administration."³⁵⁵ Let's just catalogue a few:

(1) Direct Family Members.

(a) Spouse. Joint returns may be disclosed to either spouse.³⁵⁶ If, with respect to a joint return, the spouses are no longer married or living together, the IRS must disclose upon request from one spouse information related to the collection activity against the other spouse.³⁵⁷ Also, returns of one spouse may be disclosed to the other spouse as needed with respect to split gifts.³⁵⁸

(b) Child. Returns of a parent may be disclosed to a child or child's legal representative as needed to comply with the child's obligation to use the parent's tax rate.³⁵⁹

³⁵² § 6103(e)(1)(A)(i).

³⁵³ § 6103(c) (as to taxpayer's representative) and 6103(e)(7) (as to taxpayer and others otherwise having access).

³⁵⁴ See § 6103(e).

³⁵⁵ § 6103(e)(7).

³⁵⁶ § 6103(e)(1)(B).

³⁵⁷ § 6103(e)(8).

³⁵⁸ § 6103(e)(1)(A)(ii).

³⁵⁹ § 6103(e)(1)(A)(iii).

(2) Partnerships. Returns of a partnership or S Corporation may be disclosed to a partner or shareholder, respectively.³⁶⁰

(3) Corporations. Returns of a corporation may be disclosed to an authorized representative of the corporation or any bona fide shareholder owning 1 percent or more of the stock.³⁶¹

(4) Estates. Returns of an estate may be disclosed to (a) the executor or administrator or (b) to a beneficiary, next of kin, or heir if the IRS determines the person has a legitimate interest in accessing the information.³⁶² Similarly, those same categories of persons may access the return information of the decedent.³⁶³

(5) Trusts. Returns of a trust may be disclosed (a) to a trustee or (b) to any beneficiary if the IRS determines the person has a legitimate interest in accessing the information.³⁶⁴

(6) Incompetents. Returns of incompetents may be disclosed to “to the committee, trustee, or guardian of his estate.”³⁶⁵

(7) Trustees in Bankruptcy Cases. Returns of bankrupts in certain bankruptcy cases may be disclosed to the bankruptcy trustee.³⁶⁶

(8) Return Information for All of the Above. Return information (that is the IRS information related to the taxpayer's return other than the return itself) may be disclosed to the foregoing persons if the IRS determines that such disclosure will not impair tax administration.³⁶⁷

(9) Trust Fund Penalty Collections. That trust fund recovery “penalty” (“TFRP”) is an enforcement mechanism to collect the withholding and FICA tax an employer withholds from an employee’s salary). Persons related to the employer who have the responsibility to collect and remit the withheld tax to the IRS are subject to the penalty. The penalty may attach to multiple responsible persons within a single employer, but the underlying tax amount may only be collected once in the aggregate from the taxpayer and all responsible persons. The IRS must disclose if requested by any person liable for the penalty (a) whether any other person also has been determined to be liable and (b) whether there have been collection efforts against such other person or

³⁶⁰ § 6103(e)(1)(C) & 6103(e)(1)(D)(v).

³⁶¹ § 6103(e)(1)(D).

³⁶² § 6103(e)(1)(E).

³⁶³ § 6103(e)(3). See Rev. Rul. 2004-68, 2004-31 I.R.B. 118 (applying the provision for heirs at law and next of kin of an intestate decedent to inspect the decedent’s income tax return for the calendar year preceding death).

³⁶⁴ § 6103(e)(1)(F).

³⁶⁵ § 6103(e)(2).

³⁶⁶ § 6103(e)(4) & (5).

³⁶⁷ § 6103(e)(7).

persons.³⁶⁸ I shall deal in some detail later in the text with the responsible person penalty which is a prominent feature of a tax controversy practice (pp. 704 ff.).

B. Tax Administration Disclosures.

1. Disclosures Within the IRS.

Disclosures within the IRS are on a reasonable need to know basis only.³⁶⁹ In order to police this mandate, the IRS has developed in its computer system the ability to track persons accessing return information by keeping an “audit trail.” Obviously, the system is not perfect, so there are prosecutions of IRS personnel who access return information of friends and foes.

2. Criminal Tax Enforcement.

The IRS investigates criminal violations of tax duties. Prior to a referral to DOJ, the IRS is the only federal agency authorized to investigate tax crimes.³⁷⁰ The IRS, however, does not prosecute tax crimes or conduct grand jury investigations with respect to tax crimes. DOJ prosecutes tax crimes and conducts the grand jury investigations of tax crimes. Accordingly, there is an exception to § 6103 permitting the IRS to disclose tax return information regarding tax crimes to the Department of Justice through a process called a “referral.”³⁷¹

3. Disclosures to DOJ for Civil Tax Litigation.

Civil tax litigation is conducted in the district courts and Court of Federal Claims where DOJ Tax conducts the litigation. The IRS may disclose tax return information relevant to the tax litigation being handled by DOJ Tax.³⁷²

³⁶⁸ § 6103(e)(9).

³⁶⁹ § 6103(h)(1); see ECC 2--036036 (7/2/09), reprinted at 2009 TNT 171-77 (“Need to know means reasonably necessary to do the job correctly, efficiently, economically. It does not require a “cannot function without it” level of need.”).

³⁷⁰ See Webster Commission, Review of the Internal Revenue Service’s Criminal Investigation Division (April 1999) from William H. Webster and the Criminal Investigation Division Review Task Force (often referred to as the “Webster Report”), p. 1 (“CI is the only agency that can investigate potential criminal violations of the Internal Revenue Code.”). This mantra has been repeated frequently by the IRS. (I have blogged on this issue; the link for the blog is [here](#).)

³⁷¹ § 6103(h)(2) & (3). For an interesting case where DOJ Tax used discovery in a pending tax case to obtain information about third party taxpayers that, because of this limitation on obtaining information from the IRS, DOJ Tax could not have obtained from the IRS, see Jade Trading LLC v. United States (Ct. Fed. Cl. 2005) (discovery opinion unofficially reproduced at 2005 TNT 80-11).

³⁷² § 6103(h)(2) & (3). For limits upon what may be disclosed, see In Re United States, 669 F.3d 1333 (Fed. Cir. 2012) (construing (h)(2) and (h)(4) and denying a taxpayer to obtain in discovery return information of another taxpayer because not “directly related” to the taxpayer’s

4. Disclosures as Necessary for Audits and Investigations.

Section 6103(k)(6) authorizes the IRS to disclose return information in an audit, collection or civil or criminal tax investigation, but only “to the extent that such disclosure is necessary in obtaining information, which is not otherwise reasonably available.” In order to conduct audits and criminal tax investigations, the IRS often contacts third parties for information and/or documents. The IRS officer must identify himself or herself and generally must state the purpose of the contact and requests for information and/or documents. The taxpayer under investigation will be identified.

The Fifth Circuit distilled the teaching of the cases as to when a disclosure is necessary under this exception:

* * * an IRS agent may disclose return information during an investigation in order to obtain information, provided three requirements are met: (1) the information sought is “with respect to the correct determination of tax, liability for tax, or the amount to be collected or with respect to the enforcement of any other provision of the [Internal Revenue Code],” (2) the information sought is “not otherwise reasonably available”, and (3) it is “necessary to make disclosures of return information in order to obtain the additional information sought.”³⁷³

This is a significant problem in a criminal investigation. The third parties contacted by the IRS may be customers, clients or patients of the taxpayer being investigated and merely being advised that the taxpayer is under criminal investigation can have serious detrimental effects to the taxpayer. Moreover, the taxpayer may lose social standing among his friends and colleagues.

A serious controversy has raged as to whether it is necessary for the IRS to advise such third party contacts that the taxpayer is under criminal investigation. That might be obvious from the fact that the agent is a “Special Agent” -- i.e., a CI agent who only conducts criminal investigations -- or the nature of the questions. But the narrow issue is whether it is necessary to disclose specifically that the taxpayer is under criminal investigation. The courts have taken different tacks on this, so be sensitive to the issue in your practice. In addition, it is likely that there will be legislation giving more guidance on how the CI Special Agent may identify himself or herself and the nature of the investigation.

An even more subtle issue is whether third party contact and the return information disclosures that attend it is “necessary” when the taxpayer has indicated willingness to supply the information. In the Fifth Circuit’s decision in Payne v. United States,³⁷⁴ the taxpayer had indicated a willingness to cooperate to get information to the IRS’s criminal investigation agent, but the agent

liability).

³⁷³ Payne v. United States, 289 F.3d 377, 382 (5th Cir. 2002), citing DiAndre v. United States, 968 F.2d 1049, 1052 (10 Cir. 1992); and Barrett v. United States, 795 F.2d 446, 449 (5th Cir. 1986).

³⁷⁴ Supra, n. 373.

nevertheless contacted third persons to gather information that, at least arguably, the taxpayer was willing to produce. The Fifth Circuit rejected the United States' argument that it is always entitled to seek information from third parties without considering the taxpayer himself as a reasonably available source of the same information. The Court said that an earlier precedent "implicitly considers the taxpayer a 'reasonably available' source of necessary information." The Court specifically rejected the Government's argument that it must be allowed to contact third parties in order to corroborate information from the taxpayer. The Court indicated that, in appropriate cases, it might be permissible for the IRS to contact third parties to corroborate, but the IRS should first consider the taxpayer as an available source of the information and contact third parties only when there is reasonable basis to assume that the taxpayer source is not adequate. The Court concluded by saying:

We do not hold that the taxpayer is always such a fruitful and reliable source of information that IRS agents may never approach third-parties for necessary information. We hold only that such a determination must be made in light of the "facts and circumstances of the case," and that the taxpayer's cooperation legitimately forms part of the inquiry.³⁷⁵

Fearing that these interpretations of improper return information disclosures might hamper its ability to conduct legitimate investigations, the IRS promulgated regulations under § 6103(k)(6) addressing the authority to disclose in connection with official duties. In pertinent part, the disclosure is authorized if the IRS officer "reasonably believes it is necessary to obtain information to perform properly the activities connected with carrying out" official duties.³⁷⁶ The Regulations continue as follows: "The term necessary in this context does not mean essential or indispensable, but rather appropriate and helpful in obtaining the information sought."³⁷⁷ Finally, the Regulations provide:

Information not otherwise reasonably available means information that an internal revenue or TIGTA employee reasonably believes, under the facts and circumstances, at the time of a disclosure, cannot be obtained in a sufficiently accurate or probative form, or in a timely manner, and without impairing the proper performance of the official duties described by this section, without making the disclosure. This definition does not require or create the presumption or expectation that an internal revenue or TIGTA employee must seek information from a taxpayer or authorized representative prior to contacting a third party witness in an investigation. Neither the Internal Revenue Code, IRS procedures, nor these regulations require repeated contacting of an uncooperative taxpayer. Moreover, an internal revenue or TIGTA employee may make a disclosure to a third party witness to corroborate information provided by a taxpayer.³⁷⁸

³⁷⁵ Payne, p. 377.

³⁷⁶ Regs. § 301.6104(k)(6)-1T(c)(1).

³⁷⁷ Id.

³⁷⁸ Regs. § 301.6104(k)(6)-1T(c)(3).

5. Disclosures to State Tax Authorities.

The IRS is permitted to disclose to state tax authorities tax return information relevant to state tax liabilities, provided certain procedures are followed.³⁷⁹ The general requirement is some type of written request from the State Tax Agency. Depending upon agreements with the state and practices pursuant to the agreements, the state tax authority may be notified upon completion of a federal tax audit. Some states have piggyback taxes (i.e., taxes based on the federal taxes) or tax regimes that substantially parallel the federal tax. Hence, a federal tax adjustment upon audit can quickly be turned into a state tax adjustment. Moreover, even when the results are not shared routinely, often the state statute of limitations will remain open until the taxpayer notifies the state of a federal audit. For this reason, in handling a federal tax audit, a good practitioner will be sensitive to potential issues in the state system that may arise from the federal audit.

6. Disclosures in Judicial and Administrative Proceedings if Directly Related to the Resolution of the Issue in the Proceeding.

The IRS may disclose return information of a person other than the taxpayer involved in the proceeding if the return information is “directly related to the resolution of an issue in the proceeding.”³⁸⁰ Suffice it to say that return information that might indicate that another taxpayer got different tax treatment for a similar item is not directly related to the issue of how the taxpayer in the proceeding should be treated and thus would not be disclosable.³⁸¹

C. NonTax Criminal Enforcement.

1. Ex Parte Order or High Level Request Required.

Return information may be disclosed only upon (a) an ex parte order from a U.S. District Judge (Article III) for purposes of investigating (including grand jury investigation) or trying any nontax criminal case or (b) a head of Department (with certain narrow exceptions) request to the IRS for the information.³⁸² There are some built-in procedural safeguards – such as reasonable cause to believe that a specific nontax crime has been committed and that the information not be reasonably available through other sources; suffice it to say that in some nontax criminal investigations and prosecutions return information may be available. The important point in this area, of course, is that requesting and obtaining the return information is not a matter of routine.

³⁷⁹ § 6103(d)(1).

³⁸⁰ § 6104(h)(4)(B).

³⁸¹ In Re United States, 669 F.3d 1333 (Fed. Cir. 2012) (issuing the extraordinary writ of mandamus to overturn an interim order of the trial court to the contrary)

³⁸² § 6103(i)(1) & 6103(i)(2). See United States v. Ajuda, 2013 U.S. Dist. LEXIS 73003 (D NM 2013) (in nontax prosecution for conspiracy, bank fraud and identity theft related to bank fraud).

2. Exception for Crimes and Emergencies.

The IRS may disclose return information (other than taxpayer return information, i.e., return information supplied by the taxpayer) to advise federal agencies of possible federal crimes.³⁸³ Further, the IRS may disclose return information in cases involving imminent danger of death or bodily injury or flight from federal prosecution.³⁸⁴

3. Other.

There are other exemptions of this genre but you should get the flavor that, while the IRS is not a “lending library” in nontax criminal enforcement because of the procedural safeguards, return information can be obtained for nontax federal criminal enforcement purposes.

D. To Congress.

1. Tax Committees and JCT.

The IRS may disclose to the Congressional tax committees (House Ways and Means Committee and Senate Finance Committee) upon written request of the chair of the Committee, but any return information that could be associated with or identify the taxpayer may only be disclosed in closed executive session.³⁸⁵

The IRS may also disclose return information to the Chief of Staff of the Joint Committee on Taxation (“JCT”), provided that the information can then be disclosed to the Congressional tax committees under the same conditions for disclosure directly to the tax committees.³⁸⁶ Staff or agents of the Congressional tax committees (including the JCT) may review the information.³⁸⁷ A “whistleblower” (such as an IRS agent) who has return information may disclose to the Congressional tax committees or agents of such committees (as defined) if he or she believes the information relates to possible misconduct, maladministration or taxpayer abuse.

2. Other Committees.

The IRS may disclose to non tax committees upon all of the following being satisfied: (a) action of the committee to request the information; (b) written request of its chair; and (c) concurrent resolution of the Houses specifying the need for the information and its unavailability from other

³⁸³ § 6103(i)(3)(A).

³⁸⁴ § 6103(i)(3)(B).

³⁸⁵ § 6103(f)(1).

³⁸⁶ § 6103(f)(2).

³⁸⁷ § 6103(f)(4)(A).

sources. The information may be disclosed in closed executive session to the requesting committee.³⁸⁸ Only limited staff of the committee may review the information.³⁸⁹

In addition, the General Accounting Office (“GAO”), an investigative arm of Congress, may have access to return information under certain circumstances.³⁹⁰

E. To the President.

The IRS may disclose return information to the President only in limited circumstances. The IRS is required to disclose if the President provides the following information: (1) the name and address of the taxpayer; (2) the kind of return or return information to be disclosed; (3) the taxable periods involved; and (4) the specific reason for the request.³⁹¹ Return information may also be disclosed to the President for Presidential appointees.³⁹² The staff to whom this information may be disclosed cannot further disclose without express written authority from the President.³⁹³

F. Tax-Exempt Organizations.

Congress determined that the public has a legitimate interest in disclosure of certain information regarding tax-exempt entities, which by virtue of their tax exemption are indirectly subsidized by the public. Certain categories of tax-exempt organization documents and information are excepted from the general prohibition of § 6103.³⁹⁴ The IRS must release the following in unredacted form: approved applications for tax-exempt status, certain related documents, and annual information returns filed by tax-exempt organizations.

G. Exchange of Information Under Treaties.

The United States has treaties that provide for mutual exchange of return information. An exception is therefore provided for disclosures under those treaties.³⁹⁵ The U.S. or treaty partner taxing authority receiving information under the treaty is required:

to treat any information received as secret in the same manner as information obtained under its domestic laws. In general, disclosure is not permitted other than to persons or authorities involved in the administration, assessment, collection or enforcement of taxes to which the treaty applies.³⁹⁶

³⁸⁸ § 6103(f)(3).

³⁸⁹ § 6103(f)(4)(B).

³⁹⁰ § 6103(i)(7).

³⁹¹ § 6103(g)(1).

³⁹² § 6103(g)(2).

³⁹³ § 6103(g)(3).

³⁹⁴ § 6104.

³⁹⁵ § 6103(k)(4).

³⁹⁶ JCT Confidentiality and Disclosure Study, Volume 1, pp. 59-60.

I discuss the exchange of information under treaties and other conventions in more detail later in the text (pp. 455 ff.).

There is a relevancy limitation for permitted disclosures under treaties. For example, the Japanese Double Tax Treaty provides for “[t]he competent authorities of the Contracting States shall exchange such information as is **pertinent** to carrying out the provisions of this Convention or preventing fraud or fiscal evasion in relation to the taxes which are the subject of this Convention.”³⁹⁷ So the argument goes, if the information shared with the treaty partner competent authority is not pertinent to the treaty partner’s tax compliance duties, it is not an authorized disclosure. In terms of § 6103 analysis, the information is return information but it cannot be disclosed unless pertinent to the treaty partners’ tax administration. And, to close that loop, a court has held that the disclosure of knowingly false information to the treaty partner competent authority is not an authorized disclosure under the statutory authorization as implemented by the U.S. Japan Double Tax Treaty.³⁹⁸ The 2006 U.S. Model Tax Treaty has a similar limitation using the word relevant rather than pertinent.³⁹⁹ The OECD Model, used by most developed countries, has a similar limitation using the words “foreseeably relevant.”⁴⁰⁰

H. Other Permitted Disclosures.

Section 6103 contains a plethora of other permitted disclosures. All are grounded in some perception of national priority that trumps the general need for secrecy. I shall not expect you to know these other exceptions for this class. You should, however, know that, when you practice in this area, you simply have to slug through the various and many permitted disclosures to assess risks of disclosure for your client and remedies that may be available for wrongful disclosure. Your intuition based on the foregoing examples should also give you a sense of when a national priority exists for which Congress might have provided an exception. But you still must read the statute, because sometimes Congress' sense of national priorities may be different than what you think it is or should be.

³⁹⁷ U.S. Japanese Double Tax Treaty, Art. 26, ¶ 1 (bold face added), as quoted in Aloe Vera of America, Inc. v. United States, 699 F.3d 1153 (9th Cir. 2012).

³⁹⁸ Aloe Vera of America, Inc. v. United States, 699 F.3d 1153 (9th Cir. 2012) (“information known to be false cannot be subject to protection as ‘pertinent’ information under the Tax Treaty.”); Aloe Vera of Am., Inc. v. United States, 2015 U.S. Dist. LEXIS 16605 (D. Ariz. 2015).

³⁹⁹ Art. 26, ¶ 1 (“The competent authorities of the Contracting States shall exchange such information as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes * * *”).

⁴⁰⁰ OECD Model Tax Convention, Art. 26, ¶ 1, as approved 7/12/12 (“The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes * * *”).

I. Accounting for Disclosures and Annual Report on Disclosures.

The IRS is required to maintain a record of disclosures under § 6103.⁴⁰¹ The IRS is also required to make annual reports to the Joint Committee on Taxation (“JCT”) on disclosures under § 6103.⁴⁰² The JCT then reports the same results to the public.⁴⁰³ I provide certain select data from the report for 2014⁴⁰⁴ to give you an idea of the magnitude and scope of the disclosures:

Disclosure To/For	IRC Section 6103 Subsections	Bulk Master File Data	Other Disclosures	Total Number of Disclosures
States	(d)	7,750,742,634	148,411,197	7,899,153,831
Congressional Committees	(f)	64,569,982		64,569,982
US Attorneys	(i)(1)		26,421	26,421
US Attorneys	(i)(2)		112	112
Foreign Countries Tax Treaty Authority (Note 6)	(k)(4)	1,124,324	2,557	1,126,881

Note (6)

Foreign Tax Treaty Disclosures –The total number of disclosures are from two sources:

2,557 – Disclosures of taxpayer-specific returns or return information made to a competent authority of a foreign government with which the United States has an income tax convention or other bilateral agreement relating to the exchange of tax information with the United States.

1,124,324 – Disclosures relating to automatic exchanges of information by the United States to a competent authority of a foreign government with which the United States has an income tax convention or other bilateral agreement relating to exchange of information with the United States. Such exchanges consist of fixed, determinable, annual or periodical (FDAP) income data pertaining to taxpayers reporting residence in a foreign jurisdiction. The data exchanged are drawn from the information reported to the IRS annually by withholding agents on Form 1042-S

⁴⁰¹ § 6103(p)(3)(A).

⁴⁰² § 6103(p)(3)(B) & (C).

⁴⁰³ § 6103(p)(3)(C).

⁴⁰⁴ Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2014, JCT Publication JCX-89-15 (6/5/15).

(Foreign Person's U.S. Source of Income Subject to Withholding). Automatic exchanges were paused in 2013 to update the processes the IRS employs to assess whether U.S. exchange partners have the appropriate legal framework and infrastructure to safeguard the information exchanged, and implement these new processes.

The report explains the § 6103 subsections as follows (although you may remember them from the discussion above):

- (d) Disclosure to State tax officials having responsibility for administering State tax law.
- (f) Disclosure to Committees of Congress or their agents (including GAO).
- (i)(1) Disclosure of returns or return information to Federal officers or employees upon the grant of an ex parte order by a Federal district court judge or magistrate for use in Federal non-tax criminal investigations.
- (i)(2) Disclosure of return information other than taxpayer return information to Federal officers or employees for use in Federal non-tax criminal investigations, upon request by the head of the agency or Inspector General thereof (or designated officials of the Department of Justice).
- (k)(4) Disclosure to foreign government competent authority pursuant to a treaty or bilateral agreement relating to the exchange of information pursuant to the terms of the treaty or bilateral agreement.

Note that the report does not contain the number of disclosures to the Department of Justice for tax administration purposes under § 6103(h)(2) & (3). There was formerly some limited reporting of disclosures under these provisions, but there are none in the 2008 report.

V. Some Issues Under § 6103.

A. Information in the Public Record.

Has the IRS made a wrongful disclosure if the information it discloses from its files is otherwise in the public record? This issue has arisen in the past where a taxpayer is convicted of a tax crime and the IRS issues a press release of information from its files that just happens to be the same as information introduced in the criminal proceeding. This issue can come up in other ways. For example, the IRS may file a tax lien in a public record. Is the IRS then free to disclose the information that the taxpayer is subject to a tax lien simply because the same information is in a public record otherwise available to the public? The courts are divided over the issue of whether the IRS's disclosure of such public information violated § 6103.⁴⁰⁵ The Fifth Circuit, we think, has

⁴⁰⁵ The cases are discussed in JCT Confidentiality and Disclosure Study, Volume 1, pp. 59-81.

the better reasoned opinion, holding that simply because information is in the public record does not make the same information from the IRS's files disclosable free of § 6103's restraints.⁴⁰⁶

B. What is Necessary to Be Disclosed.

We have discussed above the controversy over what needs to be disclosed in a criminal investigation. Please review those materials here.

C. An IRS Workaround for Humane Purposes (The IRS as Good Guy).

As we noted, virtually everything the IRS knows about a taxpayer is subject to § 6103. That includes a taxpayer's address. So, the IRS cannot be used as a national contact directory. However, since the IRS is not prohibited from receiving information about a taxpayer, the IRS says that "In circumstances where a humane purpose may be served or in extreme emergency situations, the Service may agree to forward a letter" to the taxpayer.⁴⁰⁷ Note in this case, where it applies, all the IRS does is to forward a letter to the taxpayer, presumably to the "last known address" (this being a statutory term of art as to the place the IRS sends notification to the taxpayer of various actions taken by the IRS).

VI. Penalties/Remedies for Wrongful Disclosure.

A. Criminal Penalties.

Disclosures without authority under § 6103 are subject to potential criminal penalties if they are "willful".⁴⁰⁸ The criminal punishment for federal employees is up to 5 years and a \$5,000 fine.⁴⁰⁹

IRS personnel and state personnel who inspect returns or return information outside the scope of their duties may be subject to a maximum fine of \$1,000, up to a year in prison, or both.⁴¹⁰

⁴⁰⁶ Johnson v. Sawyer, 120 F. 3d 1307 (5th Cir. 1997). The JCT Confidentiality and Disclosure Study, however, recommends that items properly in the public record not be subject to § 6103.

⁴⁰⁷ Policy Statement P-1-187. Examples of such urgent circumstances include: (i) "serious illness, imminent death, or death of a close relative;" (2) "The health or well being of a number of persons is involved, such as where persons are being sought for medical study to detect and treat medical defects;" and (3) notification of entitlement to assets (e.g., an estate) where the person is otherwise unlocatable.

⁴⁰⁸ § 7213.

⁴⁰⁹ Id. The fine is increased under the Criminal Fine Enforcement Act, 18 USC sec. 3571.

⁴¹⁰ § 7213A. The fine is increased under the Criminal Fine Enforcement Act, 18 USC sec. 3571.

B. Civil Remedies.

A taxpayer whose tax return information has been wrongfully disclosed has a civil remedy for damages.⁴¹¹ The Government agent making the wrongful disclosure must have done so “knowingly or by reason of negligence,”⁴¹² but there is no liability where the disclosure resulted from “a good faith, but erroneous interpretation of § 6103.”⁴¹³ The cases generally charge the agent with knowledge of the statute, regulations and IRM, so that failure to meet some specific requirement in those sources will negate good faith.⁴¹⁴ The suit for damages is against the United States. Damages are the greater of either (1) minimum damages of \$1,000 per act of disclosure⁴¹⁵ or (2) actual damages and, if the disclosure was willful or the result of gross negligence, punitive damages.⁴¹⁶ Note that a taxpayer may not recover the minimum damages and punitive damages;

⁴¹¹ § 7431.

⁴¹² § 7431(a)(1).

⁴¹³ § 7431(b)(1).

⁴¹⁴ Huckaby v. United States Dept. of Treasury, I.R.S., 794 F.2d 1041, 1048 (5th Cir. 1986); Barrett v. United States, 51 F.3d 475, 479 (1995). Even where disclosures are otherwise permitted to other Government agencies (or foreign tax administrators under tax treaties), the disclosure of knowingly false information is a violation of § 6103 and is not subject to the good faith disclosure exception. Aloe Vera of America, Inc. v. United States, 699 F.3d 1153 (9th Cir. 2012) (alleging disclosure of knowing false information to the Japanese tax administrator under the U.S. Japan Double Tax Treaty); and Aloe Vera of Am., Inc. v. United States, 2015 U.S. Dist. LEXIS 16605 (D. Ariz. 2015).

⁴¹⁵ Act of disclosure is not defined, although its usual application is not in doubt. If an agent tells a third party that a taxpayer is under investigation and that disclosure is reasonably necessary to the investigation. But, what if an agent makes the disclosure in a speech before 100 people? One court of appeals has held that the disclosure is a single act of disclosure, but another court of appeals disagrees. Siddiqui v. United States, 359 F.3d 1200, 1202-03 (9th Cir. 2004) (single act of disclosure); Snider v. United States, 468 F.3d 500, 509 (8th Cir. 2006) (100 acts of disclosure); see AOD 2007-03, IRB 2007-30 (7/23/07) (nonacquiescence in this aspect of Snider). What if, in a single session with a single third party, an IRS agent discloses multiple discrete items of return information? In Snider, the Eighth Circuit held that each item of return information is a separate act of disclosure, despite having been disclosed in a single session. Snider, 508-509, but see AOD 2007-03 (nonacquiescence in this aspect of Snider). Finally, what if an agent discloses to a person with the expectation and even desire that that person disclose to other people? To use a possible example, suppose the disclosure is to a reporter who the agent would have reason to believe will publish the information in a newspaper with a circulation of 1,000,000 readers, with statistical data showing that it is likely that 200,000 persons read the information in the newspaper. The courts seem to reject liability for such secondary disclosures by persons other persons (e.g., Snider, supra, agreeing with Miller v. United States, 66 F.3d 220 (9th Cir. 1995)). However, this seems like a formalistic reading and if the evidence is strong that the audience the agent intended in making the disclosures was the newspapers readership and was simply using the reporter as a tool to make the disclosures, I suspect those cases might be distinguished or rejected.

⁴¹⁶ § 7431(c). See Snider v. United States, 468 F.3d 500, 510 (8th Cir. 2006)

rather, the taxpayer must show actual damages in order to recover punitive damages. In this regard, the purpose of the minimum damage recovery is to allow some minimum, because Congress recognized that it would be difficult and sometimes impossible for the taxpayer to show actual damages.

The taxpayer may also recover costs of the action, including attorneys fees.⁴¹⁷

VII. Return Preparers Prohibited from Disclosing Return Information.

Obviously, in our tax universe, not only does the IRS have the return information, but the ubiquitous tax return preparer also has return information. If return information is leaked to the detriment of a taxpayer, it doesn't matter whether it came from the IRS or from the return preparer. Accordingly, § 7216 imposes misdemeanor criminal penalty upon preparers who disclose return information.⁴¹⁸ There are certain exceptions (such as authorized disclosures, disclosures required by legal process, etc.). Unauthorized disclosures are also subject to a parallel civil penalty of \$250 per disclosure up to a maximum of \$10,000 per calendar year.⁴¹⁹

Readers should note that there are also other professional prohibitions on disclosure of confidential information that may include return information. Thus, information a client provides to attorneys and CPAs may be subject to state law prohibitions on disclosure. Some of this may be return information (e.g., if the CPA is also a return preparer and if the attorney, although not preparing the return itself, is treated as a return preparer with respect to an item that is included on a return). As with § 7216's prohibitions on disclosure, there are exceptions to these state law prohibitions.⁴²⁰

VIII. Summary.

Obviously we could only hit selected highlights of the confidentiality issue. I hope that you have a good sense from this discussion that Congress perceives confidentiality as quite important to the proper functioning of the revenue system, even though it has provided many targeted exceptions to confidentiality.

⁴¹⁷ § 7431(c)(2) and (3).

⁴¹⁸ The IRS has issued final and temporary regulations under § 7216. See Regs. § 301.7216-2, promulgated by T.D. 9479 (12/29/09); see also Rev. Rul. 2010-4; 2010-4 IRB 1.

⁴¹⁹ § 6713(a).

⁴²⁰ See e.g., In re Grand Jury Proceedings, Grand Jury No. 08-4, 607 F.Supp. 803 (W.D. Tex. 2009) (involving exception to Texas CPA prohibitions for grand jury subpoena).

Ch. 5. Returns.

I. The Self-Assessment System.

The IRS says:

The Internal Revenue Code places three primary obligations on taxpayers: (1) to file timely returns; (2) to make accurate reports on those returns; and (3) to pay the required tax voluntarily and timely. Taxpayers are compliant when they meet these obligations. Noncompliance — and the tax gap — results when taxpayers do not meet these obligations.⁴²¹

This chapter deals principally with the first two obligations — the requirements that returns be filed⁴²² timely and accurately. This chapter deals also an aspect of the third obligation — the voluntary payment of taxes along with the returns (or in advance through withholding or estimated taxes). I defer until a later chapter discussion of taxes that are due but not paid timely — a general subject referred to as Collections.

Our tax system is described as a “self-assessment” system. All this means is that the taxpayer reports the amount of the tax obligation via a tax return. The IRS must assess the tax reported on the return. **§ 6201(a)(1)**. The taxes thus reported are often referred to colloquially as “self-assessed” which is probably a fair characterization since the statutory requirement that the IRS assess the amount reported is mandatory, making the IRS’s formal assessment a ministerial act.

Our tax system is also sometimes referred to as a voluntary assessment or voluntary self-assessment system. “Voluntary” is a euphemism. I discuss in a later chapter a system of penalties (criminal and civil) that encourages taxpayers to file returns reporting their tax liabilities correctly and pay the amounts they owe. If the penalties did not exist, our tax system might be considered voluntary, for even if the law commanded some action (e.g., the filing of a true, correct and complete return and payment of all tax), the absence of penalties would take the practical compulsion out of the law. We can fairly speculate that such a real voluntary system would have a low level of compliance. In any event, the penalties do exist, so the “voluntary” description is not correct. Still, as euphemism, its not bad, particularly when you consider that in other countries, even those with penalties in the law, tax evasion is rampant and may even approach a sport for those playing the game and entertainment sometimes for bystanders. To the extent that that’s not the case in the

⁴²¹ Treasury Dept. Update on Reducing the Federal Tax Gap (7/8/09), Appendix: Understanding the Tax Gap, available [here](#).

⁴²² Filed, in this sense, means delivered to the IRS. See Hotel Equities Corp. v. Commissioner, 65 T.C. 528, 531 (1975), aff’d, 546 F.2d 725 (7th Cir. 1976). As discussed later in this chapter, the key exceptions to delivery as filing relate to delivery to the U.S. Postal Service or to a private authorized courier service that permits timely sending to be treated as timely filing. There are related common law mailing rules that might also deem a mailing to be delivered to the IRS prior to the actual date it is delivered. These are discussed below.

United States, so the myth goes, it is because our citizens generally do what the law requires (motivated in significant part by a penalty system) and in other countries their citizens don't. Still, there are the penalties, civil and criminal, to induce this "voluntary compliance,"⁴²³ that has been called a system of taxation by confession.⁴²⁴

II. The Return.

A. Return Filing Requirement.

1. Returns to Report Tax Liabilities.

The filing of the return starts various legal and administrative processes that constitute a significant portion of this course. Although the IRS has general Regulation authority to require returns (§ 6011), the Code specifically requires the following returns that you will most frequently encounter in tax practice:

1. Income tax returns for individuals when income exceeds the exemption and standard deduction amounts (§ 6012(a)(1)).
2. Income tax returns for corporations regardless of the amount of income, provided that the corporation is otherwise subject to tax (§ 6012(a)(2)).
3. Income tax returns for estates having gross income in excess of \$600 or having any nonresident alien beneficiary (§ 6012(a)(3) & (a)(5)).
4. Income tax returns for trusts having (1) any taxable income, (2) gross income in excess of \$600, or (3) any nonresident alien beneficiary (§ 6102(a)(4) & (a)(5)).
5. Returns for transfer tax liabilities (gift tax, estate tax and generation skipping tax) in certain cases (§§ 6018 and 6019).

Returns may be due even if no tax is due. Thus, a taxpayer having large amounts of gross income may have deductions and credits that eliminate the tax liability. An income tax return is still due.

⁴²³ See <http://www.becker-posner-blog.com/archives/2007/11/>, wherein Judge Posner and Gary Becker, a Nobel Prize winner in economics, discuss tax compliance and Judge Posner concludes that: "more tax compliance can be attributed to rational fear of punishment than he suggests and less to taxpayers' feeling a moral duty to pay taxes." In support of his conclusion, Judge Posner notes, in addition to the risk of criminal prosecution, the high civil penalties (which he misstates as 100% rather than 75%), heavy costs of legal and accounting expertise to defend against a criminal tax charge, and information costs involved in merely acquiring the expertise to do any sophisticated type of tax evasion.

⁴²⁴ United States v. Kahriger, 345 U.S. 22, 36 (1953) (Black, J.).

If a taxpayer fails to file a return, the IRS may file a substitute for return (often acronymed as “SFR”) for the taxpayer and/or invoke deficiency procedures to result in the taxpayer settling up with the IRS for taxes he or she may owe. I discuss these procedures later in the text. In addition, as noted, the IRS has civil and criminal penalties that may apply in the case of failure to file.

Finally, certain taxpayers may elect to not show the tax due on the return otherwise properly reporting income, deductions and credits, whereupon the IRS will compute the tax and notify the taxpayer of the tax due.⁴²⁵ This election is available only to certain taxpayers (e.g., conjunctive requirements of no itemization, gross income of less than \$10,000, no income other than wages, dividends and interest). As stated, qualifying taxpayers are likely to be few. By regulation, the IRS has expanded the categories of taxpayers included.⁴²⁶ I have never seen taxpayers use this opportunity in my practice. Since, once the other parts of the return must be completed, the tax calculation is relatively simple (taxable income taken to the tax table should do it), it seems to me not that great a relief provision for all except those taxpayers owing little, if any, tax.

2. Information Returns or Reports.

a. General - the Concept.

Many returns are so-called “information returns” that simply report tax-relevant information but require no tax payments by the person required to file the returns. For example, partnerships are required to file returns, principally for the purpose of quantifying the components of income, deduction and credit at the entity level and then allocating those components to and among the partners so that the partners can report their shares on their tax returns.⁴²⁷ There is a similar requirement for reporting to shareholders of S Corporations and to beneficiaries of trusts and estates.⁴²⁸ These returns facilitate the return preparation process and permit the IRS to determine whether the components of income have been properly reported on the returns of the taxpayers who are supposed to report the income.⁴²⁹ Often the IRS makes that determination through computer

⁴²⁵ § 6014. When this election is properly made, the payment due date for purposes of the payment delinquency penalty is 30 days after the date of notice, made by a notice and demand for payment. § 6151(b)(1).

⁴²⁶ § 6014(b)(authorizing expansion by regulation); Regs. § 1.6014-2(b).

⁴²⁷ § 6031.

⁴²⁸ §§ 6037 & 6034A.

⁴²⁹ These information returns, if incorrect, can create significant hassles for the persons identified in the form. For example, if a person files with the IRS a false Form 1099 reporting independent contractor income to a third party with whom he had a grudge but no independent contractor relationship, the third party will likely not report the income and thus be subject to audit by the IRS. Section 7434(a) imposes civil liability for filing a “fraudulent information return with respect to payments purported to be made to any other person.” The liability is the greater of (a) \$5,000 or (b) the sum of (i) actual damages, (ii) costs of the action, and (iii) in the court’s discretion, reasonable attorneys fees.

matching techniques where information reported on information returns is matched against the individual income tax returns of the ultimate taxpayer.

One of the risks of information returns is that the information can be incorrect. In such cases, the IRS's reliance on the information returns will be incorrect. **Section 6201(d)** provides that, if, in a court proceeding, an information return serves as the basis for the determination of a deficiency and the taxpayer "asserts a reasonable dispute as to the information," the burden of production shifts to the Commissioner to produce "reasonable and probative information" so long as the taxpayer has cooperated in the audit and litigation.⁴³⁰

b. Commonly Encountered Information Returns.

(1) W-2s and 1099s.

In addition to partnership and S Corporation information returns, there are other commonly encountered information return filing requirements with respect to items that impact another person's return. An employer must file information returns for wages and salaries paid to employees (Forms 941) and send each employee a **Form W-2**, businesses paying dividends and interest must file similar forms and send each recipient a **Form 1099** stating the dividends or interest paid, and businesses making payments to independent contractors must file forms with the IRS for the payments made and send each independent contractor a Form 1099 reporting the amounts paid.⁴³¹ The recipient taxpayers use the information to complete their tax returns, and the IRS uses the information on the forms filed with the IRS for matching against the income the various taxpayers report on their returns. Similar information forms are required for payors of dividends and interest. There are a host of other information filing requirements. Significant penalties apply for failure to file these information returns which are so critical to the IRS's enforcement program. I do not deal in detail with the information returns and penalties in this text. I do expect you to know generally that there are institutional preferences reflected in legislation to impose on business taxpayers an obligation to file informational returns that can be used in IRS enforcement efforts with respect to other taxpayers having some relationship to the business taxpayer upon whom the obligation is imposed. You noticed also that I said business taxpayer here, but it is not always a business taxpayer. A nonbusiness taxpayer – i.e., individual – is required to make informational filings with respect to a household employee, although this informational filing is accompanied by a requirement to pay Social Security taxes (but not withholding which is generally required for business taxpayers) with respect to the household employee. I do also expect you to know that that many audits are generated by discrepancies between the information returns filed with the IRS and the taxpayer's tax returns or failures to file returns.

⁴³⁰ See Del Monico v. Commissioner, T.C. Memo. 2004-92.

⁴³¹ See e.g., §§ 6041, 6042, 6049, and 6051.

(2) Currency Transaction Reports (“CTRs”).

There are still other return reporting requirements that are designed to identify income of types that might easily escape the tax system or that might evidence nontax illegal conduct. The broadest example is **§ 6050I** which requires that persons involved in a trade or business who receive cash payments in excess of \$10,000 in one transaction (or more than one transaction, if the transactions are related) to report the receipt to the IRS.⁴³² The report is made by **Form 8300** (sometimes referred to as a currency transaction report or “**CTR**”), which in its latest iteration is called both **IRS Form 8300 and FinCEN Form 8300**.⁴³³ This means that the information is available to each of those agencies and may be used for congressionally approved purposes, most specifically federal law enforcement (not just tax law enforcement). **FinCEN** is the acronym for the Government’s Financial Crimes Enforcement Network which gathers information useful in investigating and prosecuting financial crimes. As most pertinent to this class, of course, the information is available to the IRS for both civil and criminal tax purposes. But, ultimately, the information may be most useful for money laundering enforcement in which the IRS is a principal investigative and information source.

This reporting requirement is designed to coordinate through the tax code with the Government's other criminal enforcement initiatives. Thus, the drug dealer purchases an upscale Mercedes for \$150,000 cash will be caught in this trap (assuming the dealer files the Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business, and the Government can assimilate and make useful the information on the Form 8300).⁴³⁴ The Government really wants to discover and punish the drug dealing, although his possession of this much cash may also indicate tax crimes. (There is a positive correlation between a illegally derived cash money and tax crimes.) Related information cash reporting requirements found outside the Internal Revenue Code but administered in part by the IRS are (i) the reporting requirement for cash transactions with financial institutions involving in excess of \$10,000 (reported on Form 4789, Currency Transaction Report and often acronymed to “**CTR**”)⁴³⁵ and (ii) the report on international transportation of currency or monetary instruments in excess of \$10,000 (reported on Form 105, Report of International Transportation of Currency or Monetary Instruments, and often acronymed to “**CMIR**”).

⁴³² See Charles P. Rettig, Form 8300: Reporting Domestic Currency Transactions (J. Practice & Procedure December 2012-January 2013).

⁴³³ Congress enacted the requirement for this report as part of the Bank Secrecy Act, 31 U.S.C. § 5331(a) and 31 C.F.R. § 103.30(a).

⁴³⁴ A filing reporting a \$20,000 cash payment will likely not be investigated based on the filing alone. A filing reporting a \$1,000,000 cash payment, I suspect, likely would be investigated based on the filing alone. I am just speculating on these parameters, but assuming that the speculation is reasonably good speculation, I cannot even speculate where the break point is in between these parameters. I don’t know whether, for example, an automobile dealer report of a \$150,000 would itself be investigated. However, even if the information form itself does not trigger an inquiry or investigation, if the agency is looking at the person for some other reason, the agency will have easy access to these and related filings for a more complete financial road map.

⁴³⁵ Required by the Bank Secrecy Act, 31 U.S.C. § 5313 and 31 CFR, Part 103.

(3) Foreign Bank Account Reports (“FBARs”).

The Bank Secrecy Act (“BSA”)⁴³⁶ and underlying regulations require a Report of Foreign Bank and Financial Accounts, **FinCEN Report 114** (often referred to as “**FBAR**,” the popular term for this form)⁴³⁷ that must be filed by United States persons having a financial or signatory interest in a foreign financial account.⁴³⁸ You may recall that Form 1040, Schedule B (i) asks whether the taxpayer has foreign financial accounts exceeding \$10,000 in aggregate amount and, if so, which countries the accounts are in and (ii) advises that there is an FBAR reporting requirement.⁴³⁹ Not only does a wrong answer on the question on the income tax return (Form 1040, Schedule B) raise the specter of a tax perjury charge or even tax evasion if income is omitted and tax underreported but failure to file the FBAR is an independent felony criminal act subject to the potentially harsher civil penalties (which I discuss below). The requirement to file an FBAR is independent of the requirement to answer the Schedule B question on the tax return and to pay tax on income related to the foreign financial account. The two are related, for a taxpayer having a reportable interest in a foreign bank account who answers the question no is unlikely to report the income or file the FBAR; similarly a taxpayer who fails to answer the question at all is unlikely to report the income or file the FBAR.⁴⁴⁰ I spend some time here on this particular informational form because, since 2009, it has become such a prominent piece of the IRS’s enforcement efforts, including criminal enforcement efforts through DOJ Tax.

A United States person is required to file an FBAR if all of the following are present: (i) at any time during the calendar year, (ii) the person has a “financial interest” in, or “signature authority” or “other authority” over (iii) one or more “financial accounts” in a “foreign country” (iv) with an aggregate value exceeding \$10,000. Financial interest and signature or other authority are defined quite broadly in order to minimize technical avoidance of the duty to file.⁴⁴¹ In its current iteration, the FBAR requires the owner or person with signatory authority over the account to identify himself, herself or the entity filing the FBAR, identify the account (bank, location and account number), state the highest amount in the account during the year for which the report is

⁴³⁶ The BSA, otherwise known as the Currency and Foreign Transactions Reporting Act, was enacted in 1970.

⁴³⁷ This report was formerly called Treasury TD 90.22.1.

⁴³⁸ 31 U.S.C. § 5314; 31 C.F.R. § 103.24.

⁴³⁹ There is also a question about dealing with foreign trusts and gifts and the obligation to file Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. Both of these Schedule B reminders deal with significant historic areas of U.S. tax noncompliance.

⁴⁴⁰ The Schedule B instructions generally do not require the Schedule B if taxable interest or ordinary dividends do not exceed \$1,500, but the Schedule B is required in all events if “You had an interest in, or signature authority over, a financial account in a foreign country.”

⁴⁴¹ See the FBAR form instructions. See also United States v. Clines, 958 F.2d 578, 583 (4th Cir. 1992), cert. denied, 505 U.S. 1205 (1992) (involving an earlier version of the FBAR form).

filed, and identify the account owner.⁴⁴² A close reading of the FBAR instructions and common sense are required to understand the quoted terminology.⁴⁴³

The FBAR is just an information report requiring no payment. The FBAR filed electronically with the IRS Detroit Computing Center (“DCC”). Upon the filing, the information from the FBAR is incorporated into the BSA financial database, which is jointly administered by DCC and FinCEN. The information is then available to FinCEN analysts, law enforcement (including the IRS), and appropriate regulatory authorities for use, among other things, in tracking flows of money. The FBAR is not subject to § 6103's privacy requirements and thus may be freely shared with law enforcement agencies. The IRS has principal responsibility to enforce the FBAR requirements.⁴⁴⁴ However, the IRS does not have authority to enforce collection of FBAR penalties.⁴⁴⁵ The IRS may refer violations of the FBAR reporting requirements to the DOJ with a recommendation for criminal prosecution or civil suits to assert the FBAR civil penalties. Since the FBAR requirements are not part of the Internal Revenue Code, the procedural safeguards applicable in civil tax contexts may not apply, but the IRS may voluntarily apply some of them (such as the internal Appeals Office review process).⁴⁴⁶

⁴⁴² The current form was revised as of January 2012. The form has seen several iterations in and will likely see further iterations in the reasonably near future as the IRS continues to refine its focus on the issues presented by foreign financial accounts.

⁴⁴³ For example, a financial account includes the usual suspects (bank and brokerage accounts), but also includes “other financial account[s].” *Id.* Courts are likely to read this expansively to include accounts that can function like such accounts. In United States v. Clines, 958 F.2d 578 (4th Cir. 1992), cert. den. 505 U.S. 1205 (1992), the court held that a profit share capital account maintained on a ledger of a foreign corporation that permitted the defendant to withdraw funds met the definition.

⁴⁴⁴ The authority to enforce the provisions of 31 U.S.C. 5314 and sections 103.24 and 103.32 has been re-delegated from FinCEN to the Commissioner of Internal Revenue by means of a Memorandum of Agreement between FinCEN and the IRS dated April 2, 2003. 31 CFR 103.56(g); IRM 8.11.6.1 (02-02-2015), FBAR Overview, par. 1. The sweep of the authority is quite broad indeed, covering the following authorities (i) to enforce the FBAR provisions of the BSA and its implementing regulations, (ii) to investigate possible violations, and assess and collect civil penalties in connection therewith (iii) to respond to public inquiries and requests for advice; (iv) to issue administrative rulings; (v) to provide related assistance to the public with respect to compliance with FBAR requirements; (vi) to revise the FBAR form and instructions, and (vii) to propose to FinCEN revisions of the applicable regulations for the purpose of enhancing FBAR compliance and enforcement.

⁴⁴⁵ IRM 5.21.6.4 (11-27-2013), Delegated Authority.

⁴⁴⁶ But, for example, the IRS will not apply the Code requirement of § 7491(c) that the IRS bear a burden of production with respect to penalties. That may not be an important matter because, as I note later, the IRS probably has an affirmative burden of persuasion at least with respect to the most draconian FBAR penalty, that will necessarily carry a burden of production. I suspect that, for the lesser FBAR penalties (the nonwillful penalties), the IRS may have the standard civil proof burden – more likely than not. It is not clear that the nonwillful FBAR penalty is

The criminal penalty for willful failure to file is 5 years incarceration or \$250,000 fine or both.⁴⁴⁷ If the proscribed conduct occurs “while violating another law of the United States or as part of a pattern of any illegal activity involving more than \$100,000 in a 12-month period,” the criminal penalty increases to 10 years or \$500,000 fine, or both.⁴⁴⁸ Although the language of this penalty “double-up” is not as crisp as I would like it, anecdotal evidence, which I cite in the footnote, suggests that these disjunctives do not include prototypical tax crimes – e.g., (i) multi-year failure to include on the return and pay tax on the interest income on the foreign account or (ii) the multi-year failure to report the foreign account(s) on FBARs.⁴⁴⁹ Willful for criminal prosecution is, presumably, Cheek⁴⁵⁰ willfulness - the intentional violation of a known legal duty, but the latter concept seems to include the criminal concept described as conscious avoidance, deliberate ignorance or similar labels.⁴⁵¹

The criminal statute of limitations is 5 years.⁴⁵²

subject to the presumption of correctness or any other similar consideration that some courts purport to use to force the burden of persuasion on the taxpayer to rebut the IRS’s determination.

⁴⁴⁷ 31 U.S.C. § 5322(a). By contrast, the criminal penalty is 5 years for false statements (18 U.S.C. §1001) and 3 years for tax perjury (§ 7206(1)). In the criminal prosecutions arising during the 2009-2011 major IRS initiatives for offshore financial accounts, the plea deal offered to most defendants was one count of FBAR violation (5 years) or one count of tax perjury (3 years) related to omitting the income and/or failing to answer the foreign account question properly, with the defendant given his choice. The Guidelines sentencing range would be the same in any event and thus the count of plea and conviction would be irrelevant for sentencing but could have some collateral consequences.

⁴⁴⁸ 31 U.S.C. § 5322(b).

⁴⁴⁹ Although a case might be made that the disjunctives in the double-up statutory text might catch the prototypical tax crime or the failure to file FBARs involving foreign accounts exceeding \$100,000, anecdotal evidence implies that the Government and courts do not apply the statute to cover such conduct. In the criminal convictions to the date of this article arising from the Government’s offshore financial account initiative commencing with the UBS onslaught in 2009, several defendants have pled to FBAR violations. In those cases which have been sentenced to date, all parties involved in the process – the Government, the defendant, the Probation Office and the court – seem to have acted on the assumption that the five year criminal penalty applied. Of course, in those cases, it seems clear that the courts were not going to actually impose penalties beyond the undoubled penalties, so these anecdotal instances may not be true indicators of whether the doubled penalties could apply to an extreme, but prototypical, tax crime. Finally, a word of caution. Similar language on the double up is contained in S.G. 3S1 which is the Sentencing Guideline applying to FBAR criminal violations.

⁴⁵⁰ Cheek v. United States, 498 U.S. 192 (1991).

⁴⁵¹ This concept is too large to develop in this text. I do note that the Supreme Court blessed this concept in a civil context and, in doing so, seemed in dicta to bless it in a criminal context. Global Tech Appliances, Inc. v. SEB, ___ U.S. ___, 131 S. Ct. 2060 (2011). I don’t think that the application of this concept in the criminal area is yet settled.

⁴⁵² 18 U.S.C. §3282.

The foregoing discusses the criminal penalty for failure to file the FBAR. It is not clear that the FBAR criminal statute covers filing a false FBAR. As a result, it is reported that false FBARs may be charged under some other statute, such as 28 USC 1001, false statements.⁴⁵³

The civil penalties for failure to file are graduated according to the gravity of the offense. In part relevant to most taxpayers,⁴⁵⁴ they are divided into willful violations and nonwillful violations.⁴⁵⁵ (i) if not willful, **up to \$10,000** per violation (which the IRS interprets as per account not disclosed per year)⁴⁵⁶ but with a reasonable cause exception⁴⁵⁷ and (ii) if willful, **up to the greater**

⁴⁵³ An IRS attorney reported at a seminar that it is not certain that the FBAR criminal penalty in 31 U.S.C. § 5314 can be applied to a **false** FBAR. In subsequent email correspondence about this issue, he explained:

My Area [geographical area of the IRS] typically recommends 1001 [18 U.S.C., false statement] be used for false FBARs since Fin Cen Form 114 (formerly TD F 90-22.1) does not contain a jurat. I think there is uncertainty whether an FBAR violation can be charged under * * * 5314 since there is no jurat and 5314 does not say that an accurate statement must be filed – just that one must be filed. This might be too cautious but since the instructions to Form 114 (and 90-22.1) explicitly state that false Forms may be prosecuted under 1001, I prefer to recommend that charge.

⁴⁵⁴ There are some penalties applicable for violations by financial institutions and nonfinancial trades of businesses. 31 U.S.C. § 5321(a)(6)(a) (dealing with negligent and pattern of negligence. I do not discuss these here because the current enforcement focus is on the individual FBAR violations which I do discuss in the text.

⁴⁵⁵ This summary is drawn from the IRS web page titled Workbook on the Report of Foreign Bank and Financial Accounts (viewed on 8/31/2009 and reviewed or updated on 2/19/09. The web page is at <http://www.irs.gov/businesses/small/article/0,,id=159757,00.html>.

The table at the web site includes a \$500 penalty which appears to relate only to types of business rather than just persons who must file the FBAR. See § 5321(a)(6).

⁴⁵⁶ 18 U.S.C. § 5321(a)(5)(b)(1) (applying penalty to a violation); see IRM 4.26.16.4 (07-01-2008), “FBAR Penalties,” par. 7, applying penalty per account, although noting that examiners are to apply discretion in the application of the penalties. I should note that I am not certain that the IRS’s interpretation permitting the penalty to apply to per account per year is correct. In this regard, I have found that there seems to be a high preponderance of U.S. persons from some countries (such as India) who have multiple accounts with small amounts, some times many multiples of such accounts. In this case, applying the nonwillful penalty per account per year could be draconian and even exceed the willful penalty. Where this would be particularly sinister is whether the IRS just did not want to bother making the extra level of proof required for the willful penalty. I don’t think the IRS would do that except in truly exceptional cases (i.e., where there is some other egregious misconduct, such as drug dealing).

⁴⁵⁷ The statutory text for the reasonable cause exception appears odd and must be interpreted in context. The exception requires both reasonable cause and that the “the balance in the account at the time of the transaction was properly reported.” In the case of a failure to report (either no FBAR filed or an FBAR filed with the account omitted), the failure to report or report properly is, of course, the act that causes the filer / nonfiler to be at risk for the penalty in the first

of \$100,000 or 50% of the balance in the account(s) at the time of the violation.⁴⁵⁸ Note in each case that these are maximum penalties; the IRS can assess less than the maximum.⁴⁵⁹ These penalties apply to false FBARs, but false FBARs are more likely to draw the willful penalty because the filing of the FBAR establishes the filer's knowledge of the FBAR requirement and an inference of willfulness in leaving one or more accounts is easier to draw. Willful for this purpose is, presumably, also Cheek willfulness - the intentional violation of a known legal duty.⁴⁶⁰ This formulation probably also allows for willfulness to include the concept variously known as conscious avoidance, willful blindness or reckless disregard.⁴⁶¹ Although the willful standard is the stated same as the criminal Cheek standard, the limited case authority to date seems to be more willing to apply the penalty in the FBAR civil penalty than they might in a criminal willfulness case.⁴⁶² For the nonwillful penalties, it is not clear exactly how the burden of proof works, since

place. Surely, a reasonable interpretation of the statute must mean something other than the original failure to file or filing improperly. The Internal Revenue Manual sensibly, at least in the case of failure to file (the most common of the two patterns), "This means that the examiner must receive the delinquent FBARs from the nonfiler in order to avoid application of the non-willfulness penalty." IRM 4/26/16/4/4 (07-01-2008).

⁴⁵⁸ 31 U.S.C. §5321(a)(5)(C). I have bold-faced the up to, because the statute provides a maximum but no minimum.

⁴⁵⁹ See IRM 4.26.16.4(6), titled FBAR Penalties (07-01-2008) (FBAR penalties are not set amounts and may be mitigated based on discretion and certain mitigation guidelines); 4.26.16.4.4(3) (07-01-2008), titled Non-Willfulness Penalties (discussing mitigation guidelines); and 4.26.16.4.6 (07-01-2008), titled Mitigation (addressing the willful penalty and providing: "The statutory penalty computation provides a ceiling on the FBAR penalty.").

⁴⁶⁰ IRM 4.26.7.4.2 (06-20-12) defines willfulness as "a voluntary, intentional violation of a known legal duty," which is the same as the Cheek / Pomponio definition of willfulness for purposes of the criminal tax provisions.

⁴⁶¹ See IRM 4.26.7.4.2 (06-20-12). The Supreme Court blessed this concept as a basis for willfulness in a civil context in Global Tech Appliances, Inc. v. SEB, ___ U.S. ___, 131 S. Ct. 2060 (2011). See in the context of FBAR willfulness penalty, United States v. Williams, 2012 U.S. App. LEXIS 15017 (4th Cir. 2012); and United States v. McBride, 908 F. Supp. 2d 1186 (D. UT 2012).

⁴⁶² United States v. Williams, 2012 U.S. App. LEXIS 15017 (4th Cir. 2012) (unpublished); and United States v. McBride, 908 F. Supp. 2d 1186 (D. UT 2012). A related question is the burden of persuasion for the Government to establish liability for the penalty. The lower court in Williams said that the preponderance of the evidence standard applied, although that holding was dicta. United States v. Williams, 2010 U.S. Dist. LEXIS 90794 (E.D. Va. 2010), reversed on other grounds without reaching the standard of proof issue, 2012 U.S. App. LEXIS 15017 (4th Cir. 2012). The district court in McBride held that the preponderance of the evidence standard applied. The district court in and United States v. Zwerner (SD Fl. - No. 13-22082), without opinion, submitted to the jury on a preponderance standard; would likely have been raised on appeal, but case settled after jury verdict). So, as of now, the only three courts that have addressed the burden of persuasion issue have held said that they were applying the preponderance of the evidence standard. I think that there is still some possibility that, ultimately, the clear and convincing test,

there is virtually no learning on that subject. Presumably, since this is not a tax penalty where factors inherent in the tax system may require some burdens to be borne by the taxpayer, the IRS will have to prove its entitlement to the penalty by the standard civil more likely than not burden and the taxpayer will have to prove entitlement to the reasonable cause exception.

The IRS is not required to assert the full amounts, but may assert some lesser amount depending upon mitigating factors such as no prior history of FBAR violations, taxpayer cooperation in the investigation, and IRS failure to assert a penalty as to any income tax under-reported related to the account.⁴⁶³ Some have argued that the IRS's assertion of multiple year willful penalties at the full 50% amount may be so punitive as to implicate the Eighth Amendment's prohibition of Excessive Fines.⁴⁶⁴ Perhaps for this reason, the IRS has in May 2015 announced mitigation of the

normally applicable in civil cases to allegations of fraud, might apply. See generally Grogan v. Garner, 498 U.S. 279 (1991) (applying, however, preponderance of evidence for fraud exception to bankruptcy discharge because of the nature and context of that exception to discharge). For example, if the IRS asserts the civil fraud penalty under § 6663, the Code only says that the burden of proof is on the IRS (§ 7454(a)) but the Code is silent as to whether the burden is preponderance of the evidence or clear and convincing. The law is clear that the IRS must prove fraud by clear and convincing evidence. See T.C. Rule 142(b); John Gamino, Tax Controversy Overburdened: A Critique of Heightened Standards of Proof, 59 Tax Law. 497, 506 n. 38 (2006) (“Tax Court Rule 142(b) echoes the statutory language but specifies the clear and convincing standard by which the government must carry its burden. While not technically controlling in other courts, Rule 142(b) is representative of the broadly prevailing rule.”). The clear and convincing burden is conceptualized as heavier than preponderance (the normal civil burden) and lighter than beyond a reasonable doubt (the criminal burden). The term “willfulness” in the FBAR statute has the same meaning as willfulness in the criminal tax statutes and the civil fraud penalty. For that reason, the IRS itself has recognized that it would expect courts to apply a “clear and convincing” standard. See ILM 200603026 (1/20/06) (“Because the FBAR penalty is not a tax or a tax penalty, the presumption of correctness with respect to tax assessments would not apply to an FBAR penalty assessment for a willful violation – another reason we believe that the Service will need to meet the higher standard of clear and convincing evidence.”) I have addressed this issue in more detail in blog entries on the Federal Tax Crimes blog and refer readers to the blog under the key word “Burden of Proof - Civil Willfulness,” for further discussion and developments.

⁴⁶³ IRM 4.26.16.4.6 (07-01-2008), Mitigation.

⁴⁶⁴ Steven Toscher and Barbara Lubin, When Penalties Are Excessive -- The Excessive Fines Clause as a Limitation on the Imposition of the Willful FBAR Penalty, *Journal of Tax Practice & Procedure* 69 (Dec.-Jan. 2009). In a civil case to reduce an FBAR assessment to judgement, the IRS filed suit for the maximum 50% penalty for four years, but ultimately after prevailing at trial for three years, settled for two years. See my Federal Tax Crimes Blog where I have several entries on this subject, but a good starting point would be [Zwerner Case Settles Without Decision on Excessive Fines Issue \(Federal Tax Crimes Blog 6/6/14; Updated 6/12/14\)](#). Readers interested in this issue might consider a similar concern if the nonwillful penalties are applied per year per account which, depending upon the number of accounts and amounts in the accounts, could approach or even exceed the willful penalty, particularly if the IRS practice is, as it seems to be, to

willful penalty so that, generally, although the willful penalty can apply to multiple years, the aggregate willful penalty for all years will not exceed 50% of the single high balance in the years for which the statute of limitations is open.⁴⁶⁵ Moreover, a court has recently held that it has the power to review whether the penalty applies in the first instance and the IRS's determination of the amount of the FBAR penalties.⁴⁶⁶

The FBAR civil penalty statute of limitations is six years for the assessment.⁴⁶⁷ After timely assessment, Treasury has two enforced collection procedures. First, Treasury may sue for collection, provided it brings suit within two years of the later of date of assessment or the date the person was convicted of an FBAR violation.⁴⁶⁸ If Treasury obtains a judgment in that suit, Treasury will then have the judgment remedies applying to judgments generally. Second, under its general statutory authority to offset debts owed by a person to a Government agency against debts any Government agency owes that person, Treasury may offset against a person's FBAR liability against payments the person is otherwise due from the federal government.⁴⁶⁹ For example, the Treasury can offset refunds due the taxpayer against the FBAR liability.⁴⁷⁰ This Government claim subject to right of offset has no statute of limitations, even if it has a statute of limitations for any other collection measure.⁴⁷¹

assert the willful penalty only in a single year. Indeed, applying the nonwillful penalty in that way could be a proxy for the willful penalty permitting the IRS to avoid the more onerous burden of proof for the willful penalty.

⁴⁶⁵ See Heather C. Maloy, Commissioner LB&I Memo dated 5/13/15 Attachment 1, par. (2). <http://www.irs.gov/pub/foia/ig/spder/SBSE-04-0515-0025%5B1%5D.pdf>.

⁴⁶⁶ Moore v. United States, 2015 U.S. Dist. LEXIS 43979 (W.D. WA 2015) ((suggesting in connection with the amount that “[t]he court looks [in the administrative record] for a ‘rational connection between the facts found and the choice [the agency] made.’”). This case involved the nonwillful penalty, but the reasoning would apply to the willful penalty as well.

⁴⁶⁷ 31 U.S.C. § 5321(b)(1).

⁴⁶⁸ 31 U.S.C. § 5321(b)(2).

⁴⁶⁹ 31 U.S.C. § 3711(g)(9). FBAR penalties constitute debts owed to federal agency. 31 U.S.C. § 3701(b)(1)(F) (2001) (debts include “any fines or penalties assessed by an agency”); see IRM 8.11.6.1(6) (10-28-2013), titled FBAR Overview; see also United States v. Simonelli, 614 F. Supp. 2d 241, 246 (D. Conn. 2008) (FBAR penalty is a civil penalty, not a tax penalty). Related to this offset authority is authority to garnish periodic payments due by the federal government, such as Social Security payments, but these may be subject to restrictions. 31 U.S.C. § 3720D. For the current definitive treatment of this offset authority for FBAR collections, see Caroline D. Ciralo, Collection of the FBAR Penalty (3/30/13). (I have posted a discussion of this issue with a link to Ms. Ciralo's presentation on my Federal Tax Crimes Blog in a posting titled [FBAR Penalty Collection -- Beyond the Collection Suit, Administrative Offsets Loom Large and Long \(4/2/13\)](#).

⁴⁷⁰ § 3711(g)(9)(B); 31 C.F.R. § 5.4(a)(6). Tax refund offsets may be used only after an attempt to collect directly from the debtor. 31 U.S.C. § 3720A(b)(5); 31 C.F.R. § 285.2(d).

⁴⁷¹ 31 U.S.C. § 3716 (e)(1). (“Notwithstanding any other provision of law, regulation, or administrative limitation, no limitation on the period within which an offset may be initiated or taken pursuant to this section shall be effective.”); and 31 C.F.R. § 285.5(d)(3)(v) (“Debts may be

After assessment, the FBAR penalty accrues no interest if payment is not made within 30 days of the mailing of the notice of penalty assessment.⁴⁷² If not paid in that period, the assessment accrues interest from the date of the notice.⁴⁷³ Further, assessments still outstanding after 90 days accrue a 6% delinquency penalty in addition to interest.⁴⁷⁴

The IRS will investigate FBAR violations in much the same way it handles audits and appeals to the Appeals Office.⁴⁷⁵ Upon completion of the investigation and the appeal to the Appeals Office (if appealed), the Secretary of Treasury may assess the penalty without any statutorily required predicate act (such as a notice of deficiency).⁴⁷⁶ If Appeals consideration is not sought pre-assessment, it may be obtained post-assessment.⁴⁷⁷ In Appeals, FBAR issues are “an Appeals Coordinated Issue (Category of Case) and require a referral to International Operations prior to holding the first conference.”⁴⁷⁸

The FBAR penalty is not a tax or tax related penalty and may be assessed by Treasury without any predicate act (such as a notice of deficiency as required for most tax assessments); but, since not a tax, the Treasury may not use the collection tools for tax assessments (covered in Chapter 14, below) but proceeds via a suit for which it has a special two year period to sue for recovery.⁴⁷⁹

The FBAR penalty draws interest if not paid within 30 days of assessment and a 6% delinquency penalty if unpaid 90 days after assessment.⁴⁸⁰

collected irrespective of the amount of time the debt has been outstanding.”). Note that the IRM says that the offset period is 10 years for FBAR offsets. IRM 8.11.6.3.1.1 (11-01-2011), titled FBAR Penalty Statute of Limitations on Collection. However, my understanding is that this IRM provision was based upon § 3716(e) as it existed prior to amendment in 2008. Prior to amendment there was a 10 year offset period. After the amendment there is no limitations period to offset payments due the person against payments the person owes the U.S. for nontax debts. I discuss the offset authority generally and for refunds in the text below, beginning at p. 216.

⁴⁷² IRM 4.26.17.4.3 (05-05-2008).

⁴⁷³ Id. The interest rate is <http://fms.treas.gov/cvfr/index.html>.

⁴⁷⁴ Id.

⁴⁷⁵ See Toscher & Stein, *supra*, p. 42. The IRS may use tax return information in the FBAR audit. See Hom v. United States, 2013 U.S. Dist. LEXIS 142818 (ND CA 2013) (holding that such use does not violate § 6103's confidentiality requirements because the FBAR statute, § 5314 is a “related statute.”).

⁴⁷⁶ Williams v. Commissioner, 131 T.C. No. 6 (2008).

⁴⁷⁷ IRM 8.11.6.1, par. 6 (10-01-2012).

⁴⁷⁸ IRM 8.11.6.1, par. 5 (10-01-2012).

⁴⁷⁹ 31 U.S.C. § 5321(b).

⁴⁸⁰ 31 USC § 3717(b); IRM § 4.26.17.4.3(6).

Persons required to file FBARs must maintain records containing considerable detail about the foreign account(s) for five years.⁴⁸¹ There are two significant consequences of this “required records” obligation. First, the FBAR civil penalty will apply if, upon request, the taxpayer has not maintained the required records.⁴⁸² Second, under the “required records” doctrine, these records are not subject to the Fifth Amendment privilege that a person may otherwise have to oppose their compulsory production.⁴⁸³

The FBAR penalty is likely not dischargeable in bankruptcy because it is a nontax “penalty . . . for the benefit of a government unit, and is not compensation for actual pecuniary loss.”⁴⁸⁴

Finally, in 2010, Congress enacted a tax return reporting requirement for foreign financial assets that parallels, but is different from the FBAR.⁴⁸⁵ The taxpayer himself or herself must make the disclosure on the income tax return, so it is not the type of information disclosure where a third party reports to the IRS with respect to a payee’s or other related party’s tax liability. The filing of this information with the return will not supplant the requirement that the taxpayer also file an FBAR. The dollar threshold for the new return reporting is higher (\$50,000), but the assets included is defined more broadly than the assets subject to the FBAR. This reporting will be an integral part of the return itself and thus is not just a separate information return reporting obligation. I discuss this new reporting requirement below starting on p. 147.

(4) Other.

There are still other filing requirements in the Code dealing with special problems. The tax shelter registration requirements are a good example.⁴⁸⁶ I discuss the registration requirements and other facets of the tax shelter problem below (pp. 781 ff.).

⁴⁸¹ 31 CFR § 103.32.

⁴⁸² The IRS usually will not seek to collect the penalty for the FBAR failure and the required records failure, although the statute permits the penalty for both of the proscribed conducts. Jeremiah Coder, District Court Allows Second FBAR Penalty Collection to Proceed, 2012 TNT 219-3 (11/10/12) (quoting an IRS attorney prominently involved in the IRS’s offshore accounts initiatives, who added that “FBAR failure-to-file penalty is significant enough that an additional penalty for the failure to keep records is usually unnecessary,” and noting that he is not aware of the application of both penalties).

⁴⁸³ United States v. Chabot, ___ F.3d ___, 2015 U.S. App. LEXIS 12367 (3d Cir 2015), the most recent in the unanimous decisions in the Courts of Appeals, citing all of those decisions.

⁴⁸⁴ 11 U.S.C. § 523(a)(7); see United States v. Simonelli, 614 F. Supp. 2d 241 (D. Conn. 2008). I do note in this regard that the offshore penalties imposed under the offshore bank voluntary disclosure programs may be dischargeable because, while they may be in whole or in part, in lieu of FBAR penalties, they are assessed as miscellaneous penalties under the Internal Revenue Code.

⁴⁸⁵ § 6038D.

⁴⁸⁶ See §§ 6111 and 6112.

There are, of course, many other filing requirements, but the foregoing are the principal ones relevant to this class.

B. Certain Types of Elections Not on Returns.

1. Introduction.

The Code offers the taxpayer elections which can have a significant tax impact. Many of these are made on the return. I do not deal with those here, since the return instructions will be sufficient in those cases and they involve no special procedural issues.

I do note one procedural issue with a common election. Many taxpayers – indeed most taxpayers of the type you would likely represent – claim itemized deductions. Itemized deductions are claimed by taxpayer election – effected by actually claiming them on the return.⁴⁸⁷ If the taxpayer does not file a return, the taxpayer may not get the benefit of itemized deductions.⁴⁸⁸ There is no requirement that return be timely filed nor is there any time stated for the filing of a delinquent return, so this problem may be fixed easily. There are other elections in the Code that require a return making an election within a certain time period.⁴⁸⁹

2. S Corporation Elections.

One of the most common elections other than on the return itself is the S Corporation election. The election is made on Form 2553 which must be filed before or within the first 2 ½ months of the taxable year to be valid for the year.⁴⁹⁰ The IRS may grant relief from the failure to timely file and, indeed, the tax publishers routinely report the granting of such relief.

⁴⁸⁷ § 63(e).

⁴⁸⁸ See e.g., Jahn v. Commissioner, 2010 U.S. App. LEXIS 17525 (3d Cir. 2010) (unpublished opinion); for an extreme extension of this rule, see United States v. Kellar, 2010 U.S. App. LEXIS 19129 (5th Cir. 2010) (unpublished) where the sentencing court excluded itemized deductions from the sentencing tax loss calculation for the years the taxpayers did not file returns.

⁴⁸⁹ See Swallows Holding Ltd. v. Commissioner, 515 F.3d 162 (3d Cir. 2008) (election under Section 882 required by regulation to be filed within time period; held, regulation requirement is valid).

⁴⁹⁰ § 1362(b)(2).

3. Check-The-Box on Entity Characterization.

Under the so-called “check-the-box” election allowed by the Regulations,⁴⁹¹ a taxpayer which is an entity having certain corporate and noncorporate characteristics may elect to be treated as a corporation or some other appropriate entity such as a partnership or a tax nothing.⁴⁹² An example of such an entity is a state-law Limited Liability Company (“LLC”). An LLC with two or more members may elect to be treated as either a corporation or a partnership; an LLC with only one member may elect to be treated as a corporation or a tax nothing where the results of the entity’s operations are reported directly on the single members’ tax return. The default rule requiring no formal election for domestic entities that have the hybrid characteristics is to treat them as a partnership or, if a single member entity, a tax nothing.⁴⁹³ So, the formal election, made on Form 8832, Entity Classification Election, is actually required only if the entity wants to be treated as a corporation. That election – whether the default rule or the formal election – determines the return filing requirements under the rules stated above.

An entity may change its classification, but if it does so it then must wait five years before changing classification again.⁴⁹⁴ Care must be taken, of course, in changing characterizations because of the collateral tax consequences. For example, if an entity is being taxed as a corporation and is eligible to elect to be treated as a partnership, the election to change will result in the entity as a corporation being liquidated with the tax consequences that attend liquidation of a corporation followed by a contribution to a partnership if the entity had two or more members. Similarly, if an entity is being taxed as a partnership or as a tax nothing, the election to be taxed as a corporation will result in a capital contribution to a deemed newly formed corporation with the tax consequences which that entails.

Practitioners should be aware that this election to avoid corporation status is not the same as electing S Corporation treatment. S Corporations are not treated as partnerships or tax-nothings, and there may be some significant differences in certain aspects.⁴⁹⁵

⁴⁹¹ Regs. § 301.7701-3. These regulations are not statutorily authorized in the sense that there is no Code or separate statute allowing the IRS to allow or honor such elections. Congress was, however, well aware of the process and, in this sense, allowed it. And, so long as the taxpayer makes the election (either actually or by inaction, thus invoking the default rules) and does not complain, the IRS will not complain either and there will be no judicial test of its authority. In McNamee v. Dept of Treasury, 488 F.3d 100 (2d Cir. 2007), the Court applied the Chevron / Mead line of authority to give the IRS broadly leeway to impose the rules of the game by regulation and declined to permit a taxpayer who elected tax nothing status for his LLC to avoid the rules.

⁴⁹² An entity treated as a tax nothing would be reported on the individual tax return on Schedule C and would be included on a corporate return as simply a division, the results of which are in the aggregate data reported on the return.

⁴⁹³ Regs. § 301.7701-3(b)(1).

⁴⁹⁴ Reg. § 1.7701-3(c)(1)(iv).

⁴⁹⁵ See e.g., Reg. § 1.1361-4(a)(7), Reg. § 301.7701-2(c)(2) as amended by T.D. 9356. These Regulations treat the check-the-box entity as the employer and as a corporation (meaning

Finally, the Tax Court held in a reviewed decision that, although the check-the-box regulations govern the tax treatment for income tax purposes, it may not govern the tax treatment for all tax purposes.⁴⁹⁶ In that case, the issue was whether a tax-nothing LLC – a check-the-box entity one owned by a single member – was to be treated as a tax-nothing for purposes of calculating the gift tax with respect to gifts of membership interests in the LLC. The Court held that the regulations did not purport to sweep that far to override the settled rule that the gift tax applies to the state law interest transferred.⁴⁹⁷ The holding drew vigorous dissents.

C. Jurat and Signature.

Section 6065 requires returns to be submitted under penalty of perjury unless provided otherwise by Regulation. The penalty of perjury statement, often referred to as the “jurat”, on the individual income tax return (Form 1040) is:

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete.⁴⁹⁸

The purpose of the jurat is to impose upon taxpayers the seriousness of the act by providing the basis for prosecution for what is commonly referred to as tax perjury.⁴⁹⁹ I discuss the tax crimes (including tax perjury) below (pp. 295 ff.). The commonly encountered tax returns -- corporate and individual income tax returns and estate and gift tax returns -- do contain a jurat.

limited liability) for tax purposes, except that a sole member is treated as self-employed for purposes of the SECA tax. Prior to that amendment, the applicable regulation imposed direct liability on the sole member of a check-the-box entity, but the amended regulation reversed that to make the entity only directly liable (although, of course, the sole member can be liable for the trust fund portion under the TFRP in § 6672). Because of the broad power the IRS has by regulation under Chevron and its progeny, courts have uniformly held that the amended regulation does not invalidate the effect of the prior regulation prior to the effective date of the amended regulation. See McNamee v. Dept of Treasury, 488 F.3d 100 (2d Cir. 2007); Littriello v. United States, 484 F.3d 372 (6th Cir. 2007) and Medical Practice Solutions LLC v. Commissioner, 123 T.C. No. 7 (2009) (holding consistent with McNamee and Littriello, rejecting argument that merely because the rule was changed by a later applicable regulation did not mean that the earlier regulation was invalid).

⁴⁹⁶ Pierre v. Commissioner, 133 T.C. 24 (2009).

⁴⁹⁷ I believe it is fair to say that, had the Regulations clearly stated that the check-the-box election covered the gift tax consequences, the Regulations might have been sustained under Chevron and its progeny.

⁴⁹⁸ For the preparer of the return, the jurat is: “Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.”

⁴⁹⁹ § 7206(1).

One caveat regarding the jurat. IRS forms that do not have a jurat can still result in criminal prosecution if the information in the form is false.⁵⁰⁰ I summarize the criminal penalties below.

If, for some reason a taxpayer is legally incapable of filing a return, the executor, administrator, guardian, etc. must file the return and sign subject to the jurat.⁵⁰¹

D. What is a Return?

1. General Requirements.

Income tax liability is reported via the income tax return – for individuals, **Form 1040** or one of its iterations (e.g., **1040 EZ** for simple individual returns, **1040NR** for nonresidents, etc.) and, for corporations, **Form 1120** or one of its iterations (such as **1120S** for S Corporations).⁵⁰² Transfer tax liabilities are reported on gift tax returns (**Form 709**), estate tax returns (**Form 706**) and generation skipping tax returns (**Form 706**). There are a host of other forms for particular types of tax and information reporting requirements.

A return has been described by some as a “first offer” to the IRS, which the IRS may accept by receiving the return and doing nothing (i.e., not asserting that the taxpayer’s offer is too little). A system of penalties that we discuss later is designed to encourage most taxpayers to make the “first offer” a “fair” offer (within certain reasonable tolerances). Congress revisits periodically the issue of whether penalties sufficiently encourage taxpayers to do right and how the penalties may be fine-tuned to do so.

In considering the role of a return, we must first know what a return is. A frequently cited test for a valid income tax return is the Beard test, named after the case in which it appeared:

First, there must be sufficient data to calculate [the] tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury.⁵⁰³

Generally, the income tax return should be filed on the proper form, contain information sufficient to calculate a tax liability, and identify the taxpayer (including the taxpayer's identification number). A return must be signed and verified under penalties of perjury.⁵⁰⁴ The IRS is authorized

⁵⁰⁰ 18 U.S.C. § 1001(a).

⁵⁰¹ § 6012(b).

⁵⁰² S Corporations which are normally flow-through entities with taxes generally paid at the shareholder level may actually have tax liability in some rare cases.

⁵⁰³ Beard v. Commissioner, 82 T.C. 766, 777 (1984), affd. 793 F.2d 139 (6th Cir. 1986).

⁵⁰⁴ §§ 6061 and 6065. There is a theory “tacit consent” which has been used to treat a joint return signed by only one of the spouses as a return. The IRS claims that it is a theory that can be used only by the IRS to validate such a return but cannot be used by the taxpayer. In Reifler v.

to allow returns without such signatures or verifications, but the common returns (income tax returns and transfer tax returns) upon which we focus in this course will require signature and verification.

Why must the return be filed on the proper form?

Congress has given discretion to the Commissioner to prescribe by regulation forms of returns and has made it the duty of the taxpayer to comply. It thus implements the system of self-assessment which is so largely the basis of our American scheme of income taxation. The purpose is not alone to get tax information in some form but also to get it with such uniformity, completeness, and arrangement that the physical task of handling and verifying returns may be readily accomplished.⁵⁰⁵

I have given you some general rules that assist in determining what is a return. They will work in most cases. However, it has been observed that the term return in the Code can have more than one meaning, with the meaning heavily influenced by context.⁵⁰⁶ Still, although you should be aware that the definition and application of the term can be nuanced, for most purposes and for purposes of this class we will focus on the general definition.

2. Missing Elements.

Let's explore some of the issues raised by the Beard summary of a return.

a. Honest and Reasonable Attempt to Satisfy.

The quintessential case where this element is lacking is the tax protestor who does not provide anything even purporting to be the type of information required by the return. The protestor may, for example, simply not provide any numbers on the return or may provide all zeros (except

Commissioner, T.C. Memo. 2013-258, the Tax Court declined to resolve that issue, finding that it could resolve the case without doing so.

⁵⁰⁵ Commissioner v. Lane Wells Co., 321 US 219, 223 (1944).

⁵⁰⁶ In In re Payne, 431 F.3d 1055, 1059 (7th Cir. 2005), Judge Posner opined: "All the cases cited to us make sense and are consistent if 'return' can vary with context; nonsense results if 'return' must bear the same meaning everywhere." See also Conforte v. Commissioner, 692 F.2d 587, 591 (9th Cir. 1982) (citing Payne and acknowledging "the possibility that the same word could have a different meaning in different parts of the code," and concluding that "where, as here, a word could well have a different meaning in different statutory contexts, a purpose-oriented approach should be used when interpreting the meaning of the word as it is used in different sections of the Code." Notwithstanding this, the form should be some type of return form recognizable as such. Other IRS forms will not be treated as returns even when they are signed by the taxpayer and show a tax liability. For example, the Form 870, Waiver of Restrictions on Assessment, can incorporate a tax liability (and will have back-up summarizing how the tax liability was derived), but, even if it is signed by the taxpayer and serves some of the functions of a return, it is not a return form and cannot be treated as a return. Mohamed v. Commissioner, T.C. Memo. 2013-255.

as to the tax that was withheld or paid in installments, so that a net refund is due). This empty return is often accompanied by protestor statements, such as that the Constitution does not allow taxation. With the exception of an older 9th Circuit case, the courts routinely hold that such returns are not returns and the IRS's position is that zero returns are not returns.⁵⁰⁷ If it is not a return, then the taxpayer, a protestor in this example, can be subject to (1) the civil and criminal penalties for failure to file a required return and (2) an unlimited civil statute of limitations that applies if no return is filed.⁵⁰⁸ But, a return that looks like a return and has information from which a – not necessarily the correct – tax liability can be derived will likely be treated as a return.⁵⁰⁹

What if the return is fraudulent? By definition, the fraudulent return does not represent “an honest and reasonable attempt to satisfy the requirements of the tax law.” Can a taxpayer facing a tax evasion charge or a civil fraud penalty on the basis of an allegedly fraudulent return (e.g., omitting large amounts of income or claiming false deductions) allege that he or she never made an honest or reasonable attempt to satisfy the law so that what he or she filed was not a return and cannot support a tax evasion or tax perjury charge for filing a false return?⁵¹⁰

The conventional wisdom is that the return does not have to indicate the correct tax liability or the components (income and deductions) necessary to derive the correct tax liability. Thus, for example, if income is omitted from a return that otherwise sets forth information (including other income, deductions and taxable income so that the return is not facially irregular), the document filed is a return. Civil and criminal penalties may apply to the understatement of tax on the return

⁵⁰⁷ Cabirac v. Commissioner, 120 T.C. 163 (2003); ILM 200651015 (11/14/06). The contrary authority is United States v. Long, 618 F.2d 74 (9th Cir. 1980).

⁵⁰⁸ See United States v. Marston, 517 F.3d 996 (8th Cir. 2008) (holding that a defendant who files a form that does not rise to the level of a return can be convicted of failure to file a return, citing United States v. Grabinski, 727 F.2d 681, 686 (8th Cir. 1984). We discuss penalties and statutes of limitations below.

⁵⁰⁹ See Sakkis v. Commissioner, T.C. Memo. 2010-256, where the Judge Holmes reasoned:

Although the Sakkises used a frivolous legal claim to reduce their tax liability to zero, the rest of their return * * * contained complete and accurate information from which the Commissioner could determine their tax liability. With the exception of the frivolous deduction itself and the disappearance of the self-employment tax and alternative minimum tax, the Sakkises made an honest and reasonable attempt to comply with the tax laws. And while the use of that deduction may indicate negligence, it does not nullify their entire tax return. We therefore find that the Sakkises filed a valid 2000 return.

⁵¹⁰ Tax crimes purists will see a technical problem in this question. Tax evasion is usually committed by filing a fraudulent return. A return, however, is not required; the conduct criminalized is an attempt “in any manner to evade or defeat any tax.” So, filing a fraudulent return even if the conduct rendered the document not a return would not be a defense to tax evasion. So I am painting in imprecise strokes in the text. Perhaps a better example would be a tax perjury charge under § 7206(1).

or the presentation of false information on the return.⁵¹¹ For example, if the document meets the minimum requirements of a return, the taxpayer could face possible tax evasion or tax perjury felony charges for deliberate omissions from or misstatements on the return,⁵¹² whereas if the document does not meet the minimum requirements for a return, the taxpayer would only face a failure to file misdemeanor charge.⁵¹³ Similarly, a fraudulent return is not a nullity so as to avoid the application of the civil fraud penalty or the unlimited statute of limitation for fraud.⁵¹⁴ In a sense, the return simply has to appear regular on its face and have sufficient components to be processable by the IRS as a return.

b. Missing Required Schedules.

A return is still a return even if it is missing schedules that are otherwise required. Thus, for example, if the individual taxpayer had significant capital gains during the year, Schedule D is required. If he files his Form 1040 without the Schedule D, it is still a return. Why is that? Because it purports to be a return and is not so irregular on its face (in contrast to a protestor facially deficient return) that it should not be a return. The requirement that it be a return is not a requirement that it be a correct return.

c. Disclaimer or Altered Jurat Returns.

If any key element is not present, has the taxpayer filed a return? Let's deal first with a straightforward case -- i.e., the taxpayer attempts to disclaim the return although the return might appear otherwise regular. (This is one form of protestor action, but in this form the taxpayer will often set forth numbers that, at one level, make the return appear regular on its face except for an

⁵¹¹ See Badaracco, et al. v. Commissioner, 464 U.S. 386, 396-397 (1984) (which I discuss at p. 155), noting that the return is still a return even if fraudulent, thus invoking the civil and criminal consequences of returns even if a nonfraudulent amended return is thereafter filed.

⁵¹² §§ 7201 and 7206(1). Judge Posner, getting to the point as usual, pungently noted (In re Payne, 431 F.3d 1055, 1058 (7th Cir. 2005)):

In Case B, the taxpayer mails to the right address a return that appears to comply fully with the requirements for a return but in it he claims a blind and dependent exemption for his pet cat, whom he describes as his mother. This is deemed a return if he is prosecuted for fraud, even though it is again not an honest and reasonable attempt to satisfy his obligations. It is a return because the submission of it is conduct that Congress intended to punish in prohibiting fraudulent tax returns.

⁵¹³ § 7203.

⁵¹⁴ Badaracco, et al. v. Commissioner, 464 U.S. 386, 396-397 (1984).

altered jurat.) Please read Williams v. Commissioner, 114 T.C. 136 (2000).⁵¹⁵ What are the consequences of a failure to file a return as set out in Williams?

d. Failure to Identify the Taxpayer.

One of the issues that you may face as a practitioner is how to deal with a person who has income from an illegal source that must be reported on the return. For example, if the taxpayer is an independent illegal drug dealer, he must report the income on the return on Schedule C. The taxpayer has no right to refuse to file a return or, if he files a return, fail to report the income. The problem for the taxpayer in this situation is not the filing of the return or not reporting the income. Rather, the problem is the requirement on the return (here Schedule C) that he or she report the income producing activity. This raises inherent tensions with the Fifth Amendment's privilege not to incriminate oneself.

The parameters of the law in this area are set by Supreme Court cases dealing with the federal wagering tax. In Marchetti v. United States, 390 U.S. 39 (1968) and Grosso v. United States, 390 U.S. 62 (1968), the Supreme Court found that the pervasive governmental regulation of gambling activities – most states made it illegal to gamble -- implicated the Fifth Amendment privilege with respect to the federal requirement that the person engaged in that activity file a special wagering tax return. The mere filing of a federal wagering tax return admitted activity that, at least then, most states declared to be illegal. Moreover, even filing a Fifth Amendment wagering tax return identifying the taxpayer but otherwise claiming the Fifth Amendment effectively admits such conduct. The Court's holdings applied only to wagering tax returns which were required only for the inherently suspect activity of wagering.

The Grosso and Marchetti holdings do not mean that persons engaged in such activity need not file **income tax** returns or can leave otherwise required schedules off the income tax return. Unlike wagering tax returns, income tax returns do not require the reporting of only suspect categories of income. Rather, income tax returns require reporting of all income from whatever source derived, and in by far the overwhelming number of cases the income is legal source income under federal and state laws. In an income tax return, the taxpayer's choice generally is to report the income and, if the return asks for information that would be incriminating (e.g., the source from which the income arose), to assert a privilege as to the incriminating information (e.g., assert the privilege as to the source only, but not the amount). In Garner v. United States, 424 U.S. 648

⁵¹⁵ See also Rev. Rul. 2005-18, 2005-1 C.B. 798. In United States v. Davis, 603 F.3d 303 (5th Cir. 2010), a criminal case, where the taxpayer “added the phrase ‘without prejudice’ near his signature on the jurats.” The preparer who was also convicted of aiding and assisting in the preparation of false returns claimed that the addition prevented the 1040 from being a return and hence from supporting the conviction. The Court that the added language did not defeat return status, giving the IRS considerable leeway as to characterization where the language is ambivalent. (The Court also noted in a footnote that, in any event, even if the Form 1040s were not returns, they were still false documents submitted to the IRS, thus invoking the aiding and assisting criminal statute.)

(1976), the Supreme Court held that a taxpayer who reports his illegal activity (there wagering) on the income tax return without asserting a privilege not to disclose, has waived his Fifth Amendment privilege and that admission can be used against him in a criminal trial.

In our example (drug dealing), the source of the income is the problem. Schedule C does request information as to the business activity giving rise to the income. The taxpayer may assert the Fifth Amendment privilege to refuse to provide the information as to the source of the income. Of course, the source of the income is relevant to the IRS's need to confirm the accuracy of the income reported on the Schedule C. Hence, the assertion of a privilege from disclosing the source of the income may wave a red flag in the IRS's face. But the taxpayer could assert the privilege as to the source of the income.

On the other hand, the same taxpayer may be tempted to misdescribe his business activity rather than wave a red flag in the IRS's face. The problem is that the taxpayer will then have committed a felony – i.e., tax perjury by filing a false return, § 7206(1), even if he otherwise properly reports his tax liability (including components of income and deduction) and pays all taxes.

We shall see a variation of this concern in the Gertner case, discussed below (pp. 398 ff.). The lawyer filed a Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business, to report cash payments in excess of \$10,000 but failed to identify the individual paying the cash in excess of \$10,000 (on asserted Fifth Amendment privilege grounds).⁵¹⁶ The IRS takes the position in such a case that the return filer has not filed a return and can be subject to the penalties for failure to file the return (which in the case of the Form 8300 are substantial, as we will discuss below). The Courts generally sustain the IRS position.

3. Consequences of A Filing Not Treated as a Return.

If whatever the taxpayer signed or filed is not treated as a return under the foregoing rules, it will be treated as if the taxpayer did not file the required return. As we shall see, there are penalties and other consequences for failure (such as an unlimited statute of limitations for assessment) to file a return. But, if the document is not a return, the penalties and other consequences of an incomplete or inaccurate return simply do not apply.⁵¹⁷

⁵¹⁶ In its current iteration, the Form is a join IRS and FinCEN form.

⁵¹⁷ In an interesting case, Mohamed v. Commissioner, T.C. Memo. 2013-255, the IRS had received a document in the form of a return but it had not been properly executed by the taxpayer. The IRS processed it as a return and asserted the § 6663 civil fraud penalty which is applicable only to returns. After trial in the case, sensing that the Tax Court would hold that the document in question was not a return, the IRS asserted that the taxpayer was liable for the § 6651(a) and (f) failure to file penalty, which under (f) increases the penalty from a maximum of 25% to 75% if the failure to file is a fraudulent failure to file. Based on earlier Tax Court authority indicating that the issues were the same for either penalty and hence the taxpayer was not prejudiced by the late assertion of the alternative penalty, the IRS considered the penalty but held that the IRS had not established fraud.

E. Return Information to Address Noncompliance.

1. General.

Returns require a great deal of information other than the basic components of tax liability. This is particularly true with respect to income tax returns because of the complexity of the Code and taxpayers' willingness to avoid and evade their tax obligations even when that tax duty is known. Given the nature of this text as an introduction to tax procedure, I cannot deal with all instances of the information required on returns, but I will give several examples that have been prominent in tax administration.

Obviously, the general goal of requiring information on the return is to undergird the tax system and assist in its implementation. Accordingly, the examples I deal with address areas in which the return reporting requirement is designed to address particular areas in which noncompliance is a significant tax administration problem.

2. Information Required For Special Compliance Initiatives.

a. Offshore Compliance Information.

(1) The General Compliance Problem.

The United States has a worldwide tax system requiring that, generally, its citizens and alien residents report and pay tax on worldwide income.⁵¹⁸ In some cases, income earned by offshore entities owned by U.S. entities is not taxed in the United States until "repatriated" (generally meaning brought into the U.S.), but in some cases for significant owners of offshore entities investment type of income is taxed immediately whether or not repatriated. The rules are complex.

Income arising outside the United States and income shifted outside the United States is often very difficult for the IRS to detect and thus offers opportunities for significant tax noncompliance. Accordingly, Congress has enacted and the IRS has implemented certain return reporting requirements designed to identify and encourage compliance with this worldwide income reporting scheme.

(2) Offshore Entity Reporting.

The Code has long had significant reporting requirements for taxpayers to report ownership in foreign entities. For example, § 6038, and the implementing **Form 5471**, requires U.S. persons

⁵¹⁸ Sometimes this system is referred to as citizenship based taxation ("CBT"). For this purpose, at least in our system, alien residents in the U.S. are taxed the same as citizens. The alternative model to CBT is residence based taxation ("RBT") where taxation is solely based on residence and not citizenship. In the RBT model, citizen of country X residing in country Y would be taxed only by country Y.

meeting certain ownership level requirements as to a foreign corporation to report to the United States certain key information about the income and assets of the foreign corporation. Similar reporting requirements exist for foreign partnerships and foreign trusts.⁵¹⁹ Significant potential penalties are imposed for noncompliance, and in some cases an extended statute of limitations applies for noncompliance.

(3) Offshore Financial Assets on 1040 Form 8938.

Bank Secrecy Act⁵²⁰ information forms like the **FBAR** are generally just information forms submitted to the agency (Treasury) separately from any tax form. Congress sometimes requires information forms (such as Form 5471) to be attached to tax returns. Congress passed an information report, effective for the tax year 2011, for offshore accounts that is to be included with the tax return. The report parallels the type of information included in the FBAR. Individual taxpayers with an interest in a “specified foreign financial asset” during the taxable year must attach a disclosure statement, **Form 8938**, to their income tax return for any year in which the aggregate value of all such assets is greater than \$50,000 (or such higher dollar amount prescribed by the IRS).⁵²¹ The IRS prescribed that the Form is required in the following circumstances with the reporting thresholds as indicated: (i) an unmarried taxpayer having specified foreign financial assets that have a value of more than \$50,000 on the last day of the year or \$75,000 at any time during the year; (ii) married taxpayers residing in the U.S. and filing a joint return having specified foreign financial assets of more than \$100,000 on the last day of the year or \$150,000 at any time during the year; (iii) married taxpayers filing separate returns and residing in the U.S. having specified foreign financial assets of \$50,000 on the last day of the tax year or more than \$75,000 at any time during the year; and (iv) taxpayers living abroad (a) not filing a joint return and having specified foreign assets of \$100,000 on the last day of the year or \$300,000 at any time during the year and (b) filing a joint return and having specified assets of \$400,000 on the last day of the year or \$600,000 at any time during the year.⁵²² There are certain limited exceptions for reporting assets that are reported elsewhere on tax forms (not the FBAR).⁵²³

⁵¹⁹ Sections 6046A and 6048.

⁵²⁰ The Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act of 1970 (31 U.S.C. 5311 et seq.

⁵²¹ § 6038D(a). For purposes of the penalty (discussed in the text below), there is a presumption that the \$50,000 threshold is met if the IRS determines that the taxpayer has one or more specific foreign financial assets and does not supply adequate information to determine that the aggregate value of all such assets is below the threshold. § 6038D(e). The Form is due for tax years after 2010.

⁵²² IRS website titled Do I need to file Form 8938, “Statement of Specified Foreign Financial Assets”?, [here](#) (last revised 11/19/14 and viewed 7/17/15).

⁵²³ For example, a foreign financial account does not have to be reported on Form 8938 if it is reported on: (i) Form 3520 reporting related to foreign trusts, (ii) Form 5471 reporting related to certain foreign corporations; (iii) Form 8621 reporting related to a passive foreign investment company and (iv) Form 8891 reporting related to certain Canadian Registered Retirement Plans.

Form 1040 Schedule B will continue to ask for information about foreign accounts and advising the taxpayer of the obligation to file the FBAR. The requirement to file the FBAR is independent of the obligation to file Form 8938 with the tax return. As a tax return filing, the Form 8938 is subject to § 6103's secrecy rules, and thus not generally available to other law enforcement agencies.

Reportable “specified foreign financial assets” are depository or custodial accounts at foreign financial institutions and, to the extent not held in an account at a financial institution, (1) stocks or securities issued by foreign persons, (2) any other financial instrument or contract held for investment that is issued by or has a counter-party that is not a U.S. person, and (3) any interest in a foreign entity.⁵²⁴ The IRS interprets these terms broadly, so IRS pronouncements must be consulted each time the issue arises, particularly during the early years of implementation when the IRS’s interpretations may be in a period of flux. The assets and foreign institutions and the maximum values during the year must be reported.⁵²⁵

The criminal penalties related to the form are the standard criminal penalties for tax obligations. The most likely criminal penalties are evasion (§ 7201) for underreported or underpaid taxes related to income from the assets required to be disclosed and tax perjury (§ 7206(1)) either for underreporting the related income or presenting false information on the Form. The criminal statute of limitations is six years.⁵²⁶

The civil penalty for failure to file the form or failure to file a complete and correct form is \$10,000 with an additional incrementing penalty if the taxpayer fails to provide the information to the IRS after the IRS notifies the individual of the failure to disclose.⁵²⁷ The penalty increases by \$10,000 for each 30 day period after the notice. There is a reasonable cause exception to this failure to disclose penalty.⁵²⁸ The penalty is an assessable penalty, meaning that the deficiency notice and advance litigation procedure prior to payment is not available.⁵²⁹

In addition, a 40% new accuracy related penalty applies to any understatement attributable to undisclosed foreign financial assets. This penalty provision not only applies to this new section but older sections requiring disclosure of foreign financial assets (such as Form 5471). Finally, of course, the traditional 75% civil fraud penalty can apply to the related understatement.

Contemporaneously with enacting this new provision, Congress provided two special extended statutes of limitations related to these assets and the income from them. First, if the

⁵²⁴ § 6038D(b).

⁵²⁵ § 6038D(c).

⁵²⁶ § 6531.

⁵²⁷ § 6038D(d). This does not appear to be a separate penalty for each asset not disclosed or misstated. By contrast, as noted earlier, the IRS interprets the FBAR nonwillful penalty to apply per account per year.

⁵²⁸ § 6038D(g).

⁵²⁹ ECC 201226028 (4/27/12), reprinted at 2012 TNT 127-61.

taxpayer omits gross income exceeding \$5,000 attributable to the foreign assets (regardless of whether the assets themselves are reported), the statute of limitations is 6 years rather than the normal 3 years.⁵³⁰ Second, the failure to report this foreign financial asset information and other types of information regarding foreign activity subjects the entire return to an open statute of limitations that does not expire until three years from the date the taxpayer furnishes the information required to be disclosed unless the failure is due to reasonable cause and not willful neglect.⁵³¹ The second extension applies whether or not the taxpayer reported the income from the foreign financial assets or other types of specified activity.

The IRS is authorized to promulgate regulations necessary to carry out the intent of the Code provision.⁵³²

b. Uncertain Tax Positions (“UTP”).

The Code is complex. This often means that tax return reporting positions are not certain. The Code’s requirements in terms of certainty may be conceptualized as a spectrum – at one end are positions that are certain to prevail and at the other are positions that are certain to fail. The tax penalty system which I discuss in detail later is designed to encourage compliance and punish, where appropriate, noncompliance. The penalty system has used this spectrum to determine when penalties are appropriate. In discussing the penalty system below, I discuss certain tax concepts such as “frivolous,” “reasonable basis,” “substantial authority,” and “more likely than not” that help locate the position on the spectrum for penalty purposes. I defer further discussion until we get to penalties, but suffice it to say for present purposes that financial accounting has developed the related concept of the uncertain tax position that is required to be reported for financial accounting purposes.

⁵³⁰ § 6501(e)(1)(A)(ii). This statute extension applies to all returns the statute for which was otherwise open on March 18, 2010, the effective date of enactment. This means that the 2006 year, with its 1040 due date of 2007, will be open because the normal 3 year statute made it open on March 18, 2010. Earlier years will be affected by the rule if there were some other event that caused the statute to be open on March 18, 2010. If that other event were the 25% omission rule causing a 6 year statute, the new statute will be irrelevant, because the statute will be 6 years anyway. Hence, practically, it would seem to have actual consequences for pre-2006 returns where there was a statute extension still in effect on March 18, 2010. For a good discussion of these interplays, see IRS Memorandum from Director, Examination Policy, dated 3/9/12, here: <http://www.irs.gov/pub/foia/ig/sbse/sbse-25-0312-022.pdf>.

⁵³¹ § 6501(c)(8), (as amended by the HIRE Act (FATCA provisions) and then by Pub. L. 111-226 (124 Stat. 2403), § 218 (8/10/10)). In PMTA-2014-18 (10/3/14), the author determined that an executor’s failure to file the Forms 8938 with respect to the decedent’s final Form 1040 and the estate’s Form 1041 invoked this suspended statute of limitations for the income tax returns (Forms 1040 and 1041) and for the estate tax return (Form 706).

⁵³² § 6038D(h).

Financial accounting, particularly as implemented for public companies, seeks to measure income from period to period and produce fair balance sheets for points during the period or periods measured (usually at the beginning and end). In order to properly measure income and balance sheets, potential liability for aggressive positions that may end up costing the company need to be measured and appropriate reserves created.⁵³³ There are auditing standards for reporting financial positions for uncertain tax positions. These positions are incorporated mostly in ASC 740-10 (previously known “Fin 48,” and still commonly referred to as Fin 48). At the risk of oversimplifying, assume that a corporation takes a deduction of \$100 and thereby reports \$35 less tax than it otherwise would have. ASC 740-10 demands that the corporation quantify the risk that the \$35 tax it “saved” will not be realized ultimately and reserve for the tax benefit if the risk is above a certain threshold. Tax benefits that are not more likely than not to be sustained if challenged will not achieve a financial statement benefit because the tax expense must be reported on the P&L statement and reflected in a reserve liability on the balance sheet. Tax benefits which are more likely than not to be sustained if challenged may achieve a financial benefit, but the quantum thereof is based upon the level of likelihood in excess of 50%. Obviously, this quantification process must be reflected in the corporation’s and the auditors’ records (often called tax accrual workpapers) and can be the mother lode to the IRS for aggressive tax positions that otherwise might be difficult to detect.⁵³⁴ (I discuss below the circumstances under which the IRS will seek to obtain the tax accrual workpapers by IRS summons, and the courts resolution of disputes arising from taxpayers’ refusal to give up the workpapers.)

The IRS requires certain larger corporations subject to this financial accounting reporting to report on Schedule UTP their uncertain tax positions as part of their annual returns. The information required will be less detailed than in the tax accrual workpapers, but will identify and rank uncertain tax positions in a Schedule UTP. The concept was announced in January 2010⁵³⁵ and has been refined through notice and public comment. Hence, I will not address it in more detail at this point, but suffice it to say is that the goal is to have the taxpayer self-report its uncertain tax positions and, without stating where on the spectrum the taxpayer thinks any particular position lies, rank order the uncertain tax positions by the amount of tax dollars involved. I will return in this text to this issue when discussing the IRS use of its information gathering powers – particularly the IRS summons – to obtain this type of information and, indeed, the details (including spectrum assessments) through the so-called tax accrual workpapers. Suffice it to say at this point that

⁵³³ In broad strokes, creating reserves will lower income for the period the reserve is created and will reduce net equity for the year or years that that reserve appears as a liability on the balance sheet.

⁵³⁴ This is a high level summary of the process. For a detailed discussion of how one public company implements the process, see Wells Fargo & Company v. United States, 2013 U.S. Dist. LEXIS 78714 (D. MN. 2013). Based on its review of the process and in the facts of the case, the court held that the taxpayer’s initial identification of uncertain tax positions requiring the FIN 48 analysis was not done in anticipation of litigation, but the analysis itself – consisting of recognition and measurement, was done in anticipation of litigation for which the work product privilege applied.

⁵³⁵ IRS Announcement 2010-9; 2010-7 IRB 1.

information reporting on uncertain tax positions appears to be part of the immediate present and future for income tax returns of larger corporations.

I should note that the proposal is controversial but the controversy appears, in this author's judgment to be self-created by a group of whiners – taxpayers and their tax professionals who financially benefit from a system the rewards those willing to hide the ball. UTP is a step in the direction to make the tax system more transparent and thus more fair; very little that the whiners whine about is justified.⁵³⁶

c. Disclosure of Aggressive Position.

Some of the potential penalties that apply for improper return reporting may be avoided by making disclosures on the return.⁵³⁷ From the IRS's perspective, the purpose of the return disclosure forms and provisions is to encourage the taxpayer to disclose aggressive positions so that the IRS may take such action upon audit as may be appropriate. And, of course, a spin-off benefit to the IRS is that some taxpayers might not take the aggressive position at all if they are unwilling to take the position without disclosing it.

Making the decision to disclose and how to disclose -- balancing the need for penalty protection against showing one's hand and inviting IRS scrutiny of the position -- is an art form and requires considerable judgment and objectivity.

The Regulations provide that the disclosure forms for income taxes are **Form 8275**, Disclosure Statement for disclosures of positions that are not contrary to Regulations, or **Form 8275-R**, Regulation Disclosure Statement for positions that are contrary to Regulations.⁵³⁸ Some practitioners forego these forms and “disclose” on a separate sheet attached to the return and sometimes even in empty space on another return form such as Schedule C or Schedule D. They often do this because they think the non-form disclosure lowers the audit profile for the disclosure. The more pertinent question, of course, is whether such a non-form disclosure is adequate to achieve the goal of making a disclosure in the first place. I think there is risk in making disclosures that do not meet the Regulations mandate of the proper Form, but am aware of no case authority on the subject to date.

⁵³⁶ That's my own conclusion, but see also Kip Dellinger, *The Sky is Falling!* Comments on the UTP Proposals, 2010 TNT 123-7 (6/28/10).

⁵³⁷ Form 8275 may generally be used to report such positions. Form 8275-R is used to report positions contrary to IRS Regulations. As noted in the text above, the IRS has launched a new initiative to require reporting of “uncertain tax positions” on Schedule UTP. Proper disclosures on this Schedule UTP will be treated as having filed the Form 8275 or Form 8275-R, as appropriate.

⁵³⁸ Regs. § 1.6662-3(c)(2).

F. How is the Return Actually Filed?

1. Introduction.

Filing means delivery to the IRS.⁵³⁹

2. Hard Copy Filing.

Returns may be filed physically through use of the mail or other courier service or by hand delivery to an appropriate office of the IRS. When filed by mail or courier service, filings are usually made to the IRS Service Center covering the area of taxpayer's residence or, if a corporation, the principal office.⁵⁴⁰ I discuss below special rules that apply when returns are filed by U.S. mail or by authorized courier service. These rules referred to as timely-mailing, timely filing, deemed the return filed on the date deposited with the mail or courier service. Returns filed by hand delivery are to be delivered to the proper office designated for receipt and initial processing of the return.⁵⁴¹ If a return is delivered to the wrong office, the filing will not be deemed made until and unless it gets to the proper office.

One of the problems that a practitioner will face is that sometimes an IRS or collection agent will request that the taxpayer file the original return with that person rather than in the prescribed manner by mail or courier service or by hand delivery to the proper office. That is may not be a proper filing until and unless it gets to the proper office.⁵⁴² This could be relevant to statute of limitations and penalty issues turning upon the date of filing that I discuss below.

3. Computer Filing (E-Filing).

Most returns may be filed electronically or physically, which means that they are delivered to and filed with the IRS virtually instantaneously. Prodded by Congress, the IRS is pushing taxpayers to file electronically. For example, most tax return preparers are required to file electronically the returns they prepare.⁵⁴³ And taxpayers using services such as Turbo Tax are

⁵³⁹ Hotel Equities Corp. v. Commissioner, 65 T.C. 528, 531 (1975), aff'd, 546 F.2d 725 (7th Cir. 1976).

⁵⁴⁰ See § 6091. The service center can be determined by the instructions with the return.

⁵⁴¹ Regs § 1.6091-2(d).

⁵⁴² See e.g., Allnutt v. Commissioner, 523 F.3d 406 (4th Cir. 2008), where the taxpayer delivered the delinquent returns to the IRS District Counsel's office upon instructions from his attorney. The attorney was wrong. His client arguably may have suffered a huge tax bill as a result of being wrong. But see Dingman v. Commissioner, T.C. Memo. 2011-116 (distinguishing Allnutt and holding in any event that, on the facts, the inference is drawn that the returns reached the proper office for filing by a date that would make the assessments untimely).

⁵⁴³ See IRS web page titled "Most Tax Return Preparers Must Use IRS e-file," [here](#) (last reviewed and updated 5/14/15 and viewed 7/17/15).

offered the opportunity to file electronically. For the fiscal year 2014, over 157 million income tax returns were filed electronically, representing 77% of income tax returns filed.⁵⁴⁴

The advantage to the IRS of such electronic filing is that the information can be incorporated into the IRS data systems through an algorithm rather than requiring either OCRing or manual input.

III. Amended Returns.

A. General.

The key return is the original return. Historically, the Code has not specifically authorized amended returns (except by implication in a few passing references).⁵⁴⁵ From virtually the inception of the modern internal revenue laws early in the 20th century, the IRS has recognized amended returns for some purposes. The Supreme Court has said that this recognition has been said to be “a creature of administrative origin and grace.”⁵⁴⁶ The Code and Regulations do not require that an amended return be filed to correct errors on the original return, and the IRS is not required to accept an amended return (although it does so routinely).⁵⁴⁷ Taxpayers thus are under no legal compulsion to file amended returns as they are to file the original returns.⁵⁴⁸ (I should note, however, that tax

⁵⁴⁴ 2014 Data Book, Table 4, p. 9.

⁵⁴⁵ E.g., §§ 6501(c)(7) and 6213(g)(1); see also e.g., Regs. § 1.6091-2(e).

⁵⁴⁶ Badaracco v. Commissioner, 464 U.S. 386, 393 (1984).

⁵⁴⁷ Regs. § 1.451-1(a) provides that, if a taxpayer discovers an erroneous exclusion from gross income or erroneous inclusion in gross income in a filed return within the statute of limitations for that return, he or she “should” file an amended return reporting the tax or claiming the refund. The key word is “should,” of course. E.g., Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 380 n.10 (1983) (acceptance of amended returns is “within the discretion of the Commissioner”); Evans Cooperage Co. v. United States, 712 F.2d 199, 204 (5th Cir. 1983) (The Code and Regulations do not “make any provision for the acceptance of an amended return in place of the original return previously filed.”); Jones v. Commissioner, 338 F.3d 463, 466 (5th Cir. 2003) (“The IRS has discretion to accept or reject an amended return.”); Dover Corp. & Subsidiaries v. Commissioner, 148 F.3d 70, 72-73 (2d Cir. 1998) (“There is simply no statutory provision authorizing the filing of amended tax returns, and while the IRS has, as a matter of internal administration, recognized and accepted such returns for limited purposes, their treatment has not been elevated beyond a matter of internal discretion.”) (internal citations omitted). As a result, until accepted by the IRS, the filing of the return does not change an assessment previously made or a notice of deficiency previously issued. McCabe v. Commissioner, 46 T.C.M. (CCH) 390, 391 (1983); cf. Miskovsky v. United States, 414 F.2d 954, 956 (3d Cir. 1969) (“[I]t would be utterly disruptive of the administration of the tax laws if a taxpayer could disregard his return and automatically change an assessment based thereon by making an amended return in his favor long after the expiration of the time for filing the original return.”)

⁵⁴⁸ Indeed, although this should be logical from the absence of a duty to file an amended return, the failure to file an amended return is not proof of a taxpayer’s intent to evade tax. Broadhead v. Commissioner, T.C. Memo 1955-328.

professionals advising taxpayers whose original returns were materially erroneous have some ethical obligations to advise the taxpayer about correcting the error by filing an amended return; the scope of that advice and whether the tax professional must or should consider withdrawal from representing the taxpayer if he or she does not correct the error is beyond the scope of this book, but I do urge you to consider this issue further and deeper when it arises in your practice.)

Amended returns are generally used in two cases – to report additional taxes due or to claim refunds of taxes paid with original returns. An amended income tax return reporting overpayments is a claim for refund.⁵⁴⁹ Amended returns may also be filed to correct problems on the original return that do not affect the bottom-line tax liability (such as, for example, correcting a false statement as to the Schedule C business activity; consider the discussion regarding voluntary disclosure below).

Amended returns are usually filed after the due date for filing the return (either the original due date or the extended due date). Sometimes, however, a taxpayer will file an original return prior to the original due date of the return or, if the original return was filed during the extension period, prior to the extended due date of the return. If the amended return were not filed, the early filed return is deemed filed on the original due date if the return is filed prior to the original due date or on the date the return is actually filed if prior to the extended due date. However, if an amended return is filed prior to the original due date or, if on extension, the extended due date, then that amended return will be deemed the “return” for most purposes, although nominally an amended return.⁵⁵⁰ The amended return in that case is referred to as a “superseding return.” Filing a superseding return can have benefits to the taxpayer or the Government, depending upon the context. As noted below, an amended return does not normally cleanse a fraudulent original return, but it can if it qualifies under these rules as a superseding return. Other penalties that might apply to the original return can be avoided by filing a superseding return.⁵⁵¹ On the other hand, at least in the case of a superseding return filed during the extension period, it effectively extends the statute of limitations on assessment.

There is one other type of amended return that I will discuss in more detail later. This is the qualified amended return, a concept that applies in the penalty area. Accuracy related penalties (such as the 20% negligence penalty) apply to a base equaling the tax due less the tax reported on

⁵⁴⁹ Reg. § 301.6402-3(a)(5). Claims for refund are filed in individual income tax cases with the Form 1040X, and in C Corporation cases with a Form 1120X. Other income tax return forms use a similar naming convention (i.e., adding X to the original return number), but claims related to other types of taxes without an “X” form may be filed on Form 843, Claim for Refund and Request for Abatement.

⁵⁵⁰ SCA 1998-024 (5/12/98), reproduced at 98 TNT 177-60 (containing an excellent compilation of the cases and synthesis); and ILM 200645019 (6/20/06), reproduced at 2006 TNT 219-22.

⁵⁵¹ For example, in ILM 200645019 (6/20/06), reproduced at 2006 TNT 219-22, the original return failed to include Forms 5471. That failure could generate a penalty under § 6038(b). The penalty is mooted by the filing of the superseding return within the extension period.

the original return. The qualified amended return concept treats additional taxes reported on the qualifying amended return as if they had been reported on the original return, thus avoiding the accuracy related penalties but not the fraud penalty.⁵⁵² I discuss the qualified amended return below (beginning on p. 341). in discussing the accuracy related penalties. For present purposes you just should know that it offers a way to mitigate or avoid penalties that might otherwise apply.

B. Fraudulent Original Returns, Amended Returns and the Civil Statute of Limitations.

In Badaracco, v. Commissioner, 464 U.S. 386 (1984) which you should read now, the Supreme Court addressed the issue of whether the filing of a **nonfraudulent** amended return to correct a **fraudulent** original return started the normal three-year civil statute of limitations on assessment running as of the date of filing the nonfraudulent amended return. The civil statute of limitations is the period during which the IRS can assert an additional tax liability (including penalties and interest). The criminal statute of limitations is the period during which the IRS can criminally prosecute. Generally, for the significant tax crimes, the statute of limitations for criminal prosecution is six years.⁵⁵³ The civil statute of limitations is generally three years but, when the return is “false or fraudulent” “with intent to evade,” is always open.⁵⁵⁴

The issue in Badaracco was whether the filing of the original fraudulent return meant that the civil statute of limitations was open forever and the unlimited statute of limitations was not affected by the subsequent filing of a nonfraudulent amended return. Certainly, as indicated in the case, policy arguments could be made that the filing of a nonfraudulent amended return gave the IRS the information it needed and in legal contemplation superseded the original fraudulent return. The notion is that the IRS needs the unlimited statute of limitations only when the taxpayer has not provided the IRS a nonfraudulent return. The Supreme Court held, however, that the fraud on the original return was the reference point for the unlimited statute of limitations.

The exception to the rule in Badaracco is the one noted above that, if after filing a fraudulent return before the due date or the extended due date for the return, the taxpayer files a nonfraudulent amended return by the due date or extended due date, respectively, the amended return will be treated as the original return, thus cleansing the fraud.⁵⁵⁵ In the real world, however, amended returns are rarely filed before the due date of the return or extended due date of the return. If you happen, however, to get a client in that window of time, you have an easy fix for his or her criminal exposure – simply file a nonfraudulent return by the due date.

⁵⁵² See Regs § 1.6664-2(c)(2).

⁵⁵³ § 6531. The statute actually provides a three year statute of limitations as the general rule for federal tax crimes, but then excepts out from this general rule the significant (i.e., usually prosecuted) tax crimes as to which a six year statute of limitations applies.

⁵⁵⁴ §§ 6501(a) and 6501(c)(1) and (2).

⁵⁵⁵ SCA 1998-024 (May 12, 1998), reproduced at 98 TNT 177-60 (containing an excellent compilation of the cases and synthesis).

C. **Fraudulent Original Returns, Amended Returns and the Voluntary Disclosure Policy.**

In a tax practice, the most sensitive context in which a practitioner will advise a client as to filing amended returns is when the original return exposes the taxpayer to potential criminal prosecution. As in Badaracco, legally, a nonfraudulent amended return will not cause the original fraudulent return problem to disappear. The taxpayer can still legally be prosecuted for fraud on the original return. Worse, in a criminal prosecution, the amended return is an admission of the unreported tax from the original return and thus establish a key element – a tax due and owing – that the Government would otherwise have to prove in a tax evasion case.⁵⁵⁶ Why then should a taxpayer even consider filing an amended return?

An amended return generally cures the criminal problem. The general cure comes because of practical phenomena not commanded by the Code. These phenomena are reflected in the “voluntary disclosure policy” – which the IRS now refers to as a “voluntary disclosure practice” – through which the Government exercises its **prosecutorial discretion** to not prosecute a taxpayer qualifying under the policy or practice. Simply because the Government may prosecute any person who commits a crime does not mean that it will prosecute. In this instance, in order to encourage taxpayers to get right on their tax liabilities, the Government gives reasonable advance assurance that it will decline to prosecute taxpayers who file amended returns “voluntarily” (i.e., before the Government has started an investigation or before a series of events that will bring the fraud to the Government’s attention has been set in place). I discuss the voluntary disclosure policy in more detail below (pp. 306 ff.).

D. **Amended Returns Claiming Refunds and Audits.**

The odds of meaningful review or audit of an original return are quite low. The conventional wisdom is that the comparable odds for amended return are much higher, particularly where the amended return claims a significant refund. Also, there is anecdotal evidence that some types of amended returns are more heavily scrutinized than others. For example amended returns claiming income tax or gift tax refunds may be scrutinized less than amended returns claiming estate tax refunds.⁵⁵⁷ I think most practitioners intuit these varying risks of scrutiny, although their intuitions may be based on such limited data that they are speculations or wishful thinking. Should these

⁵⁵⁶ § 7201.

⁵⁵⁷ See e.g., Lane v. United States, 286 F.3d 723 (4th Cir. 2002); and Burgess J.W. Raby and William L. Raby, Sentiment or Greed: Gift or Compensation?, 34 Tax Practice (Tax Analysts) 169 (5/24/02) (“the IRS is much more likely to process Form 1040X income tax refund claims without challenge than it is to issue a gift tax refund without question.”) Apparently, for this reason, Circular 230 prohibits contingent fees (including return of fees) with respect planning transactions and positions reported on original returns but permit them for preparation of or advice with respect to amended returns. Circular 230, § 10.27.

varying risks of scrutiny affect how the practitioner advises a client to present claims for refund to the IRS?⁵⁵⁸

As noted below in Chapter 8 discussing penalties, Congress has imposed a penalty for aggressive positions on amended returns claiming refunds.⁵⁵⁹

IV. Time for Filing Returns.

A. General.

Individual returns are due 3 ½ months after the end of a tax year (i.e., due April 15 for calendar year individual returns; virtually all individual returns are based on the calendar year, but for those on a fiscal year, the return is due 3 ½ months after the close of the fiscal year).⁵⁶⁰ Corporate returns are due 2 ½ months after the end of the tax year (i.e., due March 15 for calendar year returns).⁵⁶¹ Estate returns are due nine months after the decedent's death.⁵⁶² Gift tax returns are due on the same date (including extensions) as the donor's income tax return.⁵⁶³

Returns otherwise due on a Saturday, Sunday or federal holiday are “considered timely” if filed on the next succeeding business day.⁵⁶⁴

Returns may be filed prior to the due date for the return. Returns filed before the original due date are deemed filed on the original due date of the return both for purposes of the statute of

⁵⁵⁸ See Burgess J.W. Raby and William L. Raby, Sentiment or Greed: Gift or Compensation?, 34 Tax Practice (Tax Analysts) 169 (5/24/02), exploring the ethical issues.

⁵⁵⁹ § 6676, added by the Small Business and Work Opportunity Tax Act of 2007.

⁵⁶⁰ § 6072(a). Returns for nonresident alien individuals and certain foreign corporations are due by June 15 for calendar year taxpayers and, for fiscal year taxpayers, on the 15th day of the 6th month following the close of the fiscal year. § 6072(c). Returns for U.S. citizens and residents with tax homes abroad are granted an automatic extension until June 15 and may then apply for the regular extension until October 15. Regs. § 1.6081-5(a)(5).

⁵⁶¹ § 6072(b).

⁵⁶² § 6075(a).

⁵⁶³ § 6075(b).

⁵⁶⁴ § 7503. This provision does not change the due date for the return, but merely considers the return timely if filed after the prescribed due date but by the next succeeding business day after the weekend or a holiday. See e.g., United States v. Johnson, 2015 U.S. App. LEXIS 5446 (6th Cir. 2015) (nonprecedential opinion ordering dismissal of indictment based on Government concession that § 7503 did not extend the due date of the return, thus making the commencement of the statute of limitations the due date and not the § 7503 date); and Hannahs v. United States, 1995 U.S. Dist. LEXIS 2117 (W.D. Tenn. 1995) (due date for purposes of commencing the three year period for claim for refund remains the same even if § 7503 otherwise applied to have the filing considered timely).

limitations on assessment and on claiming refunds. **§ 6501(b)(1) and § 6513(a).**⁵⁶⁵ This rule does not apply to returns filed after the original due date during the period of extension (e.g., 1040s filed after April 15 during the period of extension to October 15).⁵⁶⁶ This rule is important in calculating the commencement date for the statute of limitations (both civil and criminal). Care should be taken here, however. The IRS takes the position that an early filed return is filed on the date prescribed in the Code (April 15 for individual calendar year taxpayers) even where the Code also treats as timely a return filed on the next business day if that date otherwise prescribed falls on a weekend day or a holiday.⁵⁶⁷ This may be illustrated by assuming that April 15 falls on a Sunday. If the individual sends his return to the IRS on February 1 and it is received and filed on February 5, the return will be deemed filed on April 15. By contrast, if the taxpayer files or mails (under the timely-mailing, timely-filing rule) on Monday, April 16, the return is deemed filed timely – i.e., April 16, as extended by the rule that returns due on a holiday are due on the next succeeding business day that is not a holiday. The key difference is that the statute of limitations for the former starts on April 16, whereas the statute of limitations for the latter starts on April 17. (Outcomes can turn on this difference, so be careful.)

B. Extensions.

1. Income Tax.

Extensions on the time for filing income tax returns may easily be obtained for up to six months. Calendar year corporate returns due on March 15 may be extended to September 15; calendar year individual returns otherwise due on April 15 may be extended to October 15.⁵⁶⁸ The request for the extension must be filed on or before the original due date of the return. For individuals, the extension request is filed on **Form 4868**, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return; the extension is automatic (as the form states) and

⁵⁶⁵ It is important to distinguish between the due date (which I sometimes call an original due date) and an extended date. For most individual returns, the due date is April 15. Certain nonresident aliens have a due date of June 15 (§ 6072(c)); hence a return for such a taxpayer filed prior to June 15 is deemed filed on June 15. Other U.S. taxpayers with tax homes abroad are granted an automatic extension until June 15 and may then apply for the regular extension until October 15 (Regs. § 1.6081-5(a) & (b)); their returns filed on or before April 15 are deemed filed on April 15 and after April 15 on the date filed.

For the comparable rule in the partnership context, see § 6229(a)(2) which triggers the TEFRA partnership statute from the later of the filing date or the “last day for filing such return for such year (determined without regard to extensions).”

⁵⁶⁶ Regs § 301.6501(b)-1(a) provides: “Any return* * * * filed before the last day prescribed by law or regulations for the filing thereof (**determined without regard to any extension of time for filing**) shall be considered as filed on such last day.” (Emphasis supplied.)

⁵⁶⁷ Rev. Rul. 81-269, 1981-2 C.B. 243.

⁵⁶⁸ § 6081.

runs through October 15.⁵⁶⁹ It is not unusual for taxpayers with complex individual returns to seek the extension and file as late as October. Crunch time for major accounting firms in early September and October may thus exceed crunch time in early April.

Incident to obtaining the extension, the taxpayer is required to estimate and pay his or her ultimate tax liability.⁵⁷⁰ The taxpayer should remit with the extension form the amount of the estimate in order to avoid the accrual of interest and penalties, since the ultimate tax the taxpayer will owe will be due as of the original unextended due date. In this regard, the extension is just for filing the return, not for paying the tax. The extension thus avoids the penalty for late filing, but does not avoid any penalty for late payment. And, if the taxpayer makes a major error in estimating, the IRS cautions that the extension may not be valid.

Filing for the extensions (October 15 for individuals who typically report on the calendar year and September 15 for calendar year corporate taxpayers) is an annual ritual for many taxpayers. I have heard taxpayers say that, as a matter of principle, they simply do not get it all together until just before October 15 and have even heard others who say that even if they have it together, they extend anyway. (It is unclear exactly what principle they refer to, unless it is the time-honored principle of not doing today what you can put off until tomorrow.)

Finally, certain pass-through entities (such as partnerships) may obtain automatic extensions to file their returns for up to 5 months.⁵⁷¹ This shorter extension period is designed to ensure that the taxpayers to whom the results apply will have the pass-through amounts by the time of their extended due date (6 months).

2. Estate Tax.

Taxpayers may request automatic extensions of 6 months beyond the normal 9 month filing date for estate tax returns.⁵⁷² The regulations require that, by the end of the extension period, a “return as complete as possible must be filed.”⁵⁷³

⁵⁶⁹ Prior to 2006, the extension was a two phase process – the first extension being through August 15 and the second through October 15. The IRS got this right by moving to one extension, because the second extension was just make work.

⁵⁷⁰ Regs. § 1.6081-1(a).

⁵⁷¹ T.D. 9407, Extension of Time for Filing Returns, 73 Fed. Reg. 37362-01 (July 1, 2008).

⁵⁷² Regs. § 20.6081-1(a).

⁵⁷³ Regs. § 20.6081-1(d).

V. When Returns Are Filed.

A. General Rule - Date of Filing with IRS.

The general rule is that returns are filed when they are received by the IRS.⁵⁷⁴

B. Exception - Returns Filed Prior to Original Due Date.

Returns filed prior to the original due date are deemed filed on the original due date. § 6501(b)(1). This gives the IRS and taxpayers a consistent starting point for applying the rules based upon the date of filing – at least a consistent starting point for returns filed on or before the original due date. This rule does not apply to returns filed after the original due date during an extension period (e.g., 1040s filed after April 15 during the extension period to October 15).⁵⁷⁵

C. Returns Filed After the Due Date During the Extension Period.

Returns filed during an extension period are generally deemed filed on the date the IRS receives the return.⁵⁷⁶ If a return is filed prior to the extended due date and an amended return is then filed before the extended due date (referred to as a superseding return), the date the superseding return is received by the IRS is the file date for the return.⁵⁷⁷

D. Timely-Mailing, Timely-Filing Rule.

1. The Statutory Rule.

Section 7502 provides a “timely-mailing, timely-filing” rule, which treats the mailing date as the filing date for a return (or certain other documents) received by the IRS after the due date (either the original due date where there is no extension or the extended due date if there is an

⁵⁷⁴ Hotel Equities Corp. v. Commissioner, 65 T.C. 528, 531 (1975), *aff'd*, 546 F.2d 725 (7th Cir. 1976) (noting “the longstanding definition of the word ‘filed’ as used in Federal statutes is ‘delivered’”); see also United States v. Lombardo, 241 U.S. 73, 76 (U.S. 1916), a nontax case, but applying a straight-forward etymological interpretation of the concept of filing, concluding that “Filing * * * is not complete until the document is delivered and received.”); see also Trout v. Commissioner, 131 T.C. 239, 246 (2008).

⁵⁷⁵ Regs § 301.6501(b)-1(a) provides: “Any return* * * * filed before the last day prescribed by law or regulations for the filing thereof (**determined without regard to any extension of time for filing**) shall be considered as filed on such last day.” (Emphasis supplied.)

⁵⁷⁶ This rule apparently can create some potentially significant administrative headaches for the IRS. See ECC 201321022 (5/2/13), reproduced at 2013 TNT 102-60 (5/25/13). There are several potential glitches based upon the different limitations on refund claims in § 6511. I will discuss some of the issues in a footnote in discussing § 6511 below.

⁵⁷⁷ ILM 200645019 (6/20/06), reproduced at 2006 TNT 219-22.

extension) but mailed on or before that due date. The timely-mailing, timely-filing rules (and risks) may be summarized as follows:

1. The document filed must be a “return, claim, statement, or other document required to be filed.” I focus here on the “required to be filed” element. Original tax returns are the quintessential type of document that is required to be filed and thus clearly meets this element of the statute. Tax Court petitions are also required to be filed by the Code in order to meet the jurisdictional requirements for the Tax Court and, in that sense, are required to be filed and thus meet this element of the statute. What about amended returns? The standard conceptualization of the amended return is that the Code itself does not require amended returns to be filed. So, do amended returns qualify? The answer is that some clearly do and some may not. Since, as we shall see later, the Code requires claims for refunds to be filed within a statute of limitations period, amended returns making refund claims qualify as returns required to be filed thus permitting the taxpayer to meet this element of the timely mailing, timely filing rule. But, that analysis does not apply to amended returns reporting additional liability. The IRS has ruled that amended returns reporting additional liability are not “required” and thus any tax reported on such returns actually filed after the assessment limitations period but otherwise mailed within the assessment period, do not qualify under § 7502.⁵⁷⁸ What this means is that the IRS may not assess and must return any payment remitted with the amended return reporting a liability.

2. The mailing must occur within the time otherwise prescribed (either on or before the due date, whether original or extended).

3. The delivery to the IRS must occur after the time otherwise required for filing (either the original due date or extended due date). If the delivery to the IRS occurs within the time otherwise required, the timely-mailing, timely-filing rule is not needed and does not apply.⁵⁷⁹ This aspect of the timely-mailing, timely-filing rule is, of course, subject to the other rule we noted that returns filed before the original due date are deemed filed on the original due date (April 15 for individuals). So, an individual return mailed to the IRS on April 1 but received after the original due date of April 15 is deemed filed on the date of mailing (April 1) but is subject to the rule that it is deemed filed on the original due date (April 15). By contrast, an individual return on extension through October 15 is mailed on October 1 but received after October 15 is deemed filed on October 1 (because the timely-mailing, timely-filing rule is needed). To carry this one step further, in the latter example, if the return is received by the IRS on October 5, the return is filed on October 5 (rather than October 1) because the timely-mailing, timely-filing rule only applies if the return is filed after the extended due date (October 15). This latter result can thus give the IRS several days on the statute of limitations for a return that has an extended due date if the IRS receives it before the extended due date.⁵⁸⁰

⁵⁷⁸ ILM 201052003, reproduced at 2011 TNT 2-21.

⁵⁷⁹ See Burgess J.W. Raby and William L. Raby, Return Filing Dates and the Statute of Limitations, 2003 TNT 89-11 (2003).

⁵⁸⁰ For technical accuracy, a return received by the IRS before the original due date is obviously subject to this rule. And, a return deemed filed on the date mailed by the timely-mailing,

4. The timely-mailing, timely-filing rule applies to qualifying documents filed with the IRS and the petition filed with the Tax Court (§ 7502(d)(1)).

5. If the Postal Service fails to deliver the mailing to the IRS (or alternatively, the IRS has lost it and has no record that it was delivered), the taxpayer may be out of luck. There is a critical exception, however. By use of registered mail or certified mail, pursuant to the conditions in the Regulations, the mailing will be prima facie evidence that the IRS received the mailing and the document will be deemed timely filed on the date of mailing.⁵⁸¹ Indeed, the document will be deemed timely filed even if the IRS has no record of ever receiving the document or it could be affirmatively proved that the IRS did not receive it. This means that the taxpayer (or his practitioner) has it within his or her power to assure timely-filing simply by meeting this condition. The taxpayer still must prove that he or she sent the document by registered or certified mail as prescribed in the Regulations; that is done by taking the envelope to the Post Office and having the Postal Service clerk stamp the retained receipt with a Postal Service stamp indicating the date.

6. There are risks if the foregoing guaranteed methods are not used. Simply mailing a return using a Postal Service postage stamp will not work unless the IRS receives the envelope and, if there is a postmark, it is or can be proved that the postmark was within the prescribed period or, if there is not a postmark, the taxpayer can prove that it was timely and properly mailed.⁵⁸² Obviously, simply using a Post Office stamp will inject risks that the Postal Service may not receive or properly process the mailing so that the taxpayer may be required at a minimum to explain the delay while in the bowels of the Postal Service. Similarly, if private post metering is used, the taxpayer is subject to rules prescribed in Regulations.⁵⁸³ Because private post metering can be manipulated, the Regulations require that the mailing sent by private post metering actually reach the office to which it is mailed within the normal period (based on Postal Service statistics) or, if delivered later than that normal period, the taxpayer can persuasively explain why it was not delivered timely (often an impossible burden while the mailing was within the very large bowels of

timely-filing rule (e.g., a return mailed before the original due date but received by the IRS after the original due date) would be deemed filed on the date mailed but, since it was mailed before the original due date, this rule treats the filing as the original due date rather than the date of mailing.

⁵⁸¹ § 7502(c). Although the term “prima facie” is not the same as conclusive, the IRS would have to prove that the document was not received by the IRS in order to rebut the prima facie evidence and, in an agency as large as the IRS, proving non-receipt would be a daunting task.

⁵⁸² § 7502(a)(2). See Maine Medical Center v. United States, 675 F.3d 110 (1st Cir. 2012) (“Most courts hold that a taxpayer must show eventual actual delivery, even if it is after the expiration of the statute of limitations, if that taxpayer is to take advantage of the benefits of § 7502(a);” and noting in any event that Regulations § 301.7502-1(e)(1) & (2) now require actual delivery except upon proof of timely mailing by registered or certified mail). In Sylvan v. Commissioner, 65 T.C. 548 (1975) held that the timely-mailing/timely-filing rule applies where a postmark is entirely omitted if the taxpayer can prove it was timely mailed with the proper postage.

⁵⁸³ § 7502(b).

the Postal Service).⁵⁸⁴ As you can see there are risks related to the use of simple postage or private post metering.

7. The foregoing rules apply to mail posted through the U.S. Postal Service. Two key expansions of the rule apply. First, mail sent via private delivery services that meet certain strict tests prescribed in IRS Regulations and in periodic announcements qualify for the rule.⁵⁸⁵ The usual suspects (Federal Express, United Parcel Service, DHL, etc.) are approved.⁵⁸⁶ These rules permit qualifying private deliveries to guarantee that the timely-mailing, timely-filing rule will apply. Second, mail delivered via foreign country postal services to the IRS qualifies for the rule.⁵⁸⁷ Note the underlining carefully, because foreign country postal service mailings do not qualify if sent to the United States Tax Court.⁵⁸⁸ Persons in foreign countries desiring to qualify for the timely-filing, timely-mailing rule for Tax Court petitions and notices of appeal must use the designated delivery services.⁵⁸⁹ Finally, the use of such private delivery services does have some risk, for the date of timely-mailing is the date the private delivery services records its acceptance of the document package over which the practitioner or taxpayer using the service has no control.⁵⁹⁰

In considering whether to go to the extra effort and expense required to insure that a document timely mailed will qualify for the timely-mailing timely-filing rule, a taxpayer and/or practitioner should consider the potential costs if the document is delivered late and the taxpayer is unable to prove entitlement to the rule. For returns, the penalty for late delivery is a late filing and/or late payment penalty and, if the return is lost, potentially a criminal investigation or prosecution for failure to file. For petitions to the Tax Court, the penalty is dismissal of the case, so that the taxpayer takes the risk that the Postal Service will not postmark the envelope, that the postmark on the envelope will be legible, and that, if illegible or late, the taxpayer cannot explain any delays in the Postal Service delivery. Since timely Tax Court petition filing is jurisdictional and cannot be remedied, it is the better part of wisdom for the taxpayer or practitioner to take the necessary effort and expense to use the registered or certified mail or the qualified private delivery procedure unless there is plenty of time left so that the taxpayer or practitioner can confirm the actual filing within the prescribed period.

⁵⁸⁴ See e.g., Robinette v. Commissioner, 123 T.C. 85 (2004), rev'd 439 F.3d 455 (8th Cir. 2006).

⁵⁸⁵ § 7502(f).

⁵⁸⁶ Notice 2015-38, 2015-21 IRB provides an updated list of qualifying private delivery services. The IRS will periodically provide notices that update the list of such services.

⁵⁸⁷ Rev. Rul. 2002-23, 2002-18 I.R.B. 811.

⁵⁸⁸ Pekar v. Commissioner, 113 T.C. 158, 168 (1999).

⁵⁸⁹ *Id.*

⁵⁹⁰ See Martinez v. Commissioner, T.C. Summ. Op. 2010-117 denying relief where the taxpayer claimed to have timely delivered the document package containing the Tax Court petition to the private delivery service but the private delivery service did not mark it as received until a date outside the 90 day window.

How does a taxpayer or practitioner prove that the certified mail receipt (or private delivery) relates to the particular return that the IRS is questioning, particularly if for some reason the IRS did not receive the mailing at all? Be wary of this issue and be prepared to prove, at least by some circumstantial evidence (regular pattern of practice, etc.) enough evidence from which a court may reasonably infer that the certified mail matches up with the return in issue.⁵⁹¹

2. Common Law Mailbox Rules.

a. General.

The Supreme Court has summarized the common-law mailbox rule as follows:

The rule is well settled that if a letter properly directed is proved to have been either put into the post office or delivered to the postman, it is presumed, from the known course of business in the post office department, that it reached its destination at the regular time, and was received by the person to whom it was addressed.⁵⁹²

This rule may apply in tax cases, although the decisions are varied as to how and if it applies (i.e. some courts think § 7502 pre-empts the field).⁵⁹³

Let's first illustrate the differences between the common law rule and § 7502 by some examples in two scenarios involving only slight variations in the fact pattern. In both cases, the IRS denies having received the return or claim for refund.

Example 1: The taxpayer allegedly mailed the return or claim for refund with postage paid (but not in the guaranteed formats of § 7502) on the last day in which the return or claim for refund could have been filed, let's say a return for Year 01 on April 15 of Year 02. If the IRS had received

⁵⁹¹ See for a tale of woe by a less than sympathetic practitioner, Schultz v. United States, 92 Fed. Cl. 213 (2010).

⁵⁹² Rosenthal v. Walker, 111 U.S. 185, 193 (1884); see also, in a refund case where such a rule was necessary to make the filing of the refund suit timely, Charlson Realty Co. v. United States, 384 F.2d 434 (Ct. Cl. 1967); and Liu v. United States, 93 Fed Cl. 184 (2010).

⁵⁹³ See Philadelphia Marine Trade Ass'n v. Commissioner, 523 F.3d 140 (3d Cir. 2008) (discussing the conflicts among the circuits and holding that the mailbox rule survives § 7502's enactment); and Sorrentino v. IRS, 383 F.3d 1187 (10th Cir. 2004). In Stocker v. United States, 705 F.3d 225, 232, n. 5 (6th Cir. 2013), the Court applied its precedent holding the statutory rule is exclusive but, in a footnote, cited a case that expressed reservations about that precedent. Some courts say that, even if the common law mail box rule survives the enactment of § 7502, the taxpayer's "own uncorroborated testimony" was sufficient under any of the interpretations of the common law mailbox rule. See United States v. Davis, 2000 U.S. App. LEXIS 2302 (Fed. Cir. 2000) (unpublished opinion). Thus, the rule has applied where there was some third party testimony confirming the delivery to the Postal Service or a mail box. Wood v. Commissioner, 909 F.2d 1155, 1157, 1161 (8th Cir. 1990); Anderson v. United States, 966 F.2d 487, 489, 491 (9th Cir. 1992).

it at all, it would have been after the due date of April 15 of Year 02. The common law mailbox rule does not supply timeliness because the IRS received the document, if at all, too late.⁵⁹⁴ This, of course, is the phenomenon for which § 7502 was enacted to take the vagaries out of times for delivery and provide a certain method to make timely mailing a timely filing.⁵⁹⁵

Example 2: The taxpayer allegedly mailed the return or claim for refund in the same manner, except the taxpayer allegedly mailed it on February 1 of Year 02. The due date is April 15 of Year 02, so the mailing should easily be delivered to the IRS within the normal time and, if it had been so delivered, § 7502 would have no operation (remember that § 7502 only applied to documents delivered to the IRS after the due date). Even if § 7502 might arguably pre-empt the field in the Example 1 situation, one court has suggested that it cannot in this Example 2 and the mailbox rule can apply.⁵⁹⁶

Courts which permit some continued application for the mailbox rule in either type of case where the IRS has no record of receipt usually will want more evidence than the taxpayer's own self-serving testimony.⁵⁹⁷

Consider another example to illustrate the limitations of the mailbox rule. Assume that the U.S. Postal Service has a two day delivery from the taxpayer's home town where she deposits the return in the mail and the IRS Service Center to which the return is addressed. If the taxpayer, an individual, deposits a Year 01 return in the mail on April 15 of Year 02, the original due date, § 7502 treats the return as timely filed on April 15 of Year 02, but the common-law mailbox rule would treat the return as filed on April 17, the date the IRS is deemed under that rule to have received it. Consider a similar example, with the taxpayer having timely filed his Year 01 return by mail on April 15 of Year 02 and then mails the IRS a claim for refund for Year 01 on April 15 of Year 05. Under § 7502, the claim for refund will be timely filed but under the common-law mailbox rule it would not because the IRS would not be deemed to have received it until April 17 of Year 05.

b. The Prison Mailbox Rule.

The "prison mailbox" rule is a special variant of the mailbox rule that may apply in some cases to persons who are incarcerated in the United States. A prisoner rarely has unfettered access to a mailbox and, hence, the rule developed that delivery to prison officials will be treated as a

⁵⁹⁴ See Maine Medical Center v. United States, 675 F.3d 110 (1st Cir. 2012) (noting that same day delivery to the addressee is not encompassed by the common law mailbox rule and, further, if redundantly, that a taxpayer could not rely on the common law mailbox rule by mailing too late for the document to be delivered in time in the ordinary course of post office business, citing Philadelphia Marine Trade Ass'n v. Commissioner, 523 F.3d 140, 148 (3d Cir. 2008)).

⁵⁹⁵ Maine Medical Center v. United States, *supra*.

⁵⁹⁶ Philadelphia Marine Trade Ass'n — Int'l Longshoremen's Ass'n Pension Fund v. Comm'r, 523 F.3d 140, 150 (3d Cir. 2008).

⁵⁹⁷ E.g., Philadelphia Marine Trade Association v. Commissioner, 523 F.3d 140 (3d Cir. 2008)

mailing so as to invoke the mailbox rule.⁵⁹⁸ A taxpayer seeking to rely on this rule (even if it ever was or still is viable) bears the burden of proving timely delivery to prison officials for filing.⁵⁹⁹ And, as articulated by some courts, the rule is like Section 7502's timely-mailing, timely filing rule – delivery to the prison official is deemed filed on that date regardless of when thereafter it should have been delivered to the court or agency, when it was actually delivered to the court or agency or whether it was ever delivered to the court or agency.⁶⁰⁰

E. Review.

For a review of these rules, consider the following examples and the dates the return is deemed filed in each. All examples deal with an individual tax return for Year 01 due on April 15 of Year 02.

Example 1: The Year 01 return is mailed on February 1 of Year 02 and received by the IRS on February 6 of Year 02. The return is timely filed, so the timely-mailing, timely-filing rule does not apply or need to apply. The return is deemed filed on the due date of April 15 of Year 02.⁶⁰¹

Example 2: The Year 01 return is mailed on Monday, April 13 of Year 02 and received by the IRS on Thursday, April 16 of Year 02. Normally, the timely-mailing, timely-filing rule would make the filing date April 13 of Year 02, the date of mailing. But, you will recall, § 6501(b)(1) requires that returns filed before the due date are deemed filed on the due date, here April 15 of Year 02. Note that, but for the application of the timely-mailing, timely-filing rule, the return would have been delinquent.

Example 3: Consider the same example, except that the IRS either never received the return or has no record that it received the return. The taxpayer is protected only if she used a protected means of filing.⁶⁰²

Example 4: After receiving extensions through October 15 of Year 02, the taxpayer mails the return on October 1 of Year 02 and the IRS receives it on October 03 of Year 02. The return is

⁵⁹⁸ Houston v. Lack, 487 U.S. 266 (1988); see also Stoot v. Cain, 570 F.3d 669 (5th Cir. 2009).

⁵⁹⁹ See Hatch v. Commissioner, 364 Fed. Appx. 401, 2010 U.S. App. LEXIS 5889 (10th Cir. 2010). Actually there is a nuance here. As generally worded, the prison mailbox rule treats the date of delivery as the filing date. See collection of cases at 38 Geo. L. J. Ann. Rev. Crim. Proc. 976, 971 fn. 2905 (2009). The general mailbox rule, by contrast, treats the date that the mail would have been delivered in due course as the filing date. Hatch mentions that it has not been definitely decided whether § 7502 displaces the general mailbox rule or co-exists with it, and of course it is conceivable that the prison mailbox rule could still exist for mailings otherwise subject to § 7502 even if the general mailbox rule were displaced by § 7502.

⁶⁰⁰ See Stoot v. Cain, 570 F.3d 669, 672 (5th Cir. 2009).

⁶⁰¹ § 6501(b)(1).

⁶⁰² § 7502(c).

filed on October 3 of Year 02. This is true even though the extension gave the taxpayer through October 15 of Year 02 to file. Note that the rule of § 6501(b)(1) does not apply to filings after the original due date.

Example 5: After receiving extensions through October 15 of Year 02, the taxpayer mails the return on October 10 of Year 02 and the IRS receives it on November 15 of Year 2. The return is deemed filed on October 10 of Year 02 under the timely-mailing, timely-filing rule. Note, however, that the timely-mailing, timely-filing rule applies only if the taxpayer establishes the elements of the timely-mailing, timely-filing rule. Hence, if a postal stamp was used, the envelope must bear a Postal Service postmark within the prescribed period (on or before October 15 of Year 02), and if the postmark is illegible, the taxpayer must prove that it was postmarked within that period. Similarly, if private post metering was used, the delivery was outside the normal delivery period and the taxpayer must show why the delivery was delayed, perhaps an impossible burden.

Example 6: The taxpayer mails on October 10 of Year 02 using registered mail or certified mail as prescribed by the Regulations and the IRS receives the return on November 15 of Year 02 or, alternatively, never receives it at all. The taxpayer wins.

Consider all of the foregoing examples with respect to the filing of a Tax Court petition that is due, at the latest, by October 15 of Year 02.

F. Timely-Mailing Timely-Filing Rule for Delinquent Original Returns Claiming Refunds.

We have discussed above § 7502 as it applies to the filing of returns. Section 7502 also applies to claims and other documents required to be filed with the IRS to establish a timely date if the IRS receives the claim or document after the due date but it was mailed on or before the due date. A special issue is presented by a return that is both a return and, because it reports an overpayment, is also a claim for refund. I discuss below statutes of limitations applying to claims for refund. In part here pertinent, however, a claim for refund of, for example, taxes that are overpaid because of withholding or estimated tax payments must be claimed within three years of the return filing date for the year involved (April 15 of Year 02 for an individual overpayment from such taxes paid by withholding or estimated taxes in Year 01). The timely-mailing, timely-filing rule applies to that delinquent original return treated as a claim for refund.⁶⁰³

VI. Assessment of Tax.

The IRS is authorized to assess immediately the amount of tax due as shown on a return. § 6201(a)(1).⁶⁰⁴ Assessment is an important event and will be discussed in more detail throughout the

⁶⁰³ Regs. § 301.7502-1(f).

⁶⁰⁴ Although the IRS is authorized to assess immediately, the actual assessment may be delayed so that the date of assessment is not the date the return was filed. United States v. Bishop, 2014 U.S. App. LEXIS 11861 (3d Cir. 2014), unpublished (citing prominently Remington v. United

book. At this point, the importance of assessment is that it entitles the IRS to pursue administrative and judicial remedies to collect if the assessed tax is not paid. I discuss those remedies in Chapter 14, Collection Procedures.

Where the taxpayer admits on the return that he or she owes the tax, there is no need for procedural actions prior to assessing the tax. As I develop later in this text, where the taxpayer does not admit liability for the tax on a filed return, the IRS generally has to take certain actions prior to assessment -- to wit, generally, the IRS must first send the taxpayer a notice of deficiency which permits the taxpayer to have a pre-assessment, pre-payment remedy in the U.S. Tax Court. But, taxes shown on the return are assessed immediately, and the IRS can move reasonably promptly to collect those taxes.

VII. Payment of Tax.

A. General.

Payment is generally due upon the original due date of the return. **§ 6151(a)**. In many cases, advance payment will have been required through, for example, withholding in the case of wages or salaries and estimated tax payments in the case of other types of income,⁶⁰⁵ those advance payments, along with payments with an early filed return, are deemed paid on the due date of the return.⁶⁰⁶ If the taxpayer obtains an extension of time for filing past the original due date, he or she is still required to estimate and pay the ultimate tax liability by the original due date. If she underpays, interest will run from the original due date; and if she did not reasonably calculate the ultimate liability, she may be subject to penalties.

The pre-payments (by withholding or estimated taxes discussed below), plus the payments made with the return will be applied against the tax assessed as reported on the return or as otherwise assessed. If there is a short-fall between the amount assessed and the amounts paid, the IRS will undertake collection measures for the difference. If there is an overpayment indicated on the return, the IRS will consider the return to be a claim for refund and process it accordingly.

B. Prepayments of Taxes.

1. Withholding of Tax on Employees.

Taxpayers often prepay their tax liabilities by withholding by the person making payments to the person whose tax is being prepaid (e.g., employers withhold on wages payable to employees). The most common instance of the withholding system is for compensation an employer pays to

States, 210 F.3d 281, 284 (5th Cir. 2000)).

⁶⁰⁵ See Baral v. United States, 528 U.S. 431, 436-437 (2000) (“Withholding and estimated tax remittances are not taxes in their own right, but methods for collecting the income tax.”)

⁶⁰⁶ § 6531(a) and (b).

employees. The employer withholds taxes with respect to the compensation and pays the amounts withheld over to the Government with the employees then claiming credit for the tax payment on their respective federal income tax returns.⁶⁰⁷ This employee “pay as you go” system, originally enacted in 1943, serves several important functions in the system: (i) it mitigates the burden on employees of a large tax liability on the due date (April 15 of the following year); (ii) provides a steadier stream of federal revenue; and (iii) protects against tax disruptions due to deaths, disappearances, and mere dropping of taxpayers from sight.⁶⁰⁸ Similar withholding mechanisms are in place in other situations (e.g., withholding with respect to certain payments made to foreign persons, etc.)

In the case of withholdings on employee compensation, the amount the employer is required to withhold is based on a table designed, very roughly, to approximate the taxpayer's tax liability with respect to the compensation upon which the withholding is based. For some types of withholding, the system permits taxpayers to adjust the amounts otherwise subject to withholding in order to account for their unique tax situations. For example, an individual employee may have a number of exemptions that the income tax withholding table does not account for and thus may file a form W-4 with the employer to lower the amount of the withholding based on extra exemptions.⁶⁰⁹

One of the major issues that is encountered in tax practice is the trust fund recovery penalty (also called the responsible person penalty) that, in the case of an employer's failure to withhold from employees and remit the withholdings to the IRS, imposes liability upon persons within the employer's organization who caused the failure.⁶¹⁰ (The withheld tax is deemed held in trust, hence the liability is called the term trust fund recovery penalty (or “TFRP.”) This circumstance often occurs when the employer is in financial difficulty and chooses to allocate its resources elsewhere than paying the deemed withheld amount to the IRS; in effect, the employer uses the employees' withholding taxes to fund the operations of the employer's business. The IRS and Social Security system credit the employee for the withheld taxes anyway, even if the employer never actually pays

⁶⁰⁷ § 31(a)(1).

⁶⁰⁸ Davis v. Commissioner, T.C. Memo. 2008-238, citing 13 Mertens, Law of Federal Income Taxation, sec. 47A.02, at 47A-8 (2005 rev.).

⁶⁰⁹ Withholding based on the W-4 and withholding tables may be overridden by the IRS in the case of an employee's pattern of noncompliance – specifically material shortfalls in the amount of withholding at the time the tax for the year is due. Where the IRS determines that an employee is in noncompliance, the IRS may issue a “lock-in letter” to the employer and to the employee which directs the employer to withhold at a rate higher than would otherwise be indicated based on the employee's W-4. For a general discussion of this program, see Cleveland v. Commissioner, 600 F.3d 739 (7th Cir. 2010). For a discussion of this program and its effectiveness on systemic compliance, see TIGTA Report 2008-40-167 (8/29/08), reproduced at 2008 TNT 175-25.

⁶¹⁰ § 6672.

the withheld amount to the IRS.⁶¹¹ The trust fund recovery penalty is designed to give persons within the employer organization the incentive to do their duty and, if they do not, give the IRS some recourse to recover the taxes for which it must credit the employees. We shall cover this liability in more detail below (pp. 704 ff.).

2. Estimated Taxes.

a. Individuals.

Individuals who receive significant income that is not otherwise subject to the withholding system are required to pay quarterly estimated taxes.⁶¹² Estimated taxes typically apply to individuals who have income that is not subject to withholding – such as the receipt of non-employee compensation (i.e., earnings as an independent contractor (such as a lawyer)), and the receipt of income from investment sources such as interest, dividends, capital gains, etc. They may apply, however, to employees otherwise subject to withholding but who do not have sufficient withholding during the year.

Individual estimated taxes are due on April 15, June 15, September 15 and January 15.⁶¹³ The estimated tax amount required to be paid on each date is 25% of the required annual payment which is the lesser of (1) 90% of the tax shown on the return for the year or, if no return is filed, the tax due for the year or (2) if a return covering 12 months was filed for the prior year, 100% of the tax due for the prior year (110% in the case of high income taxpayers).⁶¹⁴ For this purpose, tax withheld on wages is deemed to be estimated taxes, so that the estimated tax payment is the total tax due net of the expected withholding on wages.⁶¹⁵ This assures that the estimated and withholding tax regimes do not overlap to require double advance payments of tax. Estimated tax payments may be less for taxpayers who have relatively more income later in the year under a special annualized income calculation.⁶¹⁶

There are exceptions to the estimated tax requirement. If the tax net of withholding is less than \$1,000, no estimated tax is due.⁶¹⁷ If the taxpayer is a citizen or resident of the U.S. and reported no tax liability for the preceding tax year including 12 months, no estimated tax is due.⁶¹⁸

⁶¹¹ See Reg. § 1.31-1(a) (“If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer.”); Emswiller v. United States, 565 F.2d 1042, 1044 (8th Cir. 1977) (“any failure by the employer to pay withheld taxes results in a loss to the government in that amount”).

⁶¹² § 6654.

⁶¹³ § 6654(c)(2).

⁶¹⁴ § 6654(d).

⁶¹⁵ § 6654(g).

⁶¹⁶ § 6654(d)(2).

⁶¹⁷ § 6654(e)(1).

⁶¹⁸ § 6654(e)(2).

These individual estimated tax provisions also apply to estates and trusts, except in certain circumstances.⁶¹⁹

b. Corporations.

Corporations are subject to a similar estimated tax regime.⁶²⁰ Corporate estimated taxes are due on the 15th of the 4th, 6th, 9th and 12th months of the corporation's fiscal year.⁶²¹ The amount of estimated tax is the "required annual payment," payable in four equal installments on those dates.⁶²² The required annual payment is the lesser of (i) 100% of the tax shown on the return for the year (or the tax due if no return filed) or (ii) if the corporation is not a large corporation, 100% of the tax shown on the preceding year return.⁶²³ There is also a provision for lower installments based on annualized income.⁶²⁴

c. Payment by Application of Overpayment.

A taxpayer may elect to apply an overpayment from one year as "a credit against estimated tax for the succeeding taxable year."⁶²⁵ For example, if my 2004 return shows \$1,000 overpayment which I am entitled to have refunded, I may instead elect to have it applied to the estimated tax for 2005 rather than having it refunded. In legal theory, it is the equivalent of receiving the refund and paying an estimated tax in the same amount. For that reason, the statute makes the election binding, so that the taxpayer may not thereafter seek to reverse the application and have the amount applied to a subsequently determined deficiency for the year of overpayment (2004 in the example).⁶²⁶

d. Penalties.

As with other payment obligations in the Code, there is a penalty if the taxpayer fails to make those payments.⁶²⁷ The penalty is a time based, nondeductible interest-like penalty that runs to the due date of the return, which for individuals is April 15. We shall cover the penalty and the possibilities of avoiding the penalty in the penalties section below.

3. Withholding on Certain Payments.

a. Backup Withholding.

⁶¹⁹ § 6654(l).

⁶²⁰ § 6655.

⁶²¹ § 6655(c).

⁶²² § 6655(d)(1)(A).

⁶²³ § 6655(d)(1)(B).

⁶²⁴ § 6655(e).

⁶²⁵ § 6513(d).

⁶²⁶ Id. See also Rev. Rul. 77-339, 1977-2 Cum. Bull. 475.

⁶²⁷ § 6654(a).

Through a procedure called “backup withholding,” the IRS can require certain payors of “reportable payments” – generally interest or dividends and certain other payments⁶²⁸ – to withhold and pay over the withheld amount to the IRS.⁶²⁹ The following are the general categories in which backup withholding applies: (i) the payee is required to furnish his TIN to the payor and does not; (ii) the IRS notifies the payor that the TIN supplied by the payee is incorrect; (iii) the IRS notifies the payor of “payee underreporting;” and (iv) payee certification failure.

The first two categories are obvious. Let’s focus on the third – notice of “payee underreporting.”⁶³⁰ The underreporting includes both failure to include reportable interest or dividends on the payee’s filed return(s) or the payee may be required to file and has not filed (thus, necessarily underreporting income required to be reported. The IRS notice is to the payee, but must be preceded by an IRS determination of underreporting and at least 4 notices to the payee over a period of at least 120 days. The notice to the payor is commonly referred to as a C-Notice. Once the IRS issues a C-Notice to the payor, the withholding is stopped after the IRS makes a favorable determination and then: (1) provides the payee with a written certification that withholding is to stop and (2) directly notifies the payor to stop the withholding.

b. Miscellaneous.

The Code has a host of other withholding requirements for payments to persons who are otherwise subject to tax. The payor is required to withhold in such cases, although exemptions may be available. For example, although tax is not normally withheld on corporate dividends, for such dividends paid to foreign persons, the payor corporation must withhold at 30% unless the shareholder payee qualifies for a lesser withholding rate or exemption from withholding under a treaty.⁶³¹ Similarly, a payer of certain wagering winnings must withhold.⁶³²

I will not expect you to know all of the myriad withholding requirements for this course. But, I do encourage you to think of the reason for the withholding requirement and you will be able to intuit when there may be a withholding requirement. Think about the employee withholding and the estimated tax system for prepaying taxes. Frequently, without such a “pay as you go system,” taxpayers would not otherwise be in a position to pay their taxes when they are due. In short, the system addresses a significant potential for noncompliance. Think also about the example I just gave for withholding on dividend payments to foreign persons. If the dividends were paid without withholding, do you think the IRS would have a significant compliance problem with respect to those foreign persons? Do you think that, absent withholding, many foreign persons would report and pay the taxes? Thus, it is quite frequent that, for payments of U.S. income items attributable to foreign persons, there will be some type of withholding mechanism. Similarly, in other areas, such

⁶²⁸ The other category is defined in § 3406(b)(3).

⁶²⁹ § 3406.

⁶³⁰ § 3406(c).

⁶³¹ § 1441.

⁶³² § 3402(q).

as the employment winnings where there is significant potential for noncompliance, there will often -- but not always -- be a withholding requirement imposed on the U.S. payor.

The significant exception to this is for payments made by taxpayers to persons in a trade or business, often referred to as independent contractors. There is a compliance problem among some classes of independent contractors (such as small operators in the services field, such as gardeners, painters, etc.), but Congress has never had the political will to impose a withholding requirement on such payments to independent contractors. Congress, however, requires that certain payors of payments to nonemployees report the payments to the taxpayer and the IRS (e.g., Forms 1099), which the IRS can then use its computers to match with the returns to see if the income was reported.

C. Extensions of Time to Pay Tax.

The IRS generally can extend payment of income tax for six months and may extend payment of estate tax for 12 months.⁶³³ The IRS may extend for reasonable cause the payment of estate taxes for up to 10 years.⁶³⁴ The reasons for this discretionary authority is that estates may be insufficiently liquid to pay the tax when due. The IRS may require the taxpayer to post a bond to protect the Government's interest.⁶³⁵

In addition, estates having a large percentage of assets in one or more closely held businesses may elect a 15-year deferral (five year interest only and then in ten annual installments) of estate tax attributable to the closely held business.⁶³⁶ A special beneficial interest rate applies to some portion of the deferred payments.⁶³⁷ The IRS may require the taxpayer to post a bond for the extension or, in lieu of the bond, a special extended estate tax lien for the deferred amount (including penalty and

⁶³³ § 6161(a)(1).

⁶³⁴ § 6161(a)(2). In Baccei v. United States, 732 F.3d 1140 (9th Cir. 2011), the taxpayer had filed an extension request for estate tax without stating the date to which the extension was requested. The Court held that the extension request was fatally defective so that the failure to pay penalty applied. The Court also found that the reasonable cause exception to the failure to pay penalty did not apply because the taxpayer should have ascertained the payment date and could not rely upon an accountant. The Court relied principally upon United States v. Boyle 469 U.S. 241 (1985), rejecting reliance on an accountant as to the filing date for the estate tax return.

⁶³⁵ § 6165.

⁶³⁶ § 6166. This election to defer tax "shall be made not later than the time prescribed by section 6075(a) for filing the return of tax imposed by section 2001 (including extensions thereof)." § 6166(d). Consistent with the plain text requirement, the IRS interprets this to preclude the election on a late filed estate tax return. ILM 200628042 (reproduced at 2006 TNT 152-16).

⁶³⁷ § 6601(j).

interest).⁶³⁸ And the statute of limitations on collection is suspended during the period of the extension of time to pay.⁶³⁹

The IRS may enter into installment agreements that have the effect of extending the time for payment. Installment agreements are usually not reached, however, at the return filing stage. We shall installment agreements cover in more detail below (pp. 639 ff.).

VIII. Return Reporting in the Marital Relationship.

A. Community Property States v. Separate Property States.

Each taxpayer having income is required to file a return. In community property states such as Texas where each spouse is generally deemed to earn one-half the community income, each spouse is required to report one-half the income earned or received by the other spouse.⁶⁴⁰ By contrast, in separate property states prior to the advent of the joint return, the earner of the income or owner thereof (in the case of income derived from property) had to report all of the income.

Prior to the introduction of the joint return, this disparate property system created two significant glitches.

First, all other things being equal, spouses in community property states with disparate levels of income owed less aggregate income tax than spouses in the same economic circumstance but residing in separate property states. By operation of law, spouses in community property states split their income which gave them rate benefits under the income tax's graduated rate schedules. Spouses in separate property states did not get the income splitting tax rate benefits. This glitch presented an issue of fairness as among citizens of the various states.

Second, on the downside in community property states, because each spouse owed tax on his or her ½ share of the community income, it did not matter whether the spouse in fact received the actual benefit of the community income. I hope you quickly spot that this rule, if applied full bore, can have inequitable consequences in a myriad of situations. For example, assume that

⁶³⁸ § 6165 (see § 6166(k)(1) cross referencing to § 6165) and § 6324A (see § 6166(k)(2) cross referencing § 6324A). In Estate of Roski v. Commissioner, 128 T.C. No. 10 (2007), the Court rejected the IRS rule requiring a bond for the election virtually in every case, holding that the IRS was imposing what is a substantive requirement to relief that the Congress did not provide in the statute. In Notice 2007-90, 2007-46 IRB, the IRS responded to Estate of Roski by establishing procedures to make the case by case determination. See also PMTA 2009-046, reproduced at 2009 TNT 129-21 (discussing procedures with respect to bonds and liens) and ILM 200803016 (discussing use of interest in an LLC as collateral for the special estate tax lien under § 6324A that secures the tax deferred under § 6166).

⁶³⁹ § 6503(d) (see § 6166(k)(3) cross referencing § 6503(d)).

⁶⁴⁰ Poe v. Seaborn, 282 U.S. 101 (1930).

husband abandons wife and wife does not know where he is and does not benefit from any share of his income. Wife is nevertheless, in theory, required to report and pay tax on one-half his income.

B. Joint Returns and Joint Liability.

1. The Concept.

In response to the first glitch noted above, Congress enacted the joint return provision of the Code.⁶⁴¹ This permits married persons to file a joint return⁶⁴² combining their income and deductions and applying for a tax table with lesser rates than the individual rate table. Generally, this produced significantly lower taxes for married couples with disparate incomes than if they filed separate returns. Couples in community property states can file joint return and, by an overwhelming majority, most do.⁶⁴³ Hence the joint return scheme will apply to most cases even in community property states.

As the cost of this tax rate relief, however, Congress imposed on both spouses joint and several liability for the entire tax due.⁶⁴⁴ Although the beneficial rate applicable for the joint return did mitigate the discrepancy in overall tax (the first glitch noted above), it imposed this cost (joint liability) that was not the inevitable consequence of the solution of the first glitch (the beneficial rate table for the combined income) and really did not address the second glitch, except to expand the problems inherent in any system in which a spouse may be held liable for tax in inequitable circumstances. The second glitch and related problems arising from joint and several liability were ultimately addressed by Congress in the so-called innocent spouse provisions which, in parallel fashion based on equitable principles, relieve one spouse of liability for tax he or she would otherwise owe with respect to the other spouse's income as a result of filing a joint return or filing a separate return in a community property state. I discuss these innocent spouse provisions below (pp. 674 ff.).

2. Couples Eligible to File Joint Returns.

The determination of marital status qualifying to file a joint return is made as of year end for the tax year. Thus, persons married during the year but divorced by year end do not qualify.⁶⁴⁵

⁶⁴¹ § 6013(a),

⁶⁴² A joint return for this purpose includes the 1040 but may also include § 6020(a) returns prepared by IRS if they are signed by the taxpayer under penalties of perjury. Rev. Rul. 2005-59, 2005-37 I.R.B. 505.

⁶⁴³ Couples with disparate incomes in community property states generally receive less benefit from the joint return than do similarly situated couples in separate property states, but generally these couples do not undertake any type of cost-benefit analysis of using the joint return, the cost being the joint and several liability noted in the text.

⁶⁴⁴ § 6013(d)(3).

⁶⁴⁵ § 6013(d)(1)(A).

However, a spouse not married because his or her spouse died during the year may file a joint return).⁶⁴⁶ Spouses who are legally separated at year end may not file a joint return.⁶⁴⁷

3. Requirements for a Joint Return.

Obviously, for a joint return, the two parties must be married under state law. The joint return they file must be a return under the rules previously discussed. And, the couple must intend to file that return as a joint return. Their signatures on the return is the normal requirement to reflect and implement that intent, but where one of the spouse's signatures does not appear on the return, the return may still qualify if the facts and circumstance show that the couple intended to file a joint return.⁶⁴⁸

4. Joint Returns Filed After Separate Returns.

Spouses may file a joint return after filing separate returns, subject to the following limitations.⁶⁴⁹ First, the joint return must be filed within three years of the date prescribed by law for filing the return for the year.⁶⁵⁰ This means, for example, that, if husband and wife file separately for Year 01, the latest they can file an amended joint return to elect joint return treatment is April 15 of Year 05. Second, a joint return cannot be filed after (a) a notice of deficiency has been sent to either spouse who then petitioned the Tax Court for redetermination, (b) either spouse has filed a refund suit, or (c) either spouse has entered into a closing agreement.⁶⁵¹ The foregoing limitations, by statute, apply only where the married taxpayers have filed a "separate return." There seems to be a conflict in the circuits over what separate return means for the limitations to apply: Does separate return mean only married filing separate (so that the limitations apply only to returns filed in that category and not, for example, to a return filed as married head of household) or does it mean any non-joint return (such as married filing head of household)?⁶⁵²

The filing date for the joint return is normally the date of filing but an earlier deemed filing date is provided under either of these two scenarios: (1) if both spouses previously filed separate returns, the deemed filing date is the date the last of the two separate returns was filed or (2) if only

⁶⁴⁶ § 6013(d)(1)(B).

⁶⁴⁷ § 6013(d)(2).

⁶⁴⁸ *O'Connor v. Commissioner*, 412 F.2d 304, 309 (2d Cir. 1969), cert. denied 397 U.S. 921 (1970); *Shea v. Commissioner*, 780 F.2d 561, 567 (6th Cir. 1986). *Estate of Campbell v. Commissioner*, 56 T.C. 1, 12 (1971).

⁶⁴⁹ § 6013(b).

⁶⁵⁰ § 6013(b)(2)(A).

⁶⁵¹ § 6013(b)(2)(B)-(D).

⁶⁵² *Ibrahim v. Commissioner*, ___ F.3d ___, 2015 U.S. App. LEXIS 9639 (8th Cir. 2015); and *Glaze v. United States*, 641 F.2d 339 (5th Cir. 1981), holding that the separate return does not include filing as head of household. Although that appears to be the consistent holding of the Courts of Appeals, it is not yet clear whether the IRS will accept the holding or will attempt to raise it in other courts of appeals.

one spouse filed a separate return, the deemed filing date is the date of that separate return if the other spouse was not required to file a return.⁶⁵³ Further, if a delinquent joint return is filed, the statute of limitations on assessment and collection will include at least the one year period from the date of actually filing the return.⁶⁵⁴

In order to preserve the integrity of the penalty provisions, if an originally filed separate return was subject to the negligence or fraud civil penalties, the filing of a joint return will not cleanse the originally filed separate returns and will be deemed to be penalizable conduct with respect to the joint return.⁶⁵⁵ Further, if the originally filed separate returns was subject to criminal penalties, the original separate returns is subject to criminal prosecution.⁶⁵⁶

C. Relief from Unjust Marital Tax Liability.

I hope that you understood from the foregoing discussion that there are inherent potential inequities in the system. In separate and community property states, spouses signing joint returns can be subject to all unreported tax whether or not they knew of or benefitted from the omitted income or overstated deductions. In community property states, even where separate returns are filed, spouses will be subject to liability on one-half the community income whether or not they knew of or benefitted from it.

Not only is omitted income a potential inequity, but improperly claimed deductions can be equally unfair to a spouse who did not know that the claim on the return was wrongful.

The Code provides potential so-called innocent spouse relief. I defer discussion until later when addressing collection issues (pp. 674 ff.). I cover it there because it usually arises in a collection context and it often comes down to whether the husband or the wife or both will be subject to collection.

IX. Return Preparer Regulation and Penalties.

A. Introduction.

The tax return – the self assessment mechanism – is the foundation of our tax system. Many taxpayers do not prepare their own returns. Rather, they rely upon tax return preparers to prepare the returns. Tax return preparers thus play a critical role in the self assessment system.

Because of the complexity of the Code, in many cases there is no (or at least no easily ascertainable) finite tax liability, so that correct reporting in many instances is just to insure that the taxpayer gets within the right range. In this regard, Money Magazine used to present to various

⁶⁵³ § 6013(b)(3).

⁶⁵⁴ § 6013(b)(4).

⁶⁵⁵ § 6013(b)(5)(A).

⁶⁵⁶ § 6013(b)(5)(B).

well-regarded return preparers throughout the country a set of facts, only moderately complex, for the preparers to prepare returns. Rarely were these preparers in agreement as to the same bottom-line tax liability on exactly the same set of facts. Hence, the penalty regime both for preparers and taxpayers must take this phenomenon into consideration, and only punish conduct that the preparers and taxpayers really knew was wrong or sufficiently risky for the civil or criminal penalty in issue.

If, even given this latitude, tax return preparers fail in their responsibility to prepare reasonably correct returns, there can be serious ramifications both to the taxpayer and to the system, since most incorrect reporting is probably never caught. Accordingly, Congress built in a series of incentives – penalties – to encourage preparers to get it right within some reasonable parameters. Thus, just as there are penalties (that I shall discuss later) to encourage taxpayers to do it right, there are also penalties to encourage tax return preparers to do it right. The topic of the present discussion is the tax return preparer penalties.

B. Who is a Tax Return Preparer?

A tax return preparer is a person who prepares for compensation a return (or any substantial portion of a return) for compensation.⁶⁵⁷ Persons who perform ministerial tasks are excluded.⁶⁵⁸ A return preparer includes not only the person who signs as preparer but also any person who prepares “a substantial portion of a return.”⁶⁵⁹ Let’s consider what this means in a couple of examples.

First, consider a case where the preparer compiling and signing the return relies upon a lawyer’s opinion as to the reporting of a transaction on the return. Is or should the signing preparer be the preparer as to that item, or should the lawyer giving the opinion be the preparer? I dare say that most of you who enter a tax law practice will have occasion to advise a taxpayer and his return preparer as to how an item should be reported on this return, so this question is not just one of academic interest. The short answer is that the lawyer giving the opinion as to the return reporting can be the preparer as to that item even though that lawyer does not sign the return as preparer.⁶⁶⁰

Second, consider return preparer A who is asked to prepare an individual income tax return (Form 1040) for individual B. Among the items B delivers to A is a K-1 prepared by another return preparer that reports B’s share of a partnership’s very substantial losses. (These loss characteristics might suggest that the partnership is a tax shelter, but it also may be a real partnership with real losses.) The K-1 reports a single line item for B’s share of partnership loss of, say, \$1,000,000. Normally, that amount is then reported as a single entry on B’s Form 1040. If A makes that single entry on the return A prepares, is A the return preparer as to that partnership item? Certainly, the

⁶⁵⁷ § 7701(a)(36)(A).

⁶⁵⁸ § 7701(a)(36)(B)(i).

⁶⁵⁹ “Substantial portion” is defined in Regs. § 301.7701-15(a)(1) and (b).

⁶⁶⁰ Regs. § 301.7701-15(a)(2) (although excluding lawyers rendering advice only as to contemplated transactions and not specific advice as to how the transaction should be reported on the return).

partnership return preparer who prepares both the partnership return and the K-1s distributed to the partners is the return preparer.⁶⁶¹

But what responsibility does the return preparer for B go behind the lawyer's opinion or the K-1 in reporting on the return he or she prepares for B? In each case, if the return preparer has facts which should alert a reasonable person that there is a problem with respect to the opinion or the K-1, the return preparer is at risk of being the return preparer as to that item. But even beyond that, what responsibility does the return preparer have?

C. Basic Preparer Responsibilities and Penalties.

The return preparer for the return (as opposed to the return preparer for a specific item on the return) must: (1) provide the taxpayer a completed copy of the return; (2) manually sign the return as the preparer; (3) supply the return preparer's address and ID number; and (4) retain a copy of the return.⁶⁶² The penalty for failure(s) to meet these requirements is \$50 up to a maximum of \$25,000.

D. Penalties for Unreasonable Positions, Negligence and Fraud.

1. Unreasonable Positions.

Section 6694(a) imposes a penalty of the greater of \$1,000 or 50% of the preparer's income with respect to a return or claim for refund prepared by the preparer having an understatement or excessive claim attributable to an "unreasonable position" that was known or reasonably should have been known to the preparer.⁶⁶³ An unreasonable position is one where

⁶⁶¹ Adler & Drobny, Ltd. v. United States, 9 F.3d 627 (7th Cir. 1993); and Goulding v. United States, 957 F.2d 1420 (7th Cir. 1992) (in which the partnership return preparer drawing a penalty attempted to pass the responsibility to the lawyers who rendered tax shelter opinions to the partnership); and see Burgess J.W. Raby and William L. Raby, Responsibility for Partnership Return Information, 2003 TNT 127-50 (7/2/2003).

⁶⁶² §§ 6107(a), 6109(a)(4) and 6695.

⁶⁶³ This section was amended in 2007 and then again in 2008. The discussion above is of the statute as amended in 2008. For a brief period from the enactment of the 2007 amendments and the 2008 amendments, the statute had a discrepancy between the penalty attracting conduct of the taxpayer and the penalty attracting conduct of the preparer that could have created a conflict of interest between the two, but Congress correlated the penalties in the 2008 amendment. I won't get into this esoteric bit of history because of the 2008 amendment.

For an excellent and comprehensive discussion of the preparer penalty rules and nuances, see Charles P. Rettig, Practitioner Penalties: Potential Pitfalls in the Tax Trenches, 123 Tax Notes 207 (April 13, 2009).

- either (i) if not disclosed, the position did not have at least substantial authority or (ii) if disclosed, the position did not have at least reasonable basis;⁶⁶⁴ **or**
- if a tax shelter or reportable transaction, the position is unreasonable “unless it is reasonable to believe that the position would more likely than not be sustained on its merits.”⁶⁶⁵ Note that this is not the preparer’s subjective belief, but some objectively reasonable belief.

Each of the key words – substantial authority, reasonable basis and reasonable to believe more likely than not – are terms of art in the penalty area that have been more fully developed for the taxpayer accuracy related penalties that are discussed in more detail below. (Beginning on p. 339).⁶⁶⁶ Suffice it to say here, one of the common methodologies for conceptualizing a meaningful construct for these key words is as follows:

- reasonable basis - at least a 20% likelihood of prevailing;⁶⁶⁷
- substantial authority - at least a 40% likelihood of prevailing;
- more likely than not – at least a 51% likelihood of prevailing.⁶⁶⁸

Stating the rules in the affirmative, the preparer can avoid the penalty for a position that is not a tax shelter or reportable transaction position by disclosing the position if there is only reasonable basis for the position or assuring at least substantial authority if not disclosed. Since there is no clear litmus test for differentiating between substantial authority and reasonable basis, the cautious preparer will be inclined to err on the side of disclosure. (By the same token, since there is no clear litmus test for reasonable basis (20%) which is the minimum standard, below which there would have to be the potential for criminal prosecution, those trying to play too close to that line might be taking risks they might regret.)

The foregoing deals with unreasonable positions as to the application of the law to the facts. What responsibility does the preparer have to verify the facts? Generally, the preparer may rely upon the facts presented by the taxpayer so long as the proffered facts are not, based on the factual circumstances known or reasonably knowable to the preparer, incomplete or incorrect. Further, the preparer may rely upon facts from third parties (such as through W-2s, 1099s or others such as other tax advisors or tax preparers), again subject to the preparer not having facts indicating that the facts are incomplete or incorrect. Of course, in those circumstances where the Code requires that the

⁶⁶⁴ § 6694(a)(2)(A) & (B).

⁶⁶⁵ § 6694(a)(2)(C).

⁶⁶⁶ See e.g., Notice 2009-5; 2009-3 I.R.B. 309 providing that, until further guidance, the definition of “substantial authority” is the same as in Regs. § 1.6662-4(d)(2).

⁶⁶⁷ The IRM says “Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper.” 20.1.5.2.4.10 (01-24-2012), Definitions. I will address reasonable basis positions later in the discussion of the accuracy related penalties applying to taxpayers for their return reporting positions.

⁶⁶⁸ Michelle M. Kwon, Dysfunction Junction: Reasonable Cause and Good Faith Reliance on Tax Advisors with Conflicts of Interest, 67 Tax Lawyer 403, 407 (2014).

taxpayer have contemporaneous documentation in order to claim the tax benefit, the preparer must make appropriate inquiry as to the existence of the documents. The Regulations indicate, for example, that where the Code requires a contemporaneous qualified appraisal to support a charitable contribution, the preparer should inquire about the existence of the appraisal.⁶⁶⁹

The penalty is not imposed if there is reasonable cause for the understatement and the tax return preparer acted in good faith.⁶⁷⁰

Finally, the penalty applies if the preparer “prepares any return or claim of refund” with the understatement.⁶⁷¹ It does not require that the return or claim have been filed with the IRS.⁶⁷² The Regulations provide that, for this purpose, the return or claim for refund “is deemed prepared on the date it is signed by the tax return preparer,” but if the preparer does not sign the return or claim, it is deemed prepared on the date filed.⁶⁷³

2. Willful or Reckless Conduct.

Section 6694(b), as amended in 2007, imposes a penalty of the greater of \$5,000 or 50% of the preparer’s income from the return for a position resulting in an understatement that is due to “a willful attempt in any manner to understate the liability for tax” or “a reckless or intentional disregard of rules or regulations.” Willful is a term of art in the tax law. It is used in most of the criminal tax provisions to mean the intentional, voluntary violation of known legal duty.⁶⁷⁴ It is a significantly higher element of consciousness than simply negligence. Reckless conduct may be viewed as just slightly less culpable conduct than willful conduct, but more culpable than negligent conduct. This penalty is thus intended to apply even if the preparer could not be convicted of a crime requiring willfulness which is the usual requirement for tax crimes.

3. Asserting and Contesting Preparer Penalties.

The IRS must assert the preparer penalty by assessment “within 3 years after the return or claim for refund with respect to which the penalty is assessed was filed.”⁶⁷⁵ The preparer may obtain judicial review by filing a claim for refund and, upon denial, a refund suit.⁶⁷⁶

⁶⁶⁹ Regs. § 1.6694-1(e)(3).

⁶⁷⁰ § 6694(a)(3).

⁶⁷¹ § 6694(a)(1)(A).

⁶⁷² See ILM 201519029 (3/25/15).

⁶⁷³ Regs. § 1.6694-1(a)(2).

⁶⁷⁴ See e.g., United States v. Bishop, 412 U.S. 346, 361 (1973) (The Court interpreted “willfully” to require an element of *mens rea* and formulated the term willfully to require “a voluntary, intentional violation of a known legal duty,”). See also Cheek v. United States, 498 U.S. 192 (1991).

⁶⁷⁵ § 6696(d)(1).

⁶⁷⁶ § 6696(c); Regs. § 1.6696-1.

E. Injunctions.

Section 7407 authorizes injunctions against tax return preparers who are subject to the foregoing penalties or violated other duties and limitations as a preparer. The court must find that the return preparer “continually or repeatedly engaged in” the conduct. Hence, the isolated return preparer penalty should not attract the injunction.

F. Criminal Penalties.

The following are the significant or more common criminal penalties to which return preparers are potentially subject:

1. Section 7206(2), a felony, for willfully aiding or assisting in the preparation which is fraudulent or false, whether or not the fraud or falsity is known to the taxpayer.
2. Section 7216, a misdemeanor, for knowingly or recklessly disclosing or using confidential taxpayer information supplied to the preparer for return preparation.⁶⁷⁷
3. 18 U.S.C. § 371, conspiracy, particularly the defraud conspiracy (in a tax setting often called a Klein conspiracy).
4. If multiple false returns claiming refunds are prepared, false claims or conspiracy to file false claims, 18 U.S.C. §§ 286 and 287.

G. Practice Penalties.

As noted above, the IRS through the Office of Professional Responsibility, regulates tax practitioners' ability to practice before the IRS. The types of conduct that can attract penalties can also result in disbarment from practice before the IRS. Isolated negligence penalties are not serious enough to result in disbarment, but willful misstatement may and certainly a criminal conviction may. Disbarment from practice can seriously limit a tax practitioner's ability to practice and, moreover, there is the threat that inappropriate conduct by one practitioner can result in disbarment from practice of the whole firm with which he or she is associated. I do not expect you to know the rules of practice before the IRS, but you should be aware that there can be serious economic consequences from inappropriate return positions.

⁶⁷⁷ As you might suspect, this crime, which has been in the Code since 1971, is probably committed often, given the sweeping definition of return information, but rarely, if ever, prosecuted. On April 27, 2005, I searched two court opinion databases (LEXIS and Tax Notes Court Opinions) for § 7216 cases and found no reported criminal case involving a prosecution under § 7216.

X. Appraiser Penalties.

Section 6695A imposes a civil penalty upon appraisers if the appraiser knows or should have known that the appraisal would be used in conjunction with a tax return or refund claim and the claimed value results in a valuation misstatement or gross valuation misstatement as defined in § 6662(e) or (h). The latter provisions impose an accuracy related penalty on taxpayers for valuation or gross valuation misstatements. I defer further discussion to the portion of the book that discusses such misstatements (pp. 349 ff.). Suffice it to say here that the valuation error must be significant (e.g., at least 150% of the correct value). The appraiser penalty is the lesser of (i) \$1,000 or 10% of the tax underpayment, whichever of the two is greater or (ii) 125% of the gross income received by the appraiser for preparing the appraisal. The appraiser may avoid the penalty by showing that the appraisal was more likely than not the proper valuation, although making that showing may be a difficult to do after the Secretary or the court has found a substantial or gross valuation misstatement.

XI. Tax Compliance and the Tax Gap.

I started this chapter with the concept of our tax system being a voluntary compliance system. I noted that there are a number of penalty provisions that incentivize taxpayers to voluntarily comply. We will study those penalties later in the text. I want to conclude the chapter on returns by talking a little about actual compliance rates. Compliance with the tax laws usually is done by filing the various tax returns and paying any tax reported due (either by prepayment or at the time of filing the return). There are other compliance duties as well, but usually when we talk about compliance and compliance rates we are talking about the bottom line – payment of tax that the taxpayers of the country owe. There is a related concept called the “tax gap” that is the underpayment of tax that results from noncompliance with the Code’s duties.

The overall voluntary compliance rate, according to the IRS’s most recent data, is estimated to be around 83.1%, which means that that percentage of tax due is timely reported and paid. The obverse noncompliance rate is around 16%.⁶⁷⁸ Noncompliance technically arises from three principal phenomena – (i) taxpayers fail to file returns reporting the tax liabilities (so that, perforce, they are not paid); (ii) taxpayers filing returns fail to report all of the tax they owe (so that, perforce, the shortfall is not paid); and (iii) taxpayers report or are otherwise assessed taxes they owe and do not pay the tax. The precise reasons for the noncompliance is beyond the scope of the book, but we do from time to time address in this text some of the underlying themes. Where the noncompliance is intentional, the bottom-line is that the taxpayer just does not want to pay the tax he or she owes. The rationale, if there is one, for such behavior may include disagreement with how the public revenue is used by the federal government or just an unwillingness to pay that cost of a civilized society, thereby shifting the burden of tax to other taxpayers. Basically, such intentional conduct

⁶⁷⁸ See IRS web page titled “IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study” (last reviewed or updated 2/6/14 and viewed 7/17/15).

is anti-social behavior. Where less intentional conduct is involved, the shortfall can be attributed to the complexity of the tax laws and mere procrastination, among other reasons.

The federal tax gap resulting from the 16% noncompliance rate is obviously significant – in the hundreds of billions of dollars, perhaps as high as \$500 billion. That is not chump change, so that the cost of a system that has such a noncompliance rate is quite significant indeed.

From the perspective of managing a tax system, there are key issues related to compliance and the tax gap. What is the optimal level of noncompliance we will accept, given our other priorities. Increasing the enforcement budget of the IRS would, at least theoretically, increase compliance, but at what cost? Most immediately, increasing the enforcement budget would at some point be subject to the law of diminishing returns – that the collections from more enforcement dollars will curve down in terms of benefit relative to cost. And, giving the IRS a larger presence in our every day lives might be intolerable for a host of real and imagined social and political reasons. These tensions between the levels of enforcement and the levels of compliance are at the heart of much of the political debate that touches on the revenue raising side of the fisc. Practitioners need to be sensitive to those tensions and the debate, because they will result in an ebb and flow in the tax practice that includes tax procedure.

Ch. 6. Statutes of Limitations.

I. Introduction.

Statutes of limitation grant repose. The Supreme Court observed that “a statute of limitations is an almost indispensable element of fairness as well as of practical administration of income tax policy.”⁶⁷⁹ This is certainly true, as a good general observation, but there are instances where an unlimited statute of limitation applies. (The saving grace when an unlimited statute of limitations might otherwise apply is that old can be cold, so that the person trying to assert an unlimited statute (in the context of this course, usually the IRS) has significant burdens to satisfying a right to relief in a distant year.) In addition, we shall see several instances in which the statute of limitations may be suspended, but these suspensions are narrowly drawn so as not to materially impair the overall need for the statute of limitations in the first place.

Statutes of limitations are affirmative defenses.⁶⁸⁰ The practical effects of characterizing statutes of limitations as affirmative defenses relate to litigation where (1) they must be affirmatively pled by the party asserting the bar of the statute of limitations,⁶⁸¹ and (2) they may be waived if not asserted timely.⁶⁸² However, in some cases, the period during which the claim must be judicially pursued is part of the right to sue which means that suit within the prescribed period may be jurisdictional, is non-waivable, and may be raised at any time.⁶⁸³

⁶⁷⁹ Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 301 (1946).

⁶⁸⁰ See e.g., Rule 8(c), Fed. R. Civ. Proc. and Tax Court Rule 39. General civil procedure concepts treat a statute of limitations defense as barring a remedy but not extinguishing the liability. One author believes that the history of the current statute of limitations regime supports treating the statute of limitations as extinguishing the liability. See Bryan T. Camp, Tax Return Preparer Fraud and the Assessment Limitation Period, 116 Tax Notes 687 (Aug. 20, 2007); accord, Diamond Gardner v. Commissioner, 38 T.C. 875, 881 (1962) (noting that the practical effect of the bar of the statute of limitations is to extinguish a tax liability that is barred by the statute of limitations.)

⁶⁸¹ Woods v. Commissioner, 92 T.C. 776, 779 (1989). This is usually the defendant, but may be the plaintiff where the defendant is seeking a judgment against the opponent of the claim asserted by the defendant. The latter phenomenon applies to Tax Court proceedings where the taxpayer is nominally in the plaintiff position (designated petitioner) and the defendant (designated respondent) seeks a decision from the Tax Court that the taxpayer owes some amount of tax.

⁶⁸² Bruce v. Commissioner, T.C. Memo. 2014-178, citing Genesis Oil & Gas, Ltd. v. Commissioner, 93 T.C. 562, 564-565 (1989) and T.C. Rule 39).

⁶⁸³ See United States v. Dalm, 494 U.S. 596, 608 (1990).

II. Assessment.

A. Introduction.

The return filed by the taxpayer is the general starting point for the processes in the system. The IRS can assess immediately tax reported due on the return. § 6201(a)(1). From the date the return is filed, the IRS generally has a time critical period in which to assert claims for tax liabilities in excess of the tax liabilities reported. Correspondingly, the taxpayer generally has a time critical period to claim refunds. These are statutes of limitation.

We discuss at this point only the statute of limitations on assessment. Payment – or collection, from the IRS perspective – is a different event than assessment. There is a separate statute of limitations on collection after assessment. IT IS CRITICAL TO DISTINGUISH BETWEEN ASSESSMENT AND COLLECTION. Assessment is only the event that establishes that the taxpayer owes the Government so that the Government then can use its formidable array of collection measures to collect that debt. I deal with collection later in a separate chapter, but until then we will be principally concerned with the processes that lead to an assessment.

B. The General Rule - Three Years.

The general rule is that the IRS may assess additional taxes within 3 years of the date the return is filed. § 6501(a).

The starting point for the running of the statute of limitations is the date the return is filed or deemed filed. The key rules on filing are (to repeat): (1) returns received by the IRS on or prior to the normal, unextended due date are deemed filed on the normal due date;⁶⁸⁴ and (2) returns received by the IRS after the normal due date (even during an extension period) are filed on the date the IRS actually receives the return. The key exception to these rules is the timely-mailing, timely-filing rule which, if applicable, establishes a deemed date for filing on the date the taxpayer mails the return timely but it is not received timely by the IRS.⁶⁸⁵ The calculation of the normal three-year period starts on the day following the filing date under the foregoing rules.

For example, if the taxpayer files his individual return for Year 01 on the due date (April 15 of Year 02), the statute of limitations begins to run one day thereafter (April 16 of Year 02) and the normal statute of limitations expires on April 15 of Year 05. The same result applies if the return is filed on February 1 of Year 02 because of the rule that returns filed before the original due date of the return are deemed filed on the original due date.

The assessment period rules are statutory and, except as specifically provided by statute, the IRS cannot assess beyond the three year period. I discuss the statutory exceptions below, but note here that the IRS cannot raise general equitable factors that might, in other contexts, permit a tolling

⁶⁸⁴ § 6501(b)(1).

⁶⁸⁵ § 7502.

of the statute of limitations.⁶⁸⁶ (I note later the general preclusion of equitable factors tolling the period during which the taxpayer may file a claim for refund.)

C. Exceptions to the General Three Year Statute.

The exceptions to assessment statutes of limitations are in the statute.⁶⁸⁷ The key exceptions to the general 3-year rule are as follows:

1. False Return or Attempted Evasion.

There is no statute of limitations if the taxpayer either files a false return with the intent to evade tax or, in the case of tax other than income tax or estate tax, willfully attempts in any other manner to defeat or evade tax. §§ 6501(c)(1) and (c)(2).⁶⁸⁸ We encountered this rule in Badaracco (pp. 155 ff.) where the Supreme Court held that a subsequently filed nonfraudulent amended return does not avoid the unlimited statute of limitations for an original fraudulent return. Fraud for this purpose is the same as the definition for fraud for purposes of the civil fraud penalty under § 6663.⁶⁸⁹

Badaracco addressed a potential anomaly between a failure to file a return and filing a fraudulent return. The anomaly is this: A person who fails to file a timely return with the intent to evade tax can get the benefit of the three year statute of limitations by simply filing a delinquent nonfraudulent original return.⁶⁹⁰ Yet, a person who files a fraudulent original return but then files an amended nonfraudulent return cannot achieve the benefit of the statute of limitations. That is the holding of Badaracco. Consider the following examples:

Example 1. Assume the taxpayer files a Year 01 original fraudulent return on April 1 of Year 02 and then files a nonfraudulent amended return on January 1 of Year 03. Under Badaracco's holding, there is no statute of limitations because his original return was fraudulent.

⁶⁸⁶ Doe v. KPMG, 398 F.3d 686 (5th Cir. 2005).

⁶⁸⁷ The Fifth Circuit rejected nonstatutory equitable tolling of the assessment statute of limitations in John Doe 1, et al. v. United States, 398 F.3d 686 (5th Cir. 2005). Although nonstatutory equitable tolling may apply to some claims against the United States, in the tax arena, equitable tolling is very circumscribed if it exists at all. I will discuss equitable tolling in discussing statutes of limitation on claims for refunds below.

⁶⁸⁸ An interesting point of construction for § 6501 is that a false return is simply an incorrect return, hence the limiting text – “with intent to evade tax” – was needed to make sure that the provision applied in cases of fraud and not to mistake. See Bryan T. Camp, Presumptions and Tax Return Preparer Fraud, 120 Tax Notes 167 at n. 29 (2008)

⁶⁸⁹ Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner, 114 T.C. 533, 548 (2000), rev'd on other grounds 249 F.3d 175 (3^d Cir. 2001).

⁶⁹⁰ Bennett v. Commissioner, 30 T.C. 114 (1958); see also Rev. Rul. 79-178, 1979-1 C.B. 435. It is possible that the Government could show that the failure to file the original return was a willful attempt to defeat or evade tax, so that the subsequent filing of the delinquent original return would not start the shorter three year statute of limitations.

Example 2. Same example, except that instead of filing an original fraudulent return, the taxpayer files no return timely and then on January 1 of Year 03 files a nonfraudulent delinquent original return. **Section 6501(c)(3)**, which provides an unlimited statute in case of failure to file, does not apply because the taxpayer filed a nonfraudulent return, albeit delinquent. Accordingly, there is a filing date to anchor the § 6501(a) statute of limitations and it will be three years from the date the delinquent nonfraudulent return is filed (except, in the case of a 25% omission, the statute is six years).

Example 3. Same as Example 2, except that, under the facts, the taxpayer's failure to file a timely return for Year 01 was fraudulent, meaning that by failing to file the taxpayer intended to evade the tax. Certainly, the Code contemplates that a failure to file may be fraudulent.⁶⁹¹ Section 6501(c)(3) can't apply because a return, albeit delinquent was filed. As the Court noted in Badaracco,⁶⁹² § 6501(c)(1) can't apply because it requires a false return and here the return, albeit delinquent, was not false. Section 6501(c)(2) which speaks of a willful attempt in any manner to evade tax does not apply to income tax. (Note that, for penalty purposes a fraudulent failure to file including an affirmative attempt to evade can be § 6501 tax evasion⁶⁹³ and can be subject to the § 6651(f) fraudulent failure to file penalty which, after 5 months, can equal the § 6663 civil fraud penalty applicable to fraudulent returns.)

Whose fraud does it have to be to keep the statute of limitations open? Of course, if the taxpayer had a fraudulent intent in signing the return, that will be sufficient; in the context of a joint return, if one of the taxpayers had the fraudulent intent, that will be sufficient.⁶⁹⁴ Moreover, the Tax Court held in Allen v. Commissioner, 128 T.C. 37 (2007) that even if no taxpayer signing the return had the fraudulent intent, the return preparer's fraudulent intent will suffice to warrant the unlimited statute of limitations.⁶⁹⁵ The opinion appears correct from a literal interpretation of the

⁶⁹¹ See § 6651(f) imposing a higher penalty for a fraudulent failure to file.

⁶⁹² At p. 401.

⁶⁹³ See Spies v. United States, 317 U.S. 492 (1943) requiring some affirmative act of evasion other than failing to file a return.

⁶⁹⁴ § 6501(c)(1), providing an unlimited statute of limitations for fraud, has no relief provision comparable to § 6663(c) which relieves a spouse from joint liability for the civil fraud penalty in the case of the other spouse's fraud. Accordingly, the statute of limitations for an innocent taxpayer signing the fraudulent joint return is open by virtue of the other spouse's fraud. For a discussion of the interrelationship between the unlimited statute of limitations and the civil fraud penalty, see FSA 200126019, reprinted at 2001 TNT 127-25 (reasoning that the fraud penalty is personal and thus, as § 6663(c) commands, is not applicable to an innocent spouse, but that the unlimited statutes of limitation for fraud is remedial and hence applies to an innocent spouse and indeed will apply if the fraud is that of the preparer even if both spouses are not liable for the civil fraud penalty).

⁶⁹⁵ For the IRS's earlier positions, see FSA 200126019 (Release Date 6/29/01); but see FSA 20010406 (Release Date 1/26/2001) (holding the contrary). FSA 200126019, however, seems to rely in part upon agency principles to attribute the preparer's fraud to the taxpayer and the facts indicate that the taxpayer may not have been wholly innocent. In some cases, however, the taxpayer

statute (the statute text requires only that the return be fraudulent) and rests on a policy notion that the IRS needs more time to audit a fraudulent return whether taxpayer fraud is involved or preparer fraud is involved.⁶⁹⁶ But the opinion has been criticized because it is cryptic and does not even consider, much less properly consider, history and context.⁶⁹⁷ Subsequently, the Second Circuit held, consistent with Allen and its progeny in the Tax Court, that the unlimited statute applies if fraud is on the return even if not the taxpayer's fraud.⁶⁹⁸ The Court of Appeals for the Federal Circuit recently held that the taxpayer's fraud is required, thus rejecting the reasoning of Allen and its progeny.⁶⁹⁹ Thus, this issue is not finally resolved.

One consequence of the Allen holding, if correct, would permit an unlimited statute of limitations period in an abusive tax shelter case where the enablers were guilty of fraud, particularly in those cases where they became signing or even unsigned return preparers as to the item. In a series of major tax shelter promoter prosecutions involving variations of Son-of-Boss and related tax shelters, the promoters were convicted of tax evasion with respect to shelters reported on taxpayers' returns (meaning the returns were fraudulent) regardless of whether the taxpayers themselves participated in the fraud (i.e., were guilty of tax evasion).⁷⁰⁰ Under the Allen reasoning, all of the returns that thus reflected fraud would have open statutes of limitation. And this would be true of similar shelters even where the promoters have not been prosecuted, for the IRS would

is innocent.

⁶⁹⁶ The text reasoning relies significantly on an email of Professor Al Lauber on a Tax Prof list serve on 4/22/10. Others argue, however, that the reasoning is flawed. See Bryan T. Camp, Presumptions and Tax Return Preparer Fraud, 120 Tax Notes 167 (2008) and Bryan T. Camp, Tax Return Preparer Fraud and the Assessment Limitation Period, 116 Tax Notes 687 (Aug. 20, 2007). I also have questioned the validity of Allen in several blog entries on my Federal Tax Crimes Blog. See [IRS Queasiness Over the Reaches of Allen](#) (Federal Tax Crimes Blog 9/22/12), which has links for earlier blog entries.

⁶⁹⁷ Bryan T. Camp, Tax Return Preparer Fraud and the Assessment Limitation Period, 116 Tax Notes 687 (Aug. 20, 2007); and Bryan T. Camp, Presumptions and Tax Return Preparer Fraud, 120 Tax Notes 167 (2008).

⁶⁹⁸ City Wide Transit, Inc. v. Commissioner, 709 F.3d 102 (2d Cir. 2013); for a discussion of the issue, see my blog [Second Circuit Holds That Fraud on the Return -- Even If Not the Taxpayer's -- Causes an Unlimited Civil Assessment Statute of Limitations to Apply \(Federal Tax Crimes Blog 2/4/13\)](#).

⁶⁹⁹ BASR Partnership et al. v. United States, ___ F.3d ___, 2015 U.S. App. LEXIS ____ (Fed. Cir. 2015). I do not have any better cite because it was decided the print date of this text.

⁷⁰⁰ United States v. Pfaff, 2010 U.S. App. LEXIS 26854 (2d Cir. 2010) (the "KPMG Related Criminal Case"); United States v. Coplan, et al. (SDNY No. (S1) 07 Cr. 453 (SHS)), on appeal (the Ernst & Young Related Criminal Case); and (3) United States v. Daugerdas, et al. (SDNY S3 09 Cr. 581 (WHP)) (the Jenkins & Gilchrest / BDO Seidman Related Criminal Case).

need to prove only in the civil case that the returns were fraudulent by clear and convincing evidence. And, finally, even if the year in which such fraud occurred has otherwise been closed out by court case or administrative action (such as Form 870-AD or Closing Agreement), the presence of fraud on the return would permit the matter to be opened up and a new notice of deficiency issued based on the unlimited statute of limitations.⁷⁰²

If the taxpayer has been convicted of criminal tax evasion, the taxpayer will be collaterally estopped from avoiding the unlimited statute of limitations (as well as the civil fraud penalty). For collateral estoppel to apply, the issue in the earlier criminal proceeding must have been tax evasion. Tax evasion requires underpayment of tax. Conviction of the taxpayer for tax evasion⁷⁰³ in a criminal case will collaterally estop the convicted taxpayer from contesting fraud in the civil tax case for the same year.⁷⁰⁴ Yet, a major tax crime can exist where the taxpayer has simply filed a false return⁷⁰⁵ without fraudulent underpayment of tax as an element of the crime (this is commonly referred to as tax perjury); for a tax perjury conviction, the taxpayer will not be collaterally estopped from contesting civilly whether the return or any portion of the deficiency was due to fraud.⁷⁰⁶

In addition to denial of repose of the statute of limitations based on a fraudulent return, there are criminal and civil penalties applicable to filing a false return. I discuss these in more detail below (pp. 302 ff. (criminal penalty) and pp. 357 ff. (civil penalty)), but note here that, as to a taxpayer having the fraudulent intent, the fraudulent return will also subject the taxpayer to the civil fraud penalty under § 6663. Accordingly, in a tax case where the assessment would be beyond the normal statute of limitations, the civil issues normally riding on fraud will be (1) the IRS's ability to assess any tax and interest (i.e., the statute of limitations issue) and (2) the taxpayer's liability for the fraud penalty under § 6663 which I discuss below at pp. 332 ff. Note, however, that if the statute

⁷⁰² See Section 6212(c)(1) which allows a notice of deficiency at any time “in the case of fraud” even if the case has otherwise been closed. See Zackim v. Commissioner, 887 F.2d 455 (3d Cir. 1989); and Burke v. Commissioner, 105 T.C. 41, 47 (1995); see also Hemmings v. Commissioner, 104 T.C. 221 (1995) (re nonpreclusive effect of refund suits). One issue in the way I have stated the proposition in the text is whether the taxpayer’s fraud is required § 6212(c)(1) to apply. That section is worded similarly to § 6201(c)(1) which provides an unlimited statute of limitations in the case of fraud. The text of both sections does not require the taxpayer’s fraud. As of this writing, it has not definitively been determined whether the taxpayer’s personal fraud is required for § 6501(c)(1) to apply. Allen v. Commissioner, 128 T.C. 37 (2007) (taxpayer’s fraud not required); City Wide Transit, Inc. v. Commissioner, 709 F.3d 102 (2d Cir. 2013) (Allen makes “intuitive sense”); and BASR Partnership v. United States, ___ F.3d ___, 2015 U.S. App. LEXIS _____ (Fed. Cir. 2015) (taxpayer personal fraud required) (cite incomplete because decided print date of this text).

⁷⁰³ § 7201.

⁷⁰⁴ Commissioner v. Sunnen, 333 U.S. 591 (1948).

⁷⁰⁵ § 7206(1).

⁷⁰⁶ McGowan v. Commissioner, T.C. Memo 2004-146. For a discussion of these concepts, see John A. Townsend, Collateral Estoppel in Civil Cases Following Criminal Convictions, 2005 TNT 4-28.

of limitations is kept open by virtue of the tax preparer's fraud in which the taxpayer or taxpayers did not participate, the taxpayer or taxpayers will not be subject to the civil fraud penalty.

Finally, even if there is fraud, the unlimited statute of limitations is subject to practical limitations. The difficulty in obtaining information about really old years may make it impossible or impractical for the IRS to pursue unpaid taxes. This practical limitation often comes into play when a taxpayer is considering filing amended returns or delinquent original returns to correct prior years. The number of years that the taxpayer will correct is influenced principally by the 6 year criminal statute of limitations but also by this phenomenon of records and information being unavailable. Thus, although in the case of fraud, the IRS can go back forever, it simply will not do so. Hence, in advising the taxpayer that there is an unlimited statute of limitations for fraud, the practitioner should also try to advise as to the practical reality that the IRS will do so.

2. No Return.

There is no statute of limitations where no return is filed. § 6501(c)(3).⁷⁰⁷ A key issue raised with respect to this exception is whether a document filed by a taxpayer is a return. I have discussed the requirements for a return above (pp. 124 ff.). There are also civil and criminal penalties for failure to file a return. I discuss these below.

Of course, the same practical problem of developing information for older years operates in the case of delinquent returns.

3. Extension by Agreement.

a. General.

Except in the case of the estate tax, the statute of limitations on assessment may be extended by written agreement entered while the statute is still otherwise open. § 6501(c)(4)(A). Reflecting Congress' views that statutes of limitations should be meaningful and respected, the IRM provides that:

⁷⁰⁷ In an interesting interpretation of this provision, the Tax Court held in Appleton v. Commissioner, 140 T.C. 273 (2013) that, although the taxpayers had filed no return with the IRS, their filing with the U.S. Virgin Islands tax authority pursuant to the "mirror code" constituted a filing that would prevent the application of § 6501(c)(3). The mirror code is the treatment of a territory or other non-U.S. jurisdiction affiliated with the U.S. (the Virgin Islands here) as having an internal revenue code mirrored to work like the Internal Revenue Code as to that jurisdiction (here the Virgin Islands) and treating the U.S., as to that jurisdiction as a foreign country. Thus, for example, all references to the United States or Treasury would be deemed to refer to the other jurisdiction. A related feature is that a citizen of one jurisdiction is resident (in some cases, bona fide resident) in the other (e.g., a U.S. citizen resident in the Virgin Islands) has a single filing requirement with the jurisdiction of residence than of citizenship (e.g., in the case of a U.S. citizen resident in the Virgin Islands, the single filing is made to the tax authority for the Virgin Islands).

It is the policy of the Service to secure consents to extend the period of time to assess tax only in cases involving unusual circumstances. See Rev. Proc. 57-6, 1957-1 C.B. 729. Every attempt should be made to resolve cases before it is necessary to extend the statute of limitations. If it is necessary to extend the statute, the period of extension should be no longer than is necessary to complete the examination and other administrative actions.⁷⁰⁸

The IRM lists circumstances in which a consent may properly be requested.⁷⁰⁹ The circumstances include:

(a) Where the limitations period expires within 180 days and there is insufficient time to complete the audit in an orderly manner.

(b) A subsequent or related year(s) is under examination and there are firm indications that substantial additional tax is due for a prior or related year and (1) the limitation period for the prior or related year will expire within 180 days, and (2) there is insufficient time to complete the examination and administrative processing of the case.

(c) The limitation period for the return under examination will expire within 180 days and the taxpayer has requested an Appeals hearing.

(d) A joint civil and criminal investigation with CID is in progress and there is danger of an expiration of the statutory period of assessment.

b. Forms for Extensions - 872 and 872-A.

The forms for extension agreement in income tax cases are (1) **Form 872**, Consent to Extend the Time to Assess Tax, and (2) **Form 872-A**, Special Consent to Extend the Time to Assess Tax. Similar forms exist in the case of other taxes (e.g., partnership items (Form 872-P) or responsible person penalty taxes). The extension must be signed by the taxpayer and the IRS within the period otherwise allowed.

The Form 872 extends the statute to a date certain stated in the Form itself. The IRS must assess (or as I shall discuss below, send a statutory notice of deficiency) on or before that stated date.

The Form 872-A, by contrast, is an indefinite extension which may be terminated upon any one of the following events: (a) 90 days after the taxpayer files **Form 872-T** (a pink form to alert the IRS as to its importance); (b) 90 days after the IRS notifies the taxpayer of termination; or (c) the IRS's issuance of a notice of deficiency to the taxpayer, plus 60 days after the period the IRS is

⁷⁰⁸ IRM 25.6.22.1(1) (03-01-2008).

⁷⁰⁹ IRM 25.6.22.1(2) (03-01-2008).

prohibited from assessing.⁷¹⁰ The Form provides that, in the event the statute is terminated by the notice of deficiency, the statute will be suspended during the period that the IRS is prohibited from making an assessment plus 60 days. These are the only ways that the Form 872-A may be terminated. Thus, for example, if after an audit, the taxpayer agrees to a tax liability (on **Form 870** or equivalent form which waives the issuance of a notice of deficiency) or issues a no change letter, the Form 872-A will remain in effect until the taxpayer files a termination. A court will not generally be sympathetic regardless of the lapse of time, but might in an extreme case.⁷¹¹ The lesson from the Form 872-A rules is that a taxpayer and/or his representative must keep ongoing reminders of the existence of a Form 872-A and revoke it explicitly by filing form 872-T if it is otherwise not revoked by the IRS's issuing a notice of deficiency.

Finally, there is an academic issue as to whether consents to extend the statute of limitations are contracts or unilateral waivers. The courts unfailingly pronounce the consent a unilateral waiver of the statute of limitations (meaning, so that notion goes, that the consent is a taxpayer gift – using the euphemism, waiver – to the IRS without return consideration from the IRS), rather than a contract (for which there must be mutual consideration). This sloppy thinking about the nature of the consent is usually not important but could be in certain cases. Since my view of the consent as a contract is a contrarian view, I relegate further discussion to the footnote, but encourage my readers not to accept too easily the notion that the consent is a waiver.⁷¹²

⁷¹⁰ These are printed on the Form 872-A. IRM 25.6.22.7.1 (08-26-2011), Form 872-A Special Consent to Extend the Time to Assess Tax. The IRM provides a fourth which is not printed on the form: “The date of assessment or overassessment of tax that reflects a final determination of tax and administrative Appeals consideration.” The scope of this is further explained by suggesting that it applies in every case except certain determinations. This conclusion of the statute is generally in the taxpayer’s benefit, but it is odd that it is not on the printed Form 872-A.

⁷¹¹ E.g., Greenfield v. Commissioner, T.C. Memo. 2008-16, aff’d by unpublished decision (11th Cir. 10/23/08). Fredericks v. Commissioner, 126 F.3d 433 (3d Cir. 1997) is a rare case of estoppel against the Government on the ongoing effect of an unterminated Form 872-A., The IRS had denied that a Form 872-A was outstanding (without which assurance the taxpayer would have or at least could have filed a Form 872-T) and had indeed sought several Forms 872 which, of course, would be meaningless if the Form 872-A were outstanding. The Court held that the taxpayer had reasonably and detrimentally relied upon the IRS’s statement that no Form 872-A was outstanding and hence invoked estoppel against the IRS claim that Form 872-A kept the statute of limitations open.

⁷¹² I and my partner discuss this issue in John A. Townsend & Lawrence R. Jones, Interpreting Consents to Extend the Statute of Limitations, 78 Tax Notes 459 (1998). Cases addressing different provisions of the prior internal revenue acts referred to the analogous form as a unilateral waiver of the statute of limitations. E.g., Stange v. United States, 282 U.S. 270, 276 (1931). Some courts even now – mindlessly, I think – carry forward those case holdings without realizing that the statute is different. The key difference that treating it as a contract makes is in interpreting the benefits and burdens of the form. If it is a contract, it is interpreted and applied like a contract. If it is not a contract, as some even later day cases suggest (e.g., Piarulle v. Commissioner, 80 T.C. 1035, 1042 (1983)), then how is it to be interpreted? Well, the courts tell

c. Procedures for Consents.

The IRM requires that the agent outline in the file the need for the consent, obtain the group manager's approval before seeking the consent, and insure that the group manager's approval is documented in the file.⁷¹³

Taxpayers are not obligated to enter an extension agreement. The IRS is required to notify taxpayers that they have a right to refuse to enter such an agreement with the IRS each time the IRS requests such an extension.⁷¹⁴ The IRS has standard forms for advising taxpayers of their right to refuse,⁷¹⁵ but what happens if the IRS fails to advise the taxpayer? The IRS takes the position that, if the taxpayer is otherwise aware of his right to refuse to consent, the IRS's failure to meet this statutory mandate to notify the taxpayer will not defeat the validity of the consent.⁷¹⁶ Whether courts will agree is an open issue.

d. Proof Issues Regarding Consents.

The Tax Court has outlined the procedural steps required where the existence or validity of a consent is in issue: (i) a taxpayer seeking to rely on the bar of the statute of limitations on assessment must affirmatively plead the bar and must bear the burden of persuasion on the issue, (ii) the taxpayer must make a prima facie showing that the assessment was outside the normal period of assessment (i.e., the three year general statutory period for assessments); (iii), if the taxpayer meets the burden in (ii), the IRS then bears the burden of production by introducing evidence that, if believed, proves the existence and validity of the consent that would justify the assessment; and (iv) the taxpayer then bears the burden of persuasion as to the nonexistence or nonvalidity of the consent.⁷¹⁷ This procedural routine would seem also to apply when, in the absence of a consent, the IRS is relying upon some other exception to the normal three-year statute of limitations.⁷¹⁸ Where,

us cryptically, by using contract-like interpretive techniques, so the difference seems to be a tempest in a teapot in most cases, but could affect some cases. The difference was important in Greenfield v. Commissioner, T.C. Memo. 2008-16, aff'd by unpublished decision (11th Cir. 10/23/08), in which the taxpayer sought to avoid the 872-A as an executory contract in bankruptcy. The lower and appellate courts held that, since the 872-A was a waiver rather than a contract, the issue as to whether it was a voided executory contract under the bankruptcy rules was not reached. I think the both courts' reasoning was superficial, but superficial reasoning has reigned supreme in this area.

⁷¹³ IRM 25.6.22.2.1(2) (03-01-2008).

⁷¹⁴ § 6501(c)(4)(B).

⁷¹⁵ See Publication 1035, titled "Extending the Tax Assessment Period" (Rev 06-2007).

⁷¹⁶ ILM 200221006 (2/6/02), reprinted at 2002 TNT 102-76 (5/28/02).

⁷¹⁷ Jordan v. Commissioner, 134 T.C. 1, 5 (2010), applying Adler v. Commissioner, 85 T.C. 535, 541 (T.C. 1985).

⁷¹⁸ See Adler v. Commissioner, 85 T.C. 535, 540 (1985). Adler does not say that specifically with respect to the six-year extended limitations period in § 6501(e), but the wording suggests that. I have not had the opportunity to research that issue, but I suspect that there may be

however, the IRS is relying upon fraud to justify the timeliness of an assessment, the IRS bears the persuasion burden (step 5) to prove fraud by clear and convincing evidence.⁷¹⁹

e. Extension Strategies.

The fact that a taxpayer and the IRS can agree to an extension does not mean that the taxpayer should agree to an extension requested by the IRS. There is no patriotic, moral or other duty to agree to an extension, and the IRS is supposed to advise the taxpayer of that upon requesting an extension. My view is that, generally, a taxpayer should not agree to any extension.

If unusual circumstances exist that might motivate the taxpayer to agree to an extension, the taxpayer should keep a tight leash on the extensions, agreeing to only such extensions as absolutely needed. For example, in one large corporate audit where the IRS requested a Form 872-A and the client reluctantly agreed, the client contemporaneously and unilaterally set a time schedule for the events that needed to happen and advised the IRS in writing that if these events did not happen as scheduled, the taxpayer would pull the plug (i.e., file a Form 872-T) by a date certain. Various other solutions could meet particular needs, but the taxpayer must keep in mind that he controls the extension decision.

In the past, in order to obtain an extension, the IRS has sometimes threatened and, in some cases, carried out threats to take arbitrary action (such as denying all deductions or denying all deductions of a certain category such as travel and entertainment (“T&E”)) and then forcing the taxpayer to go to court to justify the denied deductions.⁷²⁰ Courts and Congress are not happy with such arbitrary action, and the IRS does not do it any more. In short, there should be no direct penalty from refusal to execute a consent. Taxpayers in ongoing audits (such as large corporate taxpayers) may, however, fear that they may be subject to audit activity in a later audit cycle that could have been avoided by “cooperating” in this fashion in the earlier cycle. That is a judgment call that should be made at the time the IRS requests an extension, but, in all events, in my judgment, the right tone is set by notifying the IRS at the beginning of the audit that extensions will not be granted.

authority out there that the IRS (or United States in courts other than the Tax Court) has the burden to establish the application of the six-year statute of limitations. Adler may thus be limited to just consents and may only be applicable in the Tax Court. Of course, as I note in the text, the language is tempered in the case of assessments justifiable only by the presence of fraud; in that case, the IRS clearly has the burden of proving fraud.

⁷¹⁹ Tax Court Rule 142(a).

⁷²⁰ Publication 1035, titled “Extending the Tax Assessment Period” (Rev 06-2007) is more circumspect if the taxpayer refuses to sign: “If you choose not to sign the consent, we will usually take steps that may ultimately allow us to assess any tax we determine to be due. These steps begin with the issuance of a notice of deficiency.”

4. Failure to Disclose Listed Transaction.

Congress' concern for abusive tax shelters hawked to high net worth individuals and corporations has led to a series of initiatives (which we consider in context below (pp. 781 ff). Among the initiatives is a special statute of limitations for failure to disclose on a return a listed transaction.⁷²¹ Taxpayers are required to report certain information regarding their participation in a listed transaction.⁷²² The limitations period on assessment with respect to such a failure shall not expire before one year after the earlier of (A) “the date on which the Secretary is furnished the information so required,”⁷²³ or (B) the date that a material advisor meets disclosure requirements pursuant to an IRS request relating to the undisclosed listed transaction.⁷²⁴

5. Significant Omissions of Income.

a. Six Year Statute for 25% Omissions.

(1) The Exception to the General Rule.

Section 6501(e)(1)(A)(i)⁷²⁵ provides a six year statute for a “substantial omission” – defined as an omission from gross income in an amount exceeding 25% of the amount of gross income stated in the return.⁷²⁶ An exception to this extended statute of limitations is provided “is disclosed in the

⁷²¹ § 6501(c)(10), as added by § 814 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004). The Tax Court has held that this special limitations suspension applies at the partnership level for adjustment of partnership items. Blak Investments v. Commissioner, 133 T.C. 431 (2009).

⁷²² The reporting requirements include both a disclosure on a particular form with the relevant income tax return(s) and a separate filing with the Office of Tax Shelter Analysis. Regs. § 1.6011-4(d); see also Rev. Proc. 2005-26, 2005-17 IRB 1 (providing guidance on § 6501(c)(10)). The notice of listed transactions is 2009-59; 2009-31 IRB 1.

⁷²³ The statute does not require that the person potentially subject to the penalty and extended statute of limitations actually supply the information or that the information be on any particular form, although the Regulations and procedures require that that person supply the information on Form 8886. Regs. § 1.6011-4(a). However, a court has held that the language of the statute does not require that the person supply it or supply it on a particular form; rather the language of the statute merely requires that the information be furnished to the IRS. May v. United States, 2015 U.S. Dist. LEXIS 76962 (D. AZ 2015) (where the IRS stipulated that it had the information by a date outside the extended 1 year statute of limitations).

⁷²⁴ § 6501(c)(10). For an application of the (B) alternative, see Bemont Investments, LLC v. United States, 679 F.3d 339 (5th Cir. 2012) (holding that the disclosure must contain the information required by Reg. § 301.6112-1T (2002), Q&A 17 and 18 and that, in this case, that requirement was not met).

⁷²⁵ As redesignated by § 513(a)(1) of the HIRE Act (FATCA provisions).

⁷²⁶ An analogous 25% omission rule is provided for partnerships (§ 6229(c)(2)) and for estate, gift and excise taxes (§ 6501(e)(2) & (3)).

return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.”⁷²⁷

The key in applying this formula is the definition of gross income. In Colony, Inc. v. Commissioner,⁷²⁸ the Supreme Court held that the focus is upon an omitted item of income. Thus, for example, if the item is included in income but just incorrectly underreported, the amount of the underreporting is not considered to be a 25% omission.⁷²⁹

The statute turns upon a fraction. The result of the fraction must exceed 25%; the numerator (omitted gross income) over the denominator (the reported gross income) must exceed 25%. Anything increasing the numerator increases the result and anything increasing the denominator decreases the result. Hence, when representing a taxpayer seeking to avoid application of the six year statute of limitations, you will look for ways to avoid or decrease the amount of inclusion in the numerator and include or increase the amount of the inclusion in the denominator. An expansive interpretation of a particular item of gross income is good for the taxpayer if the taxpayer reported that item of gross income (because it then is included in the denominator) but is bad for the taxpayer if the taxpayer did not report the item (because it is included in the numerator).

Other nuances of the critical definition will be developed in the examples below, which are intended to be illustrative rather than exhaustive.

(2) Examples.

Let's put some parameters on this exception with examples.

Example 1: On Schedule C, the taxpayer, a lawyer, reports \$200,000 of income (all fee income) and claims \$150,000 of deductions, for net Schedule C income of \$50,000. The taxpayer reports no other income on the return. The taxpayer, however, failed to include \$20,000 of interest income. The six-year statute does not apply. Although the omitted \$20,000 exceeds 25% of the taxpayer's taxable income (\$50,000), it does not exceed 25% of the gross income reported on the return (the Schedule C gross receipts of \$200,000). If the amount of interest income omitted were \$60,000, then the omission would exceed the 25% threshold and the six year statute of limitations would apply.

Example 2: Assume the same facts, except that the interest income is \$300,000 and that the interest income is reported, but the taxpayer fails to include the Schedule C income by omitting the Schedule C. The net unreported taxable income (\$50,000) is about 16%. (\$50,000 divided by \$300,000) However, the benchmark omitted gross income is not the schedule C net income (taxable income) but the Schedule C gross income. The omitted gross income clearly exceeds 25% of the reported gross income. This variation from example 1 shows a truism of the critical fraction –

⁷²⁷ § 6501(e)(1)(B)(ii).

⁷²⁸ 357 U.S. 528 (1958).

⁷²⁹ The focus is on the return as filed.

interpretations of the term gross income that help the taxpayer when calculating the denominator may hurt the taxpayer when calculating the numerator, and vice-versa.

Example 3: On Schedule C, the taxpayer reports \$200,000 of gross sales income and \$140,000 cost of goods sold (“COGS”) for net revenue before ordinary deductions of \$60,000. The taxpayer reports \$10,000 of Schedule C ordinary deductions, for a net Schedule C income of \$50,000 (i.e., \$200,000 gross sales income less \$140,000 COGS and \$10,000 of ordinary deductions). The taxpayer reports no other income, and as in Example 1 fails to report \$20,000 of interest income. The issue raised by this slight variation is whether the benchmark denominator figure in the critical calculation includes the \$200,000 gross sales revenue or only the net \$60,000 (i.e., gross revenue less COGS). Gross revenue is the benchmark, so the six year statute does not apply.⁷³⁰

Example 4: The taxpayer reports \$100,000 of salary income and a sale of property. He sold the property for \$100,000. On his return, he reported the \$100,000 as the amount realized, claimed a basis of \$80,000, and reported taxable gain of \$20,000. Assume that the taxpayer omitted an item of dividend income of \$40,000 and that the omission was not fraudulent. The question is whether, in computing the denominator of the key fraction, the reported amount realized is used or the reported gain is realized. The calculations are as follows:

	If amount realized	If net gain only
Income Reported on Return		
Salary	\$100,000	\$100,000
Sale of Property	\$100,000	\$20,000
Income Reported (Denominator)	\$200,000	\$120,000
Unreported Income (Dividend)	\$40,000	\$40,000
% of Unreported Income	20%	33%

In Colony, Inc. v. Commissioner, 357 U.S. 28 (1958), the Supreme Court held that the amount includable in the denominator is the amount realized rather than the gain realized.⁷³¹ Thus, the taxpayer with this profile would avoid the 6-year statute of limitations. (Readers who find joy in math calculations should also quickly perceive that, where the sale transaction is omitted from the return, the use of the amount realized for the calculations can have the reverse effect in calculating

⁷³⁰ § 6501(e)(1)(A)(i).

⁷³¹ The Supreme Court confirmed the continuing validity of Colony in United States v. Home Concrete, ___ U.S. ___, 132 S.Ct. 1836 (2012).

the numerator of the fraction, thus imposing a 6-year statute of limitations where using the gain realized would not.)

Example 5: Now for a variation of Example 4. Assume that (i) the taxpayer had only two components of income (salary income of \$100,000 and the property sale transaction) and (ii) the real basis in the property sale was \$0 but, on the return, the taxpayer claims an improper (but arguably not fraudulent) basis of \$80,000, thus reporting \$20,000. Here are the calculations:

	If amount realized	If gain only
Income Reported on Return		
Salary	\$100,000	\$100,000
Sale of Property	\$100,000	\$20,000
Income Reported (Denominator)	\$200,000	\$120,000
Unreported Income	\$0	\$80,000
% of Unreported Income	0%	67%

Colony seems to require the amount realized computation, resulting in no 6-year statute of limitations. The Supreme Court so held in this precise type of circumstance (artificially created basis resulting in a reduction of net gain). United States v. Home Concrete, ___ U.S. ___, 132 S.Ct. 1836 (2012).⁷³²

⁷³² The context of Home Concrete and the flurry of cases that produced the inconsistent courts of appeals decisions leading to Supreme Court review was the widespread proliferation of tax shelters creating artificial basis. In the late 1990s and early 2000s, there were a number of so-called basis enhancement shelters – the most notorious being so-called Son-of-Boss shelters. Some of these shelters (a limited number but representative of the class) were subsequently held to be fraudulent in criminal prosecutions of the promoters. The IRS’s first line of attack in trying to get to these shelters where the 3 year statute was closed was to assert the six year § 6501(e) but needed an interpretation of that exception different than Colony’s holding that overstatement of basis was not an omission of income. In Home Concrete, the court rejected the IRS’s interpretation of § 6501(e), holding that it was foreclosed by Colony. It is not clear to me why the IRS did not alternatively argue the unlimited civil fraud statute in at least some of the cases on the argument(s) that the return was fraudulent, permitted an unlimited statute of limitations under § 6501(c)(1) because either (i) the taxpayers committed fraud, at least in their representations of non-tax profit motive or (ii) even if the taxpayers did not commit fraud, the returns were still fraudulent based on either the preparer’s fraud or the promoters’ fraud. See Allen v. Commissioner, 128 T.C. 37 (2007) (preparer’s fraud alone permits the § 6501(c)(1) unlimited statute of limitations.); but I note elsewhere in the text that strong arguments can be made that the taxpayer’s personal fraud is required under § 6501(c)(1).

Example 6: The taxpayer reports \$50,000 of salary income and Schedule E partnership net income of \$10,000. As in Example 1, the taxpayer fails to report \$20,000 of interest income. No other income is reported on the return. Does the omission meet the 25% requirement? The answer is maybe/maybe not. Certainly, on the face of that taxpayer's return, the taxpayer has omitted in excess of 25%. However, the taxpayer reported net income from a partnership of \$10,000. What if that partnership's share of gross income reported on the partnership return and the partnership K-1 issued to the taxpayer is \$100,000, with allocable deductions of \$90,000 for the net of \$10,000 reported by the taxpayer on his return? Is the \$100,000 treated as gross income reported on the taxpayer's return for purposes of § 6501(e)(1)(A)? If so, then the taxpayer's gross income reported on the return is \$160,000 and the amount omitted is \$20,000, so it does not exceed the 25% threshold and the six year statute of limitations does not apply. The answer is that the allocable gross income reported by the partnership is deemed reported on the taxpayer's return, provided that the taxpayer reports the \$10,000 net from his partnership K-1.⁷³³ You should note that the partnership K-1 itself is not attached to the return. So partnerships may be quite useful in avoiding the 6-year statute of limitations. Indeed, the opportunities to avoid the six year statute of limitations are compounded when a first tier partnership has income from lower tier partnerships.⁷³⁴

(3) Disclosure To Avoid 6-Year Statute.

As noted above, even if income is omitted from the calculations on the return, the omission will be disregarded if an adequate disclosure of the omitted income is provided on the return. What is adequate disclosure? The statute requires disclosure "in a manner adequate to apprise the Secretary of the nature and amount of such item."⁷³⁵ Some have read the Supreme Court's decision in The Colony, interpreting a pre-1954 Code version of the 6 year exception, to bless disclosure of a mere clue as a way to avoid application of the 6 year exception. The language of the 1954 Code version (the current version), however, requires adequate notice⁷³⁶ and not just a "a mere clue that might intrigue Sherlock Holmes."⁷³⁷

⁷³³ Regs § 1.702-1(c)(2). See e.g, Davenport v. Commissioner, 48 T.C. 921 (1967); Roschuni v. Commissioner, 44 T.C. 80 (1965); Hoffman v. Commissioner, 119 T.C. 140 (2002) (addressing the issue in a collection due process case and holding that any partnership will do, even if the taxpayer did not materially participate under the at risk rules).

⁷³⁴ Harlan v. Commissioner, 16 T.C. 31 (2001).

⁷³⁵ CC&F Western Operations Limited Partnership v. Commissioner, 273 F.3d 402, 407 (1st Cir. 2001), citing George Edward Quick Trust v. Commissioner, 54 T.C. 1336, 1347 (1970), aff'd per curiam, 444 F.2d 90 (8th Cir. 1971).

⁷³⁶ Estate of Fry v. Commissioner, 88 T.C. 1020, 1023 (1987) ("The statement must be sufficiently detailed to alert the Commissioner and his agents as to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one.").

⁷³⁷ George Edward Quick Trust v. Commissioner, 54 T.C. 1336, 1347 (1970), aff'd per curiam, 444 F.2d 90 (8th Cir. 1971). Consider this discussion from Benson v. Commissioner, 560 F.3d 1133, 1136-1137 (9th Cir. 2009):

The Bensons also argue that Colony can be read to preclude the application of the extended limitations period because the Commissioner was able to discover

The disclosure contemplated is one filed on or with the taxpayer's own original return which contains the substantial omission.⁷³⁸ For this reason, the filing of an amended return will not cure the original return failure to disclose that caused the extended statute of limitations.⁷³⁹ (Students will recall that the same concept applies with respect to the filing of a nonfraudulent amended return where the original return was fraudulent; the amended return does not cure the fraud that triggers the unlimited statute of limitations.) Where, however, the taxpayer's original return provides a reference to another return that has been filed on or before the date the taxpayer's return is filed, the references can constitute adequate notice.⁷⁴⁰ For example, where a taxpayer reports on his return items from a flow-through entity such as a partnership or an S-corporation, the information on the referenced entity return filed on or before the filing of the taxpayer's return can be considered in assessing whether the taxpayer has made adequate disclosure.⁷⁴¹

the unreported income, despite their omissions. For this proposition, the Bensons cite the Court's language stating that the extended limitations period was meant to give the Commissioner additional time to "investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors." Colony, 357 U.S. at 36. The Bensons argue that the Commissioner was at no such special disadvantage here, as evidenced by the fact that the Commissioner actually detected the errors, and therefore the six-year period should not apply. However, the Supreme Court's gloss on the statutory language does not alter the statute's plain language, which simply provides that the Commissioner is afforded extra time whenever a taxpayer "omits" a certain amount from his or her gross income. 26 U.S.C. § 6501(e)(1)(A). The Bensons omitted the constructive dividends from their tax returns.

The taxpayer's argument was, of course, circular. If the IRS did not discover the omission, then the statute was six years but would be meaningless because the IRS did not discover the omission even in the six years. If the IRS did discover it in the six year period, then the six year period would not apply because the IRS discovered it.

⁷³⁸ Colony did note the reason for the extended statute being that Congress deemed the IRS to be "at a special disadvantage" with respect to omitted income. That does not mean that, if for some other reason, the IRS may not in fact be at a special disadvantage, the 6-year statute does not apply; the sole focus is on the omission rather than the special disadvantage. See Heckman v. Commissioner, ___ F.3d ___, 2015 U.S. App. LEXIS 9638 (8th Cir. 2015).

⁷³⁹ Houston v. Commissioner, 38 T.C. 486, 489 (1962) (stating that this is "settled law," citing Goldring v. Commissioner, 20 T.C. 79 (1953)).

⁷⁴⁰ E.g., Benson v. Commissioner, T.C. Memo. 2006-55.

⁷⁴¹ E.g., White v. Commissioner, 991 F.2d 657, 661 (10th Cir.1993), affg. T.C. Memo.1991-552 (partnership); and Benderoff v. United States, 398 F.2d 132 (8th Cir. 1968). The notion is that, if the entity return is filed later than the taxpayer's original substantial omission return, then the subsequent filing of the entity return is like the filing of an amended return by the taxpayer which, as noted in the text, does not qualify. See CCM 201333008 (6/27/13); for a deeper discussion of this IRS pronouncement, see Leslie Book, Disclosure and the 6-Year Statute of Limitation: S Corp Issues (Procedurally Taxing Blog 11/13/13). For the limits of these types of disclosures outside the taxpayer's own return, see Heckman v. Commissioner, ___ F.3d ___, 2015 U.S. App. LEXIS 9638 (8th Cir. 2015).

The disclosure escape from the six year statute of limitations is not a license for a taxpayer to omit income that is clearly taxable and attempt to provide some obtuse disclosure so as to avoid § 6501(e). Gamesmanship via an erroneous or misleading disclosure could result in criminal prosecution and/or the civil fraud penalty. Rather, it would seem that such disclosure is most effectively employed where the taxpayer has some reasonable argument that the income may not be taxable and desires to achieve two goals by a reasonable disclosure -- first the avoidance of criminal and civil penalties and second the application of the normal three year limitations period.

For taxpayers who pay close attention to odds, disclosing solely to avoid a six year limitations period is not generally a recommended option. Providing that the taxpayer is reasonably certain he or she can avoid civil and criminal penalties for the omission, the taxpayer may want to take the risks involved in having a six year rather than a three year statute of limitations. The IRS hardly ever commences audits of returns that are over 2 ½ years old anyway, so that the additional three year risk may not be that great. Thus, for each year during the first three years when the statute is open under the general rule, the odds of an IRS audit of the return are far greater than in the succeeding three years (Years 04 through 06). Nevertheless, even with the decreased odds in the “out years,” the IRS will sometimes stumble upon an out year problem while auditing years within the normal statute of limitations and will seek to invoke § 6501(e). And, of course, a disclosure will likely eliminate the far worse risk than a 6 year statute of limitations – a criminal investigation and prosecution.

(4) Burdens of Proof.

In litigation, the burdens will shift as follows: First, the taxpayer makes a prima facie case that the normal three year statute of limitations has expired. If the three year statute is open, of course, whether there is a six year statute is irrelevant. The taxpayer makes a prima facie case that the three year statute is closed by proving the date of filing and the lapse of three years. That burden is relatively easy. Second, if the taxpayer meets that burden, the IRS must then establish the 25% omission of gross income. Third, if the IRS meets that burden, the taxpayer must then establish the affirmative defense of adequate disclosure.⁷⁴²

b. \$5,000+ Omissions of Income from § 6038D Reportable Foreign Assets.

I discussed above a new special income tax disclosure requirement on Form 8938 required by § 6038D for foreign financial assets.⁷⁴³ If a taxpayer omits gross income from foreign financial assets in an amount that exceeds \$5,000, the statute of limitations on the return is six years rather than three years.⁷⁴⁴ It is important to distinguish for this purpose between (i) the information about

⁷⁴² See Hoffman v. Commissioner, 119 T.C.1 40, 146 (2002).

⁷⁴³ § 6038D, added by the § 511 of HIRE Act (FATCA provisions).

⁷⁴⁴ § 6501(e)(1)(A)(ii), as added by § 513(a) of the HIRE Act (FATCA provisions). The determination of the dollar amount is made without regard to the § 6038D’s dollar threshold, the statutory exception for nonresident aliens and any exceptions provided by regulation which might make the foreign financial assets otherwise not subject to actually being reported on the return.

the foreign financial asset subject to § 6038D's disclosure regime and (ii) the income from the assets subject to the disclosure regime. Thus, even if a taxpayer actually discloses the assets in the manner required, but omits income from those reported assets, the taxpayer's return will be subject to this 6 year statute of limitations. (As discussed below, if the taxpayer fails to provide disclosures required by § 6038D on the return, the statute of limitations will not begin to run until the information required is provided to the IRS; and this is true even if the taxpayer reports the income from the foreign financial assets required to be reported.)

6. Special Rules for Transfer Tax Returns.

a. Gift Tax Returns.

Gift tax returns pose special statute of limitations problems. The gift tax returns are subject to the normal statutes of limitations – generally three years – as noted above. Because of the unified estate and gift tax system, even if the gift tax statute of limitations otherwise closed, the amount of the gifts (not just the amount reported on the gift tax returns) must be included in the estate tax calculation at death. This gave the IRS a second opportunity, outside the normal gift tax statute of limitations, to increase the reported value and collect an estate tax at the highest marginal estate tax rate on the increase.⁷⁴⁵ In effect, this circumvents the finality otherwise offered by the normal application of the statute of limitations to the gift tax return. In order to offer some possibility for closure of old and cold transactions, special rules are provided that will lock in the gift tax consequences and their effect on the ultimate transfer tax at death, provided adequate disclosure is made on the gift tax return.

The gift tax statute of limitations will commence only for gifts “disclosed in such [the gift tax] return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item.”⁷⁴⁶ And, in computing the prior taxable gifts for purposes of the unified estate tax calculation, the values of the prior gifts reported on the prior gift tax returns will control only if they met that same standard.⁷⁴⁷

In addition, there is a 25% omission six year statute of limitations paralleling § 6501(e)'s 6-year statute for income tax purposes.⁷⁴⁸ This 6-year gift tax statute applies where the taxpayer omits from the total amount of gifts made during the period for which the gift tax return was filed an amount which exceeds 25% of the total amount of gifts stated on the return. As with the income tax six year statute, gifts are not included if they are adequately disclosed on the return.

Example: A taxpayer undertakes classic family partnership planning in which the taxpayer creates a limited partnership (“FLP”) and gifts limited partnership interests to his son. The taxpayer

⁷⁴⁵ See Estate of Smith v. Commissioner, 94 T.C. 872, 878 (1990).

⁷⁴⁶ § 6501(c)(9).

⁷⁴⁷ § 2001(f)(2)(a). See Estate of Hicks v. Commissioner, T.C. Memo 2014-100.

⁷⁴⁸ § 6501(e)(2). The Tax Court has said that this statute is in pari materia with the income tax 6-year statute (§ 6501(e)) and can be interpreted by reference to that statute. Estate of Williamson v. Commissioner, T.C. Memo. 1996-426.

files a gift tax return reporting only the gifts to his son. The description on the return is: “FLP Limited Partnership Units acquired by the taxpayer on January 1 of Year 1 for \$200,000 cash with an adjusted basis of \$200,000 and having a value of \$200,000.” The date of the transfer is January 2 of Year 1. Assume that the actual value is \$1,000,000. Is the quoted disclosure adequate to avoid the two special statutes noted above? The Regulations indicate that that would not be an adequate disclosure because it does not contain information about the methodology for valuation of the interest.⁷⁴⁹ Moreover, if (as is assumed) the actual value of the gift exceeds the 25% threshold, the IRS will have at least the six year statute of limitations because the return did not make an adequate disclosure.

b. Estate Tax Returns.

If the estate tax return is not filed or, if filed, is fraudulent, the statute of limitations is open forever under the general rules.⁷⁵⁰ There is also a six year statute of limitations for substantial omissions which is the same as applies for gift tax returns.⁷⁵¹

7. Requests for Prompt Assessment.

A decedent's estate may request prompt assessment with respect to income tax returns.⁷⁵² The assessment must then be made within 18 months of the date of the request. A similar rule applies for liquidating corporations.⁷⁵³ This shorter statute of limitations does not eliminate the requirement that the IRS send a predicate notice of deficiency; the timely sending of the notice of deficiency will, of course, invoke the suspension of the statute of limitations as discussed elsewhere.

8. Minimum Statute to Assess Tax Reported on Amended Return.

Where there is a statute of limitations that applies, if, within the 60 days before the expiration of the statute, the taxpayer files an amended return reporting additional tax due, the IRS will have at least 60 days to assess the reported tax liability.⁷⁵⁴

9. Other Statutes.

The foregoing are the general statutes of limitations on assessment that you will encounter as a tax practitioner. There are, however, a plethora of other special statutes of limitations to address particular tax imperatives. In this section, I will summarize two examples of these other statutes of limitation to give a general idea of the type of special tax needs that spawn special statutes of limitations.

⁷⁴⁹ Reg. 301.6501(c)-1(f)(2)(iv).

⁷⁵⁰ § 6501(c)(1)-(3).

⁷⁵¹ § 6501(e)(2).

⁷⁵² § 6501(d).

⁷⁵³ Id.

⁷⁵⁴ § 6501(c)(7).

First, the U.S. Code allows a U.S. taxpayer certain tax credits for income taxes paid to foreign jurisdictions. It may be many years before the final amount of the foreign tax liabilities may be determined. A special statute of limitations applies for foreign tax credits.⁷⁵⁵

Second, certain Code provisions require the taxpayer to disclose certain transfers and transactions with foreign entities. For example, a U.S. taxpayer discloses relationships with foreign entities and transactions with those related foreign entities on Form 5471 which is attached to the return. If the taxpayer fails to report the information either altogether or the information is not substantially complete, the assessment statute of limitations on the entire tax return stays open unless the failure to report is due to reasonable cause and not willful neglect in which case the statute is open only with respect to tax relating to the failure.⁷⁵⁶

I hope that this gives you a sense that there are special statutes of limitations that meet perceived special tax imperatives. For this class, I do not expect you to scour the Code or other laws for these special statutes but will expect you to know for this class the ones discussed above.

D. Suspensions by Deficiency Notice and Tax Court Petition.

1. General - Suspensions to Insure Right to Prepayment Remedy.

If the IRS timely (i.e., within the limitations period for assessment) issues a **notice of deficiency**, the statute of limitations is suspended in order to insure that the taxpayer is given an effective prepayment remedy in the United States Tax Court. The notice of deficiency gives the taxpayer the right to litigate in the Tax Court before the tax is assessed and the taxpayer is required to pay. To insure this right, **Section 6213(a)** prohibits the IRS from making an assessment for 90 days after the notice of deficiency is issued and, if the taxpayer petitions the Tax Court, until the decision of the Tax Court becomes final.⁷⁵⁷ In order to give the IRS some period to assess after the period of prohibition prescribed in § 6213(a), **§ 6503(a)(1)** suspends the period of limitations to take account of § 6213(a)'s period of prohibition on assessments. I provide the pertinent portions of § 6503(a) here (because some services have a variant reading with some internal inconsistencies):

§ 6503. Suspension of running of period of limitation.

(a) Issuance of statutory notice of deficiency.

(1) General rule. The running of the period of limitations provided in section 6501

*** on the making of assessments *** in respect of any deficiency as defined in

⁷⁵⁵ § 6501(c)(5).

⁷⁵⁶ § 6501(c)(8), as amended by the HIRE Act and then by Pub. L. 111-226 (124 Stat. 2403), § 218 (8/10/10).

⁷⁵⁷ If the IRS erroneously assesses during this prohibition period, upon notice of the error, it will abate the assessment so that, effectively, the assessment is ignored. The assessment which has been abated is a nullity. Cf. The Connell Business Co. v. Commissioner, T.C. Memo. 2004-131 (“While the abatements might be construed to constitute an admission that the prior assessments were premature, they in no way constitute admissions as to the proper amount of the deficiencies.”)

section 6211 (relating to income, estate, gift and certain excise taxes), shall (after the mailing of a notice under section 6212(a)) be suspended for the period during which the Secretary is prohibited from making the assessment or from collecting by levy or a proceeding in court (and in any event, if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, until the decision of the Tax Court becomes final), and for 60 days thereafter.

Parsing the text of the statute, § 6503(a)(1) suspends the period of limitation on assessments until 60 days **beyond** whichever of the following dates applied (depending upon whether the taxpayer petitions the Tax Court): (1) if the taxpayer does not petition the Tax Court, the end of the 90-day period during which the IRS was prohibited from making the assessment (the same 90 period during which the taxpayer could have petitioned the Tax Court but did not), and (2) if “a proceeding in respect of the deficiency is placed on the docket of the Tax Court,”⁷⁵⁸ the date the Tax Court decision becomes final.⁷⁵⁹

2. Notice of Deficiency and No Tax Court Petition.

As noted, § 6503(a)(1) suspends the period for assessment when no Tax Court petition is filed for the period during which the IRS is prohibited from making an assessment plus 60 days. Under § 6213(a), that period the IRS is prohibited from assessing is normally 90 days after the notice of deficiency is issued. These rules in the normal case require 90 days to elapse before the IRS may assess and thereafter an additional 60 days during which it may assess. The general rule, therefore, is that the IRS always has at least 150 days from the date of a timely notice of deficiency in which to assess if the taxpayer does not petition the Tax Court. There are some exceptions, however, to § 6213(a)’s prohibition on assessment. First, the IRS may make a jeopardy assessment if collection of the tax is in jeopardy as determined under jeopardy assessment procedures discuss later in this text. Second, pursuant to § 6213(b)(4), the IRS may make an assessment notwithstanding § 6213(a) if the taxpayer makes a payment of the tax. Taxpayers are entitled to make a payment prior to assessment and, upon receipt of the payment, the IRS may assess.

If the IRS makes a jeopardy assessment after a notice of deficiency is issued but before the lapse of 150 days, the jeopardy assessment will perform be timely because it is clearly within the

⁷⁵⁸ Recognizing the text’s substantial meaning, see Shockley v. Commissioner, 686 F.3d 1228 (11th Cir. 2012) (holding that the filing of a Tax Court petition invoked the suspension even if the notice of deficiency was invalid or the filing was not by the proper person; per the statute, the suspension occurs “if a proceeding in respect of the deficiency is placed on the docket of the Tax Court”). For a discussion of this and related issues, see Robert W. Wood and Dashiell C. Shapiro, For Whom the Statute Tolls, 140 Tax Notes 1035 (Sept. 2, 2013).

⁷⁵⁹ If the IRS assesses during this prohibition period, barring one of the exceptions to assessment in § 6213(b) or the jeopardy assessment remedy, the assessment is illegal and should be abated by the IRS upon request. The abatement, of course, does not mean that the taxpayer does not owe the tax asserted in the notice of deficiency. It just means that it was prematurely assessed. The assessment may thereafter be made after the prohibition period lapses. For an instance discussing such an abatement, see Mackey v. Commissioner, T.C. Memo 2004-70.

statute as suspended. If, on the other hand, the taxpayer makes a payment during the 150 day period, thus permitting the IRS to assess under § 6213(b)(4) notwithstanding § 6213(a), the question is whether, in the event the IRS does not assess although permitted to, the suspension under § 6503(a) continues. The technical legal question is whether the payment lifts the prohibition on assessment so that the IRS cannot thereafter use the entire 150 day period to make the assessment. In a fascinating decision covering the interface of these rules, Court of Federal Claims Judge Allegra concluded that this 150 day suspension period applied even if there were some exception otherwise applicable that permitted an assessment during the period of prohibition stated in § 6213(a).⁷⁶⁰ Thus, § 6213(b) contains exceptions to the prohibition in § 6213(a). The exception to § 6213(a) in play was § 6213(b)(4). The taxpayer argued that, since it had fully paid the tax, penalties and interest by application of a deposit during the period assessment was otherwise prohibited by § 6213(a), the IRS was not prohibited from making the assessment and therefore the suspension provided in § 6503(a) ceased. The consequence, the taxpayer urged, was that the suspension period ended upon the date of payment, thereby making the delayed assessment in that case untimely. Judge Allegra deftly weaves the Code sections and legislative history to conclude that, properly interpreted, § 6503(a) suspends for a flat 150 days once a notice of deficiency is issued regardless of any exception to the prohibition on assessment that might apply and lift the prohibition on assessment in the interim. Judge Allegra's conclusion is, I think, right, but I note that it is dicta in the case.⁷⁶¹ If Judge Allegra is not correct, however, it would appear that the 150 day period might be shortened by a payment on the tax, penalties and interest during the interim.

3. Notice of Deficiency and Tax Court Petition.

If a Tax Court petition is filed, the IRS is prohibited from making the assessment and thus the statute is suspended until the Tax Court decision becomes final.⁷⁶² That is a flat suspension of the statute that is not dependent upon any period during which the IRS is prohibited from making an assessment (although, in theory, it is somewhat related to that period).⁷⁶³

⁷⁶⁰ Principal Life Insurance Co. v. United States, 95 Fed. Cl. 786 (2010).

⁷⁶¹ Judge Allegra noted: "For reasons unexplained, however, defendant has not argued this. And the court thus will not decide this case on this basis." (Pp. 795-796.)

⁷⁶² Once a petition is filed purporting to respond to a notice of deficiency, the statute is suspended even if it is determined thereafter that the person other than the taxpayer actually filing the petition (someone otherwise authorized to practice before the Tax Court) did not have authority to file the petition. See Eversole v. Commissioner, 46 T.C. 56 (1966) and Martin v. Commissioner, T.C. Memo 2003-288, aff'd 436 F.3d 1216 (8th Cir. 2006).

⁷⁶³ One issue is whether the filing of a Tax Court petition that successfully challenges the validity of the notice of deficiency will result in a tolling of the statute of limitations under § 6501(a)(1), which requires tolling "if a proceeding in respect of the deficiency is placed on the docket of the Tax Court." I don't know that that has been definitively answered. It might depend upon whether the IRS reasonably did not know that the notice of deficiency was invalid, although the statutory text does not require that nuance. See Robert W. Wood and Dashiell C. Shapiro, For Whom the Statute Tolls, 140 Tax Notes 1035 (Sept. 2, 2013).

Normally, we would think that finality is not achieved until all appeals (including petitions to the Supreme Court for writ of certiorari) have been concluded in the case. And indeed the statute says that Tax Court decisions are not final while such further proceedings are pending. § 7481(a). However, § 7485(a) lifts the prohibition on assessment when the taxpayer appeals from the Tax Court unless the taxpayer posts bond.⁷⁶⁴ Without a bond, the IRS can assess despite the pendency of an appeal. But does that mean that the suspension on the statute of limitations is then lifted, so that the IRS must make the assessment within 60 days plus whatever period remained on the statute when it was suspended? No. Why? Because § 6503(a)(1) states that the suspension occurs while the IRS is prohibited from assessing **but** in any event, if a Tax Court petition is filed, until the decision of the Tax Court becomes final and for 60 days thereafter. Thus, even though § 7485(a) lifts the prohibition on assessment, the Tax Court decision will still not be final under the rule stated in § 7481(a) and the suspension of the period of limitations continues until the Tax Court decision becomes final. Section 7485(a) does not affect the rules as to when the Tax Court decision becomes final; all it does is to lift the prohibition on assessment. Piecing together these rules, even if the taxpayer appeals (provided he does not post bond), the IRS will be able to assess from a date 90 days after the Tax Court decision is rendered through a date which is the number of days after all appeals have been taken and become final determined by adding the number of days remaining on the statute when the notice was issued plus 60 days.

Let's illustrate these rules. The examples I use do not include a notice addressed to a taxpayer outside the United States.

Example 1: The IRS issues a notice of deficiency to T on the last date that the IRS could make an assessment. The IRS cannot make the assessment in the 90 day period during which the taxpayer may file a petition in the Tax Court. § 6213(a) (second sentence). The statute of limitations on assessment is suspended during the period that the IRS is prohibited from making the assessment. § 6503(a)(1). If the taxpayer fails to file a petition, the IRS can make the assessment on the 91st day (the prohibition on assessment being lifted on the last day the taxpayer could have filed a petition in the Tax Court) through the 150th day (the special 60 day extension period provided in § 6501(a)(1)). Note that, in this example, there is no additional time remaining on the statute of limitations at the time the notice of deficiency was issued, but if there had been that number of days would be added to the 60 day extension period. If the taxpayer petitions the Tax Court, the statute continues to be suspended, and the IRS can make the assessment at the earliest 90 days after the Tax Court decision is entered (§ 7485(a)), regardless of whether the taxpayer takes an appeal. And the IRS will then have a minimum of 60 days to make the assessment (if the taxpayer does not appeal) or until 60 days after all appeals are final under § 7481.

⁷⁶⁴ See also Tax Court Rule 192 reminding parties that the prohibition on assessment will be lifted if bond is not filed. The amount of the bond is determined by the Tax Court to cover the deficiency and penalties as determined by the Tax Court, plus interest through 2 ½ years after the notice of appeal, with a cap of double the amount of the deficiency. Poinier v. Commissioner, 90 T.C. 63 (1988). The posting of the bond does not stop the running of interest on the deficiency, penalties (if any) and interest finally determined. Until the notice of appeal, the IRS has had no assurance that the taxpayer will be able to pay the tax and generally will proceed with collection unless the bond is filed. Approved sureties are listed in Treasury Circular 570.

Example 2:

Year 01 Return Actually Filed by Mail: 10/01 of Year 2 Saturday
Return Filing Extension Date: 10/15 of Year 02 Thursday
Date Return Received by IRS: 10/14 of Year 02 Wednesday
Notice of Deficiency Date: 10/01 of Year 05 Wednesday
No Forms 872 or 872-A

1. If the taxpayer does nothing. Section 6213(a) prohibits the IRS from assessing during the 90 day period that the taxpayer can go to the Tax Court. The earliest the IRS may assess is 91 days after 10/01 of Year 05. The latest the IRS may assess is the sum of (i) 150 days⁷⁶⁵ after 10/01 of Year 05 (remember § 6503(a)(1) provides an automatic 60 day extension) and (ii), the number of days remaining on the statute when the notice was issued. Fourteen days remained on the statute when the notice was issued. You will remember that, since the return was actually filed within the extension period on 10/14 of Year 02, the timely-mailing, timely-filing rule does not apply and the filing date for the return is 10/14 of Year 02. So, the IRS may assess no later than the 164th day after 10/01 of year 05.

2. If T files a Tax Court petition on 12/1 of Year 5. Focusing solely on § 6213(a) and § 7481, one would conclude the earliest the assessment may be made is when the Tax Court decision becomes final after all appeals become final. For further consideration, assume the following:

Tax Court decision entered: 6/1 of Year 07
T appeals to Fifth Circuit: 8/1 of Year 07
Fifth Circuit Decision Judgment entered: 6/1 of Year 08
Fifth Circuit Judgment Becomes Final: 9/29 of Year 08
No Petition for Certiorari is Filed

When is the earliest the IRS can assess? Keep in mind § 7481 says that the decision does not become final until 9/29 of Year 08, so is that the earliest the IRS can assess? No. If all we had was § 7481, then the answer would clearly be yes, because there would be no provision lifting § 6213(a)'s prohibition on assessment prior to the date of ultimate case finality. But, § 7485(a) provides that, if the taxpayer appeals a Tax Court decision, the prohibition on assessment is lifted as of the date of appeal unless the taxpayer files a bond. Does this mean that, once there is an appeal and the prohibition on assessment lifted, the IRS must assess within 74 days from the date of appeal (the § 6503(a) 60-day grace period plus 14 days)? No, for § 6503(a)(1) suspends the period for assessment if a Tax Court petition is filed (see the parenthetical) until the decision becomes final as defined in § 7481, so that the IRS would have 74 days after that date to assess at the latest. So, the IRS may make the assessment anytime from the date of the appeal, assuming no bond, through 74 days after 9/29 of Year 08, the date of case finality.

⁷⁶⁵ See the discussion of Principal Life above.

4. Waiver of Prohibitions on Assessment During Suspension Period.

I noted earlier that § 6213(d) authorizes a taxpayer, “at any time,” to waive the prohibitions on assessment in § 6213(a) (which requires a notice of deficiency and allows the taxpayer time to petition the Tax Court). The suspension period in § 6503(a) discussed above can be shortened by the taxpayer filed a waiver of the restrictions on assessment (such as by Form 870). The filing of the waiver “filed within the 90-day period of suspension provided by sections 6213(a) and 6503(a)(1) of the Code, has the effect of terminating the running of such 90-day period and starting the running of the 60-day period provided by section 6503(a) of the Code on the date it is filed.”⁷⁶⁶ Thus, if the notice is sent 4 days before the normal statute of limitations period expires, and the taxpayer files the waiver a week after the notice is issued, the prohibitions on assessment are lifted and the IRS has 4-days plus the § 6503(a) 60-day suspension period in which to assess.⁷⁶⁷

E. Exceptions -- No Statute of Limitations for Some Assessments.

Although, as noted above, tax statutes of limitations reflect a general policy that statutes of limitations are an essential element of fairness, there are some instances in which tax claims may be made forever, with no statute of limitations. We have already noted above that there is no statute of limitations if taxpayer fails to file the return with respect to which the assessment may be made or files a fraudulent return with respect to which the assessment may be made. You can easily, I hope, understand that, in those cases, countervailing policies may outweigh the need for repose and, in those cases, Congress has mandated an unlimited statute of limitations.

Still, in Anglo-American jurisprudence, there is a bias toward statutes of limitation even where the statute may seem to provide none. Consider the following from the estimable Judge Posner in a case where the IRS, by regulation, provided the equivalent of a statute of limitations for an administrative claim:

[T]he Tax Court's basic thought seems to have been that since some statutes (in this case, some provisions of a statute) prescribe deadlines, whenever a statute (or provision) fails to prescribe a deadline, there is none. That is not how statutes that omit a statute of limitations are usually interpreted. Courts “borrow” a statute of limitations from some other statute in order to avoid the absurdity of allowing suits to be filed centuries after the claim on which the suit was based arose. They borrow an existing statute of limitations rather than create one because “the length of a limitations period is arbitrary -- you can't reason your way to it -- and courts are supposed not to be arbitrary; when they are, they get criticized for it.” Courts even say that in borrowing a statute of limitations from one statute for use in another they are doing Congress's will: “Given our longstanding practice of borrowing state law,

⁷⁶⁶ Rev. Rul. 66-17, 1966-1 C.B. 272.

⁷⁶⁷ ECC 201518015 (2/2/2015), published at 2015 TNT 85-38, citing Rev.Rul. 66-17, 1966-1 C.B. 272.

and the congressional awareness of this practice, we can generally assume that Congress intends by its silence that we borrow state law.”⁷⁶⁸

As in other areas of the law adverted to by Judge Posner, there are situations in which the Code just does not address the issue of a statute of limitations for assessment. Given the Anglo-American predilection for repose, courts will look for some related statute of limitations to borrow. Let’s consider, by way of example, the trust fund recovery penalty (“TFRP”) which we shall discuss in more detail below (pp. 704 ff.). For present purposes, I will just summarize the nature of the penalty. As you know, an employer is required to withhold from employees and pay over to the Government an amount for income tax with regard to compensation paid and the amount of the employee's share (½) of the FICA obligation. The employer is said to hold these amounts in trust between the time they are withheld from the employee and the time they are paid over to the Government, hence the taxes are often referred to as trust fund taxes. As a mechanism to collect the amounts that should have been withheld and paid over, § 6672 imposes a penalty in the amount of the unpaid trust fund tax on the person or persons in the employer’s organization who had the responsibility and authority to insure that the taxes were withheld and paid over. The § 6672 penalty applies only in the amount of the withheld taxes not actually paid over to the Government and, although each responsible person is subject to the tax not paid over, in the aggregate the IRS collects only the amount of the tax not paid over by the employer. As such, the § 6672 penalty is just a collection mechanism for the underlying tax not paid over. Now, as you may already know, the employer's liability for the tax not paid over is subject to a limitations period under the general rules noted above. So, if the employer files a nonfraudulent employment tax return reporting trust fund tax liability, the statute of limitations is generally three years from the date of filing to assess additional tax trust fund tax liability against the employer. What is the limitations period for the trust fund penalty against the responsible person?

There is no requirement of a return for the trust fund tax penalty (i.e., the putative responsible person does not voluntarily report trust fund tax liability on an IRS form). So the general rules, technically applied, are not applicable to commence and end a statute of limitations on the trust fund penalty. Is there a statute of limitations on assessment of the trust fund penalty?

The answer is yes. The courts have held -- and the IRS has acquiesced in the holding -- that the § 6501 statute of limitations applies by reference to the employer’s return. The theory is that, because the penalty is not a real penalty but a collection mechanism (via an alternative source to collect the employee’s withheld taxes), the statute should not be longer than the period allowed to assess the tax from the person directly liable (the employer).⁷⁶⁹ Thus, although responsible persons are not required to file returns reporting the penalty, the penalty does relate to the return that the employer is required to file and the liability related to that return and the statute is the same as for the employer on trust fund taxes.

⁷⁶⁸ Lantz v. Commissioner, 607 F.3d 479, 481-82 (7th Cir. 2010) (case citations omitted).

⁷⁶⁹ Lauckner v. United States, 68 F.3d 69 (3d Cir. 1995), aff’g No. 93-1594 (D.N.J. 1994), A.O.D. 1996-006, 1996-2 C.B. 1.

Still, there will be cases where the courts may not be willing to stretch to borrow and grant repose when the statute is silent. For example, § 6111 requires that persons involved in the promotion of certain tax shelters must register the tax shelter with the IRS. Section 6707 imposes a penalty for failure to register. There is no Code provision for a statute of limitations during which the IRS must assess these penalties. The IRS takes the position that the § 6707 penalty has no statute of limitations, relying on cases holding that other penalties not linked to a return filing requirement⁷⁷⁰ have no statute of limitations.⁷⁷¹ Another example is § 905(c) which requires taxpayers to notify the IRS if foreign tax credits differ from the foreign tax accrued. The IRS appears to have an unlimited statute of limitations to assess any tax related to those differences.⁷⁷² Still another is the § 6702 penalty for frivolous returns which, as the Tax Court observed, has no “readily observable statute of limitations.”⁷⁷³

These are the tools for analysis. If the Code provides that a tax liability or a penalty may be assessed, but provides no statute of limitations upon assessment, the assessment may be made at any time, unless liability is somehow related to and in lieu of a tax liability for which there is a statute of limitations.⁷⁷⁴ The practitioner will want to think creatively about how these equitable arguments can be marshaled to support a statute of limitations (in the case of desiring the avoid an open-ended assessment period) or support an argument that a limitation period should not apply.

F. IRS Erroneous Abatements.

If the IRS makes a timely assessment of the tax liability, it may thereafter abate an assessment that is “(1) is excessive in amount, or (2) is assessed after the expiration of the period of limitation properly applicable thereto, or (3) is erroneously or illegally assessed (emphasis added).” § 6404(a). The IRS may also abate for collection factors (e.g., the size of the unpaid

⁷⁷⁰ E.g., §§ 6700 and 6701.

⁷⁷¹ See ILM 200112003 (11/28/2000), reprinted in 2001 TNT 58-74 (3/26/01), citing Mullikin v. U.S., 952 F.2d 920 (6th Cir. 1991); Lamb v. U.S., 977 F.2d 1296 (8th Cir. 1992); Capozzi v. U.S., 980 F.2d 872 (2d Cir. 1992); and Sage v. U.S., 908 F.2d 18 (5th Cir. 1990).

⁷⁷² By contrast, a U.S. taxpayer accruing foreign taxes for a year (say Year 01) and thereafter paying more taxes than accrued has only a 10 year window in which to claim the resulting tax refund for Year 01 under § 6501(c)(5). See Neal M. Kochman and H. David Rosenbloom, Deconstructing Section 905(c): An Examination of the Redetermination Rules after TRA 1997, 2002 WTD 77-20 (4/22/02).

⁷⁷³ Crites v. Commissioner, T.C. Memo. 2012-267 (the Tax Court, however, said that, even if the three year statute could be borrowed, since the penalty was based upon the amended return and was assessed less than 3 years of the amended return, the assessment was timely). If the assessment had been over 3 years from the date of the penalized amended return, then the Court might or might not have been willing to borrow the 3 year statute and hold for the taxpayer.

⁷⁷⁴ See, e.g., ILM 200142021 (10/22/01), reprinted in 2001 TNT 204-25 and PMTA 2013-004 (4/3/13), reproduced at 2013 TNT 206-19, using this analysis for the §§ 6721 and 6722 penalties for failure to file certain information returns and differentiating between § 6721 and 6722 in this regard.

assessment) make collection action inappropriate or the IRS compromises the assessment for less than the amount paid.⁷⁷⁵ Or, the abatement may occur simply from administrative mistake. What is the effect of an abatement? Can the IRS simply reverse the abatement, thereby reinstating the pre-abatement assessment amount? Or, must the IRS make a new assessment which may then be prohibited because outside the statute of limitations for assessment?

The law is not clear. The line that seems to be drawn is as follows: If the abatement was just an administrative error (e.g., in the case of posting another taxpayer's payment), then the error can be corrected without a reassessment.⁷⁷⁶ If, however, the abatement was affirmatively intended by the IRS as a substantive redetermination of the taxpayer's liability (even if the IRS's determination is wrong), the abatement wipes out the predicate assessment, the wiped-out assessment cannot be revived, and a new timely assessment (with the predicate notice of deficiency) must be made if the statute of limitations on assessment remains open.⁷⁷⁷

G. Special Rule for Assessment of Interest.

We shall cover in Chapter 7 the rules for determining interest on taxes that are assessed. The rules we have discussed in the foregoing section determine the statute of limitations on assessment of tax. Normally, accumulated interest is assessed at the same time the underlying tax is assessed and, if the underlying tax is timely, that assessment of interest is timely. However, if the tax and assessed interest remain unpaid after the initial assessment of tax and interest, interest will continue to accrue until the tax is paid. That means that, since the statute of limitations on the assessment of tax will likely expire, there needs to be a special extension of the statute of limitations to permit the additional assessment of interest on timely assessed tax and interest. The Code provides such an extended period to assess interest during the period within which the assessed underlying tax may be collected.⁷⁷⁸

III. Collections.

Collection is different from assessment. Business men – including lawyers – know that collecting is quite different than sending a bill for work performed. Assessment is the act permitting the IRS to “send the bill.” Collecting the amount assessed is quite another matter. We discussed above the statute of limitations on assessment. Now we turn to the statute of limitations on collection.

⁷⁷⁵ E.g., § 6404(c) & (d).

⁷⁷⁶ See e.g. Bugge v. United States, 99 F.3d 740 (5th Cir. 1996); and Crompton-Richmond Co. v. United States, 311 F. Supp. 1184 (S.D.N.Y. 1970); and Rev. Rul. 74-580, 1974-2 C.B. 400, distinguished by Rev. Rul. 85-67, 1985-1 C.B. 364; but see In re Becker, 407 F.3d 89 (2d Cir. 2005), questionably analyzing the Bugge and Compton-Richmond.

⁷⁷⁷ See generally Bryan T. Camp, The Mysteries of Erroneous Tax Refunds, 114 Tax Notes 231 (Jan. 15, 2007) & 2007 TNT 11-55 (1/16/07).

⁷⁷⁸ § 6601(g).

The statute on collection is ten years from the date of assessment. § 6502(a).⁷⁷⁹ Piecing assessment and collection statutes together, you can see that normally the IRS has three years to make an assessment and ten years to collect the assessment, for a maximum of thirteen years. If the assessment is made before the end of the three year period, then the maximum thirteen years will be cut down accordingly.

In considering these maximum periods, you must also factor in those circumstances which might cause a valid assessment to be made beyond the three year period. These include an extended or no statute of limitations on assessment (e.g., failure to file, fraud and six year statute), suspensions of the statute of limitations on assessment when the IRS issues a notice of deficiency, and extensions of the statute of limitations upon mutual written consent. Thus, it is not unusual for the assessments (even where there is no substantial omission or fraud) to be made five or six years or even longer after the return was filed. Then, upon assessment, the IRS will have ten years to collect the tax.

As with the statute of limitations on assessment, the IRS and a taxpayer have historically been permitted to extend the collection statute by agreement.⁷⁸⁰ That general authority has been taken away, except where (1) the extension is agreed to at the same time as an installment agreement between the taxpayer and the Service, or (2) the extension is agreed to prior to a release of levy under § 6343 which occurs after the expiration of the statutory ten-year period for collection.⁷⁸¹

There are events that will suspend the collection statute of limitations and thus effectively give the IRS more than ten years to collect. These are (using terms that will be discussed in more detail later in this text):

1. Bankruptcy: From the date of filing the petition until the date of discharge, plus 6 months. § 6503(h).
2. Pending Installment Agreement: From the date of the request for an installment agreement, plus appeals, plus 30 days. § 6331(k)(3).⁷⁸²

⁷⁷⁹ The ten year period to collect, measured from the date of assessment, applies with respect to assessments arising from substitutes for returns under § 6020(b). In this regard, the IRS interprets the unlimited statute for collection in § 6501(b)(3) as not applying once the assessment has been made. See IRS CCA 200149032 (10/22/01), republished in 2001 IRS CCA LEXIS 222; see also ILM 201238028 (6/19/12), republished in 2012 TNT 185-28. In IRS jargon, the collection statute of limitations is called the CSED.

⁷⁸⁰ See § 6502(a)(2) (prior to amendment by the 1998 Restructuring Act).

⁷⁸¹ § 6502(a) (after amendment). In Jordan v. Commissioner, 135 T.C. No. 1 (2010), the Tax Court held that the taxpayer seeking to assert the bar on collection bears the ultimate burden of persuasion as to the nonexistence or non-validity of a consent, but affirmed the procedural rules in Adler v. Commissioner, 85 T.C. 535, 541 (T.C. 1985) as to the procedural and production burdens encountered at trial where the issue of the bar on collection is in play.

⁷⁸² The taxpayer also may contractually agree to extend if he obtains an acceptable installment agreement.

3. Termination of Installment Agreement: 30 days from the date of termination, plus appeals. § 6331(k)(3).
4. Pending Offer in Compromise: From the date of acceptance for processing of the OIC plus appeals after rejection, plus 30 days. § 6331(k)(3).
5. CDP Hearings: From the date of a timely request until final disposition. § 6330(e). Additionally, if it is less than 90 days from the CSED, the CSED is reset to 90 days from the date of final disposition. Reg. § 301.6330-1(g)(3).
6. Military-related Service in a Combat Zone: The length of service, plus 180 days. § 7508(a)(1)(i).⁷⁸³

The general basis for extending the collection statute of limitations is that there is some reason that the IRS is prohibited from exercising its collection remedies, so that, during that period, the collection statute of limitations is suspended.

Finally, if the Government files a timely collection suit it can effectively extend the statute as to the taxpayer because the assessment will be merged into a judgment and the period of limitations will be extended until the judgment against the taxpayer is satisfied or becomes unenforceable.⁷⁸⁴ Less well known is that, if the Government has remedies against third parties as to the taxpayer's tax liability (e.g., transferee liability, alter ego, etc.), the Government's filing of a collection suit against the taxpayer will extend the statute of limitations for the IRS to collect by levy as to its remedies against the third parties.⁷⁸⁵

⁷⁸³ This list is from Patrick Thomas (Guest Blogger), Inability to Correctly Calculate CSED – Confusion Leads to Unlawful Results (Procedurally Taxing Blog 3/6/15), <http://www.procedurallytaxing.com/inability-to-correctly-calculate-csed-confusion-leads-to-unlawful-results/> (viewed 3/7/15 and as modified to eliminate the IRC before the Code Sections).

⁷⁸⁴ § 6502(a). In United States v. Ligas, 549 F.3d 497 (7th Cir. 2008), the IRS timely filed such a collection suit within the ten year statute of limitations but, in an incredible set of facts, failed to properly serve the defendant, thus preventing the IRS from extending the statute of limitations on collection.

⁷⁸⁵ § 6502(a) (“If a timely proceeding in court for the collection of a tax is commenced, the period during which such tax may be collected by levy shall be extended and shall not expire until the liability for the tax (or a judgment against the taxpayer arising from such liability) is satisfied or becomes unenforceable.”). United States v. Anderson, 2013 U.S. Dist. LEXIS 102086 (MD FL 2013).

IV. Overpayments.

A. What Are Overpayments?

1. Actual Overpayments (Herein of Refunds and Credits; Offsets).

Overpayments are taxes paid in excess of taxes owed.⁷⁸⁶ The IRS may refund to the taxpayer an “overpayment” in tax or may credit an overpayment against other tax due from the taxpayer and, in some cases, against a debt due other federal, state agencies and even child-support payments certified by the state. § 6402.⁷⁸⁷

Where the taxpayer has overpaid for a year, the IRS may refund the overpayment. Resolving the overpayment by refund is probably done in most cases, except, perhaps, where the taxpayer files a timely return showing an overpayment and elects to apply the overpayment to the following year’s tax liability. Conceptually, of course, crediting the overpayment against the following year’s tax liability is the equivalent of refunding the overpayment and contemporaneously, at the taxpayer’s direction, applying it as an advance payment to the next year’s tax liability.

⁷⁸⁶ In Jones v. Liberty Glass Co., 332 U.S. 524, 531 (1947), the Court said:
* * * we read the word “overpayment” in its usual sense, as meaning any payment in excess of that which is properly due. Such an excess payment may be traced to an error in mathematics or in judgment or in interpretation of facts or law. And the error may be committed by the taxpayer or by the revenue agents. Whatever the reason, the payment of more than is rightfully due is what characterizes an overpayment.

See also United States v. Dalm, 494 U.S. 596, 609 n. 6 (1990) (“The commonsense interpretation is that a tax is overpaid when a taxpayer pays more than is owed, for whatever reason or no reason at all.”)

In Sunoco v. Commissioner, 663 F.3d 181 (3d Cir. 2011), the Court addressed the jurisdiction of the Tax Court with regard to quantifying overpayment interest where the overpayment was refunded before the Tax Court case was commenced. In this setting, the Court made the point that overpayment interest is not itself an overpayment of tax and thus a suit to dispute the IRS’s calculation of overpayment interest in this context will be outside the Tax Court’s jurisdiction and must be pursued as a general monetary claim against the United States in the district court or Court of Federal Claims within the general six-year statutes of limitations in 28 U.S.C. §§ 2401 and 2501.

⁷⁸⁷ § 6402(a), cited in the text, is a codification of the common law right of setoff which may also apply to the setoff. United States v. Munsey Trust Co., 332 U.S. 234, 239 (1947). The credit of a refund to another tax liability is deemed to be a refund of the overpayment and payment of the tax liability to which the overpayment is made. Cf. § 7422(d) (providing that for purposes of refund the payment via credit is deemed made on the date the credit is made). Under 31 U.S.C. § 3720A, tax refunds may be reduced by debts to federal agencies. For a case offsetting a DOE claim against a tax refund under this program, see Kipple v. United States, 2012 U.S. Claims LEXIS 821 (2012).

And, of course, IRS's unilateral crediting of a refund otherwise due against a tax liability otherwise owed by the taxpayer is the equivalent of a refund. Take the simplest of situations – a taxpayer is determined to have overpaid his tax liability for Year 03 when he has an outstanding liability for Year 01. Section 6402(a) gives the IRS authority to credit the tax overpayment against the Year 01 tax liability.⁷⁸⁸ All of this is effected through IRS's authority and systems. The IRS also may offset the refund otherwise due against nontax federal liabilities (such as FBAR civil penalty assessments) and certain state liabilities, as well as support obligations certified by a state agency.⁷⁸⁹ This nontax offset authority is maintained through a Treasury program, titled Treasury Offset Program ("TOP") which manages payment of amounts owed by the federal government and offsets debts due the federal government or state agencies against the amounts that would otherwise be paid.⁷⁹⁰ Thus, a scheduled refund will be vetted through the TOP system and the appropriate credit against the liability made.⁷⁹¹

Overpayments may not be refunded or credited after expiration of the statute of limitations for refund, unless the taxpayer filed a timely claim for refund and, if it is denied, filed a timely suit for refund.⁷⁹² And, to state the obvious, generally, overpayments may only be refunded or credited to the taxpayer suffering the economic burden of the tax paid.⁷⁹³

⁷⁸⁸ The tax liability against which the overpayment is offset must have been assessed, be assessable, or subject to an already issued notice of deficiency. See PMTA 2011-035 (8/8/11), reprinted at 2012 TNT 18-23, citing Regs. § 301.6402-1.

⁷⁸⁹ § 6402(c)-(i).

⁷⁹⁰ The TOP program is summarized from the Debt Management Services Website as follows:

The Treasury Offset Program is a centralized offset program, administered by the Financial Management Service's (FMS) Debt Management Services (DMS), to collect delinquent debts owed to federal agencies and states (including past-due child support), in accordance with 26 U.S.C. § 6402(d) (collection of debts owed to federal agencies), 31 U.S.C. § 3720A (reduction of tax refund by amount of the debts), and other applicable laws. FMS disburses federal payments, such as federal tax refunds, for agencies making federal payments (known as "payment agencies"), such as the Internal Revenue Service. "Creditor agencies," such as the Department of Education, submit delinquent debts to FMS for collection and inclusion in TOP and certify that such debts qualify for collection by offset.

FMS maintains a database with information of delinquent debts of the type authorized for offset and then, upon receiving notice of a payment due the payee, will compare the payee's name and TIN number against the names in the database and make the offset before paying the payee.

⁷⁹¹ As to refunds applied to other agency debts under the TOP program, the taxpayer may not pursue a refund or otherwise challenge the offset, but may bring appropriate actions against the agency receiving the credit. § 6402(g).

⁷⁹² §§ 6411(a) and 6532(a)(1).

⁷⁹³ Generally, is the key qualification. Section 6415(a), titled "Credits or refunds to persons who collected certain taxes," and implementing regulations permit nontaxpayers collecting

2. Constructive Overpayments.

Overpayments may also include taxes that **are** actually owed. **Section 6401(a)** provides that “the term overpayment” includes “tax . . . assessed or collected after the expiration of the period of limitation properly applicable thereto.”

The following examples will illustrate the normal operation of this rule and how it preserves the integrity of the statutes of limitation on assessment and collection.

Example 1: On April 15 of Year 02, T timely files his tax return for Year 01 showing a tax liability of \$1,000. T has, however, underreported his tax liability by \$100 and therefore really owes an additional \$100. As you know from the discussion above, the statute of limitations for the IRS to assess the additional tax liability expires on April 15 of Year 05. (Assume no exception to the three year statute on assessment applies.) The IRS timely audits the taxpayer, but does not send the notice of deficiency until February 1 of Year 06. The taxpayer does not file a timely petition in the Tax Court to have the notice of deficiency declared invalid because outside the assessment statute of limitations. On June 1 of Year 06, the IRS assesses the tax. Based on the rules for assessment, I hope you easily see that the assessment is untimely. The taxpayer pays on July 1 of Year 06. Two related questions: (1) has the taxpayer made an overpayment and (2) can the taxpayer now claim a refund of the taxes paid pursuant to the assessment? The answer is yes to both questions, for they are in a tax procedure sense the same question. It may seem counterintuitive to say that the taxpayer has made an overpayment of taxes he admittedly owed. The statute creates a constructive overpayment as the mechanism to insure that the statute of limitations on assessments works; the constructive overpayment thus gives the taxpayer the refund mechanism to get the untimely assessed taxes back. A refund requires that the taxpayer have overpaid his tax; this constructive overpayment permits the tax payment to be refunded.

Example 2: Assume the same facts, except that the IRS makes a timely assessment on April 1 of Year 05. The IRS has a ten year statute of limitations in which to collect taxes that have been assessed. § 6502. This statute runs from the date of assessment. In this example, the IRS would have until April 1 of Year 15 to collect the tax. Suppose that the taxpayer does not pay within the ten year collection period and instead pays in the eleventh year (Year 16 in this example). This

and remitting the tax to the Government to have the tax refunded to the collector if “has repaid the amount of such tax to the person from whom he collected it, or obtains the consent of such person to the allowance of such credit or refund.” Where a nontaxpayer’s assets are seized to apply to another taxpayer’s tax, the nontaxpayer may bring a wrongful levy suit under § 7426, titled “Civil actions by persons other than taxpayers.” In addition, in rare circumstances, a court might allow a nontaxpayer to pursue a refund where the nontaxpayer bore the economic burden of the tax applied to another’s tax liability. See e.g., United States v. Williams, 514 U.S. 527 (1995), discussed elsewhere in this text. Of course, if a nontaxpayer voluntarily pays the tax of the taxpayer, the taxpayer may not be viewed as having suffered the economic burden, but in that case the amount paid is properly viewed as a gift or compensation to the taxpayer who, then, economically does suffer the burden at least for these purposes.

statute again creates a constructive overpayment to preserve the statute of limitations on collection by using the real overpayment procedures (i.e., refund procedures) for the taxpayer to have the constructive overpayment refunded.

Example 3. Using the same facts as Example 2, assume that the taxpayer in anticipation of the final outcome of the audit realizes that he owes an additional \$100 of tax and sends it in to the IRS as a payment on the Year 01 tax liability. For some reason, the IRS does not assess that tax liability until June 1 of Year 06, well outside the statute of limitations. Must the IRS refund the payment? A literal reading of the Code section (quoted above) is that an overpayment is any amount assessed outside the applicable statute of limitations. In this example, the assessment was outside the applicable statute of limitations. Nevertheless, the IRS may retain payments made before the applicable assessment period expires which do not represent actual overpayments of the tax liability.⁷⁹⁴

Finally, just a few observations about the nature of a statute of limitations. It is a defense that can be waived. Thus, if the taxpayer pays and does not file a claim for refund, the IRS can keep the tax paid. Consider the following:

Where * * * a payment of additional tax is made after expiration of the period for assessment, the Service may accept voluntary payments of additional tax, but cannot assess the additional amount tendered. I.R.C. section 6501* * *. Where a taxpayer voluntarily makes a payment of additional tax after the expiration of its period of limitation for assessment, the taxpayer is entitled to a refund of its payment. * * * . In such cases, the Service must refund the amount of the voluntary payment, provided the taxpayer files a timely claim for refund in accordance with the terms of section 6511(a). * * * *⁷⁹⁵

In this regard, when the IRS receives a payment for a period that it recognizes as beyond the normal three-year statute of limitations without any basis to assume that a different statute applies, from an administrative perspective it could just return the payment as a refund of an overpayment

⁷⁹⁴ See Ewing v. United States, 914 F.2d 499 at 503 (4th Cir. 1990); and Williams-Russell & Johnson, Inc. v. United States, 371 F.3d 1350 (11th Cir. 2004), cert. denied 125 S.Ct. 676 (2004). See also Principal Life Insurance Co. v. United States, 95 Fed. Cl. 786 (2010) for an exhaustive, highly recommended analysis of the principle illustrative in the example in the text.

This may explain why the taxpayer in New York Life Insurance Company v. United States, 118 F.3d 1553 (Fed. Cir. 1997), cert. denied 523 U.S. 1094 (1998) argued that an advance remittance when the IRS thereafter failed to assess timely was a deposit which does not draw interest rather than a payment which would draw interest. If the mere untimely assessment would entitle the taxpayer to a refund, then the taxpayer in New York Life would have been better off arguing that the remittance was a payment. However, if the taxpayer were concerned that the IRS could retain a timely payment even though the assessment was untimely, the taxpayer would be better off arguing that the remittance was a deposit. In that case, the taxpayer so argued and prevailed.

⁷⁹⁵ FSA 200049012, 2000 TNT 238-51 (2000)

or it could keep the payment and notify the taxpayer that he or she may be entitled to have it returned. In my practice, I have encountered both responses. If the taxpayer actually gets the refund (or refund equivalent by crediting against other taxes), there will be no overpayment.

What happens where the IRS does not sua sponte return the money even though it has not determined that an extended statute of limitations might apply? This circumstance often happens when the taxpayer files an amended return for a year that is beyond the normal three year statute of limitations. I will give you a real-world example. Suppose a taxpayer comes to you in June of Year 07 for your advice about potential criminal fraud for returns for Years 01-06. The criminal statute of limitations is 6 years, so each of these returns, the earliest of which was filed on April 15 of Year 02, could be a criminal problem. Standard advice in this area is to file nonfraudulent amended returns correcting the matters that might be considered fraudulent. The more conservative approach is to file amended returns for all six years. If the normal civil statute of limitations applied, the returns for Years 01-03 would be barred (assume April 15 filing for all years). So, when the IRS receives the amended returns for Years 01-03 (filed only to mitigate a potential criminal problem), its records will show no reason for the civil statute of limitations to exceed 3 years (assuming the corrections on the amended returns will not show on their face that the six year statute of limitations (25% omission) applies). The IRS often responds in this circumstance with a letter to the taxpayer advising that the payment appears to be outside the statute of limitations and, if that is true, the taxpayer might consider filing a claim for refund. If the taxpayer, being somewhat greedy, files a claim for refund, the claim will usually receive at least some level of review. The IRS may then do whatever work is necessary to determine whether an extended statute applies. Specifically, although the taxpayer may have solved his criminal problem by filing the amended returns and paying the tax, the IRS may conclude that the original returns were fraudulent and assert that there is no constructive overpayment because the payment and assessment were made within the unlimited **civil** statute of limitations for fraud. And, even worse, that might trigger the IRS to assert the fraud penalty. (See the discussion of qualified amended returns beginning on p. 341.)

3. Determination of Overpayment.

Before the IRS makes a refund or credit, the IRS must determine that there is an overpayment. There are two key exceptions to the requirement that the IRS determine the existence of the overpayment. First, if the taxpayer claims on his or her return that amounts paid in advance (e.g., withholding taxes on wages or estimated taxes during the year) are in excess of the tax due,⁷⁹⁶ the IRS may refund or credit the amount of the indicated overpayment without first making a determination (via audit) that there is an overpayment.⁷⁹⁷ Second, under § 6411, a taxpayer may apply for a tentative carryback refund for a prior year based on the carryback of tax attributes earned in a later year (pp. 768 ff.). In both cases, the IRS may subsequently audit the claim for refund and, if it determines that the refund allowed was inappropriate, invoke the deficiency procedures to assess and collect the tax refunded or sue for erroneous refund.

⁷⁹⁶ The income tax return itself constitutes a claim for refund if it indicates an overpayment to be due. Regs. § 301.6402-3(a)(5).

⁷⁹⁷ Regs. § 301.6402-4.

4. Overpayment of Installments.

If a tax is payable in installments, an overpayment of an installment is credited against unpaid installments and only when the aggregate installment payments exceed the tax due is the amount treated as an overpayment subject to the foregoing rules.⁷⁹⁸

B. The Claim for Refund.

1. The Role and Nature of the Claim.

In order to recover an overpayment, the taxpayer must first file a claim for refund with the IRS. This predicate requirement is a familiar one in administrative law -- the taxpayer will not be denied his right ultimately to a judicial remedy, but she will be required first to pursue reasonably available administrative remedies. I deal more below (pp. 767 ff.) with some of the requirements for a claim for refund, but let's turn now to statute of limitations issues.

You will notice that I said that the claim for refund must be filed before the taxpayer may recover the claim for refund. The IRS may voluntarily make a refund payment without a claim for refund,⁷⁹⁹ and often does in a situation where it conducts an audit and determines an overpayment.⁸⁰⁰ But, a taxpayer wanting to preserve her right to force the IRS to refund must make sure that a timely claim for refund is filed.

The IRS has the right to prescribe the format of claims for refund. The individual income tax claim for refund can be either on the original return by claiming a refund (Form 1040) or on an amended returns (Form 1040X) claiming a refund.

⁷⁹⁸ § 6403. For this reason, overpaying installments effectively is a prepayment of the amount applied to later installments – i.e., the taxpayer has accelerated the time of payment. A dramatic instance of this might occur where, with the favorable installment of estate tax permitted for estate attributable to closely held business, the taxpayer overpays the portion not attributable to the closely held business which is not deferred will mean that the amount thus overpaid is applied to the deferred portion, thus denying pro tanto the benefit of the installment method. See Estate of McNeely v. United States, 2014 U.S. Dist. LEXIS 80000 (D. MN 2014)

⁷⁹⁹ E.g., Regs. § 601.105(d)(1)(iii) (report of examiner after audit may allow overassessment or abatement “with or without a claim for refund.”)

⁸⁰⁰ One of the documents the IRS asks the taxpayer to sign at the conclusion of an audit is a form essentially accepting for administrative purposes the results of the investigation. The two forms commonly used for this purpose are the Form 870 Waiver of the Restrictions on Assessment and Collection of Deficiency or Acceptance of Overassessment, and the Form 4549, titled Income Tax Examination Changes. If the examination concludes there is prior overassessment or overpayment, the respective Form can constitute a claim for refund or abatement. Rev. Rul. 68-65, 1968-1 C.B. 555.

2. Statute for Filing of the Claim for Refund.

a. General.

Just as there are statutes of limitation on assessment and collection taxes, there are also statutes of limitation on taxpayers claiming tax refunds from the Government. There are two applicable rules.⁸⁰¹

First, there is a statute of limitations for filing the claim for refund. A claim for refund must be filed within three years from the date the return was filed or two years from the date the tax was paid, whichever is later, and, if no return is filed, within two years from the date of payment. § 6511(a).⁸⁰² Read literally, this means that a taxpayer can file a return 40 years late and qualify under this first rule.⁸⁰³ I hope readers will instinctively say something must be missing here, for statutes of limitations do not normally allow such lengthy lapses before the claim must be pursued. The answer to that concern is in the second rule to which I now turn.

⁸⁰¹ Whether these statutes of limitation are jurisdictional or simply bars to recovery is a question sometimes, but not always, without practical consequence. Most often, the practical consequence is that, for failing to meet the tests, the taxpayer cannot recover the refund. However, consider the following from a Court of Claims case, Ebeyer v. United States, 2013 U.S. Claims LEXIS 1291 (Fed. Cl. 2013) (case cites and quotations omitted):

In addressing this issue, the court is mindful of the Federal Circuit's recent admonition that mastering the distinction between a dismissal for lack of jurisdiction and a dismissal on the merits is not merely an intellectual exercise without practical utility. This is because a dismissal on the merits usually carries *res judicata* effect whereas a dismissal for lack of jurisdiction typically does not, and, further, a court's characterization of a decision as jurisdictional rather than as on the merits affects its treatment of disputed facts. For example, unlike motions to dismiss for failure to state a claim or motions for summary judgment, motions to dismiss for want of subject matter jurisdiction permit courts to inquire into jurisdictional facts that are disputed and resolve such disputes through findings of fact.

Even though the Federal Circuit cases were not consistent, the Court in Ebeyer held that the requirements were not jurisdictional. I don't think the last word has been written on this subject.

⁸⁰² Actually, the statute is a little more nuanced than the general statement in the text which is likely to address most of the situations you will find in practice (hence its generality). The claim for refund limitation period applies to taxes "imposed by this title in respect of which tax the taxpayer is required to file a return." Suppose the taxpayer was not required to file a return (e.g., because it was tax exempt) but in error did file one? Does the three year limitations period apply? See Little People's School, Inc. v. United States, 842 F.2d 570 (1st Cir. 1988) and Wachovia Bank, N.A. v. United States, 455 F.3d 1261 (11th Cir. 2006) (both answering yes by rejecting a literal interpretation of the status in favor of a contextual meaning).

⁸⁰³ See Oropallo v. United States, 994 F.2d 25, 30 (1st Cir. 1993).

Second, there is a statute of limitations on the **amount** of tax that can be refunded if the claim is timely under the first rule. The IRS may only refund the amount of tax paid within three years plus the period of any extension⁸⁰⁴ and, if the foregoing rule does not apply, then it may only refund the tax paid within two years of the date of the claim. § 6511(b)(2).⁸⁰⁵ This is called the “lookback” rule.⁸⁰⁶

⁸⁰⁴ Facially, if the taxpayer filed for and received the requested extension, § 6511(b)(2)(A) applies to make the 3 year period apply from the extended due date even if (i) the taxpayer filed before the extended due date (e.g., for individual return extension, say he received the extension to file the Year 01 return by 10/15/02 and filed it on 9/1/02) or (ii) the taxpayer filed after the extended due date (e.g., the taxpayer filed the original delinquent return claiming the refund in the following example on 10/15/05 (3 years after the extended due date). For the latter, see CC-2000-09 (11/13/2000) (discussing Weisbart v. Treasury, 222 F.3d 93 (2d Cir. 2000) where the facts were: (i) extension for 2001 return from 4/15/92 to 8/17/92; and (ii) delinquent original return claiming refund mailed on 8/17/95); this CC, technically addressing the timely mailing, timely filing rule is based on the notion that, had the taxpayer actually filed on 8/17/05 – three years from the extended due date – the filing would have been timely; the only issue being whether the timely mailing, timely filing rule applied to a delinquent original return mailed on the last day of the three year period calculated from the extended due date.

⁸⁰⁵ For the esoteric application of these rules in the context of jurisdiction for a refund court (a district court or the Court of Federal Claims) to the issue of whether these rules are jurisdictional or just bases upon which to deny a refund with a court otherwise having jurisdiction, see Murdock v. United States, 103 Fed. Cl. 389 (2012). It is not clear to me whether, from a real world perspective, it makes any difference whether a refund claimant loses his or her suit for refund because of jurisdiction or on the merits of whether it has met these rules, which in any event result in the case being dismissed. But the Murdock court thought it important to struggle with these concepts, all the while pouring the refund claimant out. The Supreme Court has struggled with the distinction between jurisdictional and statutory time limit requirements in Henderson v. Shinseki, 562 U.S. 428 (U.S. 2011), the Court noted important consequences in the distinction, including that jurisdictional rules must be applied by the courts even if not asserted by the parties and other consequences. The Court offers no clear guidance except that (i) a rule should not be treated as jurisdictional unless it governs the court’s adjudicatory capacity and (ii) so-called “claim-processing rules” requiring procedural steps at specific times should generally not be considered jurisdictional. I don’t know if this will change the historical perception of the refund timing rules as not being jurisdictional, but I don’t dwell on it further now because I don’t think it makes a lot of difference in the tax universe. I do note one prominent instance where, over the parties’ objection, a court did invoke what it perceived to be a jurisdictional rule – the full payment rule of Flora v. United States, 357 U.S. 63 (1958), *aff’d on reh’g*, 362 U.S. 145 (1960) – to dismiss a case. Shore v. United States, 26 Cl. Ct. 829 (Cl. Ct. 1992). The dismissal turned upon the proper interpretation of the jurisdictional rule. On appeal, the holding was reversed, because the court of appeals interpreted the rule differently, but did not quarrel with the rule as being jurisdictional. Shore v. United States, 9 F.3d 1524 (Fed. Cir. 1993).

⁸⁰⁶ Commissioner of Internal Revenue v. Lundy, 516 U.S. 235, 240 (1996).

This may be a bit confusing. I provide examples to illustrate.

Example 1: The taxpayer files his Year 01 tax return on 4/15/02 and pays the indicated tax of \$100. In January of Year 05, the taxpayer discovers he overpaid the Year 01 tax by \$50. He may file a timely claim for refund any time on or prior to 4/15/05 and receive a full refund. He satisfies both rules.

Example 2: Assume the same facts, except for some reason, the taxpayer does not file the claim for refund until 6/01/05. Both of the rules would prohibit the IRS from granting the claim. First, he has not filed a claim for refund within the period provided in the first rule. Second, the amount he seeks to have refunded was paid beyond the three year period before the filing of the claim, as provided in the second rule, the lookback rule.

Example 3: Assume the same facts except that the taxpayer received an extension to file the Year 01 return and files the return on 10/15/02. Under the first rule, the taxpayer will have until 10/15/05 to file a claim for refund and, under the second rule, he may recover the full refund because extension periods are added to the three year lookback rule.⁸⁰⁷

Example 4: Assume the same facts as **Example 3** (most prominently a requested extension to 10/15/02 for the Year 01 return), but the taxpayer files his original 01 return on 7/1/02 (that is the actual date the IRS receives it and files the 01 return). As noted elsewhere in the text the filing date for this return is 7/1/02. The three year claim for refund period ends 7/1/05. This follows inexorably from the statutory requirement that the claim be filed 3 years from the date of filing and the absence of any provision that treats a return filed during the extension period before the extended due date to be treated as filed on the extended due date. Specifically, from the statutory text, the taxpayer does not have until 10/15/05, the extended due date plus 3 years, to file the claim. Notwithstanding this analysis, the IRS may treat a claim filed by the extended due date for an original return filed before the extended due date as timely under the 3 year rule.⁸⁰⁸ The better part of wisdom, however, would be to file the claim no later than 7/1/05.

Example 5: Assume the same facts as **Example 3** (extension to 10/15/02 and actual filing on 10/15/02) except that the IRS issues a notice of deficiency for an additional \$100 tax on the last

⁸⁰⁷ § 6511(b)(2)(A).

⁸⁰⁸ In exchanges on the Tax Prof List Serv on 6/23/10, the Tax Profs discussed the fact that the IRS instructions for filing a 1040X indicate that the 3 years is measured from the extended due date without any nuance for a return on extension filed prior to the extended due date. The IRS apparently recognizes that its computer systems are not up to the task of applying the complexity to recognize that the refund statute date closes in the example above on 7/1/05. See ECC 201321022 (5/2/13), reproduced at 2013 TNT 102-60 (5/25/13) (noting that, in this example, the IRS computers would key to the extended due date and generate a refund even if the refund claim is filed after 7/1/02). The publication laments: “The section 6511 rules are so complicated that the system cannot currently be programmed to figure out every situation.” Other complexities are also addressed in ECC 201321022.

day of the three year period (10/15/05), the taxpayer does not petition the Tax Court, and the IRS assesses the \$100 tax and interest on February 1 of Year 06. The taxpayer pays the assessed amounts on February 8 of Year 06. Then, on January 1 of Year 07, the taxpayer files a claim for refund for the taxes and interest he paid on February 8 of Year 6 plus \$50 of the tax he paid on October 15 of Year 2 with the original return. The taxpayer is timely with respect to the taxes paid on February 8 of Year 06 but is not timely with respect to the taxes paid on October 15 of Year 02. Why? Because the taxpayer failed to file a claim within three years from the date the return was filed, but did file the claim within two years from the date the additional assessed taxes were paid.

Example 6: Assume the same facts as **Example 5** except that, in response to the notice of deficiency, on December 15 of Year 05, the taxpayer filed a timely petition in the Tax Court, and, on June 1 of Year 07, the Tax Court determines that the taxpayer overpaid the taxes he paid on October 15 of Year 02. Can the taxpayer get a refund? Yes, the Tax Court can determine the overpayment and order a refund if on the date the Tax Court notice of deficiency was issued the taxpayer could have filed a timely claim for refund. **§ 6512(b)(3)**. Can you articulate the reason for this rule?

Example 7: This example will illustrate some of the more byzantine possible constructions of these rules. Assume that the taxpayer has paid more tax than he really owes through one of the prepayment mechanisms (either withholding or estimated taxes). Despite owing no additional tax and even being entitled to a refund, the taxpayer fails to file a tax return on the regular due date of April 15 of Year 02. Can the taxpayer file the required return claiming the refund on October 15 of Year 04, 2 ½ years after the due date of April 15? One possible interpretation of **§ 6511(a)** is that a **timely** filed return is required for the three year period to operate, so that the taxpayer loses because he did not file the refund claim within two years of payment. Section 6511(a) does not expressly require a timely return, but one can construct a contextual argument that **§ 6511(a)** only makes sense if it refers to a timely filed return. Nevertheless, the courts and the IRS, although flirting with that notion and even imposing it in at least one case, seem now to embrace a three year period for a taxpayer in this situation.⁸⁰⁹ But that does not get the taxpayer his refund because that only clears the first rule. Fortunately for the taxpayer, he can clear the second rule because his claim is still within the three year period of **§ 6511(b)(2)(A)**.⁸¹⁰

Example 8: Taxpayer prepays Year 01 taxes in the amount of \$100,000 by combination of estimated tax and withholding tax, but then fails to file the return timely on 4/15/02 and does not

⁸⁰⁹ I shall not go through the Code gyrations to get you there, but for further reading, see Leandra Lederman, Late Returns Claiming Refunds: Negotiating the “Fantastic Labyrinth”, 2000 TNT 224-67 (11/20/2000); see also Weisbart v. United States, 222 F.3d 93 (2d Cir. 2000); and Omohundro v. United States, 300 F.3d 1065 (9th Cir. 2002); and CC-2003-021, reproduced at 2003 TNT 126-13. See also **§ 6512(b)(3)** which now permits the Tax Court to award an overpayment in such a case.

⁸¹⁰ But see Dickow v. United States, 654 F.3d 144 (1st Cir. 2011) denying the claim for refund because the original delinquent return (an estate tax return) was filed over three years after the taxes were paid.

request an extension. Those prepayments are deemed paid on 4/15/02. The taxpayer thereafter files a delinquent original Year 01 return on 7/15/05 on which he reports a tax liability of \$50,000, claims credit for the prepaid tax of \$100,000, and claims a resulting Year 01 refund of \$50,000. The taxpayer meets the three year requirement of § 6511(a) because the claim for refund is filed contemporaneously with the return. However, he flunks § 6511(b)(2)(A)'s look-back period requirement because the refund cannot exceed the taxes paid in the preceding three year period.⁸¹¹ Strangely, if the taxpayer had originally timely received an extension of the Year 01 return which would have permitted him to file a timely Year 01 return by 10/15/02, then the taxpayer will have met the § 6511(b)(2)(A) 3-year lookback requirement because extensions are counted even if not used.

Example 9: Same Example 8, except assume (i) the taxpayer does not apply for an extension, (ii) for some reason, the IRS treats the prepayment of \$100,000 not as a payment of tax deemed paid on 4/15/02 but as a deposit or cash bond and (iii) the IRS applies the cash bond as a payment on 9/1/02. The refund claim is then timely because the 7/15/05 filing is within 3 years of the date of payment.

I have noted above several special rules like the timely-mailing, timely-filing rule and the holiday rule (making timely a return due on a holiday or weekend if filed the day after a holiday or weekend). Practitioners must pay careful attention to these intersection of these rules with the claim for refund requirement. For example, assume that a return is due on April 15 of Year 02 which is a Saturday, so that the return will be deemed timely if filed on April 17 of Year 02. The taxpayer mails the return on March 1 of Year 02 and the IRS receives it on March 5 of Year 02. The return is deemed filed on the original due date of April 15 of Year 02 and not the statutorily extended date of April 17 of Year 02. The three year period for filing a timely claim for refund expires April 15 of Year 05, not April 17 of Year 05.⁸¹²

I noted above that, in certain special situations, Congress has provided an extended statute of limitations on assessment. So, too, there are special situations that Congress feels justify extended periods for claiming refunds. For example, taxpayers are entitled to deduct their losses arising from bad debts and worthless securities in the year in which bad debts and securities become worthless. It is often very difficult to determine the year in which bad debts and securities actually become worthless. For this reason, § 6511(d)(1) provides a special seven year statute of limitations for claims for refund related to bad debts and worthless securities. Another example is the extended period for claiming refunds related to foreign tax credits.⁸¹³ Still another example is the carryback

⁸¹¹ Reynoso v. United States, 692 F.3d 973 (9th Cir. 2012). The case also discusses the taxpayer's arguments that, because the IRS inappropriately credited the amount involved to another year's return, he should escape the prohibition of § 6511(b)(2)(A)'s look-back period and move it forward to the year the improper credit occurred. That is esoterica which can be consulted in the opinion as the readers needs.

⁸¹² See Burgess J.W. Raby and William L. Raby, Return Filing Dates and the Statute of Limitations, 2003 TNT 89-11 (2003). The authors also note other examples of problems in the interface of the three year refund claim rule and other rules.

⁸¹³ § 6511(d)(3)(A).

of net operating losses in which case the three year period is measured not from the year to which the losses are carried but from the year that generated the losses that are carried back.⁸¹⁴

b. Interest Claims.

Usually, a taxpayer files a claim for refund claiming that he overpaid his tax liability for the year. As we learn elsewhere, if a taxpayer overpays his tax, he will be entitled to recover interest at the statutory rate (just as when he owes a tax, he will owe interest for the period of the underpayment). To illustrate, when the taxpayer files a claim for \$100 overpayment on his or her Year 01 return that was due and filed on April 15 of Year 02, the taxpayer will be entitled to interest after April 15 of Year 02 until the overpayment is refunded. For this reason, in filing a claim for refund, tax practitioners often include a statement that the refund request includes interest⁸¹⁵ but, since the amount of the interest is a moving target, a specific statement of the amount of the interest requested is often not included in the claim for refund. In this example, no separate claim for refund of interest is required.⁸¹⁶ So the general rule is that, if you have made a valid claim for principal tax liability overpayment, interest on the overpayment will be automatic.

Now, let's vary the example slightly. Assume that the taxpayer filed his Year 01 tax return on April 15 of Year 02, reporting \$0 tax liability and paying no tax. Then on April 15 of Year 03, the IRS asserts a deficiency of \$100 and \$8 of underpayment interest, which the taxpayer promptly pays the same date by cutting a check for \$108. The taxpayer then files a claim for refund of the tax and interest paid on the ground that the \$100 deficiency determined by the IRS was not owed. Does the taxpayer have to claim refund of the deficiency interest of \$8 paid? The answer is yes.⁸¹⁷ The

⁸¹⁴ § 6511(d)(2). For an application of this rule, see Electrolux Holdings, Inc. v. United States, 491 F.3d 1327 (Fed Cir. 2007).

⁸¹⁵ The statement will often be as simple as “plus interest as allowed by law.” More pontifically, the statement may be “plus interest on such amount or such greater amount of tax and interest as may be legally refundable on such taxes and interest.” Mobil Corp. v. United States, 2002 U.S. Claims LEXIS 92 (Fed. Cl. 2002).

⁸¹⁶ § 6611(a) provides that interest “shall be allowed and paid upon any overpayment.” The instructions on the claims for refund generally state that the “IRS will figure any interest due or owed and will either include it in [the] refund or bill [the taxpayer] for the interest.” E.g., Form 1120X Instructions. The latter calculation – deficiency interest – provides an apt analogy. In a notice of deficiency, the IRS does not assert the general interest calculation, since that is automatically provided by law.

⁸¹⁷ Alexander Proudfoot Co. v. United States, 454 F. 2d 1379 (Ct. Cl. 1972). The Court there illustrated this holding (p. 1383, n. 10):

Plaintiff suggest that, if the Service happened to impose deficiency interest at 9% rather than the allowable 6%. . . the taxpayer could bring an independent action not subject to the requirements of a tax refund claim to recover the excess. We agree, however, with the Government that this is precisely one situation in which Congress would want the Service to have an opportunity to correct its mistake before litigation was begun.

deficiency interest paid (\$8) is not a moving target and can be easily stated on the claim. Of course, if the taxpayer prevails on the claim that the \$100 deficiency and \$8 deficiency interest were not owed, the taxpayer will automatically recover interest on the \$108 from April 15 of Year 03. Arguably in this case, a general claim for interest as allowed by law might suffice, but the cautious practitioner will specifically include in the requested refund the \$8 deficiency interest paid on April 15 of Year 03.

Now, let's vary the example and say that the taxpayer does not contest the \$100 deficiency, but does contest the computation of the interest by the IRS. Let's say that the taxpayer believes that the interest, properly calculated, should have been \$7.50 rather than \$8.00. So, the taxpayer will desire to claim \$.50 refund.⁸¹⁸ In the claim for refund, the taxpayer should state his basis for calculating interest differently than the IRS did in computing the deficiency interest.⁸¹⁹

c. Adequacy of the Claim; Variance.

The claim for refund must state the basis for the refund in such detail as "sufficient to apprise the Commissioner of the exact basis thereof."⁸²⁰ The claim for refund is analogous to a pleading -- it must timely and fairly put the IRS on notice of the factual and legal basis for the refund. That does not mean that a lengthy brief need be filed -- but the essential facts and summary of the legal position should be provided in the claim. More detail cannot hurt -- hence detailed statements of the claims are often provided. But too little detail can mean that the IRS has not been put on fair notice of the claim and that the claim will be defective. The consequence of a defective claim -- i.e., not fairly putting the IRS on notice of the claim -- is that the taxpayer may forfeit any right to a refund in a later refund suit through the application of the doctrine of variance unless the defective

⁸¹⁸ When large numbers are involved, the amounts involved in disputed interest calculations can be quite large and can thus make the claim for refund and refund suit quite cost effective.

⁸¹⁹ See Mobil Corporation v. United States, 52 Fed. Cl. 327 (2002). In this case, the taxpayer filed a claim for deficiency interest which it had paid but did not include an explanation as to one component (because it did not know of its entitlement to refund on that basis at the time). Years later, the taxpayer sought to expand the scope of the claim on the basis of this new component. The Court applied the doctrine of variance to deny the claim.

⁸²⁰ Regs. § 301.6402-2(b)(1); See pp. 767 ff., below. For this reason, the taxpayer and the practitioner will recognize from the amended return form that an explanation must be given. However, the original return can serve as a claim for refund also, but it will often be less evident that the taxpayer must state the basis for the claim. See Waltner v. United States, 679 F.3d 1329, 1333 n. 2, 2012 U.S. App. LEXIS 7956 (Fed. Cir. 2012) (stating both that the specificity requirement for original and amended returns). For this reason, if a claim for refund with an original return has not been granted in a reasonable time or at least by the time the refund statute of limitations approaches (generally 3 years from the date of the return or 2 years from the date of payment), the taxpayer and practitioner should consider filing an explanation is sufficient detail to establish the specificity requirement.

claim is clarified within the statute of limitations.⁸²¹ The doctrine of variance is not a technical rule, but a rule of fair notice to the IRS. Hence, the variance must be a “substantial variance,” meaning that the claim pursued in the refund suit must “substantially vary the legal theories and factual bases set forth in the tax refund claim presented to the IRS.”⁸²²

The requirement that a claim be adequately stated in order to give the IRS a fair opportunity to act on the claim has both factual and legal facets. The claim should fairly put the IRS on notice of the facts. The claim should also fairly put the IRS on notice of the legal claim asserted on the basis of the facts presented. But, you may say, the IRS should be presumed to know the law, so that setting forth facts which entitle the taxpayer to a refund should be sufficient. Wrong, or at least risky.⁸²³

The disastrous consequence of the doctrine of variance in an ensuing refund suit means that the taxpayer and his practitioner must be very careful in drafting claims for refund. Taxpayers may be tempted to state claims very generally, thinking that they can later make them more specific, thus merely refining the general claim without varying from it. The problem, of course, that, if the claim is too generally stated, it may be defective on its face because it does not fairly put the IRS on notice of the specific nature of the claim.⁸²⁴

⁸²¹ The variance doctrine is described as follows: “a ground for a refund that is neither specifically raised by a timely claim for a refund, nor comprised within the general language of the claim, cannot be considered by a court in a subsequent suit for a refund.” Ottawa Silica Co. v. United States, 699 F.2d 1124, 1138 (Fed. Cir. 1983) (citations omitted). For a good discussion of the doctrine, see Margaret C. Wilson, The Variance Doctrine: No Forks in the Road to Refunds, 55 Tax Lawyer 605 (Winter 2002), and Burgess J.W. Raby and William L. Raby, Full Disclosure and Adequacy of Refund Claims, 2004 TNT 10-51 (1/15/04); see also Burgess J.W. Raby and William L. Raby, Refund Claim Defects and the Tax Practitioner, 2005 TNT 51-105.

One author claims that the Chevron line of cases (particularly Mayo Foundation) at least curbs some of the Government’s ability to claim fatal variance. Patrick J. Smith, Life After Mayo: Silver Linings, 131 Tax Notes 1251 (June 20, 2011).

⁸²² Lockheed Martin Corp. v. United States, 210 F.3d 1366, 1371 (Fed. Cir. 2000) (internal quotation marks omitted).

⁸²³ Lockheed Martin Corp. v. United States, 210 F.3d 1366, 1371 (Fed. Cir. 2000) (“With regard to the legal component of the substantial variance rule, any legal theory not expressly or impliedly contained in the application for refund cannot be considered by a court in which a suit for refund is subsequently initiated. The taxpayer similarly may not substantially vary at trial the factual bases raised in the refund claims presented to the IRS.”) (internal quotation marks and citations omitted).

⁸²⁴ We will see a similar phenomenon of the tension between general statements and specific statements and variance play out in the notice of deficiency area. In a Tax Court proceeding, the taxpayer bears the burden of proof as to claims the IRS makes in the notice of deficiency which is the jurisdictional prerequisite to Tax Court suits but the IRS bears the burden of proof as to new matter – matter outside the scope of the notice of deficiency. Hence the risk to the IRS in too general a notice is generally that it may have to bear the burden of proof in order to

A lawyer encountering a variance problem that seems to offer no solutions must think creatively. In a recent case, the taxpayer urged that, at least with respect to any counterclaim for unpaid assessed taxes that the Government asserts in the refund suit, the variance doctrine will not apply with respect to the counterclaim because it is not suit for refund based on a claim for refund.⁸²⁵ Note that this can occur where there is a common issue on the refund claim and on the counterclaim (e.g., the type of issue involved with so-called divisible taxes where the taxpayer is permitted to pay the minimal amount to file and sue for refund).

d. Form for Claims.

Given the disastrous consequences of variance – i.e., the loss of the right to the refund – practitioners must know the rules for what constitutes a claim in addition to the specificity required.

(1) IRS Prescribed Forms.

A formal claim for refund is a request made on a proper form that the IRS refund the tax allegedly overpaid. In the case of individual income taxes, the proper form is the 1040 if the refund is claimed on the original return and the 1040X when claimed after filing the original return. In the case of corporate income taxes, the claim for refund is the 1120 if the refund is claimed on the original return or the 1120X when claimed after filing the original return. There are other forms for claiming other types of taxes, such as the general Form 843. Finally, if the taxpayer signs a Form 870 or Form 4549 prepared by the IRS or the taxpayer and the IRS sign Form 870-AD indicating a refund is due, that will be treated as a refund claim.⁸²⁶

(2) Informal Claims.

The statute requires a claim for refund. Administrative necessity reflected in the regulations requires that the claim be formally presented. Accordingly, claims should be presented with the proper forms (discussed above) and, where required by procedures, with any required accompanying information.⁸²⁷ However, from time to time, courts will recognize informal claims as satisfying the

sustain a deficiency. Note that this remedy of shifting the burden of proof is a significant but still less drastic remedy than barring the claim altogether, which is the result of variance in a claim for refund setting.

⁸²⁵ Cencast Services, L.P. v. United States, 729 F.3d 1352 (Fed. Cir. 2013).

⁸²⁶ Rev. Rul. 68-65, 1968-1 C.B. 555. These forms are used at the end of an audit and indicate the IRS' and taxpayers agreement that a deficiency is due or a refund is due. Relative to the text above, the form would indicate that a refund is due, hence the taxpayer need not be concerned about variance because the IRS is conceding the refund.

⁸²⁷ 26 C.F.R. § 301.6402-2(b)(1); See Abston v. Commissioner, 691 F.3d 992 (8th Cir. 2012) (denying a timely claim for refund seeking to invoke the suspension of the statute of limitations under § 6511(h) (i) because the taxpayer did not provide with the claim "proof of [a disabling impairment] is furnished in such form and manner as the Secretary may require" and (ii) the IRS required by Revenue Procedure a particular format for such proof, which the taxpayer did

statutory predicate for a claim for refund where the taxpayer has in fact presented a claim to the IRS and, in the court's view, the IRS did or should have considered the claim. These cases are rare and are driven by unusual facts and equities.⁸²⁸

Broadly speaking, the components of an informal claim are: (1) the IRS was on actual or constructive notice that the taxpayer was making a claim; (2) just as with a formal claim, the claim must adequately advise the IRS of the legal and factual basis for the claim; (3) the informal claim must have a written component; and (4) the taxpayer filed a formal claim, albeit late, before initiating litigation.⁸²⁹ Some courts add the requirement that the IRS have either considered the informal claim or otherwise lead the taxpayer to believe that the claim was sufficient.⁸³⁰ Simply because the IRS may have had somewhere in the system information indicating that the taxpayer might claim a refund does not meet the requirement for a claim.⁸³¹ The taxpayer must make the claim, even if informal, and there must be no doubt that he or she is making a claim.⁸³² And, finally,

not submit; held there was no compliance, hence the issue of substantial compliance was not reached).

⁸²⁸ Judge Posner has noted: "One office of the judge-made informal-claim doctrine is to plug that gap by excusing harmless noncompliance with the formalities prescribed for refund claims by the Treasury regulation." BCS Financial Corporation v. United States, 118 F.3d 522, 524 (7th Cir. 1997).

⁸²⁹ For discussions and applications of these informal claim requirements, see e.g., BNSF Railway Company v. United States, 775 F.3d 743 (5th Cir. 2015); Kaffenberger v. United States, 314 F.3d 944 (8th Cir. 2003) and Mobil Corporation v. United States, 67 Fed. Cl. 708 (2005). The Court in Kaffenberger found, inter alia, that the written component of the requirements was imbedded in Form 4868 which included application of the amounts of the claimed refund toward the following year's taxes. The IRS has acquiesced in the portion of the opinion applying the informal claim for refund requirements. See acquiescence on this issue in 2004-35 IRB 1, reproduced at 2004 TNT 171-4. The Court in Mobil Corporation, found a viable informal claim as to some but not all claims. See also Greene-Thapedi v. United States, 549 F.3d 530 (7th Cir. 2008), as to the written component.

⁸³⁰ Nick's Cigarette City, Inc. v. United States, 531 F.3d 516 (7th Cir. 2008), citing Kikalos v. United States, 479 F.3d 522, 525 (7th Cir. 2007).

⁸³¹ BCS Financial Corporation v. United States, 118 F.3d 522, 524-5 (7th Cir. 1997) (citing Miller v. United States, 949 F.2d 708, 712 (4th Cir. 1991)).

⁸³² Bauer v. United States, 594 F.2d 44, 47 (5th Cir. 1979). The Court of Federal Claims expounded in Mobil Corporation v. United States, 67 Fed. Cl. 708, 717 (2005) (citations omitted and quotations omitted for readability):

It is well-established that the basic underlying principle [of an informal claim] is the necessity to put the [IRS] on notice of what the taxpayer is claiming and that he is in fact making a claim for refund. It is not enough that the Internal Revenue Service have in its possession information from which it might deduce that the taxpayer is entitled to, or might desire, a refund; nor is it sufficient that a claim involving the same ground has been filed for another year or by a different taxpayer.

the informal claim must be “filed” within the applicable statute of limitations.⁸³³ These are often fact intensive inquiries, ultimately resolved by common sense and fairness.⁸³⁴

For present purposes, I expect you to know two things: (1) you should always present your claims on a proper form for claiming the refund your client seeks and (2) if for some reason your client did not so present the claim, you should review the facts, with particular attention to whether the claim was informally presented to and considered by the IRS and the cases dealing with informal claims, to see if you can extract victory from the jaws of defeat.

(3) Waiver.

The IRS’s actual consideration of a claim not formally stated may waive whatever defense the IRS might otherwise have that the claim was not properly made.⁸³⁵ Logically, for this argument to be pressed, the IRS’s actual consideration must have occurred within the time otherwise available to file a claim for refund.⁸³⁶

If, in the refund suit, the Government asserts a new defense which it is entitled to do, it may be deemed to have waived variance, at least to the extent equitably required to permit the taxpayer to respond to the new defense.⁸³⁷

⁸³³ Furst v. United States, 678 F.2d 147, 151 (Ct. Cl. 1982).

⁸³⁴ See e.g., Mobil Corporation v. United States, 67 Fed. Cl. 708 (2005); and Pala Empl. Profit Sharing Plan v. United States, 234 F.3d 873, 877 (5th Cir. La. 2000) (“There are no ‘hard and fast rules’ for determining the sufficiency of an informal claim, and each case must be decided on its own facts with a view towards determining whether under those facts the Commissioner knew, or should have known, that a claim was being made.”).

⁸³⁵ Angelus Milling Co. v. Commissioner, 325 U.S. 293, 297 (1945). See also BCS Financial Corporation v. United States, 118 F.3d 522, 526 (7th Cir. 1997) (noting the relationship between the informal claim doctrine discussed above and waiver and the relationship between waiver and estoppel; Judge Posner notes: “Despite the tensions between the informal-claim doctrine, when interpreted as a doctrine of waiver or estoppel rather than merely as one of forgiveness of technical deficiencies, and other principles of law, the Supreme Court has never retracted its approval of the doctrine, and we therefore consider ourselves bound to follow it.”).

⁸³⁶ Mobil Corporation v. United States, 2002 U.S. Claims LEXIS 92 (Fed. Cl. 2002).

⁸³⁷ Bowles v. United States, 820 F.2d 647, 649 (4th Cir. 1987); Brown v. United States, 427 F.2d 57, 62 (9th Cir. 1970); Computervision Corp. v. United States, 445 F.3d 1355, 1372 (Fed. Cir. 2006). These cases would seemingly not apply if the taxpayer should have anticipated the new defense and thus addressed it in the claim for refund. For a dramatic instance involving a lot of money where the Court held that the taxpayer there should have anticipated the new defense and thus poured it out, see The Proctor & Gamble Company v. United States, 2008 U.S. Dist. LEXIS 53938 (SD Ohio 2008).

(4) Amendments.

What if the taxpayer timely files a claim for refund that generally states a claim but may not provide sufficient detail to constitute a claim for refund and then, outside the otherwise applicable statute of limitations, amends the claim to state more particularly the basis for the claim? The result depends upon whether, by the time the amended claim is filed, the IRS has disallowed the original claim. So long as the amended claim is within the scope of the original claim, provides more specificity, and is filed before the original claim is finally disallowed, the amended claim will be effective.⁸³⁸ However, if the IRS has finally acted on the original claim (either by allowance or denial, before the amendment is filed) and the statute has otherwise closed, the taxpayer will not be able to amend the claim.⁸³⁹

There are many other subtleties,⁸⁴⁰ but the foregoing should introduce you to the rules you will generally encounter.

⁸³⁸ See United States v. Ideal Basic Industries Inc., 404 F.2d 122, 124 (10th Cir. 1968); see United States v. Kales, 314 U.S. 186, 194 (1941). Some cases say that the otherwise untimely amendment must be “germane” to the claim made in the timely filed claim for refund. United States v. Andrews, 302 U.S. 517, 524 (1938); and Western Company of North America v. United States, 323 F.3d 1024, 1034 (Fed. Cir. 2003). Other cases say that the subsequent claim must not require investigation of matters beyond the scope of the investigation required by the original claim. E.g., United States v. Andrews, 302 U.S. 517, 524-26 (1938); and Pink v. United States, 105 F.2d 183, 187 (2d Cir. 1939).

⁸³⁹ United States v. Memphis Cotton Oil Co., 288 U.S. 62, 72 (1932); see also Tobin v. Tomlinson, 310 F.2d 648 (5th Cir. 1962), cert. denied, 375 U.S. 929 (1962); Computervision Corp. v. United States, 445 F.3d 1355, 1372 (Fed. Cir. 2006); and FSA 200121008 (reproduced in 2001 TNT 103-82 (5/29/01)). In Bemis Bro. Bag Co. v. United States, 289 U.S. 28 (1933), the Court held that the IRS has not finally acted on a claim for refund where it rejected only one of three grounds stated in the claim, so that a subsequent amendment after the statute of limitations is timely. See ILM 201216033 (1/5/12), reproduced in 2012 TNT 78-22 (applying the Bemis Bro. Bag rationale in a very taxpayer friendly way where the IRS had disallowed the claim but had “overlooked the grounds stated in the Form 1040X” that had been disallowed).

⁸⁴⁰ For example, in Mutual Assurance, Inc. v. United States, 56 F.3d 1353 (11th Cir. 1995), the Court held that where the IRS had allowed all of the amount requested in the claim but the amount stated in the claim contained computational errors which the IRS had sufficient information to determine, the taxpayer could file an amendment after the period of limitations has expired to correct the computational error and it will be deemed a timely amendment of the original claim. The IRS disagrees with the holding in this case and will follow it only in the 11th Circuit. Action on Decision 1999-014 (October 12, 1999); see also ILM 200547011 (8/5/05), reproduced at 2005 TNT 227-7 (continuing to state the IRS’s disagreement with Mutual Assurance but reaching a very practical and just result favoring the taxpayer in the facts considered in the ILM).

e. Claims After Consent to Extend Statute.

We discussed above the use of a written agreement, called a consent, to extend the statute of limitations on assessment. The IRS form for such a consent with respect to income tax is either Form 872, Consent to Extend the Time to Assess Tax, or Form 872-A, Special Consent to Extend the Time to Assess Tax. Where such a consent is entered, the statute of limitations for filing a claim for refund does not expire prior to six months after the extended period for assessment expires. § 6511(c). The amount that may be refunded, however, is the amount of tax paid after the consent was filed plus the amount that could have been refunded under the foregoing rules if the taxpayer had filed a claim for refund on the date the consent was executed.⁸⁴¹

Normally, a consent to extend the statute of limitations is sought by the IRS in order to prolong the period for assessment. Can the taxpayer obtain a consent in order to prolong the period of time for filing a claim for refund? A taxpayer in this position who can adequately frame the claim for refund should do so and that will solve the problem. But what if, for some reason, the taxpayer believes he or she may be entitled to a refund but can not adequately frame the claim within the period required? The answer is that, generally, the IRS will not enter a consent for the purpose of allowing additional time to file a claim for refund; however, this is not an iron-clad rule and the IRS may make an exception. I have, however, been able to obtain a consent in a very unique case with facts and general issues I am sure I will not encounter again.

The downside to protecting the refund statute via a consent is that it also prolongs the period of time that the IRS may assess. A taxpayer may believe that, if any adjustment is appropriate, it will result in a refund rather than a deficiency and thus be willing to take this risk inherent in a consent in order to obtain additional time in order to develop the right to a refund. What should the taxpayer do if the IRS refuses to enter a consent for this purpose? The answer is to assess the cost/benefit, devote the appropriate resources based on that analysis, and frame the best claim for refund in the period allowed. You should consider asking in the cover letter and refund claim that the IRS not act promptly on the claim in order to allow time for the taxpayer to resolve the uncertainties that do not permit the framing of a proper claim at that time.

Finally, there is yet another potential work-around to an expiring refund statute that you should consider. File a protective claim for refund stating as much about the claim as you can and ask the IRS to postpone action on the claim for some period of time when you expect the facts and circumstances to firm up to amend the timely filed but otherwise deficient claim. You will have to tell the IRS a good story as to why it should postpone action and give them a reasonable time frame to postpone action. Upon being presented with a good story and reasonable time period request, the IRS will likely postpone action and the amended claim will cure the problems in the original deficient claim.

⁸⁴¹ For a very practical application of this rule in the case of multiple consents, see IRS CCA 201349014 (9/20/13) (applying the rule in the case of multiple consents, looking to the date of the first consent rather than the last so that the taxpayer is not disadvantaged from filing multiple consents rather than one for the period of the multiple consents).

3. Overpayments in Tax Court Litigation.

I discuss elsewhere that the IRS may determine that the taxpayer owes additional tax -- referred to as a deficiency -- and the taxpayer can litigate whether he or she owes the deficiency in the U.S. Tax Court. However, it is not uncommon for the taxpayer not only not to owe the deficiency determined but to be entitled to a refund. In order to wrap the case up in one litigation, the Tax Court has jurisdiction to determine an overpayment (as opposed to a deficiency) if and to the extent that, at the time the IRS issued the notice of deficiency, the taxpayer could have filed and received a refund. § 6512(b)(1) & (3).⁸⁴² The wording for this jurisdiction is designed to preserve the integrity of the general two year / three year statute of limitations scheme in § 6511 for refunds.

Almost invariably the refund statute is still open when the notice of deficiency is issued where a return has been timely filed, and hence the Tax Court's overpayment jurisdiction in those cases is assured. Moreover, even if the taxpayer has not timely filed a return, if the notice of deficiency is issued within three years of the date the return was due, the Tax Court's overpayment jurisdiction is virtually assured.⁸⁴³

4. The Payment/Deposit Distinction.

a. The Distinction.

In Rosenman v. United States, 323 U.S. 658 (1945), the Supreme Court made the critical distinction between a payment toward a tax liability and a deposit against any tax liability that may be due. This distinction is important in several contexts. In the current context of the statute of limitations for refunds, it is important because the refund statute of limitations applies to payments and not to deposits.

In Rosenman, the taxpayer (an estate acting through its executors) was under audit, but before assessment remitted a then large sum of money to the IRS. The cover letter stated that the remittance was "a payment on account of Federal estate tax. . . . made under protest and duress, and solely for purposes of avoiding penalties and interest, since it is contended by the executors that not all of this sum is legally and lawfully owed." The Court held that, because the taxpayer made clear that he did not agree to the taxes and none had been assessed, the remittance was a deposit rather than a refund and therefore the taxpayer's right to recover the amount was not subject to the limitation periods set forth in the predecessor to § 6511.

Rosenman established an important and enduring principle of tax law that a taxpayer may advance a remittance to the IRS and, at the taxpayer's option, have it treated as either a payment or a deposit. Taxpayers and their advisors usually considered remittances in advance of an assessment for the same reason as the taxpayer in Rosenman did -- i.e., to stop the running of interest on the underlying deficiency and on penalties that bear interest.

⁸⁴² For an extensive discussion of certain nuances of this jurisdiction, see Estate of Smith v. Commissioner, 123 T.C. 15 (2004), rev'd 429 F.3d 533 (5th Cir. 2005).

⁸⁴³ See Zarky v. Commissioner, 123 T.C. 132 (2004).

Congress codified the Rosenman rule permitting a deposit with some modifications.⁸⁴⁴ Since the primary application of the distinction relates to interest, I defer more detailed discussion of this codification to that portion of this text (pp. 277 ff.).

What are other practical differences between a deposit and a payment in the current refund context? Here are the more obvious:

First, a deposit, not being a payment, is simply held by the IRS pending assessment and must be returned to the taxpayer upon the taxpayer's request. The request for return of the deposit is not a claim for refund.

Second, if the amount were a payment, of course, the taxpayer must file a claim for refund and pay careful attention to the refund statutes of limitation. If it is a deposit, there is no statute of limitations.

Third, if the IRS were to erroneously return to the taxpayer an amount remitted as a payment, it would have to follow the erroneous refund procedure to recover the amount, which allows a general two year statute of limitations, with a five year statute if the refund were caused by the taxpayer's fraud or misrepresentation.⁸⁴⁵ By contrast, if the IRS were to erroneously return to the taxpayer an amount the taxpayer had remitted as a deposit, the Government must seek recovery under a general cause of action for return of money either without a statute of limitations or subject to the general Government claim six-year statute of limitations.⁸⁴⁶ Alternatively, of course, if the underlying statute of limitations is still open on the underlying tax liability, the IRS could proceed through the normal procedures to obtain an assessment.

b. Examples and Strategies.

Seeking to avoid the period of limitations on claims for refund, taxpayers may argue that amounts remitted to the IRS are deposits rather than payments. If the remittance to the IRS is treated as a deposit, there is no statute of limitations on recovering the remittance.

A quintessential case of this sort is a taxpayer who is overpaid via withholding or estimated taxes but who does not file a return until long past any possibly applicable refund statute of limitations. That taxpayer would prefer that the IRS treat the withholdings and estimated taxes as deposits rather than payments. In **Baral v. United States**, 528 U.S. 431 (2000), the Supreme Court held that those remittances (by the employer as to withholding and by the taxpayer as to estimated

⁸⁴⁴ § 6603.

⁸⁴⁵ §§ 6532(b) and 7405. In a related context, misrepresentation is interpreted not to require culpability. NPR Invs., L.L.C. v. United States, 740 F.3d 998 (5th Cir. Tex. 2014) (§ 6223(f) bars a second FPAA notice except for "fraud, malfeasance, or misrepresentation of a material fact;" held, misrepresentation does not require culpability).

⁸⁴⁶ See 28 U.S.C. § 2415; and United States v. Domino Sugar Corp., 349 F.3d 84 (2d Cir. 2003).

taxes) were payments made on April 15 of the tax year involved and were not deposits. The same rule has been applied to estimated payments made with extension requests.⁸⁴⁷

Consider the following not untypical setting presenting the issue of whether a remittance to the IRS should be treated as a cash deposit or a payment. Assume that the IRS is conducting an audit and has preliminarily determined that the taxpayer, a large corporation, has a deficiency of \$1,000,000, but has not yet issued a notice of deficiency. Assume that the corporation will be subject to the “hot interest” penalty of § 6621(c). (We have not covered interest yet, but suffice it to say for present purposes that this increases the deficiency interest rate by 2% for large corporate underpayments (pp. 271 ff.)) The taxpayer should think seriously about remitting the \$1,000,000 and accumulated interest to the IRS. But, how should the taxpayer characterize the remittance – payment or deposit? If the taxpayer wants to contest liability or even just hold open the opportunity to litigate it in the Tax Court, the taxpayer should designate the remittance (or some portion of it) as a deposit, for if the taxpayer paid the entire amount of the deficiency, the taxpayer would lose the opportunity to litigate in the Tax Court.⁸⁴⁸ But, as should be obvious, by designating the remittance as a deposit, in the event for any reason that the IRS does not assert the deficiency or, alternatively some court ultimately holds that the taxpayer does not owe the additional \$1,000,000, the deposit will be returned with a lower rate of interest than the taxpayer could have obtained if it were a payment. Taxpayers in this situation might consider remitting \$950,000 designated as a payment of tax and \$50,000 designated as a deposit. Then, the IRS will have to issue a notice of deficiency for \$50,000.⁸⁴⁹

In this example the taxpayer will make the remittance before the IRS has actually made a determination of additional tax due. What happens if the taxpayer were to simply send a remittance to the IRS with the year properly designated but with no indication as to whether it is a payment or deposit? The IRS’s records, of course, will not show a tax due against which to apply the remittance. If the IRS treats it as a payment on its records, it will show as an amount due the taxpayer (i.e., an overpayment). If the IRS treats it as a deposit, it will be placed in a suspense account designated as such and the taxpayer’s account for the tax year will show a zero balance due to and from the taxpayer. In such a situation, some courts adopt a per se rule which treats as a deposit an undesignated remittance before the IRS records shows a tax due.⁸⁵⁰ Other courts adopt a “facts and circumstances” test.⁸⁵¹ The better part of wisdom on a remittance is to state the nature of the remittance with specificity.

⁸⁴⁷ Deaton v. Commissioner, 440 F.3d 223 (5th Cir. 2006); Ertman v. United States, 165 F.3d 204 (2d Cir. 1999) (noting some earlier contrary authority in other circuits and the trend toward this holding as a better analysis); and Vancanagan v. United States, 231 F.3d 349 (Fed. Cir. 2000).

⁸⁴⁸ Baral v. United States, 528 U.S. 431, 439 n.2 (2000).

⁸⁴⁹ Obviously, the taxpayer might cut the margin thinner, depending upon the facts of the case.

⁸⁵⁰ United States v. Dubuque Packing Co., 233 F.2d 453, 460 (8th Cir. 1956); Thomas v. Merchantile Nat'l Bank, 204 F.2d 943, 944 (5th Cir. 1953).

⁸⁵¹ Ertman v. United States, 165 F.3d 204, 208-09 (2d Cir. 1999).

Taxpayers will sometimes seek to avoid their own designation of the remittance as a payment or deposit and may even succeed in doing so.⁸⁵² These adventures are risky, and the arguments were posited ex post facto after there was nothing to lose. The careful taxpayer and its practitioner will determine in advance the treatment – payment or deposit – it needs and so designate and even follow-through to insure that the remittance was treated as designated.

Sometimes the IRS with a little nudging will make a taxpayer-friendly blurring of the distinctions between a payment and a deposit. Consider the following from an IRS legal memorandum.⁸⁵³ The IRS levied upon and sold the taxpayer's real property. The net sales proceeds exceeded the taxes, penalties and interest, so the net was credited on the taxpayer's account as an overpayment and the taxpayer was entitled to a refund. The IRS so notified the taxpayer that he should file a claim for refund. The taxpayer nevertheless failed to make a timely claim for refund, apparently because he was suffering under the delusion that the proceeds were the work of the devil. The equities only generally favored the taxpayer, but, as you know by now, the application of the refund statute of limitations does not consider the equities. (In this regard, the special statute of limitations under § 6511(h) for disability did not apply in this case.) The author nevertheless reasoned that the taxpayer's failure to claim a refund that was due transformed the payment into a deposit and, therefore, the deposit could be returned to the taxpayer because there is no statute of limitations on deposits. The cost to the taxpayer of procrastinating, of course, was that he lost interest on the amount during the period the IRS held it. However, by treating what appeared to be a payment as a deposit, the IRS was at least able to do some good for the taxpayer.

Finally, strategically, on the front end, is it wise to remit as a deposit rather than a payment? The only advantage of the deposit is the right to request the payment back without going through

⁸⁵² New York Life Insurance Company v. United States, 118 F.3d 1553 (Fed. Cir. 1997), cert. denied 523 U.S. 1094 (1998) (taxpayer successfully argued that a remittance designated in the cover letter as a payment was a deposit with the result that the recovery was not subject to the refund limitations periods); and United States v. Tate & Lyle North American Sugars, Inc., 162 F.Supp.2d 236 (S.D. N.Y. 2001) (taxpayer arguing that a remittance designated in the cover letter as a deposit was a payment in order to assert the two year limitations period for erroneous refunds), an argument that the taxpayer ultimately lost in United States v. Tate & Lyle North American Sugars, Inc., 228 F.Supp. 2d 308 (S.D. N.Y. 2002).

Note, for review, that, in New York Life, the remittance to the IRS was before the expiration of the statute but the assessment was after the expiration of the statute. The taxpayer wanted to avoid having the remittance treated as a payment because the rule of Lewis v. Reynolds would permit the Government to retain all of it. The taxpayer opted instead to argue that it was a deposit and therefore that the Government's assessment outside the period coupled with the converting the deposit to an assessment outside the assessment limitations period required that it be treated as an overpayment. § 6401(a). Normally, the taxpayer would prefer to have a remittance treated as a payment because, if it is entitled to received the principal back, it gets interest, but does not get interest on a deposit. But, treating the remittance as a payment would have precluded the taxpayer from getting the principal or any interest related thereto. By successfully urging that it was a deposit, the taxpayer at least got the principal back.

⁸⁵³ ILM 200237001, reproduced at 2002 TNT 180-27 (9/17/02).

the elaborate refund procedures. There is a cost to exercising the right to request the deposit back – i.e., if the taxpayer is ultimately held liable for the deficiency, then the return of the money will result in the accrual of deficiency interest. Further, if the remittance is a deposit rather than a payment and it is ultimately determined that the remittance exceeded the amount of the tax and interest due, the taxpayer will get a lower interest rate on the excess than the taxpayer would have received if it were a payment.⁸⁵⁴ For these reasons, I have never seen a case where, on the front end, the mere right to request immediate return of the money was so important as to outweigh the benefits of the straight payment of tax. That is not to say that I cannot imagine a case where a bond would be preferable; I just haven't seen one.⁸⁵⁵ And, because of the downsides of bonds, I recommend that practitioners be able to articulate a clear affirmative reason for remitting as a bond before recommending that to the client.

5. Related Party Transactions.

Many related party transactions involve transactions where one of the related parties makes payments that would otherwise be deductible to another related party who treats it as income. If, for some reason, the expense claimed is denied to the payor, thus resulting in a deficiency, the consequence to the related payee may be that its income should be reduced accordingly. The classic case for this situation is a § 482 adjustment. Let's use an example, USCO1 is related to USCO2 (both are U.S. taxpayers, hence their names in this example) but they do not file consolidated returns. They have a related party transaction where USCO1 pays USCO2 \$100 for services. (This is often called “transfer pricing” – the price at which goods and services are transferred between related parties.) Upon audit, the IRS focuses on the transfer pricing on the related party transaction

⁸⁵⁴ A good example of this phenomenon is United States v. Domino Sugar Corporation, cited above. There, although the taxpayer remitted as a bond, the IRS erroneously paid \$1,512,100 interest on the bond and then successfully sued to recover the interest erroneously paid. If the remittance had been a payment, the taxpayer would have been entitled to that interest.

⁸⁵⁵ To illustrate with a real example, some lawyers have used the “bond” remittance where the strategy was to avoid identifying the taxpayer to the IRS. The scenario involves a taxpayer who feels that he has committed an act of evasion and desires to get right with the IRS but fears that admitting the fraud will result in prosecution. The taxpayer's lawyer (or even a third lawyer, depending upon the number of layers the taxpayer wants to create) will send in an anonymous remittance for deposit with the IRS. Obviously, in order to have it treated as a payment, the taxpayer would have to identify himself so that the payment could be posted to his account. Taxpayers using this stratagem hope that, in the event they are discovered by the IRS, the anonymous payment will mitigate the IRS's incentive to prosecute or ability to convict, if prosecuted. Of course, as we shall see, the voluntary disclosure program will achieve this effect for the taxpayer, so the continuing benefit of this strategy is doubtful. Nevertheless, one court faced with the strategy rejected an IRS attempt to force the lawyer to identify the taxpayer. The court held that, although the attorney-client privilege does not normally protect client identity, it could where it could be used as a last link in a chain to incriminate the taxpayer. Baird v. Koerner, 279 F.2d 623 (9th Cir. 1960) (but apparently reaching that conclusion under state law of California which it felt controlled); but see In re Shargel, 742 F.2d 61, 62 n. 2 (2d Cir. 1984). We discuss the so-called identity privilege further below in discussing privileges in tax investigations.

and obtains a consent to extend the statute of limitations from USCO1. The IRS then determines that the proper transfer price for the services was \$50 and asserts a timely deficiency accordingly. By that time, assume that the USCO2's statute of limitations for claiming refunds has expired. Without anything further, USCO2 would be out of luck. However, the Regulations under § 482 may impose a requirement for a refund even if the statute has expired.⁸⁵⁶ The more prudent course would be for USCO2 to file a protective claim for refund when it first becomes aware that the IRS may make a § 482 transfer pricing adjustment to USCO1.

What happens, however, if the IRS obtained the consent to extend before the IRS has focused on the possibility of a § 482 adjustment and focuses on it only after the USCO2 claim for refund statute of limitations has expired. In that case, the relief implied in § 482 and the underlying regulations may be what the taxpayer has to rely upon.⁸⁵⁷ Alternatively, the taxpayer may have to rely upon equitable arguments (unlikely but worth a shot) or see if it can shoehorn relief into the mitigation provisions of the Code (highly unlikely).

But what if you have a situation where the related party adjustment is not made under § 482? Take the USCO1 and USCO2 example described. What if the IRS asserted its authority under § 162 to deny a portion of the overpaid expense because it was not ordinary and necessary. Just as with § 482, that adjustment would result in a deficiency to USCO1, but there would be no § 482 correlative adjustment to USCO2 and the regulations under § 482 would offer no possible relief. The necessary consequence of the adjustment to USCO1, however, is that USCO2 did not have income to the extent of the adjustment and may just be out of luck, subject to such relief as equitable principles or mitigation may apply. The practitioner must be diligent to file protective claims for refund, but there is obviously some risk in this situation. This, of course, is another reason not to sign consents to extend the statute of limitations.

Finally, § 482 adjustments usually are made where one or more of the parties is a foreign taxpayer.⁸⁵⁸ The IRS would assert a § 482 adjustment to adjust the transfer pricing to push taxable income from the foreign taxpayer(s) to one of the U.S. taxpayer(s). If the U.S. taxpayer(s) underpaid its (their) U.S. tax, it is typical that the related foreign taxpayer(s) overpaid its (their) foreign country tax liabilities. Obviously, there will be no U.S. tax rules that can hold open the foreign country refund statute of limitations. So the taxpayer must pay careful attention to those foreign country refund statutes of limitation in order not to be whipsawed into double taxation. The principal treaties under the U.S. tax treaty network – with many but not all countries – deal with this possibility of double taxation as a result of transfer pricing adjustments by one of the treaty

⁸⁵⁶ See Collins Elec. Co. v. Commissioner, 67 T.C. 911 (1977).

⁸⁵⁷ See Collins Elec. Co. v. Commissioner, *supra*.

⁸⁵⁸ This is because, in many related party transactions involving only U.S. companies, there is no net tax dollars at issue for the IRS because the parties are in the same tax brackets. Where one or more of the related parties are foreign taxpayers, however, the related party transactions may be used to push taxable income out of the U.S. tax regime and into the foreign tax regime. In those cases, there can be quite large U.S. tax dollars affected by § 482 adjustments.

partners.⁸⁵⁹ Under the treaties, the treaty partners commit to consult under a Mutual Agreement Procedure to reach a consistent transfer price for their respective tax purposes. The treaties have language which arguably requires the treaty partner not initiating a transfer pricing adjustment to open an otherwise closed statute of limitations for refunds if the other treaty partner initiates a transfer pricing adjustment and the taxpayer invokes the treaty procedure through the initiating country's "competent authority."⁸⁶⁰ The language is somewhat uncertain, so U.S. taxpayers subject to potential U.S. transfer pricing adjustments involving foreign related taxpayers are cautioned to take measures under foreign country law to protect the foreign country refund statute of limitations.⁸⁶¹

C. The Refund Suit.

There is still another key statute of limitations that relates to refunds – the period during which a taxpayer must institute a suit for refund. The suit for refund may be brought only after the IRS has denied the claim for refund or the claim for refund has been filed for six months without IRS action. And then, if the claim is actually denied, the suit for refund must be actually filed – timely mailing will not work – within two years from the date of the notice of disallowance of the claim. § 6532(a)(1).⁸⁶² If, in some rare cases of additional consideration after a notice of

⁸⁵⁹ The U.S. treaties are often called "Double Tax Treaties" as a short form reference to the usual formal title an example of which is: "The Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains." Transfer pricing adjustments are not the only form of potential double taxation dealt with in the treaties.

⁸⁶⁰ See paragraph 2 of Article 25 of the Model Treaty; and Treasury Explanation Article 9, paragraph 2 (re waiver of procedural barriers).

⁸⁶¹ Rev. Proc. 96-13, 1996-1 C.B. 616 (a taxpayer facing a U.S. initiated adjustment must take protective steps in the treaty country to protect the statute of limitations so that the competent authority process can be effective).

⁸⁶² Like the notice of deficiency, the notice of disallowance of the claim for refund need only be mailed by certified or registered mail; there is no requirement that the taxpayer receive the notice of disallowance. *Id.*; see Rosser v. United States, 9 F.3d 1519 (11th Cir. 1993). Another formality for the notice of disallowance is that the IRS "provide the taxpayer with an explanation for such disallowance." § 6402(l).

To state the obvious, where the 2-year statute of limitations applies, the suit has to be actually filed in the court within that 2-year period. There is the potential for limited relief from a late filing in the Court of Federal Claims, but that potential is so narrow as to be almost nonexistent. See Langan v. United States, 2013 U.S. Claims LEXIS 740 (2013) (possibility that mailed complaint when it could, in normal course, have timely arrived at court will be deemed timely filed even if untimely received and filed by the court; not applied in case because taxpayer's lawyer placed in mail so late that its timely delivery was not assured). I hope everyone reading about or reading the Langan case will do better. There is no timely-mailing, timely-filing for refund suits.

disallowance, that first notice starts the two year period even if there is a later notice erroneously stating that it is the notice of disallowance.⁸⁶³

This means that the key statute of limitations – beyond which the taxpayer is prohibited from filing a suit for refund – is based on the date of denial of the claim. But can a taxpayer tarry indefinitely? Maybe, maybe not. 28 U.S.C. § 2401(a) provides that “every civil action commenced against the United States shall be barred unless the complaint is filed within six years after the right of action first accrues.” The courts are in conflict as to whether § 2401 applies to close the statute after 6 years from accrual (presumably the accrual being 6 months after the refund claim is filed, because that is the earliest date the taxpayer may file a suit for refund).⁸⁶⁴ The IRS, however, published an informal Chief Counsel Notice reiterating its long-standing position that § 2401(a) does not apply and hence the taxpayer who has not received notice has an indefinite period in which to file suit for refund.⁸⁶⁵

As with the assessment statute of limitations, the IRS and the taxpayer may extend this two year period by written agreement.⁸⁶⁶ Also, another way to achieve the same thing (extension of the

⁸⁶³ Palm v. United States, 2014 U.S. Claims LEXIS 500 (2014).

⁸⁶⁴ See Detroit Trust Co. v. United States, 131 Ct. Cl. 223 (Ct. Cl. 1955) (the principal case cited for the proposition that § 2401(a) does not apply, so that the tax refund suit statute of limitations can be extended indefinitely) with Wagenet v. United States, 2009 U.S. Dist. LEXIS 115547 (C.D. Cal. Sept. 14, 2009) (holding that § 2401(a) does apply so that the taxpayer must sue within 6 years, and pronouncing that Detroit Trust was wrongly decided). Wegenet was appealed but the appeal was dismissed. See Adam R. F. Gustafson, An "Outside Limit" for Refund Suits: The Case Against the Tax Exception to the Six-Year Bar on Claims Against the Government, 90 Or. L. Rev. 191 (2011) (arguing that tax refund suits are governed by the six-year bar setting the outside limit for tax refunds so that, where the tax specific statute has no statute of limitations where the IRS does not act on the claim, the taxpayer will be barred after six-years from the date of accrual of the refund claim; per the authorities in fn. 19 on p. 195, the refund claim accrues on the earlier of the denial of the claim for refund or six months after filing of the claim for refund, citing § 7422(a) and 6532(a)).

⁸⁶⁵ CCN 2012-012 (6/1/12), reproduced at 2012 TNT 108-12, citing Rev. Rul. 56-581, 1956-2 Cum. Bull. 953.

⁸⁶⁶ § 6532(a)(2). The Form 907 is used for this extension. There is a subtlety here in comparing this extension to the assessment extension in § 6501(c)(4)(A). By its express terms, the latter extension must be executed before the statute otherwise expires but that express language does not appear in § 6532(a)(2). The IRS ruled in Rev. Rul. 71-57, 1971-1 C.B. 405, that § 6532(a)(2) nevertheless should be interpreted to include that requirement. In Kaffenberger v. United States, 314 F.3d 944 (8th Cir. 2003), the court held contrary to the Rev. Rul. The IRS has indicated that, in other circuits, it will continue to apply the rule of the Rev. Rul. In a nonacquiescence in Kaffenberger at 2004-35 IRB 1, reproduced at 2004 TNT 171-4, the IRS noted that it “disagree[s] with the court's refusal to follow a published ruling,” which seems to suggest that the IRS believes the court should have deferred to the interpretation in the ruling. This notion hearkens back to the

statute of limitations) is to have the IRS withdraw the notice of disallowance, but as with other areas of the law getting the IRS's action – here withdrawal – in writing is the better part of wisdom rather than relying upon informal understandings.⁸⁶⁷

Finally, this two year statute in which a refund suit must be filed is not a prohibition upon the IRS allowing a refund after that two year period provided that the taxpayer asked for reconsideration during the two year period.⁸⁶⁸

V. Abatements of Erroneous Assessments.

The IRS has the power to abate erroneous assessments. Indeed, that is how the IRS makes a refund if it determines that the taxpayer is entitled to a refund or the taxpayer prevails in a refund suit. As noted above, however, the taxpayer still must claim his right to a refund timely, and, if he fails to do so, the statute of limitations on actually getting the refund will prevent the taxpayer from having it refunded. If for some reason, after the statute of limitations for refund has closed, the taxpayer establishes his or her right to an abatement, the IRS may make the abatement because there is no statute of limitations on abatement.⁸⁶⁹ The problem, of course, is that the IRS cannot refund or credit the abated tax liability, if paid, to the taxpayer and, instead, the payments will be posted internally by the IRS to the Excess Collections File.

VI. Erroneous Refund Remedies.

A. Introduction; Rebate Refunds and Nonrebate Refunds.

issue we discussed earlier in Chapter 1 regarding deference for IRS administrative interpretations of the Code, although it does not mention the word deference or cite the deference cases.

⁸⁶⁷ Section 6532(a)(4) provides that IRS reconsideration after issuing a notice of disallowance “shall not operate to extend the period within which suit may be begun.” See Cadreja v. United States, 104 Fed. Cl. 296 (2012) (discussing and limiting cases where an IRS orally withdrew the notice of disallowance to situations where the withdrawal was specifically discussed between the taxpayer or the representative and the IRS and agreed orally.)

⁸⁶⁸ Section 6532(a)(4) allows such requests for reconsideration of the notice of disallowance, but prevents the 2 year statute of limitations for filing the refund suit on the original notice of disallowance from being suspended. The Internal Revenue Manual permits Appeals to consider such and allow, if appropriate, a request for reconsideration even after the 2 year refund suit statute of limitations provided that the request was filed during the period. See ILM 201048030 (8/5/10), reproduced at 2010 TNT 233-34. However, I am not sure the reasoning which says that there is no prohibition on a post 2 year period allowance of a refund compels the conclusion that the taxpayer must request reconsideration in the 2 year period. The IRS in the administration of the Code might place that requirement as a practical way to make the 2 year statute for refund suits meaningful, but it certainly is not a compelled one.

⁸⁶⁹ ILM 200915034 (3/2/2009), published at 2009 TNT 68-16.

If the IRS makes an erroneous refund, may the IRS recover the erroneous refund (or does the taxpayer get to keep the refund)?⁸⁷⁰ The IRS does have remedies to recover the erroneous refund. However, in order to understand the availability of the remedies we must divide erroneous refunds into two categories.⁸⁷¹

First, there are erroneous refunds that the IRS affirmatively intended to make because it erroneously determined that the taxpayer was entitled to the refund based on the merits of the taxpayer's tax liability. An example of this first category of erroneous refund is: the taxpayer files a claim for refund and, upon review, the IRS improvidently but intentionally grants the refund. This first category of erroneous refund is a "rebate refund." Rebate refunds are refunds the IRS intends to make based on substantive calculation of the taxpayer's liability.⁸⁷² These refunds are the IRS's substantive determination that less tax is due than has been paid in. Second, there are other refunds that do not reflect a redetermination of tax liability. An example of this category is the IRS's improvident double crediting of a single payment to the taxpayer so that the taxpayer's account shows a credit that is then refunded. This second category of erroneous refund is a "nonrebate refund."⁸⁷³

B. Rebate Refunds.

1. Deficiency Procedures.

Rebate refunds require a new assessment which can be made only if the statute of limitations for assessment is still open.⁸⁷⁴ For income and estate and gift taxes, this requires the ubiquitous

⁸⁷⁰ An erroneous refund includes any refund after the period for filing a claim for refund has expired or the period for filing a suit for refund has expired. § 6514(a).

⁸⁷¹ See Bryan T. Camp, The Mysteries of Erroneous Tax Refunds, 114 Tax Notes 231 (Jan. 15, 2007).

⁸⁷² § 6211(a)(2) and (b)(2); Acme Steel Co. v. Commissioner, T.C. Memo. 2003-118.

⁸⁷³ See Acme Steel Co., Inc. v. Commissioner, T.C. Memo 2003-118 for a good discussion of the differences between the rebate and nonrebate refund. Acme Steel discusses the key cases, including O'Bryant v. United States, 49 F.3d 340 (7th Cir. 1995). See also Bryan T. Camp, The Mysteries of Erroneous Tax Refunds, 114 Tax Notes 231 (Jan. 15, 2007) & 2007 TNT 11-55 (1/16/07).

⁸⁷⁴ See In re Becker, 407 F.3d 89, 97 (2d Cir. 2005); and §§ 6211-6215. For the types of taxes requiring a predicate deficiency notice before assessment, the deficiency notice for the amount of the erroneous refund must be issued within the applicable assessment period of limitations. I have assumed in the text that the taxpayer really owed the tax that the IRS erroneously refunded. The Tax Court noted in Allcorn v. Commissioner, 139 T.C. 53, 60 n. 5 (2012) that an erroneous refund can be made to a taxpayer who actually has no liability, so the deficiency notice is not a tool that can be used to reinstate an assessment for the amount of the erroneous refund; in that case the IRS must pursue the erroneous refund by suit as an erroneous refund.

predicate notice of deficiency.⁸⁷⁵ The taxpayer is then accorded a Tax Court prepayment remedy to contest whether the refund was erroneous and will also have available a traditional refund remedy if he pays the erroneous refund amount asserted by the IRS.

2. Erroneous Refund Suits.

The IRS may also recover erroneous rebate refunds through the erroneous refund suit. § 7405(a) & (b). The statute of limitations for the erroneous refund suit is two years from the date of the refund, except that it is extended to five years if the erroneous refund was induced by fraud or misrepresentation of a material fact. § 6532(b).⁸⁷⁶ Note that the predicate for the extended period is in the disjunctive. Is there a difference between fraud and misrepresentation? Obviously, in terms of reprehensible behavior, fraud is a stronger word. Does the term misrepresentation include innocent misrepresentations (no culpability or even negligence in the speaker, just error)? Or does it at least require some negligence? That is not yet definitively decided.⁸⁷⁷

In an erroneous refund suit, the Government bears the burden of proving both that some amount has been erroneously refunded and what the amount is.⁸⁷⁸

⁸⁷⁵ Section 6211(a) defines the deficiency in relevant part as the amount of tax due, *less* the tax reported and assessed and *plus* the amount rebated. So, if the taxpayer owed \$200 and reported \$100 and the IRS subsequently made a rebate refund (intended, erroneously, to make the refund) of \$50, the deficiency would be \$150 (tax due of \$200 *less* amount reported and assessed of \$100 and *plus* the \$50 rebate refund). See United States v. Frontone, 383 F.3d 656, 661 (7th Cir. 2004) (“A deficiency can * * * arise as a result of a determination that the rebate * * * was in error.”).

⁸⁷⁶ The courts have held that the statute starts running when the taxpayer, having deposited the erroneous refund check, the erroneous refund check then clears the Federal Reserve and payment is actually made by the IRS. O’Gilvie v. United States, 519 U.S. 79, 91 (1996); United States v. Commonwealth Energy Sys. and Subsidiary Cos., 235 F.3d 11, 14 (1st Cir. 2000); and United States v. Greene-Thapedi, 398 F.3d 635 (7th Cir. 2005).

⁸⁷⁷ See e.g., Lane v. United States, 286 F.3d 723 (4th Cir. 2002), discussing the cases and noting the Government’s position that even innocent misrepresentations trigger the extended statute but not deciding the issue because the facts showed gross negligence. In United States v. Northern Trust Company, 372 F.3d 886 (7th Cir. 2004), the Court observed pithily: “‘Misrepresentation’ differs from ‘fraud;’ otherwise § 6532(b) would be redundant.” The court noted the Government’s position that even innocent misrepresentations trigger the longer statute of limitations. But, beyond observing that misrepresentation is less than fraud, the court did not resolve the issue of whether the misrepresentation must be grossly negligent, simply negligent or not negligent at all, so long as it was a misrepresentation.

In an analogous context, a court has held that misrepresentation does not require culpability. NPR Invs., L.L.C. v. United States, 740 F.3d 998 (5th Cir. Tex. 2014) (interpreting § 6223(f)).

⁸⁷⁸ United States v. McFerrin, 570 F.3d 672, 675 (5th Cir. 2009) (quoting Soltermann v. United States, 272 F.2d 387, 387 (9th Cir. 1959)); see also 26 U.S.C. § 7405. In this sense, it

Can the Government use its common law offset authority or its § 6402(a) offset authority to collect an erroneous refund? The answer to that is probably yes as to the common law authority but no under § 6402.⁸⁷⁹ But, can the IRS use that offset authority after the period of limitations that it is permitted to file an erroneous refunds suit? The answer to that is uncertain, but the IRS has interpreted its general offset authority to expire when the erroneous refund suit limitations period expires.⁸⁸⁰

3. Offsets to Claims for Refund.

We shall discuss below the equitable doctrine of offsets, but note here that, under that doctrine, the Government may assert in defense of a refund claim that the taxpayer owed more tax for the year based on a previously unconsidered item, even if the statute of limitations is not otherwise open for the year. So too may the Government assert an erroneous refund as a basis for offsetting an otherwise valid refund claim, even if the time to assess or sue for the erroneous refund is past.⁸⁸¹ In the refund matter, the issue is still whether the taxpayer is entitled to a refund for the year and he may not be to the extent that he has previously received an erroneous refund for the year.

C. Nonrebate Refunds.

The IRS may not use the deficiency procedures to pursue erroneous nonrebate refunds. Nonrebate refunds do not require a new assessment. The old assessment improperly abated can be reinstated by eliminating the improper abatement. The IRS can then pursue administrative collection measures based on the revised assessment and/or pursue the erroneous refund suit discussed above.⁸⁸²

resembles a suit for money suit, like the refund suit, where the taxpayer as plaintiff claiming a refund must prove that he is entitled both to a refund and the amount he is entitled to.

⁸⁷⁹ PMTA 2011-035 (8/8/11), reprinted at 2012 TNT 18-23. I think the reason under §6402 is that the tax in question must be assessed, assessable or subject to a pending notice of deficiency. Erroneous refunds of income tax would not generally satisfy these conditions.

⁸⁸⁰ PMTA 2011-035 (8/8/11), reprinted at 2012 TNT 18-23.

⁸⁸¹ For an interesting application of this concept, see United States v. Peterson, 2010 U.S. Dist. LEXIS 93571 (CD IL 2010). In Pacific Gas and Electric Co. v. United States, 417 F.3d 1375 (Fed. Cir. 2005), rehearing and rehearing en banc denied, 2006 U.S. App. LEXIS 1632 (Fed. Cir. 2006), the court recognized the principle stated in the text, but found that, for technical reasons, it did not apply to refund interest overpaid by the IRS on an earlier refund. The IRS has non-acquiesced in the Federal Circuit's decision at AOD 2006-02; 2006-26 IRB 1.

⁸⁸² See Acme Steel Co., Inc. v. Commissioner, *supra*.

VII. Smoothing the Harsh Effects of Statutes of Limitation.

A. The Problem - Statutes of Limitation Can Be Harsh.

Statutes of limitations are designed to draw objective finality to potential disputes. Mere unfairness in denying a remedy for a valid claim is generally not enough to pre-empt the intended operation of statutes of limitation. Congress and the courts have, however, recoiled in some cases where a party – a taxpayer or the IRS – tries to take advantage of the statute of limitations by claiming a **double** benefit. A double benefit is a benefit in the year that is closed by the statute of limitations and another benefit in an open year which is not consistent with having claimed the benefit in the closed year.

In this section we will explore some limited contexts in which Congress and the courts have seen fit to provide relief from the statute of limitations, particularly in the context of some double benefit. These contexts are limited, so that you should be aware that Congress and the courts have limited tolerance for overriding tax statutes of limitations because, from an overall policy and tax administration perspective, statutes of limitations are necessary.

B. The Protective Claim for Refund.

A taxpayer may file a timely protective claim for refund to deal with a refund statute of limitations that is about to expire.⁸⁸³ Such a protective claim for refund may be desirable in several circumstances.

First, the taxpayer may be aware that a refund is due but cannot complete a proper claim for refund within the statutory period. A timely protective claim followed up by a more detailed claim will usually do the trick. The risk, as noted above, is that the IRS may deny the deficient protective claim before a proper amended claim can be filed, but that risk is usually solved by advising the IRS on the protective claim or the cover letter for the protective claim what the problem is, so that the IRS can defer action to give the taxpayer time to prepare a proper amended claim. I have found in my practice that the IRS is willing to work with taxpayers to give them the time that they need.

Second, as we discussed above, where the IRS (or even a foreign tax authority) proposes adjustments that, if made, would mean that a related U.S. taxpayer's taxes have been overpaid, a timely protective claim can be made in order to protect against the expiration of the refund statute of limitations. This situation is frequently encountered in cross-border transfer pricing

⁸⁸³ See Kristy M. Bowden, Protective Claims for Refund: Protecting the Interests of Taxpayers and the IRS, 56 Me. L. Rev. 149 (2004); see also ILM 200547011 (8/5/05), reproduced at 2005 TNT 227-7, citing inter alia IRM 25.6.6.5.5(3) (05-17-2004). In the ILM, the IRS stretched a bit to reach a taxpayer favorable and just result.

adjustments.⁸⁸⁴ It may also be encountered in more common situations illustrated by leading cases where a protective claim was not filed (as discussed later in this section) such as:

- A decedent's estate makes a payment to an individual and reports the payment as a bequest (hence no deduction in computing estate tax), and the IRS subsequently determines that the recipient received taxable income because the payment was received in consideration for services rendered decedent prior to death (which would mean that the estate should have deducted the payment in computing the estate tax). The refund statute of limitations for estate may have closed before the matter is resolved with the individual.
- A decedent's estate reports on the estate tax return a low value for property that is left to an individual who sells the property upon receipt claiming as his or her basis the estate tax return value and the IRS later determines in an audit of the estate tax return that the property was valued too low. The refund statute of limitations for the individual may have closed before the matter is resolved with the estate.

Third, there may be circumstances where there is some event that is not known that might justify a refund but there is some reasonable expectation that it may become known after the normal expiration of the statute of limitations. A protective refund may be appropriate in such cases.⁸⁸⁵

I do not attempt to catalogue here all of the circumstances in which a timely protective claim might be used. Even in the absence of a timely protective claim for refund, some of these problems are resolved through application of principles and rules discussed later in this section. Nevertheless, because of some of the uncertainty and hassle of invoking these potential remedies, the timely protective claim is the best insurance and usually has no down side.⁸⁸⁶

C. General Equitable Principles.

Please read **United States v. Brockamp, 519 U.S. 347 (1997)**. The taxpayers filed claims for refund beyond the normal statute of limitations for claims for refund. The taxpayers' disabilities rendered them unable to file their claims within the times prescribed. The issue was whether, under

⁸⁸⁴ Similarly, the IRS encourages taxpayers subject to IRS proposed adjustments that, if sustained, would mean that a related foreign taxpayer's taxes were overpaid to a foreign country to protect the refund statute of limitations in the foreign country via filing a protective claim or similar device in the foreign country.

⁸⁸⁵ Rev. Proc. 2011-48, 2011-42 IRB 527 deals with such a situation where amounts otherwise deductible against the gross estate that would be deductible if paid but payment is deferred beyond the normal refund filing date. In those cases, a protective claim for refund is allowed; the Rev. Proc. sets forth the procedures for filing the protective claim.

⁸⁸⁶ For this reason, some authorities advise as follows with respect to protective claims: "File them early; file them often." Burgess J.W. Raby and William L. Raby, Protecting the Protective Refund Claim, 2003 TNT 79-4 (4/24/03) (quoting an earlier article).

general equitable principles applicable with respect to some other types of claims against the Government, the statute of limitations could be equitably tolled by disability. In an earlier case⁸⁸⁷ involving a nontax statute of limitations, the Court had held that statutes of limitation may be equitably tolled, framing the inquiry to be whether there was good reason to believe that Congress intended strict compliance with the statute of limitations. In Brockamp, the Court held that textually and in context § 6511 indicated a Congressional intent that there should be no equitable tolling.

After Brockamp, Congress provided for limited equitable tolling in § 6511(h) which now permits a suspension of the statute of limitations on claiming refunds during the period that an individual taxpayer is “financially disabled,” defined to mean the “individual is unable to manage his financial affairs by reason of a medically determinable physical or mental impairment of the individual which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.”⁸⁸⁸ The relief does not apply during any period that the individual spouse or any other person (e.g., a guardian) is authorized to handle the individual's affairs.⁸⁸⁹ Further, the relief is not available if the taxpayer is distracted from his personal affairs while caring for someone who is disabled.⁸⁹⁰

Two further points about Brockamp. First, Brockamp dealt only with the refund statute of limitations in § 6511. The court found support for not permitting tolling in the detailed statutory scheme itself. This reasoning did not foreclose the inquiry as to other time limitations in the Code where the time imperative may not be so clearly pronounced.⁸⁹¹ Second, it is important to distinguish between a time period that is a true statute of limitations and a time period that is a jurisdictional prerequisite to the action. A true statute of limitations merely bars a remedy that was available before the statute of limitations expired. A time period that is jurisdictional requires the timely institution of the action in order to support the action. You may think the difference semantical, but one theoretical instance in which it might be important is where the defendant in an action was willing to or inadvertently did waive the bar of the statute of limitations (e.g., by not timely asserting it). If the time period is a jurisdictional requirement, it cannot be waived. More to the point of the application of Brockamp, a nonjurisdictional statute of limitations may avoid

⁸⁸⁷ Irwin v. Department of Veterans Affairs, 498 U.S. 89 (1990).

⁸⁸⁸ § 6511(h)(2)(A). The statute requires that the taxpayer be an individual. Hence, a corporate taxpayer's statute of limitations is not affected even though its responsible corporate officer is financially disabled. Alternative Entertainment Enterprises, Inc. v. United States, 2008 U.S. App. LEXIS 13997 (6th Cir. 2008) (unpublished opinion). For the procedure for making the claim for relief under § 6511(h), see Rev Proc 99-21, 1999-1 CB 960 and Estate of Rubinstein v. United States, 95 Fed. Cl. 460 (2011) (holding that merely following the procedures merely protects the claim procedurally but the taxpayer must also satisfy the underlying requirements for relief).

⁸⁸⁹ See Bova v. United States, 80 Fed. Cl. 449 (Fed. Cl. 2008).

⁸⁹⁰ Brosi v. Commissioner, 120 T.C. 5 (2003).

⁸⁹¹ See Carlton M. Smith, Cracks Appear in the Code's 'Jurisdictional' Time Provisions, 137 Tax Notes 511 (Oct. 29, 2012).

Brockamp's rejection of equitable tolling.⁸⁹² That does not resolve the semantical issues to help you distinguish between the two, but it does tell you of the consequences depending upon how the issue is resolved.

The Supreme Court has reaffirmed the potential for equitable tolling of statutes of limitations in Young v. United States.⁸⁹³ Young involved the discharge of taxes in bankruptcy. The general rule is that taxes for which the return was due within three years of the date the petition for bankruptcy is filed are given a priority in bankruptcy and, most importantly, are not discharged. The taxpayers filed their 1992 income tax return on October 15, 1993, reporting a net tax liability due but did not pay the amount due. On May 1, 1996, within the three year period, the taxpayers filed a Chapter 13 bankruptcy proceeding. The filing of a bankruptcy proceeding stays the IRS's collection actions, so after May 1, 1996, the IRS could not use its collection tools to try to collect the tax. Chapter 13 is a reorganization provision for wage earners and requires the approval of a plan which must include provision for the tax due. The taxpayers thereafter moved to dismiss the Chapter 13 proceeding and, on March 12, 1997, the day before the bankruptcy court entered its order of dismissal, the taxpayers filed for Chapter 7 liquidating bankruptcy. Taxes may be discharged in a Chapter 7 proceeding. The taxpayers urged that the 1992 tax liability was discharged in the Chapter 7 bankruptcy proceeding because it had been filed more than three years from date the return was due. The IRS urged, on the other hand, that the three year period had been tolled during the pendency of the Chapter 13 proceeding and therefore that the three year period, as thus tolled, had not lapsed upon the filing of the Chapter 7 proceeding. Taxpayers throughout the country were exploiting this "back-to-back" Chapter 13/Chapter 7 bankruptcy gambit to attempt to achieve discharge of their tax liabilities where a straight Chapter 7 proceeding could not have achieved it unless instituted after the three year period during which the IRS would have had unfettered power to collect.

The Courts of Appeals had reached conflicting conclusions. Some read the statute literally and held for the taxpayers. Some applied equitable tolling. The Supreme Court resolved the conflicts in Young. A unanimous Supreme Court, speaking through Justice Scalia, accepted the IRS's argument that the three year period had tolled during the pendency of the Chapter 13 proceeding so that the hapless taxpayers in Young (for whom I feel no sympathy since they were clearly trying to game the system) were not discharged.

In the opinion, the Court said that the lookback period for dischargeability was a limitations period subject to "traditional equitable tolling principles." The Court cited as "hornbook law" that limitations periods are subject to equitable tolling unless such tolling is inconsistent with the statute. The Court said that Congress enacted these limitations with the understanding that tolling might

⁸⁹² In Volpicelli v. United States, 777 F.3d 1042 (9th Cir. 2015), the Ninth Circuit held that the § 6532(c)(1)'s nine month period for pursuing wrongful levy suits was not jurisdictional and thus subject to equitable tolling despite Brockamp. The Ninth Circuit rejected an earlier contrary precedent in another Circuit, Becton Dickinson & Co. v. Wolckenhauer, 215 F.2d 340 (3d Cir. 2000).

⁸⁹³ 535 U.S. 43 (2002).

apply, and this reasoning would be particularly true in bankruptcy, itself an equitable court. The taxpayers attempted to construct an argument, as the Government had in Brockamp, that the statute evidenced Congress' intent not to allow equitable tolling, but the Court rejected the argument.

Can you articulate a principled distinction between Brockamp and Young? In Brockamp, of course, the IRS – the party asserting the benefit of the statute – was not trying to game the system; it was simply responding to the statute. In Young, although the Supreme Court said it was not necessary to look at the taxpayers' intent in the back-to-back filings, it was clear that the taxpayers were gaming the system. Is a statute of limitations a heads the Government wins, tails the taxpayer loses? Do bad cases really create bad law?

Although not dealing with equitable principles per se, the Supreme rejected a taxpayer's attempt to end run the refund claim statute of limitations by dressing the refund suit up as a Tucker Act suit. In United States v. Clintwood Elkhorn Mining Co., 553 U.S. 1, 128 S.Ct. 1511 (2008), the taxpayer paid a coal excise tax that was subsequently invalidated as violating the Constitution's Export Clause. The general 2/3 year statute for filing claims for refund limited the taxpayer's ability for refund. The Tucker Act is the general act permitting claims against the Government and has a 6 year statute of limitations, hence the taxpayer sought to characterize its claim as a general claim rather than a tax claim. As in Brockamp, the Court said that the refund statute was straight-forward and emphatic in limiting tax claims to the prescribed period. And, if it looks and acts like a tax, that is what it is and the taxpayer must meet the prescribed statute of limitations. It just does not matter that, when paid, albeit then unbeknownst to the taxpayer, the tax was unconstitutional.

D. Equitable Recoupment.

In Bull v. United States, 295 U.S. 247 (1935) and subsequent cases, the Supreme Court developed and applied the doctrine of equitable recoupment in tax cases which mitigates some harsh effects of the statute of limitations. The Ninth Circuit in Estate of Branson v. Commissioner, 264 F.3d 904 (9th Cir. 2001), which is assigned reading for this class, described the doctrine as follows:

Equitable recoupment arises when a single “transaction, item or taxable event” is subject to two inconsistent taxes. United States v. Dalm, 494 U.S. 596, 608 n.5 (1990); Boyle v. United States, 355 F.2d 233, 236 (3rd Cir. 1965). The doctrine permits a party to a tax dispute to raise a time barred claim in order to reduce or eliminate the money owed on the timely claim. Rothensies v. Elec. Storage Battery Co., 329 U.S. 296, 300 (1946) (“amount of [the] tax collected on the wrong theory should be allowed in recoupment against an assessment on the correct theory”). Equitable recoupment cannot be used offensively to seek a money payment, only defensively to offset an adjudicated deficiency. Dalm, 494 U.S. at 611.

Estate of Branson illustrates the potential application of equitable recoupment. Please read that case now and be prepared to discuss the doctrine of equitable recoupment.

In addition to considering whether the circumstances for equitable recoupment existed, the Estate of Branson Court also addressed the threshold issue of whether the Tax Court has jurisdiction

to entertain equitable recoupment issues ab initio. Historically, the Tax Court had taken the position that its jurisdiction was statutorily limited to determining the amount of a deficiency or overpayment. That has nothing to do, it was thought, with whether the taxpayer (or a related taxpayer) over or underpaid in an earlier year not before the Court and as to which the normal statute of limitations would prevent any relief. The district courts had reached a different result based on Supreme Court cases under their general equitable jurisdiction (which the Tax Court does not have). The historical view that the Tax Court and the District Courts would thus decide the same tax case differently is disquieting for there is no indication that Congress intended that difference in result. Indeed, Congress's clear purpose was to funnel as much tax litigation as possible into the Tax Court and certainly there was no evidence that Congress intended this disincentive to Tax Court litigation. Perhaps to resolve that anomaly, in Estate of Mueller, which shortly preceded Estate of Branson, the Tax Court suddenly discovered that it indeed does have jurisdiction to apply equitable recoupment.

As noted in Estate of Branson, the Sixth Circuit in an earlier case had rejected the Tax Court's new found position about its jurisdiction, but the Tax Court stuck to its guns in Estate of Branson and has now been affirmed by the Ninth Circuit. Congress has finally settled the uncertainty by legislating that the Tax Court may apply equitable recoupment principles to the same extent as District Courts and the Court of Federal Claims.⁸⁹⁴

Keep in mind what equitable recoupment does. It reduces the open year tax deficiency or refund by the principal amount of tax from the erroneous treatment in the barred year.⁸⁹⁵ There is no allowance for interest from the barred year to the year in which recoupment applies.⁸⁹⁶ For example, if the taxpayer saved \$100 in now barred Year 01 and then, in the current open Year 04, claims a \$120 refund related to the erroneous treatment in the barred year, recoupment would reduce the Year 04 refund by \$100. There would be no further offset by the amount of the interest from April 15 of Year 02 (the date the tax was due for Year 01) to April 15 of Year 05. What if in the same example, the taxpayer were to claim only a \$50 refund in Year 04? The recoupment would be \$50 in Year 04. Why?

⁸⁹⁴ Pension Protection Act of 2006, Public Law 109-280, 120 Stat. 780, effective as to Tax Court cases that are not final as of August 17, 2006.

⁸⁹⁵ See Estate of Buder v. United States, 372 F. Supp.2d 1145 (E.D. Mo. 2005), aff'd 436 F.3d 936 (8th Cir. 2006) (applying an equitable reduction of an equitable recoupment offset in favor of the Government). The language of some cases suggests that the statute of limitations for the barred year is opened. E.g., Minskoff v. United States, 490 F.2d 1283, 1285 (2d Cir. 1974) ("The theory of the doctrine of equitable recoupment is that one taxable event should not be taxed twice, once on a correct theory and once on an incorrect theory, and that to avoid this happening the statute of limitations will be deemed waived."). The theory, however, does not waive the statute of limitations for an otherwise barred year, but permits the party claiming equitable recoupment to reduce a cost in an open year.

⁸⁹⁶ See Estate of Buder, supra (justifying the denial of interest on the amount of the recoupment as exercise of equity and fairness).

I have given you a simplified example. Keep in mind that equitable recoupment is, as the name implies, an equitable remedy. Equities, if present, may favor some adjustments. Vary the initial example above (\$120 refund in Year 04 and \$100 unpaid tax in Year 01), by the fact that only one-half of the tax underpaid in Year 01 (\$50, being ½ of \$100) actually benefitted the related party who now seeks the refund. A court considering these facts may hold that the equities justify equitable recoupment in favor of the Government by one \$25.⁸⁹⁷ Other fact variations may present similar equities that the taxpayer or the Government may exploit.

Branson and Dalm, the Supreme Court case cited in Branson, involved two different but related taxpayers.⁸⁹⁸ Equitable recoupment may apply also when only a single taxpayer is involved. In IES Industries, Inc. v. United States,⁸⁹⁹ the taxpayer brought a refund suit and succeeded in having the court of appeals reach a decision justifying a refund of about \$25,000,000 for each of Years 01 and 02 and about \$5,000,000 for Year 05. Years 03 and 04 were otherwise closed, but the Government asserted equitable recoupment on the theory that consistent application of the basis upon which the taxpayer was entitled to the refunds in Years 01, 02 and 05 would mean that the taxpayer had underpaid its tax in Years 03 and 04 by about \$14,000,000, thus entitling the Government to recoup this amount against the refunds due for Years 01, 02 and 05. The district court and the circuit court agreed with the Government.⁹⁰⁰

Finally, equitable recoupment is not the same as offset or setoff in a refund suit. In a refund suit, the Government may assert an offset as a defense that the taxpayer filing a claim for refund or filing a suit for refund is not entitled to a refund for reasons not previously asserted. For example, if the taxpayer sues for refund for year 01 based on taxes he paid for reasons asserted in a notice of deficiency on the basis that those reasons are incorrect and he does not therefore owe the tax, the Government can assert in defense to his entitlement to a refund that there are other reasons, not previously asserted, that the taxpayer did not overpay his tax for the year and is not entitled to a refund. This right to offset was established in Lewis v. Reynolds, 284 U.S. 281 (1932), as modified

⁸⁹⁷ In Estate of Buder, supra, the estate of the husband claimed a marital QTIP deduction improperly, thus not paying estate tax that was due. After the wife's later death, the wife's estate initially included the property in her estate, but thereafter sought a refund after the statute of limitations had closed on the husband's estate. The IRS sought to equitably recoup the unpaid estate tax from the husband's estate against the refund due the wife's estate. The court sustained equitable recoupment but reduced the amount the IRS could recoup because all of the assets did not go to the wife (e.g., there had been a charitable beneficiary also in the husband's estate). Wendy C. Gerzog, Buder: The Extent of Equitable Recoupment, 110 Tax Notes 1361 (Mar. 20, 2006).

⁸⁹⁸ Buder, discussed above in the footnotes, also involved two different but related taxpayers.

⁸⁹⁹ 349 F.3d. 574 (8th Cir. 2003).

⁹⁰⁰ For students who really want to understand why the courts strained to apply equitable recoupment, one way of looking at it is that the Eighth Circuit gave the taxpayer an outrageous result on the underlying ADR transaction itself and, thus, were susceptible to some opportunity to mitigate the benefit of its extravagant largesse to the taxpayer.

in 284 U.S. 599 (1932). Equitable recoupment, by contrast, involves using equitable principles to allow some tax paid or not paid for another year or even another type of tax to affect the amount of tax due or refund due in the case before the court.

E. Duty of Consistency.

Sometimes the Courts will apply a “duty of consistency” to prevent the taxpayer or, less frequently, the IRS from claiming a benefit in an open year that is inconsistent with some position, amounting to a representation, in a barred year.⁹⁰¹ The reason the duty is more commonly invoked against taxpayers is that taxpayers are more commonly in the position of making a “representation” in a barred year than is the IRS. So, the core of the court decisions and development of the concepts discussed relate to application of the duty against the taxpayer.

The Tax Court has described the duty of consistency as follows:

The “duty of consistency”, sometimes referred to as quasi-estoppel, is an equitable doctrine that Federal courts historically have applied in appropriate cases to prevent unfair tax gamesmanship. The duty of consistency doctrine “is based on the theory that the taxpayer owes the Commissioner the duty to be consistent in the tax treatment of items and will not be permitted to benefit from the taxpayer's own prior error or omission.” It prevents a taxpayer from taking one position on one tax return and a contrary position on a subsequent return after the limitations period has run for the earlier year. If the duty of consistency applies, a taxpayer who is gaining Federal tax benefits on the basis of a representation is estopped from taking a contrary return position in order to avoid taxes.⁹⁰²

The Ninth Circuit has expressed the concept more pungently:

When all is said and done, we are of the opinion that the duty of consistency not only reflects basic fairness, but also shows a proper regard for the administration of justice and the dignity of the law. The law should not be such a idiot n3 that it cannot prevent a taxpayer from changing the historical facts from year to year in order to escape a fair share of the burdens of maintaining our government. Our tax system

⁹⁰¹ See Herrington v. Commissioner, 854 F.2d 755, 758 (5th Cir. 1988), cert. denied, 490 U.S. 1065 (1989); Estate of Letts v. Commissioner, 109 T.C. 290 (1997), aff'd 212 F.3d 600 (11th Cir. 2000). As to IRS inconsistency, see generally Steve R. Johnson, An IRS Duty of Consistency: The Failure of Common Law Making and a Proposed Legislative Solution, 77 Tenn. L. Rev. 563 (2010).

⁹⁰² Blonien v. Commissioner, 118 T.C. 541 (2002), quoting Hollen v. Commissioner, T.C. Memo. 2000-99, aff'd. 25 Fed. Appx. 484 (8th Cir. 2002). For good articles discussing some aspects of the duty of consistency, see Burgess J.S. Raby and William L. Raby, A Foolish Consistency in Filing Positions, 2004 TNT 52-8 (3/17/04); and Burgess J.S. Raby and William L. Raby, Duty of Consistency: Facts vs. Law, 2004 TNT 103-27 (5/26/04).

depends upon self assessment and honesty, rather than upon hiding of the pea or forgetful tergiversation.⁹⁰³

n3 Charles Dickens, *Oliver Twist* 439 (Pocket Library ed., Pocket Books, Inc. 1959) (1837).

The duty of consistency has the following elements:⁹⁰⁴

1. Representation of Fact in the Closed Year. The taxpayer represents a fact in the now closed year. Usually this will be a return reporting fact and the nature of the factual representation can be quite subtle. For example, a failure to report income in the closed year may be a factual representation that the timing of the receipt of the income did not occur in that year or, alternatively, may even be a representation that the receipt was a loan repayment rather than income. Thus, for example, a taxpayer who benefitted from a representation in one tax year may not reduce his tax in a subsequent tax year by arguing, after the statute of limitations has expired on the earlier year, that the taxpayer's original representation was incorrect, and that more tax was due in the now-closed year.⁹⁰⁵ Note that it must be a representation of fact and not a spin on facts that are correctly presented.⁹⁰⁶ The actual taxpayer making the representation need not be the taxpayer against whom the duty of consistency is invoked, so long as there is sufficient relationship that the two taxpayers. The duty is thus often invoked against an estate beneficiary to compute gain on inherited property after it was valued too low for estate tax purposes.⁹⁰⁷

⁹⁰³ Estate of Ashman v. Commissioner, 231 F.3d 541, 544 (9th Cir.2000) (footnote omitted). Just in case you don't know what tergiversation means (although I think you should be able to extrapolate from the context), the dictionary I consulted defines it as the noun form of the verb tergiversate which means: "1. To use evasions or ambiguities; equivocate. 2. To change sides; apostatize." American Heritage Dictionary of the English Language (4th ed. 2000), online edition at www.bartleby.com. There now, many of you inveterate readers of footnotes will have learned a new word.

⁹⁰⁴ These elements set forth basically the standard formulation of the duty of consistency. See Blonien v. Commissioner, 118 T.C. 541, 555 at n. 9 (2002) (and cases there cited); see also Estate of Ashman v. Commissioner, 231 F.3d 541, 545 (9th Cir. 2000).

⁹⁰⁵ See Portland Oil Co. v. Commissioner, 109 F.2d 479, 485- 486 (1st Cir. 1940), affg. 38 B.T.A. 757 (1938) (not reporting a sale in 1929 was a representation that the sale did not occur in 1929); Wentworth v. Commissioner, 244 F.2d 874, 875 (9th Cir. 1957), affg. 25 T.C. 1210 (1956); (not reporting the receipt of funds on an income tax return was a representation that the funds were a loan repayment).

⁹⁰⁶ Estate of Rose B. Posner, deceased, et al. v. Commissioner, T.C. Memo. 2004-112.

⁹⁰⁷ E.g., Janis v. Commissioner, 461 F.3d 1080, 1085 (9th Cir. 2006) (covers "both the taxpayer and parties with sufficiently identical economic interests;" this includes an estate where the taxpayer beneficiary makes the representation as executor on the estate tax return and then seeks to avoid the representation on his personal return as beneficiary). Based on the facts, other situations can invoke the duty because of sufficient identify of interest. See Van Alen v. Commissioner, T.C.

2. IRS Reliance on the Representation of Fact. This element is present if the IRS grants or even acquiesces in the tax benefit achieved by the factual representation in the closed year (e.g., by not auditing or accepting the return treatment on audit).⁹⁰⁸ However, if the IRS was aware or put on notice that the representation was not correct in time to correct the treatment in the year as to which the representation was made, then the IRS has not relied to its detriment and the duty of consistency does not apply.⁹⁰⁹

3. The Taxpayer Claims Inconsistent Tax Benefits in an Open Year. This element is self evident, for the taxpayer must be claiming some tax benefit in the open year in order for the IRS to assert the preclusive effect of the duty of consistency.

If these elements are present, the application of the duty of consistency will prevent the taxpayer from claiming the tax benefit in the open year, even if the true facts means that the taxpayer is entitled to that benefit in the open year and, correspondingly, was not entitled to the benefit in the closed year where the misrepresentation was made. In this way, the duty of consistency acts like estoppel in the open year. It does not technically affect the statute of limitations for the closed year, but the imperative to apply the doctrine of consistency is caused by the fact that the statute is closed for the earlier year.

A real world application of the duty of consistency is presented in Blonien v. Commissioner,⁹¹⁰ where the taxpayer, a nominal partner in a high-flying national law firm (Finley Kumble) that imploded in Enron-like extravagance, took the position that he was not a partner in the firm at all, but was instead an employee of the firm. The tax result he desired was to avoid the cancellation of indebtedness (COD) distributive income that arose when the firm imploded and the creditors walked away with large claims unsatisfied. Those of you who have taken partnership taxation will recall that the partners get outside basis in their partnership interests from both their distributive share of partnership income and inside partnership borrowing. They are of course taxed on partnership income as the partnership reports it (through their distributive shares), but they are not taxed on partnership borrowings even though the partnership may have used such borrowings to make distributions to the partners. In this case, the taxpayer was distributed far more cash than he reported as his distributive share of income, but only reported his share of partnership income. The excess was funded effectively from borrowings that increased the partners basis, thus permitting

Memo. 2013-235 (involving an estate's § 2032A special valuation election with the beneficiaries trying to claim a higher valuation on sale who had consented to the original election and benefitting from it; § 1014(a)(3) would seem to compel that result but the duty of consistency was applied in the alternative).

⁹⁰⁸ Herrington, supra.

⁹⁰⁹ Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 91 (1971), aff'd per curiam, 456 F.2d 622 (5th Cir. 1972).

⁹¹⁰ 118 T.C. 541 (2002). The setting for Blonien was an interesting procedural question dealing with the partnership unified audit and litigation rules that we discuss below. We do not discuss these rules here but will discuss them later in this book as a separate topic.

the tax-free excess distribution. The tax piper must be paid, however, and that occurs when the partnership pays the debt from earnings that are taxed to the partners (not the case here) or, if the borrowings are not paid, the phantom COD income flows through to the partners to impose tax without cash flow (because they had their cash flow earlier in tax-free distributions). So, the Tax Court looked back to the fat year when this partner took received distributions in excess of his distributive income (obviously funded by debt). The Tax Court found that the taxpayer then took the return reporting position that he was indeed a partner, thus getting the benefit of the increase in basis for inside partnership borrowings allowed only to one who is a partner and thus sheltering his distributions in excess of partnership income and actual contributions. Thus, the taxpayer benefitted in the earlier years by taking the return reporting position that he was a partner and, the Tax Court held, will not now be heard to urge that he was not a partner.⁹¹¹

It is important to notice the close parallel to the statutory mitigation provisions which I discuss next. If the mitigation provisions apply, the proper treatment will be allowed in the correct open year regardless of whether any misrepresentation was made in a closed year and the closed year will be opened up for the limited purpose of correcting the error in the closed year. By contrast, if mitigation does not apply and the duty of consistency does apply, the taxpayer will be denied the tax benefit in the correct open year but will be allowed to keep the tax benefit in the closed year. In terms of priority, where the mitigation provisions apply, they will apply in preference to the duty of consistency.

As I said at the beginning, the IRS too can be subject to the duty of consistency, although the circumstances in which it would have made a representation in a barred year are less frequently encountered.⁹¹² Essentially the same elements will apply.

Finally, there may be other themes and holdings in the tax law that deal with denying a taxpayer an inconsistent benefit, but I don't treat them further since this is an introductory text.⁹¹³

⁹¹¹ Those of you who do not have more than a passing acquaintance with the partnership tax rules might ask why he could not have changed his status from partner to employee by the year in issue before the Court. The answer is that the partnership tax rules would have caught him at the point of change by treating his share of the inside partnership debt as a distribution to him thus capturing the income that had previously been sheltered by distributions in excess of his actual contributions to the partnership. Needless to say, the taxpayer did not take that position on his prior year return and pay the tax at that time.

⁹¹² See Steve R. Johnson, An IRS Duty of Consistency: The Failure of Common Law Making and a Proposed Legislative Solution, 77 Tenn. L. Rev. 563 (2010); and Stephanie Hoffer, Hobgoblin of Little Minds No More: Justice Requires IRS Duty of Consistency, 2006 Utah L. Rev. 317 (2006), citing inter alia Alamo National Bank of San Antonio v. Commissioner, 95 F.2d 622 (5th Cir. 1938).

⁹¹³ An illustration is the theme in Charles Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934) and its progeny that double deductions are disfavored and may be corrected by denying the second deduction on the notion that, deductions of the same economic loss twice is not to be accepted unless there is a clear congressional mandate for the double deductions. This notion is called the Ilfeld

F. Claim of Right Relief - § 1341.

In a practical application of the annual accounting principle, the tax law developed the “claim of right doctrine” that says that income received under claim of right is included in gross income and subject to tax⁹¹⁴ even if there is some contingency that might take it away in a later year.⁹¹⁵ The original safeguard for unfairness was that the taxpayer could or at least might claim a deduction in the year of repayment. That is a rough and ready fix subject to variances in effective rates in the two years. In some cases, those variances could be harsh. For example, if the taxpayer receives \$100 taxed at a 35% rate in year 01 and then must return it in year 05 (after Year 01 is closed), the taxpayer could claim a deduction but that deduction might achieve only, say, 5% tax savings.

Section 1341 was enacted to mitigate some of this harsh effect of having to include the income, subsequently determined not be economic income, in a closed year under the claim of right doctrine. Section 1341 provides that, if, in a closed year, a taxpayer included in income an item of income because he subjectively that he had a claim of right to the income⁹¹⁶ and, after the close of that year, the taxpayer is entitled to a deduction for returning the income because, as it turns out, he did not have a claim of right in the earlier closed year, then the taxpayer can claim (i) a deduction for the amount in the later open year **or** (ii) a tax for the current open year calculated without the deduction but with a reduction in tax for the tax paid on the item in the closed year. In the example cited above, the taxpayer would have paid a tax on the item in the closed year (Year 01) of \$35, so if he returns it in Year 05, he will claim either a \$100 deduction or a \$35 tax reduction in the open year (Year 05). If the tax reduction exceeds the tax otherwise due, the excess is refundable.⁹¹⁷

doctrine. The Ilfeld doctrine arose and continues to be applied in consolidated return cases but probably has traction in other areas of the law as well. And, it does not require that the claiming of the original or the double deduction have been in error if considered in isolation; obviously, the deduction in the current year must be in issue, but if it is otherwise proper and, considered in isolation, the original deduction is otherwise proper, the deduction in the current year will nonetheless be disallowed without a clear congressional mandate not only for the current year deduction but for the duplicated deduction.

⁹¹⁴ Tax exempt income, for example, is not taxable even if received under a claim of right.

⁹¹⁵ North American Oil Consolidated Co. v. Burnet, 287 U.S. 417 (1932).

⁹¹⁶ Proceeds of theft or embezzlement, thus, are not within the scope of the relief provision. Such proceeds are taxable. But the relief provision will apply. Thus, the taxpayer failing relief for such proceeds is left to the deduction claim which, often in the year of payment, is a year in which the benefit of the deduction is slim or none.

⁹¹⁷ § 1341(b)(1).

G. Mitigation Provisions of the Code.

1. Introduction.

The mitigation provisions (§§ 1311 - 1314) of the Code mitigate the effect of the statute of limitations in some cases. I deal here with the principal mitigation provisions most practitioners encounter in their practice.⁹¹⁸ These mitigation provisions parallel the equitable recoupment doctrine and the doctrine of consistency in the sense that they seek to prevent a party from getting a double benefit. The legislative history of these provisions state the case for their need as follows:

The purpose of the statute of limitations to prevent the litigation of stale claims is fully recognized and approved. But it was never intended to sanction active exploitation by the beneficiary of the statutory bar, of opportunities only open to him if he assumes a position diametrically opposed to that taken prior to the running of the statute. Legislation has long been needed to supplement equitable principles applied by the courts and to check the growing volume of litigation by taking the profit out of inconsistency, whether exhibited by taxpayers or revenue officials and whether fortuitous or the result of design.⁹¹⁹

These provisions deny the double benefit if a party (the IRS or the taxpayer) actively (generally) seeks and obtains a benefit in the correct open year which means, perforce, that the party should not have obtained the benefit in the barred year. Unlike the doctrines discussed above, the correction is made by allowing the correct treatment in the open year and opening up the otherwise barred year solely to correct the erroneous benefit. I shall review here only some of the simpler examples so that you can get a feel for how the mitigation provisions operate.

Note to students, although I think every tax lawyer should read the mitigation provisions “cover to cover,” you should for this class read **only** the specific sections cited in the text below.

2. Examples of Double Benefits Covered.

a. Double Inclusion of Income.

The classic case is where a taxpayer includes income on a tax return for Year 01, paying the resulting Year 1 tax. Then, after the statute of limitations for Year 01 has closed but the Year 05 statute is still open, the IRS insists that the same item of income be included in Year 05. Obviously, if the IRS succeeds in forcing the taxpayer to include the item in income in Year 05, the IRS will have realized a double benefit – a tax on the same item of income in both years. In that case, the mitigation provisions will operate to force open the Year 01 statute of limitations solely to allow the

⁹¹⁸ I do not deal with other mitigation provisions. For example, § 6521, with which we do not deal here, provides mitigation via reduction of an open year tax (similar to equitable recoupment as discussed above) in the case of the FICA and SECA requirements.

⁹¹⁹ S. Rep. No. 1567, 75th Cong., 3d Sess. 49 (1938).

taxpayer to obtain a refund plus interest since Year 01. Keep in mind the key elements of this example: the party who benefits insists on the treatment in the correct open year after having benefitted from the same item in an incorrect but now barred year. Relief is available by lifting the bar of the statute of limitations but only to correct that item.

Let's walk through the statute to see how mitigation works in this example. Section **1311(a)** provides that, if a “determination” (as described in § **1313(a)**) is made that creates a double benefit to the IRS (as described in § **1312, subsection (1)** of which includes the double inclusion of income) and, on the date of the determination the correction of the error in the erroneous year (Year 01 in the example) is barred, the error can be corrected (as described in § **1314**) by allowing the taxpayer to file a claim for refund for Year 01. Let's focus on some technical issues.

First, a **determination** is required. Section 1313(a) defines determinations. A determination is a final court decision, a closing agreement, IRS final action denying a claim for refund, or an agreement as permitted by regulations. Any other disposition allowing a double benefit is not a determination. The party who will benefit from opening the otherwise closed year must take care not to dispose of the correct open year (Year 05 in the example) without forcing a determination as defined. The party who is hurt by the other side achieving a double benefit – either the taxpayer or the IRS – will have the ability to force a determination. For example, if the taxpayer in filing his Year 5 return includes the item in income on the Year 05 return, there will be no determination. (Note also that, in this example, the IRS did not maintain a position that it be included in Year 05, but we will get to that issue below.) Moreover, if the taxpayer does not include the item in the Year 05 return and then only pays the tax upon the IRS's issuance of a notice of deficiency and assessment, there will be no determination. How can the taxpayer force a determination to meet this prerequisite for mitigation? The taxpayer can include it on his Year 05 return (either the original return or an amended return) and file a claim for refund for the tax paid for Year 05. If the IRS denies the claim (as it is entitled to do because the item is properly includable in year 05), § 1313(a)(3)(B) will treat the denial as a determination. (Note that this will also force the IRS to maintain a position inconsistent with the inclusion of the item in Year 01.) There are other ways to force the event of determination, but for now you must know that you have to have an event of determination and it is your job as a practitioner to get your client there if he or she needs to avoid the IRS getting a double benefit. By the same token, it is your duty to avoid a determination, if possible, if your client is the beneficiary of the double benefit.

One issue that I hope you have spotted is how a taxpayer can file a legitimate claim for refund for Year 05 when the item is properly included in Year 05? Stated otherwise, how can the taxpayer claim under penalty of perjury on the claim for refund that he or she is entitled to a refund for the correct open year? The taxpayer can, but I ask you now to hold that thought and we shall return to it. There is a further related question. I said that the IRS is entitled to deny the claim because the item of income is properly included in Year 05. The question I want you also to hold in your mind is whether the IRS can grant the claim and refund the tax for the correct open year so as to avoid opening up the barred year (no double tax)? The IRS can, and we will come back to why.

Second, there must be a “**circumstance of adjustment**” giving rise to a double dip with respect to the same item. In this case, § 1312(1) describes a double inclusion of income as a circumstance of adjustment that can be corrected. In this example, taxing the items in Year 05 would be a double dip for the IRS.

Third, correction of the error must be barred at the time of the determination. Obviously, as with recoupment, a party on notice that the other party is claiming or even might claim a double dip should protect the statute of limitations if the earlier year might become barred is still open. In our example, therefore, if for some reason the refund statute of limitations on Year 01 is still open, the taxpayer should file a protective claim for refund. Nevertheless, if such a protective move is not made, the mitigation provisions pull the fat out of the fire by permitting relief so long as the incorrect year (Year 01) is barred at the time of the determination.⁹²⁰

Fourth, if the above requirements are met, a correction adjustment may be made under § 1314. In our example, the correction is made by opening up the statute of limitations for Year 01 to exclude the income and compute a refund accordingly. Note the critical difference in the relief afforded between mitigation and equitable recoupment. Mitigation opens up the closed year to allow a refund for that otherwise closed year. Equitable recoupment offsets a tax otherwise due in the open year by the amount of tax overpaid in the closed year (i.e., it does not open up the closed year). Further, mitigation requires essentially two proceedings – one to determine the tax treatment in the correct open year and a second one to correct the incorrect treatment in the closed year; equitable recoupment, by contrast, through netting in the correct open year, makes the correction in a single proceeding.

b. Double Deductions.

Mitigation, like equitable recoupment, is a two way street – it can benefit the IRS as well as the taxpayer. Thus, if the taxpayer seeks a deduction in a correct open year (e.g., Year 05 in our example) but has also claimed the deduction erroneously in a barred year (Year 1 in our example), the IRS may open up Year 01 to assess and collect additional tax for Year 01. Let's walk through the elements of mitigation because some may not be intuitive.

First, a determination is required. Just as the taxpayer must force a determination in the double inclusion circumstance of adjustment, so the IRS must force a determination in the double deduction circumstance. How does the IRS do that? Well, if the taxpayer claims the deduction on the Year 05 return (either the original or the amended return) the IRS must deny the deduction by notice of deficiency which alone is not a determination, which will force the taxpayer to either (i) forego the deduction in the correct open year so as not to open up the barred incorrect year (Year 01 in the example) or (ii) force a determination by either pursuing a Tax Court proceeding or paying the tax and filing a claim for refund. Under § 1313(a), either of the events in (ii) will lead to a determination. You will recall that in discussing the determination in the double inclusion circumstance, I asked how the taxpayer could file a claim for refund for Year 05 when the income

⁹²⁰ § 1311(a).

item is properly included in Year 05? So, here, in the double deduction situation, I ask you how the IRS can deny a deduction in Year 05 when the deduction is properly claimed in Year 05? Hold on to that thought.

Second, there must be a circumstance of adjustment. Section 1312(2) provides that the double allowance of a deduction or credit is a circumstance of adjustment.

Third, correction of the error must be barred at the time of the determination. If Year 01 is not barred, the IRS should simply correct the error by deficiency determination for Year 01.

Fourth, if the foregoing requirements are met, the error is corrected under the mechanism in § 1314.

3. Maintenance of an Inconsistent Position.

As to most of the circumstances of adjustment, the party in whose favor the bar of the statute of limitations operates must have maintained an inconsistent position in the correct open year. § 1311(b)(1). This effects the statutory policy to take the double benefit out when a party actively exploits the statute of limitations by actively asserting the benefit in the correct open year. In the above examples, we have assumed that Year 01 is the incorrect barred year and Year 05 is the correct open year. Accordingly, as to a double inclusion of income, the IRS must be the party maintaining successfully the position that the income item be included in the correct open year (Year 05). Correspondingly, as to the double deduction, the taxpayer must be the party maintaining successfully the position that the deduction be included in the correct open year (Year 05).

Example 1. Assume that the taxpayer erroneously claims a deduction in Year 01 that becomes time-barred from correction by the IRS. The deduction is properly allowable in Year 05 but the taxpayer does not claim it on his Year 05 tax return. If nothing else happens, the taxpayer has received the benefit of the deduction in Year 01 (the improper year) but not in Year 05 (the proper year). The taxpayer has not received a double benefit. That is the end of the matter.⁹²¹

Example 2. Same facts except, at a time when the statute for Year 01 assessment is closed, that taxpayer files an original or an amended return for Year 05, claiming the benefit of the deduction. The taxpayer has now maintained an inconsistent position, thus meeting this requirement for the mitigation provisions to apply. The IRS must allow the deduction because the taxpayer so insists – Year 05 is, after all, the proper year for the deduction. The taxpayer has maintained an

⁹²¹ One question is whether the taxpayer, knowing that the deduction is properly allowable in Year 05, can properly sign the jurat which says, in effect, that the return is true, correct and complete? The answer is yes, but perhaps the better part of wisdom would be to identify in a disclosure attachment that the taxpayer is omitting the deduction in the correct open year.

inconsistent position. Assuming that the other requirements for mitigation exist, the IRS can open up the closed year (Year 01) to deny the benefit of the deduction.⁹²²

Example 3. Same facts except that, for Year 05, the taxpayer does claim the deduction on an original or amended return. Rather, the IRS sent the taxpayer a notice of deficiency proposing other adjustments for Year 05 and the taxpayer files a petition in the Tax Court. In preparing the answer, the IRS attorney determines from a review of the file that the taxpayer was entitled to the deduction in Year 05 and, without any prompting from the taxpayer, concedes in the IRS's answer in the Tax Court that the taxpayer is entitled to the deduction. Upon settlement of the other issues, the IRS and the taxpayer submit to the Court an agreed decision document which states a tax liability determined with the deduction. The Tax Court dutifully enters the decision. In this case, the taxpayer never insisted on the deduction and thus never sought a double benefit. Instead, the IRS foisted the double benefit upon the taxpayer by simply allowing the deduction. The taxpayer has not maintained an inconsistent position, so this requirement of mitigation is absent.⁹²³

Basically what this illustrates is that the IRS cannot force on the taxpayer the double benefit, thus opening up the closed year. Logically, this would mean that, even if the IRS is aware of the deduction, the IRS can choose not to volunteer the benefit of the deduction to the taxpayer in Year 05 so as to force upon the taxpayer the choice of (1) insisting upon the benefit in Year 05, thus maintaining an inconsistent position or (2) declining the benefit in Year 05, thus keeping the benefit for Year 01.⁹²⁴

Similarly, in the case of a double inclusion of income, the taxpayer cannot invoke mitigation simply by including the income on his original or amended return for the correct open year. Simply by accepting the return, the IRS has not **maintained** an inconsistent position; if anything, the taxpayer has maintained the inconsistent position. As I noted above, with regard to the determination requirement, the taxpayer could include the item on the Year 05 return and file a claim for refund to force a determination which will force the IRS to adopt the position of inclusion in Year 05 or forego its inclusion in Year 05 by granting the claim for refund; alternatively, if the taxpayer excludes the item from his or her Year 05 return, the IRS will get the double benefit only

⁹²² One issue you should think about in this context is how the IRS would discover the incorrect claim in the now barred year. Obviously, if the IRS does not know that a double benefit has been achieved, the IRS will not exercise its rights to take away the double benefit under the mitigation provisions. I dare say that, in many perhaps most cases where this is done, the IRS will not learn of the double benefit, so the taxpayer keeps the double benefit. What are the ethics of this? Would a taxpayer be subject to criminal prosecution for claiming the benefit in the correct open year although he had also claimed it in the incorrect open year? Is the taxpayer obligated to tell the IRS so that the IRS can exercise its rights under these mitigation provisions? I think these are good questions (and posit them as such because this is, after all, my book). Think about the questions and your answers.

⁹²³ Regs. § 1.1311(b)-1(c)(1).

⁹²⁴ The IRS attorney, before volunteering a benefit in an open year, would be well advised to at least inquire whether the taxpayer claimed the benefit in another year.

by asserting a deficiency in Year 05. In either event, if the IRS insists on inclusion in Year 05, the IRS's action will meet two requirements for mitigation -- i.e., it will be a maintenance of a position in the correct open year (Year 05) that is inconsistent with the position in the barred year (Year 01) and it will be a determination as required by § 1313(a).

I now return to the questions I asked earlier as to how either party can take a position in the correct open year (Year 05) that the item should not be properly treated in computing the tax for the correct open year (Year 05)? You remember that, in a double inclusion of income situation, I asked how the taxpayer could file a tax return or a claim for refund for the open year that fails to include an income item properly includable in the open year (Year 05 in the example). Similarly, can the IRS grant the claim for refund in Year 05 even though the income item is properly includable in Year 05? Can the party who would get the **double** benefit by its correct treatment in the open year decide not to claim that double benefit in the correct open year and thus avoid opening up the statute for the barred year? In the case of a potential double deduction, this would require the taxpayer to forego claiming a deduction in the correct open year, thus avoiding a double benefit and thus avoiding opening up Year 01 for a correction. Similarly, in a potential double inclusion of income situation, can the IRS not insist that the taxpayer include the income in the correct open year (i.e., Year 05), in order to avoid opening up the statute for the taxpayer to get a refund in the incorrect barred year (Year 01)? That is the nub of the issue and the role of the requirement that the claiming of the benefit in the correct open year be at the insistence of the party getting the benefit in the correct open.

Let's take an example. If the income has been improperly reported in Year 01, the Year 01 tax has been paid, and the Year 01 statute on claims for refund has closed. In year 05, the taxpayer discovers that the income was properly reported in Year 05. The taxpayer then reports the income in Year 05 without the IRS insisting that he do so. Providing the taxpayer can meet the other requirements of the statute (e.g., determination), can the taxpayer unilaterally force open Year 01? And, conversely, in a potential double deduction situation, can the IRS force the taxpayer to get the benefit of the deduction in the correct open year (Year 05) even though the taxpayer does not want to claim the double benefit and thus does not want to exploit the closed statute of limitations?

What the maintenance of an inconsistent position requirement does is to give the party in whose favor the bar of the statute potentially operates (the taxpayer in a double income inclusion case and the IRS in a double deduction case) authority to not insist that the item be properly treated in the correct open year. Thus, in the double income inclusion case, the IRS must actively insist that the income item be included in the correct open year, otherwise the double benefit is not at the IRS's insistence. The mitigation provisions are not designed **just** to prevent double benefits -- but to prevent double benefits where a party seeks to exploit the bar of the statute of limitations by insisting on the **double** benefit in the correct open year. Thus, in a double inclusion case, if the taxpayer in the correct open year (Year 05) simply includes the item on his or her return without the insistence of the IRS, the IRS has not maintained an inconsistent position. Only if the taxpayer then files a claim for refund for the correct open year (Year 05) and the IRS denies the claim, will the IRS have maintained an inconsistent position. But, in acting on the claim for refund, the IRS can grant the refund for the correct open year and thereby avoid maintaining an inconsistent position, solely

in order to avoid opening up the barred year. Similarly, in the double deduction situation noted above (see Example 5), the IRS attorney could have not allowed the deduction in Year 05 and thus it would be allowed only if the taxpayer insisted on the deduction.

How, courts ask, can either the IRS or the taxpayer treat the item improperly in the correct open year? Isn't the taxpayer required to report and pay his tax correctly based on what occurred in the open year? Isn't the IRS required to assess and collect the correct amount of tax due for the open year? The answer is that a party (either the IRS or the taxpayer) can avoid the double benefit by foregoing the benefit in the correct open year in order to avoid the application of the mitigation provisions. If that were not the case, the maintenance of an inconsistent position requirement would be a nullity – either party could force open the statute simply by claiming the correct treatment in the open year. The statute expressly requires that the party receiving the double benefit be the one maintaining the inconsistent position in the correct open year. Moreover, the whole purpose of the provisions would be defeated for it is only the claiming of the **double** benefit to which the statute is directed. If there is only one benefit in a barred year, there is no reason to lift the statute of limitations.

4. Other Circumstances of Adjustment; Complications.

a. Double Exclusions of Income.

Now we get into more complex territory. There are two possible scenarios here. In Scenario 1, the taxpayer (i) excludes the item from income in Year 01 when he or she should have included it in that year, (ii) includes the item in income on his or her return in Year 03, and (iii) files a claim for refund for Year 03. In Scenario 2, same facts except the taxpayer does not include the item in Year 03 but the IRS insists that he include it. In either case, the taxpayer can prevail in Year 03 by showing that the item was properly taxed in Year 01 when it was erroneously excluded from income, but the year is now barred except for the operation of the mitigation provisions. I shall go through the elements, as before, but I first ask you to think about the equities.

Let's take Scenario 2 first. Has the taxpayer actively sought a double benefit? He or she did not include the item in the now barred closed year (Year 01). That is a single benefit, not a double benefit. The exclusion of the item from the Year 03 return is totally consistent with the proper treatment of the item – i.e., it was taxable in Year 01 not Year 03. Can or should the IRS be able to force open the now barred year (Year 01) simply by making a bogus claim that it should be included in an open year -- Year 03 of the example? Similarly, in the Scenario 1, the taxpayer just made a mistake by including it erroneously on the return for Year 03; should he or she be able to avoid mitigation by just correcting the mistake in the incorrect open year? If you will think deeply about these scenarios, you will see factors that might justify different treatment. I will develop these factors by addressing the elements of the statute.

First, there must be a determination. I have noted above that the IRS can force a determination -- in the Scenario 1 by denying the claim for refund and in Scenario 2 by issuing a notice of deficiency for Year 03 which will force the taxpayer to pursue litigation in the Tax Court or pay the tax and file a claim for refund.

Second, there must be a circumstance of adjustment. The first scenario is addressed in § 1312(3)(A), and the second is addressed in § 1312(3)(B). So far so good.

Third, correction in the barred year is now closed. Here, a critical distinction is made between the two scenarios. In both Scenarios, the barred correct year (Year 01) is closed at the time of the determination. Section 1311(b)(2), however, creates a special additional requirement for Scenario 2 (where the taxpayer excluded the item in the incorrect open year). As I noted above, in this circumstance there is a single benefit -- erroneous exclusion in the barred year -- and the taxpayer does not seek to exploit a double benefit. If the IRS could force mitigation simply by making a wild assertion in an incorrect open year, the IRS could open up any such barred year. Section 1311(b)(2) requires in the second scenario (taxpayer exclusion on the return in the incorrect open year, also referred to as the § 1312(3)(B) scenario) that the statute of limitations in the correct barred year be open at the time the IRS first maintains the position in the incorrect open year. Thus, the IRS cannot force open a barred year simply by taking a position in an incorrect open year. Now, I ask you why the drafters of the mitigation provisions permit the statute of limitations to be opened up when the statute of limitations for the correct, now barred year was open when the IRS first maintained the position as to the open year? The reason is that it is often not clear when income should be included. Obviously, in that circumstance, the IRS could have taken inconsistent positions -- that it was includable also in the earlier year for which the statute of limitations was still open at the time it adopted the position that it was includable in the later year. So, in order to take the gamesmanship out of that by forcing the adoption of inconsistent positions, the bar on the closed year will be lifted if the IRS could have taken that position for the correct barred year when it first took the position as to the incorrect open year. You should also note that, in this second scenario, there is no requirement that the IRS maintain an inconsistent position in the later year. § 1311(b)(1). Why suspend this requirement here? Simple, in order to take the uncertainty in picking the correct year.

That resolves the issue for the second scenario (where the taxpayer excluded it from income in the later incorrect year). What about the first scenario where the taxpayer included it (albeit erroneously) in the later incorrect year? If you understood why there was an exception in Scenario 2, permitting lifting the bar where the IRS first takes the position when the statute on the now barred correct year is still open, you should understand why the bar is lifted in the Scenario 1. As noted above, it is often ambiguous as to which year an item should be included in income. Many times that is controlled by the taxpayer and, in all cases, the taxpayer is usually more aware of the factors that bear on the resolution of the proper year than is the IRS. If the taxpayer voluntarily and without coaxing by the IRS includes the item in income for the incorrect open year, an argument can be made that the taxpayer should not be heard to later assert that the item should be excluded from income in the incorrect open year without allowing the IRS to open up the correct closed year.

Fourth, and finally, if the elements are met, the IRS can obtain relief in the manner prescribed in § 1314.

b. Double Disallowance of a Deduction or Credit.

Let's assume that the taxpayer does not claim a deduction in Year 01, the correct year for the deduction, and then either does not claim it in Year 03 or, if claimed, the IRS disallows the deduction in Year 03. In either event, there is only one benefit to the IRS -- the tax wrongfully collected in Year 01. What ought the result be, realizing that you are essentially dealing with the same circumstance in reverse that we dealt with immediately above on the double exclusion? Think about it, and the answer will be a parallel answer.

The same equitable factor exists. Should the taxpayer be able to force open a barred correct closed year simply by incorrectly claiming a deduction in an open year? Now let's go through the elements.

First, there must be a determination. OK, you must know by now how a taxpayer can force a determination.

Second, there must be a circumstance of adjustment. There is. § 1312(4).

Third, correction in the barred year is closed at the time of the determination. As in the reverse situation, however, there is special relief if, at the time the taxpayer first took the position in the later year (Year 03 in the example), the statute of limitations was still open on Year 01. § 1311(b)(2)(B). I hope you see the reason. The taxpayer could, of course, file a protective claim for refund for the earlier year (just as in the reverse situation the IRS could issue a protective notice of deficiency). But in order to take the gamesmanship out, the provisions will operate if the statute was open when the taxpayer first maintained the position before the IRS or the Tax Court. Here, too, there is no requirement that the party in whose favor the statute operates has maintained an inconsistent position. § 1311(b)(1).

c. Other.

There are still other circumstances of adjustment, but they are basically variations on the theme in more complicated tax situations. For all of these, you should go through the drill of satisfying the statutory elements. You should, however, be able to intuit when the mitigation provisions might potentially be applicable from the foregoing.

The mitigation provisions are exceedingly complex in more complicated fact patterns and are truly one of the wonders of the Internal Revenue Code. You could spend several classes just on the topic, but what I want you to have is a general understanding of when they might apply. Anytime the IRS or the taxpayer has a double benefit, you should spend the time necessary to see if they apply.

5. Supplementary Reading for Mitigation Enthusiasts.

I commend to your further study on mitigation the best (in my judgment) tax procedure law review article ever written: **John M. Maguire, Stanley S. Surrey and Roger John Traynor,**

Section 820 of the Revenue Act of 1938, 48 Yale L. J. 509 (Part 1) and 719 (Part 2) (1939). Students using this book may not recognize the authors, but they are a team of all-time legal “superstars.” The authors were young brain trusters lured to Washington by Franklin Delano Roosevelt's “New Deal.” They assisted in the drafting and enactment of the mitigation provisions of the Code in the late ‘30s. Maguire and Surrey rose to the heights of tax academia with distinguished private and public careers. Traynor became one of this country's most respected jurists as a Justice on the California Supreme Court where he shaped the debate of thoughtful discussion in many legal areas. All law students and lawyers should at least know who Traynor is. The ultimate contributions to American jurisprudence by each these authors in their own way was foreshadowed by this article.

H. Accounting Method Adjustments.

Section 481 requires that, in computing taxable income for a taxable year of an accounting method change, “there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted * * *.” Section 481 can require inclusion in the current year of items that were, under the new method, improperly deducted in a prior year had the new method applied if, as a consequence of the new method, items will be duplicated or omitted. This can have the practical effect of requiring adjustments for items treated improperly in an otherwise closed year, albeit those adjustments are made in the open year of the accounting method adjustment.⁹²⁵

I illustrate with an example.⁹²⁶ The taxpayer improperly deducts \$100 in Year 01 but it is an isolated improper deduction and not part of an accounting method of the taxpayer in Year 01. The taxpayer has an accounting method in year 01, but this deduction is just erroneous and not related to the accounting method. The taxpayer should properly deduct the item in year 10. In an audit for year 05 after Year 01 has closed, the IRS determines that the taxpayer’s accounting method is incorrect and forces the taxpayer to change the method. In the process, the IRS spots the erroneous \$100 deduction in Year 01. Section 481 would not apply because the \$100 erroneous deduction in Year 01 is not related to the accounting method change. Of course, should the taxpayer claim the deduction in Year 10 when he is entitled to, the IRS can invoke the mitigation provisions or the other equitable doctrines to mitigate the double benefit for the taxpayer.

But, take the same example and assume that the erroneous \$100 deduction claimed in Year 01 was pursuant to the taxpayer’s method of accounting, albeit an erroneous method of accounting. This would mean that, pursuant to that method which should allow a deduction only once, the taxpayer would not be entitled to the deduction in Year 10. Then, if the IRS requires an accounting method change in Year 05, that, if applicable in Year 01 would have deferred the deduction to Year

⁹²⁵ Mingo v. Commissioner, 773 F.3d 629, 635-636 (5th Cir. 2014) (quoting Graff v. Chevrolet Co. v. Campbell, 343 F.2d 568, 572 (5th Cir. 1965) noting that the § 482 adjustment does not happen until the open year and that section 481 would be virtually useless if it did not affect closed years.).

⁹²⁶ This example is inspired by Bosamia v. Commissioner, 661 F.3d 250 (5th Cir. 2011).

10, then the IRS can require that the income in the year of change (05) be adjusted to include the \$100 erroneous deduction. In effect, the IRS has corrected the erroneous deduction in Year 01 in year 05. The taxpayer in this instance can still deduct the item under the now correct method in Year 10.

Ch. 7. Interest.

I. Introduction.

Interest is compensation for the use of money. A taxpayer can use the Government's money by failing to pay taxes due; correspondingly, the Government can use the taxpayer's money by collecting more than the taxpayer owes. The right to compensation for the use of money in the tax context is strictly statutory and is not based upon any equitable or economic notions merely because the taxpayer or the Government benefitted from the interim use of the other's money (which, of course, is the basis for the statute, but in the absence of the statute there would be no right to interest). The Code provides interest in many, but not all, situations in which the Government or the taxpayer uses the other's money.⁹²⁷

II. When the Taxpayer Owes the Government.

A. General.

1. Interest on Underpayments.

The taxpayer uses the Government's money as a result of underpaying his or her tax. Interest is due on tax that is due but not paid from the last date required for the payment through the date it is paid. § 6601(a). liability. The interest compensates the Government's for the taxpayer's use of the tax beyond the date that it was due and unpaid.⁹²⁸

The last date required for payment is generally the last date for filing the return, determined without regard to extensions. § 6151(a).⁹²⁹ As we discussed above, for individuals, that date is April 15, and that is the date payment is due. Individual tax payments not made by April 15 bear interest from April 15. For a corporation, the last date prescribed for payment is 2 ½ months after the end of the tax year – in the case of a calendar year corporation, the payment is due March 15 – and interest will accrue thereafter to the extent of underpayment.

⁹²⁷ For a very good review of the interest rules summarized in this section, see William K. Drew, A Guide to Interest Overpayments and Underpayments of Internal Revenue Taxes, 107 Tax Notes 1271 (6/6/05) and 2005 TNT 108-19 (6/7/05).

⁹²⁸ Interest on an underpayment is “not a penalty but is intended only to compensate the Government for delay in the payment of a tax.” Avon Prods., Inc. v. United States, 588 F.2d 342, 343 (2d Cir. 1978).

⁹²⁹ But see Avon Products, Inc. v. United States, 588 F.2d 342 (2d Cir. 1978) (where the actual deficiency or tax due arose only later in an unusual fact pattern, so that the taxpayer was not charged interest because the tax was not due). The point is to focus on whether the taxpayer in effect has the Government's money and should be charged with the interest.

2. Underpayments of Required Prepayments.

The Code provides mechanisms for prepaying the tax. Thus, an individual employee is subject to withholding against his compensation that effectively prepay the tax prior to the April 15 due date. Similarly, an individual may be required to pay estimated tax prior to the April 15 due date. Does the individual owe the Government interest if he or she does not prepay the tax either by withholding or estimated tax? The technical answer is no.⁹³⁰ What, then, is the taxpayer's incentive to pre-pay via withholding and estimated tax payments? Can the taxpayer achieve an interest-free loan from the Government by not making prepayment until the actual due date? No. Although no "interest" accrues, the cost of paying later rather than as required for withholding or estimated tax is a penalty which is calculated like interest by reference to the underpayment interest rate. §§ 6654 & 6655, referring to § 6621 (the interest provision).

3. Erroneous Refunds.

The taxpayer also uses the Government's money as a result of an erroneous refund of tax. During the period the taxpayer has the money, the taxpayer is required to pay interest on the erroneous refund. However, under a special rule, the interest may be abated if the amount of the refund is \$50,000 or less and the refund was not caused in any way by the taxpayer.⁹³¹

B. Underpayment Interest Rates.

1. General.

The underpayment interest rate is the federal short-term borrowing rate plus 3 percentage points. § 6621(a)(2). The interest rate is reset quarterly and announced in a Revenue Ruling. For the third quarter 2015, this interest rate is 3%.⁹³² Interest is compounded daily.⁹³³ Since the interest rate may vary from quarter to quarter, in order to compute the interest due on an underpayment, it is necessary to consider all the interim quarterly rates from the due date of the underpayment.

2. Large Corporate Underpayments ("Hot Interest").

Section 6621(c) imposes a higher rate for large corporate underpayments defined as a C corporation underpayment exceeding \$100,000. The interest rate is 2 percentage points above the

⁹³⁰ § 6622(b).

⁹³¹ § 6404(e)(2). In *Allcorn v. Commissioner*, 139 T.C. 53 (2012), the Court held that, even if an erroneous refund is collected by assessment and levy procedures rather than an erroneous refund suit under § 7405, if it could have been collected by erroneous refund suit, the test for abatement of interest is under § 6404(e)(2).

⁹³² Rev. Rul. 2015-12, 2015-26 IRB 1.

⁹³³ § 6622. The exception is for the calculation of the addition to tax for underpayments of estimated tax. § 6622(b).

normal rate. For the third quarter of 2015, this interest rate is 5%.⁹³⁴ This interest rate also is re-set quarterly in the same manner as regular interest. For the period to which the additional rate applies, the base to which the rate applies is the same base as the underlying tax liability base.⁹³⁵ Practitioners often refer to this additional interest as “hot interest.”⁹³⁶

The hot interest rate applies from the earlier of (1) the first letter of proposed deficiency or (2) the notice of deficiency. § 6621(c)(2)(A). Thus, the higher rate does not apply from the due date of the return, but only from the first date that the taxpayer is advised that deficiencies will be asserted.⁹³⁷

This hot interest rate does not apply to the extent that the taxpayer pays during the 30 day period from the starting date. The higher rate encourages large corporations to borrow from others rather than the Government, by giving them the incentive to pay the Government earlier than they would otherwise have paid. Bottom-line, if the corporation can borrow for a lesser interest rate than the large corporate underpayment rate, it will have an incentive to pre-pay the Government. In practice, many corporations will estimate the amount they expect to pay when the audit is finally concluded and litigated, so that they can pay the amount of the estimate to stop the accrual of this higher interest. Of course, to the extent that they underestimate, the hot interest will apply.

3. Deferred Estate Tax on Closely Held Business.

A special low interest rate applies to estate taxes attributable to closely held businesses (including farms) that are deferred under § 6166. § 6601(j). That provision permits deferral for up to 15 years -- with payments of interest for up to five years and with equal principal payments and accrued interest at the special rate for the next ten years. The interest rate is 2% on a portion and 45% of the regular interest rate on the balance. The complex computations are basically designed to give a 2% interest rate on \$1,000,000 and 45% of the regular rate on the balance attributable to small business. Under time value of money principles, these favorable rates have the effect of significantly lowering the effective estate tax. (Example: if I owe \$1 which I can either pay today or defer for 10 years at an annual interest cost of 1%, the effective current economic cost of the

⁹³⁴ Rev. Rul. 2015-12, 2015-26 IRB 1.

⁹³⁵ See Med James, Inc. v. Commissioner, 121 T.C. 147 (2003) where the taxpayer had understated its tax liability by \$255,753 in Year 1 but had a net operating loss in Year 2 which it carried back to Year 1 to bring the Year 1 understatement to \$63,573, easily under the \$100,000 threshold for hot interest. Under the rules for calculating regular interest, the base for calculating interest is \$255,753 until the Year 2 tax return is due but then, because of the effect of the NOL carryback, the base is reduced for subsequent period interest calculations. The IRS argued that the threshold \$100,000 determination is made without regard to the effect of the NOL. The taxpayer argued otherwise. The Tax Court held for the taxpayer.

⁹³⁶ See RHI Holdings, Inc. v. United States, 142 F.3d 1459 (Fed Cir. 1998).

⁹³⁷ A functionally equivalent starting point applies to interest on taxes not subject to the deficiency procedures. § 6621(c)(2)(B)(i).

deferred payout today is substantially less than \$1; economically, of course, I will choose the deferred payout.) Thus, estates with closely held businesses as a major part of the estate pay a significantly less estate tax than estates of equal net value with liquid assets such as stocks and bonds.⁹³⁸ The “cost” of this very significant benefit is that the interest is not deductible for estate tax purposes.⁹³⁹

C. Relief from the Accrual of Interest.

1. General.

Since interest on an underpayment is simply compensation for the taxpayer’s interim use of the Government’s money, there is generally no equitable reason for the Government to waive the interest. The taxpayer owed the Government and, because he did not pay, had the use of the money after the due date and should pay interest on it. Accordingly, the general rule is that there is no relief from interest on an underpayment.⁹⁴⁰

2. Abatement of Interest Otherwise Due.

The Code allows abatement of interest on income tax otherwise due in certain limited situations “where failure to abate interest would be widely perceived as grossly unfair.”⁹⁴¹ I discuss here the ones that are most important in terms of your practice.

a. Delays for Ministerial or Managerial Acts.

Section 6404(e)(1) permits the IRS to abate interest for certain types of taxes (most prominently those to which the deficiency procedure applies)⁹⁴² for the period during which there

⁹³⁸ Estates with closely held businesses also usually qualify for beneficial valuation reductions that have the further effect of reducing the effective tax rate as compared to estates with more liquid assets.

⁹³⁹ § 2053(c)(1)(D). Foregoing the interest as a deduction against the estate tax eliminates one of the significant procedural problems of deferred estate tax payments -- the periodic reduction of the taxable estate and estate tax as interest is accrued and paid.

⁹⁴⁰ Johnson v. United States, 602 F.2d 734, 738 (6th Cir. 1979) (without a specific statutory exception, neither the IRS nor the courts have the authority to excuse a taxpayer from interest); Suffness v. United States, 974 F.2d 608, 610 (5th Cir. 1993) (interest compensates for the Government's loss of use of the money, regardless of the reason for the late payment).

⁹⁴¹ Krugman v. Commissioner, 112 T.C. 230, 238-239 (1999) (quoting H.R. Rept. No. 99-426, at 844 (1985), 1986-3 C.B. (Vol. 2) 1, 844; S. Rept. No. 99-313, at 208 (1986), 1986-3 C.B. (Vol. 3) 1, 208).

⁹⁴² You will recall that the deficiency procedure applies principally to income and estate and gift taxes. Thus, for example, employment tax is not subject to deficiency procedure and does not qualify for the interest abatement. Woodral v. Commissioner, 112 T.C. 19 (1999); Miller v.

were unreasonable delays attributable to the IRS's failure to perform ministerial or managerial acts and no significant aspect of the delay was caused by the taxpayer.

This relief is discretionary – the statute says the IRS “may abate.” If the taxpayer requests this relief and it is denied, he has a judicial remedy for abuse of the discretion granted. If the taxpayer is not a large taxpayer (defined in the same way that disqualifies a large taxpayer from obtaining attorneys fees if he prevails in tax litigation), the taxpayer may litigate the IRS’s denial of relief in the Tax Court. § 6404(h).⁹⁴³ Tax Court jurisdiction is exclusive for § 6404(e)(1) interest abatement.⁹⁴⁴

b. Reliance on Written IRS Advice.

Section 6404(f) requires the IRS to abate interest attributable to erroneous written advice given to a taxpayer by the IRS if (1) the taxpayer reasonably relied on the written advice given in response to a written request and (2) the taxpayer did not provide inadequate or inaccurate information. This relief is not discretionary if the factual requirements are met – the statute says that the IRS “shall abate.” Courts may thus review de novo the presence of the facts that require the relief. The statute does not provide a special Tax Court remedy, and hence the taxpayer will normally be able to litigate the issue only in a refund forum.

c. Delay in Notification of Tax Liability.

If an individual taxpayer (not a corporate taxpayer) is not notified of the asserted tax liability within 3 years⁹⁴⁵ after the later of the original due date of the return (April 15 for individuals on the calendar year) and the actual filing date if within an extension period, interest⁹⁴⁶ is suspended from the end of the 3-year period until 21 days after the taxpayer is so notified. § 6404(g)(1) & (3).⁹⁴⁷ Notice includes both a notice of deficiency and, if earlier, a notice of proposed adjustment. A timely return (either by the original due date or the extended due date) is required. An amended return will

Commissioner, 310 F.3d 640, 644 (9th Cir. 2002); and Scanlon White, Inc. v. Commissioner, 472 F.3d 1173 (2006).

⁹⁴³ As to the small taxpayer limitation, see § 7430(c)(4)(A)(ii) which refers to 28 U.S.C. § 2412(d)(2)(B) which denies relief to certain taxpayers as therein defined.

⁹⁴⁴ Hinck v. United States, 550 U.S. 501 (2007).

⁹⁴⁵ The period that must elapse before interest is suspended was increased to 3 years for notices after November 25, 2007. Previously, that period was 18 months.

⁹⁴⁶ Interest-like additions –“addition[s] to tax and additional amount[s]” – are also suspended. These interest like additions are such additions “computed by reference to the period of time the failure continues to exist and which is properly allocable to the suspension period.” § 6404(g)(1).

⁹⁴⁷ This Code section has been amended several times. On June 20, 2007, the IRS issued proposed and temporary regulations consolidating the guidance for the amendments. As usual, the Regulations should be consulted.

generally not affect the running of this period; however, if an amended return or other signed document is filed showing an increase in tax liability, the 3-year period does not begin to run with respect to the items that gave rise to the additional tax liability until that amended return or other signed written document is provided to the IRS.⁹⁴⁸ This suspension of interest gives the IRS an incentive to audit and complete the audit earlier rather than later in the normal statute of limitations period.

The interest exemption does not apply in certain cases. The more commonly encountered exceptions are: (i) § 6651 (failure to pay penalties), (ii) any tax, penalty or interest attributable to fraud, (iii) any interest or penalty with respect to tax shown on the return, and (iv) any “reportable transaction with respect to which the requirement of section 6664(d)(2)(A) is not met and any listed transaction (as defined in 6707A(c)).” § 6404(g)(2). Why do you think the IRS exempted these categories?

The suspension of interest does not affect the running of the statute of limitations on assessment.

3. Delay in Assessment After Waiver of Restrictions.

If, in response to proposed deficiency assessment by the IRS, the taxpayer signs a waiver of restrictions on assessment (**Form 870 or Form 4549 for income taxes**) and the IRS fails to assess within 30 days, interest on the deficiency will be suspended. The suspension period is through the date the assessment is made. § 6601(c).

As I note elsewhere, the purpose of the waiver of restrictions on assessment is to waive the statutory requirement that the IRS issue a notice of deficiency before making an assessment. You will recall from the statute of limitations chapter that § 6213(a) prohibits the IRS from making an assessment unless the IRS first issues a notice of deficiency and then waits at least 90 days thereafter to give the taxpayer time to file a petition in the Tax Court; the Form 870 waiver or Form 4549 (and its counterparts for taxes other than income taxes) waives the requirement of a notice of deficiency and permits immediate assessment.

The rationale for this suspension of interest if the tax is not assessed within 30 days of the waiver is that, without the predicate requirement of a notice of deficiency, the IRS should set about making the assessment promptly and, if it fails to do so within 30 days, it is fair to suspend interest. As noted above, at one level, since the taxpayer continues to use the money even if the IRS delays the assessment beyond 30 days, it would not be inequitable to charge rent on that use. However, the policy decision here is not that the taxpayer has not benefitted by the use of money during the period, but that the IRS must be encouraged to move promptly to make the assessment. The suspension of interest gives the IRS the incentive to get its processes in order.

⁹⁴⁸ § 6404(g)(1) (flush language). See ILM 200815034, published at 2008 TNT 72-14 (citing Prop. Treas. Reg. 301.6404-4(a)(2)(i) and applying the concept to returns filed under the LCCI initiative with regard to offshore bank accounts and credit cards).

4. Prompt Payment Grace.

There is still one other interest-free period, although it is quite brief. If the deficiency is under \$100,000, no interest accrues from the date of notice and demand for payment for 21 days if the taxpayer pays during that period. If the deficiency is over \$100,000 that grace period is 10 days.⁹⁴⁹

D. Making and Contesting IRS Interest Calculations.

Interest calculations can be exceedingly complex. I do not introduce those complexities here. For purposes of getting ball park interest numbers for assisting most taxpayers in making strategy decisions, there are computer programs to calculate interest that work well. I use a program called TaxInterest software, authored by Time Value Software,⁹⁵⁰ that serves me and my client's purposes to get a pretty good idea of what the interest and penalties will cost. (I offer some calculations of interest using this program in the Appendix B to this text.) For situations requiring a more precise calculation, large accounting firms have staffs that calculate deficiency or refund interest more precisely. The need for that level of calculation and specificity usually arises when the IRS has made or proposes to assess and the interest the IRS calculated is sufficiently large that it is worth checking. The IRS does make mistakes in its calculations. Large taxpayers have found it in their interest to pay substantial fees – often contingency fees – to accounting firms and other interest specialists to check up on the IRS on the calculations.

Interest, however calculated, is generally assessed automatically at the same time that the tax is assessed (and then periodically after the tax is assessed as to any portions of the tax and interest that remain unpaid). Thus, for example, in a Tax Court case, the Court will determine the deficiency for the year and will not determine the interest, at least in its initial consideration of a case. The IRS, in making the assessment of the deficiency determined by the Tax Court, will calculate the interest and assess it at the same time as it assesses the underlying deficiency determined by the Tax Court. A deficiency notice is not required for assessment of the interest. If the interest is improperly calculated or the taxpayer may be entitled to waiver of interest, the taxpayer may then (after the original Tax Court decision) file a supplemental proceeding in the Tax Court to have the Court determine the correct amount of interest. **§ 7481(c)**.

If an improper calculation of interest occurs outside the context of a predicate Tax Court proceeding, the taxpayer may have to pay the interest and sue for refund if the taxpayer is unable to get the IRS to abate the assessment.

⁹⁴⁹ § 6601(e)(3).

⁹⁵⁰ See www.TimeValue.com/.

E. Payments or Deposits to Stop the Running of Interest.

The issue addressed here is how the taxpayer can mitigate the running of interest on a deficiency. As noted above, interest is rent for the use of money. If the taxpayer owes a deficiency, the taxpayer has use of the IRS's money and interest will accrue. The taxpayer can avoid the accrual of interest by prepaying the ultimate tax liability. The taxpayer may also use the bond procedure to suspend the accrual of interest. The bond is simply a deposit toward ultimate payment. In either case, the taxpayer is not has surrendered control of the money to the IRS, the taxpayer is not earning interest on the money, the IRS via the federal fisc is earning interest on the money, and the taxpayer is therefore not liable to the IRS for interest. Under Rosenman, the case establishing the bond procedure (pp. 235 ff.), the deposit did not accrue interest in favor of the taxpayer if it turned out the bond amount paid exceeded the tax deficiency finally determined.⁹⁵¹ So, if the amount remitted to the IRS exceeded the amount of the deficiency finally determined, there was a real economic difference between the payment and the bond procedure.⁹⁵²

Under § 6603, the bond / payment distinction is retained but the economic difference is mitigated somewhat. Section 6603 now codifies and modifies the bond procedure as follows:

⁹⁵¹ The administrative round rules for the bond procedure under Rosenman were set forth in Rev. Proc. 84-58, 1984-2 C.B. 501, which has now been superseded by Section 6603 and the IRS guidance issued under that Section, Rev. Proc. 2005-18, 2005-13 IRB 798.

⁹⁵² For a costly example, see Ford Motor Co. v. United States, 768 F.3d 580 (6th Cir. 2014), cert. denied ___ S.Ct. ___, 2015 U.S. LEXIS 4225 (2015). The Sixth Circuit summarized the tradeoffs between the two procedures (p. 588):

So when Ford sent its remittances, it faced a tradeoff: If a taxpayer remitted a cash-bond deposit but subsequently demanded the deposit's return, the IRS would not pay the taxpayer any interest for the period during which the government held the funds. When a taxpayer demanded a refund of an excessive advance tax payment, by contrast, the IRS allowed the taxpayer to recoup interest. Thus the revenue procedures forced taxpayers to choose: immediate access without interest, or interest without immediate access.

To Ford's credit, it made a creative, if ultimately unavailing, argument. The argument was that, under § 6601, interest accrues on underpayments, so prepayments reduce the amount of underpayments and logically reduce interest on the underpayment. By the IRS concession that a deposit also reduces interest on the interest for § 6601 purposes, the IRS must be saying that a deposit is a payment (because, under the statute, only payments reduce the underpayment subject to interest). If it is a payment for purposes of the interest reduction under § 6601, Ford argued, it must also be interest for purposes of § 6611 which allows interest to accrue in favor of the taxpayer over-depositing. The Court rejected the argument. Ford is a knowledgeable taxpayer which knew precisely how to get interest from the date of payment but chose instead to deposit. (In rejecting the argument, the Court said that the claimed inconsistency might be resolved by not allowing the deficiency interest reduction in § 6601.)

(1) The taxpayer may make a cash deposit with respect to any tax that has not been assessed at the time of the deposit.⁹⁵³ This is a codification of practice under Rosenman.

(2) When and to the extent that the deposit is applied against a tax liability, the amount is deemed a payment at the time of the original deposit.⁹⁵⁴ Under the interest accrual rules discussed above, this will suspend the running of interest on the amount of the deposit just as if it had been designated a payment at the time. This is a codification of practice under Rosenman.

(3) To the extent not yet applied in payment of a tax, the IRS will return the amount of the deposit.⁹⁵⁵ This is a codification of practice under Rosenman.

(4) Any deposit returned under (3) will carry interest to the extent attributable to a “disputable tax” during the period of the deposit.⁹⁵⁶ The interest rate is the federal short term rate (i.e., 3% less than the overpayment / refund rate for individuals).⁹⁵⁷ This is a taxpayer favorable modification of practice under the Rosenman rule which did not allow interest on any portion of a deposit that is returned to the taxpayer (and correspondingly did not suspend the running of interest on any underlying tax). In effect, under the prior Rosenman practice, the Government had use of the taxpayer’s money for a period for which it did not pay rent via interest. Now, at least to the extent of a disputable tax, the taxpayer can get interest on return of the deposit. The taxpayer is allowed to make a reasonable estimate as to the maximum tax on disputable items.⁹⁵⁸ Disputable items, in turn, are defined as items as to which the taxpayer has both a reasonable basis and a reasonable belief that the IRS could have a reasonable basis to disallow the taxpayer’s position.⁹⁵⁹ The reasonable estimate is at least the amount the IRS has claimed in a 30-day letter.⁹⁶⁰

As indicated, the key modification to the practice under the Rosenman rule is the provision for interest on reasonable estimates as to disputable items. This substantially increases the benefit of the use of the bond as opposed to prepayment of the tax.⁹⁶¹ The practice under § 6603 is set forth

⁹⁵³ § 6603(a).

⁹⁵⁴ § 6603(b). Since deemed a payment at the time applied to the tax, the statute of limitations for refunds will be calculated from that date. See ECC 201316015 (2/14/13), reproduced at 2013 TNT 77-45.

⁹⁵⁵ § 6603(c). In PMTA 2010-067 (12/16/10), reproduced at 2011 TNT 78-14, the IRS concluded that it had no authority to apply any excess § 6603 payment to other taxes under either its statutory authority in § 6402(a) or its general offset authority.

⁹⁵⁶ § 6603(d)(1). See CC-2010-002, reproduced at 2009 TNT 232-18.

⁹⁵⁷ § 6603(d)(4).

⁹⁵⁸ § 6603(d)(2)(A).

⁹⁵⁹ § 6603(d)(3)(A).

⁹⁶⁰ § 6603(d)(2)(B).

⁹⁶¹ See Peter H. Winslow, Samuel A. Mitchell and Joseph A. Sergi, Jobs Act May Change the Economics in Favor of Deposits, 105 Tax Notes 1149 (Nov. 22, 2004).

in a Revenue Procedure,⁹⁶² and Regulations will undoubtedly be issued in the future. The Rev. Proc. addresses a number of key practices that will be observed in applying § 6603 and thus is a must read for those considering making a deposit or a payment during the course of an audit, but the following points should give you a sampling of some of the ground rules:

(1) Sets the procedure for a taxpayer to lay the foundation for a taxpayer establishing the disputable tax requirement (via a statement sent with the deposit).⁹⁶³

(2) Cautions that a deposit made before or during an examination will be applied as payment of the tax if the taxpayer executes a waiver of the restrictions on assessment, so that if the deposit fully covers the amount of the assessment pursuant to the waiver, there will be no deficiency notice issued and the taxpayer will not have a Tax Court remedy.⁹⁶⁴ The taxpayer can prevent this by asking for and getting refund of some portion of the deposit so that there will be an unpaid amount once the waiver of the restrictions on assessment is signed.

(3) An undesignated remittance received by the IRS when there is no outstanding liability or proposed liability will be treated as a deposit.⁹⁶⁵ If there is no statement of the disputable tax, the taxpayer may forego interest on a deposit that is returned.

The deposit will serve the function of suspending interest to the extent that it is not returned to the taxpayer but is applied to the payment of a tax liability.

The key contexts in which the bond procedure should be considered are:

First, the deposit can be used to stop the running of interest while preserving the taxpayer's right to litigate in the Tax Court. Thus, assume the taxpayer is in audit and expects significant adjustments, but the audit and appeals processes have not yet been finalized. If the taxpayer were to make a remittance to the IRS as a payment, the amount might fully pay any tax that is subsequently determined to be due and thus the IRS would not issue a notice of deficiency. As we will discuss, the notice of deficiency is generally the ticket to the Tax Court – no notice of deficiency, no Tax Court remedy. In order to guard against the possibility of wiping out a deficiency, the taxpayer might want initially to designate the remittance as a deposit, but ask that the deposit be applied as a payment after the notice of deficiency is issued.⁹⁶⁶ For optimum funds

⁹⁶² Rev. Proc. 2005-18, 2005-1 C.B. 798. For example, the Revenue Procedure provides transitional rules for amounts on deposit at the time of enactment.

⁹⁶³ § 4.01(1).

⁹⁶⁴ § 4.02(1).

⁹⁶⁵ § 4.04(1).

⁹⁶⁶ Baral v. United States, 528 U.S. 431, 439 n.2 (2000) (“[T]he taxpayer will often desire treatment of the remittance as a deposit -- even if this means forfeiting the right to interest on an overpayment -- in order to preserve jurisdiction in the Tax Court, which depends on the existence of a deficiency, 26 U.S.C. § 6213 (1994 ed. and Supp. III), a deficiency that would be wiped out by

management, the taxpayer might make a split remittance – i.e., designating one part as a payment in just below the amount that the taxpayer estimates to be the an estimate of the amount the IRS may ultimately sustain and the other part designated as a deposit. Then, after the notice of deficiency is issued, the taxpayer could have the deposit amount applied as a payment, so that it can get the maximum possible interest on an amount refunded. In estimating the amount to be applied as a payment either prior to the notice of deficiency or afterwards, the taxpayer of course will want to consider not only interest on a possible refund but also the potential application of “hot interest” as discussed above.

Second, the taxpayer might want to preserve the opportunity to obtain return of the money if doubts are resolved in its favor before the end of the audit and/or litigation process. I illustrate in the following example. Assume that the IRS sends a 30-day letter to a large corporate taxpayer asserting \$1,000,000 in additional tax. The taxpayer assesses its exposure as follows: (1) \$500,000 of the proposed adjustments are good adjustments, so the taxpayer knows that the minimum deficiency and liability is \$500,000; (2) \$250,000 is up in the air -- i.e., the taxpayer might or might not be liable for that amount; and (3) the remaining \$250,000 does not represent good adjustments, so that the taxpayer will not ultimately be liable for that amount. This taxpayer might want to advance \$750,000 to the IRS (plus interest thereon), since that is the maximum reasonable liability. That taxpayer might want to make at least \$250,000 of that advance a deposit, so that if the taxpayer can determine later in the process before assessment (i.e, in IRS appeals or in Tax Court litigation) that the middle \$250,000 or some portion will be resolved in the taxpayer's favor, the taxpayer can ask that the \$250,000 (or some portion) be returned so that the taxpayer can deploy those assets for other more productive uses. In this regard, note that, if that middle \$250,000 were advanced to the IRS as a payment rather than a deposit the interest it might forego on an ultimate refund may not be as significant a benefit as having the flexibility to force a return of a deposit before the underlying tax liability is finally resolved.

These funds management techniques get more critical as the zeros in the potential liability stack up (i.e., if the proposed adjustment were \$100,000,000 rather than \$1,000,000).

Finally, keep in mind that the amounts designated as a payment will be subject to a statute of limitations on refund. We covered statute of limitations earlier. The taxpayer must pay careful attention to insure that the right to refund of the principal amount is not foreclosed by the statute of limitations, for the opportunity to recover any interest depends upon the statute being open to recover the principal amount paid. Of course, if the taxpayer prepays during an audit or during a

treatment of the remittance as a payment.”). In *LaRosa Int’l Fuel Co., Inc. v. United States*, 499 F.3d 1324 (Fed. Cir. 2007), cert denied 127 S.Ct. 2871 (2008), the Court held that an amount paid into an escrow was neither fish nor fowl – neither payment nor deposit, so that the taxpayer was subject to interest on the amount ultimately determined to be due. The escrow account was allegedly used to avoid losing Tax Court jurisdiction if the funds were treated as a payment. The problem, of course, is that the use of the escrow account device meant that the funds were not a deposit either thus avoiding interest on the underpayment.

Tax Court proceeding, the refund statute of limitations will almost certainly be open, but you should go through those rules to be sure. Make no assumptions!

F. Time For Assessment of Interest.

As noted above (p. 213, discussing § 6601(g)), the time for assessing interest with respect to the underlying tax is extended to include the period during which the IRS may collect the underlying tax.

III. When the Government Owes the Taxpayer.

A. Overpayments.

1. General Rule - Interest is Due.

Interest is generally due where the taxpayer has made an overpayment. In this case, under the use of money construct, the IRS has had the use of the amount of the overpayment during the period that it was not owed and should pay interest.

Section 6611(b) triggers the interest starting date to the date of the overpayment. Where the taxpayer overpays as of the date of the timely return (whether by withholding, estimated taxes, or taxes paid with the timely return), the interest will accrue from the due date of the return. No interest accrues, however, during the period from the due date to the date that a delinquent return is filed in processible form.⁹⁶⁷ The IRS may compute the interest through a date preceding the date of the refund by not more than 30 days.⁹⁶⁸

Keep in mind that we are dealing here with overpayments – when the amount paid exceeds the amount due. We are not dealing with amounts remitted to the IRS under the bond procedure discussed above. Amounts in excess of the tax due under the bond procedure are not overpayments but amounts deposited with the IRS that may be returned to the taxpayer upon request.

⁹⁶⁷ § 6611(b)(3) (no interest until delinquent return filed); and § 6611(g) (no interest under (b)(3) until the delinquent return is “processable,” meaning generally on the permitted form, with proper identifying information and information to permit the mathematical verification of the tax liability shown on the return. As to the processible requirement, see Deutsche Bank AG v. United States, 2014 U.S. App. LEXIS 2876 (Fed. Cir. 2014). Where, however, the taxpayer is not required to file a return, overpayment interest may accrue from the time of the actual payment. See MNOPF Trustees, Ltd. v. United States, 123 F.3d 1460, 1465 (Fed. Cir. 1997) (overpayment resulting from improper withholding for a tax exempt entity not required to file a return).

⁹⁶⁸ § 6611(b)(2).

2. No Interest Prior to the Tax Due Date.

We study elsewhere certain payment mechanisms whereby taxpayers pay the tax in advance of the normal due date required for payment. The most frequently encountered examples of such prepayments prior to liability are withholding from employees' compensation and estimated payments of tax made during the year. Another form of such prepayment is to apply a tax refund due for one year to the tax liability of the succeeding year. No interest accrues on such prepayments through the date the tax is deemed paid (April 15 of the following year in the case of an individual).⁹⁶⁹ Interest will accrue from the date the tax so prepaid is deemed paid (April 15 in the case of an individual) until the refund is made. So, the taxpayer does not get interest for the period of the from the date of the remittance until the date the tax is due (i.e., the period prior to April 15 of the succeeding year when the tax becomes technically due).⁹⁷⁰

3. IRS 45 Day Grace Period on Overpayments.

The IRS has certain grace periods, generally 45 days, during which interest will not accrue if a refund is timely made. These are:

- The IRS has a grace period where no interest is paid if the refund is made within 45 days of (a) the original due date of the return for a return filed on or before the original due date of the return, or (b) the date of filing a return after the original due date (i.e., a delinquent return).⁹⁷¹

⁹⁶⁹ §§ 6611(d) & 6513.

⁹⁷⁰ Assume the taxpayer, an individual, is entitled to a refund of \$100 for Year 1 and applies it toward his tax liability for Year 2. This is the functional equivalent of an actual refund to the taxpayer and the taxpayer's payment of an equivalent estimated tax payment for the Year 2 tax liability as of April 15 of Year 2, the date the refund for Year 1 became due. Assume then, at the end of Year 2, the taxpayer has no tax liability for Year 2. The taxpayer then will be entitled to a refund of the Year 2 tax of \$100 that he prepaid by applying the Year 1 refund. Interest on the Year 2 refund will begin accruing as of April 15 of Year 3, the due date of the Year 2 return. The taxpayer will not get interest for the period that the Government held the money from April 15 of Year 2 until April 15 of Year 3. If, however, the taxpayer had taken the Year 1 refund rather than crediting the Year 1 refund against the Year 2 tax, the taxpayer could have earned interest on the \$100 during that period. Variations of this type of interest free loan to the Government are explored in Marsh & McLennan Cos., Inc. v. United States, 302 F.3d 1369 (Ct. Fed. Cl. 9/6/02). The same phenomenon of denying interest on prepayments is true for all types of prepayments (including withholding and estimated taxes), so where large numbers are involved (as was the case in Marsh & McLennan), taxpayers should take steps to avoid prepaying too much tax.

⁹⁷¹ § 6611(e)(1). Note that the loss of interest from the date of the overpayment through the filing of a delinquent original return is a penalty for filing late if the IRS refunds during that 45 day period.

- If the taxpayer files a claim for refund (i.e., an amended return claiming a refund), the IRS has a grace period of 45 days to pay the refund and interest will not accrue in the 45 day period if it does so;⁹⁷²
- For IRS initiated refunds, the IRS is authorized to subtract 45 days from the date of the refund in calculating the interest on the refund.⁹⁷³
- In each of the foregoing instances, the interest-free grace period is extended to 180 days if the overpayment refunded results from withholding tax for which the taxpayer claims credit.⁹⁷⁴

These grace periods only affect the accrual of interest in the suspension periods – 45 or 180 days respectively.

The IRS’s position is that the refund is tendered when the check is mailed to the proper address (the old “its in the mail” gambit), even if the taxpayer does not receive the check.⁹⁷⁵

B. Interest Rate.

1. General Overpayments.

For individuals, the overpayment interest rate is the same as the general underpayment rate – i.e., short-term federal rate plus 3 percentage points. §§ 6611(a) referring 6621. For the third quarter in 2014, this interest rate is 3%.⁹⁷⁶

2. Special Reduced Corporate Overpayment Rates.

a. General 1% Reduction (the “GATT Rate”).

For corporations, however, the overpayment interest rate is reduced by one percent (i.e., the rate is the short-term federal rate plus 2 percent rather than 3 percent). § 6621(a)(1). (This reduced

⁹⁷² § 6611(e)(2).

⁹⁷³ § 6611(e)(3).

⁹⁷⁴ § 6611(e)(4). This provision was added in 2010 by Public Law 111–147 (HIRE Act) to give the IRS more time for the type of fraud most commonly used for Stolen Identity Refund Fraud.

⁹⁷⁵ FSA 200152001, reprinted at 2001 TNT 251-23.

⁹⁷⁶ Rev. Rul. 2015-12, 2015-26 IRB 1.

interest rate is often referred to as the “GATT rate”⁹⁷⁷). For the third quarter 2014, this interest rate is 2%.⁹⁷⁸

b. Reduction on “Large” Corporate Overpayments.

There is a critical exception – for corporate overpayments exceeding \$10,000 – the short-term federal rate is only increased by 0.5 percentage points. § 6621(a)(1) (flush language).⁹⁷⁹ For the third quarter 2012, this interest rate is 0.5 %.⁹⁸⁰ As you can see, this low interest rate is a powerful incentive for corporations not to loan money to the Government via overpayment of taxes, because they can likely achieve a better return elsewhere. (By the same token, of course, as noted above, the large corporate underpayment interest premium – the so-called “hot interest” in § 6621(c) – creates a powerful incentive to avoid being a debtor to the Government at least after the IRS makes the critical determinations of additional tax due and owing; in short, there are incentives for corporations to better manage the due tos and due froms in the tax area.) Although S Corporations are normally not subject to tax, sometimes they can be; the court opinions conflict as to whether any overpayment by S Corporations will be subject to this reduced interest rate.⁹⁸¹ This reduction is also applied to any amounts due by the Government that are treated as a tax for purposes of calculating interest on the amounts due, such as, for example, interest due on wrongful levies.⁹⁸²

⁹⁷⁷ The statutory language in § 6621(a)(1) (flush language) effecting the reduction was added as part of the Uruguay Round of Multilateral Trade Negotiations conducted under the auspices of the General Agreement on Tariffs and Trade (“GATT”), Pub. L. 103-465, sec. 713(a), 108 Stat. 5001-5002 (1994). For cases involving the effective 1994 effective date (although not a continuing issue, these cases do have discussion of the environment giving rise to the reduced interest rate), see Gen. Elec. Co. v. United States, 384 F.3d 1307 (Fed Cir. 2004), State Farm Mut. Auto. Ins. Co. v. Commissioner, 126 T.C. 28 (2006), and ExxonMobil Corporation v. Commissioner, 126 T.C. 36 (2006), *aff’d* 484 F.3d 731 (5th Cir. 2007).

⁹⁷⁸ Rev. Rul. 2015-12, 2015-26 IRB 1.

⁹⁷⁹ For an interesting application of this reduced interest rate on large corporate overpayments, see General Electric Co. v. United States, 56 Fed. Cl.488 (2003), technically turning on the effective date of this reduced interest (which the opinion refers to as the “GATT rate” because it was enacted by the GATT legislation, Section 713 of the Uruguay Round Agreements Act, Pub. L. No. 103-465, 108 Stat. 4809, 5001 (1994)) but noting by dicta in the parties concession that after the effective date the issue turns wholly upon whether there was an aggregated overpayment in the required amount of \$10,000.

⁹⁸⁰ Rev. Rul. 2015-12, 2015-26 IRB 1.

⁹⁸¹ Garwood Irrigation Co. v. Commissioner, 126 T.C. 233 (2006) (holding the reduced interest rate does not apply); and Eaglehawk Carbon v. United States, 2015 U.S. Claims LEXIS 862 (2015) (rejecting the holding of Garwood).

⁹⁸² Steven N.S. Cheung, Inc. v. United States, 545 F.3d 695 (9th Cir. 2008).

C. Deposits.

I discussed deposits above to illustrate that a deposit stops the running of interest on a deficiency plus accrued interest up to the amount of the deposit. You will also recall that, under Rosenman, generally deposits do not accrue interest in favor of the taxpayer if they are returned to the taxpayer because the deposit exceeds the amount due. **Section 6603** (pp. 277 ff.) mitigates this in some cases by providing for interest on a bond but at a lower rate than the normal overpayment rate.

I return here to the deposit concept to remind you of the downside of deposits when the Government ends up owing the taxpayer. To put this in context, let's assume that, on 12/1/XX, the IRS issues a notice of deficiency for \$1,000,000. The corporate taxpayer calculates the interest on a deficiency of \$1,000,000 is \$1,000,000 by 12/31 of the same year. The corporate taxpayer will file a Tax Court petition to contest the deficiency and believes that it will ultimately prevail on ½ of the asserted deficiency (and, since the interest is just ad valorem based on the deficiency, on ½ of the calculated interest). Accordingly, on 12/31/XX, the taxpayer sends \$1,000,000 to the IRS. Let's assume then that the taxpayer succeeds spectacularly and eliminates the deficiency altogether. If the taxpayer had sent the \$1,000,000 as a deposit, the taxpayer will be entitled to return of the \$1,000,000 and may either get no interest or interest at the reduced § 6603 rate.

Why would a taxpayer direct a remittance to the IRS be treated as a deposit? The advance treated as a deposit will, like a payment, stop the running of interest if there is a deficiency. So, in terms of stopping interest on a deficiency, the deposit acts just like a payment. However, as noted, historically, the deposit did not draw interest if the bond is in excess of deficiency and accrued interest on the deficiency, whereas a payment will draw interest to the extent it exceeds the deficiency plus accrued interest on the deficiency. In 2004, Congress provided for interest at the federal short term rate on some deposits. An overpayment will draw interest under the rules noted above – e.g., for individuals, it is the federal short term rate plus 3%. So there is still a 3% interest cost to a deposit that is returned to a taxpayer as opposed to a payment that is returned to the taxpayer. The advantage to a taxpayer of making the advance to the IRS as a deposit rather than a payment is that the taxpayer can, upon request, require the IRS to return an amount sent as a deposit. It is a rare case where this advantage will justify giving up the potential right to interest if the taxpayer has overestimated the payment that is required.

D. Interest on Judgment of Refund.

When an overpayment is determined in a tax refund suit and incorporated in a court judgment, the interest on the judgment is the same as the overpayment rate discussed above.⁹⁸³

⁹⁸³ 28 U.S.C. § 2411.

IV. Miscellaneous Interest Issues.

A. Interest on Penalties.

The penalties that are subject to the deficiency procedures (most prominently the fraud and accuracy related penalties that I discuss below) accrue interest from the due date of return. § 6601(e)(2)(B).⁹⁸⁴ I hope that you understand why. If interest did not accrue, a taxpayer subject to the penalty could delay the assessment of the penalty and thus mitigate the economic impact of the penalty. So-called assessable penalties (i.e., those not requiring a notice of deficiency)⁹⁸⁵ often do not accrue interest until the notice and demand for payment (with parallel 21/10 day grace periods from the date of notice and demand for payment). § 6601(e)(2)(A).⁹⁸⁶

B. Carrybacks and Carryforwards.

The Code provides for certain carrybacks and carryforwards which have the effect of mitigating some of the harsh consequences of the requirement that taxes be computed annually. For example, a new corporate taxpayer may lose \$1,000,000 in the first year (with the losses achieving no tax benefit) and earn \$1,000,000 in the second year. If there were not a mechanism to consider the losses in the first year, this corporate taxpayer would have a substantial Year 2 tax liability, even though economically it has made no net profit. Thus, the Code permits a taxpayer having certain tax beneficial attributes (e.g., net operating losses or foreign tax credits) that the taxpayer cannot use in the year in which they accrue to carry them back to an earlier year or carry them forward to a later year.⁹⁸⁷ The carrybacks and carryforwards permit the taxpayer to “set off its lean years against its

⁹⁸⁴ The reference to “under part II of subchapter A of chapter 68” includes the accuracy related and civil fraud penalties.

⁹⁸⁵ For example, the penalties under § 6677 for failure to file Forms 3520 and 3520A (required by §§ 6048 and 6038(b)) and § 6707A (failure to disclose participation in certain tax advantaged transactions) are assessable penalties not requiring a predicate notice of deficiency. See, as to § 6707A, *Smith v. Commissioner*, 133 T.C. 424 (2009).

⁹⁸⁶ An example of an assessable penalty that bears interest only from the date of the assessment is the § 6672 trust fund recovery tax penalty. See *Purcell v. United States*, 1 F.3d 932, 942 (9th Cir. 1993). However, the failure to file penalty under § 6651(a)(1) runs from the due date of the return. § 6601(e)(2)(A). The failure to pay penalty (FTP) is an assessable penalty that does not bear interest until assessed.

⁹⁸⁷ § 172(b)(1)(A) (NOL deductions). The carryback period has been extended for eligible small businesses pursuant to an amendment to § 162(b)(1)(H) by the American Recovery and Reinvestment Act of 2009. The amendment permits electing small businesses a 3,4 or 5 year carryback for net operating losses, rather than the usual 2 year carryback. The Worker, Home Ownership and Business Assistance Act of November 26, 2009 contained a provision to allow most taxpayers an increased carryback period for losses in 2008 and 2009. This new provision is not limited to small businesses. See David Culp, Josh Kaplan, Alla Kashlinskay, Rob Liquerman, Steven Lainoff and Paul Manning, *New Law Provides Five-Year Carryback for 2008 or 2009 NOLs*,

lush years, and to strike something like an average taxable income computed over a period longer than one year.”⁹⁸⁸ The carryback (as opposed to carryforward) period is **generally** 2 years.⁹⁸⁹

A carryback to an earlier year can create an overpayment and resulting right to a refund in the earlier year. For example, if an individual taxpayer pays \$100 tax for Year 1 and, in Year 2, incurs a net operating loss that can be carried back to Year 1, the loss will create an overpayment of all or a portion of the Year 1 tax paid. For purposes of computing interest on the overpayment, the overpayment is deemed to occur at the earliest on the original due date of the Year 2 return.⁹⁹⁰ However, if the IRS pays the resulting refund within the 45 day grace period after filing the Year 1 refund claim incorporating the NOL carryback, the taxpayer will be entitled to no interest on the overpayment.⁹⁹¹

What happens in the above example if Year 1 is a deficiency year so that the effect of a carryback from Year 1 is to reduce or eliminate the deficiency? Interest, of course, accrues on deficiencies, so the question is what effect the carryback has on the accrual of interest on the deficiency for Year 1. To the extent that the carryback reduces a deficiency for the earlier year, interest still accrues on the deficiency in the prior year until the return is filed for the year of loss.⁹⁹² Thus, in this example, interest on the Year 1 underpayment (deficiency) will accrue from the due date of the Year 1 return to the filing date of the Year 2 return claiming the loss giving rise to the carryback.

C. Mutual Indebtedness, Setoffs and Interest Netting.

Frequently, particularly with large corporate taxpayers, there will be years where substantial refunds are due and other years for which substantial deficiencies are due.⁹⁹³ A strict application of the interest rate rules noted above could mean that the taxpayer owes the large corporate interest rate (federal short-term rate plus 5 percentage points) on the underpayments and yet is entitled to only the corporate overpayment rate (federal short-term rate plus .05 percentage point) on its

126 Tax Notes 467 (Jan. 25, 2010).

⁹⁸⁸ Libson Shops, Inc. v. Koehler, 353 U.S. 382, 386 (1957).

⁹⁸⁹ This carryback period was extended up to 5 years for NOL arising in 2008 and 2009. § 172(b)(1)(H). The reason was, of course, the drastic downturn in the economy during those years for which Congress felt an extended carryback period was appropriate.

⁹⁹⁰ § 6611(f)(1) and (4) (earliest date for interest is the filing date for the loss year return, but filing date is defined as the original due date). The rule was applied in an unreported decision in Hunt v. United States (4th Cir. - No. 02-1896), unofficially reported at 2004 TNT 127-13 (7/1/04).

⁹⁹¹ This rule may be gathered from the language of § 6611(f)(4)(B). I don't encourage anyone to sort this out unless they have a real need.

⁹⁹² § 6601(d).

⁹⁹³ A common instance where this occurs is where the IRS denies the taxpayer deductions in an earlier year that are then allowed in a later year.

contemporaneous overpayments, when in fact there was really no net amount due the Government. Even though there is no net principal amount due, the net interest rate cost (4.5%) could be major.⁹⁹⁴

The Code provides two mechanisms for resolving this inequity. First, if the IRS credits an overpayment against an underpayment,⁹⁹⁵ interest does not accrue on the underpayment during any period for which the taxpayer would have been entitled to a refund on the overpayment being credited.⁹⁹⁶ One problem with this relief provision is that the IRS is not required to credit, but may actually refund the overpayment and demand the underpayment, thus making the relief unavailable. Second, under a provision commonly referred to as the “global interest netting” the interest rate is zero in such mutual indebtedness situations by the same taxpayer during the period of mutual indebtedness.⁹⁹⁷ This relief is not discretionary.

D. Restricted Interest.

The IRS uses the term “restricted interest” to mean “any interest that is computed from other than the normal interest start and stop dates.”⁹⁹⁸ The difference between restricted interest and normal interest is “that the computer may not be able to identify all conditions involved in a

⁹⁹⁴ In Federal National Mortgage Association v. United States, 379 F.3d 1303 (Fed. Cir. 2004), the Court noted that this disparity generated a net interest cost of over \$10,000,000 for the periods involved. The taxpayer obtained no relief there because the court held that, during the transition period, both the refund and deficiency statutes of limitation need to be open.

⁹⁹⁵ § 6402(a).

⁹⁹⁶ § 6601(f).

⁹⁹⁷ § 6621(d). In Energy East Corp. v. United States, 645 F.3d 1358 (D.C. Cir., 2011), the court held that, really, “the same taxpayer” requirement of the statute means “same taxpayer” when the offsetting overpayment and underpayments existed. Actually, perhaps, the issue was more nuanced than that, but not much. The corporations were separate taxpayers wholly unrelated to the parent corporation when the underpayment was due and the overpayments were made.

In Exxon Mobil Corp. v. Commissioner, 689 F.3d 191 (2d Cir. 2012), the Second Circuit applied this interest netting rule retrospectively based on its interpretation of special non-codified legislation that permitted such retrospective application prior to the date of enactment of the required interest netting prospectively. This precise holding is probably of no future precedential importance because of its limited nature for the retrospective years, but the Second Circuit does have some interesting analyses of statutory interpretation in reaching the conclusion. Moreover, for procedural reasons, the issue appears to be most often presented in cases that must be pursued in the Court of Federal Claims which has a pro-government interpretation. See Marie Sapirie, Exxon Mobil Shows Importance of Transition Rules, 136 Tax Notes 873 (Aug. 20, 2012).

Finally, in Wells Fargo & Co. v. United States, 119 Fed. Cl. 27 (2014), the Court held that two separate taxpayers who merge under state law, which generally for state and tax purposes treats the merged entity as the same as both of the merging entities, were entitled to interest netting with regard the pre-merger offsetting positions of the two merging entities.

⁹⁹⁸ IRM 20.2.1.6.5(1) (07-18-2008).

restricted interest situation,” so the restricted interest calculations cannot be completed by the computer and must be computed by someone familiar with the interest restrictions.⁹⁹⁹ For example, § 6404(g) provides for interest suspension periods and thus requires special interest calculations taking into account the interest suspension period.¹⁰⁰⁰ Section 6621(c) provides some cross-references to Code Sections which restrict interest, but the IRM compiles the provisions of the Code restricting interest.¹⁰⁰¹

E. Deficiency or Refund Interest Paid or Accrued.

Interest received by the taxpayer on overpayments is taxable income.¹⁰⁰² Interest paid by the individual taxpayer on deficiencies, however, is personal interest which is not deductible by individuals.¹⁰⁰³ Interest paid by the corporate taxpayer, however, is not personal interest and may be deducted.¹⁰⁰⁴ In short, the interest deduction mitigates the corporate taxpayer's cost for borrowing from the Government via underpaid taxes.

F. Contesting Interest Calculations.

Interest is a function of the amount of the principal and the length of time involved. Interest on underpayments or overpayments can be significant depending upon the amount of tax and/or time involved. The actual interest calculations can be arcane.¹⁰⁰⁵ That is why accounting firms and in-house tax departments spend considerable time checking the IRS interest calculations.

The taxpayer may contest the IRS interest calculations if the taxpayer disagrees with the IRS and is unable to resolve the calculation internally. Section 7481(c) gives the Tax Court jurisdiction to redetermine IRS interest calculations which are based on the tax and penalties determined in a Tax Court case.¹⁰⁰⁶ The taxpayer must fully pay the tax and interest, thus making the procedure in

⁹⁹⁹ IRM 20.2.8.1(1) (12-04-2009)

¹⁰⁰⁰ IRM 20.2.7.6 (08-01-2006).

¹⁰⁰¹ IRM Exh. 20.2.8-1 (12-04-2009).

¹⁰⁰² § 61(a)(4).

¹⁰⁰³ § 163(h). See Robinson v. Commissioner, 119 T.C. 44 (2002) discussing the cases on this subject.

¹⁰⁰⁴ § 163(a).

¹⁰⁰⁵ Thomas Johnston, Ian Friedman, and Richard Gagnon, Jr., Third Circuit Warns in Sunoco: Don't Put Off Interest Issues, 134 Tax Notes 1155 (Feb. 27, 2012).

¹⁰⁰⁶ Apart from the special grant in § 7481(c), the Tax Court generally lacks jurisdiction to hear disputes about interest. Bax v. Commissioner, 13 F.3d 54, 56 (2d Cir. 1993); ASA Investerings Pship. v. Commissioner, 118 T.C. 423, 424 (2002); LTV Corp. v. Commissioner, 64 T.C. 589, 597 (1975). This is because assessment of interest, unlike assessment of the tax, does not require a predicate notice of deficiency. See § 6213(a) requiring a predicate notice of deficiency for the tax.

effect a refund procedure. The procedure must be brought within one year of the date the Tax Court decision becomes final.¹⁰⁰⁷ In other cases, where the taxpayer disagrees with the IRS's interest calculations on a deficiency, the taxpayer may pay the tax and interest, file a claim for refund and bring a refund suit.¹⁰⁰⁸

Finally, at least in large dollar tax cases where interest is also large, the interest issues should be addressed and identified early so as to not have a procedural footfault as the dispute over the correct tax liability grinds along.¹⁰⁰⁹

G. Who Really Does This Type of Work?

The procedures for calculating restricted interest, somewhat arcane in application, are beyond the scope of this work.¹⁰¹⁰ Interest calculations (including restricted interest calculations) are for the back room green eye shade guys, and not us lean and mean gregarious tax lawyers, so I recommend that my students pass this work on to guys with the skills and personality to see the calculations through. In this regard, most major accounting firms and any number of boutiques do interest calculations for an appropriate fee, which often is a contingency fee.¹⁰¹¹

However, as I noted above, for purposes of general tax practice, it is often sufficient to have a general ballpark number so that clients can understand the consequences of their decisions and the financial risks that might be involved. In such cases, I use a Tax Interest program authored by Time Value Software. The program is actually a pretty good interest calculator. A number of return preparers with whom I work use the program, for example, to calculate interest that will be due on amended returns showing a tax due and in other contexts where a good interest calculator is required. And, of course, for my purposes as a tax controversy attorney, the program gives me a

¹⁰⁰⁷ Finality is determined under § 7481(a) and, as you might suspect, the Tax Court decision does not become final until all appeals, including by writ of certiorari to the Supreme Court, have been exhausted. We encountered § 7481(a)'s finality concept above (pp. 208 ff.) in discussing the rules for determining the period of suspension of the statute of limitations when a taxpayer pursues a Tax Court petition for redetermination.

¹⁰⁰⁸ Although extremely rare, if a taxpayer contests only the interest the IRS calculates in making an overpayment not resulting from a Tax Court decision, the taxpayer must sue in the Federal Court of Claims pursuant to 28 U.S.C. § 1491. The applicable statute of limitation is 6 years. 28 U.S.C. §§ 2401 and 2501.

¹⁰⁰⁹ Thomas Johnston, Ian Friedman, and Richard Gagnon, Jr., Third Circuit Warns in Sunoco: Don't Put Off Interest Issues, 134 Tax Notes 1155 (Feb. 27, 2012). I have to say, in candor, that all of this interest nuance makes my head hurt

¹⁰¹⁰ See Rev. Proc. 83-58, 1983-2 C.B. 575 for the procedures.

¹⁰¹¹ Under new Circular 230 rules, practitioners are normally precluded from charging contingency fees, but for interest and penalty calculation work, they can charge contingency fees. Reg. § 10.27; See Jeremiah Coder, Back-to-Back Circular 230 Changes Reveal Winners, Losers, 2007 TNT 187-1 (9/26/07).

critical tool I need to help my clients make decisions and anticipate results. And this would be true in both small and very large cases.

Ch. 8. Penalties.

I. Introduction.

You have heard many times that we have a voluntary tax system. So the myth¹⁰¹² goes, U.S. taxpayers voluntarily report and pay their tax liabilities because they are honest and are willing to pay this price of civilized society. The truth is that our tax system is not voluntary. The law commands that taxpayers report and pay their tax liabilities. The law doesn't simply say that they may volunteer to report and pay in whatever amounts they think appropriate. The law provides inducements for reporting and paying. Those inducements are the penalties that apply if certain minimum reporting and paying obligations are not met. The IRS has an enforcement program designed to impose these inducements.¹⁰¹³ We focus here on these penalty inducements.

The IRS states its overall policy for penalties as follows:

1. Penalties are used to enhance voluntary compliance.

2. The Internal Revenue Service has a responsibility to collect the proper amount of tax revenue in the most efficient manner. Penalties provide the Service with an important tool to achieve that goal because they enhance voluntary compliance by taxpayers. In order to make the most efficient use of penalties, the Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance.

(3) Penalties encourage voluntary compliance by:

1. demonstrating the fairness of the tax system to compliant taxpayers; and
2. increasing the cost of noncompliance.¹⁰¹⁴

¹⁰¹² I use myth in its academic sense to mean a cultural acceptance of something that may or may not be true in an absolute sense. From Wikipedia (<http://en.wikipedia.org/wiki/Myth>): The term “myth” is often used colloquially to refer to a false story; however, the academic use of the term generally does not pass judgment on its truth or falsity.

and

One of the foremost functions of myth is to establish models for behavior.

¹⁰¹³ Policy P-5-1, IRM 1.2.14.1.1 (8-18-94): “A tax system based on voluntary assessment would not be viable without enforcement programs to ensure compliance.”

¹⁰¹⁴ IRM 1.2.20.1.1 Policy Statement 20-1 (06-29-2004) (bold face in original), Formerly P-1-18.

Federal tax penalties are not conceived of as either a revenue measure or a recovery of IRS's compliance costs. Indeed, since they are conceived of as inducements for taxpayer compliance, if they achieved that goal, there would be no penalties, no revenue and no compliance costs.¹⁰¹⁵

I have never counted the penalty provisions of the Code, but the IRM indicates that there are over 140 separate penalty provisions.¹⁰¹⁶ Most practitioners usually encounter in practice only a small number of the applicable penalty provisions – most importantly, the accuracy related and civil fraud penalties for income tax and estate tax. Practitioners must, however, assume that for every command in the Code there is a penalty for failure to meet the command; that assumption will usually be correct and can encourage you to research further when the occasion arises.

Since the goal of the tax system is compliance, the penalties are properly viewed as incentives for compliance or, alternatively, disincentives for noncompliance. The Supreme Court in a famous criminal tax case said that the tax system imposes “a system of sanctions which singly or in combination were calculated to induce prompt and forthright fulfillment of every duty under the income tax law and to provide a penalty suitable to every degree of delinquency.”¹⁰¹⁷ The criminal penalties are viewed as the punishment for conduct deemed most offensive to the tax system; the panoply of civil penalties includes conduct for which a criminal sanction is appropriate independently of the penalty¹⁰¹⁸ and conduct which is deemed to not justify the independent criminal sanction.

Focusing on the overall goal of compliance, it has been noted that taking the risk of being punished for tax crimes may be viewed from an economic modeling perspective as “a special form of gambling.”¹⁰¹⁹ Using the gambling metaphor, “a rational taxpayer will evade taxes if the expected

¹⁰¹⁵ Jeremiah Coder, Achieving Meaningful Civil Tax Penalty Reform and Making It Stick, 27 Akron Tax J. 153, 158 (2012).

¹⁰¹⁶ IRM Penalty Handbook, par. 20.1.1.1.1 (11-25-2011). (“In 1955 there were approximately 14 penalty provisions in the Internal Revenue Code. There are now more than ten times that number.”) The IRM Penalty Handbook, Chapter 1 of IRM Part 20, is a useful source for study into the penalty provisions. A caveat for this source – the Penalty Handbook is a statement of the IRS's position with respect to the penalties and is not necessarily the position that a court might adopt.

¹⁰¹⁷ Spies v. United States, 317 U.S. 492, 497 (1943).

¹⁰¹⁸ The criminal sanctions usually have civil penalty parallels to make the cost of criminal noncompliance more costly than provided in the criminal statutes. For example, tax evasion is a crime; the parallel civil penalty sanction is § 6663 which imposes a 75% income tax penalty – often referred to as the civil fraud penalty.

¹⁰¹⁹ Leandra Lederman, The Interplay Between Norms and Enforcement in Tax Compliance, 64 Ohio St. L. J. 1453, 1463 (2003) (quoting Michael W. Spicer, Civilization at a Discount: The Problem of Tax Evasion, 39 Nat'l Tax J. 13, 14 (1986) (“The term 'aversion' on occasion has been used to refer to tax avoidance activity of questionable legality.”).) For a good general discussion of these issues by Nobel Prize winning economist (Gary Becker) and an

value of the punishment is lower than the expected gains from evasion.”¹⁰²⁰ Simplified economic modeling would suggest that (i) if detection and properly scaled punishment for noncompliance¹⁰²¹ were certain to occur, taxpayers would not use the tax system as an outlet for their gambling urges, for the odds would be against them and only the very stupid and ill-informed would cheat,¹⁰²² but (ii) if detection and punishment were certain not to occur, the tax system would fail, for the odds would be with the gamblers and the odds would be highly in their favor; only the very stupid and ill-informed – or those generous citizens willing to bear a disproportionate share of the cost of government – would not cheat.¹⁰²³ Still, traditional ways of modeling taxpayer compliance

outstanding federal judge (Judge Posner of the Seventh Circuit), see <http://www.becker-posner-blog.com/archives/2007/11/>.

¹⁰²⁰ Id. Professor Lederman illustrates this in a simple example that I quote in full, without the footnotes that explain some of the subtleties of the simple example (pp. 1464-5):

As a simplified example, assume that a taxpayer is facing a decision whether or not to report \$3,000 of income received in cash. Assume that the applicable tax rate is 33 1/3% so that the tax at stake is \$1,000. Also assume that if the taxpayer is caught, the taxpayer will owe a penalty of \$3,000 plus the tax that was legally due. (Assume for simplicity that all amounts are adjusted to current dollars.) If there is a 2% chance that a taxpayer will be audited and a 100% chance that, if audited, the taxpayer will owe the \$3,000 penalty, the expected penalty for noncompliance is only \$60, while the expected benefit of noncompliance is \$980 (reflecting a 98% chance of retaining the unpaid \$1,000). In other words, the expected value of cheating is \$920, and rationally the taxpayer should cheat whenever the expected value is positive.

This example assumes only dollar penalties (often referred to as civil penalties) for noncompliance. The risk of criminal penalties will increase the risk to reward ratio but in a manner that is less easily quantifiable under economic modeling concepts.

¹⁰²¹ A notion that the punishment should fit the crime.

¹⁰²² Of course, the odds are against gamblers at casinos in Las Vegas and at state sponsored lottery casinos and people still gamble. But the truth is that the odds, objectively viewed, are not against gamblers in the tax lottery.

¹⁰²³ This assumption involves two key variables – the certainty of detection and an appropriate penalty to fit the crime – conduct of noncompliance. Given the audit rates Congress has historically authorized, the real world is that there is no certainty of detection. And, if there were certainty of detection, the penalty rate required to discourage the conduct could be low. But with the audit rates we have, taxpayers applying an expected utility model to their tax behavior should be subject to very high penalty rates to discourage the behavior. For example, one author has concluded that “[I]n the simple case of a risk-neutral taxpayer evading \$ 1 million of taxes with a 20 percent probability of being caught, a penalty of 400 percent . . . would leave both the taxpayer and a risk-neutral government indifferent between evasion and compliance.” Daniel Shaviro, Disclosure and Civil Penalty Rules in the U.S. Legal Response to Tax Shelters, in TAX AND CORPORATE GOVERNANCE 229, 239 (Wolfgang Schön ed., 2008), as quoted in Sarah B. Lawsky, How Tax Models Work, 53 B.C. L. Rev. 1657, 1667 (2012). As readers will quickly

suggested by the foregoing spectrum does not fully explain the high level of taxpayer compliance in the United States. Consider the following:

This phenomenon [of U.S. taxpayer voluntary compliance] has inspired some scholars to assert that U.S. taxpayers are “pathologically honest,” in the sense that they pay more in taxes than the standard deterrence model would suggest. It is almost as if taxpayers are, in effect, making a “gift” to the government. This argument is often overstated, insofar as it fails to recognize that, with many individual taxpayers (especially those whose primary source of income is in the form of wages), the level of compliance is very high, just as the traditional deterrence model would predict. This fact seems to be due, in large part, to the role of information returns, which the IRS can easily cross reference with tax returns. Still, with respect to the corporate income tax, as well as with respect to some forms of individual income (such as self employment income), the well-documented opportunities for undetectable evasion are so plentiful that the traditional model, narrowly construed, clearly does not provide the full explanation [for the high level of voluntary compliance].¹⁰²⁴

I focus in this chapter on penalties and their role to encourage compliance and, correspondingly, punish noncompliance. From the administrator’s viewpoint, the overarching question is whether the penalties support the system by appropriately penalizing the conduct to which they apply – does the punishment fit the crime? From the practitioner’s viewpoint, the question is whether the lines drawn for the penalized conduct permit the practitioner to advise the client properly as to conduct he or she is contemplating and, as to past conduct, whether there are defenses to the IRS’s assertion of penalties.

II. Criminal Penalties.

A. Introduction.

I merely introduce the major tax crimes. They are not a focus of this class, but you should have a passing familiarity with them. I offer three general caveats to trying to understand tax crimes, even superficially from just reading the Internal Revenue Code.

- First, although the Internal Revenue Code defines tax crimes, there are other general federal crimes (found in 18 U.S.C.) that can be deployed against people cheating on

discern, there are no such penalty structures in the Code – indeed, for conduct that bears a far lesser probability of being caught, the maximum income tax penalty provided by the Code is 75% of the tax attributable to fraud. § 6663.

¹⁰²⁴ Kyle D. Logue, The Problem of Tax Law Uncertainty and the Role of Tax Insurance, Va. Tax Rev. 339, 349, n. 12 (Fall 2005). The indented text above is not an exact quote. I have made some changes for readability, but it is close to an exact quote. The author cites at n. 13 authorities offering some explanation for the phenomenon.

taxes; these Title 18 crimes can be charged along with or in lieu of a tax crime in the Internal Revenue Code. For example, if a taxpayer lies to an agent in an audit, that lie may be an act of tax evasion or tax obstruction (defined in §§ 7201 and 7212(a), respectively, of the Code) or it may be a false statement usually prosecuted under 18 U.S.C. § 1001. Similarly, tax crimes often involve more than one person, thus potentially constituting a conspiracy crime under 18 U.S.C. § 371.

- Second, even with the tax crimes, the Code words defining the crimes are not plain language, the depth of which is plumbed just by reading the Code provision. There is a body of interpretation behind virtually every word in the definition of a tax crime. If you practice in this area, you will need to know that body of interpretation. But, in the tax crimes and other criminal contexts, the body of interpretation is necessarily constrained more to the text because these are criminal provisions designed to put the nonspecialist public at risk of criminal conviction and thus the text itself needs to be more understandable to the public than Code provisions that just affect their pocket books. Indeed, there is an interpretive doctrine known as the rule of lenity that applies to construe uncertainties in the text in favor of a defendant.
- Third, along with defining the tax crime, the Internal Revenue Code states a maximum incarceration period and a maximum fine. Those Code maximums can be misleading to those not familiar with the federal criminal justice system. Monetary penalties are now set under a provision of the general criminal Code (18 U.S.C.), and both sentencing and monetary penalties are ultimately determined at sentencing where the statutory goal is to make the punishment fit the crime.¹⁰²⁵ A principal factor – at least a starting point – in the sentencing matrix will be the now advisory Federal Sentencing Guidelines which almost always set incarceration and monetary penalties of less than the maximum provided in the Internal Revenue Code or in Title 18.¹⁰²⁶

I cover here only the Internal Revenue Code provisions and will not expect you to know provisions from other statutes or the Sentencing Guidelines except in the summary discussion below.

The Government does not detect most tax crimes; perhaps more counterintuitive, the Government does not prosecute most tax crimes it detects.¹⁰²⁷ The Government has a limited budget

¹⁰²⁵ See 18 U.S.C. § 3553(a).

¹⁰²⁶ The Sentencing Guidelines are not mandatory (United States v. Booker, 543 U.S. 200 (2005)), but they may be deemed presumptive as to appropriate sentences. Rita v. United States, 127 S. Ct. 2456 (2007).

¹⁰²⁷ I could chew on that general statement for a long time, but I must forego doing so here. For more discussion of tax and related crimes, I offer two sources: John Townsend, Larry Campagna, Steve Johnson and Scott Schumacher, Tax Crimes (LEXIS-NEXIS 2015), a casebook for law students; and Michael Saltzman and Leslie Book, IRS Practice and Procedure (Thomsen Reuters 2015), Chapter 12, Criminal Penalties and the Investigation Function (I was the principal

for investigating and prosecuting tax crimes. Throughout the United States, in any given year, on average less than 2,500 tax crimes will be prosecuted. Many of these tax crimes are prosecuted as adjuncts to prosecutions for other offenses (such as drug offenses or money laundering). So, there will be less (significantly less) than 2,000 pure tax prosecutions a year. As I hope you can appreciate, the number of tax crimes in a system involving hundreds of millions of taxpayers (consisting of individuals and entities such as corporations, partnerships and trusts) is far, far larger than these numbers would indicate. Accordingly, the government uses the limited prosecutions in a manner that will not only punish the particular offender but will send a message to other taxpayers encouraging them to do right. This collateral goal is recognized in the U.S. Sentencing Guidelines as follows (2002 Guidelines Ch. 2, Part T, par. 1, Introductory Comment):

The criminal tax laws are designed to protect the public interest in preserving the integrity of the nation's tax system. Criminal tax prosecutions serve to punish the violator and promote respect for the tax laws. Because of the limited number of criminal tax prosecutions relative to the estimated incidence of such violations, deterring others from violating the tax laws is a primary consideration underlying these guidelines. Recognition that the sentence for a criminal tax case will be commensurate with the gravity of the offense should act as a deterrent to would-be violators.

Because of this collateral goal, criminal tax prosecutions and particularly convictions are often highly publicized by the IRS and DOJ Tax. Moreover, the government perceives that it is very important that it obtain convictions in a very high percentage of the cases that it brings. The goal is a 90+% conviction rate.¹⁰²⁸ A significantly lower conviction rate would defeat the collateral goal of encouraging other taxpayers to do right. With a lower conviction rate, taxpayers might perceive the criminal enforcement effort as a paper tiger -- i.e., there is not a very high chance that the taxpayer will be detected in criminal activity in the first instance, but if he or she is detected, there is not a very high likelihood that the government will choose to prosecute, and then, if the government does choose to prosecute, there is a significant chance of acquittal. By choosing its cases carefully, and insisting upon pursuing only cases where it is virtually certain to succeed, the government can publicize the particular convictions and a high conviction rate. The government feels that, given its resources, that achieves the maximum benefit for the buck.

draftsman on this chapter which numbers 311 pages and 1298 footnotes as originally published, probably more with updates).

¹⁰²⁸ DOJ Tax claims a higher goal – 95% – and a higher actual success rate – 97%. I am skeptical. I think the actual success rate is lower than 95%. I cover this in my Federal Tax Crimes book. But, keep in mind that these are statistics – the worst kind of lies according to the famous popularized by Mark Twain (“There are lies, damn lies and statistics.”). There is, as usual, a more nuanced aphorism: “It is easy to lie with statistics, but easier to lie without them,” attributed to Fred Mosteller, one of the most eminent statisticians of the 20th Century.

B. The Sentencing Guidelines.

The statutes defining the Title 26 tax crimes provide the maximum sentence and fine that can be imposed. The actual sentences are determined un 18 U.S.C. § 3553 and the U.S. Sentencing Commission's Sentencing Guidelines (“Sentencing Guidelines”) which are easily available on the internet.¹⁰²⁹ Before the Sentencing Guidelines, federal judges imposed sentences and fines without any guidelines except the parameters set forth in the criminal statute itself. The Code provides a maximum sentence for tax evasion of up to 5 years. Thus, a judge could sentence from 0 to 5 years incarceration, with no guidance, prior to the Guidelines, as to the actual sentence. Sentencing varied depending upon a specific judge's individual predilections, prejudices, etc. and sometimes upon regional attitudes. The Sentencing Guidelines thus note (2012 Guidelines § 2T1.1, Background):

Under pre-guidelines practice, roughly half of all tax evaders were sentenced to probation without imprisonment, while the other half received sentences that required them to serve an average prison term of twelve months. This guideline is intended to reduce disparity in sentencing for tax offenses and to somewhat increase average sentence length. As a result, the number of purely probationary sentences will be reduced. The Commission believes that any additional costs of imprisonment that may be incurred as a result of the increase in the average term of imprisonment for tax offenses are inconsequential in relation to the potential increase in revenue. According to estimates current at the time this guideline was originally developed (1987), income taxes are underpaid by approximately \$90 billion annually.

And the Introductory Commentary provides:

The criminal tax laws are designed to protect the public interest in preserving the integrity of the nation’s tax system. Criminal tax prosecutions serve to punish the violator and promote respect for the tax laws. Because of the limited number of criminal tax prosecutions relative to the estimated incidence of such violations, deterring others from violating the tax laws is a primary consideration underlying these guidelines. Recognition that the sentence for a criminal tax case will be commensurate with the gravity of the offense should act as a deterrent to would-be violators.

The Sentencing Guidelines create guideline ranges for sentencing based upon certain prescribed sentencing factors determined by the drafters, after significant review of historical sentencing practices, to be relevant to sentencing. In a tax setting, the most important sentencing factor is the intended tax loss from the tax crime.¹⁰³⁰ The tax loss is not the actual tax loss, for once the IRS puts its criminal hair-sights on a taxpayer that taxpayer might well pay up (with penalties) -- either before a criminal trial or after -- so that there is often no real ultimate tax loss. Rather, the tax loss for sentencing purposes is that tax loss the taxpayer intended from the criminal activity.

¹⁰²⁹ <http://www.ussc.gov/guidelines-manual/2014/2014-ussc-guidelines-manual>.

¹⁰³⁰ S.G. §2T1.1 and §2T4.1 (Tax Table).

Generally, that is the portion of the tax underpayment that the taxpayer intended to evade, and the Government must prove that by a preponderance of the evidence. (Note that this is not necessarily the entire underpayment, for the Government may not be able to prove criminal intent as to the some portion of an underpayment.) Other sentencing factors such as acceptance of responsibility may also be considered. For tax crimes, unless the tax loss number is truly very large, the incarceration period is significantly less than the maximums for the crimes prescribed in the Code. Since most tax prosecutions result in plea bargaining and a guilty plea to one or more counts, the major strategy will be to get the tax loss number to a sufficiently low amount that the guideline range will be acceptable to the taxpayer.

The Sentencing Guidelines ranges for incarceration and fines serve as guides to the sentencing judge in setting an appropriate sentence. If the judge sentences within the guideline range, the sentence will generally not be reversed upon appeal (unless the judge articulated some improper consideration in setting the sentence or misapplied the guidelines). If, however, the judge chooses to depart from the guideline range, the judge must state the basis for the departure.

For a long time, the players in the system (the Sentencing Commission, judges, prosecutors, defendants and their counsel) thought and acted as if the Sentencing Guidelines were binding in the sentencing process. Many of these players, particularly judges and defense counsel, complained noisily that the Guidelines were too rigid and took away the unique discretion of the sentencing judge to tailor a sentence appropriate to the particular defendant being sentenced.

In a series of remarkable decisions beginning with **United States v. Booker, 543 U.S. 220 (2005)**, the Supreme Court held that the Guidelines were advisory rather than mandatory. The precise ramifications of that holding are beyond the scope of this text, but suffice it to say that, as of the date of this text was last revised, the sentencing judge must make the Guidelines calculations and consider them in sentencing but is authorized to impose sentence different than the Guidelines sentence based on factors unique to the defendant. This will permit what are called “variances” from the Guidelines. Any variance will be reversed on appeal only if the judge did not compute and properly consider the Guidelines and imposed a sentence that is sufficiently out of line that the court of appeals believes that the judge was unreasonable.¹⁰³¹

C. Return Reporting Crimes.

1. Tax Evasion - § 7201.

Section 7201 defines the felony commonly referred to as tax evasion – a willful attempt in any manner to defeat or evade tax. As interpreted, the tax evasion felony has three elements: (1) a substantial tax due; (2) willfulness (being an intent to evade payment); and (3) some affirmative act

¹⁰³¹ For an extreme case showing the wide discretion for variances in a tax crime setting see United States v. Warner, ___ F.3d ___, 2015 U.S. App. LEXIS 11938 (7th Cir. 2015), which I discuss in a blog, [Seventh Circuit Affirms No Incarceration Sentence for Ty Warner \(Federal Tax Crimes Blog 7/10/15; 7/14/15\)](#).

(however minimal) in furtherance of the intent. Incarceration is up to 5 years per count (per year of tax evasion).

Tax evasion usually occurs on a false return underreporting tax liability. This is commonly referred to as evasion of assessment because by failing to report the liability, the taxpayer hopes to avoid assessment. Evasion of assessment can also occur by failing to file a return, but that type of evasion is rarely charged since Congress provided a separate criminal penalty for the mere act of failing to file a return (§ 7203); for failure to file to be evasion, the taxpayer must commit some further affirmative act in furtherance of the evasion. Tax evasion may also occur through acts to avoid payment of tax after or in anticipation of an assessment of the tax. This is commonly referred to as evasion of payment.

The Supreme Court has referred to tax evasion as the capstone of the federal system of penalties to encourage compliance with the Code.¹⁰³² Tax evasion carries the highest nominal sentence (5 years) and monetary fines (\$100,000 for individuals and \$500,000 for corporations). (I say nominal because, as I note above, the real life sentence is likely to be a lot less except where the tax loss is quite large.)

2. False Return (Tax Perjury) - § 7206(1).

Section 7206(1) imposes a felony criminal penalty for willfully making a material false statement on return or other document filed with the IRS under penalty of perjury. The commonly encountered tax returns (income and estate and gift) are filed under penalties of perjury;¹⁰³³ as you recall, we quoted the jurat on the individual income tax return (Form 1040) above (p. 139). There is no requirement, as in tax evasion, that there be an understatement of tax liability. Indeed, the tax liability can be correctly stated and even overstated and the tax fully paid or overpaid; the taxpayer can still be guilty of this crime if he or she made material misstatements on the return. For example, a drug dealer improperly stating on his Schedule C that his business is a retail clothing business can be found guilty for that reason alone. In addition, a taxpayer improperly answering the question as to signatory authority over foreign bank accounts can be found guilty for that reason alone, even though no additional tax is due.¹⁰³⁴ A material false statement is basically any statement that could

¹⁰³² Spies v. United States, 317 U.S. 492, 497 (1943); see Boulware v. United States, 552 U.S. 421, 424, 128 S.Ct. 1168, 1173 (2008) (citing Spies).

¹⁰³³ § 6065 requires that, except as otherwise provided by regulations, returns and other documents filed with the Treasury under the internal revenue laws be signed under penalty of perjury.

¹⁰³⁴ Boulware v. United States, 552 U.S. 421, 432 n. 9, 128 S.Ct. 1168, 1178 n. 9 (2008) (“the Courts of Appeals are unanimous in holding that § 7206(1) ‘does not require the prosecution to prove the existence of a tax deficiency . . .’”).

mislead the IRS as to whether it should audit or in the event it did audit, which basically is any statement required by the return.¹⁰³⁵

Because of the jurat, false statements on a return also are within the ambit of the general federal perjury crime, 18 USC § 1621. Such false statements on tax returns are, however, prosecuted under either § 7201 or § 7206(1) rather than under 18 USC § 1621, because they are the more specific provisions Congress intended to apply to tax return false statements.¹⁰³⁶ It is interesting to note that the general federal perjury statute imposes a 5 year maximum sentence whereas § 7206(1), tax perjury, imposes a 3 year maximum sentence. One could infer that the legislature has evidence a belief that tax perjury is only 60% as damaging to society than is perjury in the setting of other sworn testimony. By similar analysis, tax perjury could be viewed as only 60% as harmful as tax evasion.

3. Aiding or Assisting - § 7206(2).

Section 7206(2) provides a felony criminal penalty for aiding or assisting in the preparation or presentation of a false return or tax relevant document. This penalty is aimed primarily at tax return preparers but can hit others such as tax shelter promoters or corporate officers assisting a corporation in filing false returns or documents. There is no requirement that the taxpayer be a co-conspirator or even be aware of the crime. The Code's maximum sentence for aiding and assisting is 3 years.

This felony is not the same as the general aiding and abetting crime under Title 18.¹⁰³⁷ Traditionally, aiding and abetting required a criminally culpable principal offender being aided and abetted; the principal offender was not required to be prosecuted, but there must have been a criminally culpable principal offender.¹⁰³⁸ Section 7206(2) permits the prosecution of a return preparer or other persons assisting some way in a false return even if the taxpayer involved is wholly innocent. Thus, a § 7206(2) prosecution does not require proof that the taxpayer so aided and assisted was criminally culpable so long as the person involved aided or assisted. Although it is not

¹⁰³⁵ See United States v. Gaudin, 515 U.S. 506 (1995) (holding that when materiality is an element, that element must be submitted to the jury).

¹⁰³⁶ Probably the most practical difference between the two in the context of tax returns is that the general perjury statute of limitations is 5 years, whereas the tax perjury statute of limitations is 6 years. See 18 USC § 3282 (general criminal perjury) and § 6531(5) (tax perjury).

¹⁰³⁷ 18 U.S.C. § 2.

¹⁰³⁸ Actually, the general aiding and abetting statute has been expanded to make a causer liable even when there is no culpable other offender, so that the causer is not aiding and abetting anyone. 18 U.S.C. § 2(b). See Townsend, John A., Theories of Criminal Liability for Tax Evasion (May 15, 2012). Available at SSRN: <http://ssrn.com/abstract=2060496> or <http://dx.doi.org/10.2139/ssrn.2060496>. (Noting that, under general tax evasion elements, the acts making a person a causer under § 2(b) would also make that person directly an offender for the crime of tax evasion.)

uncommon for courts to refer to § 7206(2) as an aiding and abetting provision, I hope my students will be a little more discriminating in description – aiding and assisting is the proper description.

4. Failure to File Return - § 7203.

Section 7203 provides a misdemeanor criminal penalty (imprisonment up to 1 year) for willful failure to file a return. This act is complete on the date the return is due (either the original due date or the extended due date, if an extension was obtained). Filing a delinquent return does not cure the criminal problem from a technical legal standpoint. (From a practical standpoint, filing delinquent returns before the IRS starts its investigation will generally cure the problem under the voluntary disclosure policy discussed pp. 306 ff.)

As you can see, the crime of failure to file is significantly less serious in terms of the defined Code penalties than the crimes discussed earlier (tax fraud and tax perjury which are felonies carrying incarceration of up to five and three years, respectively). During the pre-Guidelines period when I first entered private practice, I heard that the difference between a tax-cheat doctor (who presumably was not aware of this difference) and a tax-cheat lawyer (who presumably was aware) was that the doctor filed a fraudulent return and the lawyer filed no return. This is just lore and probably not supported by empirical data, but those who practice in this area do know that there seem to be a lot of lawyers who fail to file returns. (The Sentencing Guidelines now lessen the difference between these crimes significantly, but precisely how that happens is beyond the scope of this course.)

There is one critical deviation in the misdemeanor status for failure to file. Section 6050I requires trades or businesses receiving more than \$10,000 in cash one or a series of related transactions to report the transaction to the IRS on a CTR. The reporting requirement applies to cash and certain types of cash equivalents (such as foreign currency and certain monetary instruments). Please review briefly **Gertner** which we cover below (p. 398). Willful failure to file the § 6050I return is a felony punishable by 5 years incarceration.¹⁰³⁹

D. Tax Administration Crimes.

1. Tax Evasion - § 7201.

As noted above, § 7201 is generally applied to fraudulent returns. However, it may apply also to fraudulent attempts to evade assessment or payment during the course of an IRS examination or investigation.

2. Concealing Assets - § 7206(4).

Section 7206(4) imposes a felony penalty upon acts designed to conceal assets upon which levy may be made to pay a tax with intent to evade or defeat payment. The acts covered by this

¹⁰³⁹ § 7203 (last sentence).

provision would commonly be affirmative acts of evasion of payment and thus, are more commonly prosecuted under § 7201, tax evasion.

3. Impeding Administration - Section 7212(a).

I hope you know or intuit without any instruction that killing or otherwise harming an IRS official, just as any government official, in the conduct of his or her duty is a serious felony crime.¹⁰⁴⁰ In addition to these general criminal penalties for conduct that would impede investigations or collections, there are some Code specific provisions.

Section 7212(a) defines as a felony either:

1. intimidating or impeding an IRS official either corruptly or by use of force or threats;
- or
2. obstructing or impeding the administration of the tax laws either corruptly or by force or threats.

The second provision is often referred to as the “Omnibus Clause.” Conduct described in both categories generally is conduct that occurs after the return is filed or should have been filed. The conduct potentially within the scope of the provision is limited only by the imaginations of persons having a motive to impede. Some examples are filing unwarranted liens against IRS agent's homes in the local real property records, filing unwarranted criminal complaints against IRS officials, and sending phony 1099s to IRS officials reporting that they received payments that they did not in fact receive. Such actions might otherwise be legal except that they have no basis in fact and are designed to impede or harass the IRS from doing its job or from doing it efficiently. These actions are often employed by tax protestors. Mere harassment of an agent, if not done to obtain improper advantage, is not within the scope of the provision. One court thus said that:

[T]here is no reason to presume that every annoyance or impeding of an IRS agent is done per se “corruptly.” A disgruntled taxpayer may annoy a revenue agent with no intent to gain any advantage or benefit other than the satisfaction of annoying the agent. Such actions by taxpayers are not to be condoned, but neither are they “corrupt” under Section 7212(a).¹⁰⁴¹

Practitioners and courts have expressed concern regarding the potential sweep of this provision and its potential overlap with more specifically targeted tax crimes. DOJ policy is to not use this provision where there is a more targeted tax crime for the conduct in question -- such as § 7206(4) or even § 7201 and § 7206(1).¹⁰⁴²

¹⁰⁴⁰ See 18 U.S.C. §§ 111 and 1114.

¹⁰⁴¹ United States v. Reeves, 752 F.2d 995, 998 (5th Cir.), cert. denied, 474 U.S. 834 (1985).

¹⁰⁴² I have written an article on the tax obstruction crime and its general counterpart, the defraud conspiracy (Klein conspiracy in a tax setting) and refer the interested reader to that article. John A. Townsend, Tax Obstruction Crimes: Is Making the IRS's Job Harder Enough, 9 Hous. Bus.

4. False Statements - 18 U.S.C. § 1001.

I noted above that the Code itself contains provisions for tax perjury and for aiders and assisters in filing false documents with the IRS. These usually come into play in connection with the filing of a return or submitting documents to the IRS. During the course of an investigation, however, the taxpayer or his representative or even a third party may make misleading oral statements to the IRS.

Title 18 U.S.C., § 1001 punishes any false statement made to a federal officer within the scope of his or her responsibility as a federal officer. This is not a tax specific crime -- it can apply to false statements to any federal government officer. The crime is a felony, with up to five years incarceration. There is no requirement that the person making the statement be under oath (in the criminal law parlance, a false statement under oath is not an element of the § 1001 offense). Making false statements under oath is the separate offense of perjury¹⁰⁴³ and, if made on a tax return, is a separate offense of tax perjury under § 7206(1). The § 1001 offense is basically the same as perjury, but perjury requires that the statement be made under oath whereas § 1001 does not require an oath. Furthermore, whereas literal truth under oath is a defense to perjury even if the testimony is highly misleading, literally true but misleading statements may violate § 1001.¹⁰⁴⁴ In a tax setting, this offense is often charged for false statements during an IRS audit or IRS collection activity.

In addition to being independently prosecutable, a false statement during an audit can refresh the statute of limitations for tax evasion that otherwise would be triggered by the filing of the fraudulent return or can be charged as an overt act in a conspiracy.

5. FBAR Violations (31 U.S.C. § 5324; 18 U.S.C. § 1001).

I have covered the FBAR, FinCEN Form 114, Foreign Bank Account Report, filing requirement. (See discussion beginning on p. 128.) Although the FBAR has other law enforcement objectives, one objective is to identify and assure that income arising from or related to foreign accounts (including income activity producing proceeds deposited into foreign accounts) is properly reported and taxed in the U.S. As discussed earlier, there are civil and criminal penalties for failure to meet the FBAR requirement. The criminal penalty for failure to file an FBAR is 5 years. 31 U.S.C. § 5322. Although not certain, the most likely criminal penalty for filing a false FBAR is 5 years, may be under § 5322 or under some other appropriate statute, most likely, 18 U.S.C. § 1001, false statements, which is discussed above.

E. Conspiracy - 18 U.S.C. § 371.

Conspiracy is defined in 18 U.S.C. § 371 as two categories of conspiratorial conduct – a conspiracy to commit an offense and a conspiracy to impair or impede the lawful functioning of a

& Tax. L.J. 255 (2009).

¹⁰⁴³ See 18 USC § 1621.

¹⁰⁴⁴ See Peterson v. United States, 344 F.2d 419 (5th Cir. 1965).

Government agency (in this context, the IRS). Conspiracy is a common charge in federal criminal cases, particularly in tax cases.¹⁰⁴⁵

The conspiracy often charged in tax cases is under the second alternative of § 371 (conspiracy to defraud the United States or any agency) -- often referred to in a tax setting as a Klein conspiracy.¹⁰⁴⁶ The reason is that the proof requirements may be less onerous to the Government than for the offense conspiracy in a tax crimes setting.¹⁰⁴⁷

F. Miscellaneous Tax-Related Crimes.

1. General - Myriad of Other Tax Related Crimes.

The foregoing are the principal tax crimes that you will see in your practice. There are, however, a host of other crimes in the Code and crimes in Title 18 and even other Titles that overlap or are frequent traveling companions with tax crimes. I discuss below only the significant ones you will see.

2. Money Laundering - 18 U.S.C. §§ 1956 & 1957.

You will often also see money laundering charges traveling with tax crimes charges. Money laundering is beyond the scope of this book. These provisions are quite sweeping and generally impose stiff penalties on the attempt to use financial institutions or monetary instruments to further serious crimes or cleanse the fruits of serious crimes. The Government usually fields these provisions to attack drug trafficking, organized crime and other major national criminal enforcement

¹⁰⁴⁵ In United States v. Reynolds, 919 F.2d 435, 439 (7th Cir. 1990), a tax case, Judge Easterbrook lamented that the conspiracy add-ons are “inevitable because prosecutors seem to have conspiracy on their word processors as Count I; rare is the case omitting such a charge.” See also Kathleen F. Brickey, In Enron's Wake: Corporate Executives on Trial, 96 J. Crim. L. & Criminology 397, 401 & 420-423 (2006) (empirical research that, in federal corporate crime cases during the period 2002 through 2006), over 2/3s of the cases had multiple defendants and all of those had at least one conspiracy count).

¹⁰⁴⁶ The Klein conspiracy is named from the leading case – United States v. Klein, 247 F.2d 908 (2d Cir. 1957), cert. denied, 355 U.S. 924 (1958). I have written an article on the Klein conspiracy and its Internal Revenue Code counterpart, tax obstruction in § 7212(a) and refer the interested reader to that article. John A. Townsend, Tax Obstruction Crimes: Is Making the IRS's Job Harder Enough?, 9 Hous. Bus. & Tax. L.J. 255 (2009),

¹⁰⁴⁷ I avoid getting into a deeper discussion on this issue. Suffice it to say that willfulness, with is a very high mens rea element, is required for tax crimes and, because the offense conspiracy requires the same level of mens rea as the substantive offense, that high mens rea is required for conspiracy to commit tax offenses. By contrast, so it is imagined, the defraud or Klein conspiracy is not articulated to have such a high mens rea element, although it may have the equivalent. Having baited your curiosity, I do refer you to John A. Townsend, Is Making the IRS's Job Harder Enough?, 9 Hous. & Bus. Tax L.J. 260 (2009) where I noice about this in great volume, and or to my Federal Tax Crimes book and class at UH.

priorities. However, because of their sweep, the money laundering laws potentially apply in many other situations of lesser criminality and the Government will use them if it feels that other crimes it might charge are not adequate to punish the gravity of the overall criminal conduct.

3. Some Other Representative Crimes.

There are also penalties for persons who are responsible to withhold taxes and pay them over to the IRS. The classic case is an employer who is required to withhold income taxes and the employees' share of FICA from the employees' compensation and pay over the withheld amounts to the IRS. The Code impose felony and misdemeanor penalties for egregious cases of failure to withhold or pay over.¹⁰⁴⁸ You will most often in a tax practice encounter failure to withhold and pay over in the context of the trust fund recovery penalty ("TFRP", discussed pp. 704 ff.), a civil liability imposed upon the person or persons in the organization who had the duty to withhold and willfully failed to do.¹⁰⁴⁹ The felony crime for failure to withhold or pay over is basically the same, except that there are heightened levels of willfulness and burden of proof.

In addition, in the employment context, there are failure to file criminal penalties for employers who fail to file information returns such as W-2's¹⁰⁵⁰ and for employees who claim too many exemptions so as to improperly lower the amount of withholding.¹⁰⁵¹

There are numerous other criminal penalties which I cannot cover here. Suffice it to say that wherever you find an important civil tax obligation in the Code there will usually be some type of criminal penalty to give the persons subject to the obligation some incentive to comply "voluntarily".

¹⁰⁴⁸ §§ 7202 and 7215. § 7202 is a felony crime, and § 7215, a misdemeanor crime. There was a time when § 7202 prosecutions were uncommon. Nevertheless, they have picked up steam over time. Thus, one should not read too literally a statement by the Ninth Circuit that the provision is "fairly rarely invoked." United States v. Easterday, 564 F.3d 1004, 1007 (9th Cir. Cal. 2009).

¹⁰⁴⁹ The civil penalty is incorporated in § 6672.

¹⁰⁵⁰ § 7204.

¹⁰⁵¹ § 7205.

G. Voluntary Disclosure.

1. The General Voluntary Disclosure Programs.

a. General Description of the Programs.

The Government has a voluntary disclosure program¹⁰⁵² that permits a taxpayer to avoid the criminal prosecution risk for tax noncompliance. In general terms, the program gives some assurance against criminal prosecution to a taxpayer who voluntarily reports his or her wrongdoing before coming into the criminal cross-hairs of the IRS. The IRS and DOJ have each had some form of voluntary disclosure program for a long time. The nuances of the programs may change from time to time, but the broad outlines have been relatively stable.

The general parameters of the program in its various iterations over the years is: where the taxpayer who has committed or has possibly¹⁰⁵³ committed a tax crime related to a filed return or a failure to file and the IRS has not yet commenced a criminal investigation or, possibly even a civil tax audit,¹⁰⁵⁴ the taxpayer may be able to cure the criminal prosecution risk by making a “voluntary disclosure.”¹⁰⁵⁵ When a disclosure qualifies under the policy, the IRS exercises its discretion not to refer the case to DOJ Tax CES for further investigation or prosecution. The taxpayer is protected only from criminal problems; he or she is not insulated from civil taxes, penalties and interest.¹⁰⁵⁶ The policy thus operates as a form of administrative amnesty. If for some reason, DOJ Tax CES were to consider prosecuting a taxpayer who made a voluntary disclosure, it will consider the

¹⁰⁵² These are variously worded as programs, policies and practices. I will try to use the word program simply to avoid confusion. Sometimes that is not possible, because the principal program administered by the IRS is called a “practice” by the IRS. I also use the word program in the singular, although (as will be noted), both the IRS and DOJ Tax CES have separate but related programs, practices or policies and, even within the IRS, there are several iterations of the practice.

¹⁰⁵³ Sometimes it is not clear. Even where the taxpayer does not think he has committed a crime which, after all, does require his or her intent to commit, other people – specifically, the IRS, the DOJ, and a judge or jury – might think he committed the crime.

¹⁰⁵⁴ As will be noted, the current IRS policy treats as untimely a voluntary disclosure attempted after a civil audit of the taxpayer and, in some cases, related parties has commenced. That has not always been the case; and, I suspect, may be honored in the breach even now through general understandings in the process of a voluntary disclosure.

¹⁰⁵⁵ Both the IRS and the DOJ have voluntary disclosure practices or policies. I discuss them in detail later in the text. Some states have from time to time adopted voluntary disclosure practices or policies. Here, we deal only with federal voluntary disclosure – to wit, the IRS and DOJ practices or policies.

¹⁰⁵⁶ An exception to this might be if, incident to the voluntary disclosure, the taxpayer files amended returns that qualify as Qualified Amended Returns (“QARs”). Regs. § 1.6664-2(c)(2). QARs avoid the accuracy related penalty (generally 20%). The QAR does not apply if the return was fraudulent, in which case the civil fraud penalty would apply to the portion of the understatement attributable to fraud and the accuracy related penalty could apply to some or all of the portion of the understatement not attributable to fraud. However, making a voluntary disclosure is not per se an admission of fraud. The taxpayer will have to disclose the facts that may be an admission of fraud. But often in voluntary disclosures, the facts are still mixed as to fraud and the taxpayer may be seeking just to avoid a misfocused criminal investigation and prosecution. In that type of case, the taxpayer will want to act consistently with qualifying for the QAR relief.

voluntary disclosure and compliance with the IRS program as a significant factor weighing against prosecution. (I discuss this in more detail below.)

The voluntary disclosure program reflects practical and fiscal imperatives. The practical imperative is that, in tax cases, a jury will often be less likely to convict where the taxpayer has corrected the criminal conduct by voluntarily filing an amended return or delinquent original return. The fiscal imperative -- probably more important to the existence of the program -- is that it is “win-win” as a revenue measure. A voluntary disclosure policy will generate significant additional revenue for the Government since the IRS would not have discovered or, if discovered, would not have prosecuted most of the taxpayers who voluntarily disclose under the policy. There are still plenty of taxpayers to prosecute who have not gotten right with the Government for the Government to meet its criminal tax enforcement needs, so the additional revenue generated by the voluntary disclosure policy is a “freebie” for the Government. The Government gives up nothing of systemic importance and gets a material amount of revenue that, but for the policy, it would never get.

The key caveat here is that the disclosure must be voluntary and must be complete. In order to avoid fact intensive queries about what precisely is motivating the taxpayer to make a disclosure, the IRS has some rules that disqualify the taxpayer based on the “timeliness” of the disclosure. The key timeliness condition is that a disclosure after a civil or criminal investigation has started is not timely.

The foregoing are the general rules of the voluntary disclosure policy. It is more detailed, and the nuances with respect to the policy shift from time to time. Still, a taxpayer having a potential criminal problem on the original return or having failed to file a return should consider voluntary disclosure, even if the circumstances might suggest that the disclosure is not really voluntary (e.g., even if the spouse waging a nasty divorce has threatened to turn him in).

Within these broad parameters, there are actually two voluntary disclosure programs. The IRS has one,¹⁰⁵⁷ and DOJ Tax CES, which prosecutes all tax crimes, has one.¹⁰⁵⁸ The two substantially overlap, but from time to time there may be differences.¹⁰⁵⁹ The important point, however, is that if you fail to qualify for the IRS's policy and the IRS forwards the case to DOJ Tax CES with a recommendation for criminal prosecution, the taxpayer may have another bite at this apple.

¹⁰⁵⁷ The current IRS policy, referred to as a practice, is reflected in [IRM 9.5.11.9](#) (6/26/09).

¹⁰⁵⁸ The DOJ Tax’s voluntary disclosure policy is reflected in its Criminal Tax Manual, often referred to as the “CTM,” available on the DOJ web site, at [¶ 4.01 Voluntary Disclosure](#).

¹⁰⁵⁹ That there may be differences is reflected in DOJ Tax Memorandum from the Acting Assistant Attorney General which is reproduced in the [CTM at ¶ 3.00](#).

b. IRS Voluntary Disclosure Policy.

(1) The “Practice.”

The IRM incorporates a voluntary disclosure “practice” (in the past often referred to as a “policy”)¹⁰⁶⁰ which provides, in relevant part (as last reviewed or updated on 10/6/11):

[9.5.11.9 \(12-02-2009\), Voluntary Disclosure Practice](#)

(1) It is currently the practice of the IRS that a voluntary disclosure will be considered along with all other factors in the investigation in determining whether criminal prosecution will be recommended. This voluntary disclosure practice creates no substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice, provided solely for guidance to IRS personnel. Taxpayers cannot rely on the fact that other similarly situated taxpayers may not have been recommended for criminal prosecution.

(2) A voluntary disclosure will not automatically guarantee immunity from prosecution; however, a voluntary disclosure may result in prosecution not being recommended. This practice does not apply to taxpayers with illegal source income.

(3) A voluntary disclosure occurs when the communication is truthful, timely, complete, and when:

a. the taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his or her correct tax liability; and

b. the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.

(4) A disclosure is timely if it is received before:

a. the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation;

b. the IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer’s noncompliance;

¹⁰⁶⁰ In an earlier IRM provision, the word policy was used in the heading, although the word practice was used in the body. I am not sure that there would be a meaningful difference between the word practice and policy in this context. Without engaging in too much semantics, I do think the practice is an IRS policy.

c. the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or

d. the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).

(5) Any taxpayer who contacts the IRS in person or through a representative regarding voluntary disclosure will be directed to Criminal Investigation for evaluation of the disclosure. Special agents are encouraged to consult Area Counsel, Criminal Tax on voluntary disclosure issues.

(6) Examples of voluntary disclosures include:

a. a letter from an attorney which encloses amended returns from a client which are complete and accurate (reporting legal source income omitted from the original returns), which offers to pay the tax, interest, and any penalties determined by the IRS to be applicable in full and which meets the timeliness standard set forth above. This is a voluntary disclosure because all elements of (3), above are met.

b. a disclosure made by a taxpayer of omitted income facilitated through a barter exchange after the IRS has announced that it has begun a civil compliance project targeting barter exchanges; however the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intention to do so. In addition, the taxpayer files complete and accurate amended returns and makes arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable. This is a voluntary disclosure because the civil compliance project involving barter exchanges does not yet directly relate to the specific liability of the taxpayer and because all other elements of (3), above are met.

c. a disclosure made by a taxpayer of omitted income facilitated through a widely promoted scheme regarding which the IRS has begun a civil compliance project and already obtained information which might lead to an examination of the taxpayer; however, the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so. In addition, the taxpayer files complete and accurate returns and makes arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable. This is a voluntary disclosure because the civil compliance project involving the scheme does not yet directly relate to the specific liability of the taxpayer and because all other elements of (3), above are met.

d. a disclosure made by an individual who has not filed tax returns after the individual has received a notice stating that the IRS has no record of receiving a return for a particular year and inquiring into whether the taxpayer filed a return for that year. The individual files complete and accurate returns and makes arrangements with the IRS to pay the tax, interest, and any penalties determined by the IRS to be applicable in full. This is a voluntary disclosure because the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so and because all other elements of (3), above, are met.

(7) Examples of what are not voluntary disclosures include:

a. a letter from an attorney stating his or her client, who wishes to remain anonymous, wants to resolve his or her tax liability. This is not a voluntary disclosure until the identity of the taxpayer is disclosed and all other elements of (3) above have been met.

b. a disclosure made by a taxpayer who is under grand jury investigation. This is not a voluntary disclosure because the taxpayer is already under criminal investigation. The conclusion would be the same whether or not the taxpayer knew of the grand jury investigation.

c. a disclosure made by a taxpayer, who is not currently under examination or investigation, of omitted gross receipts from a partnership, but whose partner is already under investigation for omitted income skimmed from the partnership. This is not a voluntary disclosure because the IRS has already initiated an investigation which is directly related to the specific liability of this taxpayer. The conclusion would be the same whether or not the taxpayer knew of the ongoing investigation.

d. a disclosure made by a taxpayer, who is not currently under examination or investigation, of omitted constructive dividends received from a corporation which is currently under examination. This is not a voluntary disclosure because the IRS has already initiated an examination which is directly related to the specific liability of this taxpayer. The conclusion would be the same whether or not the taxpayer knew of the ongoing examination.

e. a disclosure made by a taxpayer after an employee has contacted the IRS regarding the taxpayer's double set of books. This is not a voluntary disclosure even if no examination or investigation has yet commenced because the IRS has already been informed by the third party of the specific taxpayer's noncompliance. The conclusion would be the same whether or not the taxpayer knew of the informant's contact with the IRS.

I have incorporated the IRM in major part because it is so important. This is virtually daily grist of the tax crimes practitioner's mill. Readers will note in the heading that I state the latest revision date which should tell you that the "practice" may change. The changes are often in nuance only. But students and practitioners should consult the IRM early and often. And, you need to understand that the wording of the policy is fraught with words of art that are not explained, except perhaps by inference to the experienced practitioner. In other words, the direct audience for the IRM is the IRS who, presumably, will know the terms of art (or have access to interpreters for the nuances). Practitioners need some experience or interpreters to understand the terms of art. I introduce below some of the major issues, but caution – or access to interpreters – is critical.

(2) How Is Disclosure Made?

(a) The "Quiet Disclosure".

Prior to the foreign financial account brouhaha starting in 2009 and the special voluntary disclosure programs for foreign financial account noncompliance, the method most commonly used for implementing a voluntary disclosure was to file the amended return(s) or delinquent original return(s) by mailing them to the Service Center. If possible, the taxpayer will include with the amended return(s) or delinquent original return(s) a check or checks for the taxes and interest. The amended return may have some explanation of the reason for the amendment in the hope that the IRS will not assert a civil penalty or will assert a lesser civil penalty; some may also include a reference to voluntary disclosure either in a cover letter or somewhere in the attachments to the amended return. Care should be taken, however, that in attempting to avoid or lessen a penalty, the taxpayer not make erroneous or misleading statements as to the reason for the earlier erroneous return. If multiple years are involved, some practitioners believe it better to mail them separately rather than in a single mailing. This form of disclosure is referred to as a "quiet" voluntary disclosure. This type of quiet disclosure does not result in the IRS giving any affirmative assurance of qualification for the voluntary disclosure policy.

One of the nice side benefits of the quiet disclosure is that the amended returns historically have not been audited or have been audited only infrequently.¹⁰⁶¹ Indeed, there is a qualified amended return process that says, in effect, that the amended return filed before an audit is started will draw no penalty except in the case of fraud (in which case, of course, the civil fraud penalty would apply).¹⁰⁶² In other words, unless the amended return is audited and a finding of fraud made, the taxpayer's cost of his type of disclosure is the tax and the interest on the tax. Penalties are not assessed. Given the audit capabilities of the IRS and the difficulties the IRS often encounters in asserting and prevailing in the assertion of civil fraud, most amended returns will get through without any penalties.

¹⁰⁶¹ I don't recall any quiet disclosure resulting in an audit. Prior to the implementation of the qualified amended return procedure (discussed below in the text), it was not uncommon for certain penalties to be applied at the Service Center without an investigation.

¹⁰⁶² Regs. § 1.6664-2(c)(2).

(b) Noisy Disclosures.

In more sensitive cases (for example, where an unusually large amount of additional tax is due), the taxpayer is concerned about some disqualifying event, or the taxpayer wants some affirmative assurance from the IRS), the taxpayer's counsel may first have a meeting with CI -- IRS's Criminal Investigation division -- to advise of the facts on an anonymous basis and, hopefully, to receive advance assurance from CI that if the facts are as represented, CI will not pursue a criminal investigation or recommendation to DOJ Tax CES for prosecution. This is often called a “noisy” or “negotiated walk-through” voluntary disclosure. Taxpayer’s counsel will want to make sure to address the sensitive issues which cautioned against merely filing the return(s) under the quiet disclosure procedure above.

The current IRS preference for voluntary disclosures is to file a preclearance letter with the IRS Lead Development Center in Philadelphia.¹⁰⁶³ The letter discloses the taxpayer’s name, date of birth and social security number. Upon receipt of the letter, the IRS checks its databases to determine whether if the taxpayer is under audit or criminal investigation or there is some other indication that the taxpayer does not qualify to make a voluntary disclosure. If the IRS finds no disqualifying factor, the taxpayer will then submit the detailed information making the voluntary disclosure. This preclearance procedure was patterned after the procedure for taxpayers to make voluntary disclosures in the IRS offshore account initiatives.

The problem with this preferred procedure is that a taxpayer will likely be reluctant to disclose identifying information before getting some assurance that he qualifies. Prior to the institution of this new preclearance procedure, practitioners sometimes made anonymous disclosures to CI and only identified the taxpayer after getting positive feedback from CI. Of course, some of the disqualifying factors can only be known after CI knows who the taxpayer is, so this anonymous procedure really helped only where there might be some sensitive issue that the practitioner can discuss in the anonymous proffer. Some practitioners think that, even with the new preclearance procedure, IRS CI personnel will still entertain an anonymous proffer as to the first step with the preclearance letter then being filed after the practitioner feels appropriate. The risk then is that, if the taxpayer files the preclearance letter and is rejected (say because there is an audit that has been scheduled), the taxpayer has not only given identifying information, the practitioner has given some details that would not have been available had the taxpayer simply filed the preclearance as the first step and been rejected.

(3) Which Type of Disclosure is “Better”?

Assessing which of the types of disclosure the taxpayer should pursue requires judgment seasoned with experience. Here are some of the issues that one should consider:

¹⁰⁶³ See IRS web page titled How to Make a Domestic Voluntary Disclosure, available at <http://www.irs.gov/uac/How-to-Make-a-Domestic-Voluntary-Disclosure> (last reviewed or updated on July 15, 2014).

- The noisy disclosure offers the possibility of giving the taxpayer some early assurance that the disclosure works and the criminal exposure is closed out. The taxpayer's attorney communicates directly with IRS personnel about the specific issues and problems. The IRS directly communicates acceptance of the disclosure with taxpayer's counsel. By contrast, the taxpayer receives no such assurance that quiet disclosure will be honored as a voluntary disclosure, so the taxpayer will go forward for some period into the future with some level of uncertainty. Even with this uncertainty which I think is minimal, my and most practitioners' preferred method of disclosure is the quiet disclosure. But, as noted, for special voluntary disclosure circumstances, like the special offshore account initiative, noisy disclosure may be required or, at least, preferred.
- The noisy disclosure is more expensive than the quiet disclosure. Both will require the preparation of amended returns, so that cost is fixed for both types of disclosure. But, if you know in advance that the returns will be looked at closely, you may want to spend more time to make sure that they are right and presented in the best light possible. Noisy disclosure requires very careful preparation of the initial overture to CI and thereafter careful and intricate dancing with CI in order to obtain the assurance of non-prosecution (or, more precisely, non-referral to DOJ Tax). Lawyers are expensive, and the process may be quite a bit more costly than the quiet disclosure method. (Heaven forbid that some attorneys might think it preferable for that reason.) And, given the only marginal benefit (absolute assurance directly from CI rather than reasonable assurance from the practitioner), the extra layer of lawyering and costs may not be cost effective for the client (as opposed to the lawyer), but that is a client choice.
- Lawyers have been concerned that the noisy disclosure will almost certainly result in the 75% civil fraud penalty for one or more of the years involved (with potentially lower penalties under a special initiative). As noted, the quiet disclosure may result in no penalty either because the IRS does nothing or the QAR relief applies. This tilts the cost / benefit ratio substantially in favor of quiet disclosure, although even this may be overstated,¹⁰⁶⁴ but again the client wanting certainty may accept the additional cost for the additional benefit. And, even where there is a noisy disclosure, a taxpayer may be able to argue for QAR relief if the facts are murky as to fraud.

(a) DOJ Tax Disclosure Policy.

Historically, DOJ Tax has had a voluntary disclosure policy that varied – at least in some of its nuances – from the IRS voluntary disclosure policy. At present, the DOJ Tax policy is (emphasis supplied):

4.01[1] Policy Respecting Voluntary Disclosure

¹⁰⁶⁴ The fear of the automatic assertion of the 75% civil fraud penalty after a noisy disclosure may be exaggerated because of lack of cooperation between CI and the civil audit function, but I have heard IRS personnel claim that they are getting better at this.

Whenever a person voluntarily discloses that he or she committed a crime before any investigation of the person's conduct begins, that factor is considered by the Tax Division along with all other factors in the case in determining whether to pursue criminal prosecution. See generally USAM, § 9-27.220, et. seq.

If a putative criminal defendant has complied in all respects with all of the requirements of the Internal Revenue Service's voluntary disclosure practice, the Tax Division may consider that factor in its exercise of prosecutorial discretion. It will consider, inter alia, the timeliness of the voluntary disclosure, what prompted the person to make the disclosure, and whether the person fully and truthfully cooperated with the government by paying past tax liabilities, complying with subsequent tax obligations, and assisting in the prosecution of other persons involved in the crime.¹⁰⁶⁵

Practitioners view this as bringing the DOJ Tax voluntary disclosure practice substantially in line with the IRS voluntary disclosure practice. But, the wording does suggest that DOJ Tax might prosecute even if the taxpayer has made a voluntary disclosure that the IRS would view as consistent with its practice – which in turn the IRS views as consistent with its mission to enforce and administer the tax laws. This raises the issue of whether DOJ Tax would or could prosecute when the IRS says that prosecution is not consistent with its administration of the tax laws. That is a big and potentially distracting issue, so I forego it now (except in the footnote).¹⁰⁶⁶

c. Does the Voluntary Disclosure Practice Confer Rights?

Both the IRM and the CTM specifically state that the practice or policy confers no rights on taxpayers. What does this mean? Basically, it means that the IRS will not be second-guessed in its application of the practice by a court.¹⁰⁶⁷ In other words, it serves to caution taxpayers that the

¹⁰⁶⁵ DOJ Tax CTM (2008).

¹⁰⁶⁶ If the IRS views the taxpayer's disclosure as meeting its voluntary disclosure practice, the IRS simply does not refer the taxpayer to DOJ Tax for criminal prosecution, and that is the end of the matter. However, let's say that DOJ Tax or some other DOJ Tax component focuses on the taxpayer for some reason other than a criminal prosecution or grand jury investigation referral from the IRS; the issue raised is whether DOJ Tax can then authorize a prosecution that the IRS insists is inconsistent with its responsibilities because the taxpayer complied with the voluntary disclosure policy and therefore declines to refer to DOJ Tax? There are some big issues here. I would like to go farther with this issue, but I don't want to turn this footnote into a book – or at least a law review article. Practitioners should be aware that, in the special IRS voluntary disclosure initiative for foreign accounts, the IRS acceptance letters into the program specifically caveated that the IRS's acceptance does not assure nonprosecution, apparently hedging the possibility that DOJ Tax might independently determine to prosecute.

¹⁰⁶⁷ See e.g., E.g., Crystal v. United States, 172 F.3d 1141, 1151 (9th Cir. 1999); United States v. Knottnerus, 139 F.3d 558, 560, 561 n.5 (7th Cir. 1998) cert. denied, 119 S. Ct. 146 (1998).

Caceres doctrine¹⁰⁶⁸ applies to the voluntary disclosure practice, which might have been required by Caceres even without the specific statement. So, you might ask, why should a taxpayer do a voluntary disclosure if he or she has no assurance that he or she will not be criminally prosecuted? The answer to that is that the IRS is not stupid, so it does a pretty good job of policing its application of the practice. The voluntary disclosure practice is win-win for the IRS. If it were to prosecute one or more taxpayers who actually met or were perceived to have met the conditions for voluntary disclosure, it would cost the IRS far more that it could ever hope to gain, because voluntary disclosures would dry up.

Of course, there are cases where taxpayers have asserted that they met the conditions for prosecution and that, therefore, the Government should not be able to prosecute them. What you will find when you scratch the surface of those cases is that the taxpayers involved did not meet the conditions for voluntary disclosure and otherwise behaved in a manner inconsistent with the requirement that to cooperate completely.¹⁰⁶⁹ This is to reinforce the applicability of the Caceres doctrine. Consider the next case.¹⁰⁷⁰

d. Timeliness, Truthfulness and Completeness.

Voluntary disclosure requires timeliness, truthfulness and completeness. When using quiet disclosure, the return will usually not include a complete exposition of the underlying facts – either as to the nature of the erroneously reported item or the reason it was not included on the original return. Nevertheless, what the amended or delinquent original return should report is all of the information called for by the return instructions, although I think it need not include a detailed mea culpa. And, the IRS would prefer a cover letter indicating that the quiet disclosure is intended to qualify as a voluntary disclosure under the practice discussed above, but I think most practitioners do not view that as necessary or appropriate, at least in some cases. I am not aware of such a quiet disclosure ever failing (even without a cover letter as described), so long as the amended return or delinquent original return contains the type of information normally required for returns in the type of detail normally required. Of course, if the IRS wants then to ask the taxpayer questions about the amended return or the delinquent original return, the taxpayer's responses will have to be complete and the taxpayer will have to be cooperative. Practitioners concerned about whether the quiet disclosure is adequate without a complete discussion of the facts can simply include that discussion.

¹⁰⁶⁸ United States v. Caceres, 440 U.S. 741 (1979) (holding that IRM does not confer rights on taxpayers; hence, evidence obtained arguably in violation of IRM cannot be excluded).

¹⁰⁶⁹ Tenzer is the poster-child for this genre of case.

¹⁰⁷⁰ A good example is United States v. Tenzer, 213 F.3d 34 (2d Cir. 2000), which I used to include in the text of this book just so that the reader will get an idea for just the quintessential type of taxpayer that asserts the benefits of voluntary disclosure – no prosecution – while not even coming close to meet the conditions of the voluntary disclosure practice. Read it if you are interested, but suffice it to say that, so long as your client meet the conditions of the practice, the chances of his meeting Mr. Tenzer's fate are slim and nonexistent.

For many reasons, the taxpayer will often be unable to file a completely accurate amended return or delinquent original return. The taxpayer may not have kept good records, the taxpayer in furtherance of the original fraud may have destroyed records, the time elapsed may have made some third party sources of relevant information unavailable, etc. Yet, something needs to be done and it needs to be done as accurately as possible, so that the taxpayer does not file a false amended return or false delinquent return, thereby compounding his or her problem.¹⁰⁷¹ Good return preparers will know how to undertake the type of due diligence to make the best return reasonably possible, and that should be acceptable. But, obviously a good faith, even if expensive, effort must be made to reconstruct the taxpayer's income, deductions and credits and proper disclosures should be made on the return where estimates and indirect methods of reconstruction are used. In many cases, this will require the return preparer to make judgment calls against the taxpayer in order to insure that the tax liability is not under reported. That is just a cost of the original fraud and insuring that the IRS will bless the voluntary disclosure, a less likely result if the taxpayer's disclosure by amended return is found wanting. Good faith is the key, and good faith will work to insure the application of the policy so long as the other requirements are met.

e. Taxpayer Cooperation.

The taxpayer is required to be forthcoming and cooperative. Certainly, as to IRS inquiries regarding the taxes or potential penalties, the taxpayer must cooperate. Does it mean more?

For example, does this mean in the case of quiet disclosure that a taxpayer who knows he or she committed a criminal act is required to "self-impose" the appropriate civil penalties that would otherwise apply to the criminal conduct? Thus, if the original return were fraudulent, is the taxpayer required to advise the IRS on or with the amended return that he or she is subject to the civil fraud penalty and pay that penalty if possible? Most practitioners say that such self-imposed penalty assessments are not required to qualify for voluntary disclosure. The assessment of the penalty is not the prerogative of the taxpayer, but is instead the prerogative of the IRS. The IRS will often, even usually, assert some penalty upon receiving an amended return reporting substantial additional tax liability or for a delinquent original return, but the taxpayer should await the IRS's call on that one without great concern that he has not been cooperative.

The tougher question will be whether and how hard the taxpayer might want to fight the imposition of any penalty that the IRS imposes upon receipt of the return. For reasons noted above, the IRS may not assert any penalty after either type of disclosure – noisy or quiet. But, if it were to do so, what should be the taxpayer's response, keeping in mind that his conduct may have been subject to the civil fraud penalty. Smart taxpayers, particularly in a fraud situation, might not want to fight for a host of strategic reasons which, in the interest of keeping these materials to an acceptable size, cannot be explored here. Would fighting the penalty be deemed noncooperation?

Frequently, persons desiring to qualify under this policy will not have the funds to pay the taxes, penalties and interest that are then due. Does this exclude from the policy taxpayers who

¹⁰⁷¹ See Blauner v. United States, 293 F.2d 723, 729-730, 724-735 (8th Cir. 1960), cert. denied 368 U.S. 931 (1961).

cannot pay in full? Surely not, but this too is the author's judgment call based on experience and a logical implementation of the policy. Of course, the taxpayer will want to avoid delay and foot-dragging, in order to meet the cooperation requirement. Accordingly, if the quiet disclosure method is used, where the taxpayer can't fully pay, the taxpayer should include as much payment as possible with the return and a cover letter or a statement attached to the return saying that he or she cannot pay the amount required but desires to cooperate and work with the IRS under existing procedures to resolve the liability. The taxpayer should thereafter cooperate with the IRS collection personnel. Existing collection procedures include installment agreements and offers in compromise. The key, of course, is for the taxpayer to show the good faith that eluded Tenzer.

If the IRS decides to investigate the circumstances of the original fraud or even the decision to disclose voluntarily, can the IRS require the taxpayer to waive his privileges in order to meet the cooperation requirement of the policy? Obviously, the taxpayer has disclosed the underlying fraud itself and has thus waived his Fifth Amendment privilege as to that conduct, although if the IRS started a full-blown inquiry and the taxpayer was really concerned, he could reassert that privilege to avoid future disclosures of information privileged under the Fifth Amendment. But what if the taxpayer had other criminal conduct, not necessarily tax criminal conduct, but still related to the tax fraud? Can the taxpayer assert the Fifth Amendment privilege and still qualify? Note that the IRS policy above applies only to legal source income, so this might be a disqualification *ab initio* if the untaxed income is illegal source income.¹⁰⁷² Similarly, can the taxpayer assert the attorney-client privilege for advice he or she received in the course of considering and making voluntary disclosure? And, can the taxpayer claim the new practitioner privilege, § 7525, to prevent the IRS from learning confidences incident to the original return preparation and still qualify for the privilege? These issues are yet to be decided.

f. Events That Prevent Timeliness or Voluntariness.

If the IRS gets on the taxpayer's trail or a series of events is in place that will likely put the IRS on the taxpayer's trail, the policy does not apply. As set forth in the IRM, these events are a civil or criminal investigation, third party information about that taxpayer's noncompliance, another civil or criminal investigation that would likely lead to the taxpayer or information from another criminal enforcement investigation.¹⁰⁷³ I hope you can see why this limitation on the policy is necessary. If all a taxpayer had to do to solve a criminal problem was to fess up when caught and maybe some civil penalties, the cost-benefit ratio of playing the audit lottery with fraudulent activity would be heavily tilted in the taxpayer's favor.

Previously, the IRM suggested that the voluntary disclosure practice was not available if some series of events had transpired which made the IRS's discovery of the taxpayer's malfeasance inevitable. The limitation is not present in the current version of the practice. I urge the reader to

¹⁰⁷² The policies do apply only to legal source income. In appropriate cases, however, a taxpayer with illegal source income might want to try the noisy disclosure route to see if he or she can get the needed assurance from the Chief of CI. If the Chief gives the assurance, it will certainly be honored. That type of advance assurance cannot be achieved via the quiet disclosure route.

¹⁰⁷³ See 9.5.11.9 Voluntary Disclosure Practice (12-02-2009), at par. (4).

go back and read the policy and consider why I say that this limitation is not in the current version. The reader will note that the practice is not available to a taxpayer if the IRS has started an investigation of another taxpayer as to a matter that is “directly related” to the taxpayer’s liability. This limitation should be read carefully, and obviously the practitioner should be prepared to mount effective advocacy as to why his client’s tax liability in the voluntary disclosure is not directly related to another previously discovered taxpayer’s tax liability. I think advocacy, even in a close case, might be effective here because the IRS could lose more than it could gain by applying the voluntary disclosure practice too narrowly. That is to say, that the IRS and DOJ Tax can get plenty of fodder for its criminal tax enforcement priorities without being stingy about voluntary disclosure. Your job may be to help the IRS and / or DOJ Tax CES realize that priority in your client’s specific case.

g. Special Voluntary Disclosure Initiatives.

In major areas of noncompliance where the IRS’s ability to detect noncompliance is limited or other special factors exist, the IRS may offer special “voluntary disclosure” type initiatives in order to encourage compliance. I mention here three prominent examples.

(1) Earlier Offshore Voluntary Compliance Initiative (and Related Audit Initiatives).

In the later 1990s, the IRS initiated a major initiative to identify taxpayers using offshore credit cards, and more broadly offshore financial institutions, as a means of implementing tax crimes with minimal (they think) risk of detection. Using so-called John Doe summonses against credit and debit card processors in the U.S. targeting transactions for tax haven foreign bank cards, the IRS began tracing the tax haven bank credit card charges through the vendors where the charges were made and on to the taxpayers; with some Sherlock Holmes techniques and some luck, the IRS could often identify the U.S. taxpayers and start U.S. audits and, where appropriate, criminal investigation processes. As an early part of this initiative, the IRS encouraged taxpayers with this problem to voluntarily disclose, and offered reasonable assurance that qualifying taxpayers will not be prosecuted. This initiative was called the Offshore Voluntary Compliance Initiative (“OVCI”). The IRS did not expect all taxpayers to accept this voluntary disclosure offer, and thus will still have plenty of taxpayers that it can identify and prosecute. But, for those taxpayers within the scope of the offer, it did offer reasonable assurance that they would not be prosecuted. Still, during audits in which an offshore account was identified or suspected, the IRS usually offered the taxpayers a similar program with stiffened penalties that were still much better than worst case called the Last Chance Compliance Initiative (“LCCI”).

(2) Tax Shelter Initiatives.

In the early 2000s after a wave of abusive tax shelters, the IRS announced initiatives as to particular highly marketed shelters permitting taxpayers to limit their risk by voluntary disclosure. These initiatives usually facially offer relief only with respect to the taxpayer’s civil exposure (principally because the complexity of the shelters and the presences of “opinions” for major tax firms criminal prosecution would be unlikely). But, in situations where the opinions were mere

window dressing which the taxpayer really did not believe (often with the assistance of his own independent counsel), careful practitioners would at least be concerned that there might criminal investigation or prosecution. The general thinking is that, in the unlikely event the taxpayer's conduct might otherwise be potentially subject to criminal prosecution, participation in the program with full disclosure will avoid the criminal problem.

(3) 2009 Offshore Account Initiative.

After a further highly publicized round of attacking offshore accounts in 2008 and 2009 (including a deferred prosecution agreement with UBS, a major Swiss bank and a John Doe Summons to UBS), the IRS announced a program similar to the OVCI initiative, but broader in scope designed to sweeten the pot for taxpayers by reducing the exposure for civil penalties and assuring that the taxpayer coming into the program will not be prosecuted.¹⁰⁷⁴ The program extended through October 15, 2009. The key features of the program were:

1. Taxpayer must file amended income tax returns or, if no original income tax returns were filed, delinquent income tax returns for 6 years and pay tax, interest, and a 20% accuracy related penalty or 25% delinquency penalty, as appropriate. The carrot here is that the IRS will not assert the fraud penalty which is 75% as to fraudulent returns or fraudulent failure to file.

2. Taxpayer must file amended or delinquent FBARs (the information return for foreign bank accounts) and pay 20% offshore penalty on the amount in nontax compliant foreign bank accounts and foreign assets in the year with the highest aggregate account or asset value in lieu of all other applicable penalties. (This penalty has been variously called the offshore penalty, the miscellaneous penalty, or the "in lieu of" penalty (because it is in lieu of all penalties other than the income tax accuracy related penalty in paragraph 1); I use the term offshore penalty because that, over time, that is the term that has gained most traction). The carrot here is that the IRS will not assert the maximum penalty (\$100,000 or 50% of the amount in the account) for each year. The 20% penalty imposed pursuant to the program may be reduced to 5% if the taxpayer didn't open the account, there was no account activity while the taxpayer controlled the account, and all taxes have been paid on the account.

3. The taxpayer must file the various other forms that may be required but the IRS will not assert the penalties that might apply to them. In some cases, the IRS will allow intermediate entities that served no purpose other than to hide the accounts to be "shammed" out (ignored for purposes of these various forms, such as 5471). The carrot here is that the IRS will not assert the otherwise substantial penalties for those delinquencies.

4. The program is available only to those who meet the voluntary disclosure policy in IRM 9.5.11.9. Although, in other contexts, practitioners pursue voluntary disclosures through disclosures by simply filing with the service center and through noisy disclosures (meetings with IRS CI), the

¹⁰⁷⁴ The program (including its processing features) is announced in a series of memoranda, FAQs and accompanying press releases. The FAQs offer the principal guidance and may be viewed here: <http://www.irs.gov/newsroom/article/0,,id=210027,00.html>.

program appears to contemplate only noisy disclosures (e.g., initial screening at CI is required and a closing agreement is required). This means more work for lawyers because most clients should be guided through the process that may have major downsides for the unwary.

5. The taxpayer otherwise must fully cooperate.

6. If the foregoing conditions are met and agreed upon, the IRS will not pursue criminal prosecution.

(4) 2011 Voluntary Compliance Initiative (“OVDI”).

After OVDP lapsed, there was a period of uncertainty as to what opportunities were available to taxpayers to make a voluntary disclosure. Finally, in 2011, the IRS announced another initiative similar to OVDP available, as extended, until September 9, 2011.¹⁰⁷⁵ Most of the requirements and costs were the same as the 2009 OVDP, except that taxpayers had a longer number of years for which amended returns and delinquent FBARs were required (i.e., back to 2003, but a couple of years had elapsed) and the offshore penalty increased to 25%.

(5) Current Voluntary Disclosure for Offshore Accounts.

After OVDI lapsed, there was again a period of uncertainty. The IRS announced that the regular voluntary disclosure program was still open for taxpayers with unreported offshore accounts. The practitioner community expected the process of such voluntary disclosures would be under the procedures and subject to the requirements of OVDI, subject to further refinements and changes. Most importantly, however, there was considerable concern that the IRS would increase the penalties for persons who did not get in the earlier programs. Thus, there appeared to be sufficient uncertainty that taxpayers and practitioners were reluctant to use the general voluntary disclosure practice.

To quell the uncertainty and encourage further voluntary disclosures, in January 2012, the IRS announced an indefinite re-opening of OVDI program.¹⁰⁷⁶ As originally announced in 2012, the key features of the earlier program are in tact, except (i) the offshore penalty rate has increased from 25% under OVDI to 27.5% under the extended program and (ii) amended returns are required only for up to 8 years.¹⁰⁷⁷ The income tax penalty remains at 20%.

¹⁰⁷⁵ The details of this program are also set forth in FAQs on the IRS website. The website for the FAQs is <http://www.irs.gov/businesses/international/article/0,,id=235699,00.html>.

¹⁰⁷⁶ See <http://www.irs.gov/newsroom/article/0,,id=252162,00.html>.

¹⁰⁷⁷ As this is worded, I suppose, this could offer an incentive to delay joining the program to let some of the early years lapse. I don't think there will be much incentive because of all the reporting requirements that the taxpayer should begin on a go-forward basis while awaiting the lapse of earlier years.

In August 2013, the DOJ Tax announced a special voluntary disclosure program for Swiss financial institutions.¹⁰⁷⁸ The program allows Swiss bank assisting U.S. taxpayer income tax evasion to avoid criminal prosecution in the U.S. in exchange for detailed disclosures and, for some banks, the payment of monetary penalties. The details of the program are nuanced and relevant only for the limited subset of Swiss Banks (although there are hundreds of them potentially within the scope of the program). For present purposes, the program has three key consequences: (1) 14 Swiss banks under criminal investigation are not included in the program (these are so-called Category 1 banks); (2) the more culpable Swiss banks (so-called Category 2 banks, being those that have a reason to believe that they have committed tax or related criminal offenses under U.S. law) will obtain a nonprosecution agreement in return for disclosing aggregate data about U.S. taxpayers sufficient for the IRS to formulate a treaty request for the more specific individual taxpayer information under the treaty and paying a significant penalty based on a percentage of noncompliant U.S. accounts after August 2008; and (3) the other banks (Categories 3 and 4) who have not engaged in criminal conduct or are deemed compliant will receive a “nontarget letter.” The key impact for U.S. taxpayers is that, as banks are identified publicly in Categories 1 and 2, the offshore penalty for individual taxpayers joining OVDP after such public identification from 27 ½% to 50%.

In June 2014, the IRS announced a new Streamlined Program designed for taxpayers who can certify that their income tax noncompliance and FBAR noncompliance was **nonwillful** for the covered years requiring that the taxpayer come into compliance by delinquent or amended income tax returns and FBARs.¹⁰⁷⁹ The scope of the Program differs for those who are U.S. residents and those who are not U.S. residents during the covered years. For nonresidents, the program requires 3 years of delinquent or amended returns and 6 years of delinquent FBARs, plus the certification of willfulness. For those nonresidents, the only cost is the income tax liability reported on the returns plus interest on the income tax reported; there is no offshore penalty. For U.S. residents, the program requires 3 years of amended returns (those who filed no returns are not eligible) and 6 years of delinquent FBARs. For those residents, the costs are the income tax liability and interest plus a 5% offshore penalty.

¹⁰⁷⁸ See DOJ web site titled United States and Switzerland Issue Joint Statement Regarding Tax Evasion Investigations (8/29/13), available here. <http://www.justice.gov/opa/pr/united-states-and-switzerland-issue-joint-statement-regarding-tax-evasion-investigations>. This web site has links to related documents. The remainder of this paragraph summarizes those documents, unless otherwise noted.

¹⁰⁷⁹ The certification is:

I understand that non-willful conduct is conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law.

There is considerable nuance in that certification. John A. Townsend, *The New Streamlined Processes' Requirement of Certifying Non-Willfulness* (Federal Tax Crimes Blog 6/19/14; rev'd 6/21/14); and Charles P. Rettig, *OVDP and Streamlined Procedures: Am I Non-Willful?* (October 13, 2014). *Journal of Tax Practice & Procedure*, August - September 2014. Available at SSRN: <http://ssrn.com/abstract=2509439>.

In addition, the IRS updated its 2012 OVDP initiative to provide that, for certain foreign financial institutions as to which the IRS or DOJ had taken publicly disclosed action (such as indictment, entry into a nonprosecution agreement under the DOJ Tax Swiss bank initiative, or the issuance of a John Doe Summons), the offshore penalty rate in OVDP for those taxpayers using any of those banks in the 8 year reporting period would be 50% rather than 27 ½%. The IRS maintains a web site listing those financial institutions, updated as such public identifications come out.¹⁰⁸⁰

Finally, U.S. taxpayers with foreign accounts who reported and paid tax on all income but did not file FBARs can file delinquent FBARs with a statement as to why they filed late.¹⁰⁸¹ No FBAR penalty will be imposed if there are no U.S. underreported tax and the taxpayer has not been previously contacted for audit.

(6) Opting Out of OVDP and OVDI (Including Extended OVDI).

The program penalties, including principally the offshore penalty in OVDP and OVDI (including extended OVDI) are significant and are a one-size fits all penalty. The IRS recognized that some taxpayers entering the program may not be as culpable as that one size penalty suggests. The IRS thus offered those taxpayers the opportunity to “opt out” of the civil penalty structure of the program and subject themselves to a regular civil audit.¹⁰⁸² Taxpayers so opting out are unable to re-join the program penalty structure if the IRS, upon audit, asserts greater penalties than the program required (as outlined above).

Because it is not certain how the IRS is administering the FBAR penalty regime in audits, many taxpayers viewed this opportunity to opt out with considerable concern. As of this presentation, there is not enough anecdotal evidence as to what is being done in audits to offer any guidance. I will offer the following observations based upon my experience and thinking about the opt out opportunity:

¹⁰⁸⁰ The IRS web site, Foreign Financial Institutions or Facilitators, is available here: <http://www.irs.gov/Businesses/International-Businesses/Foreign-Financial-Institutions-or-Facilitators> (revised 5/18/15, but periodically updated thereafter).

¹⁰⁸¹ IRS web site Options Available to Help Taxpayers with Offshore Interests (revised 4/30/15), available here: <HTTP://WWW.IRS.GOV/INDIVIDUALS/INTERNATIONAL-TAXPAYERS/OPTIONS-AVAILABLE-TO-HELP-TAXPAYERS-WITH-OFFSHORE-INTERESTS>

¹⁰⁸² In OVDP, there was an analogous process actually within the program without opting out to have what is called an FAQ 35 review to insure that the program penalties were not in excess of the penalties the IRS would otherwise assert. Technically, this was inside OVDP rather than an opt out, but the drill was essentially the almost the same as the opt out audit. Perhaps the key benefit of the FAQ 35 review was that it did not require the taxpayer to give up the benefits of the program penalties in order to find out what the alternative result would be. Under the opt out described in the text, the taxpayer would not know what the alternative result is until he or she has given up the penalty regime inside the program.

- The decision to opt out should be made only with the advice of experienced counsel.
- The opt out audit will permit adjustments for all open years. The statute of limitations for income tax adjustments is normally 3 years, but may be 6 years in the case of a 25% omission of gross income and unlimited in the case of civil fraud. Any Form 872 consent to extend the statute of limitations executed during the OVDP process will only be valid as to years for which the statute of limitations was open on the date of execution.¹⁰⁸³ The statute of limitations for FBAR penalties is 6 years, but taxpayers who submit a consent to extend the FBAR statute of limitations in the OVDP process may have a statute defined by the consent (usually 8 years).¹⁰⁸⁴
- Taxpayers clearly intending to use foreign accounts for tax noncompliance (such as via offshore entities to mask beneficial ownership of foreign accounts) should not opt out. Those persons are at high risk of the maximum FBAR penalties – the willful penalty of 50% of the amount in the account for multiple years (although one can infer from the criminal cases that the IRS would only assert that penalty for a single year). They are also at risk of many years – potentially even before 2003 – being open and subjected to tax, civil fraud penalties and interest for those years. They also would be subjected to foreign entity related tax penalties, which can be significant. These taxpayers should not opt out.
- Other taxpayers may have a shot at a lesser penalty, but I strongly recommend that, except in the simplest and most clearly innocent of cases, they only do so with the counsel of an experienced tax attorney.
- Opting out is a major advantage if the foreign noncompliant assets are weighted toward assets other than foreign financial accounts (such as real estate or entities) which must be included in the penalty base inside the civil penalty structure in the program. On opt out, however, the IRS cannot include only foreign financial accounts in the FBAR penalty. However, those considering this type of opt out should consider the additional other income tax penalties that might apply. I noted above the civil fraud penalty, but a taxpayer with a civil fraud penalty risk is not a good candidate for opting out. The other income tax penalties that might apply relate principally to the penalties for failing to report and file with respect to foreign entities (corporations and trusts), which can be significant.

¹⁰⁸³ § 6501(c)(4)(A) requires that the consent be signed “before the expiration of the time prescribed in this section for the assessment.”

¹⁰⁸⁴ The FBAR statute of limitations has no provision such as § 6501(c)(4)(A) limiting the scope of the consent to years otherwise open on the date the consent is signed. Accordingly, there is some concern that general statute waiver principles would permit the consent to open up otherwise closed years. My experience, however, is that the IRS will assert FBAR penalties only for years that were open when the FBAR consent was executed.

- Taxpayers must do the drill of making at least business-judgment “what if” type calculations for the opt out.

The new Streamlined Programs discussed in the prior section are designed to, at least from the date of announcement, permit nonwillful taxpayers a streamlined resolution so that they do not have to join OVDP and then opt out.

H. Statutes of Limitation.

The statutes of limitations for criminal prosecutions for tax crimes are provided in § 6531. For the crimes I expect you to know (the crimes discussed in these materials), the statute is 6 years from the last act. For tax evasion and false returns, it is six years from the date the false return was filed, although it is possible some subsequent act in furtherance of the criminal conduct will “refresh” the statute of limitations. For example, if a false return is filed and, during the audit, the taxpayer makes false statements in order to cover up the fraud, the new false statements will start the statute of limitations on § 7201 running from that date.¹⁰⁸⁵ Note in this example, that the misrepresentation in the audit could be viewed as tax evasion (covering up the original evasion) or simply as a false statement to a government agent punishable under the false statement provisions of 18 U.S.C. § 1001.

If the crime is tax related, but not defined in the Internal Revenue Code, the statute of limitations will usually be provided in the Code defining the crime. For example, for false statements under 18 U.S.C. § 1001 the statute of limitations is 5 years.¹⁰⁸⁶ There is one significant exception. Section 371 of Title 18 defines the conspiracy crime that applies in tax cases, meaning that the general 5 year statute of limitations would apply; the Internal Revenue Code, however, provides a 6 year statute “where the object of the conspiracy is to attempt in any manner to evade or defeat any tax or the payment thereof.”¹⁰⁸⁷

I. Criminal Investigations and Prosecutions.

1. Introduction.

A prototypical tax criminal investigation and prosecution involves two broad phases. The first phase is an IRS administrative investigation by IRS's Criminal Investigation (“CI”). Upon completion of this phase, CI either (1) decides not to pursue the matter further criminally and releases the matter to the civil branches of the IRS for any further appropriate consideration or (2) sends the case to the Criminal Enforcement Section (“CES”) of DOJ Tax. The second phase of the case is then conducted by the CES working with and often through the local United States Attorney

¹⁰⁸⁵ See United States v. Beacon Brass Co., Inc., 244 U.S. 43 (1952); cf. United States v. Anderson, 319 F.3d 1218 (10th Cir. 2003).

¹⁰⁸⁶ § 3282.

¹⁰⁸⁷ § 6531(8).

which is a branch of DOJ. Government attorneys from the CES and/or the United States Attorneys office conduct all further proceedings through prosecution and sentencing.

2. The Usual Criminal Tax Investigation.

a. CI Investigation.

The general flow of a CI criminal investigation is as follows: The CI Special Agent often assisted by a revenue agent will conduct such investigation as necessary using whatever investigative resources are appropriate. I cover those investigative resources below (pp. 387 ff.). The taxpayer is usually aware that a criminal investigation is being pursued, but sometimes the IRS conducts a clandestine investigation. Upon conclusion of the IRS's criminal investigation, if the investigating Special Agent desires to pursue prosecution or further investigation by a grand jury, CI will have several review processes, including a review by a CI attorney (whom the Special Agent would have used as a resource during the investigation). The Special Agent in Charge ("SAC") of the CI district will then decide whether to forward the case to CES. If CI does not recommend criminal prosecution, CI closes the criminal aspect of the case and, if appropriate, sends the case to the examination function for any further civil tax investigation and assessments.

b. DOJ Review Through Prosecution.

If CI recommends that the taxpayer be prosecuted or that the case be further investigated through a grand jury, the case will be referred to CES. CES will then decide how and if to proceed. CES may return the case to the IRS with a final decision of no prosecution or may return the case for the IRS to conduct such further investigation as appropriate and then refer the case again if that is appropriate. Alternatively, CES may forward the case to the local United States Attorney to either present the case to a grand jury for indictment or, alternatively, to have the grand jury investigate further. In all events, CES retains final authority as to whether a tax crime will be indicted and prosecuted. CES retains this authority because the government systemically has limited resources to investigate and prosecute tax crimes, and CES is charged with the responsibility to insure that the government's enforcement efforts are consistent with priorities and resources. Technically, CES does not have responsibility over the IRS's CI which generates most tax criminal cases, but CES sends powerful signals to CI by which cases it prosecutes or declines, thus influencing CI's criminal investigations.

If CES forwards the case to the U.S. Attorney for indictment or grand jury investigation, either a local Assistant U.S. Attorney ("AUSA") or a CES attorney will handle such further processes as are required. If the grand jury indicts, the case will proceed to trial. As in the federal criminal system generally, most criminal tax cases are resolved by plea agreement. Indeed, because of the care with which CES picks its cases, the cases are generally stronger than the average criminal case and produce pleas in 95%+ of the cases. That does not mean that the target pleads to the charges as framed by the prosecutor and grand jury; rather, it means that some compromises are made that from the parties' perspectives is better than going to trial.

If a plea does not result, the case goes to trial.

If the taxpayer is convicted either by plea or after trial, the court will sentence under the Sentencing Guidelines noted above.

c. Taxpayer Conferences.

At each critical stage in this process, the taxpayer's attorney will usually have an opportunity for a meeting with decision makers to attempt to influence their decision as to whether to ratchet the case toward criminal prosecution. At the CI level, the taxpayer's attorney will usually interface with the Special Agent and have an opportunity to advance such arguments as appropriate to prevent the Special Agent from recommending prosecution. At the conclusion of the investigation if the Special Agent is recommending referring the case to CES, the taxpayer will have an opportunity for a meeting either with the SAC or a designated management representative to attempt to persuade CI not to forward the case to DOJ. These opportunities are usually afforded, but are not inalienable rights of the taxpayer. (Remember the Caceres doctrine (p. 63)?)

Similarly, at the DOJ's CES level, the taxpayer will usually have an opportunity for a meeting to attempt to persuade CES not to pursue the matter. This meeting is also not a matter of right, but a taxpayer request for the meeting will usually be honored.

The taxpayer will have a final opportunity to meet with the local AUSA handling the case. By this time, the wiggle room for the AUSA may not be great because of CES's control. Still, some opportunities may be available.

3. Unusual Processing of Criminal Tax Investigations.

The foregoing is a general discussion of the flow of a criminal investigation from CI through DOJ's CES on to the United States Attorney for further investigation or prosecution. Tax criminal cases sometimes take a different route. There are two such routes.

Sometimes DOJ Tax and CI may determine that a grand jury investigation is the preferred investigation route from the beginning. This happened, for example, in some areas of the country in the fuel tax excise tax scams that were rampant in the late 1980's and early 1990's. This also happened in the investigation of major tax shelter abuses by the large accounting firms, including most prominently KPMG and Ernst & Young which have produced several indictments. The administrative investigation by CI is not used in such cases, but one or more CI Special Agents are assigned to assist the grand jury in its investigation.

The second route involves a grand jury investigating nontax crimes that uncovers evidence also of tax crimes. It is not unusual for tax crimes to accompany other illegal activities that are governmental enforcement priorities, such as mob activity and drug dealing. If the prosecutor (an AUSA or DOJ attorney) leading that nontax investigation discovers tax crimes that he or she wants to pursue, the prosecutor can seek appropriate approvals from CI and CES to pursue the tax crimes via the grand jury investigation and indictment process. In both of these situations, there may be no significant investigative activity conducted by CI as CI (as opposed to CI agents assisting the grand jury).

4. Secrecy Rules in Criminal Tax Investigations.

Two secrecy rules play a prominent role in this division of investigations between CI investigations and grand jury investigations.

First, as I mentioned above, § 6103 generally precludes the IRS from disclosing tax return information. Information developed by CI in a CI investigation is tax return information that cannot even be disclosed to DOJ attorneys until CI refers the case to CES. This information can be used by the IRS for any purpose, civil or criminal. Once the case is referred to CES, the IRS can no longer use the IRS administrative summons or begin a proceeding to enforce a previously issued summons;¹⁰⁸⁸ further compulsory investigative process must be only through the grand jury processes, most significantly the grand jury subpoena.

Second, Rule 6(e), Federal Rules of Criminal Procedure, prohibits disclosure of information developed by the grand jury, so that even tax relevant information developed by the grand jury cannot be shared with the IRS, except for IRS personnel (usually Special Agents) assigned to assist the grand jury.

The combination of these rules require that the IRS CI investigation be kept distinct from the grand jury investigation. Of course, the fruits of any CI investigation may go to CES when the case is referred, but the fruits of the grand jury investigation can only be shared with the IRS's CI to the extent necessary to obtain approvals for criminal prosecution. The fruits of the grand jury investigation cannot be used for any other IRS purposes, including civil tax assessment.

To illustrate, I mentioned above that a nontax grand jury may learn of tax crimes and, if CES and the IRS determine that tax indictments would be consistent with tax enforcement priorities, the prosecutor of that grand jury may seek an indictment on the tax crime. The IRS can use that information for the limited purpose of recommending prosecution for the tax crime. The IRS cannot use the information for its own use either civilly or in an IRS administrative investigation. Any of the grand jury information that is subsequently publicly disclosed in the criminal prosecution phase can be available to the IRS for civil tax and other purposes, but often in a plea bargain situation much of the grand jury information will not be disclosed of public record and thus available for general IRS purposes. Thus, the investigative efficiency achieved through using grand jury processes is mitigated by the limitations upon the use of the fruits of the grand jury investigation for civil tax purposes.

5. Sentencing Guidelines Strategy.

Finally, I mentioned above that the Government's enforcement priorities for tax crimes is to select the relatively few cases it selects well so that it obtains a 90+% conviction rate. That does not mean conviction as to all counts charged. Most activity that generates a tax crime charge such as

¹⁰⁸⁸ § 7602(d). A summons enforcement proceeding commenced before the referral, however, may be continued after the referral. Drum v. United States, 602 F.Supp. 834 (M.D.Pa. 1985).

evasion (§ 7201) or tax perjury (§ 7206(1)) will be activity that itself can draw other charges (e.g., Klein conspiracy) or will be accompanied by activity that can draw other charges (e.g., 18 U.S.C. § 1001). Such separate charges would be separate counts in an indictment. Furthermore, if only evasion or tax perjury is charged, each year involved will be a separate count. So most tax crimes indicted will involve multiple counts.

In authorizing the indictment, DOJ Tax's CES will designate a major count or, in more serious cases, perhaps two major counts as to which it desires conviction; the AUSA is then authorized to negotiate a plea as to the major count(s) with the other counts falling by the wayside. For example, in a case I handled, the indictment charged two related defendants with one count each of conspiracy (Klein tax conspiracy), two counts of tax perjury for one (one count for each of two years) and two counts of aiding and assisting (§ 7206(2)) for the other (one count for each of the same two years of the returns). The Government's major count was, respectively, the second year tax perjury count for the one and the second year 7206(2) count for the other, thus evidencing a willingness to drop the conspiracy charge, the tax perjury count for the first year and the 7206(2) count for the second year. This may sound like a good deal for the taxpayer, but it is deceiving.

The reason is that the Sentencing Guidelines recognize that the Government plays games with counts. Thus, in tax crimes (as well as other economic crimes), the Guidelines base sentencing principally upon the tax loss numbers rather than the number of counts. The tax loss numbers will include all relevant conduct, including the tax loss in the counts that were not included in the indictment or are included in the indictment but dropped. Hence, in order to obtain a plea, the Government is really not giving up anything substantial by dropping the non-major counts so long as it obtains a plea to the major counts.

Why then, you have surely questioned by now if you understood what I just said, does the Government charge multiple tax related counts in the first place? I can't crawl into the Government's collective mind, but certainly multiple counts give the Government a chip to play (or give up) without really giving up anything material. An unsophisticated defendant or worse, lazy or incompetent counsel, might think that requiring a plea to only one major count is one hell of a deal, when four or five or 20 other counts are dismissed. Moreover, I suspect, the Government feels that it is sometimes helpful to have multiple counts to charge the atmosphere before the jury in the Government's favor if it is unable to force a plea. The more counts may project to the jury that the defendant is a really bad character. If the Government can coax out several different law violations and package them as separate counts from the same basic tax misconduct, it will have achieved an advantage at trial – if nothing else it gives the jury some room to compromise and still obtain a felony conviction. (It may also, of course, have an opposite effect if the jury or the judge were to believe that the Government were just piling on counts for one basic crime.) Also, by charging Klein conspiracy, a frequent traveling companion for tax crimes, the Government can better shape the evidence that it may get admitted at trial. There are thus reasons for the Government to allege several or even many counts even though they will not affect sentencing.

III. Civil Penalties.

A. Introduction.

There are a plethora of civil penalties for tax violations.¹⁰⁸⁹ I discuss here and expect you to know for the examination only the more frequently encountered provisions. I work from the heaviest penalty to the lightest.

The IRM states that the purpose of penalties is “to encourage voluntary compliance by supporting the standards of behavior expected by the Internal Revenue Code” and states that penalties do that by:

- Defining standards of compliant behavior,
- Defining remedial consequences for noncompliance, and
- Providing monetary sanctions against taxpayers who do not meet the standard.¹⁰⁹⁰

I present in this section the significant civil penalties you will encounter in a tax practice. First, however, I address burden of proof.

B. Burden of Proof - General and § 7491(c).

As I cover in more detail below in discussing burden of proof (pp. 569 ff.), generally in civil tax controversies that taxpayer bears the burden of proof with respect to his civil tax liability. The burden of proof has two components – the burden of persuasion (or ultimate burden in the case) and a predicate burden of production historically used for a court to determine if the evidence meets some minimum level that a fact issue should be submitted to a jury. Generally, the taxpayer bears both these burdens. By virtue of being assigned the burden of persuasion, the taxpayer will perforce bear the burden of production. There is considerable logic to this assignment of these burdens as to the underlying tax liability. There is also some logic to this assignment of these burdens as to penalties. As to both aspects of a taxpayer’s potential liability, the taxpayer is usually better in command of the relevant information than is the IRS and better able to persuade on the issue one way or the other.

Nevertheless, in response to expressions of concern that the IRS may be less than even-handed with respect to the assertion of penalties, thereby unfairly imposing burdens on taxpayers and the courts, Congress enacted § 7491(c) to impose upon the IRS the **burden of production** in any court proceeding with respect to “any penalty, addition to tax, or additional amount imposed by

¹⁰⁸⁹ The Penalty Handbook says that there are more than 140 penalties. Penalty Handbook, par. 120.1.1.1.1.

¹⁰⁹⁰ Penalty Handbook, par. 120.1.1.2.

this title.”¹⁰⁹¹ I think it is best at this point to merely state the rule in generalities rather than in detail and defer a more detailed discussion until a later point in the text. The burden of production is a fairly minimal burden to show the court that the IRS has some minimal reasonable basis for asserting penalty. Once the IRS makes that minimal reasonable showing, the taxpayer bears the burden of persuading the court that the penalty should not be imposed.

There is one exception to the foregoing, where the penalty is a fraud penalty (fraudulent return or fraudulent failure to file, both of which are civil fraud penalties. As noted in the two succeeding sections, the IRS bears the burden of establishing the fraud predicate to those penalties by clear and convincing evidence. Since it bears the burden of persuasion on that issue, it necessarily bears the burden of production.

C. Fraudulent Return - § 6663.

Section 6663 imposes the civil fraud penalty “If any part of any underpayment of tax required to be shown on a return is due to fraud.” § 6663(a). This penalty is often referred to as the civil fraud penalty. The penalty is “75 percent of the portion of the underpayment which is attributable to fraud.” *Id.* The underpayment is the amount of tax the taxpayer owes over what the tax the taxpayer reported; some or all of that underpayment may be due to fraud.¹⁰⁹² The civil fraud penalty is a civil sanction with a remedial character rather than a punishment in addition to the criminal fraud penalty, so that it is not double jeopardy and will survive the death of the taxpayer subject to the penalty.¹⁰⁹³

¹⁰⁹¹ There may be tax that appears to serve as a penalty. For example, § 72(t) imposes an “additional tax” on distributions from qualified with certain exceptions (including most prominently distributions after the age 59 ½) and distributions after separation from service for an employee 55 or older. § 72(t)(f)(2)(A). That may look and operate like a penalty for early distributions, but it is an additional tax that is not a penalty that invokes the requirement that the IRS bear a burden of production for the imposition of the tax. El v. Commissioner, 144 T.C. ___, No. 9 (2015).

¹⁰⁹² In Feller v. Commissioner, 135 T.C. 497 (2010), the taxpayer fraudulently overstated withholding tax credits, thereby understating the amount of tax due with the return. The taxpayer argued that, in determining “underpayments” under the statute, withholding tax credits were not considered and therefore the Regulations permitting fraudulent withholding credits to be considered was invalid. In a reviewed decision, the Court determined that, the Regulations adopted under the general authority of § 7805(a), were to be tested under the Chevron analysis and, under that test, were a reasonable construction of the statute.

¹⁰⁹³ Helvering v. Mitchell, 303 U.S. 391, 401 (1938); see Reiserer v. United States, 478 F.3d 1160 (9th Cir. 2007) (involving a promoter penalty but with the same analysis as to whether the civil penalty is remedial or punitive and holding that, since remedial rather than punitive, the penalty survives death).

The Code does not define fraud, but it may be viewed as the civil counterpart of criminal tax evasion in § 7201, the crime of tax evasion.¹⁰⁹⁴ Courts have stated that for civil fraud: (i) “Fraud is the intentional commission of an act or acts for the specific purpose of evading tax believed to be due and owing;”¹⁰⁹⁵ and (ii) fraud requires that “the taxpayer have intended to evade taxes known to be due and owing by conduct intended to conceal, mislead or otherwise prevent the collection of taxes and that is an underpayment.”¹⁰⁹⁶ In making the determination, as with criminal cases, courts will often look to certain common patterns indicating fraud – referred to as badges of fraud, such as unreported income, failure to keep adequate books, dealing in cash, etc.¹⁰⁹⁷ The key differences between the two is that § 6663 is a civil penalty and different burdens of proof apply as I note later.

Because of this commonality between § 7201, tax evasion, and § 6663, civil fraud, the interpretations of willfulness for tax evasion may apply to the civil fraud penalty. Thus, the courts allow the jury to consider willful blindness in considering whether the Government in a tax evasion case has established the requisite willfulness beyond a reasonable doubt. Also, the so-called “Cheek” defense to tax evasion – a subjective good faith misunderstanding of the law, however objectively unreasonable, precludes the element of willfulness or its civil penalty counterpart in § 6663. Cheek v. United States, 498 U.S. 192 (1991) (interpreting willfulness under § 7201).¹⁰⁹⁸ This defense is not available if the taxpayer knew the law and simply disagreed or the taxpayer knew the law and thought it unconstitutional; rather he must have a good faith belief that his actions complied with the law.¹⁰⁹⁹

¹⁰⁹⁴ Anderson v. Commissioner, 698 F.3d 160, 164 (3d Cir. 2012), cert. denied ___ U.S. ___, 133 S. Ct. 2797 (2013) (“the elements of evasion under 26 U.S.C. § 7201 and fraud under 26 U.S.C. § 6663 are identical.”).

¹⁰⁹⁵ Erikson v. Commissioner, T.C. Memo 2012-194.

¹⁰⁹⁶ Nelson v. Commissioner, T.C. Memo. 1997-49; and Fiore v. Commissioner, T.C. Memo. 2013-21 (“Fraud is the ‘willful attempt to evade tax’” and using the criminal law concept of willful blindness to find the presence of civil fraud; note that, in the criminal law, the concept of willful blindness goes by several names, including conscious avoidance which is the one I usually use.)

¹⁰⁹⁷ E.g., Kosinski v. Commissioner, 541 F.3d 671, 679-80 (6th Cir. 2008). For use of a negative inference from assertion of the Fifth Amendment privilege in concluding that the IRS had met its burden of proving civil fraud by clear and convincing evidence, see Loren-Maltese v. Commissioner, T.C. Memo. 2012-214.

¹⁰⁹⁸ Technically, although commonly referred to as the “Cheek” Defense, this is not a defense in the traditional meaning that a defense that avoids a conviction after the Government has proved the elements of the crime or elements of the civil fraud penalty. Rather, if the trier of fact believes that the taxpayer acted under a mistaken but good faith misunderstanding of the law, the Government will not have proved willfulness under § 7201 or the intent counterpart for civil fraud under § 6663.

¹⁰⁹⁹ E.g., Cheek, supra (§ 7201); Porter v. Commissioner, T.C. Memo 2015-122 (§ 6663).

In order to prevail on the civil fraud penalty, the IRS is first required to prove that some portion of the understatement is attributable to fraud by clear and convincing evidence. § 7454(a).¹¹⁰⁰ Like the criminal standard “beyond a reasonable doubt,” there is no satisfactory language to inform precisely what “clear and convincing” is; perhaps the best that can be said is that it lies somewhere on the continuum between “more likely than not” (the usual civil burden) and “beyond a reasonable doubt” (the criminal burden)¹¹⁰¹ If the IRS meets that burden, the entire understatement will be subject to the penalty except to the extent that the taxpayer establishes by a preponderance of the evidence that it does not arise from fraud. § 6663(b).

A spouse signing a joint return is not subject to the penalty unless he or she participated in the fraud. § 6663(c). Furthermore, a spouse thus innocent is not liable for the substantial

¹¹⁰⁰ Section 7454(a) provides that the IRS must prove fraud; that the IRS prove fraud by clear and convincing evidence is nonstatutory, but has developed as a consistently applied rule consistent with historic pleading and proof rules. See e.g., Tax Court Rule 142(b).

Section 7454(a) was initially enacted in a 1928 Revenue Act provision that applied by its terms only in the Tax Court. Revenue Act of 1928, c. 852, § 601, 45 Stat. 791; see Paddock v. United States, 280 F.2d 563 (2d Cir. 1960). Indeed, the section refers to “petitioners,” the term used for the taxpayer in Tax Court deficiency proceedings; notwithstanding that reference, however, the few courts addressing the issue say that the burden is on the IRS to prove fraud regardless of the forum that the fraud issue arises. Leo P. Martinez, Tax Collection and Populist Rhetoric: Shifting the Burden of Proof in Tax Cases, 39 *Hastings L.J.* 239, 263-264 (1988) (citing Paddock and Carter v. Campbell, 264 F.2d 930, 937-38 (5th Cir. 1959); Trainer v. United States, 145 F. Supp. 786, 787 (E.D. Pa. 1956); see Lee v. United States, 466 F.2d 11, 14 (5th Cir. 1972)).

¹¹⁰¹ One author says that “typical jury instructions” require persuasion that the fact is “highly probably true.” Michael S. Pardo, Second-Order Proof Rules, 61 *Fla. L. Rev.* 1083, 1097 n. 80 (2009) (citing 7th Circuit Pattern Jury Instructions and See McCormick on Evidence § 340 (John W. Strong ed., 5th ed. 1999) (1954)). Playing the numbers game, Judge Jack B. Weinstein, certainly one of the deeper thinkers in this area, observed that the lesser clear and convincing standard of proof (the standard applicable in civil fraud matters such as a civil fraud penalty under § 6663) might be quantified as proof above 70%. See United States v. Copeland, 379 F. Supp. 2d 275 (ED NY 2005), *aff’d* United States v. Copeland, 2007 U.S. App. LEXIS 19794 (2d Cir. 2007), quoting United States v. Fatico, 458 F. Supp. 388, 411 (E.D.N.Y. 1978). Other thoughtful observers quantify the proof for “clear and convincing” at 75%. See Lewis Kaplow, Burden of Proof, 121 *Yale L.J.* 738, 779 n. 77 (2012) (citing a survey of federal judges showing a range of 70% to 80%, with an average of 74.99%).

Based on empirical studies, some authors suggest that juries actually, and erroneously, perceive the “clear and convincing” standard to be greater than the “beyond a reasonable doubt standard.” See Lawrence Solan, Refocusing the Burden of Proof in Criminal Cases: Some Doubt about Reasonable Doubt, 78 *Tex L Rev* 105, 128-129 (1999); Michael S. Pardo, Second-Order Proof Rules, 61 *Fla. L. Rev.* 1083, 1097 (2009). Bench trials, presumably would not present this logical inconsistency but perhaps suffer from some judges relaxed assessments of the quantum of proof required for proof “beyond a reasonable doubt.”

understatement penalty with respect to that portion of the understatement to which the fraud penalty applies against the other spouse.¹¹⁰²

This civil fraud penalty is usually asserted after a taxpayer has been criminally prosecuted under § 7201 (evasion) or § 7206(1) (false return, provided, as is usually the case, that there is a deficiency due to fraud).¹¹⁰³ The civil fraud penalty may be asserted in cases where there has been no criminal prosecution. If the taxpayer is found guilty of tax evasion (§ 7201) in the context of a filed tax return in the criminal prosecution, the conviction will act as collateral estoppel on the issue of the taxpayer's fraud at least as to some portion of the understatement and will thus meet the Government's initial burden.¹¹⁰⁴ If, however, the taxpayer is convicted under § 7206(1), the conviction merely establishes that the taxpayer filed willfully a false return in some respect and thus will not be preclusive by collateral estoppel on the issue of whether the “underpayment . . . is due to fraud” as required for the civil fraud penalty.¹¹⁰⁵ If, however, the taxpayer admitted fraud in the

¹¹⁰² Said v. Commissioner, T.C. Memo. 2003-148.

¹¹⁰³ This has been my experience. TIGTA reported that the IRS' follow-through on the civil side after criminal investigation (whether or not a prosecution results) is not as uniform as my experience. TIGTA, Improvements Are Needed to Ensure Information Developed During Criminal Investigations Is Referred for Civil Action (Audit # 200310041), unofficially reproduced at 2004 TNT 210-4.

¹¹⁰⁴ See Williams v. Commissioner, 114 T.C. 136, 143 (2000) (§ 6662(a) accuracy related penalty not applicable if the purported return is not a return). Focus now on the fraud penalty. Does the text of § 6663 really require a return? The answer is no, but there is a more appropriate penalty where evasion relates to failure to file – the fraudulent failure to file penalty under § 6651(f), which we shall discuss in the next section.

¹¹⁰⁵ Wright v. Commissioner, 84 T.C. 636, 643 (1985) (reviewed opinion); see also IRM 25.1.6.4 (10-30-2009). For an interesting discussion of the potential application of collateral estoppel from findings made in a sentencing hearing after a § 7206(1) conviction, see FSA 200221002 (dated 2/25/02). Also, I throw out an issue here of whether the tax loss number that is normally required to be determined under the Sentencing Guidelines in order to sentence could, in some cases, operate as collateral estoppel on both the issue of some fraudulent underreporting and the amount thereof or, digging deeper in nuances, the taxpayer might be able to assert that the tax loss number determined at sentencing is the cap on the base to which the civil fraud penalty applies. The trend of the case holdings is that that, as to the tax loss number, the sentencing findings are not preclusive. Kosinski v. Commissioner, 541 F.3d 671 (6th Cir. 2008), a well reasoned and nuanced opinion citing, inter alia, the Booker shift in binding effect of the Sentencing Guidelines and Maciel v. Commissioner, 489 F.3d 1013 (9th Cir. 2007); but see John A. Townsend, Collateral Estoppel in Civil Cases Following Criminal Convictions, 2005 TNT 4-28 (2005) arguing for preclusive effect as to the sentencing tax loss number. The Kosinski opinion does make clear that, although the scope of its holding might suggest that any sentencing finding would not be preclusive, it was in fact holding only that tax loss findings were not preclusive. And, to use the old saying that consistency is the hobgoblin of small minds, at the same time as denying preclusive effect to tax loss findings when the taxpayer attempts to invoke the doctrine, courts appear willing to permit the doctrine in other cases. See Arguelles-Olivares v. Mukasey, 526 F.3d 171 (5th Cir. 2008) (in an immigration

plea agreement or at sentencing, even though he was not convicted of evasion, that admission may be controlling or persuasive in a civil case where the IRS must establish fraud (such as for the fraud penalty or an unlimited statute of limitations).¹¹⁰⁶

If the taxpayer is acquitted in the criminal proceeding, however, collateral estoppel does not prevent the IRS from asserting and prevailing as to the civil fraud penalty. Why? A finding of not guilty is not necessarily a finding of innocence; it is only a finding that the Government failed to prove guilt beyond a reasonable doubt.¹¹⁰⁷ In an ensuing civil tax case, the Government must establish fraud only by clear and convincing evidence, a substantially lesser burden than the beyond a reasonable doubt requirement for criminal conviction. Accordingly, the IRS may and usually does assert the civil fraud penalty when the taxpayer has been acquitted.¹¹⁰⁸

In applying collateral estoppel, it is critical to focus on precisely what was determined in the prior criminal case. A § 7201 conviction will, as noted, be on all squares to establish that **some portion** of the underpayment was due to fraud. That is all that is required to invoke § 6663's burden shifting rules, so that, although the taxpayer previously convicted of evasion is not collaterally estopped as to the amount of tax or the amount attributable to fraud, the taxpayer then bears the burden of proof in the civil case to reduce the tax and to reduce the amount attributable to fraud. A § 7206(1) conviction, however, will not act as collateral estoppel on the fraud issue because a

proceeding, accepting the court's sentencing finding (based on the PSR) as to the tax loss for purposes of determining that the tax loss exceeded \$10,000, a key element of the immigration statute).

¹¹⁰⁶ See e.g., Evans v. Commissioner, T.C. Memo. 2010-199 (Although Evans' conviction for subscribing a false Federal tax return does not collaterally estop him from denying that he fraudulently understated petitioners' income tax liability, his conviction is evidence of fraudulent intent”).

¹¹⁰⁷ Of course, the jury could have returned the not guilty verdict based upon their unstated finding that the defendant was innocent. So, a not guilty verdict is consistent with innocence in fact but certainly does not establish innocence in fact because a not guilty verdict is also consistent with a jury unstated finding that guilt was proved by a preponderance of the evidence but not beyond a reasonable doubt. Consider the following quote from United States v. Gricco, 277 F.3d 339, 352 n. 4 (3d Cir. 2002):

It has frequently been stated that judgments of acquittal are not even relevant on the issue of guilt because “they do not necessarily prove innocence but may indicate only that the prosecution failed to meet its burden of proof beyond a reasonable doubt as to at least one element of the crime.” [Case citation omitted]

¹¹⁰⁸ Collins v. Pond Creek Mining Co., 468 F.3d 213, 217-218 (4th Cir. 2006) (The doctrine does not apply “where the party against whom the doctrine is invoked had a heavier burden of persuasion on that issue in the first action than he does in the second, or where his adversary has a heavier burden in the second action than he did in the first”), cited and quoted in McHan v. Commissioner, 558 F.3d 326, 331 (4th Cir. 2009).

fraudulent underpayment is not an element of the crime; rather only a false statement is required.¹¹⁰⁹ Hence, the civil fraud penalty requiring fraud as to the underpayment cannot be based on a § 7206(1) conviction; the IRS will be required to prove fraud without the benefit of collateral estoppel.

Let's look at another application of collateral estoppel. For tax Year 1, taxpayer fraudulently claims large fraudulent deductions, thus wiping out his Year 01 tax liability and creating a net operating loss on the tax Year 1 tax return filed 4/15 of Year 02. Taxpayer elects not to carryback his losses, and therefore carries them forward. He claims some portion of the NOL carryforward in Year 04 on his return filed 4/15 of Year 05. On ½ of Year 06, he is indicted for tax evasion for Year 1. He is subsequently convicted of the charge. Based on the foregoing, the conviction of tax evasion for Year 1 is collateral estoppel as to civil fraud in Year 01. But, is the Year 01 conviction collateral estoppel on the civil fraud issue as to the Year 04 return? One court has so held, reasoning that the claiming of a fraudulent NOL carryforward perforce renders the later year return fraudulent and, since the claiming of the NOL loss itself has already been litigated between the parties in the NOL year (Year 01 in this example), it is collateral estoppel in the subsequent non-conviction year (Year 04 in the example).¹¹¹⁰ What would you argue in response?

D. Fraudulent Failure to File Return - § 6651(f).

I discuss the general civil failure to file penalty below. However, if the failure to file is due to fraud, the failure to file penalty is tripled (from 5% per month to 15% per month, up to a 75% maximum). § 6651(f). Fraud for this purpose is the same as for the civil fraud penalty – a willful attempt to evade tax – except that it occurs in the context of a failure to file rather than a filed return.¹¹¹¹ Essentially, the same fraudulent intent for § 6651(f) is required in a failure to file context as is required for the § 6663 civil fraud penalty in the case of a filed return.¹¹¹² (The criminal analog to civil fraudulent failure to file is tax evasion, § 7201, which is not that commonly prosecuted, but requires some affirmative act of evasion in addition to failure to file; applying that concept to civil fraudulent failure to file, the IRS will have to show that the taxpayer did something in the nature of an affirmative beyond the mere failure to file.)

The critical differences that distinguish the civil fraudulent failure to file penalty from the civil fraud penalty are: (1) the fraudulent failure to file penalty is based upon the net tax due on the due date of the return (i.e., appropriate credits are given for tax payments on or before the date of the return), whereas the civil fraud penalty is based on the portion of amount shown on the return attributable to fraud, which excludes the tax payments and any portion of the tax underpaid not attributable to fraud; and (2) the fraudulent failure to file penalty is a time based penalty that permits mitigation where the taxpayer acts promptly after the event giving rise to the penalty. The latter is

¹¹⁰⁹ Wright v. Commissioner, 84 T.C. 636, 643 (1985) (intent to evade tax is not an element of the § 7206(1) offense).

¹¹¹⁰ Gandy Nursery, Inc. v. United States, 318 F.3d 631 (5th Cir. 2002).

¹¹¹¹ See Clayton v. Commissioner, 102 T.C. 632, 653 (1994); Mohamed v. Commissioner, T.C. Memo. 2013-255.

¹¹¹² Mohamed v. Commissioner, T.C. Memo. 2013-255.

illustrated where a taxpayer fails to file a Year 01 return on April 15 of Year 02 with the intent to commit fraud by the failure to file and then, in 4 months or less (before August 15 of Year 02), files a nonfraudulent delinquent return for Year 1. The taxpayer will thus not be subject to the entire 75% penalty, but will be subject to some lesser percentage depending upon when in that 4 month period the taxpayer files the delinquent return. This pristine illustration is not a real world example because, barring absolutely bizarre facts, the filing of the delinquent return so quickly will cure any practical fraud risk, civil or criminal. The IRS will never look for fraud because, by the time the IRS would look for a reason for the original failure to file timely, a delinquent return will have been filed and the IRS will not expend resources to inquire as to the reason for the original delinquency. The only fraud the IRS will concern itself with is fraud with respect to the delinquent return, but the example posits the filing of a nonfraudulent delinquent return. Hence, as a practical matter, if you have a client subject to this penalty, it will be the maximum 75% which, except for the potential difference in the amount to which the percentage applies, will be the same as civil fraud penalty.

The difference in the amount of the base may be illustrated by a variation of the same example. Let's say that the tax due on a correct return would be \$100, and there is no advance payment of tax. The taxpayer fraudulently fails to file the Year 01 return on April 15 of Year 02, the due date for the Year 01 return. On October 1 of Year 02, the taxpayer files a return reporting \$20 of tax. Assume that, of the underreported tax of \$50 on the delinquent return, \$50 is attributable to fraud and \$50 is attributable to erroneous but nonfraudulent positions. The civil fraudulent failure to file penalty would be \$75. By filing the delinquent but fraudulent return, the taxpayer would have practically avoided the IRS investigating fraud with respect to his original delinquency, and will have reduced his civil penalty exposure to 75% of \$50, or \$37.50. But, by filing a fraudulent delinquent return, the taxpayer will also have raised the potential stakes of criminal prosecution from what would likely be a failure to file misdemeanor prosecution under § 7203 to a felony evasion prosecution under § 7201.¹¹¹³

The latter point further illustrates that one of the easiest tricks in the lawyer's arsenal for a client who is in the situation of having failed to file a return is to advise the client to promptly file a return. The filing of a delinquent return before a criminal investigation starts will usually forestall the institution of a criminal investigation in the first instance and the IRS is not likely to expend resources to determine whether the original failure to file was fraudulent so as to assert the fraudulent failure to file penalty. The IRS will usually automatically assert the general failure to file penalty (5% per month up to 25%) when it receives the delinquent return, but the risk of the IRS's

¹¹¹³ OK, those of you who have been paying careful attention will recall that, in some cases, a § 7201 evasion case can be made in the absence of filing a fraudulent return and for this example, I assumed a fraudulent failure to file. It would accordingly be possible under these facts for the IRS to investigate and perhaps even pursue and obtain an evasion conviction for the original delinquency in filing the return. Practically speaking, however, if the IRS desired to investigate and DOJ desired to prosecute, they would pursue the § 7203 failure to file misdemeanor charge rather than the evasion charge. First, failure to file cases require less investigative, prosecutive and court resources than evasion cases. Second, the example posits a single year delinquency, and the IRS prefers to charge multiple years in any criminal tax prosecution. The Government's prosecution needs would likely be satisfied with a failure to file prosecution, if it prosecuted at all.

investigation and assertion of the fraudulent failure to file penalty will be practically cured. (See the discussion elsewhere in the text on Voluntary Disclosure.)

Finally, as with the fraudulent failure to file penalty, since fraud is the critical component of the penalty, the IRS must prove fraud by clear and convincing evidence. § 7454(a).¹¹¹⁴

E. Accuracy-Related Penalties - § 6662.

Section 6662 establishes accuracy related penalties designed to penalize certain types of inaccurate return reporting.¹¹¹⁵ The penalty in most cases is 20 % of the amount of understatement attributable to the conduct penalized, but may be increased to 40% for certain egregious misconduct. This penalty does not apply to any portion of the understatement to which the 75% civil fraud penalty applies.¹¹¹⁶ Only one accuracy related penalty applies to each portion of the understatement. In other words, if the taxpayer has an understatement of \$400, it is conceivable that \$100 is subject to no penalty, \$100 is subject to the negligence penalty (one subset of the accuracy penalty), \$100 is subject to the substantial understatement penalty (another subset of the accuracy penalty), and \$100 is subject to the civil fraud penalty.

1. Introduction to the Concepts.

When should a return reporting position draw a penalty either for the taxpayer or the practitioner preparing the return? Keep in mind that this is only a real issue after the IRS and perhaps, ultimately, a court has first determined that the return reporting position was not correct and there is a resulting understatement and underpayment of tax. It is a hindsight look at the taxpayer's reporting of the position in the beginning. As we know from sports, hindsight can be most unforgiving. In a penalty context, it is a search for culpability, and in a tax reporting context culpability has many shades. Consider these shades as illustrated by the tax jargon for confidence in return reporting positions (from least confidence to most confidence):

The tax law has developed the following jargon in quantifying levels of confidence in reporting return positions, with the percentage being the projected chances for success if litigated:

nonfrivolous = 10 percent or better chance of winning
reasonable basis = 20 to 25 % or better chance of winning
realistic possibility of success = 33 1/3 % or better chance of winning

¹¹¹⁴ As noted above, § 7454(a) provides that the IRS must prove fraud; that the IRS prove fraud by clear and convincing evidence is nonstatutory, but has developed as a consistently applied rule. See e.g., Tax Court Rule 142(b).

¹¹¹⁵ The understatement must be made with respect to a filed return. § 6664(b); Regs. § 1.6662-2(a). If a purported return is filed but does not meet the definition of a return (discussed above), then there is no understatement to which the penalty applies, and the only penalty that can apply is the failure to file penalty. See Williams v. Commissioner, 114 T.C. 136, 143 (2000).

¹¹¹⁶ § 6662(b) (flush language at end).

substantial authority = perhaps 35 to 40 % chance of winning
more likely than not = more than 50 % chance of winning
probable = 70 to 90 % chance of winning
will = 90+ % chance of winning¹¹¹⁷

1118

These standards can be stated in the inverse:

nonfrivolous = 90% or less chance of losing
reasonable basis = 75-80% chance of losing
realistic possibility of success = 66 2/3 % chance of losing
substantial authority = perhaps 60 to 65% chance of losing
more likely than not = less than 50 % chance of losing
probable = 10-30 % chance of losing
will = <10% chance of losing.

(Note that the probable and will level opinions do not apply in a tax context and have found some application in financial accounting and in individual comfort levels that various persons in the decision process might desire for some tax positions.)

One issue the student and practitioner should think seriously about is whether these percentages are meaningful generally or in the context of any particular position. What is the difference between a more likely than not opinion at the 51% confidence level and a not more likely than opinion? That difference could be as low as 1% or even a fraction of 1% if the more likely than not opinion were, say, 50.05%, which still exceeds 50%. That is not a meaningful difference in trying to determine what a court would do with the claimed tax benefit. Indeed, trying to discern a 50.05% confidence level or even a 55% confidence level is often an exercise that is more driven by the desired result than a thoughtful and objective analysis of the law and a projection for what a court would determine. The major tax shelter prosecutions have involved tax professionals rendering more likely than not opinions which, under any reasonable analysis, could never be more likely than not. Usually, those prosecutions were based mostly on other recognizable criminal

¹¹¹⁷ This list was originally summarized from Burgess J.W. Raby and William L. Raby, Painting the Accounting Practitioner Into a Tax Practice Corner, 2005 TNT 178-4, but comparable lists more explanation are in Michelle M. Kwon, Dysfunction Junction: Reasonable Cause and Good Faith Reliance on Tax Advisors with Conflicts of Interest, 67 Tax Lawyer 403, 407 (2014); Charles P. Rettig, Practitioner Penalties: Potential Pitfalls in the Tax Trenches, 123 Tax Notes 207, 215-219 (April 13, 2009) and in David Weisbach and Brian Gale, The Regulation of Tax Advice and Tax Advisors, 130 Tax Notes 1279, 1283-1284 (Mar. 14, 2011) (citing at n. 25 Jasper L. Cummings, Jr., The Range of Legal Tax Opinions, With Emphasis on the “Should” Opinion, Tax Notes, Feb. 17, 2003). For a humorous extension of these probability percentages, see Anonymous, A Detailed Guide to Tax Opinion Standards, Tax Notes 1469 - 1470 (3/21/05).

¹¹¹⁸ Michelle M. Kwon, Dysfunction Junction: Reasonable Cause and Good Faith Reliance on Tax Advisors with Conflicts of Interest, 67 Tax Lawyer 403, 407, 409 (2014).

problems (lying, cheating and stealing),¹¹¹⁹ but the backdrop for the prosecutions were more likely than not opinions that were just false.

Moving toward the bottom of the spectrum, the “reasonable basis” position which is quantified as only a 20 or 25% chance of success (or 75-80% chance of failing). That does not sound like a very high standard, but the IRM says: “Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper.”¹¹²⁰ Query whether positions that merely avoid characterization as frivolous or patently improper mean that they have a reasonable basis, unless the law is that taxpayers have a reasonable basis for positions that they are most likely to lose if the IRS discovers them?

Just for completeness on this note of trying to state confidence levels in words and percentages, financial accounting has added higher levels confidence – “should” (which may be similar to “probable” in the list above) and “will” (which I suppose is at least 99%).¹¹²¹ These levels may permit some financial accounting treatment not otherwise available, but I don’t go further with these concepts here because they are not part of the tax regime.

2. Penalty Base - Tax Understatement; Qualified Amended Return (“QAR”).

The accuracy related penalties apply a penalty rate (20% or 40%) to a penalty base which is the tax underpayment.¹¹²² If a taxpayer reports \$100 of tax and upon audit is determined to have owed \$150, the underpayment is \$50. Some portion or all of the underpayment may be subject to the accuracy related penalty.

I mentioned earlier in discussing amended returns that there is a special category of amended return called a qualified amended return (“QAR”) The QAR – relief granted by Regulations rather than by statute – permits a taxpayer to treat the amount of tax reported on the QAR as the tax reported on an original return so that the accuracy related penalty will not apply.¹¹²³ In the example above, if the taxpayer files a QAR reporting the correct \$150 tax liability after reporting only \$100 on the original return, the reporting of the correct \$150 liability will avoid the accuracy related

¹¹¹⁹ Of course, a false more likely than not opinion is a lie thus prosecutable as a tax crime, but if that were the only lie, it might be hard to attack a tax professional’s belief that his opinion really was more likely than not. This gets into an area covered by the analogous so-called Cheek defense to tax crimes where a sincerely held belief, however unreasonable cannot be the basis of a tax crime having an element requiring willfulness – intentional violation of a known legal duty. Cheek v. United States, 498 U.S. 192 (1991).

¹¹²⁰ IRM 20.1.5.2.4.10 (01-24-2012), Definitions.

¹¹²¹ David Weisbach and Brian Gale, The Regulation of Tax Advice and Tax Advisors, 130 Tax Notes 1279, 1283-1284 (Mar. 14, 2011).

¹¹²² § 6664(a); see Regs § 1.6664-2(a).

¹¹²³ Regs. § 1.6664-2(c)(2).

penalty. QAR relief does not apply, however, as to the amounts originally underreported attributable to fraud.¹¹²⁴

What are the circumstances in which the taxpayer may achieve the benefit of the QAR? A QAR is an amended return filed after the original due date of the return (determined with extensions) but before any of the following events: (i) the date the taxpayer is first contacted for examination of the return; (ii) the date any person is contacted for a tax shelter promoter examination under § 6700;¹¹²⁵ (iii) as to a pass-through entity item, the date the entity is first contacted for examination; (iv) the date a John Doe Summons is issued to identify the name of the taxpayer; and (v) as to certain tax shelter items, the dates of certain IRS initiatives published in the Internal Revenue Bulletin.¹¹²⁶ Undisclosed listed transactions are excluded.¹¹²⁷

The QAR is a formal procedure to achieve a result in the civil penalty arena that a “voluntary disclosure” – often effected by amended return(s) – does in the criminal tax enforcement arena in generally the same relevant equitable circumstance – i.e., the IRS has not yet started a criminal investigation against the taxpayer or a related proceeding (e.g., § 6700 investigation or John Doe Summons) likely to lead to the taxpayer. These programs that permit taxpayers to avoid penalties – civil in the case of a QAR and criminal in the case of the voluntary disclosure practice – are designed to encourage taxpayers to get right voluntarily with the IRS. The programs produce significant additional revenue that might otherwise escape the IRS net; in the circumstances, foregoing the penalties is consistent with overall revenue enforcement policies. I discussed the criminal voluntary disclosure policy earlier in this book.

There is yet another opportunity to avoid the impact of the accuracy related penalties. An IRS Rev. Proc. permits a taxpayer in large case audits to make appropriate disclosures at the commencement of the audit that will then be treated like a QAR, thus avoiding the accuracy related penalty under the concepts noted above.¹¹²⁸ Some practitioners have claimed that the Rev. Proc., although applicable only to certain taxpayers, can be invoked by all large case taxpayers or, indeed, all taxpayers to avoid accuracy related penalties.¹¹²⁹

¹¹²⁴ § 1.6664-2(c)(2).

¹¹²⁵ For an application of this exception to QAR status, see Bergmann v. Commissioner, 137 T.C. 136 (2011), aff’d 2014 U.S. App. LEXIS 720 (9th Cir. 2014) (involving the John Doe Summons to KPMG during its foray into criminal tax shelters). See also Hale E. Sheppard, The Parameters of Qualified Amended Returns Examined by Tax Court in Case of First Impression, 116 *Journal of Taxation* No. 2 (February 2012).

¹¹²⁶ Regs § 1.6664-2(c)(3)(i).

¹¹²⁷ Regs. § 1.6664-2(c)(3)(ii).

¹¹²⁸ Rev. Proc. 94-69, Rev. Proc. 94-69, 1994-2 C.B. 804, § 3; see 20.1.5.7.2.1.1 (01-24-2012), Special Rules for Disclosure.

¹¹²⁹ Although the language of Rev. Proc. 94-69 and the IRM states that it applies only to taxpayers in Coordinated Industry cases (successor to the Coordinated Examination Program mentioned in the Rev. Proc.), which are subject to regular and annual audits, practitioners report the

3. Negligence and Disregard of Rules and Regulations.

a. Negligence.

The negligence penalty applies to the portion of the understatement due to negligence or disregard of rules and regulations. I set aside for now the disregard disjunctive basis for the penalty to focus on negligence.

Negligence includes “any failure to make a reasonable attempt to comply with the provisions of this title.” § 6662(c). In a commonly cited formulation, the Fifth Circuit has said that “Negligence is lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances.”¹¹³⁰ Courts will subject a taxpayer if, under the circumstances and regardless of how elaborate the tax planning, the taxpayer should have known or had reason to believe it was just “too good to be true.”¹¹³¹ Keep in mind that the court reaches the penalty issue only after it has found or the parties have conceded that the planning was in fact too good to be true.

The portion of the tax underpayment that has a reasonable basis does not draw this penalty, at least if the basis for the penalty is negligence (as opposed to disregard).¹¹³² Reasonable basis is a higher standard than not frivolous and not patently improper (the latter standards may apply in other situations not here relevant). Reasonable basis is, however, less than the substantial authority standard discussed below in the substantial understatement penalty. In the percentages notes above, reasonable basis is just a 20 to 25% chance of prevailing, so this is not a particularly high standard.¹¹³³

We observed above that a spouse innocent of fraud but signing a joint return is relieved of the civil fraud penalty arising from the other spouse’s conduct. However, a spouse “innocent” of negligence is not automatically relieved of the negligence penalty arising from the other spouse’s

potential for having it apply to other taxpayers. [IRS Practice and Procedure Deskbook, Chapter 7, Large Case Examinations § 7:5.5 p. 7-58 \(Practicing Law Institute 11/10\)](#) (all large case taxpayers; my anecdotal experience has been consistent for large case taxpayers); [Ryan Lardinois and Mark Heroux, LB&I Directives on Information Document Requests and Rev. Proc. 94-69 \(The Tax Advisor 2014\)](#) (claiming that it should apply to all taxpayers on the notion that the IRS cannot discriminate among taxpayers, citing [Computer Sciences Corp. v. United States](#), 50 Fed. Cl. 388 (2001); [Oshkosh Truck Corp. v. United States](#), 123 F.3d 1477 (Fed. Cir. 1997); and [International Business Machines Corp. v. United States](#), 343 F.2d 914 (Ct. Cl. 1965); the authors state that, although agents might resist, they will ultimately be convinced of the “universal applicability” of the Rev. Proc.).

¹¹³⁰ [Marcello v. Commissioner](#), 380 F.2d 499, 506 (5th Cir. 1967).

¹¹³¹ [Santa Monica Pictures, LLC v. Commissioner](#), T.C. Memo. 2005-104, at p. 353.

¹¹³² IRM 20.1.5.7.1.3 (01-24-2012), Negligence.

¹¹³³ But see IRM 20.1.5.2.4.10 (01-24-2012), Definitions. (“Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper.”).

conduct if they file a joint return.¹¹³⁴ (We cover elsewhere the innocent spouse provisions that may permit the qualifying spouse to avoid liability (pp. 674 ff.))

You are assigned **Streber v. Commissioner, 138 F.3d 216 (5th Cir. 1998)**, involving the application of the negligence penalty. There, the Fifth Circuit said that “the relevant inquiry for the imposition of a negligence penalty is whether the taxpayer acted reasonably” and that good faith reliance on a tax professional is reasonable. (A watershed on this issue was an earlier Fifth Circuit decision in Heasley,¹¹³⁵ a case which has been cited with favor by many courts, and is cited by the Fifth Circuit in Streber.) The Streber Court did not distinguish carefully between the elements of the conduct penalized under § 6662(c) and the reasonable cause exception under § 6664(c) which it did not even mention. In other words, a taxpayer can avoid the penalty if the return position is not negligent or, even if negligent, he had reasonable cause under that standard (discussed in more detail below). The Court held that “Due care does not require young, unsophisticated individuals to independently examine their tax liabilities after taking the reasonably prudent step of securing advice from a tax attorney,” apparently referring to the conduct penalized in § 6662(c) itself.

The Streber Court relied also upon language from **United States v. Boyle, 469 U.S. 241 (1985)** which you should read now. In Boyle, the issue was whether the taxpayer, an estate, was subject to the § 6651(a)(1) failure to file penalty for failing to timely file an estate tax return. Relief from the failure to file penalty is available if the failure is due to reasonable cause and not to willful neglect. There, the taxpayer (through the executor) also relied upon a professional (lawyer) to advise as to when the estate tax return was due and to make sure it was timely completed for filing. The Supreme Court held that the estate did not have reasonable cause because reasonable taxpayers, and particularly the taxpayer there involved, certainly knew a return was due and is charged with the responsibility for ascertaining the due date. The Supreme Court distinguished professional advice on return reporting positions because, due to the complexity of the Code, return reporting positions often involve subtleties requiring reliance on professionals. Courts have picked up on this distinction to avoid the application of the accuracy related penalties where a lawyer has been consulted. I discuss Boyle and some of its subtleties later in the reasonable cause defense to accuracy related penalties.

b. Disregard of Rules and Regulations.

As noted, this penalty may apply even in the absence of negligence if the taxpayer disregards rules and regulations, which is defined to include “careless, reckless, or intentional disregard.” § 6662(c). Where the disregard of the rule or regulation is intentional, a court might not relieve the taxpayer from the penalty, and it is not clear that it would do so if the taxpayer’s conduct is careless or reckless.¹¹³⁶ This penalty will not be asserted if the return reporting position contrary to the rules

¹¹³⁴ Estate of Sperling v. Commissioner, T.C. Memo. 1963-260, affd. 341 F.2d 201 (2d Cir. 1965); see also Dillin v. Commissioner, 56 T.C. 228, 248 (1971).

¹¹³⁵ Heasley v. Commissioner, 902 F.2d 380, 383 (5th Cir. 1990).

¹¹³⁶ See Druker v. Commissioner, 697 F.2d 46 (2d Cir. 1982).

or regulations is disclosed on the proper form on the return.¹¹³⁷ (Note, however, that the taxpayer may obtain relief under § 6664 for reasonable cause and good faith.)¹¹³⁸

4. Substantial Understatement Penalty.

a. Introduction.

The substantial understatement penalty of § 6662(d) is designed to impose a more objective penalty where the taxpayer knew that he was taking an aggressive position. I outline here the key elements of the penalty. But you should understand the “evil” to which the provision was directed. Prior to enactment of this penalty, many taxpayers played the audit lottery (betting they will not be audited, as suggested by the low rates of audit), but hedged their bets by taking return reporting positions that skirted the negligence penalty (reasonable basis position, being only a 20 - 25% chance of winning), which prior to the accuracy related penalty was the only civil penalty for nonfraudulent returns. One such gambit was to “rely” upon questionable opinions from tax professionals engaged by the tax shelter promoter as “insurance” against the IRS assertion of the negligence penalty. Furthermore, they might insert other professionals for the same reason -- to make a facial showing of reasonable cause. Congress reacted to these and related perceived abuses by increasing the negligence penalty from 5% to 20% and by adding other accuracy related penalties that use more objective standards. I shall expect you to know the substantial understatement penalty I discuss here and the substantial valuation misstatement penalty I discuss in the next subheading.

b. Understatement Threshold and Preliminary Base.

The starting point is the understatement threshold. A minimum understatement is required. For an individual, the understatement must exceed the greater of 10% of the tax required to be shown on the return or \$5,000. § 6662(d)(1)(A). For a corporation, the understatement must exceed the greater of (i) 10% of the tax shown on the return or, if greater, \$10,000 or (ii) \$10,000,000. § 6662(d)(1)(B).¹¹³⁹ At this point, if the threshold is met, the **entire** understatement is the penalty base – the amount subject to the penalty. § 6662(d)(2)(A).

c. Reductions to the Penalty Base.

(1) Design of the Statute for Reductions.

Reductions from the entire understatement are provided for the amount attributable to:

¹¹³⁷ IRM 20.1.5.7.2.1 (01-24-2012), Adequate Disclosure. The proper forms are Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement.

¹¹³⁸ See Regs. § 1.6662-3 (“the reasonable cause and good faith exception in § 1.6664-4 may provide relief from the penalty for negligence **or disregard of rules or regulations**, even if a return position does not satisfy the reasonable basis standard.”)

¹¹³⁹ As amended by the 2004 Jobs Creation Act.

- a reporting position that has substantial authority (§ 6662(d)(2)(B)(i)); or
- a reporting position where the two following conditions are met: (i) “the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return,” and (ii) “there is a reasonable basis for the tax treatment of such item by the taxpayer” (§ 6662(d)(2)(B)(ii)).¹¹⁴⁰

(2) Substantial Authority and Reasonable Basis.

I discussed the reasonable basis standard above in discussing the negligence penalty.¹¹⁴¹ Reasonable basis alone is not enough for the substantial understatement penalty. To help bracket these standards for your better understanding, there is a “more likely than not” that means the position more likely than not will prevail (i.e., more than 50% chance of prevailing). Accordingly, the substantial authority standard lies somewhere between the reasonable basis standard and the more likely than not standard.¹¹⁴² The substantial authority standard might be a 40% chance of prevailing.

The substantial authority standard is, according to the Regulations, an objective standard involving an analysis of the law and the application of the law to the relevant facts.¹¹⁴³ Basically, in order to have substantial authority there must be authority supporting the position even though not rising to the level of more likely than not.

The Regulations provide a list of the types of authorities that may be considered in the mix of determining whether the return reporting position has substantial authority. Basically, they are as you might suspect -- the Code, the Regulations, published rulings, private rulings issued to the taxpayer, etc. Please review Streber's discussion of substantial authority at this point.

The substantial authority standard is most frequently considered in the context of a determination of the law relating to the taking of a return position. However, the law is not applied in a vacuum, but is applied to the facts. The facts are not always clear or certain. What is substantial authority where the facts are not certain? Stated otherwise, even if in hindsight a court were to determine the facts differently than assumed in taking the return position, can it be said that the taxpayer did not have substantial authority for taking the fact position? Stated conversely, does the penalty necessarily apply when the facts are determined inconsistently with the return reporting position? The cases are few in this context, but support the position that a return reporting position

¹¹⁴⁰ This reduction will not apply to a corporate return position for “a multiple-party financing transaction if such treatment does not clearly reflect the income of the corporation.” § 6662(d)(2)(B) (flush language).

¹¹⁴¹ We also discussed a variation of the reasonable basis standard in discussing relief for employee re-characterization for service providers treated as independent contractors (so called § 530 relief). See pp. 90 ff.

¹¹⁴² Regs. 1.6662-4(d)(2).

¹¹⁴³ Regs. 1.6662-4(d)(3).

can have substantial authority even where the facts are different than assumed in taking the return reporting position. Perhaps a quintessential case illustrating this concept involves the issue of whether a taxpayer is in a trade or business as to an activity which has certain “hobby” overtones, such as horse raising or racing. In determining the ultimate issue of whether the taxpayer is entitled to claim losses in excess of income, a court must determine whether or not the taxpayer was in the trade or business. A key factual inquiry is whether the taxpayer had a legitimate profit making intent in conducting the activity. If the court holds otherwise, does that mean that the penalty should apply because the necessary factual underpinning for the return reporting position has been shown to be false? Arguably not, because the key factual determination is a conclusion based on a mixed set of facts, a set of facts which were substantial enough for the taxpayer to have taken a reasonable return reporting position. Hence, the courts have determined that a mixed set of facts may constitute substantial authority for a return reporting position.¹¹⁴⁴

(3) Disclosure.

The Regulations provide that disclosure is adequate if made on the original return or a qualified amended return¹¹⁴⁵ via the Form 8275 (Disclosure Statement) or, if the return position is contrary to a regulation, on Form 8275-R (Regulation Disclosure Statement).¹¹⁴⁶ The Regulations do not deny disclosure status if the disclosure is made on or with the return, although not on the indicated Form. For example, many practitioners make some disclosures either on the form or on a separate attachment without using the Form 8275. Provided that such disclosures are not buried so as to avoid the IRS’s normal scrutiny, they probably will work. The better part of wisdom, of course, is to use the authorized form.

The IRS publishes periodically a Revenue Procedure to identify the circumstances under which a disclosure on a return may avoid the § 6662(d) substantial understatement penalty (as well as the preparer penalty under § 6694(a)).¹¹⁴⁷ Taxpayers and their preparers should familiarize themselves with this Revenue Procedure if they are taking positions that are potentially subject to the penalty.

¹¹⁴⁴ See the Streber case cited. Also, see Estate of Kluener v. Commissioner, 154 F.3d 630 (6th Cir. 1998); and Osteen v. Commissioner, 62 F.3d 356 (11th Cir. 1995); and for a discussion of these cases, Burgess J.W. Raby, and William L. Raby, How Tax Practitioners Provide Taxpayers with Penalty Insurance, 2002 TNT 236-50 (12/9/02).

¹¹⁴⁵ Qualified amended return is defined in part here pertinent as a return filed before the taxpayer is first contacted by the IRS for examination. Regs. § 1.6664-2(c)(3). A proper qualified amended return essentially is treated as the original return for penalty purposes, so that proper disclosure on the qualified amended return may qualify the taxpayer for penalty relief. The time to file a qualified amended return is terminated once the IRS issues a John Doe summons or contacts a promoter in a tax shelter context. Regs. § 1.6664-2T(c)(3)(i)(D) & (E).

¹¹⁴⁶ Regs. § 1.6662-4(f)(1).

¹¹⁴⁷ Regs. § 1.6662-4(f)(2). The current version is Rev. Proc. 2014-15; 2014-5 IRB 456.

d. No Reduction for Tax Shelter Positions.

Congress has adopted a panoply of provisions to address the problem of tax shelters. I discuss these provisions in the overall context of tax shelters below pp. 785 ff. For present purposes, § 6662(d)(2)(C) precludes any reduction in the substantial understatement penalty base for tax shelter items. (Technically, what the statute does it to make the substantial authority reduction unavailable for tax shelters.) Tax shelters are broadly defined as

- (I) a partnership or other entity,
- (II) any investment plan or arrangement, **or**
- (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.¹¹⁴⁸

These words are hardly self descriptive, are very broad and are in the disjunctive. Note that the conditional clause at the end of (III) – “significant purpose” – applies to each of (I), (II) and (III). Hence, all partnerships are not tax shelters but only if a “significant purpose . . . is the avoidance or evasions of Federal income tax.” The Regulations flesh this out, although they define a prior iteration of the definition which used the term principal purpose defining a tax shelter as one of the three types:

if the principal purpose [a significant purpose] of the entity, plan or arrangement, based on objective evidence, is to avoid or evade Federal income tax. * * * * Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard commercial business practices, or the mis-characterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter.

Consider the following from a case involving the federally authorized tax practitioner privilege (often initialized to “FATP”) which relies upon this definition of tax shelter to deny application of the privilege for the promotion of a tax shelter. The Court said, after quoting the broad definition:

Nothing in this definition limits tax shelters to cookie-cutter products peddled by shady practitioners or distinguishes tax shelters from individualized tax advice. Instead, the language is broad and encompasses any plan or arrangement whose significant purpose is to avoid or evade federal taxes. See BDO III, 492 F.3d at 823 (noting that the tax shelter exception is broad “but such breadth does not make the text ambiguous”). By advocating such a narrow definition of promotion, Valero is,

¹¹⁴⁸ § 6662(d)(2)(C)(ii).

through the back door, proposing a definition of tax shelters at odds with the text of the statute. We decline to read such a contradiction into the statute. This definition of tax shelter is broad and could, as Valero points out, include some legitimate attempts by a company to reduce its tax burden. But it is not our place to tinker with the unambiguous definition provided by Congress. And even under this definition, tax shelters are not boundless. Only plans and arrangements with a significant--as opposed to an ancillary--goal of avoiding or evading taxes count.¹¹⁴⁹

That does not mean that all is lost for taxpayers who lose on the substantive tax merits of the tax shelter. They may still obtain relief under § 6664 for reasonable cause and good faith, albeit that safety relief valve is stringently applied for tax shelters (see below).

5. Substantial Valuation or Basis Misstatement Penalty.

a. Improper Valuation Claims.

Section 6662(e)'s substantial valuation misstatement penalty is directed to return reporting positions where the law is correctly applied but a critical valuation is grossly erroneous, resulting in the substantial understatement of the tax liability. In many of the abusive tax shelters over the years, the Achilles heel was inflated valuations. The legal superstructure had some facial merit, but it was built on a factual house of cards because of gross overvaluation. A facet of this problem was that, since tax professionals were not valuation experts, they could render their opinions without taking responsibility for the key valuation facts that supported the whole purported tax shelter superstructure. For example, as to property otherwise qualifying for the old investment tax credit (10% of qualifying investment in property), tax shelter promoters would sometimes inflate the value of property to 10 or 20 times its true value and sell it to investment partnerships (where the partners were tax shelter investors) for the inflated value. Of course, only crazy people would pay the inflated value, so the tax shelter investors paid only a small amount down and "paid" the balance by nonrecourse indebtedness (before the rules related to nonrecourse indebtedness and passive losses). Assuming that the value was correct, the taxpayers would be entitled to the credit; the problem was in the valuation. Many, many tax issues, not just tax shelter issues, rely upon valuations. Thus, for example, estate and gift tax returns rely upon reasonably correct valuations. The purpose of this penalty is to put some sting in overly aggressive valuations.

b. Improper Basis Claims.

A related problem is improperly inflating basis. This often occurs in the erroneous valuation context just described. By inflating the purported value of property, a taxpayer purporting to purchase at a fair value (i.e., really the improperly inflated value) claims an inflated basis for the

¹¹⁴⁹ Valero Energy Corp. v. United States, 569 F.3d 626, 632 (7th Cir. 2009). Query whether the language of the statute is really unambiguous as the Court said in Valero and in the predecessor case it cites, United States v. BDO Seidman, LLP, 492 F.3d 806, 823 (7th Cir. 2007). At least, I think, it probably is ambiguous in terms of the IRS's ability under Chevron to adopt regulations further defining the terms.

property and claims improper tax benefits. But improperly inflated basis claims appear in contexts other than inflated valuations. Hence, the penalty applies in the disjunctive – i.e., inflated basis claims alone can be subject to the penalty.

Of course, if the taxpayer simply artificially inflates a basis claim, he can be subject to the 75% civil fraud penalty. But inflated basis claims can have at least the superficial appearance of a legal basis, thus precluding application of the civil fraud penalty. In this case, the substantial valuation misstatement penalty can apply. The Supreme Court so held in United States v. Woods, ___ U.S. ___, 134 S. Ct. 557 (2013). In that case, a TEFRA proceeding, the issue was whether an artificial basis enhancement shelter could avoid the penalty if, by concession or otherwise, the basis overstatement fails the threshold test of economic substance (i.e., was a sham). A couple of courts had held that it could avoid the penalty. Most courts held that it could not. The Supreme Court resolved the issue by holding that the penalty is not avoided just because the tax claim is rejected on some other threshold basis.

c. Error Thresholds for Penalty.

The penalty applies if the valuation claimed in reporting the return position is 150% or more of the correct valuation of the property and the tax attributable to the incorrect valuation exceeds \$5,000 (\$10,000 if a corporation other than an S corporation). § 6662(e)(1)(A) & (2).¹¹⁵⁰ The penalty is increased to 40% if the valuation is 200% or more of the correct valuation. § 6662(h)(2)(A)(i).¹¹⁵¹

d. Section 482 Valuation Misstatements.

The substantial valuation misstatement applies in a special way to § 482 (transfer pricing) valuation misstatements if the reporting position value is 200% or more or 50% or less than the correct value. § 6662(e)(1)(B). U.S. tax can be substantially affected by transfer pricing. Thus, for example, a U.S. subsidiary purchasing inventory from a foreign parent corporation can understate its U.S. tax liability by paying too much for the inventory. Similarly, a U.S. subsidiary of a foreign

¹¹⁵⁰ As amended by the Pension Protection Act of 2006. Prior to the amendment, the threshold was 200%. For math enthusiasts, a lively debate has engaged over the mathematics of the calculation where the originally claimed basis is greater than zero and the correct basis is zero (as in the case of a sham partnership). The statutory interpretation issue is (i) whether the test is to divide the claimed basis by the correct basis to determine the percentage, which can't be done if the correct basis is zero or (ii) multiply the correct basis times the percentage with the penalty applying if the claimed basis exceeds the product of that multiplication. I won't get into the esoterica of that debate, but direct readers to the articles engaging the debate: Andy S. Grewal, Petaluma and the Limits of Treasury's Authority, 144 Tax Notes 479 (July 28, 2014); Michael L. Schler, Dividing by Zero Is Not So Strange, 144 Tax Notes 627 (Aug. 4, 2014); Andy S. Grewal, To Undefined . . . and Beyond!, 144 Tax Notes 865 (Aug. 18, 2014); and Ajay Gupta, The Tax Lawyer Who Knew Infinity, 144 Tax Notes 869 (Aug. 18, 2014).

¹¹⁵¹ As amended by the Pension Protection Act of 2006. Prior to the amendment, the threshold was 400%.

parent selling inventory to a foreign parent corporation can understate its U.S. tax liability by charging too little for the inventory. There are many variations on the transfer pricing theme but they are all valuation issues and this is illustrative. If the valuation is 200% or more or 50% or less, a 20% valuation misstatement penalty may apply. The penalty is increased to 40% if the overstatement is gross (defined as 400% or more or 25% or less). Certain § 482 adjustments are excluded.¹¹⁵² In order to be excluded several requirements are imposed, one of which is that the taxpayer have contemporaneous documentation as to the transfer pricing methodology.

e. Parallel Estate and Gift Tax Penalties.

Finally, § 6662(g) imposes a parallel substantial estate or gift valuation understatement penalty for similar understatements of value (20% penalty for 50% understatements and 40% penalty for 25% understatements).

f. No Fault.

I hope you get the point of these penalties -- they act as a no-fault penalty for aggressive return reporting positions. Of course, most taxpayers engaged in aggressive valuation or basis claims will have some degree of subjective fault, but by imposing the penalty based solely on the substantiality of the error (200% error required), the issue of fault is irrelevant. Please note, however, that there is a general reasonable cause and good faith exception that I shall discuss.

6. Undisclosed Foreign Financial Account Understatement.

In 2010, Congress included within the accuracy related penalty provisions a penalty for “any undisclosed foreign financial asset understatement. § 6662(j).¹¹⁵³ I discussed above contemporaneous enactment of a requirement that individuals disclose their foreign financial assets on their tax returns, and this requirement somewhat overlaps the information requirement for the FBARs (which are not tax return forms and are not required by the Internal Revenue Code). There is now a separate Code penalty just for failure to provide the information, but if there is an understatement with respect to “any transaction involving an undisclosed foreign financial asset,” an accuracy related penalty of 40% applies.¹¹⁵⁴ This penalty applies not only to the new required form for return disclosure for foreign financial assets, but also to certain other information disclosures for foreign activities.¹¹⁵⁵ The effective date for this provision is for taxable years beginning after the date of enactment (taxable year 2011 for most individuals).¹¹⁵⁶

¹¹⁵² § 6662(e)(3)(B).

¹¹⁵³ § 6662(b)(7) and (j), as added by Section 512 of the HIRE Act (FATCA provisions).

¹¹⁵⁴ As added by the HIRE Act (FATCA provisions).

¹¹⁵⁵ § 6662(j)(2), citing Code §§ 6038, 6038B, 6038D, 6046A, or 6048. Section 6038D is the new provision for reporting foreign financial accounts.

¹¹⁵⁶ § 512(b) of the HIRE Act (FATCA provisions).

7. Other Accuracy Related Penalties.

Section 6662 contains other penalties for substantial errors, applying similar concepts to other types of taxes. In this class, I expect you only to know the ones we cover above.

8. Innocent Spouse Relief.

I noted above that a spouse innocent of fraud but signing a joint return is relieved of the fraud penalty arising from the other spouse's conduct, but that such a spouse "innocent" of negligence is not relieved of the negligence penalty arising from the other spouse's conduct if they file a joint return. As with the negligence penalty, there is no relief to such an "innocent" spouse with respect to the other spouse's conduct. However, as we note elsewhere, there is general innocent spouse relief available to the innocent spouse which will, if applicable, relieve the innocent spouse of liability for the tax, penalties and interest.

9. Reasonable Cause Exception.

a. General.

Section 6664(c)(1) establishes an exception to the accuracy-related penalty if the taxpayer has reasonable cause for the conduct otherwise punished and acted in good faith. This is an affirmative defense. The taxpayer bears both the burden of production and persuasion with respect to this defense.¹¹⁵⁷ The regulations contain helpful examples to give you a sense of when the reasonable cause exception applies.¹¹⁵⁸

Reasonable cause becomes an issue only if the accuracy-related penalty is first otherwise applicable under § 6662. Thus, it is important to distinguish between those factors which make the conduct not punishable ab initio, as opposed to relieving the taxpayer from the punishment. Sometimes that may not be easy. You will recall that the Court in Streber blended these two concepts -- liability and relief from liability for reasonable cause -- in its discussion.¹¹⁵⁹

¹¹⁵⁷ There is no requirement that, in meeting the production burden imposed generally with respect to penalties (§ 7491(c)), the IRS disprove or even meet a production burden as to the reasonable cause defense. Wheeler v. Commissioner, 127 T.C. 200 (2006); Santa Monica Pictures LLC v. Commissioner, T.C. Memo. 2005-104, citing Higbee v. Commissioner, 116 T.C. 438, 446-447 (2001); H. Conf. Rept. 105-599, at 241 (1998), 1998-3 C.B. 747, 995. Thus, for example, the IRS meets the burden as to the failure to file penalty by simply introducing evidence of the failure to file; if the taxpayer has defenses such as reasonable cause, the taxpayer must establish them. See Wheeler v. Commissioner, supra.

¹¹⁵⁸ See Regs § 1.6664-4.

¹¹⁵⁹ See also Stobie Creek Investments, LLC v. United States, 82 Fed. Cl. 636, 708 (Fed. Cl. 2008), aff'd, 608 F.3d 1366 (Fed. Cir. 2010).

Consider Roco v. Commissioner¹¹⁶⁰ where the taxpayer failed to report on his return a substantial amount from a qui tam action in which a private citizen may bring a suit on behalf of the United States and obtain a portion of the recovery. The taxpayer received a Form 1099-MISC reporting the receipt. The taxpayer filed a private ruling request asking that the IRS determine the recovery not to be taxable. The ruling specialist informally advised the taxpayer that the IRS would rule that the qui tam recovery was taxable. The taxpayer then withdrew his ruling request. The taxpayer and his wife then faced the issue of what they should do on their tax return. The taxpayer's wife was an employee of the New York state tax authority. In prior years, they had filed joint returns. This year, for some unexplained reason, they decided to file separate returns. On his tax return, the taxpayer did not report the proceeds as income and did not disclose the omission. The Tax Court held on the merits that the proceeds were taxable. The Court then held that the taxpayer was subject to the substantial understatement penalty. The Court reasoned:

Petitioner received a Form 1099-MISC for the qui tam payment and expected respondent to audit his return. Triggering an audit by omitting income reported on a Form 1099 is not a good faith attempt to comply with the tax laws. Petitioner's claim that he was merely seeking to test the income tax laws is not credible because he failed to disclose the payment on his return.

Petitioner contends that the language in Eisner v. Macomber, *supra*, to the effect that income includes only proceeds from labor or capital, provides substantial authority for his position that the qui tam payment was not includable in gross income. We disagree. A taxpayer has substantial authority for his or her position if the weight of authority in support of the taxpayer's position is substantial in relation to the weight of authorities supporting contrary positions. Antonides v. Commissioner, 91 T.C. 686, 702 (1988), *affd.* 893 F.2d 656 (4th Cir. 1990). The description of income in Eisner v. Macomber, 252 U.S. 189 (1920), clearly is inapplicable here. See, e.g., Commissioner v. Glenshaw Glass Co., 348 U.S. at 431; Helvering v. Bruun, 309 U.S. 461 (1940); United States v. Kirby Lumber Co., 284 U.S. 1 (1931). The Supreme Court has limited Eisner v. Macomber, *supra*, chiefly to the taxability of stock dividends. See Helvering v. Griffiths, 318 U.S. 371, 373, 375, 394 (1943). We conclude that Eisner v. Macomber, *supra*, is not substantial authority for petitioner's position here.

Petitioner's withdrawal of his request for a letter ruling upon learning that it would be adverse does not suggest he exercised good faith. The bona fides of his claim of reliance on Mrs. Roco, who held (and holds) a responsible tax law enforcement position with New York State, is undermined by the fact that she did not act consistently with what she told him; i. e., she filed separately for 1997, unlike their practice for prior years.¹¹⁶¹

¹¹⁶⁰ 121 T.C. 160 (2003).

¹¹⁶¹ The implication is that Mrs. Roco may have decided to file a separate return because of concern as to Mr. Roco's return reporting position – i.e., not reporting the Form 1099-MISC amount and no disclosure as to the omission.

We conclude that petitioner did not act in good faith in claiming that the 1997 qui tam payment was nontaxable, and that he is liable for the accuracy-related penalty under section 6662(a).

As noted above, there are two ways to avoid the substantial understatement penalty. First, for a non-tax shelter such as involved in Roco, the penalty is avoided if (i) the taxpayer either had substantial authority or (ii) had a reasonable basis and disclosed the position on the return. The Court found that the taxpayer did not have substantial authority and that he had not disclosed on the return. Hence, the penalty applied. Second, the penalty although otherwise applicable is avoided under § 6664(c)'s reasonable cause exception if the taxpayer shows reasonable cause and good faith. The Court also held that the taxpayer failed this good faith requirement.

Finally, given the popularity of tax software, some taxpayers have tried to blame the software for the problem, thus constituting reasonable cause. This defense became more popular when, in his confirmation hearings for Secretary of Treasury, Timothy Geithner alleged that a substantial tax underpayment was the result of a TurboTax error. Despite at least feigned outrage from Republicans, he was confirmed as Secretary of the Treasury. Thereafter, Geithner's "precedent" – a political precedent as opposed to a legal precedent – has been cited and rejected in criminal¹¹⁶² and civil¹¹⁶³ tax cases where it was clear that the problem was in the operator / taxpayer and not the software. If indeed the problem were in the software or its instructions, I would imagine that the defense would be successful.¹¹⁶⁴

b. Reasonable Reliance on Tax Advisor.

Reasonable reliance on a qualified tax professional should permit this defense.¹¹⁶⁵ Reasonable reliance is not determined in a vacuum – i.e., it does not apply simply because a qualified tax professional was involved.¹¹⁶⁶ Rather, it applies only if, under all the circumstances, reliance upon the qualified tax professional was reasonable. The Regulations thus caution:

¹¹⁶² E.g., United States v. Hendrickson, 664 F. Supp. 2d 793, 806 n. 16 (ED MI 2009) (making the argument generally and specifically with respect to Geithner but turning the argument against the taxpayer's selective prosecution argument). The Geithner phenomenon could even give rise to a variant that I call the tax software or, more narrowly, a TurboTax defense. Geithner testified that he used TurboTax and, while saying the problem was his rather than his TurboTax software's problem, did say that TurboTax did not bring to his attention that he should pay more tax.

¹¹⁶³ Lam v. Commissioner, T.C. Memo. 2010-82.

¹¹⁶⁴ See Thompson v. Commissioner, T.C. Memo. 2007-174.

¹¹⁶⁵ Regs. 1.6664-4(c).

¹¹⁶⁶ The mere existence of legal advice does not immunize taxpayers from penalties in blatant tax schemes. See Nicole Rose Corp. v. Commissioner, 320 F.3d 282, 284-285 (2d Cir. 2002). Moreover, the Tax Court held that a taxpayer did not realize when his tax return preparer omitted such a large amount of income that the taxpayer should have spotted with minimal review of the return. Woodsum v. Commissioner, 136 T.C. 585, No. 29 (2011).

All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith. In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.¹¹⁶⁷

The reliance on the advisor must be objectively reasonable. You should now read **Addington v. Commissioner, 205 F.3d 54 (2d. Cir. 2000)**. By way of background, the taxpayers were lawyers who invested in a hokey tax shelter. They sought to rely upon their hired tax specialists, “Guy Maxfield, a professor of tax law at New York University School of Law,” and conferred with “John Y. Taggart,” also at one time a professor of tax law at NYU Law who had helped prepare the offering documents for the shelter. Well, you can read the opinion as to whether that worked.

The Tax Court has held that this relief requires reliance on an independent tax advisor.¹¹⁶⁸ In the context of that holding, the independent element precluded reliance on an in-house advisor. There are, of course, myriad of possibilities as to independence. The case held that during the period the tax advisor was not in-house but was an independent consultant, the taxpayer could rely and qualify for penalty relief. But there are many less obvious situations – perhaps the worst cases typified by taxpayers claiming reliance on an ostensibly independent tax advisor but known to be affiliated with the promoter of the tax scheme for which the taxpayer desires penalty relief. The fact that the such an affiliated tax advisor is not really independent bears on the reasonableness of the taxpayer’s reliance on the tax advisor.

Finally, one of the dangers in a taxpayer asserting this defense is that the taxpayer thereby waives the attorney-client privilege or the new Federally Authorized Tax Practitioner privilege which parallels the attorney-client privilege for non-lawyer practitioners.¹¹⁶⁹ Since many counsel

¹¹⁶⁷ Regs. § 1.6664-4(c)(1).

¹¹⁶⁸ Seven W. Enterprises v. Commissioner, 136 T.C. 539 (2011).

¹¹⁶⁹ In re G-I Holdings, Inc., 218 F.R.D. 428 (D. N.J. 2003) (taxpayer asserted “reasonable basis” and “reasonable cause” based upon consultation with “outside legal counsel and others” as a defense to the accuracy related penalties; held this defense waived the privilege); and AD Investment 2000 Fund LLC et al. v. Commissioner, 142 T.C. 248 (2014) (“By putting the LLCs’ legal knowledge and understanding into contention in order to establish a good-faith and state-of-mind defenses, Ps forfeit the LLCs’ privilege protecting attorney-client communications

realizing the dangers lurking in high risk planning tend to hedge their opinions, the actual underlying opinion may do more harm than good for the defense.

c. Tax Shelters.

(1) General.

The Regulations address reasonable cause for tax shelter items of corporations¹¹⁷⁰ and to hearken back to the time when corporate tax shelters were automatically excluded from the substantial authority reduction for the substantial understatement penalty. Now that all tax shelters are excluded, these conditions probably are instructive as to reasonable cause and good faith in the case of all tax shelters. Those regulations provide (I substitute taxpayer for corporation):

- A general rule that it is a facts and circumstances inquiry.¹¹⁷¹
- At a minimum, the position must have “substantial authority” and the taxpayer “reasonably believed that the position was more likely than not the proper treatment.”¹¹⁷²
- A reasonable belief exists only if, independent of the possibility that the position will not be audited, the taxpayer either analyzes the facts and authorities and concludes in good faith that a greater than 50% likelihood of prevailing exists or relies in good faith on the opinion of a professional tax advisor which makes a similar analysis.
- The foregoing are just the minimum requirements and may not be enough to qualify for relief. Thus, depending upon the facts, the following are negative factors for the taxpayer: “the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.”¹¹⁷³

I think that practical planning should require the taxpayer and his advisor(s) to assume that a planning arrangement that has some odor piscatorial to is going to be subject to the penalty. You will know it when you see it.

d. Other.

There are exceptions to the reasonable cause defense:

relevant to the content and the formation of their legal knowledge, understanding, and beliefs* * *”).

¹¹⁷⁰ Regs. § 1.6664-4(g).

¹¹⁷¹ Regs. § 1.6664-4(b)(1).

¹¹⁷² Regs. § 1.6664-4(b)(2)(i). This is the test that used to apply to permit noncorporate taxpayers to refund the base for the substantial understatement penalty, thus eliminating the item from the penalty.

¹¹⁷³ Regs. § 1.6664-4(b)(b)(3).

- the defense is not applicable to underpayments from a transaction lacking economic substance under § 7701(o) or “failing to meet the requirements of any similar rule of law.”¹¹⁷⁴
- as to underpayments from charitable contributions:
 - attributable to “gross valuation overstatement;”
 - attributable to a “substantial overstatement penalty” unless (i) “the claimed value of the property was based on a qualified appraisal made by a qualified appraiser” and (ii) the taxpayer made “a good faith investigation of the value of the contributed property.”¹¹⁷⁵

10. Penalties and Carryovers.

We have discussed previously the carryover of certain tax attributes to reduce tax liability in another year (the carryover year). For example, net operating losses in one year (let's assume Year 03, the source year) do not reduce tax liability in the source year, but may be carried backwards or forwards to reduce liability in another year. In this example, let's say that they are carried back to Year 01 and reduce liability in Year 01. The penalties may be applied to the carryover year (in this case Year 01, a carryback year).¹¹⁷⁶

F. Failure to File Penalty.

1. Most Returns With Tax Due.

I mentioned general failure to file penalty (§ 6651(a)(1)) above in discussing the Fraudulent Failure to File Penalty. The general failure to file penalty base is the amount required to be shown on the return less any tax paid on or before the due date of the return (e.g., paid by withholding or estimated tax payments).¹¹⁷⁷ **§ 6651(a)(1) and (b)(1)**. The penalty rate when fraud is not present, is 5% per month up to a maximum of 25%. If the return otherwise subject to the penalty is filed more than 60 days after the due date, the minimum penalty is the lesser of \$135 or 100% of the tax required to be shown on the return. § 6651(a), flush language.

The penalty is not applicable if the taxpayer's failure to file is due to reasonable cause and not to willful neglect. The penalty when fraud is present is tripled -- i.e., 15% per month up to a

¹¹⁷⁴ § 6664(c)(2), referring to § 6662(b)(6).

¹¹⁷⁵ § 6664(c)(3). For a case holding that the taxpayer had met these requirements for the reasonable cause defense, see Chandler v. Commissioner, 142 T.C. 279 (2014).

¹¹⁷⁶ Regulations § 1.6662-3(d) (negligence penalty); § 1.6662-4(c) (substantial understatement penalty); § 1.6662-5(c) (substantial and gross valuation misstatements); and § 1.6662-6(e) and (f) (§ 482 adjustments, but quantifying whether there is an adjustment is done in the source year).

¹¹⁷⁷ In a notice a client received, the IRS explained the penalty: “The penalty for filing late is based on the tax ultimately due, which was not paid by the original return due date without regard to extensions.”

maximum of 75%. Thus, in this case, the apocryphal story I mentioned above about the difference between lawyers and accountants does not technically apply to the civil penalty. The civil penalty for fraudulent failure to file is the same (at least if the failure continues for 5+ months) as the penalty for filing a fraudulent return.

Please re-read **United States v. Boyle**, 469 U.S. 241 (1985). Can you now make arguments both ways as to whether and when Boyle's reasoning might apply to the accuracy related penalties?

Let's return briefly to the reasonable cause exception to liability. Obviously, mental impairment would constitute reasonable cause. The executor in Boyle was not mentally impaired and thus could not meet the reasonable cause exception. What about financial hardship? Can a taxpayer urge that, because of financial hardship, he could not pay the taxes and, for that reason, did not file the return? The answer is that inability to pay does not excuse failure to file and report the liability. Filing and paying are two different things. We shall cover below the failure to pay penalty which also has a reasonable cause exception.

Does Boyle mean that there is no reasonable cause when a failure to file timely results from erroneous legal advice upon which the taxpayer relied? The answer is no. The result in Boyle was driven by the fact that the particular event – a time limit in which to file – should have been known and put a reasonable executor upon inquiry. What about some more esoteric legal rule relating to the time during which a return must be filed? The cases are not clear on this issue, but it seems that the issue may turn upon the complexity of the legal rule and the objective reasonableness of the assumptions the lawyer made in rendering the advice.¹¹⁷⁸

There is limited relief even without a showing of reasonable cause for a first time failure to file. This relief, called First Time Abate (“FTA”) is administrative relief rather than statutory relief contained in the IRM.¹¹⁷⁹ The relief is available if the taxpayer has a compliant history for the preceding three years. This type of relief would not apply to a filing of an estate tax return, because it is a one-time event rather than a periodic, repeated event which FTA assumes.

There is also another penalty for failure to file U.S. income tax returns due from foreign taxpayers doing business in the United States. Such foreign taxpayers obtain the benefits of deductions and credits only by “filing or causing to be filed” a “true and accurate” return as required by subpart F (the procedure sections) which must include “all the information which the Secretary

¹¹⁷⁸ Estate of Liftin v. United States, 754 F.3d 975 (Fed. Cir. 2014) noting the importance of the filing dates for returns and that an objective reasonableness of the legal advice standard best preserves the competing interests. So, if the advice as to time of filing is erroneous but objectively reasonable, the taxpayer has reasonable cause for late filing, but if the advice is not objectively reasonable, the taxpayer has no reasonable cause (but, of course, does have a malpractice claim against the attorney).

¹¹⁷⁹ IRM 20.1.1.3.6.1 (11-25-2011), First Time Abate (ATA).

may deem necessary for the calculation of such deductions and credits.”¹¹⁸⁰ The Regulations require that the return be “timely” but provide certain extended periods during which a return will be deemed timely filed to avoid this “penalty.”¹¹⁸¹ The IRS may waive this “penalty” if the taxpayer establishes that he acted reasonably and good faith and then cooperates in determining the tax liability.¹¹⁸² This “penalty” applies even if a treaty requires that a foreign taxpayer be taxed only on its U.S. source business income attributable to a permanent establishment.¹¹⁸³ The Regulations do allow foreign taxpayers to file protective returns to insure their ability to claim the deductions and credits.¹¹⁸⁴

2. Information Returns.

The § 6651 penalties are ad valorem penalties -- i.e., they are based on the amount that would have been due with the return. If no tax is due, there is no penalty. This has a certain logic as to returns for which tax could be due, but has no logic for returns where no tax is due. Information returns such as the various Forms 1099 for interest and dividends have no tax due and therefore an effective penalty system cannot be ad valorem based on the tax due. There is a penalty structure for information returns.¹¹⁸⁵ The penalty applies if the return is not filed or if material information is left off the return.¹¹⁸⁶ The penalty is \$250 per return up to a maximum of \$3,000,000.¹¹⁸⁷ Lower penalties are permitted for smaller taxpayers and the taxpayer can take prompt corrective measures that will mitigate the amount of the penalty.¹¹⁸⁸ Higher penalties are provided if the failure is due to intentional disregard.¹¹⁸⁹

A key exception to this general penalty regime for information returns applies to the **§ 6050I** information returns (CTRs) for trade or business cash receipts exceeding \$10,000. If the nonfiling

¹¹⁸⁰ See § 874(a)(1) (foreign individual taxpayers) and § 882(c)(2) (foreign corporate taxpayers).

¹¹⁸¹ Regs. § 1.874-1(a) & (b)(1) and 1.882-4(a).

¹¹⁸² Regs. § 1.874-1(b)(2) and 1.882-4(a)(3)(ii). The IRS earlier announced an “amnesty” program that will forego the draconian disallowance of deductions and credits for foreign taxpayers who remedy their nonfiling status on or before September 15, 2003. See Amy Hamilton, IRS Holds Partial Amnesty for Nonresident Aliens, Foreign Firms, 2003 TNT 117-3 (6/18/03).

¹¹⁸³ Regs. § 1.874-1(b)(3). See U.S. Treasury Department Technical Explanation of U.S. Model Treaty 79 (2006), explanation of Article 24 (Nondiscrimination), paragraph 2; and TAM 199941007 (concluding that the denial of deductions and credits does not violate the treaties).

¹¹⁸⁴ § 1.874-1(b)(4).

¹¹⁸⁵ § 6721. See Larry Jones and Eugene G. Sayre, The Wolf Has False Teeth – Code Sec. 6721, 8 J. Tax Prac. & Proc. 23 (February - March 2003).

¹¹⁸⁶ § 6721(a)(2).

¹¹⁸⁷ § 6721(a)(1), as amended by the Trade Preferences Extension Act of 2015.

¹¹⁸⁸ § 6721(b)-(d).

¹¹⁸⁹ § 6721(e).

is the result of “intentional disregard,” the penalty for any transaction is the greater of \$25,000 per return or the amount of cash involved up to \$100,000¹¹⁹⁰ and the general limit of \$3,000,000 does not apply.¹¹⁹¹

Although not a penalty, there are other adverse consequences that may attend failure to file information returns. For example, there is a special relief provision available for a service provider who might otherwise be classified as an employee to be treated as an independent contractor if he or she has been consistently treated as an independent contractor and the person for whom the services were provided filed the appropriate tax forms (in the case of an independent contractor, Forms 1099).¹¹⁹² As you can see, this relief, usually beneficial to the person to whom the services are provided, is unavailable if the filing requirement has not been met.

G. Failure to Pay Penalty.

1. Failure to Pay Tax Reported on the Return.

Section 6651(a)(2) imposes a penalty for failure to pay an amount reported as tax on a return. This failure to pay penalty is 0.5% per month up to 25%. For amounts that are reported on a return (even a delinquent return), (i) the penalty base is the amount shown on the return less the amount paid by the due date,¹¹⁹³ and (ii) the penalty commences accruing on the due date for payment (generally the original due date of the return). **Section 6651(a)(3)** imposes a penalty for failure to pay a tax not shown on a return but assessed by the IRS (e.g., after audit). The penalty commences effective as of the date of notice and demand unless the taxpayer pays in the grace period (generally 21 calendar days after notice and demand, but if the assessment exceeds \$100,000, the grace period is 10 days).

Consider these examples to illustrate.

Example 1: Assume that, for year 01, the taxpayer has withheld \$10,000 so that that is deemed paid on the due date, 4/15/02. The taxpayer files his return on 4/15/02, reporting a tax liability of \$20,000, tax withheld credit of \$10,000 and resulting remaining tax liability due of \$10,000. The taxpayer pays the \$10,000 due on 4/15/02. The IRS audits the 01 return in 2003 and, pursuant to the audit in which the tax liability is determined to be \$80,000, on 9/1/03 assesses tax of \$60,000 and sends the taxpayer notice and demand for payment. The taxpayer fails to pay the \$60,000 assessment within 21 days of the notice. The taxpayer will be subject to a failure to pay

¹¹⁹⁰ § 6721(e)(2)(C).

¹¹⁹¹ § 6721(e)(3).

¹¹⁹² This is known as § 530 relief, referring to that section in the Revenue Act of 1978. The section is not part of the Internal Revenue Code but is a statute that is the law.

¹¹⁹³ Note that this is the amount actually shown as due, not the amount required to be shown as due (the latter being the base for the failure to file penalty). For this purpose a substitute for return (“SFR”) filed under Section 6020(b) is not a return upon which this penalty can be based. Cabirac v. Commissioner, 120 T.C. 163 (2003).

penalty on the deficiency amount (\$60,000), but only from the date of assessment of the deficiency tax on 9/1/03. Note that the taxpayer is not subject to a failure to pay penalty on the \$60,000 tax which was actually unpaid for the period from 4/15/02 to the date of the later assessment on 9/1/03.

Example 2: Same facts as Example 1, except that, instead of timely filing the 01 return, the taxpayer files the year 01 return on 2/1/03, showing the same tax liability of \$20,000 and net tax due of \$10,000 which he pays contemporaneously with the delinquent return. The taxpayer will be subject to the § 6651 failure to pay penalty for the period from 4/15/02 to the date of filing the delinquent return on 2/1/03. The base for the penalty will be \$10,000 (\$20,000 (tax liability reported) less \$10,000 (tax paid by 4/15/02)). The number of months is 9 months, so the failure to pay penalty is 4.5%. The taxpayer will also be subject to the failure to pay penalty for the period after the assessment of \$60,000 on 9/1/03 if he does not pay within 21 days.

These examples illustrate what some people think is an illogical result. In fact, the taxpayer has underpaid his year 01 tax liability after 4/15/02, the original due date. Why then does not the failure to pay penalty apply to the actual underpayment? The reason is that the § 6651(a)(2) penalty only applies to amounts which are reported on a return and not paid. In Example 1, involving timely filing and timely payment of the entire tax, there is no amount unpaid per the return to which the penalty applies. There is an unpaid amount – the amount ultimately determined to be due in excess of that previously reported – but the § 6651(a)(2) base is only the difference between the amount reported and the amount timely paid. Of course, although avoiding the failure to pay penalty, the taxpayer will have to pay the interest on the tax during the period of underpayment. And, to close the loop, the § 6651(a)(3) penalty only applies to the amount assessed on 9/1/03 which is unpaid after 21 days of notice and demand.

The penalty is not applicable if the taxpayer's failure to pay is due to reasonable cause and not to willful neglect.¹¹⁹⁴ What is reasonable cause? A good example is financial hardship. We noted above that financial hardship is not an excuse for failing to file. But, if the taxpayer cannot pay because of financial hardship, that may be reasonable cause for failing to pay, at least in most

¹¹⁹⁴ At least one taxpayer has argued unsuccessfully that, based on the facts, the IRS should be equitably estopped from assessing the failure to pay penalty. See Shafmaster v. United States, 707 F.3d 130 (1st Cir. 2013) (casting doubt on the use of such estoppel in failure to pay cases).

Circuits.¹¹⁹⁵ In addition, applying the reasoning of Boyle, reliance on accountant as to the due date for payment will not constitute reasonable cause.¹¹⁹⁶

Also, subsequent year events (e.g., NOL or credit carrybacks) that might ex post facto lessen the tax otherwise subject to the failure to pay penalty will not relieve the taxpayer of the failure to pay penalty in the interim.¹¹⁹⁷

A taxpayer failing to file and failing to pay may be subject to both the failure to file and failure to pay penalties whereas a taxpayer filing and reporting but not paying will be subject to only the failure to pay penalty. However, during the period that both penalties apply, the failure to pay penalty is allowed as an offset against the failure to file penalty.¹¹⁹⁸ This offset is not available, however, if the minimum failure to file penalty (rather than the percentage ad valorem penalty) applies.¹¹⁹⁹

A taxpayer may be fully paid (e.g., by withholding or estimated tax payments) but fail to file the return. In such cases, the taxpayer will be subject only to the failure to file civil penalty. (The taxpayer, of course, might be subject to criminal prosecution for failure to file, but it would be a rare case indeed that the IRS would exercise its discretion to prosecute where the taxpayer had fully paid his taxes.)

Finally, as with the failure to file penalty, the IRS offers limited relief even without a showing of reasonable cause for a first time failure to pay. This relief, called First Time Abate (“FTA”) is administrative relief rather than statutory relief contained in the IRM.¹²⁰⁰ The relief is available if the taxpayer has a compliant history for the preceding three years.

¹¹⁹⁵ E.g., Diamond Plating Co. v. United States, 390 F.3d 1035, 1038-39 (7th Cir. 2004) (“We agree with the majority of circuit courts that have considered this issue, and recognize that financial hardship may constitute reasonable cause for abatement of penalties for nonpayment of taxes in some circumstances.”) (see cases cited and discussed in Diamond Plating); see also Synergy Staffing, Inc. v. United States, 323 F.3d 1157, 1160 (9th Cir. 2003) (noting that financial hardship may constitute reasonable cause, but “Evidence of financial trouble, without more, is not enough.”). However, there is a split in the circuits on this issue, with one court holding that financial difficulty not reasonable cause. See Brewery, Inc. v. United States, 33 F.3d 589 (6th Cir. 1994); see also Staff-It, Inc. v. United States, 482 F.3d 792 (5th Cir. 2007) (acknowledging a split in the circuits, but declining to decide the issue for the Fifth Circuit since the taxpayer did not qualify under the facts and circumstances test anyway).

¹¹⁹⁶ Baccei v. United States, 732 F.3d 1140 (9th Cir. 2011).

¹¹⁹⁷ Shafmaster v. United States, 707 F.3d 130 (1st Cir. 2013) (citing Simon v. Commissioner, 248 F.2d 869, 877 (8th Cir. 1957); Rev. Rul. 72-484, 1972-2 C.B. 638; and Manning v. Seeley Tube & Box Co. of N.J., 338 U.S. 561, 565-66 (1950).

¹¹⁹⁸ § 6651(c)(1).

¹¹⁹⁹ § 6651(c)(1).

¹²⁰⁰ IRM 20.1.1.3.6.1 (11-25-2011), First Time Abate (ATA).

2. Failure to Pay Estimated Taxes.

We discussed the general concept of the estimated tax system for prepaying tax liability prior to the statutory due date (April 15 of the succeeding year for individuals). Taxpayers failing to pay estimated taxes are subject to the estimated tax penalty.¹²⁰¹ Corporations and individuals are subject to the penalty. We discuss the penalty for individuals here since that is the most frequently encountered in practice.

The amount of the penalty is the general underpayment interest rate under § 6621 calculated on the installment amount¹²⁰² based on the “required annual payment” from the date the estimated installment is due to the earlier of the date the tax is paid or the original due date of the return.¹²⁰³ The required annual payment is defined as the lesser of 90% of the tax shown on the return for the year or 100% of the tax shown on the prior year return (subject to increase in the case of taxpayers with gross income over \$150,000).¹²⁰⁴ The penalty does not apply if (i) the tax shown on the return or tax due if no return was filed is less than \$1,000 and (ii) there is no tax due on the prior year return covering a full 12 months and the taxpayer was a citizen or resident of the U.S. for the entire year.¹²⁰⁵

The penalty is waivable if the IRS “determines that by reason of casualty, disaster, or other unusual circumstances the imposition of such addition to tax would be against equity and good conscience.”¹²⁰⁶ In addition, the penalty is not due if the IRS determines that the underpayment was after the taxpayer retired after age 62 or became disabled.¹²⁰⁷ The Code confers no waiver of the corporate penalty otherwise due.

¹²⁰¹ § 6654 for individuals and § 6655 for corporations.

¹²⁰² The installment amount is generally 25% for each installment (i.e., there are 4 installments). An annualized method can be used if it produces better results. § 6654(d)(2).

¹²⁰³ § 6654(a) & (b) and § 6655(a) & (b).

¹²⁰⁴ § 6654(d)(1)(B) & (C). It is important to note the focus on the current year return and the prior year return. Assuming each of the returns was filed, they may have substantially underreported the actual tax liability, but still the reference point is the return as filed. There are, of course, penalties that may apply if the taxpayer files an inappropriate return. If, of course, the taxpayer files no return for the current year, the reference point will be the tax actually due. See Mendes v. Commissioner, 121 T.C. 308 (2003) (rejecting a taxpayer attempt to file a substantially delinquent return showing no tax due as a basis for avoiding the penalty based on a literal reading of the statute).

¹²⁰⁵ § 6654(e)(2).

¹²⁰⁶ § 6654(e)(3)(A).

¹²⁰⁷ § 6654(e)(3)(B).

The penalty is, of course, the Code's incentive for the taxpayer to pay the estimated tax installment when it is due.

H. Frivolous Returns.

Section 6702(a) imposes a \$5,000 fine for filing a frivolous tax return.¹²⁰⁸ This penalty applies in addition to any other penalty that may apply. The penalty applies where the frivolous return is based on a position identified by the IRS as frivolous or reflects a desire to delay or impeded the administration of the tax laws.¹²⁰⁹

Section 6702(b) imposes a parallel \$5,000 penalty for a "specified frivolous submission". Such submissions include various forms of relief in IRS collection activity, including applications for compromise or installment agreements and requests for a collection due process hearing.¹²¹⁰ The submission is subject to the penalty if based on a position the IRS "has identified as frivolous" or "reflects a desire to impede the administration of Federal tax laws."¹²¹¹ We cover these collection activities below in Ch. 14. The penalty is \$5,000. If the IRS provides notice of the frivolous position and the taxpayer withdraws the submission within 30 days of the notice, the penalty does not apply; however, the statute does not seem to require the IRS to give the notice that is the predicate for the 30 day period.

The § 6702 penalties are not subject to the deficiency procedures.¹²¹² They are assessable without a predicate notice of deficiency. This means that they may not be litigated in the Tax Court,¹²¹³ which historically meant that they could only be litigated in a refund suit. In order to mitigate the hardship that might attend a requirement of full prepayment under the traditional Flora rule, a special district court proceeding is allowed if the taxpayer pays 15% and files a claim for refund within 30 days and, denied a refund suit within 30 days of denial.¹²¹⁴ If the taxpayer pursues this special remedy, collection procedures on the balance will be suspended and the statute of limitations on collection will also be suspended.

Section 6702(d) allows the IRS discretionary authority to reduce the § 6702 penalties "if the Secretary determines that such reduction would promote compliance with and administration of the Federal tax laws." Under this authority, the IRS has prescribed relief on a one-time basis for outstanding unpaid § 6702 penalties upon the party's request, provided that the party "must abandon

¹²⁰⁸ As amended by the Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, 120 Stat. 2922.

¹²⁰⁹ § 6702(a)(2).

¹²¹⁰ § 6702(b)(2)(B).

¹²¹¹ § 6702(b)(2)(A).

¹²¹² § 6703(b).

¹²¹³ Van Es v. Commissioner, 115 T.C. 324, 328-29 (2000).

¹²¹⁴ § 6703(c).

any frivolous positions regarding the Federal tax laws” and meet certain specific eligibility requirements.¹²¹⁵ The relief is to reduce the penalties to \$500.

Congress enacted Collection Due Process procedures which we discuss later in the Collection Chapter. The Tax Court has held that, in the Collection Due Process cases, amended § 6330(d)(1) gives the Tax Court jurisdiction to decide the merits of the IRS’s assessment of the frivolous return penalties.¹²¹⁶

Finally, the Tax Court held that the § 6702 penalty has no “readily observable statute of limitations.”¹²¹⁷ We discussed above that courts might “borrow” a statute of limitations from some related provision. For example, returns have a statute of limitations; hence, a court might be willing to borrow that statute for a frivolous return, but has not done so to date.¹²¹⁸

I. Refund Claims.

1. Refund Claims Without a Reasonable Basis.

Section 6676, added in 2007, imposes a 20% penalty for claims for income tax refund in “an excessive amount, unless it is shown that the claim for such excessive amount has a reasonable basis.”¹²¹⁹ As worded, the penalty applies if the claim is excessive unless the taxpayer affirmatively shows that it has reasonable basis; presumably, however, the IRS will make some attempt to see if the claim has reasonable basis before asserting the penalty and shifting the proof to the taxpayer. Excessive amount is the amount of the claim less the refund allowable. Unlike the accuracy related penalty, this penalty is assessable, meaning that it is not subject to the deficiency procedures

¹²¹⁵ Rev. Proc. 2012-43, 2012-49 IRB 1. The eligibility requirements include: (i) filing all tax returns and paying all outstanding taxes, penalties (other than § 6702 penalties), and related interest; (ii) filing the reduction request before the government files suit against the individual, either for collection of the penalty or to reduce any assessment of the penalty to judgment; (iii) no prior § 6702 reduction; and (iv) no prior reduction of a § 6702 penalty and an offer in compromise, partial payment installment agreement, or closing agreement that includes any § 6702 penalty.

¹²¹⁶ Callahan v. Commissioner, 130 T.C. 130(2008)

¹²¹⁷ Crites v. Commissioner, T.C. Memo. 2012-267.

¹²¹⁸ In Crites, the Tax Court held that, because the penalty was assessed within the three year period from the date the penalized frivolous amended return was filed, even if the three year period were borrowed, the assessment was timely. The Tax Court specifically said that it was not deciding that the penalty was subject to the three year statute of limitations.

¹²¹⁹ Reasonable basis is not defined in § 6676 but is defined in Reg. 1.6662-3(b)(3) for the accuracy related penalty. Since § 6676 was designed to complement the accuracy related penalty, the concept should mean the same in § 6676, See IRS Internal FAQs, at Q 3, reproduced at 2010 TNT 153-24.

allowing a prepayment litigation opportunity.¹²²⁰ The accuracy related penalties we discussed earlier do not apply because they apply the penalty percentage to the underreported tax liability. Where the tax has been reported and paid and a refund is requested, there is no underreported tax liability, thereby escaping the accuracy related penalties. For this reason, some practitioners felt that it was better to assert aggressive positions on a claim for refund to avoid the accuracy related penalties. The IRS and Congress were concerned that there was significant gaming of the system – specifically, the IRS’s strained resources – by taking this risk-free approach to aggressive refund claims. Section 6676 now imposes risk unless the taxpayer has a reasonable basis for the refund claimed.¹²²¹ You will recall from the discussion of the accuracy related penalties applying to positions on original returns, the reasonable basis standard is a fairly low standard, but this penalty will discourage people from filing frivolous amended returns.¹²²² The statute does not provide a statute of limitations for assessment of the penalty, but as I note elsewhere in the textual discussion of statute of limitations, courts will often import a statute from a related provision and it is likely that Congress will amend the Code to provide a statute of limitations.¹²²³

2. Refund Claims Where No Tax Paid.

If a taxpayer files a fraudulent refund claim to recover tax in an amount that exceeds the tax paid, the taxpayer may be subject to triple forfeiture in the amount of the tax so fraudulently claimed (i.e., the excess claimed over the amount of tax paid).¹²²⁴

¹²²⁰ The IRS uses the Form 8278, Computation and Assessment of Miscellaneous Procedures, to assess the § 6676 penalty. See IRS Internal FAQs, at Q 10, reproduced at 2010 TNT 153-24.

¹²²¹ An argument has been made that the penalty may be unconstitutional. Derek T. Ho & Christopher Klimmek, Penalizing Tax Petitions: Why the Erroneous Refund Penalty in Code § 6676 Violates Taxpayers’ First Amendment Rights, 68 Tax Law. 463 (2015). The argument is a long-shot.

¹²²² As usual with legislation issues are unresolved. At the extreme, is this civil penalty the only civil penalty that can apply with an amended return (i.e., can the civil fraud penalty apply)? Also, the taxpayer needs to be careful that unreported issues (omitted income or overstated deductions) have sufficient basis ab initio to permit the taxpayer to even sign the jurat on the amended return, for it is still a return could be subject to the criminal sanctions of evasion or false return. §§ 7201 and 7206(1). And, the preparer will want to make sure that he or she has met the civil and criminal requirements. §§ 6694 and 7206(2).

¹²²³ See IRS Internal FAQs, at Q 12, reproduced at 2010 TNT 153-24, noting the absence of an explicit statute of limitations, recommending a “best practice” of assessing within 3 years, and advising that Chief Counsel has submitted a proposal for a legislative change to provide a statute of limitations.

¹²²⁴ § 7304.

J. Penalties Applicable to Nontaxpayers (Enablers).

The foregoing penalties apply to taxpayers. However, as we know from the abusive tax shelter arena, other persons are more than willing to aid taxpayers in underpaying their taxes. Their conduct has been the focus of various penalties.¹²²⁵

1. Tax Shelter Related Penalties.

The Code provides several penalties targeted to tax shelter activity. I deal in more detail with these penalties later (pp. 781 ff.).

2. Aiding and Assisting Understatement of Tax.

Section 6701 imposes a penalty on any person who (1) aids, assists,¹²²⁶ procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) knows (or has reason to believe) that the document will be used in connection with any material matter arising under the internal revenue laws, and (3) knows that the document would result in an understatement of another person's tax liability. The penalty is \$1,000 (increased to \$10,000 for corporate returns). This penalty is the civil penalty analog to the tax crime of aiding and assisting, § 7206(2).¹²²⁷

This penalty is typically assessed against tax return preparers, but may apply to others who meet the elements and contribute to the making of the understatement. For example, an appraiser rendering a materially false valuation opinion that underlies false charitable contribution claims on a return may be subject to the penalty.¹²²⁸

¹²²⁵ See generally Jay A. Soled, Third-Party Civil Tax Penalties and Professional Standards, 2004 Wis. L. Rev. 1611 (2004).

¹²²⁶ The header for the section uses the term “aiding and abetting.” The term abet is one familiar from the criminal law. 18 U.S.C. § 2 (making a person who “abets” a crime punishable as a principal). The text of the provision, however, uses the term “aids or assists in” rather than the word abets. The statutory text thus parallels a related criminal provision. § 7206(2) (“willfully aids or assists in”). There is at least one key difference between 18 U.S.C. § 2 and § 7206(2). The former requires the commission of the underlying offense but the latter does not. United States v. Griffin, 814 F.2d 806, 811 (1st Cir. 1987). Section 7206(2) does not require proof of the taxpayer’s or any other person's guilty knowledge or participation in any crime. All it requires proof of is that the defendant (not the taxpayer) committed the crime of aiding and assisting. See United States v. Motley, 940 F.2d 1079, 1082 (7th Cir. 1991). Presumably the same concept applies for purposes of § 6701, despite the outline reference to “abets.”

¹²²⁷ Conf. Committee Report 97 H. Rept. 760 (describing current law providing the criminal penalty in § 7206(2) and adopting the civil penalty).

¹²²⁸ Regs. § 1.170A-13(c)(5)(D). See also authorities, including legislative history and cases, discussed in CCA 200512016, unofficially reproduced at 2005 TNT 58-24.

There is an open issue of whether the Government must prove the elements of this penalty by a preponderance of the evidence or by clear and convincing evidence, which is the standard of proof for civil tax penalties involving fraud.¹²²⁹

K. Penalty Administration.

1. Authority to Assess.

Penalties are serious business. They should not be lightly asserted nor, on the other hand, should the IRS be reticent to assert penalties in appropriate cases. The IRS has been accused of both. In response to concerns about agents asserting the penalty too routinely, § 6751(b)(1) requires that the supervisor of the IRS employee asserting a penalty personally approve in writing the assertion of the penalty.¹²³⁰ Any penalty asserted originally in a notice of deficiency or other notice of determination by the IRS will meet the requirement since the written approval of the supervisor of the agent making the determination is required. However, in other situations, the requirement may not be met. For example, if the IRS attorney in a Tax Court case asserts a new penalty by answer or amended answer, which the IRS is entitled to do (§ 6514), does the “approval” of the attorney and the attorney’s supervisor meet the requirement? There are other situations in which the issue might arise, so practitioners need to exercise some diligence.¹²³¹ Of course, the careful tax practitioner should be careful not to stir up that pot too soon if the IRS can correct any problem simply by correcting the problem. There is some controversy as to the time by which the approval in writing must be given – at or before the issuance of the notice of deficiency or at or before the assessment.¹²³²

¹²²⁹ United States v. Carlson, 754 F.3d 1223 (11th Cir. 2014) (holding that clear and convincing evidence standard applies; Carlson created a conflict with other Circuits on this issue and has a good discussion of the conflicting positions).

¹²³⁰ In H.R. Rep. No. 247, 101st Cong., 1st Sess. 1393 (1989), the House Ways and Means Committee stated its concern that, prior to that tax legislation, accuracy-related penalties were “determined too routinely and automatically” and stated its expectation that “the IRS [will] consider fully whether the imposition of these penalties is appropriate before determining these penalties.”

The trust fund recovery penalty under § 6672 has been described as more akin to a tax than a penalty and therefore may not be subject to this requirement. United States v. Rozbruch, 2014 U.S. Dist. LEXIS 91789 (SDNY 2014).

¹²³¹ See Carl Smith, Tax Court Trying to Coordinate its Forthcoming Novel Section 6751(b)(1) Penalty Rulings (Procedurally Taxing Blog 7/16/15).

¹²³² Ajay Gupta, How Late is Too Late for Slapping on a Penalty?, 2014 TNT 238-1 (12/11/14).

2. Assessing Penalties.

Most of the penalties with which we dealt above are penalties that are assessed like the underlying taxes to which they relate. This means that, as to taxes that require a notice of deficiency (income and estate and gift taxes), the penalties must be asserted first in a notice of deficiency, thereby giving the taxpayer the right to contest them in the Tax Court without having to pay them before they are assessed and must be paid.¹²³³ Thus, if the IRS desires to assert the fraud penalty under § 6663 or the accuracy related penalties under § 6662, the IRS must send a predicate notice of deficiency.¹²³⁴

Some penalties are, however, so-called assessable penalties which means that they can be immediately assessed without a predicate notice of deficiency.¹²³⁵ Frequently encountered assessable penalties are the failure to file and failure to pay penalties unless attributable to a deficiency in tax.¹²³⁶

3. Penalty Handbook.

The IRS has a Penalty Handbook which is part of the IRM.¹²³⁷ This is the major source for IRS field employees in the application of the penalties. The OPA updates the Penalty Handbook as needed.

For those practicing in the audit and litigation area where penalties and the risk of penalties are frequently encountered, the Penalty Handbook is an essential source.

4. IRS Goals in Penalty Administration.

The Penalty Handbook encouraged IRS employees to:

- treat similar cases and similarly-situated taxpayers alike.

¹²³³ § 6665(a). For example, the § 6707A penalty for failure to report certain tax advantaged transactions is an assessable penalty. See Smith v. Commissioner, 133 T.C. 424 (2009).

¹²³⁴ There can be a glitch if there turns out to be no deficiency

¹²³⁵ § 6665(b).

¹²³⁶ § 6655(b)(1). See Smith v. Commissioner, 133 T.C. 424 (2009) (as to the § 6707A penalty). The Tax Court in Smith did note that, if the assessable penalty is related to the deficiency, the Tax Court might have some form of derivative jurisdiction, but held the § 6707A penalty, like most other assessable penalties, does not relate to a deficiency.

Even here, there are subtleties if the taxpayer failing to file is subject to the § 6651 penalty, otherwise immediately assessable, files a delinquent return before the tax is assessed and the IRS then determines that there is a deficiency with respect to the delinquent return. See Chief Counsel Notice CC-2002-002 (published in 2001 TNT 204-7 (10/22/01)).

¹²³⁷ IRM 20.1.

- give each taxpayer the opportunity to have his or her interests heard and considered.
- Strive to make a good decision in the first instance. A wrong decision, even though eventually corrected, has a negative impact on voluntary compliance.
- Provide adequate opportunity for incorrect decisions to be corrected.
- Treat each case in an impartial and honest way (i.e., approach the job, not from the government's or the taxpayer's perspective, but in the interest of fair and impartial enforcement of the tax laws).
- Use each penalty case as an opportunity to educate the taxpayer, help the taxpayer understand their legal obligations and rights, assist the taxpayer in understanding their appeal rights and, in all cases, observe the taxpayer's procedural rights.
- Endeavor to promptly process and resolve each taxpayer's case.
- Resolve each penalty case in a manner which promotes voluntary compliance.¹²³⁸

Obviously, those are worthy goals. The IRS, however, is a very large organization with many cooks in what are effectively many kitchens in penalty administration. The goals are not always achieved. For example, there are many judgment calls made by the agents, their supervisors, and Appeals Officers in the application or nonapplication of penalties. 100% consistency from agent to agent, supervisor to supervisor, and Appeals Officer to Appeals Officer cannot be expected. But, through the guidance in the Penalty Handbook and the IRS's other efforts at guidance (through various internal publications such as FSAs), the IRS does make the effort at consistency.

5. Deadly Sins and Penalty Administration.

It has been reported that the 1998 Restructuring Act and, in particular, its 10 Deadly Sins (pp. 91 ff.) have created a climate within the IRS that have caused agents to forego the assertion of penalties in situations where penalties should be asserted.¹²³⁹ The evidence is anecdotal in specific instances, but the overall statistics suggest that the assertion of penalties is down. Does this mean

¹²³⁸ IRM 20.1.1.3(4) (12-11-2009) (some of the quote material in the text is verbatim quotes for which I have not provided quotation marks).

¹²³⁹ E.g., Lee A. Sheppard, The Sixth Deadly Sin, 92 Tax Notes 1018 (8/20/2001) (“Assertion of penalties is thought by IRS executives to be going down because examiners perceive they will be accused of harassment.”). The Sixth Deadly Sin is:

violations of the Internal Revenue Code of 1986, Department of Treasury regulations, or policies of the Internal Revenue Service (including the Internal Revenue Manual) for the purpose of retaliating against, or harassing, a taxpayer, taxpayer representative, or other employee of the Internal Revenue Service.

that the IRS asserted penalties too often before this trend? Does it mean that the IRS is not asserting penalties in many cases where it should do so now? Further study is required.

Ch. 9. The IRS Compliance Function (Examination).

I. Introduction.

The IRS compliance function is the backstop to the taxpayer's initial responsibility to report. The compliance function checks to see whether taxpayers have reported properly and takes remedial action to collect taxes that are underpaid. In the macro sense, the underpaid tax liability is called the tax gap¹²⁴⁰ and, as you might suspect, the tax gap is large and the IRS' compliance function's responsibility is to keep it as low as possible given the amount of resources that Congress allows for the task. The IRS periodically estimates that the tax gap. The most recent statistics are for 2006 and show the following:¹²⁴¹

	Tax Year 2006 (billions)
Total Tax Liabilities	\$2,660
Gross Tax Gap	\$450 (83.1% compliance)
Enforcement and Late Payments	\$65
Net Tax Gap	\$385 (85.5% compliance)

The IRS further explains:

The tax gap can be divided into three components: non-filing, underreporting and underpayment.

**** the underreporting of income remained the biggest contributing factor to the tax gap in 2006. Under-reporting across taxpayer categories accounted for an estimated \$376 billion of the gross tax gap in 2006 ****. Tax non-filing accounted for \$28 billion in 2006 ** *. Underpayment of tax increased to \$46 billion ****

Overall, compliance is highest where there is third-party information reporting and/or withholding. For example, most wages and salaries are reported by employers to the IRS on

¹²⁴⁰ Kyle D. Logue, The Problem of Tax Law Uncertainty and the Role of Tax Insurance, Va. Tax Rev. 349, n. 10 (Fall 2005).

¹²⁴¹ IRS web page titled [IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study, IR-2012-4 \(1/6/12\)](#) (Page Last Reviewed or Updated: 06-Feb-2014).

Forms W-2 and are subject to withholding. As a result, a net of only 1 percent of wage and salary income was misreported. But amounts subject to little or no information reporting had a 56 percent net misreporting rate in 2006.¹²⁴²

The IRS's compliance function has two major components – first to determine whether taxpayers have met the responsibility to self-assess and take corrective measures to the extent they have not (this is often called the examination function), and second to collect the unpaid taxes that have been self-assessed or assessed by the IRS (this is often called the collection function). I focus in this chapter on the examination component of the compliance function. Functionally, although internal IRS appeals after initial examination and subsequent litigation to quantify the amount of tax liability may be viewed as components of the examination function, I deal with them in separate chapters. I thus deal here with what has been traditionally considered the examination or initial level administrative tax determination by the IRS.

II. Types of Examinations.

A. Civil Examinations.

1. Correspondence.

The Service Center initiates correspondence inquiries, often called correspondence audits, which are simple written requests for information.¹²⁴³ The two principal reasons for such inquiries are (1) facial errors on the return that the IRS believes can usually be answered by correspondence and (2) discrepancies between information returns (such as 1099-INT (for interest paid) or 1099-DIV (for dividends paid)) and the tax return. The IRS principally identifies returns for correspondence audits through an automated scoring process, but sometimes through manual review on referral from various office in the IRS.¹²⁴⁴ There can be correspondence inquiries at the district level also. These are relatively low level audits, but can escalate into more intense audits and are not audits at all for purposes of the limitations on second audits.

¹²⁴² Id.

¹²⁴³ See generally GAO Report titled “IRS Correspondence Audits: Better Management Could Improve Tax Compliance and Reduce Taxpayer Burden” (GAO-14-479 June 2014).

¹²⁴⁴ Id. The GAO report has this example:

For example, the main determinant for selecting EITC returns for audit is the score from the Dependent Database (DdB). DdB relies on decision rules applied to tax returns claiming EITC and related tax benefits. Using filters created from various criteria, the DdB creates scores for returns before refunds are disbursed. Returns with the highest scores are selected for audit.

2. Office Audits.

The taxpayer may be invited by letter to the IRS office to address certain issues identified in the letter and produce information documents about the identified issues. This is the next level. Office audits are usually handled by a mid-level Examination person and deal with simpler issues (verification of deductions, etc.). This type of audit might escalate to the next level if a satisfactory resolution is not achieved or the office auditor identifies characteristics that justify more intense audit activity.

3. Field Examinations.

Field examinations or field audits are full blown examinations where a higher grade revenue agent is assigned and may do such field (out of IRS office) work as he or she deems appropriate to the circumstances. The balance of this chapter deals principally with the field examination.

The larger Field Examinations handled by the IRS's LB&I division are further divided between those that require multiple examiners operating as a team and those that require only a single examiner. Coordinated Industry Case ("CIC") taxpayers are generally the largest taxpayers, thus requiring a team of examiners on the audit. Industry Case ("IC") taxpayers are generally the smaller taxpayers who generally require only a single examiner on the audit.

Outside large case examinations, usually one auditor will be assigned principal responsibility for the case and the taxpayer and his representative will have principal and often sole contact with that one auditor. As I shall note below, the auditor may seek assistance from various areas of the IRS to help address issues that arise in the audit, but the taxpayer or his representative will often not be involved significantly in that process.

4. Unnecessary Examinations Prohibition.

a. Unnecessary Examinations.

Section 7605(b) provides that "No taxpayer shall be subjected to unnecessary examination or investigations. . . ." This prohibition prevents unnecessary examinations and harassment of taxpayers. What is an unnecessary examination, however, may be in the eye of the beholder. Many taxpayers, at least while in the surge of the storm, believe that their audits are unnecessary and that they are being harassed. But obviously Congress contemplated ordinary, non repetitive, non harassment audit activity as an essential component of the tax system.

In **United States v. Powell, 379 U.S. 48 (1964)**, the taxpayer argued that, given the confluence of the policy evident in § 7605(b) regarding unnecessary examinations and the summons provisions, where the IRS seeks to audit outside the normal statute of limitations for additional assessments, the IRS must make some predicate showing of probable cause that the statute is open before it may conduct a legitimate audit of the otherwise closed years (and use the summons power during that audit). In that case, depending upon what the examination developed, the IRS could

assert fraud to keep the statute of limitations open beyond normal statute of limitations. The taxpayer therefore urged that the court should require the IRS to make a predicate showing that fraud might be involved. The Court rejected the argument. We deal in more detail with and read Powell below in discussing the summons power.

Although the Court dealt directly with the use of the summons and formulated the classic test of a valid summons, presumably the same broad standard for an enforceable summons also applies in determining whether an audit is “unnecessary” for purposes of § 7605(b). Having said that, I defer further discussion to the discussion of the scope of the summons power.

b. Second Examinations.

As a subset of the larger prohibition on unnecessary audits, section 7605(b) permits only one inspection of the taxpayer’s books (an audit) unless the taxpayer requests it or the IRS makes a specific determination that a second audit is necessary and so notifies the taxpayer in writing of the determination.¹²⁴⁵ This is often referred to as the prohibition against second audits. However, technically, the statute does not prohibit a second audit but only a second inspection of the “taxpayer’s books of account,” which means that the IRS is entitled to consider information from other sources and do whatever is appropriate with it.

In order to apply this limitation, we have to identify a first audit. The IRS has several programs for contacting taxpayers about the accuracy of their returns. The following are the types: (1) Math error program in which the IRS computer catches math errors; (2) underreporter program in which, via computer, the IRS matches the taxpayer's return with third party information returns (such as W-2's and 1099's); (3) so-called “soft” notices asking the taxpayer to review and make adjustments as appropriate, used in the following cases -- (i) one to taxpayers whose return cites a dependent or spouse SSN that has been used on at least one other return and (ii) another to taxpayers who report business-type income but fail to pay self-employment tax; and (4) audits formally designated and treated as such. The IRS takes the position that only the 4th category is a first audit subject to the § 7605(b) prohibition.¹²⁴⁶ Furthermore, the first audit must have closed; otherwise examination activity will be treated as just a continuation of the first audit.¹²⁴⁷ Finally, activity to collect a tax after an audit (the first examination) is not considered a second examination.¹²⁴⁸

Section 7605(b) does not prohibit a second examination where the IRS makes an appropriate decision and notifies the taxpayer. The Court in Powell stated that this prohibition serves “to

¹²⁴⁵ The procedures are set forth in IRM 25.5.4.4.3 (10-04-2006).

¹²⁴⁶ IRM 1.2.13.1.1 (12-21-1984), Policy Statement 4-3. See also Rev. Proc. 2005-32, 2005–1 C.B. 1206 (listing types of contacts that will not be considered a second examination).

¹²⁴⁷ United States v. Morgan, 761 F.2d 1009, 1010-1011 (4th Cir. 1985) (suspension of civil audit on referral to CI is not a closing of the audit; hence second inspection of books does not violate § 7605(b) prohibition); United States v. Lang, 792 F.2d 1235, 1242 (4th Cir. 1986).

¹²⁴⁸ IRM 5.17.6.9 (10-15-2010), Unnecessary Examinations and Barred Years.

emphasize the responsibility of agents to exercise prudent judgment in wielding the extensive powers granted to them by the Internal Revenue Code.¹²⁴⁹ The minimum conditions for such a second audit are set forth in an IRS Revenue Procedure.¹²⁵⁰

B. Criminal Investigations.

The IRS's Criminal Investigation ("CI") branch conducts criminal tax investigations. The goal of CI is not to determine the taxpayer's correct tax liability. Determining the correct tax liability is the job of the civil investigative function -- often referred to as the examination function -- discussed above. CI investigates criminal tax conduct and refers cases to DOJ Tax when it concludes that a taxpayer or other target of their investigation (e.g., a return preparer) should be prosecuted. This book deals principally with the civil tax procedures and processes. I have summarized the process on pp. 326 ff. above.

III. Selection for Audit.

A. Computer Selection.

1. DIF.

Returns are generally selected at the Service Center principally on computer modeling based on past IRS experience. The IRS uses a scoring system, which it calls the Discriminant Index Function ("DIF"), to identify the returns that appear to have the most effective audit potential given the IRS's resources.¹²⁵¹ The scoring system is a computer-based system incorporating the IRS's modeling of noncompliant behavior. The IRS keeps the factors in this system secret, otherwise many taxpayers would conform their cheating on returns to avoid audit selection under the DIF.¹²⁵²

Although the IRS does not publish its scoring techniques, the process is easy to illustrate in concepts. For example, the DIF undoubtedly scores high charitable contributions relative to income negatively in terms of at least justifying a look at the return. Thus, a return that claims \$50,000 of wage income and no other income, but \$25,000 in charitable contributions is likely to receive a

¹²⁴⁹ United States v. Powell, 379 U.S. 48, 56 (1964).

¹²⁵⁰ Rev. Proc. 2005-32, 2005-1 C.B. 1206.

¹²⁵¹ IRM 4.19.11.1.4 & 5 (11-09-2007). See also IRM 4.1.3.2 (08-10-2012), Discriminant Index Function (DIF) Overview:

DIF as referenced in IRM 4.19.11.1.4, Sources of Returns for Classification, is a mathematical technique used to score income tax returns for examination potential. These formulas were developed based on available NRP data. Each return measured under DIF receives a DIF score. Generally, the higher the score, the greater the audit potential. The highest scored returns are made available to Examination upon request.

¹²⁵² See IRM 4.19.11.1.5.1 (11-09-2007)(9) & 10) (10-09-2007).

relatively higher DIF score thus increasing its likelihood of audit. By contrast, whereas the same return claiming \$2,000 in charitable contributions would receive a relative lower score and would likely not be kicked out for audit in the absence of other unusual return characteristics. What this means is that taxpayers who are not pigs may be able to do some level of cheating without materially increasing their risk of audit. To avoid such gaming of the system is why the IRS does not publicize its DIF scoring biases. Still, people do try to game the system in this manner,¹²⁵³ but I strongly recommend against it because (i) it is wrong and (ii) the taxpayer might be identified for audit in some other way.

B. Related Party Audits.

Incident to the audit of one taxpayer's return, the IRS may audit a related party's return. This often happens when there are transactions between the audited taxpayer and the related party. A common example is to audit a foreign sales corporation ("FSC") at the same time that the U.S. corporation is audited. Also, in the course of auditing a closely held corporation, the IRS may at least take a cursory look at the returns of the shareholder-employees.

C. Return Disclosures.

You will recall that taxpayers may file return disclosures in order to avoid penalties for return positions or, in some cases, to avoid the applicability of the 6 year period of limitations for 25% omissions. I have discussed earlier how such disclosures are made.¹²⁵⁴ The IRS does from time to time review such disclosures and initiate audits based on the disclosures. (In the case of large corporate taxpayers whose returns are always audited in two or three year audit cycles, such disclosures may not initiate an audit, but can shape some of the audit activity that will be pursued.)

D. Initiatives in Areas of Noncompliance.

1. General.

From time to time the IRS will have national or local initiatives in areas where it thinks that compliance is unusually low or at least low enough that the benefit (tax collection) to cost ratio of the initiative is positive and where a higher level of audit activity, particularly if it can receive some publicity, will not only produce audit change dollars but may affect future compliance among other taxpayers similarly situated, thus enhancing the revenue effect. For example, there has been a lot of noncompliance -- and indeed outright fraud -- in the fuel tax and foreign trust areas, and the IRS has long had major national initiatives -- both civil and criminal -- in those areas.

¹²⁵³ Particularly ingenious taxpayers with a motive might try to guess the system in order to improve their chances. E.g., Amir D. Aczel, How to Beat the I.R.S. at Its Own Game: Strategies to Avoid-And Fight-An Audit (Four Walls Eight Windows 1995); see David Cay Johnston, Your Taxes: Some New Tricks to Help Filers Avoid an Old Audit Trap, NYT (2/25/96)(online ed.4/7/09, <http://query.nytimes.com/gst/fullpage.html?res=9500E1D71039F936A15751C0A960958260>).

¹²⁵⁴ See pp. 151, supra.

2. Offshore Initiative.

I discuss elsewhere the IRS's initiatives with regard to offshore banks. (See discussion beginning on p. 320.)

3. High Wealth Taxpayer Compliance Initiatives.

a. Global High Wealth Industry Group.

The IRS has found that there is sufficient noncompliance among high wealth individuals to justify special compliance initiatives, in particular audits. The offshore bank initiative is perhaps a subset, although a lot of low wealth individuals were caught up in that special initiative. Thus, in 2009, the IRS "launched the **Global High Wealth Industry Group** to centralize and focus IRS compliance expertise involving high wealth individuals and their related entities."¹²⁵⁵ According to the IRM:

GHW [Global High Wealth Group] was formed to take a holistic approach in addressing the high wealth taxpayer population; to look at the complete financial picture of high wealth individuals and the enterprises they control. A GHW Enterprise Case consists of a key case, generally an individual income tax return, and related income tax returns where the individual has a controlling interest and significant compliance risk is deemed to exist. Controlling interest can include significant ownership of and/or significant influence over an entity or multiple entities within the enterprise. The enterprise case may include interests in partnerships, trusts, subchapter S corporations, C corporations, private foundations, gifts, and the like. GHW consists of two functions, Workload Services (WLS) and the field examination group.¹²⁵⁶

This group is within LB&I, but draws on the experience and expertise of both LB&I and SB/SE.¹²⁵⁷

E. Informants (the Whistleblower Program).

The IRS often receives tips from disgruntled spouses, ex-spouses, lovers, employees, partners, enemies, etc. Each such tip does not automatically lead to an audit or indeed any work by the IRS other than receiving it. Often, however, if the tip is accompanied by some hard information

¹²⁵⁵ IR-2010-13 (1/26/10) Prepared Remarks of IRS Commissioner Doug Shulman to New York State Bar Association Taxation Section Annual Meeting in New York City; see also IRM 4.52.1 Global High Wealth Industry Processes and Procedures.

¹²⁵⁶ IRM 4.52.1.1 (08-12-2013), Overview.

¹²⁵⁷ Jeremiah Coder, IRS Continuing Its Focus on High-Wealth Taxpayers, Official Says, 2010 TNT 122-2 (6/25/10).

or reliable indication of significant noncompliance, the IRS will initiate an audit or even a criminal investigation.

Often these tips are made directly to IRS's CI -- the criminal investigation division in the IRS. This type of tip -- particularly if accompanied by good information and/or a good source -- might justify an immediate criminal investigation without prior Examination involvement. On the other hand, if it is not a strong criminal indication based on the known evidence or CI is otherwise busy, CI may send the matter to Examination to determine whether an audit is appropriate with the understanding that if indications of fraud are discovered the case might be referred back to CI.

In any event, the IRS does have an informant's reward program, acronymed to "IRP." One category of such informants is called "whistleblowers." The IRP is designed to encourage persons to report significant underpayment of tax by giving them some percentage of the tax collected from the information reported. A TIGTA report concluded that the program works well, but needs some fine tuning.¹²⁵⁸ Among the key points of the report are: (i) from fy 2001 through 2005, over \$340 million in taxes, penalties and interest were collected under the program; (ii) rewards of over \$27 million were paid; (iii) the program has significantly contributed to the IRS's enforcement efforts; and (iv) examinations resulting from the program are "often more effective and efficient" than those initiated through the IRS's primary examination process.

In apparent response to the TIGTA report, in 2006, Congress amended the statute to provide: (1) whistleblower rewards for certain larger claims (\$2,000,000 or higher) are increased to a minimum of 15% and a maximum of 30% of collected proceeds, interest, penalties, and additional amounts;¹²⁵⁹ and (2) an above-the-line deduction is allowed for attorneys fees and court costs related to whistleblower rewards, so that the taxpayer is taxed only on the net amount he or she receives without the miscellaneous items deduction or the AMT tax haircuts that normally attaches to recoveries other than personal injury damages.¹²⁶⁰ The IRS denial of a whistleblower claim or its granting a claim less than the whistleblower believes is due may be judicially contested in the Tax Court.¹²⁶¹

¹²⁵⁸ TIGTA Report, The Informants' Rewards Program Needs More Centralized Management Oversight Reference, Number 2006-30-092, June 2006.

¹²⁵⁹ § 7623(a). The section requires the tip to involve tax, penalties and interest of more than \$2 million and involve either a business or, in the case of an individual, someone whose gross income exceeds \$200,000 for any year in question. Furthermore, for there to be an award, the IRS must collect tax, penalty and/or interest related to the claim; stated otherwise, if the IRS does not act on the claim and therefore collects no tax, penalties or interest. Cooper v. Commissioner, 136 T.C. 597 (2011) (denying judicial review of the claim when the IRS does not collect tax, penalties or interest).

¹²⁶⁰ § 62(a)(21).

¹²⁶¹ § 7623(b)(4). See Cooper v. Commissioner, 135 T.C. 70 (2010) (denial letter can be contested) and Whistleblower 14106-10W v. Commissioner v. Commissioner, 137 T.C. No. 15 (2011) (upon proper showing, a whistleblower filing a claim can proceed anonymously).

The IRS Whistleblower's Office must give an annual report to Congress on how the program is working. Because the program is new and processing whistleblower claims to fruition with the actual collection of tax, penalties and interest from which to pay claims, rewards under the new whistleblower program are yet to be made, although substantial payments have been made under the general program. Other than the annual IRS WBO reports and occasional litigation instituted by whistleblowers who felt they are entitled to more, there is generally little publicity about the program and its success. Many whistleblowers don't want anyone to know about the deed, and the IRS zealously protects their identities. However, the popular and tax press have greatly publicized a very prominent whistleblower, one Bradley Birkenfeld, a UBS officer who participated in promoting UBS deposits as a U.S. tax evasion opportunity. After enactment of the new automatic reward program in 2006, Mr. Birkenfeld saw his opportunity to turn in U.S. taxpayers for substantial rewards; since very rich U.S. taxpayers cheated on their U.S. tax through UBS and he was aware of a number of these U.S. taxpayers, the whistleblower reward opportunity appeared very lucrative. Birkenfeld also simultaneously wanted immunity from prosecution for his own crimes in assisting U.S. taxpayers to cheat on U.S. tax. Mr. Birkenfeld's disclosures brought UBS to its knees and cracked out – at least partially – the Swiss franchise on secrecy to help tax cheats (U.S. and others).¹²⁶² For this reason, he was named 2009 Tax Analysts Person of the Year¹²⁶³ But, because of the way he allegedly handled the disclosure of information (being selective, perhaps to the point of being misleading, rather than open and fully cooperative), he failed to achieve immunity, but he still may obtain rewards from the IRS.¹²⁶⁴

F. Information from State Agencies.

Another agency source for information of noncompliance is the state tax agency. We have noted above that the IRS has authority to and does share with state tax agencies vast quantities of data for use by the state tax agencies in their compliance function. Sharing can be a two way street. The IRS can obtain compliance information from the state.¹²⁶⁵

¹²⁶² The reports of Mr. Birkenfeld's key role are all over the press and the internet. A good summary is in Tax Analyst's article naming Mr. Birkenfeld the "2009 Person of the Year." Tax Analysts, Year in Review: The 2009 Person of the Year, 126 Tax Notes 7 (Jan. 4, 2010).

¹²⁶³ Id.

¹²⁶⁴ For further information, the Washington Post had a good article on Mr. Birkenfeld's saga: David S. Hilzenrath, Swiss Banker Turned Whistleblower Ended Up with a Prison Sentence, Washington Post (5/16/10).

¹²⁶⁵ See, e.g., TIGTA Final Audit Report -- Information from State Tax Amnesty Programs Could Bolster Compliance Efforts and Ensure Federal Tax Obligations Are Also Met, Reference 2005-30-165 (9/26/05), reproduced at 2005 TNT 197-17 (noting that, although the IRS may obtain information from state tax agencies, information from state tax amnesty programs has not been used by the IRS and concluding that "the State tax amnesty information could be used effectively to bolster IRS efforts for improving compliance.")

G. Audits to Develop Compliance Initiatives (TCMP, NRP, etc.).

The IRS believes that it needs to conduct detailed audits via a statistical sampling process for the purpose of identifying areas of noncompliance so that its audit scoring – the statistical process whereby returns are scored for potential audit – can better achieve its goal to support voluntary compliance. Historically, a major resource in developing the IRS's audit modeling was the Taxpayer Compliance Measurement Program (“TCMP”). That program used statistical random sampling techniques to identify taxpayers within selected categories and subject them to detailed, line by line audits, to determine where, within each category, there were trends in noncompliance. For those unfortunate taxpayers selected, these audits were “audits from hell.” The last TCMP was conducted in the 1990's as to the tax Year 1988; in the 1990s, when the IRS geared up for another round of these detailed audits, Congress listened to the complaining taxpayers and, in response to Congress' concerns, the TCMP audits were abandoned.¹²⁶⁶

The need for audits to help on audit scoring, however, has not gone away and gets more acute with the passage of time, since the last TCMP audit results are substantially outdated. Accordingly, the IRS adopted and continues to refine random audit techniques that curb some of the more offensive features of the TCMP audits. These are summarized in the Commissioner's Written Testimony with respect to IRS's fye 2008 Budget Request:¹²⁶⁷

Enhancing Research

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively. Historically, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line-by-line audits of random samples of returns. This provided us with information on compliance trends and allowed us to update audit selection formulas. However, this method of data gathering was extremely burdensome on the taxpayers who were forced to participate. One former IRS Commissioner noted that the TCMP audits were akin to having an autopsy without the benefit of death. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done for Tax Year (TY) 1988.

We have conducted several much narrower studies since then, but nothing that would give us a comprehensive perspective on the overall tax gap. As a result, until the recent NRP data, all of our subsequent estimates of the tax gap were rough projections that basically assumed no change in compliance rates among the major

¹²⁶⁶ Whether abandoning the TCMP was wise is debatable. See Christopher E. Bergin, TCMP and the Lessons of History, 138 Tax Notes 1011 (Feb. 25, 2013).

¹²⁶⁷ Commissioner Mark Everson's Written Testimony Before House Appropriations Committee Subcommittee On Financial Services and General Government On Internal Revenue Service's Fy 2008 Budget (3/29/07), reproduced at 2007 TNT 62-53.

tax gap components; the magnitude of these projections reflected growth in tax receipts in these major categories.

The National Research Program, which we have used to estimate our most recent tax gap updates, provides us a better focus on critical tax compliance issues in a manner that is far less intrusive than previous means of measuring tax compliance. We used a focused, statistical selection process that resulted in the selection of approximately 46,000 individual returns for TY 2001. This was less than previous compliance studies, even though the population of individual tax returns had grown over time. Like the compliance studies of the past, the NRP was designed to allow us to estimate the overall extent of reporting compliance among individual income tax filers, and to update our audit selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The NRP provided updated estimates for determining the sources of noncompliance. The IRS also uses the NRP findings to better target examinations and other compliance activities, thus increasing the dollar-per-case yield and reducing “no change” audits of compliant taxpayers. Innovations in audit techniques to reduce taxpayer burden, pioneered during the 2001 NRP, have been adopted in regular operational audits.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the first NRP reporting compliance study was on individual income tax returns. It did not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. Our estimates of compliance with taxes other than the individual income tax are still based on projections that assume constant compliance behavior among those major tax gap components since the most recent compliance estimates were compiled (i.e., for TY 1988 or earlier).

Recurring and timely compliance research is needed to ensure that the IRS can efficiently target resources, effectively provide the best service possible, and respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, as this reduces the burden of unnecessary taxpayer contacts.

The FY 2008 Budget requests funds for two significant research initiatives. First, the budget requests \$41 million to improve compliance estimates, measures, and detection of noncompliance. This will fund research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance. Unlike in the past, the IRS will conduct an annual study of compliance among 1040 filers based on a smaller sample size than the 2001 NRP study. This will provide fresh compliance estimates each year, and by combining samples over

several years, will provide a regular update to the larger sample size needed to keep our targeting systems and compliance estimates up to date.

H. Audit Priorities.

The IRS has audit priorities in terms of the taxpayer profiles for audits. The IRS set the following audit priorities for individuals, these audit priorities:¹²⁶⁸

- Offshore credit card users.
- High-risk, high-income taxpayers.
- Abusive schemes and promoter investigations.
- High-income non-filers.
- Unreported income.
- The National Research Program.

The IRS also has audit priorities for other types of taxpayers – e.g., corporations and nonprofits. It has not publicized those priorities, but, from the activity that is visible to the public, it is clear for example that corporate tax shelters are a top priority for corporations.

The IRS also has established audit priorities that, in an apt metaphor, encourages its auditors to go after the “low hanging fruit” in an audit so that they can harvest from more “trees” using the descriptive metaphor. As in many endeavors, often the audit-worthy items identified fairly early in the audit will account for the bulk of the potential for adjustment and obtaining the balance will require an inordinate expenditure of resources. A high ranking IRS official is reported to have pronounced:

“The gist of the idea is you get 80 percent of the return on the audit within the first 20 percent of the time, and after that you're digging for a diminishing amount of dollars,” Brown said at a November 8 meeting of the American Institute of Certified Public Accountants in Washington. “And frankly, you're ticking off taxpayers.”

According to Brown, the IRS can look less deeply and uncover 80 percent of the potential money in eight different audits for the same resources it would take to collect 100 percent in only four audits.

“Our view is that it's better for the system to touch more taxpayers,” he said.¹²⁶⁹

¹²⁶⁸ IRS Website titled IRS Fact Sheet FS-2002-12, September 2002 (Page Last Reviewed or Updated: 18-Aug-2012).

¹²⁶⁹ Dustin Stamper, IRS Audits Touching More Taxpayers, Digging Less Deep, Brown Says, 2006 TNT 217-7.

I. Audit Coverage and the Audit Lottery.

In 2014, the IRS collected total tax revenue of over \$3.064 trillion.¹²⁷⁰ Still, there is a major tax gap – the distance between the tax due and the tax collected. The tax gap in 2006 (the latest year where an estimate is available) was \$450 billion out of total tax liabilities of \$2.6 trillion, or between 20 and 25%.¹²⁷¹ The gap exists because taxpayers do not comply with their reporting and payment obligations. The gap exists in part because budget and political constraints prevent the IRS from auditing many tax returns. The following is from the IRS 2014 Data Book reporting the statistics for the Government fiscal year ended October 2014.¹²⁷²

- Number of returns filed by type (selective list)¹²⁷³
 - income tax (1040, 1120, 1065, etc.) - 185+ million.
 - estate tax (including generation skipping) - 34,000
 - gift tax - 335,000.
- Returns from the foregoing amount that were examined:¹²⁷⁴
 - individual income tax returns (1040) - 145+ million filed; 1,2+ million audited; for an audit coverage of 0.9%.
 - corporate returns (except 1120S) - 1.9+ million filed; 25,905 audited; for audit coverage of 1.3%.

Right now, all I want you to focus on is the gross numbers of returns and potential for audit. Don't focus on the audit coverage, because most of the audit coverage is not random. That is, within the categories and subcategories of each type of return, the IRS generally selective applies its audit resources to the returns with the most potential for compliance issues to exist.

A taxpayer falling in the category of having unidentified tax dollars (because he did not report the liability and it is not identified through the examination function) is said to have played the audit lottery and won. I discuss below the system of penalties that operate as an incentive to not play the audit lottery – to correctly report tax liability. Practitioners and the IRS know, however that the penalty only imperfectly performs its functions, leaving a lot of taxpayers with the incentive to play the audit lottery at a level consistent with their tolerance for risk.¹²⁷⁵

¹²⁷⁰ [IRS 2014 Data Book](#) Table 1.

¹²⁷¹ IRS web site, [IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study, IR-2012-4 \(1/6/12\)](#).

¹²⁷² [IRS 2014 Data Book](#).

¹²⁷³ 2014 Data Book, Table 2, counting income and estate gift tax returns only.

¹²⁷⁴ Id., table 9a.

¹²⁷⁵ One could make strong arguments that, considering all taxpayers, the penalty system is not a sufficient incentive because it still leaves the risk / reward ratio tilted in the favor of players of the audit lottery. See generally Leandra Lederman, [The Interplay Between Norms and Enforcement in Tax Compliance](#), 64 Ohio St. L. J. 1453 (2003).

IV. IRS Players In the Process.

A. Revenue Agent.

The line-level IRS person in a civil audit is a revenue agent. Depending upon the size of the examination, there may be only one agent directly involved. For larger audits, there will be a team managed by a manager.

For larger audits with multinational taxpayers (either U.S. companies operating abroad or foreign companies with U.S. operations), the audit team may include specialized international agents as well as managers and counsel. Similarly, as to particular industries particularly those with specialized tax regimes (such as banks and life insurance companies), the team may include revenue agents specialized in the particular industries.

B. Other Disciplines.

The IRS has team members other than agents who bring specialized skills. The IRS thus has in-house real estate experts, valuation engineers, economists and the like. Sometimes, during the audit stage where a particularly large adjustment is involved, the IRS may engage an outside expert. This has happened, for example, in transfer pricing cases.

C. Industry Experts.

The IRS is developing expertise in various industries by assigning industry experts whose responsibility is to know the industry. Often these experts produce Audit Technique Guides for specific industries under the so-called Market Segment Specialization Program (“MSSP”) to assist other agents when auditing in that industry.¹²⁷⁶ The Audit Technique Guides are audit guidelines or plans for particular industry segments (e.g., lawyers or retail gasoline stores).

In addition, the IRS has for a long time had an Art Advisory Panel of independent art experts to “review and evaluate the acceptability of tangible personal property appraisals taxpayers submit in support of the fair market value claimed on the wide range of works of art involved in income, estate, and gift tax returns.”¹²⁷⁷

D. Counsel.

Counsel are assigned to the various divisions (LB&I, etc.). Counsel are the in-house lawyers for the division. Personnel within the division may consult with Counsel on any matter they deem appropriate. Specifically in the present context, agents and other personnel involved in the examination function in the division may consult with and seek the advice of Counsel. Usually, on smaller audits, Counsel has very little involvement. On larger audits, Counsel may have significant

¹²⁷⁶ See IRS web page titled “[Audit Techniques Guides \(ATGs\)](#).”

¹²⁷⁷ See Art Advisory Panel Annual Report for Fiscal Year 2011, unofficially reproduced at 2012 TNT 140-22.

involvement, for example, in drafting summonses and the like. The IRS promulgated Regulations providing that Counsel may participate in summons proceedings (discussed below).¹²⁷⁸

E. National Office Players.

The National Office rarely gets involved in examinations. However, the agents and supervisors may from time to time seek National Office advice. I have mentioned above that the examination function, with the participation of the taxpayer, may seek Technical Advice from the National Office. In addition, the examination function may seek other types of advice, exemplified by the Field Service Advice procedure, and the taxpayer may not be aware of National Office involvement until after the fact.

F. CI Agent (“Special Agent”).

The focus of this book is IRS civil procedure. I do cover, however, certain points related to the criminal investigation function managed by an IRS branch named Criminal Investigation (“CI”). CI agents are commonly referred to as “Special Agents” and are the tax analogue of FBI Agents. When they show up (either after a civil audit has commenced or, in the absence of a civil audit, as the first indication that the IRS is interested the client), a whole separate set of procedures and considerations kick in. I mention the Special Agent at this stage only to say that he or she can show up during the course of a civil tax audit. If that happens, the IRS civil audit will generally go quiet while the CI investigation and any further tax criminal enforcement (such as referral to DOJ Tax for prosecution) is in effect. If the Special Agent shows up, the practitioner should immediately refer his client (usually the taxpayer but sometimes another potential criminal target such as a return preparer) to a criminal tax specialist and strongly advise the client not to discuss anything with the Special Agent until he or she has consulted with a criminal tax specialist.

In an audit, of course, the careful practitioner will have done the work necessary to spot criminal tax potential in the case. Sometimes the client will convincingly lie to the practitioner about the facts necessary to assess criminal tax potential or will not allow the practitioner the budget to explore such issues. **Practice Tip:** It is always better practice to document the key facts upon which the practitioner relies and/or the limitations that the client imposes upon the engagement, so that it is clear that the client accepts the risks that come with those assumed facts and limitations.

If you become aware that the client you represent in a civil tax investigation really has some underlying criminal tax (or other) exposure, you should immediately assure that someone with criminal tax (or other) experience is on the client's team. This situation is often referred to as an “eggshell audit.” Mistakes can be very costly to the client -- both in terms of freedom and assets. Moreover, the practitioner himself or herself can be exposed to malpractice or worse, -- i.e., some potential civil or criminal penalty by blundering in the representation in a way that the Government might perceive as the practitioner's willful conduct. Inexperienced practitioners should not get their experience by handling eggshell audits without a criminal tax expert on the team. The problem, of course, is that their inexperience may cause them not to recognize the eggshell audit.

¹²⁷⁸ See Regs. § 301.7602-1(b), promulgated 3/31/05.

V. Initiation of the Audit.

Upon initiating the audit, the IRS will advise the taxpayer in writing of the audit and provide an IRS publication regarding the process (IRS Pub. 1). The notice letter will often also enclose an Information Document Request (often acronymed to “IDR”) which asks the client to produce certain identified documents as the first salvo in the audit.

VI. IRS Information Gathering Process.

A. Informal Requests.

The agent may make informal requests by telephone, across the table or by correspondence. There is no legal compulsion to respond to the informal request.

B. Information Document Requests (“IDR”s).

The agent may put a request in writing on an Information Document Request (“IDR”), Form 4562, that is a more formal request for information.¹²⁷⁹ There is also no legal compulsion to respond to the IDR, but failure to respond may generate an IRS summons¹²⁸⁰ which is compulsory. (I cover the IRS summons below.) I generally require that, whenever the IRS wants information or a document, the agent put the request in an IDR so that, hopefully, it is clear what the agent is asking for and what the agent is not asking for and no misunderstandings can arise later about the propriety of the response. In the larger examinations where the taxpayer and the examiner drafting the IDR have more daily or weekly communications, the taxpayer may be more proactive in shaping the wording of the requests in the IDR.

C. Third Party Contacts.

The IRS has historically been able to contact third parties who may provide the IRS information either informally without legal compulsion or formally pursuant to the IRS issuance of an administrative summons (which I shall discuss in the next section).¹²⁸¹ **Section 7602(c)** provides

¹²⁷⁹ The form used for the IDR is Form 4564. TIGTA studied the IDR process in LB&I, including the so-called IDR Management Process implemented to bring more internal structure to the use of IDRs. See TIGTA, Final Audit Report - The New Process for Managing Requests for Tax Records During Examinations of Large Businesses Can Reduce Taxpayer Burden if Implemented Consistently (Audit # 200230052), unofficially reported at 2003 TNT 154-39 (8/11/03). A key element of the IDR Management Process in LB&I is to increase the communication and collaboration between the examiner(s) and the taxpayer and thereby improve the quality of the audit both for the taxpayer and the IRS.

¹²⁸⁰ Form 2039.

¹²⁸¹ Informal contacts for information and the compulsory summons are different procedures. The requirements for summonses to third parties are not applicable to informal contacts.

that (i) the IRS may not contact such third parties unless the IRS first notifies the taxpayer under audit that such contacts “may be made,”¹²⁸² (ii) the IRS must keep a record of third party contacts, and (iii) the IRS shall provide that record to the taxpayer both periodically and also upon the request of the taxpayer.¹²⁸³ Third party contacts are defined for this purpose as a communication with all of the following elements:

- (1) Is initiated by an IRS employee;
- (2) Is made to a person other than the taxpayer;
- (3) Is made with respect to the determination or collection of the tax liability of such taxpayer;
- (4) Discloses the identity of the taxpayer being investigated; and
- (5) Discloses the association of the IRS employee with the IRS.¹²⁸⁴

This third party contact requirement does not apply in the following circumstances: (i) the investigation is criminal;¹²⁸⁵ (ii) the IRS determines that notice would jeopardize the collection of the tax or may involve reprisal against the third party;¹²⁸⁶ and (iii) the taxpayer authorizes the contact.¹²⁸⁷

The IRS takes the position that the third party contact requirement does not apply when, pursuant to a treaty requirement, the IRS is obtaining information for a treaty partner to use in its audit and the IRS is not auditing the taxpayer for U.S. purposes with respect to the matter. This has not yet been litigated, but there is authority for saying that such procedural requirements normally

Regs. § 301.7609-1(a)(2).

¹²⁸² This requirement of advance notice does not apply to contacts made during trial preparation activity after a Tax Court petition is filed. Seawright v. Commissioner, 117 T.C. 204 (2001); see also Prop. Reg. § 301.7602-2(f)(7).

¹²⁸³ Although the statutory language expressly requires the IRS to report periodically to the taxpayer and make a report available to the taxpayer upon request, the regulations state simply that “A record of persons so contacted must be made and given to the taxpayer upon the taxpayer’s request.” Regs. § 301.7202-2(a); see also (e)(1). It seems that the IRS is ignoring the mandate of the Code by requiring a predicate request. Moreover, apparently because the IRS was not complying with § 7602(c), a taxpayer tried to blast the list out under FOIA but was unsuccessful because, even though possibly required to be disclosed under f § 7602, the list did qualify for a FOIA exemption. EduCap, Inc. v. IRS, 2009 U.S. Dist. LEXIS 12339 (D. DC 2009).

¹²⁸⁴ Regs. § 301.7602-2.

¹²⁸⁵ § 7602(c)(3)(C).

¹²⁸⁶ § 7602(c)(3)(B).

¹²⁸⁷ § 7602(c)(3)(A).

applicable to the use of the IRS summons for U.S. tax purposes do not apply to use of the IRS summons pursuant to a treaty.¹²⁸⁸ Now, in the reverse situation when the IRS through the U.S. competent authority contacts a treaty partner competent authority to make a request for information, the IRS takes the position that is a third party contact subject to this requirement.¹²⁸⁹

D. The IRS Administrative Summons.

1. General.

a. The IRS Summons.

Section 7602(a) authorizes the IRS to issue a compulsory summons in an audit.¹²⁹⁰ The summons is an administrative summons, requiring only the action of the IRS; it does not require any action or approval by a court prior to its use, except in the case of a John Doe summons which I discuss below. The summons is comparable to a subpoena (either a trial or a grand jury subpoena), but has certain procedures that are not available for trial subpoenas and certainly not available for grand jury subpoena. As a practical matter, it is relatively easy for the IRS to use the summons if the taxpayer or third party does not respond or does not respond timely to less formal requests for information or documents.

The summons is served by one of the following three methods:

- delivery “in hand” to the addressee;
- delivery by leaving a copy at the “last and usual place of abode;” **or**
- if a “third party recordkeeper summons” (discussed below), delivery by certified or registered mail.¹²⁹¹

Failure of a witness (whether the taxpayer or a third party witness) to appear pursuant to the summons is a misdemeanor offense, although the practical risk of prosecution appears negligible.¹²⁹²

¹²⁸⁸ See *United States v. Stuart*, 489 U.S. 353 (1989) (requirement that IRS summons not be used if case has been referred to DOJ; courts will not look to see whether the foreign country’s examination is criminal in focus or has reached an equivalent stage under its procedures).

¹²⁸⁹ ITA 200117040 (12/14/99), reproduced at 2001 TNT 83-36 (4/30/01).

¹²⁹⁰ The IRS summons is Form 2039. The summons may also be used in collection matters.

¹²⁹¹ § 7603(a) & (b). For an example of service abroad where the IRS is unable to rely upon a treaty exchange of information provision (see below, pp.461 ff.) and must instead rely upon the more general Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters, see ILM 200143032, 2001 WTD 210-29 (10/30/01).

¹²⁹² § 7210. The Second Circuit held that the misdemeanor sanction cannot apply unless the Government seeks judicial enforcement of the summons and the witness then refuses to comply

In addition, as we learn in Powell which we read in the next section, a court may treat a contumacious default as a contempt.¹²⁹³ Risk of these penalties are mitigated if a witness appears but asserts some semblance of a non-laughable argument that he or she is not required to answer questions or produce the documents requested. If the IRS disagrees with the argument made and desires to pursue the matter further, the IRS will seek judicial enforcement of the summons and, if the court orders enforcement and the taxpayer then fails to comply with the court order, the court may impose appropriate sanctions.

The IRM contains a “Summons Handbook” which practitioners should have available to understand details of IRS procedures for summons.¹²⁹⁴ DOJ Tax has a Summons Enforcement Manual on the web.¹²⁹⁵

The IRS is not required to use the summons in order to gather evidence. It may instead use informal requests to gather evidence.¹²⁹⁶ The summons is usually employed when informal requests are deemed insufficient.

b. The Summons Power and the Powell Standards.

The IRS summons power is broad. As we learn from United States v. Powell, 379 U.S. 48 (1964), which you should read now, the relevance standards for a valid summons are very broad. I expect you to know for the examination the Powell standards and therefore refer you to that case for those standards. The major issue addressed in Powell was the taxpayer’s argument that, in order to inquire into years that are beyond the normal statute of limitations on assessment (recall that the normal statute of three years is inapplicable in case of a 25 % omission or fraud), the IRS must meet some predicate burden like a production burden to show that the alternative longer statute(s) of limitation might apply. The statute, of course, did not require such a predicate showing and the Court declined to read one into the statute. Instead, the Court imposed quite minimal burdens on the IRS for the enforcement of the administrative summons.

Courts and commentators routinely cite Powell’s test as the applicable standard in determining whether a summons is valid. Powell articulates the test:

that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already

with any resulting court order. Schulz v. I.R.S., 395 F.3d 463 (2d Cir. 2005), affirmed and clarified, 413 F.3d 297 (2d Cir. 2005). Even apart from the correctness of Schulz, prosecutions under § 7210 are virtually non-existent. The IRS almost certainly would pursue summons enforcement in district court, obtain an order to comply, and then seek contempt for violation of the order.

¹²⁹³ § 7604(b).

¹²⁹⁴ IRM 25.5. This portion of the manual is referred to as the IRS Summons Handbook.

¹²⁹⁵ [DOJ Tax, Summons Enforcement Manual \(May 2006\)](#).

¹²⁹⁶ United States v. McLaughlin, 126 F.3d 130 (3d Cir. 1997), cert. denied, 524 U.S. 951 (1998).

within the Commissioner's possession, and that the administrative steps required by the Code have been followed * * * .¹²⁹⁷

The standards are quite broad and “designed to ensure only the basic propriety of the investigation.”¹²⁹⁸

With this broad a standard, I hope you appreciate that the IRS need only make a minimal showing of potential relevance to a tax liability. As the Supreme Court said,

has a power of inquisition . . . which is not derived from the judicial function. It is more analogous to the Grand Jury, which does not depend on a case or controversy for power to get evidence but can investigate merely on suspicion that the law is being violated, or even just because it wants assurance that it is not.¹²⁹⁹

While Powell's standards are not so elastic as to be illusory, they are very low; thus for example, relevance is simply by showing that the information or documents “may be” – not “are” – related to the IRS duty to determine and collect tax.¹³⁰⁰ The IRS's burden is to establish a “prima facie” Powell case, a burden described as minimal.¹³⁰¹ Related to relevance, however, courts may in the exercise of discretion decline to enforce “over-broad and disproportionate to the end sought.”¹³⁰²

¹²⁹⁷ Powell, at 57-58.

¹²⁹⁸ Mollison v. United States, 481 F.3d 119, 122 (2d Cir. 2007).

¹²⁹⁹ Id., p. 57 (internal quotes omitted, but quoting United States v. Morton Salt Co., 338 U.S. 632, 642-643 (1948), involving an analogous agency investigation device).

¹³⁰⁰ Adamowicz v. United States, 2008 U.S. App. LEXIS 14323 (2d Cir. 2008). This focus on relevance and proportionality in Powell gives meaning to the Powell test. For example, the Powell test suggests that the summons should not be enforced if the documents or information is otherwise in the possession of the Government or the IRS in particular. This cannot be read literally. Indeed, this spin in the Powell test is not in the statute authorizing summonses but is a gloss imputed to the summons procedure from the Code's prohibition on unnecessary examinations. See Powell, 379 U.S., at 56-58; and United States v. Davis, 636 F.2d 1028, 1037 (5th Cir. 1981) (“[r]ead in context, we construe the ‘already possessed’ principle enunciated by Powell as a gloss on § 7605(b)'s prohibition of ‘unnecessary’ summonses”). Accordingly, courts may apply the “already possessed” test in a practical way based on the circumstances.

¹³⁰¹ E.g., Robert v. United States, 364 F.3d 988, 996 (8th Cir. 2004).

¹³⁰² Adamowicz v. United States, 2008 U.S. App. LEXIS 14323 (2d Cir. 2008) (synthesizing case authority and noting that this requirement is rooted in the Fourth Amendment protection against unreasonable searches and seizures). Variations of this theme are addressed in United States v. Hubbell, 530 U.S. 27 (2000) (although not mentioning the Fourth Amendment, noted that overbroad subpoena subject to Fifth Amendment privilege where the witnesses' response to the subpoena is inherently testimonial; I discuss Hubbell below in discussing the Fifth Amendment).

How this plays out in the real world is that the IRS's ability to summons tax information has only minimal limits, so long as the IRS can make some showing of a potential revenue function purpose. An author has noted:

While statistics certainly do not tell the whole story, it is nonetheless significant that in the reported outcomes of 201 summons enforcement cases during five calendar years, district courts apparently completely quashed only 1 and partially enforced only 14 others; that is, only about 1 out of 200 times did courts actually overturn the Service's evidence-gathering decision.¹³⁰³

c. Routine for Summonses.

The basic song and dance routine for the IRS summons is as follows: The IRS issues the summons, directing the witness (either the taxpayer or a third party witness) to appear at a designated time and place to give testimony, to produce documents, or to do both. Usually, when the IRS is interested only in document production, the witness can negotiate compliance with the IRS by agreeing to photocopy the required documents and deliver either the originals or copies to the IRS or have the agent pick them up at a mutually convenient place. Otherwise, the witness must appear as required and either respond (i.e., produce documents and/or answer the questions), or, as to any questions or requests for documents, assert any grounds that the witness may have for not responding to any question or request for documents.¹³⁰⁴ The grounds for not complying are typically privileges such as the Fifth Amendment privilege and the attorney client privilege (which I shall cover separately below (pp. 409 ff.)) but may also include other privileges or inability to respond (lack of possession of the documents summoned).

If the witness complies with the summons by producing the requested documents or giving the testimony, that will be the end of the summons compulsion.

If the witness does not comply, however, then additional processes are required because the summons is not self-enforcing.¹³⁰⁵ The IRS may then seek judicial enforcement in the U.S. district

¹³⁰³ Bryan T. Camp, Tax Administration as Inquisitorial Process and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998, 56 Fla. L. Rev. 1, 35 (2004) (citing in fn. 159 LEXIS searches by the author). I have not replicated that research nor attempted any such detailed research, but my experience tells me it is about right and certainly close enough for the point I illustrate in the text. Professor Camp also relates another LEXIS analysis – that, through 5/22/03, Powell, decided 10 years after the major constitutional case of Brown v. Board of Education, 347 U.S. 483 (1954), has been cited by courts in decisions in the LEXIS database 1,658 times as compared to 2,096 for Powell. I'll let you draw your own conclusions on this statistic.

¹³⁰⁴ The Q&A at the summons proceeding has historically been performed by the line IRS person (revenue agent or collection officer). That person may have been prepped by counsel, but counsel did not perform the Q&A.

¹³⁰⁵ Because the summons is not self-enforcing, compliance with the summons may be considered a voluntary act rather than compulsion for purposes of suppression. United States v.

court. See §§ 7402(b) and 7604. In the summons enforcement proceeding, the IRS will introduce an affidavit from the agent that will facially establish the Powell standards, including most prominently a good faith reason for the information or documents summonsed.¹³⁰⁶ The summons will be enforced summarily on that showing unless the taxpayer meets the following burden:

As part of the adversarial process concerning a summons's validity, the taxpayer is entitled to examine an IRS agent when he can point to specific facts or circumstances plausibly raising an inference of bad faith. Naked allegations of improper purpose are not enough: The taxpayer must offer some credible evidence supporting his charge. But circumstantial evidence can suffice to meet that burden; after all, direct evidence of another person's bad faith, at this threshold stage, will rarely if ever be available. And although bare assertion or conjecture is not enough, neither is a fleshed out case demanded: The taxpayer need only make a showing of facts that give rise to a plausible inference of improper motive. That standard will ensure inquiry where the facts and circumstances make inquiry appropriate, without turning every summons dispute into a fishing expedition for official wrongdoing.¹³⁰⁷

Provided that the witness has asserted the grounds in good faith, the worst the district court can do is reject the witness's good faith position and order compliance with the summons.¹³⁰⁸ If the district court orders compliance with the summons, it will often do so without giving the witness time to appeal the order, although that is within the discretion of the trial court.¹³⁰⁹ The witness then must either comply or refuse to comply, which will put the taxpayer at the risk of contempt if, upon the completion of the appeal, the court of appeals sustains the district court.

The district court's order to enforce the summons is appealable, but district courts often do not stay enforcement so that an effective appeal can be taken. The taxpayer will then be given an opportunity to comply pursuant to the order. If the taxpayer fails to comply with the district court's order, the Government may institute a "show cause" proceeding before the same district court to hold the taxpayer in contempt for violation of the order enforcing the summons. In the contempt phase of the case, the taxpayer generally may not relitigate defenses he or she could have argued, but did not, in the summons enforcement phase prior to the issuance of the court's order.¹³¹⁰

Peters, 153 F.3d 445 (7th Cir. 1998). A witness really concerned about suppression down the road would be well advised to resist compliance and force the Government to enforce in the manner noted above in the text. However, this may not be an exercise for the faint hearted, so only do that after obtaining competent counsel.

¹³⁰⁶ United States v. Dynavac, Inc., 6 F.3d 1407, 1414 (9th Cir. 1993) (The Powell burden "is a slight one, and may be satisfied by a declaration from the investigating agent").

¹³⁰⁷ United States v. Clarke, ___ U.S. ___, 134 S. Ct. 2361 (2014).

¹³⁰⁸ See Reisman v. Caplin, 375 U.S. 440 (1964), cited and discussed briefly in Powell.

¹³⁰⁹ See e.g., Boyd v. United States, 2002 U.S. Dist. LEXIS 25425 (E.D. Ky 2002).

¹³¹⁰ Reisman v. Caplin, 375 U.S. 440, 447 (1964) ("noncompliance is not subject to prosecution thereunder when the summons is attacked in good faith. "); see also United States v.

The witness asserting a good faith ground for failing to comply with a summons is well advised to appear pursuant to the summons and assert the ground(s) at that time, rather than taking the risk that first asserting a ground at some later time (e.g., the summons enforcement proceeding or the show cause hearing) may be held too late or to have shifted some burden to him that he will have difficulty meeting. Practitioners who come in late to the representation after the witness has already failed to assert properly the grounds may find some hope in the certain cases that may allow late assertions of the privileges or other grounds involved. But practitioners on the scene from the beginning should always advise that the taxpayer appear pursuant to the summons and assert properly the grounds for noncompliance.

d. Summons for Software Source Code.

Computer software and its source code is within the scope of the IRS's general summons authority under § 7602.¹³¹¹ However, concerned that the IRS might abuse this power with respect to source code the disclosure of which might be competitively damaging to the taxpayer, Congress enacted § 7612 to limit and put conditions on the IRS's ability to summons and use taxpayer computer source code. For this class you need not know the details; suffice it to say that, if the issue surfaces in your practice, you need to consult § 7612 and other authorities.

e. Summons in Criminal Investigations.

There is a point beyond which the summons power cannot be used. The IRS has the power to investigate tax crimes and may use the summons power in the criminal investigation. However, the IRS cannot prosecute nor use the grand jury process in an IRS investigation. Rather, the Department of Justice has sole authority over criminal prosecutions and grand jury investigations. When the IRS determines that it will recommend a taxpayer to DOJ for criminal prosecution, it will make a "referral" to DOJ. The IRS cannot issue a summons or begin a summons enforcement proceeding after the referral of the taxpayer to DOJ. § 7602(d).¹³¹² (Note, however, that this limitation applies when the taxpayer whose taxes are being considered is referred; it does not apply to a third party witness where the taxpayer has not been referred but the third party witness has been referred.¹³¹³)

The reason for limiting the use of the summons after DOJ referral is the dichotomy in the criminal investigation and prosecution functions. The IRS cannot prosecute or conduct grand jury investigations. DOJ Tax can; its Criminal Enforcement Section ("CES") is charged with the sole responsibility to do both. When the IRS investigation has reached the point of a formal DOJ referral, further investigative work should be done by a grand jury rather than by the IRS. That act of referral is simply a bright-line test to differentiate between the critical functions.

Rylander, 460 U.S. 752 (1983).

¹³¹¹ United States v. Norwest Corporation, 116 F.3d 1227 (8th Cir. 1997).

¹³¹² A summons enforcement proceeding commenced before the referral, however, may be continued after the referral. Drum v. United States, 602 F.Supp. 834 (M.D.Pa. 1985).

¹³¹³ Khan v. United States, 548 F.3d 549 (7th Cir. 2008)

Prior to the bright-line test, the courts expressed grave concerns about the IRS continuing to use the administrative summons after the IRS had “institutionally” determined that the taxpayer should be referred to DOJ Tax for criminal prosecution.¹³¹⁴ The concern was that further investigation after that institutional determination should be made only by the DOJ Tax upon referral through the grand jury process and the IRS should not continue to use the IRS administrative summons. When the critical point of an “institutional” determination had been reached was, however, most unclear and spawned much litigation. Congress adopted the bright-line test to provide certainty as to the point when the IRS should no longer use an administrative summons.

The issue of the IRS's bona fides in the use of the administrative summons is still present, despite the “bright-line” test. The IRS controls the timing of the DOJ Tax referral and can thus continue an IRS investigation long beyond the time that it should have been referred. There is some continuing uncertainty as to whether the bright-line test pre-empts further litigation over the issue of the IRS's bona fides for use of the administrative summons.

2. Third Party Summonses.

a. General Requirement of Notice to Party Being Investigated.

A third party summons is a summons to a person other than the person being investigated (usually the taxpayer whose taxes are being investigated) for the records or information of the person being investigated. The third party summons uses the same form as a regular summons.¹³¹⁵ The third party summons will identify the person being investigated (again, usually the taxpayer). The investigated party – the taxpayer in most cases – must be notified of all third party summonses in sufficient time (minimum of 23 days notice) to bring a proceeding to quash the summons. § 7609(a).¹³¹⁶ The notice is sent to the investigated party’s last known address.¹³¹⁷

¹³¹⁴ E.g., United States v. LaSalle Nat'l Bank, 437 U.S. 298 (1978).

¹³¹⁵ Form 2039.

¹³¹⁶ A circuit split has developed on the issue of whether failure to meet this notice requirement is fatal to a summons and summons enforcement or whether failure to meet the requirement can be ignored if the taxpayer was not prejudiced. See Jewell v. United States, 2014 U.S. App. LEXIS 7899 (10th Cir. 2014) (holding that because the requirement is stated as “shall” the requirement is mandatory and failure to give the notice is fatal to the validity of the summons; the court discusses the contrary authority from other circuits.

In United States v. First Bank, 737 F.2d 269 (2d Cir. 1984), the Court held, under the plain language of § 7609(a)(2), a co-owner of an account not identified in the summons is not entitled to notice of the summons. The notice is, of course, the key practical predicate to a motion to quash under § 7609(b) and, consistently, the courts hold that a co-owner not identified in the summons is not entitled to bring a motion to quash if he or she otherwise learns of the summons. Stewart v. United States, 511 F.3d 1251 (9th Cir. 2008).

There are some exceptions to the requirement of notice even to the taxpayer involved. § 7609(c)(2). For example, a summons solely to determine the identity of person having a numbered account with a financial institution is excepted. § 7609(c)(2)(C) (reflecting the practical reality that

b. Exceptions to Notice Requirement.

There are two key exceptions you will most frequently be concerned with in practice.¹³¹⁸

First, summonses used in aid of collection of an assessed liability against the taxpayer or a transferee require no notice to the third party whose liability is being investigated (again, usually the taxpayer).¹³¹⁹ This would typically be a summons to a person having assets that might be levied to collect the assessed liability. Thus, for example, the requirement for notice to third party record keepers does not apply to such summonses.¹³²⁰

the IRS does not know the identify and therefore can't give notice). For an example of this type of summons, referred to as a "no notice" summons, see Charles v. United States, 2013 U.S. Dist. LEXIS 153586 (WD MI 2013) (holding that IRS improperly used the "no notice" summons because the account was not a "numbered account."). Also, notice need not be given for summonses in aid of collection of an assessment or judgment against the person named in the summons or, as to a third party's derivative liability (e.g., transferee of the person named in the summons). § 7609(a)(2)(D).

¹³¹⁷ § 7609(a)(2).

¹³¹⁸ I list in the text the key exceptions. There is one other exception for a summons issued based upon a court determination that "there is reasonable cause to believe the giving of notice may lead to attempts to conceal, destroy, or alter records relevant to the examination, to prevent the communication of information from other persons through intimidation, bribery, or collusion, or to flee to avoid prosecution, testifying, or production of records." § 7609(g), which eliminates the notice requirement via § 7609(c)(3). The court proceeding is, of course, *ex parte* (§ 7609(h)(2)), meaning that the taxpayer is not notified because that would defeat the purpose of seeking authority to issue a summons without notice to the taxpayer.

¹³¹⁹ § 7609(c)(2)(D). Congress enacted this exception to notice from concern "that giving notice of a third-party summons to the taxpayer would allow him to withdraw the funds in his accounts before the summons could be enforced." Barnes v. United States, 199 F.3d 386, 389 (7th Cir. 1999). One court has noted that, although the plain language of the statute exempts the IRS from having to give notice for a summons issue in aid of collection, a more subtle reading of the legislative history permits the statute to be interpreted to require notice in some cases. See Ip v. United States, 205 F.3d 1168 (9th Cir. 2000) (deriving "the rule that a third party should receive notice that the IRS has summoned the third party's records unless the third party was the assessed taxpayer, a fiduciary or transferee of the taxpayer, or the assessed taxpayer had 'some legal interest or title in the object of the summons.'" Viewtech, Inc. v. United States, 653 F.3d 1102, 1104-5 (9th Cir. 2011) (citing and quoting Ip), acknowledging that the plain language of the statute is inconsistent with the Ip holding but applying it anyway)); see also e.g., Ginsburg v. United States, 2002 U.S. Dist. LEXIS 19046 (D. Conn. 2001) (declining to follow Ip because other cases more persuasive and noting that the Government's position is that Ip is wrongly decided because the statute is "clear and unambiguous.").

¹³²⁰ The exception excepts such summons from § 7609. So the general requirement within § 7609 that requires notice to such third party record keepers is not applicable. By contrast, as noted below in the text, which excepts summonses in criminal investigations § 7609, by special provision, the requirement for notice for third party recordkeeper summons is made applicable for

Second, summonses issued by an IRS criminal investigator require no notice.¹³²¹ Even in a criminal investigation, however, the IRS must always give the taxpayer notice of the **third party record-keeper summons**.¹³²² A third party record keeper summons is a summons issued to the certain types of third parties, including most prominently financial institutions,¹³²³ consumer reporting agencies, attorneys, and accountants.¹³²⁴ Again, the same form is used.¹³²⁵

Of course, a taxpayer and his or her practitioner will want to know if the case has been referred by the civil agent to CI for criminal investigation. The civil agent is not supposed to announce the referral. If the taxpayer receives a notice of a third party record-keeper summons issued by a CI Special Agent, the taxpayer or at least his or her practitioner will know that a criminal investigation is afoot and will be able to respond accordingly. The risk is that the IRS will first use straight third party summonses in the criminal investigation which requires no notice to the taxpayer and, unless the third party advises the taxpayer, the Special Agent can be out gathering evidence while the taxpayer and his or her practitioner are unaware.

3. The John Doe Summons.

The “John Doe Summons” is a summons to a third party who has or may have information related to one or more taxpayers whose identities are unknown to the IRS. § 7609(f). The quintessential example of a target of a John Doe Summons is the promoter of an allegedly abusive tax shelter that has been widely sold where the IRS desires to discover the names of all the investors.

Since the John Doe Summons is issued to determine the identity of one or more unknown taxpayers as well as to obtain other tax relevant information or documents, the IRS cannot give the

such summonses in criminal investigations.

¹³²¹ § 7609(c)(2)(E)(ii). There is another exception which seems to overlap this exception. Section 7609(c)(2)(F) and (g) permit the IRS to seek court approval to forego notice by establishing reasonable cause to believe that the giving of notice may lead to spoliation of potential evidence relevant to the examination. This would likely occur only in a criminal investigation, so the exception cited in the text would apply without the need for court approval. There nevertheless may be real world circumstances, however rare, to which the court approval exception may apply. Note that in the case of either exception there is not prohibition upon the summoned party itself notifying the taxpayer of the receipt of the summons.

¹³²² § 7609(c)(2)(E)(ii).

¹³²³ The Right to Financial Privacy Act (“RFPA”), 12 U.S.C. § 3401, requires privacy from government searches except in certain cases. An except is in § 3414(c), which provides “Nothing in this chapter prohibits the disclosure of financial records in accordance with the procedures authorized by Title 26.”

¹³²⁴ § 7603(b)(2).

¹³²⁵ Form 2039.

taxpayer(s) notice otherwise required for third party summonses.¹³²⁶ Rather, the IRS must first convince a court that the investigation relates to a particular person or ascertainable group or class of persons, that there is reasonable cause to believe that the person or persons so identified may not have complied with the tax laws, and that the information sought is not readily available from other sources. The check in the normal third party summons procedures is that the taxpayer, who must be notified (subject to the rules noted above), will have the incentive to contest any overreaching by the IRS. As to unidentified taxpayers, however, the IRS cannot provide notice because it does not know who they are. The requirement for advance court approval for such summonses is a surrogate -- a check by an objective third party -- for notice to the taxpayer.

The John Doe Summons procedures were designed to provide checks and balances. But, the IRS often finds that the procedures slow it down. The IRS must convince DOJ Tax, whose attorneys are plenty busy with other work, that it is worth going through the procedures to get the summons. DOJ Tax must gear up and present the matter to a frequently skeptical and almost always overworked District Judge who must play devil's advocate to the Government's ex parte application for the summons. Obviously, the IRS would much prefer just to use its administrative summons which has no such cumbersome steps.

In **United States v. Tiffany Fine Arts, Inc.**, 469 U.S. 310 (1985), the Supreme Court blessed the IRS's use of the regular administrative summons rather than the John Doe summons where the target of the summons has transactions relevant to its tax liability which, if discovered, might also identify unknown third parties' and be relevant to their tax liabilities. The context there was a tax shelter promoter who sold the product to unknown third parties. By allegedly investigating the promoter's tax liability to support inquiries into whether it reported its income from those unknown third parties, the IRS could summons the information under the general administrative summons by meeting the minimal requirements of Powell. The Supreme Court blessed that gambit and refused to require the John Doe Summons procedure. After Tiffany Fine Arts, the IRS saw the end-run around the John Doe Summons procedures -- simply find a reason to audit the third party record-keeper such as the tax shelter promoter and find some pretext that obtaining the names of the third parties is relevant under the Powell standards to the audit of the record-keeper.

In **United States v. Gertner**, 65 F.3d 963 (1st Cir. 1995), which you should now read, a law firm filed a Form 8300 (Report of Cash Payments Over \$10,000 Received in a Trade or Business) notifying the IRS that the law firm had received in excess of \$10,000 in cash. The form, however, failed to identify the taxpayer, asserting ethical grounds, the attorney client privilege and constitutional grounds. The IRS then issued a regular IRS summons to the law firm to produce the withheld information. The IRS used the regular IRS summons as opposed to the John Doe summons on the ground the Supreme Court blessed in Tiffany Fine Arts -- i.e., that the summonsee's taxes were being investigated as well as the unknown taxpayer's taxes. Analyzing the case under the Powell good faith standard, the district court concluded that the IRS's grounds for using the general summons -- i.e., that it was investigating the law firm's tax liability -- was pretextual, mere smoke

¹³²⁶ § 7609(c)(2)(F) excepts this situation from the general taxpayer notice requirement. See also Regs. 301.7609-2(f).

and mirrors to achieve the real goal of investigating the unidentified taxpayer. The Court of Appeals affirmed, noting importantly that the John Doe Summons procedure required advance court approval, a procedure the Government sought to avoid here on the pretext that it was after something more than the taxpayer's identity. The Court of Appeals noted that the requirement of advance court approval could not be ignored by the IRS simply by chanting a litany based on Tiffany Fine Arts.

In the IRS moves against tax shelters, the IRS issued general IRS summonses directly to advisors promoting the products (large accounting and law firms) to obtain the lists of investors that the statute requires them to keep when selling tax shelters. The general summons was used because the obligation to maintain the lists is on the promoter and thus the IRS was investigating whether they had met that obligation. Obviously, if the IRS got such a list, the IRS would have the identities of the investors and could proceed against them accordingly. The accounting and law firms, looking to protect their “clients,” asserted the various privileges (including the attorney-client identity privilege and a variant thereof under the new tax practitioner privilege under § 7525). After meeting some resistance in the courts, the IRS shifted to using the John Doe summons against the accounting and law firms, and indeed in a recent filing used both the regular summons and John Doe Summons. In the class materials is a copy of the enforcement petition in that recent filing. It is perhaps not yet foreclosed that the IRS will not ultimately be successful, but the likelihood is that the IRS will be able to obtain the identities of the investors.¹³²⁷

In two successive initiatives involving foreign bank accounts, the Government has also used John Doe Summonses to identify holders of foreign bank accounts and foreign bank credit or debit cards that are the frequent tools of U.S. tax evaders.¹³²⁸ The first round in the late 1990s was directed toward the Caribbean banks offering credit cards to the U.S. taxpayers that supposedly left no U.S. paper trail. The John Doe summons was issued to the U.S. based credit card receipt processors.¹³²⁹ The second round, a 2009 initiative, was against UBS, a prominent Swiss bank, that allegedly had up to 52,000 U.S. taxpayer accounts and had extensive U.S. presence so as to be subject to the jurisdiction of U.S. courts. The IRS’s ability ultimately to force compliance with the summons to UBS, a foreign bank, was ultimately never tested because the Government combined a criminal initiative against UBS (ultimately including a deferred prosecution agreement and a fine of \$780 million). The combination gave UBS and the Swiss Government incentive to reach a deal with the United States. Compliance ultimately came, at least for 4,500 of the names, from Switzerland’s re-imagining of its obligations under the mutual information exchange provisions of the U.S. / Switzerland’s double tax treaty.

Both of the initiatives discussed in the last paragraph were coupled with specially targeted voluntary disclosure initiatives to get the U.S. taxpayers to pony up the delinquent tax and interest

¹³²⁷ See Sheryl Stratton, Privilege Sidelines Shelter Actions, Gov't Changes Tack, 100 Tax Notes 295 (7/21/03).

¹³²⁸ For a good article, see William M. Sharp, Sr. and Larry R. Kemm, The UBS Summons and Voluntary Disclosure, TNI 1043 (9/22/2008).

¹³²⁹ For a case showing how the IRS used the John Doe summons in this initiative, see United States v. Norwood, 420 F.3d 888 (8th Cir. 2005).

for significantly reduced penalties. In the case of the second initiative, the penalty relief included relief from the potentially draconian FBAR penalties discussed beginning on p. 128. I discuss these voluntary disclosure initiatives beginning on p. 320.

Since the UBS John Doe Summons, the IRS has continued to use the John Doe Summons in its broader offshore account initiative when it has been able to obtain a foreign bank affiliate with sufficient U.S. presence to support the issuance of a summons with effective contempt power.

4. The Designated Summons.

Section 6503(j)(2) authorizes the IRS to issue a designated summons to a corporate taxpayer under the coordinated issue case program (“CIC”)¹³³⁰ or a third party with respect to a corporate tax liability under the program. The designated summons unilaterally extends the statute of limitations if (1) the corporate taxpayer or third party does not comply with the summons and (2) the IRS brings a judicial enforcement proceeding before the end of the statute of limitations. § 6503(j)(1).¹³³¹

The designated summons is just a type of summons and therefore must meet the Powell standards. Further, the IRS can issue the designated summons without any requirement that the taxpayer has been uncooperative or dilatory.¹³³² In other words, the IRS can issue the summons when it (the IRS) has itself been dilatory or has not timely allocated adequate audit resources to conclude the audit within the time frame that Congress allowed for audits, and thereby unilaterally keep open the statute of limitations. The suspension period begins on the date the court proceeding to enforce the summons is commenced and ends on the day the court proceeding is finally resolved. § 6503(j)(3). The regulations provide guidance as to when the court proceeding is finally resolved so as to end the suspension period.¹³³³ The Commissioner or his delegate makes the determination of final compliance as soon as practicable. A procedure is established for the summoned party to make a statement of compliance that will require that the IRS respond with notice that the IRS takes the position that the party has or has not complied.

¹³³⁰ Prop. Reg. § 301.6503(j)-1(c)(1)(i). The statute refers to the “coordinated examination program” which was the program the IRS previously used to exam larger corporate taxpayers. The statute contemplates that the program may evolve and thus applies to “any successor program.” The IRS has identified the current program in the Proposed Regulations as the CIC specified in the text. See IRS Notice of Proposed Rulemaking reproduced at 2003 TNT 147-10 (7/31/03). For audit purposes, taxpayers are divided into two categories – CICs and ICs with CICs generally comprising the largest taxpayers each of whom is examined by teams of IRS examiners and ICs each of whom is generally assigned to one examiner.

¹³³¹ For a discussion of the interplay of the suspension for the designated summons and consents to extend the statute of limitations, see FSA 200221004 (2/6/02), reprinted at 2002 TNT 102-74 (5/28/02).

¹³³² United States v. Derr, 968 F.2d 943 (9th Cir. 1992).

¹³³³ Regs. § 301.6503(j)-1.

Because it can be used to keep open the statute of limitations unilaterally, Congress required that the designated summons be reviewed by the Division Commissioner and the Division Counsel of the Office of Chief Counsel for the organizations that have jurisdiction over the corporation whose liability is the subject of the summons.¹³³⁴ Consistent with Congress' purpose, the IRS uses the designated summons only sparingly because, so it is reported, just the threat that the summons might be used has modified taxpayer behavior in response to IRS's requests for information and documents.

The IRS uses the standard IRS summons¹³³⁵ for the designated summons but must display prominently at the top of that summons the following: “**This is a designated summons pursuant to section 6503(j).**”

5. Litigation Regarding Summonses.

Litigation regarding summonses may arise in the following contexts.

(1) If the IRS is not satisfied with the witness's response, the IRS may bring a summons enforcement proceeding under §§ 7402(b) and 7604. The summons enforcement proceeding is pursued as in Powell and Tiffany Fine Arts by the government filing a petition (just a pleading) and an affidavit containing the critical allegations of fact, along with any other supporting documents to establish its prima facie case. The taxpayer will then have a limited opportunity to contest the existence of the Powell predicates. See the discussion earlier in the text (beginning on p. 393) about summons enforcement proceedings. To summarize, courts usually summarily enforce the summons with only limited discovery or hearing on the IRS's petition to enforce, if the petition is procedurally regular with an IRS affidavit asserting the Powell predicates and no taxpayer responsive allegation with some support as to the absence of one or more of the Powell predicates. Usually, the taxpayer will be unable to successfully perfect a Powell attack.

The IRS will often choose not to file a summons enforcement proceeding upon a witness' noncompliance, if it has some alternative method for obtaining the information, if the information is deemed relatively unimportant, or if the statute of limitations does not permit the orderly conclusion of the judicial enforcement proceedings (including the administrative steps to obtain DOJ approval to institute the proceedings). Note, however, that the key element of the designated summons -- the suspension of the statute of limitations -- requires the prompt commencement of judicial enforcement proceedings. One issue that is unresolved among the circuits is whether the district court must enforce the summons as is or may impose conditions upon enforcement.¹³³⁶

¹³³⁴ Actually, the statute requires review by the Regional Counsel for the region. § 6501(j)(2)(A)(i). However, the Regional Counsel position was abolished in the IRS restructuring. The Proposed Regulations accordingly substitute the offices noted in the text to make the review commanded by the statute.

¹³³⁵ Form 2039.

¹³³⁶ See cases discussed in Burgess J.W. Raby and William L. Raby, No Penalty for Failure to Comply IRS Summons, ..., 2005 TNT 36-87.

(2) If the witness is a third party witness, the taxpayer identified in the summons (but not the party witness summonsed) may file a court proceeding to quash or intervene in a proceeding to enforce the summons. **§ 7609(b)(1) & (2).**¹³³⁷ The proceeding to quash must be brought in the district where the witness “resides or is found.”¹³³⁸ The petition to quash must be filed within 20 days after notice of the summons and a copy of the petition must be contemporaneously mailed to the summonsed party and to the IRS.¹³³⁹ However, taxpayers and their counsel considering such action need to seriously review the bases they will assert for quashing. As noted above, under the Powell standard the bases for overturning an IRS summons are limited indeed. Accordingly, framing the motion to quash must be done with care and with attention to the fact that a frivolous motion might attract sanctions under Rule 11 of the Federal Rules of Civil Procedure.

I have placed in the class materials copies of two petitions for enforcement. The first relates to the now defunct law firm of Jenkins & Gilchrist and is a combined “promoter summons” and John Doe summons relating to abusive tax shelters. The second is a John Doe summons to UBS bank related to its alleged assistance to U.S. tax evaders via foreign entities and devices. You may look at them now, but will want to revisit them when we discuss the John Doe summons.

The rights to move to quash or intervene are rights to participate in litigation. The statute does not confer any rights for the taxpayer being investigated to participate in or attend the summons interview itself. The statute does not deny the taxpayer the right to participate in or attend the interview, but courts have generally held that the taxpayer has no such right unless the taxpayer has some legally protectable interest – such as confidential attorney-client communications -- involved that the summonsed witness might not properly preserve.¹³⁴⁰

¹³³⁷ Thus, parties who might potentially be affected but who are not entitled to notice may not file a petition to quash. For example, the third party witness upon whom the summons is directed may not bring a proceeding to quash because the summons itself is not the required notice which is the jurisdictional prerequisite to a proceeding to quash. Xoriant Corporation v. United States, 2014 U.S. Dist. LEXIS 152675 (ND CA 2014). In addition, other affected parties who are not entitled to notice cannot bring a proceeding to quash. For example, in Stewart v. United States, 511 F.3d 1251 (9th Cir. 2008), the IRS summoned the records of a bank account in which husband and wife were co-owners and the husband and wife then filed a motion to quash. The Court held that the wife, who was not name in the summons, could not file a petition. See also United States v. First Bank, 737 F.2d 269 (2d Cir. 1984) (holding that, under § 7609(a)(2), a co-owner of an account not identified in the summons is not entitled to notice of the summons).

¹³³⁸ § 7609(h)(1). See Deal v. United States, 759 F.2d 442, 444 (5th Cir. 1985); Masat v. United States, 745 F.2d 985, 986-8 (5th Cir. 1984).

¹³³⁹ § 7609(b)(2)(B); see Regs. § 301.7609-4(b)(3) and Mollison v. United States, 568 F.3d 1073, 1075 (9th Cir. 2009) (holding that the requirements in the text above must be met, but no requirement that the United States be served within the 20 day period)..

¹³⁴⁰ United States v. McEligot, 2015 U.S. Dist. LEXIS 45519 (N.D. Cal. Apr. 6, 2015) (discussing cases).

Litigating the propriety of the summons can affect the statute of limitations even if the summons is not a designated summons. If the taxpayer brings the proceeding to quash a summons subject to the limitations of § 7609, the civil and the criminal statute of limitations will be suspended during the period that the proceeding, including appeals, is pending. § 7609(e)(1).¹³⁴¹ Further, if the IRS and the summoned party – either a third party to which the taxpayer is entitled to notice of a third party served a John Doe Summons – do not resolve compliance with the summons, the civil and criminal statute of limitations for the taxpayer with respect to whom the summons was issued is suspended from a date six months after the summons was issued until compliance is finally resolved. § 7609(e)(2).¹³⁴² The point, of course, that merely moving to quash the summons even if you can avoid potential sanctions under Rule 11 may not be in the client's interest. On the other hand, however, in some situations depending upon close analysis of the situation, merely slowing down the IRS's investigative juggernaut even at the cost of a suspended statute of limitations may be a good strategic call.

The district court ordering enforcement of the summons may order compliance with the summons before an appeal can be pursued. The taxpayer feeling the district court has improperly enforced the summons then faces the Hobson's choice of complying or refusing to comply, thus being held in contempt by the district court. Courts will undertake a balancing of the following interests in determining whether to stay compliance pending an appeal: (1) whether the stay applicant has made a strong showing that he is likely to succeed on the merits; (2) whether the applicant will suffer irreparable injury without a stay; (3) whether issuance of a stay would substantially injure the other parties; and (4) whether the public interest would be served by a stay.¹³⁴³

¹³⁴¹ Note that, if the summons is not subject to the requirements of § 7609, its contest in litigation also does not invoke the § 7609 provision for suspending the statute of limitations on assessment. Thus, for example, summons in aid of collection of an assessment already made are not subject to § 7609 (and obviously do not need a suspension of the assessment statute of limitations). See ILM 200550001 (11/9/05), reproduced at 2005 TNT 242-20.

¹³⁴² Regs. § 301.7609-5(d)(1) and (3). A John Doe summonsee is required to notify the ultimate taxpayer(s) – the “John Doe(s)” – of the statute suspension. § 7609(i)(4); Regs. § 7609-3(d) (reiterating the statutory notice requirement and stating the contents of the required notice and the time and manner of notification).

¹³⁴³ Hilton v. Braunskill, 481 U.S. 770, 776 (1987); see also Ruiz v. Estelle, 650 F.2d 555, 565 (5th Cir. Unit A June 1981); see also Boyd v. United States (E.D. Ky. 12/24/02), unofficially reported at 2003 TNT 152-11 (8/7/03).

In United States v. Batton, unpublished opinion 2008 U.S. App. LEXIS 16297 (2008), the court denied the Hobson’s choice metaphor, finding that in a situation where the taxpayer asserted the Fifth Amendment privilege he could unlike the contempt lock with the key of compliance. That, however, simply begs the question. In that case, by the time the final contempt proceeding had been reached, the Government announced that “a referral to [Criminal Investigation] is imminent.” The court said that, even so, the taxpayer must establish his right to assert the privilege and, quoting United States v. Roundtree, 420 F.2d 845, 852 (5th Cir. 1969), may not “draw a conjurer's circle around the whole matter by his own declaration that to write any word upon the government blank

The district court may not enforce the summons as written by the IRS. The district court may enforce as to part of the summons but not as to a part as to which the Powell factors are not present, or the district court may conditionally enforce a summons. Consider the following from the Sixth Circuit:

We should clarify, however, the distinction between granting partial enforcement of a summons and conditionally enforcing a summons, because this distinction has become muddled throughout these proceedings. Monumental's request for a protective order covering the documents sought by the IRS would constitute conditional enforcement of the summons because restrictions would be imposed on the IRS's use of summoned materials. Partial enforcement, in contrast, narrows the scope of the summons by limiting the type and amount of documents that the summoned party must produce. Although this court has permitted a summons to be limited in scope, * * * we have never addressed the question of whether conditional enforcement is permissible—a question that has been addressed by both the Fifth and Ninth Circuits. See Jose [United States v. Jose, 131 F.3d 1325, 1329 (9th Cir. 1997)], 131 F.3d at 1326-29 (requiring the IRS to give the summoned parties five-days notice before transferring the documents to other divisions within the IRS was held to constitute impermissible conditional enforcement); United States v. Barrett, 837 F.2d 1341, 1350 (5th Cir. 1988) (holding that district courts cannot place conditions on enforcement of a summons, but must simply decide “whether to enforce or not to enforce the summons”). This circuit's position on the issue need not be decided at the present time in light of our disposition of the enforcement request.¹³⁴⁴

For those practitioners advising clients whether to contest a summons, consider the following quote:

Those who resist an IRS summons all have one thing in common: They lose. Only about one challenge in 200 succeeds even in part.

* * * *

Practically speaking, “the taxpayer bears an almost impossible burden to resist enforcement of the summons.”¹³⁴⁵

would bring him into danger of the law.” If all the court meant to say that the taxpayer had not properly established that he had a Fifth Amendment privilege, then that would not be that bad, but it used some rather loose language to get there. I still think it is a Hobson's choice where there is some reasonable possibility that the court of appeals will reverse, and that is what the above protections are designed to mitigate.

¹³⁴⁴ United States v. Monumental Life Ins. Co., 440 F.3d 729 (6th Cir. 2006).

¹³⁴⁵ Bryan T. Camp, The Inquisitorial Process of Tax Administration, 2004 TNT 120-43 (6/10/04), quoting United States v. Garden State Nat'l Bank, 607 F.2d 61, 67 (3rd Cir. 1979) (when “the IRS has not recommended criminal prosecution to the Justice Department and the investigating

Finally, it is not inconceivable that contesting a summons without some minimum good faith basis might draw sanctions in the proceeding but might even be viewed as an attempt to obstruct justice as a sentencing enhancement in a subsequent criminal conviction.¹³⁴⁶

6. Use Of IRS Summonses Under U.S. Tax Treaties.

In an increasingly globalized economy, records relevant to tax administration in one country may be possessed by someone in another country. Under many U.S. bilateral tax treaties, one treaty partner is obligated to assist the other in gathering information relevant to the latter's tax administration. For example, the Canadian tax authority (referred to as the “competent authority” in treaty parlance) under the U.S./Canada Double Tax Treaty may request the U.S. tax authority (i.e., the U.S. competent authority) to obtain information in the U.S. for Canadian tax administration. If the request is within the scope of the treaty, the U.S. competent authority will authorize the IRS to issue an administrative summons. The ultimate taxpayer involved may then bring a motion to quash if the summons is to a third party or, if the summons is to the taxpayer, may invoke any basis for noncompliance and await the IRS's pursuit of a summons enforcement proceeding.

In United States v. Stuart, 109 S. Ct. 1183 (1989), Canada made such a request to the U.S., the U.S. issued summonses to third parties, and the taxpayer brought a motion to quash. The issue presented was whether the Code's limitation on the use of administrative summonses when a DOJ referral is in effect (§ 7602(d)) applies in the case of a summons issued under the Canadian treaty in relation to the Canadian tax. That Code limitation had been enacted after the U.S./Canadian treaty in question had been negotiated and entered into force. Arguably, even if that limitation were not in the treaty, Congress's subsequent legislation may have created a treaty override. The taxpayer argued that the status of the Canadian tax investigation was the equivalent of a DOJ referral and thus the use of an IRS administrative summons was not proper. The Court held that, notwithstanding the subsequent enactment, the treaty itself controlled and had no such limitation, so that it need not inquire into the status of the Canadian investigation.

The situation discussed deals with the procedure whereby the IRS uses its processes to obtain information for treaty partner tax administration. I shall discuss below the processes available when, for U.S. tax administration, the IRS requests foreign authorities to use their processes to obtain information in their jurisdiction.

7. Taxpayer Interviews.

a. Taxpayer Rights.

Section 7521 grants certain rights for taxpayer interviews, whether voluntarily or pursuant to a summons. The authorized practitioner may represent the taxpayer at meetings with the IRS, and

agent has not recommended prosecution to his superiors within the IRS, the taxpayer bears an almost impossible burden to resist enforcement of the summons”).

¹³⁴⁶ See Sentencing Guidelines § 3C1.1 (2008 ed.).

the IRS may not require the taxpayer to be present in the absence of an IRS summons.¹³⁴⁷ If the taxpayer does attend voluntarily or is summoned, the taxpayer may record the interview¹³⁴⁸ and consult with his representative.¹³⁴⁹ The IRS must explain the process -- either the examination process or the collection process, as appropriate.¹³⁵⁰ Section 7521 does not apply to criminal investigations.¹³⁵¹ However, in criminal investigations, the taxpayer has a constitutional right to be represented by an attorney and may invoke the constitutional privilege against self-incrimination.

b. Special Risks / Issues in Criminal Investigations.

Taxpayer interviews in criminal investigations are dicey. The best advice a taxpayer (or any potential criminal target) can receive is to decline, respectfully, to participate, which he or she can do simply by deferring any questions to seek advice of counsel if the interview is attempted outside the presence of counsel or by invoking the Fifth Amendment privilege. Often, however, a taxpayer is not well advised or even not advised at all at the first interview. It is not uncommon for two IRS CI agents (one may be a civil agent assisting a CI agent) to show up to talk with the taxpayer. This will be the first time the taxpayer becomes aware of a criminal investigation and often the taxpayer does not have an attorney engaged with respect to his potential criminal liability. The CI agent will read the taxpayer a modified version of the Miranda warnings, advising him or her of the right to counsel. Many times the taxpayer will attempt to “fade the heat” at that interview, without seeking counsel or invoking the Fifth Amendment, thinking that he or she can talk the agents into giving up the investigation. Two bad things can and often do happen in such interviews. First, the taxpayer may make a damaging admission that can then be used against him or her. Second, the taxpayer may lie, thus committing a separate offense (remember § 7212(a) and 18 U.S.C. § 1001). Either way, it is not a pretty picture.

The IRS's internal procedures require the CI agent to give the modified Miranda warnings at the beginning of the interview. The Miranda rule applies only to custodial or similarly coercive interviews. Typically, an interview at the taxpayer's place of business or home on one of these surprise visits is neither custodial nor coercive in the Miranda sense. Accordingly, the question is whether Miranda requires any warning at all. The IRM now requires a limited form of a Miranda warning. What happens if the IRS violates the IRM requirement? Remember the Caceres doctrine? Normally, the Caceres doctrine holds that the failure to follow the manual as to a matter not otherwise required is not a problem. However, in this area although Miranda has not been formally extended to noncustodial and noncoercive interviews in nontax contexts, some courts have been

¹³⁴⁷ § 7521(c).

¹³⁴⁸ § 7521(a)(1). The Tax Court has read this entitlement to record expansively so as to permit a taxpayer to invoke it in the Appeals hearing in a Collection Due Process case. Keene v. Commissioner, 121 T.C. 9 (2003). We discuss Collection Due Process and the special procedures below. (pp. 657 ff.)

¹³⁴⁹ § 7521(b)(2) & (c).

¹³⁵⁰ § 7521(b)(1).

¹³⁵¹ § 7521(d).

willing to suppress the evidence obtained in an interview that was not preceded by the modified Miranda warning required by the IRM.

Although CI agents routinely give the modified Miranda warning, civil agents do not. Often IRS administrative criminal cases are preceded by IRS civil examinations. The IRS revenue agent conducting the civil examination is supposed to throttle back on the civil investigation to consult with his manager and Technical Fraud Advisor and to refer the case to CI when there is a firm indication of fraud. Sometimes IRS revenue agents will prefer not to give the matter up quite at that point and proceed to conduct their own criminal investigation. They will usually then not give the modified Miranda warning and often will give some assurance, express or implied, that the investigation continues to be civil in nature when, in fact, it has turned criminal (although systemically even the IRS may not know that yet). The IRM prohibits the IRS from developing a criminal investigation under the guise of a civil audit. The question is whether the fruits of any taxpayer interviews in that context can be suppressed. Courts sometimes state a willingness to suppress the evidence under various theories -- such as that the interview under deception as to its nature (civil or criminal) is an unreasonable search and seizure, but often find some way to avoid suppression.¹³⁵²

8. Representing the Taxpayer and a Summned Witness.

A common pattern in IRS investigations is for the IRS to summons the taxpayer's accountant, a family member, partner, employee or former employee or other person or formerly associated in some way with the taxpayer. Often the summoned person will not want to engage separate counsel in order to respond to the summons. The summoned person will often seek advice from the taxpayer's attorney as to how to respond and may even ask the taxpayer's attorney to appear with the person at the summons proceeding. Particularly in an "eggshell" case with criminal potential, the taxpayer's practitioner will want to control the flow of information to the IRS and will thus want to be involved in the process. The issue presented is whether the practitioner can represent the third party witness in the summons proceedings.

This raises fundamental ethical issues for the attorney. The easy answer in that situation is to have the summoned person obtain separate counsel. The taxpayer's counsel can then work with the third party's counsel to bring him or her up to speed efficiently. Often, however, the third party will not want to go to the trouble or expense of hiring a lawyer and will lean on the taxpayer's counsel to represent him or her at the summons proceeding. But, there is at least usually a potential, if not actual, built-in conflict of interest. If there are problems with the return and there are potential civil or criminal penalties involved, the taxpayer may point the finger at the accountant, thus putting the accountant at jeopardy of civil or criminal penalties or potential disbarment by the Office of Professional Responsibility. Moreover, the taxpayer may want to bring a malpractice case against the accountant, which would put the attorney who undertook dual representation in a tough spot.

¹³⁵² See e.g., United States v. McKee, 192 F.3d 535 (6th Cir. 1999); and United States v. Peters, 153 F.3d 445 (7th Cir. 1998); but see United States v. Kontny, 238 F.3d 815 (7th Cir. 2001). These cases are discussed in John A. Townsend, Taxpayer Rights in Criminal Investigations, 90 Tax Notes 1842 (2001).

Dual representation is thus a potential problem that could blow up in the lawyer's face. This dual representation ethical problem can appear in many contexts -- often more subtle than the accountant-taxpayer relationship. For example, in an investigation with criminal overtones and having more than one potential target, representing more than one target can raise serious problems because of the opportunity for one to strike a deal at the expense of the other. In dual representation, it is difficult to give effective representation as to this negotiation because to do so might hurt another person who is represented. On the other hand, under our system, individuals can choose the lawyer they want to represent them and, with proper advice as to the problems of dual representation, can waive any conflict or appearance of conflict of interest. Whether or not they have made a knowing and intelligent waiver is a different issue, but the attorney must address that issue as the first order of business in a dual representation.

Not surprisingly, the IRS does not like dual representations because the Special Agent or IRS Revenue Agent assumes that the taxpayer's attorney may be only nominally representing the summoned party but is really there to protect the interests of the taxpayer by interfering with the agent's ability to develop the case. The feeling is that the taxpayer's lawyer will have woodshedded the witness to give favorable testimony for the taxpayer or simply intimidate the witness by his presence, so that the witness is less candid than he might otherwise be. In any event, the dual representation will, they perceive, hamper the information gathering process. Accordingly, in such cases, the IRS agents are directed to review the dual representation carefully, consult with their superiors and Division Counsel, as deemed appropriate, and take action to disqualify the attorney in extreme cases -- such as where the attorney is obstructing the interview.¹³⁵³ In order to determine whether the dual representation is potentially a problem, the agent may attempt to discuss the issue directly with the witness, including inquiring as to whether the taxpayer is paying the attorney and whether the witness knows that there is a conflict of interest or potential conflict of interest.

E. Formal Document Requests.

Section 982 authorizes the IRS to issue a "formal document request"¹³⁵⁴ which is not a summons but finds a surrogate for compulsion by evidence preclusion. If the taxpayer fails to comply within 90 days of the request, the taxpayer may be prohibited from using in any subsequent judicial proceeding any foreign documentation within the scope of the request that was not produced during the 90 day period unless the taxpayer establishes that its failure to produce was due to reasonable cause. Foreign law prohibitions imposing civil or criminal penalties are not reasonable cause. The taxpayer may bring a proceeding to quash the formal document request, but the statute

¹³⁵³ See IRM 25.5.5.5 (10-28-2011), Dual Representation.

¹³⁵⁴ The formal document request is made by IRS Letter 2261.

of limitations for both civil and criminal purposes will be suspended.¹³⁵⁵ The IRS uses this process quite sparingly.

F. Privileges at the Examination Level.

1. Privileges to Withhold Information from the IRS.

a. Introduction.

Privileges are an evidentiary concept. The general rule in Anglo-American jurisprudence is that each person – both individuals and artificial entities – may be compelled to tell what the witness knows to administrative agencies and courts in order to assist those agencies and courts administer the laws and dispense justice. In pithy language, the Supreme Court has admonished that “the public has the right to everyman’s evidence.”¹³⁵⁶ Privileges, where applicable, permit persons to withhold evidence and hence to hamper the truth finding process so critical to good government. Privileges are thus justified only where there is some overriding public benefit – a “public good transcending the normally predominant principle of utilizing all rational means for ascertaining truth.”¹³⁵⁷ Hence, privileges must be justified, and, the party asserting the privilege must establish that the privilege applies.¹³⁵⁸

¹³⁵⁵ § 982(c)(2). For an example of taxpayers unsuccessfully bringing a proceeding to quash, see Good Karma, LLC v. United States, 2008 U.S. Dist. LEXIS 87132 (E.D. IL 2008) (holding that “If Petitioners wish to introduce responsive documents in Tax Court, they simply must do as the Government suggests and ‘produce (or have produced) such document(s) to the IRS pursuant to the FDR.’”

¹³⁵⁶ Trammel v. United States, 445 U.S. 40, 50 (1980) (internal quotes and words omitted for clarity), quoting United States v. Bryan, 339 U.S. 323, 331 (1950)).

¹³⁵⁷ Trammel v. United States, 445 U.S. 40, 50 (1980) (internal quotes omitted, but quoting Elkins v. United States, 364 U.S. 206, 234 (1960) (Frankfurter, J., dissenting)).

¹³⁵⁸ United States v. BDO Seidman, 337 F.3d 802, 811 (7th Cir. 2003). See also FRCP 26(b)(5) (requiring that a party asserting privilege in discovery must expressly assert the claim and provide sufficient detail to support the privilege without disclosing the underlying privileged information). As to documents for which a privilege is claimed in whole or in part (through redaction), this is usually done via a “privilege log,” containing as much detail as possible (e.g., date of the document, author, etc., supported by an accompanying affidavit describing the confidential nature of the documents. Maura I. Strassberg, Privilege Can Be Abused: Exploring the Ethical Obligation to Avoid Frivolous Claims of Attorney-Client Privilege, 37 Seton Hall L. Rev. 413, 461-462 (2007) (noting that the precise requirements of the privilege log may vary from district to district, but all require minimal information to support the privilege).

In the federal system, the recognized privileges are those that existed at common law subject to such adjustments as Congress or, sometimes, the courts have made “in light of reason and experience” to the common law privileges.¹³⁵⁹

b. Privileges in the Federal Universe Generally.

A witness’ obligations for an IRS summons (and other compulsory processes such as subpoenas) are subject to the traditional privileges and limitations of any other compulsory process.¹³⁶⁰ The traditional privileges most commonly encountered in tax practice:

- (1) The attorney/client privilege;
- (2) A variant of the attorney/client applicable only in certain (but not all) tax contexts - the federally authorized tax practitioner privilege;
- (3) Work product privilege;
- (4) Fifth Amendment privilege against self incrimination; and
- (5) Spousal Privileges.

There are other privileges that may apply in a tax setting and, of course, practitioners and students should be aware of them. For example, there is a doctor / patient privilege. These other privileges are not commonly encountered in tax practice, so I do not discuss them here.

¹³⁵⁹ Rule 501 of the Federal Rules of Evidence states:

Except as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience.

The “in light of reason and experience” mandate is a quote from Wolfe v. United States, 291 U.S. 7, 12 (1934). Under this Rule, courts may develop the law – the common law – on a case by case basis. See United States v. Cintolo, 818 F.3d 980, 1002 (1st Cir. 1987), citing United States v. Gillock, 445 U.S. 360, 367 (1980); Trammel v. United States, 445 U.S. 40 (1980). Courts do not view this as a license to create new privileges, but certainly they can embellish the privileges that are there. See Trammel (embellishing the common law privilege), and United States v. Arthur Young & Co., 465 U.S. 816 (1984) (refusing to create a new privilege)..

¹³⁶⁰ Upjohn Co. v. United States, 449 U.S. 383, 398 (1981) (quoting United States v. Euge, 444 U.S. 707, 714 (1980)); see also FRE Rule 501 (except as otherwise specifically provided, privileges are “governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience”).

Privileges apply both in administrative proceedings – such as, most prominently here, IRS audits and collection activities – and in judicial proceedings. They apply in basically the same way. The party having the privilege can assert the privilege to prevent a compelled disclosure of the information subject to the privilege.¹³⁶¹ The privileges can usually be waived either by not asserting them to a compulsory disclosure requirement or by some affirmative act inconsistent with maintaining the privilege. For example, clients can waive the privilege for otherwise privileged attorney-client communications by disclosing the communications to persons other than those authorized to receive the privileged communications.¹³⁶²

c. Attorney-client Privilege.

(1) General.

The privilege that we are most familiar with is the attorney-client privilege. FRE 501 recognizes the privilege “governed by the principles of the common law as [it] may be interpreted by the courts of the United States in the light of reason and experience.” The privilege is normally an absolute bar to compulsory disclosure of a qualifying attorney-client communication.¹³⁶³ That privilege may be asserted at the examination stage, even in response to an IRS summons, just as it could in a litigated case. However, as always with privileges, the party asserting the privilege must prove entitlement to the privilege or, stated otherwise bears the risk that the privilege may not be available.

Perhaps the classic statement of the attorney-client privilege is from Wigmore:

where legal advice of any kind is sought, from a professional legal adviser in his capacity as such, the communications relating to that purpose, made in confidence, by the client, are at his instance permanently protected, from disclosure by himself or by the legal adviser, except the protection be waived.¹³⁶⁴

¹³⁶¹ See e.g., FRCP Rule 26(b) providing for discovery of nonprivileged matter.

¹³⁶² FRE 502 protect against unintended waivers incident to litigation discovery or even waivers as to so-called sneak-peeks designed to narrow down real discovery disputes as to potentially privileged matters. FRE 502 should be read along with FRCP 26(b)(5)(B).

¹³⁶³ There may be one significant exception for congressional investigations. Although some committees will not press the issue, some committees have made strident noises that the privilege will not apply to congressional investigations. However, the courts have not yet resolved the propriety of that claim. See Kalah Auchincloss, Note: Congressional Investigations and the Role of Privilege, 43 Am. Crim. L. Rev. 165, 179-185 (Winter 2006); Jonathan P. Rich, Note: The Attorney-Client Privilege in Congressional Investigations, 88 Colum. L.Rev. 145 (1988) (arguing that the attorney-client privilege is applicable to congressional investigations).

¹³⁶⁴ 8 Wigmore, Evidence § 2292, at 554 (McNaughton Rev. Ed. 1961). Courts routinely and sometimes even rotely cite this definition as the starting point for analysis of attorney-client privilege claims. E.g., United States v. Mass. Inst. of Tech., 129 F.3d 681, 684 (1st Cir. 1997); and United States v. Evans, 113 F.3d 1457, 1461 (7th Cir. 1997).

Federal Courts apply a more generalized federal common law attorney-client privilege.¹³⁶⁵ There is no definitive statement of this federal common law privilege, so Wigmore's definition is often used as a starting point. In addition, Proposed FRE 503(b), 56 F.R.D. 183, 326 (1972), although not adopted, is recognized as "a source of general guidance regarding federal common law principles."¹³⁶⁶ That proposed rule is:

A client has a privilege to refuse to disclose and to prevent any other person from disclosing confidential communications made for the purpose of facilitating the rendition of professional legal services to the client, (1) between himself or his representative and his lawyer or his lawyer's representative, or (2) between his lawyer and the lawyer's representative, or (3) by him or his lawyer to a lawyer representing another in a matter of common interest, or (4) between representatives of the client or between the client and a representative of the client, or (5) between lawyers representing the client.

The following communication is clearly a confidential attorney-client communication: client, for purpose of seeking legal advice, advises his attorney that he filed a fraudulent tax return. However, if the client sees the attorney with a group of friends at church and, in a repentive and confessional mood, advises the attorney (as well as the others within easy hearing distance) that he filed a fraudulent tax return, that is not a confidential attorney-client communication. There are two reasons that the privilege would be denied under the classic definition: (1) the communication was not intended to be confidential; and (2) under the facts, the client may have just been making a statement and not seeking legal advice.

Real world cases outside these easy extremes may not be so easily resolved. In discussing the attorney-client privilege, I shall also refer to cases decided under the federally authorized tax practitioner privilege ("FATP") of § 7525. I discuss the FATP after this discussion, but for present purposes what the FATP privilege does is to create a privilege like the attorney-client privilege for communications from a client to a federally authorized tax practitioner who is not an attorney. Cases resolving the FATP privilege thus use attorney-client privilege analysis; in reverse, those cases may offer insight into the attorney-client privilege.

Please note that the following is a limited discussion of the attorney-client privilege. A more complete discussion would expand this Tax Procedure text beyond reasonable needs. Hence, I deal only with certain facets of the privilege that appear to be most relevant to a tax practice as of the date of publication of this text.

¹³⁶⁵ Rule 501, Federal Rules of Evidence; see Johnston v. Commissioner, 119 T.C. 27 (2002).

¹³⁶⁶ In re Grand Jury Investigation, 399 F.3d 527, 532 (2d Cir. 2005); see also United States v. BDO Seidman, LLP, 492 F.3d 806 (2007) (quoting In re Grand Jury Investigation).

(2) Client Communications for Legal Advice.

The privilege only protects confidential communications made by the client to the attorney in order to obtain legal advice. The purpose for the client communication is thus critical. The question of the purpose of the communication often comes up where the attorney participates at some level in the business decision making process. For example, an attorney (either outside or in-house) may attend a business meeting of corporate employees where they discuss and make business decisions that may or may not be related to the need for legal advice and may even seek the business judgment of the lawyer. Since the party asserting the privilege must prove that the communication was made for the purpose of seeking legal advice, difficulty can be encountered by such mixed-purpose meetings.¹³⁶⁷

The privilege only protects the client communication. It does not protect the attorney's communication to the client. However, if the attorney's communication directly or indirectly discloses the client's communication to the lawyer for obtaining legal advice, the attorney's communication to the client is protected, not because it is an attorney's communication but because it reveals the client's communication.¹³⁶⁸ Furthermore, the attorney's communication of his or her legal advice is protected apparently without regard to whether the legal advice directly or indirectly discloses the client communication.¹³⁶⁹

(3) Reasonable Expectation of Confidentiality.

As in the example, the communication must be given in circumstances where the client expected that it be a confidential communication. This reasonable expectation requirement for the privilege is seen in several tax areas.

Perhaps the principal area is where the tax practitioner is both a tax return preparer and an attorney (or person qualifying for FATP privilege). Are communications to that person expected to be confidential when they are reflected on the return that is filed with the IRS? A facet of this issue is whether the tax practitioner is serving as an attorney at all or just a tax preparer, a compiler and reporter of data, as to the communication? We will address that subject below.

¹³⁶⁷ United States v. BDO Seidman, 337 F.3d 802 (7th Cir. 2003), cert. denied sub nom., Roes v. United States, 134 S. Ct. 1410 (2004); United States v. KPMG LLP, 237 F. Supp.2d 35 (D. D.C. 2002).

¹³⁶⁸ United States v. Defazio, 899 F.2d 626, 635 (7th Cir. 1990).

¹³⁶⁹ See United States v. Defazio, 899 F.2d 626, 635 (7th Cir. 1990) (“Communications from attorney to client are privileged only if they constitute legal advice, or tend directly or indirectly to reveal the substance of a client confidence.” (Emphasis supplied). Still, although this is slicing it a bit thin, if the attorney's communication were totally unsolicited to any direct or indirect communication from the client, it might arguably not be covered by the attorney-client privilege. I doubt that that thin a line would ever be tested.

The issue of reasonable expectation of privacy surfaced in abusive tax shelter litigation. As we note elsewhere, persons involved in the promotion of tax shelters are required to maintain lists of the persons purchasing the shelters and turn the lists over to the IRS upon request. Some of these persons include attorneys rendering opinions to the taxpayers and FATPs who may otherwise qualify to assert the attorney-client or FATP privilege. These persons may assert an “identity privilege,” which is a branch of the attorney-client privilege (discussed below). The courts hold that, because of the Code’s list maintenance and disclosure requirements, the clients could have no reasonable expectation of confidentiality as to their names and thus that the privilege does not apply.¹³⁷⁰

(4) Client Identity Privilege.

What if there is no statutory requirement that the attorney disclose the client’s name (such as with the tax shelter list maintenance rule noted above)? Is the identity of the client then privileged? The context in which this question is most often presented is in the context of the cash reporting requirements via the Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business. The conventional holding in this context is that the identity of the client in an attorney-client relationship is not privileged. Some courts of appeals, but not all, recognize at least in theory that there may be a “special circumstance” where there is a strong probability that disclosure of the client's identity would implicate the client in the very criminal activity for which the client sought legal advice. For purposes of convenience I shall refer to this as the “identity privilege” which is a common term for it, but you should remember that it is not a separate privilege but rather a particular subset of one or more other privileges or policies that might be involved. The lower court in Gertner had relied upon the identity privilege but the Court of Appeals did not address the issue because it denied enforcement of the summons in any event because the Government had not used the proper John Doe summons procedure.

In Gerald B. Lefcourt, P.C. v. United States, 125 F.3d 79 (2d Cir. 1997), the Second Circuit refused to apply the identity privilege. The Court noted the argument about linkage to the crime itself bore overtones of the Fifth Amendment issue in Marchetti v. United States, 390 U.S. 39 (1968), which, you will recall (pp. 144 ff.), held that a gambler was not required to file a wagering tax return because of the linkage between that return and the commission of a crime. While there might be some linkage between the payment of a large sum in cash and the commission of a crime, it is not inherently tied to a commission of a crime and, moreover, the disclosure requirement can be avoided simply by using a noncash medium of payment.

To be contrasted with these holdings is United States v. Liebman.¹³⁷¹ A law firm was engaged in rendering advice regarding tax shelter real estate partnerships. The law firm advised that the fees the taxpayers paid would be deductible. The IRS took the position that the fees were nondeductible brokerage fees required to be capitalized with the investment. The IRS issued a John Doe summons to the law firm seeking the identity of the clients paying the fees. The Third Circuit held that, although the identity of a lawyer’s client is normally not a privileged communication, here the nexus between the information the IRS sought and the taxpayer was a specific type of privileged

¹³⁷⁰ United States v. BDO Seidman, supra; and United States v. KPMG (D. D.C. 5/4/04).

¹³⁷¹ 742 F.2d 807 (3rd Cir. 1984).

communication (i.e., as to the deductibility of the fees) and therefore the disclosure of the identities would necessarily disclose the privileged communication made to them. This assertion of the attorney-client privilege as to the client's identity is often referred to as the "identity privilege" but you must remember that it is just a specific application of the attorney-client privilege. Please keep this privilege in mind, for we shall discuss a case dealing with the issue in the next section discussing § 7525, a relatively new provision extending some sort of privilege akin to the attorney-client privilege to tax practitioners in certain situations. Liebman is usually distinguished on the facts, so that the privilege does not apply.¹³⁷²

The identity privilege has been the subject of much controversy in the spate of tax shelter litigation where the Government seeks to discover the identities of the investors in abusive tax shelters. The courts' clear trend is to reject the existence of the privilege.¹³⁷³ But, you as a practitioner must be keenly aware of overreaching by the Government (IRS or grand jury) in this context and be prepared to recognize and marshal those unique facts which would, together, convince a court of Government overreaching.

(5) Attorney Communications to Client.

The privilege is for confidential communications from the client to the attorney. It is not for communications from the attorney to the client, except as the attorney's communications disclose the client's communications to the attorney. Of course, most critical communications from the attorney to the client will disclose at least indirectly confidential client communications to the attorney (e.g., what the nature of the client's problems are based upon the client's communications to the attorney).

Consider in this regard, whether the attorney's billing and payment information is confidential. Generally, billing and payment information is not treated as within the privilege. The amount the client pays an attorney does not disclose any privileged communication to or from the attorney. Similarly, the amount of time the attorney spends on a client matter does not per se disclose any privilege communication. However, many lawyers prepare detailed billing statements that describe the services rendered. Such detailed statements often contain information as to the nature of the client communication and the attorney's advice. The few cases that have addressed the issue have parroted the general rule that fee information is not privileged but have permitted redaction from the fee statements of any information that may implicate client communications to the attorney.

Practice Pointer: One of the dangers of such detailed fee statements is that clients sometimes do not keep them confidential. For example, if you provide services to a large corporation, there is

¹³⁷² E.g. United States v. Sidley Austin Brown & Wood LLP, 2004 U.S. Dist. LEXIS 6452, *21-23 (N.D. Ill. 2004), Deng v. United States, 2015 U.S. Dist. LEXIS 78804 (D. Del. 2015) ("A bare list of clients who paid fees does not fall within the privilege unless such a list would "automatically identify" unknown clients with a known communication.")

¹³⁷³ E.g., United States v. KPMG, 316 F. Supp.2d 30 (D. D.C. 2004), and cases discussed therein.

no question that, within a need-to-know control group, communications between the client and the members of the group are confidential. However, fee statements may be sent through processes that are broader than that group and, if they contain confidential information, may constitute a waiver of the privilege. In such representations, I prepare both a cover summary billing statement containing the bottom-line number and an underlying detailed statement. Both statements are sent initially to a person within the corporation who is within the group with need-to-know and has authority to approve the fee statement because he or she is knowledgeable as to the kind and quality of services rendered. I direct that person to separate the summary cover statement from the detailed statement and to forward only the summary cover statement to the appropriate support offices (usually accounts payable).

This issue of what attorney communications to the client are subject to the privilege surfaced in the contentious abusive tax shelter arena. Many abusive tax shelter opinions are written in conjunction with a prototype tax shelter plan developed by a promoter (perhaps with the active involvement of the tax professional rendering the opinions). The opinion (including the facts it assumes and the representations from the client) are standard and, in fact, do not actually represent communications from a real client. Often, when the promoter gets a taxpayer to buy the shelter, the attorney simply requires the taxpayer to sign a pre-packaged set of factual representations (such as profit motive) and churns out the form opinion (often referred to pejoratively as a “cookie cutter” opinion). The only other interaction between the attorney and the taxpayer is to obtain the fee (which often precedes the delivery of the opinion). Is there any attorney-client communication in this context? Some courts have held or strongly suggested that the privilege may not apply.¹³⁷⁴

(6) Relationship to Legal Representation.

The communication must be incident to legal representation. One issue that is often encountered in the tax practice where an attorney is both a lawyer and a tax return preparer is whether communications to and from the client are privileged. This issue is set up and thoughtfully (maybe even correctly) discussed in United States v. Frederick, 182 F.3d 496 (1999),¹³⁷⁵ which you should read now and be prepared to discuss in class. I assign this case because it is an important and recurring issue as to which the dividing line is quite fuzzy, and because it is a Judge Posner opinion (I like to have at least one per class).

We shall encounter another iteration of this issue below in discussing how the attorney can field a team consisting of various non-lawyer disciplines to provide more effective legal representation and assure that client communications to non-lawyers on the team are protected (pp.

¹³⁷⁴ John Doe #1 v. Wachovia Corp., 268 F. Supp. 2d 627 (W.D.N.C. 2003); E.g., United States v. KPMG, 316 F. Supp.2d 30 (D. D.C. 2004).

¹³⁷⁵ 182 F.3d 496 (1999). This case is in the materials. Judge Posner’s analysis, while a good one, is not the only good one. See e.g., Colton v. United States, 306 F.2d 633, 637 (2nd Cir. 1962) (“[t]here can, of course, be no question that the giving of tax advice and the preparation of tax returns -- which unquestionably constitute a very substantial part of the legal services rendered[--] [are] sufficiently within the professional competence of an attorney to make them prima facie subject to the attorney-client privilege.”)

449 ff.). In addition to fielding the team having the necessary expertise to give effective legal advice, the client and the lawyer may have communications with and among other persons who have common legal interests. For example, lawyers representing co-defendants in a criminal case may enter a joint defense agreement and thus preserve the attorney-client privilege (as well as the work product privilege) for information shared pursuant to the joint defense agreement. The joint defense agreement in this setting is just a specific iteration of a larger doctrine that information shared pursuant to common legal interests should permit the attorney-client privilege to be preserved.¹³⁷⁶ Specifically, there is a “small circle of others with whom information may be shared without loss of the privilege.”¹³⁷⁷ Included within that circle are persons and entities who have a common interest in legal advice from another's lawyer; accountants and other non-legal experts useful to a lawyers' delivery of legal advice; and a parent present when a child consults a lawyer.¹³⁷⁸ But the person asserting such privilege must be prepared to prove its existence and suffer the consequences if unable to do so.¹³⁷⁹

(7) Privilege and In-House Counsel.

In Upjohn v. United States, 449 U.S. 383 (1981), the Supreme Court held that the privilege was not necessarily limited to communications from the corporation's control group. In Upjohn, the corporation's in-house counsel conducted an internal investigation requiring that he receive communications from persons outside the control group. The Court sustained the corporation's assertion of the attorney-client privilege, based upon a fact-specific inquiry. In Upjohn, the corporation engaging the attorney to conduct the investigation asserted the privilege. Could the person outside the control group that is interviewed assert the privilege to prevent the corporation from waiving the privilege without his consent? Probably not, under the Wigmore definition, because the lawyer was the corporation's lawyer, not the individual's lawyer and his communication to the lawyer was not for the purposes of obtaining personal legal advice.

Two significant areas of potential controversy are implicated by this analysis.

¹³⁷⁶ See United States v. M.I.T., 129 F.3d 681 (1st Cir. 1997).

¹³⁷⁷ Id at 684. The so-called common interest doctrine is “an exception to the rule that no privilege attaches to communications between a client and an attorney in the presence of a third person,” in effect extending the attorney-client privilege to otherwise non-confidential communications in limited circumstances. United States v. BDO Seidman, 492 F.3d 806, 815-816 (2007).

¹³⁷⁸ Id. See also In re Grand Jury Proceedings Jean Auclair, 961 F.2d 65, 69 (5th Cir. 1992) (“The [attorney- client] privilege is not, however, waived if a privileged communication is shared with a third person who has a common legal interest with respect to the subject matter of the communication” (quoting Hodges, Grant & Kaufman v. United States Government, 768 F.2d 719, 721 (5th Cir. 1985))).

¹³⁷⁹ See Cavallaro v. United States, 284 F.3d 236 (1st Cir. 2002) (where less than careful practitioners failed to preserve the privileges).

First, we have noted above a setting where the privilege for corporate counsel might be compromised by having a meeting where general business is discussed rather than focusing on communications for obtaining legal advice. For this and related reasons, the following precautions should be implemented in a corporate setting communications for which the privilege is desired:

- Generally communicate, if possible, with the highest level management officer for decision making with respect to the matter involved.
- Avoid if possible questions seeking business advice, and avoid offering it sua sponte. This may not be possible where the corporation desires the business advice or participation of the attorney, but the attorney must be especially diligent in making sure that there is a clear record that the communication in question was for the purpose of seeking legal advice rather than business advice.
- Depending upon the setting for the communications, use the formality of indicating the intention for the communication to qualify for the privilege and the need for confidentiality. Thus, if in written form, it should contain a prominent notation that it is attorney-client privileged information and is confidential.
- Do not overdo the claims for confidentiality. Overdoing confidentiality claims will water down the claims as to the real good stuff and thus may jeopardize a court's view of the claims.¹³⁸⁰
- Make sure all writings (including handwritten notes) contain a date and some indication of the purpose of the writing.
- Protect the intended confidentiality of the communication. Do not discuss such communications in areas where persons outside the permitted circle can hear the communications, and maintain systems that prevent persons outside the circle to have access to written communications.¹³⁸¹

Second, is the corporation's potential waiver of employee interviews in internal investigations to ferret out the existence of wrongdoing within the corporation. Often, the corporation will desire to disclose to prosecutors internal wrongdoing in order to curry favor with the prosecutors or, if not unmitigated favor, at least a decision not to prosecute the corporation by throwing some of the employees under the bus. In the internal investigations, the attorney-client privilege and, in this context, the related work product privilege, are the corporation's privileges with respect to an employee's communications to a corporation's lawyer. It is not the employee's privilege, even if the employee is a member of a control group (e.g., officer or director).¹³⁸² In such

¹³⁸⁰ This actually occurred in United States v. KPMG LLP, 316 F. Supp.2d 30 (D. D.C. 2004).

¹³⁸¹ These bullet points are inspired in part by Bufkin Alyse King, Preserving the Attorney-Client Privilege in the Corporate Environment, 53 Ala. L. Rev. 621 (2002). I have, however, refined and modified them to reflect my experience.

¹³⁸² Commodity Futures Trading Corporation v. Weintraub, 471 U.S. 478 (1986); In re Grand Jury Subpoenas, 144 F.3d 653, 658 (10th Cir. 1998). Notwithstanding this general demarcation, the facts may permit at least an argument that, in communicating with the attorney, the corporate employee thought that the attorney was also acting for him or her personally. In such

a circumstance, where the corporate attorney is not representing the individual being interviewed, the corporation would not have an attorney-client privilege with respect to the employee's statements but would have a work product privilege. But, the danger is that the officer may confuse the corporation's privilege with his own privilege, on some notion that the attorney is somehow also the attorney for the officer or director. (I discuss this below.) And, so long as the officer is in the control group, he or she may have some assurance that the corporation will assert the privilege, thus protecting the officer's communications to the attorney, but if the officer is not within the group or leaves the group (e.g., by leaving the corporation, willingly or not so willingly), the then former officer may find that the new control group is not so interested in asserting a privilege to help the former officer.¹³⁸³

Corporations appear increasingly willing to trade their privileges for more favorable treatment by prosecutors investigating or prosecuting the corporation's misdeeds through its officers, usually former officers. Often, because of the Government's prosecution policies for corporations,¹³⁸⁴ the Government will be reluctant to charge the corporation because the inevitable effect will be to further harm shareholders or other innocent employees or interested parties that have already been burned by the underlying fraudulent conduct. In order to encourage the Government not to prosecute the corporation, the corporation may be required or "encouraged" to waive the privileges (attorney-client, as well as the work product privilege) that might otherwise apply with respect to the underlying conduct.¹³⁸⁵ Furthermore, in the event the corporation is charged, its sentencing will be reduced when it discloses all pertinent information.¹³⁸⁶ In short, officers of corporations take substantial risk in undertaking risky behavior that the corporation will not act to protect them.

One of the side effects of the corporation's waiver of the attorney-client privilege in order to curry favor with the prosecutors is, to state the obvious, it has waived the privilege. For the attorney-client privilege, any waiver is a waiver in all contexts. Thus, for example, corporations have made disclosures of attorney-client privileged information to the Government subject to a

cases, some courts have developed a strict test that is often impossible to meet. See In the Matter of Bevill, Bresler & Schulman Asset Management Co., 805 F.3d 120,123 (3d Cir. 1986); U.S. v. International Brotherhood of Teamsters, 199 F.3d 210, 215 (2d Cir. 1997); In re Grand Jury Proceedings, 156 F.3d 1038, 1040 (10th Cir. 1998); In re Grand Jury Subpoena, 274 F.3d 563, 572 (1st Cir. 2001).

¹³⁸³ See e.g., Commodity Futures Trading Corporation v. Weintraub, supra.

¹³⁸⁴ See USAM 9-28.000 - Principles Of Federal Prosecution Of Business Organizations.

¹³⁸⁵ It is important in this regard to differentiate between such privileges that arose contemporaneously while the underlying fraud was being committed and those that arise because of representation in the investigation or prosecution of the underlying fraud. The prosecutor may request and receive a waiver of both the work product and attorney-client privileges arising contemporaneously with the conduct being investigated or prosecuted, but would usually only ask waiver of the work product privilege with respect to privileges arising during the investigative or prosecutive stage.

¹³⁸⁶ Sentencing Guidelines § 8C2.5.

reservation of the privilege; courts have rejected the reservation of the privilege, saying that if that nuance is to be recognized, Congress rather than the courts must do it.¹³⁸⁷ Of course, as in other areas where the attorney-client privilege fails, the proponent may still be able to assert work product privilege which is not subject to the unconditional waiver rule.¹³⁸⁸

Finally, returning to the situation of the hapless employee in an internal investigation. Particularly delicate attorney-client issues can arise in any setting where a person – the employee here – may be confused as to whether the lawyer is representing him or her. This can be particularly important in internal investigations into actions that may have criminal aspects. As in Upjohn, the corporation may have an outside legal team conduct the investigation pursuant to an appropriate attorney-client privilege with the corporation. As noted above, under Upjohn, the corporation's privilege may extend to communications to the lawyer by certain high-level officers. But, within its normal contours, it would not apply to many of the persons within the entity that would be interviewed within the scope of the internal investigation. (Those communications would not be attorney-client communications but would be work-product.) Indeed, even employees in the control group cannot claim the privilege for interviews by the corporation's lawyer in such investigations unless the facts support that the lawyer was in fact also representing the employee or the employee had a reasonable belief that the lawyer was representing him or her. In order to avoid confusion in the employee's mind (thus potentially affecting his or her valuable right to remain silent), the better part of wisdom is for the lawyer conducting the internal investigation to warn the employee at the outset that the attorney represents the entity and not that individual being interviewed. This warning is commonly referred to as an **Upjohn warning**, for reasons that should be obvious. Indeed, the Upjohn warning, properly given, can be quite elaborate with several components, which in the aggregate is often referred to in the plural as Upjohn warnings, so I use the plural here.¹³⁸⁹

The Upjohn warnings are particularly important for three reasons. First, most obviously, is to put the interviewee on clear notice that the attorney doing the interview is not the interviewee's attorney and therefore the interviewee cannot rely upon the attorney to protect his or her interests or to keep the statements confidential. Second, and related, the lawyer ethically is bound to make sure the interviewee understands that the lawyer is not representing him or her. Third, although the

¹³⁸⁷ United States v. Thompson, 562 F.3d 387 (D.C. Cir. 2009) (discovery in a criminal case of the results of internal investigations produced to the Government under a selective waiver; discovery required subject to the traditional limited criminal discovery rules such as Brady, Jencks Act, etc.); see also In re Qwest Communications Int'l, Inc. 450 F.3d 1179 (10th Cir. 2006) (civil litigants' access to privileged material produced to government under a selective waiver).

¹³⁸⁸ Id at p. 394 (noting, however, that such selective disclosure of work product might still be a waiver if the circumstances of the disclosure is inconsistent with the maintenance of the privilege).

¹³⁸⁹ See particularly Upjohn Warnings: Recommended Best Practices When Corporate Counsel Interact with Corporate Employees (7/17/09) (published by ABA WCCC Working Group), which may be found at: <http://new.abanet.org/sections/criminaljustice/CR301000/PublicDocuments/ABAUjohnTaskForceReport.pdf>.

statements would be at least attorney work product and, in context, even confidential attorney-client communications **as to the corporation**, the corporation can make the choice to waive any protections afforded by the attorney-client or work product privileges. Indeed, as noted above, in many criminal investigations where the corporation is a potential target, there may be great pressure on the corporation to waive these privileges and even where the prosecutor may not be formally exerting the pressure, the entity could believe that waiving the privileges would be in its best interests. The employee's statements could then be delivered up to the prosecutors on a silver platter and be used against the employee. But, a prosecutor's ability to use the statements may be compromised if the employee had not been properly warned that the interviewing lawyer was not representing him or her¹³⁹⁰ and, where there is murkiness about whether the employee could have reasonably believed that the attorney might be representing him or her and the corporation cannot prove that the warnings were given. The result is that the corporation's bargaining power with the prosecutor has been compromised, and that may be a very bad result for the corporation.

(8) Waiver.

The privilege can be waived. Waiver is usually encountered where the communication originally intended to be confidential is shared beyond the attorney-client relationship. Of course, if (as often encountered in tax return preparation situations), the information when originally disclosed was intended to be shared beyond that relationship, it would not have qualified for the attorney-client privilege at all, because a necessary requirement is that the communication be intended to be confidential. There are some contexts in which potential waiver is commonly encountered in a tax practice.

Waiver may occur if a taxpayer asserts reliance on counsel as a defense to a criminal or civil penalty.¹³⁹¹ Thus, it is not unusual in the tax shelter context for taxpayers to obtain an opinion from counsel or from a practitioner with the § 7525 privilege that will serve principally or in major part to be asserted as a defense to a penalty if the shelter is discovered and successfully challenged on the merits. If that was the purpose of the opinion, then the opinion arguably did not qualify for the attorney-client privilege at all, although I think that the mere possibility but not certainty that it will be so used means that it is privileged until so used.

¹³⁹⁰ For a dramatic instance where an employee, a CEO of the company, suffered this fate, see United States v. Ruehl, 583 F.3d 600 (9th Cir. 2009). In that case, the trial court found that the investigating attorneys had not properly warned the CEO that it was not representing him with respect to the interviews and even referred the attorneys to the state bar for ethical violations. The court of appeals pulled the fat out of the fire to permit the Government's use of the statements in prosecution because, under the circumstances, it found that the CEO had not made the statements with an understanding of confidentiality.

¹³⁹¹ In re G-I Holdings, Inc., 218 F.R.D. 428 (D. N.J. 2003) (taxpayer asserted "reasonable basis" and "reasonable cause" based upon consultation with "outside legal counsel and others" as a defense to the accuracy related penalties; held this defense waived the privilege).

The Federal Rules of Evidence contain special rules to avoid “footfault” waivers for unintentional and inadvertent waivers in federal proceedings, including agency proceedings and limits subject matter waivers beyond the document being disclosed.¹³⁹²

d. Federally Authorized Tax Practitioner Privilege (“FATP”).

The 1998 Restructuring Act extended the attorney-client privilege to federally authorized tax practitioners as to tax advice. § 7525. The provision extends to non-lawyers the same privilege that would be available with respect to the same type of client communication from a client to the lawyer.¹³⁹³ Thus, the communication must meet all of the requirements for an attorney-client protected communication except that the tax advisor is not an attorney but is rather a federally authorized tax practitioner (e.g., accountant or enrolled agent).

Unlike the attorney-client privilege, however, this privilege is not absolute.

- The privilege may only be asserted in any **non**criminal administrative tax matter with the IRS or in judicial proceedings involving taxes brought by or against the U.S. § 7525(a)(2).
- The privilege is **not** available in a criminal investigation. § 7525(a)(2)(A).¹³⁹⁴ When a taxpayer really, really needs the privilege most, it is just not there.
- The privilege is also not available for written advice “in connection with the promotion of the direct or indirect participation of the person in any tax shelter.” § 7525(b).¹³⁹⁵

¹³⁹² FRE 502, added in 2008. The text states a general summary of the rule. I caution that it should be reviewed carefully by those making the types of disclosures that could invoke the Rule.

¹³⁹³ E.g., Valero Energy Corp. v. United States, 569 F.3d 626, 630 (7th Cir. 2009) (“This privilege is no broader than the existing attorney-client privilege. It merely extends the veil of confidentiality to federally authorized tax practitioners who have long been able to practice before the IRS . . . to the same extent communications would be privileged if they were between a taxpayer and an attorney.”)

¹³⁹⁴ Sorry for the redundancy, but this is important.

¹³⁹⁵ As amended by the American Jobs Creation Act of 2004. Prior to this amendment the exception to confidentiality applied only for corporate tax shelter promotion. The Government and taxpayers have sparred over who has the burden of proof with respect to the existence of this element which takes away the privilege. In United States v. BDO Seidman, LLP, 492 F.3d 806 (7th Cir. 2007) held that, being an exception to the privilege, the Government must “prove preliminary facts that would support a finding that the claimed privilege falls within an exception.” See also Countryside L.P. v. Commissioner, 132 T.C. No. 17 (2009). This burden may not be very great because of the broad meaning of tax shelter. See e.g., Valero Energy Corp. v. United States, 569 F.3d 626 (7th Cir. 2009). But, the Tax Court in Countryside said that it would interpret the elements of the exception practically (i.e., the written communication requirement does not include an FATP’s handwritten notes of oral communications and the requirement of a nexus to “promotion”

- But the privilege would be available for otherwise covered client communications in an audit, even if the underlying transaction were a tax shelter.¹³⁹⁶

Once the taxpayer shows that the communication is to an FATP, the IRS then has to establish its right to the exception to the general rule of confidentiality.¹³⁹⁷

Now review what Judge Posner had to say about the new privilege in **Frederick** (noting limits on the privilege under § 7525 and noting that it does not apply at all to work product).

In an important decision,¹³⁹⁸ the Seventh Circuit considered the limits of § 7525 and the identity privilege we previously discussed. The IRS summoned information from an accounting firm relevant to the enforcement of the statutory requirement that promoters of potentially abusive “tax shelters” register tax shelters they promote and maintain lists of persons purchasing the shelter (requirement discussed pp. 781 ff.). The summonses were the regular IRS summonses using the Tiffany Fine Arts gambit to obtain the identities of the persons to whom the tax shelters were sold (that being, of course, Congress’ express purpose for the requirement that lists of the names of investors be maintained by promoters).¹³⁹⁹ Two sets of investors moved to intervene using pseudonyms to protect their identity (“John Doe and Jane Doe”). They asserted the standard defenses (e.g., no legitimate purpose under Powell for the summons), but the significant issue considered on appeal was their assertion of the identity privilege under § 7525. Quoting its holding in Frederick, the Seventh Circuit said: “Thus the section 7525 privilege is no broader than that of the attorney-client privilege, and ‘[n]othing in [section 7525] suggests that. . . . nonlawyer

is not met where the taxpayer’s established accountant was advising at the regular hourly rate with respect to a one-off deal unrelated to a broad promotion of a strategy at premium rates).

¹³⁹⁶ There seems to be agreement on this point (e.g., Robert H. Aland and B. John Williams, Parsing the Practitioner Privilege, 2005 TNT 79-47), but the privilege in the context of the audit may be unexceptional and really superfluous because the communications (as well as the accountants’ other work) would probably be covered by the work product privilege. See Kip Dellinger, The Dubious Value of the Practitioner Privilege, 2005 TNT 84-46. The in-between question is whether communications with respect to the return preparation – an event that occurs after the promotion – included in the exception?

¹³⁹⁷ In United States v. BDO Seidman, LLP, 492 F.3d 806 (7th Cir. 2007); Countryside L.P. v. Commissioner, 132 T.C. No. 17 (2009). Both cases deal with the promotion of a tax shelter exception.

¹³⁹⁸ United States v. BDO Seidman, 337 F.3d 802 (7th Cir. 2003), cert. denied sub nom., Roes v. United States, 134 S. Ct. 1410 (2004).

¹³⁹⁹ You will recall from our discussion of the John Doe summons that the regular IRS summons should not be used unless the IRS is seeking information relevant to the liability of the summonsee. Tiffany Fine Arts blessed the use of a regular summons even when it would have the incidental effect of identifying investors in tax shelters promoted by the summonsee. Gertner held that the investigation of the liability of the summonsee must not be pretextual to avoid the John Doe summons requirement. Here, of course, the IRS easily cleared that hurdle and the Seventh Circuit did not even consider that an issue in the case.

practitioners are entitled to privilege when they are doing other than lawyers' work.” The Court then considered the applicability of the attorney-client privilege, apparently assuming that the accounting firm was performing legal services in relation to the clients.¹⁴⁰⁰ The Court said that a requirement of the attorney-client privilege and thus the § 7525 privilege is that the communication be made in confidence and this requirement is not present where the information is intended for disclosure to others. The Court noted the general rule that client identity is not a confidential communication and then moved to consideration of the limited exception which we refer to as the client identity exception. The Court distilled the holdings in the Seventh Circuit as applying only where the client’s identity would disclose the client’s motive for seeking legal advice (the motive being at least an implicit client communication to the attorney). The issue thus was whether the client’s identity would disclose the client’s motive for seeking tax advice from the accounting firm. The Court questioned whether the intervenors had made or could make this showing. However, “more fundamentally,” the Court held that, because Congress had required that the promoter register and maintain lists of investors, the clients could not have had any expectation of privacy with respect to their names. Hence, the case before the Court was “easily distinguishable” from the few cases recognizing a limited client identity privilege.

e. Fifth Amendment Privilege.

(1) Compulsory Testimonial Communications.

Taxpayers may assert the Fifth Amendment privilege against compelled self-incrimination. The privilege has been narrowed only to compulsory testimonial self-incrimination. Certainly, we all recognize that a taxpayer cannot be forced to testify as to incriminating matters. Thus, in a summons proceeding and in an ensuing summons enforcement proceeding, a taxpayer having a substantial fear of incrimination from answering the questions posed can assert the Fifth Amendment.

(2) Documents.

(a) General - The Act of Production Doctrine.

In a tax investigation, all competent practitioners and most taxpayers will know that no person can be compelled to testify as to matters that may be incriminating. IRS agents will also know that. So they tend to focus on documents which often tell a story more powerful than a confession or at least well enough to convict if a confession cannot be obtained. Does a taxpayer or other witness subject to summons (or subpoena in the case of a grand jury investigation) have a Fifth Amendment privilege against being required to produce documents that may incriminate? The answers to this question are not without some degree of uncertainty.

¹⁴⁰⁰ The Court does, however, fuzz this issue by stating that the party asserting the privilege must “show that the attorney-client communication was made for the purpose of obtaining legal advice, or, more precisely in the case of the section 7525 privilege, tax advice.” This may suggest that the court viewed “tax advice” under § 7525 as not necessarily being coterminous with the attorney-client privilege.

Generally, the concept that has evolved is that compelling the production of pre-existing documents does not per se constitute compulsory testimony. At one time, this pre-existing document exclusion from the Fifth Amendment privilege was thought to apply only to juridical entities such as corporations, so that personal papers of an individual (a diary being a classic example) were subject to the privilege. However, over time, the Supreme Court accepted the concept that, since the documents themselves were not produced under act of compulsion, the contents of the documents are not subject to a Fifth Amendment privilege by anyone.

Under this current jurisprudence, while the person compelled to produce the documents may not assert a Fifth Amendment privilege as to the contents of the documents, the person may have and assert a Fifth Amendment privilege as to any testimonial characteristics inherent in the compulsory act of producing the documents. This is called the Act of Production Doctrine. For example, as we discussed above, a person is not compelled to keep a diary wherein he or she records her innermost thoughts. If the IRS or other governmental agency summonses or subpoenas the person to produce the diary, the Fifth Amendment privilege against compulsory self-incrimination is implicated only by the testimonial characteristics of the compulsory act -- i.e., producing the diary. If in response to the summons or subpoena, the witness produces the diary, he or she is implicitly testifying that (i) I understand the summons or subpoena to require production of my diary and (ii) this book I deliver is my diary. Then, if the diary contains incriminating information, the Government can introduce the diary at trial and link it to the witness by showing that he or she produced it pursuant to the summons or subpoena. This latter “link” is referred to as the testimonial aspects of the “act of production.” That link is testimonial as to which the Fifth Amendment privilege may be asserted.

(b) Hubbell and the Act of Production.

This Act of Production Doctrine was addressed in United States v. Hubbell, 530 U.S. 27 (2000), a case of some notoriety because it involved Webster Hubbell, former Deputy Attorney General and, until then, a long-time friend of Bill Clinton. In Hubbell, The special prosecutor investigating virtually anything criminal President Clinton or his cronies might be associated with (including, as we know, sex lives), fixed on Webster Hubbell. As a tool to get to the president, the special prosecutor investigated Hubbell's potential nontax crimes. The hapless Hubbell pled guilty to those nontax crimes. In doing so, he promised to provide the special prosecutor information against the President. Subsequently, the special prosecutor instituted a grand jury investigation of whether Hubbell had complied with his promise. The special prosecutor had the grand jury issue to Hubbell broadly worded grand jury subpoenas for a number of categories of financial records. Hubbell appeared before the grand jury and invoked his Fifth Amendment privilege. The prosecutor thereupon delivered to Hubbell an order from the district court commanding that he comply and granting immunity “to the extent allowed by law.” The immunity is referred to as derivative use immunity, meaning that, if the Government subsequently prosecutes the person, the Government must show that the prosecution is based on information other than the testimonial information it obtained only by the grant of immunity. Hubbell then produced over 13,000 pages of documents. From the documents thus produced, the special prosecutor obtained an indictment of Hubbell for tax crimes and mail and wire fraud. The Government admitted that it could not prove those crimes independently of the documents produced under compulsion, so the parties agreed that the charges would be dropped altogether if the “Act of Production” doctrine would be a significant bar to

prosecution. In that posture, the Supreme Court granted certiorari at the request of the special prosecutor “to determine the precise scope of a grant of immunity with respect to the production of documents in response to a subpoena.”

The Court started by repeating the distinctions that have been recognized establishing the parameters of the problem:

The word “witness” in the constitutional text limits the relevant category of compelled incriminating communications to those that are “testimonial” in character. As Justice Holmes observed, there is a significant difference between the use of compulsion to extort communications from a defendant and compelling a person to engage in conduct that may be incriminating. Thus, even though the act may provide incriminating evidence, a criminal suspect may be compelled to put on a shirt, to provide a blood sample or handwriting exemplar, or to make a recording of his voice. The act of exhibiting such physical characteristics is not the same as a sworn communication by a witness that relates either express or implied assertions of fact or belief. * * * Similarly, the fact that incriminating evidence may be the byproduct of obedience to a regulatory requirement, such as filing an income tax return, maintaining required records, or reporting an accident, does not clothe such required conduct with the testimonial privilege.

The Court then reasoned, consistent with the Act of Production Doctrine that:

The “compelled testimony” that is relevant in this case is not to be found in the contents of the documents produced in response to the subpoena. It is, rather, the testimony inherent in the act of producing those documents. The disagreement between the parties focuses entirely on the significance of that testimonial aspect.

The Court then summarized the special prosecutor's argument that the Act of Production did not apply as follows:

The Government correctly emphasizes that the testimonial aspect of a response to a subpoena duces tecum does nothing more than establish the existence, authenticity, and custody of items that are produced. We assume that the Government is also entirely correct in its submission that it would not have to advert to respondent's act of production in order to prove the existence, authenticity, or custody of any documents that it might offer in evidence at a criminal trial; indeed, the Government disclaims any need to introduce any of the documents produced by respondent into evidence in order to prove the charges against him. It follows, according to the Government, that it has no intention of making improper “use” of respondent's compelled testimony.

The Court then rejected the argument as follows:

The question, however, is not whether the response to the subpoena may be introduced into evidence at his criminal trial. That would surely be a prohibited “use” of the immunized act of production. * * * But the fact that the Government intends no such use of the act of production leaves open the separate question whether it has already made “derivative use” of the testimonial aspect of that act in obtaining the indictment against respondent and in preparing its case for trial. It clearly has. It is apparent from the text of the subpoena itself that the prosecutor needed respondent’s assistance both to identify potential sources of information and to produce those sources. * * * * Given the breadth of the description of the 11 categories of documents called for by the subpoena, the collection and production of the materials demanded was tantamount to answering a series of interrogatories asking a witness to disclose the existence and location of particular documents fitting certain broad descriptions. The assembly of literally hundreds of pages of material in response to a request for “any and all documents reflecting, referring, or relating to any direct or indirect sources of money or other things of value received by or provided to” an individual or members of his family during a 3-year period, Appendix, *infra*, at 19, is the functional equivalent of the preparation of an answer to either a detailed written interrogatory or a series of oral questions at a discovery deposition. Entirely apart from the contents of the 13,120 pages of materials that respondent produced in this case, it is undeniable that providing a catalog of existing documents fitting within any of the 11 broadly worded subpoena categories could provide a prosecutor with a “lead to incriminating evidence,” or “a link in the chain of evidence needed to prosecute.”

* * * *

* * * we cannot accept the Government’s submission that respondent’s immunity did not preclude its derivative use of the produced documents because its “possession of the documents [was] the fruit only of a simple physical act—the act of producing the documents.” *Id.*, at 29. It was unquestionably necessary for respondent to make extensive use of “the contents of his own mind” in identifying the hundreds of documents responsive to the requests in the subpoena. * * * * The assembly of those documents was like telling an inquisitor the combination to a wall safe, not like being forced to surrender the key to a strongbox. *Id.*, at 210, n. 9. The Government’s anemic view of respondent’s act of production as a mere physical act that is principally non-testimonial in character and can be entirely divorced from its “implicit” testimonial aspect so as to constitute a “legitimate, wholly independent source” (as required by Kastigar) for the documents produced simply fails to account for these realities.

In sum, we have no doubt that the constitutional privilege against self-incrimination protects the target of a grand jury investigation from being compelled to answer questions designed to elicit information about the existence of sources of potentially incriminating evidence. That constitutional privilege has the

same application to the testimonial aspect of a response to a subpoena seeking discovery of those sources.

The Court distinguished an earlier case where it had rejected the Fifth Amendment because there the Government already knew of the existence of the specific documents in question. Where, as in Hubbell, the government is just out on a fishing expedition, the Act of Production applies if the Government lands the big one. In this respect, the Court specifically rejected the notion that a mere assumption as to the existence of the type of records will cure the defect. This offers a lot of opportunity for the potential application of the Act of Production Doctrine.

What level of knowledge of existence of the documents is required to support compulsory production by subpoena or its administrative counterpart, the IRS summons? In 2005 case,¹⁴⁰¹ the IRS had instituted a much heralded initiative to discover foreign bank accounts by issuing John Doe summonses to credit card processing agencies within the United States who would have records of processed charges for foreign bank accounts. From those records, the IRS obtained evidence of a particular taxpayer, the taxpayer-defendant in this summons enforcement proceeding, The IRS issued the summons for the taxpayer's bank and credit card records and related documents. The taxpayer appeared pursuant to the summons and asserted privileges. The Government then brought the summons enforcement proceeding and requested that the Court also issue an order requiring compliance with a consent directive directing the offshore bank to disclose information to the IRS. In the affidavit in support of the summons (recall that such an affidavit is used to meet the Powell requirements in the summary summons enforcement proceeding), the IRS Agent recounted the evidence that: (i) the taxpayer had a foreign bank account with two associated credit cards; (ii) the bank account number for that account; and (iii) the taxpayer had answered no to the foreign bank account question on Schedule B of his 1040.

One of the taxpayer's defenses to compliance was the Hubbell defense. The district court and the court of appeals rejected the defense on the basis that the information the IRS already had made the existence of the foreign bank account virtually a "foregone conclusion," sufficient to meet Hubbell's requirements. The court of appeals reasoned:

The existence of the requested records relating to Norwood's [foreign bank credit] cards and [related foreign bank] account is a foregone conclusion. The summons seeks records such as account applications, periodic account statements, and charge receipts, all of which are possessed by the owners of financial accounts as a matter of course. Norwood does not contend that he does not possess any of these documents, and the government knows far more about the documents associated with Norwood's [foreign bank] cards and account than it did about the defendant's business records in Hubbell. 530 U.S. at 44. In Hubbell, the government could not show "any prior *knowledge* of either the existence or whereabouts" of the documents sought. *Id.* (emphasis added). Here, by contrast, the government knows the name and location of the bank that created the records sought, Norwood's payment card numbers, and even the details of a number of discrete transactions

¹⁴⁰¹ United States v. Norwood, 420 F.3d 888 (8th Cir. 2005).

involving the cards and his [foreign bank] account. Accordingly, the district court's conclusion that "Norwood's production of the records has no testimonial significance," is not clearly erroneous.

One of the issues left open by Hubble is the level of knowledge the prosecutor must have and be able to prove to overcome a Fifth Amendment act of production claim. The D.C. Circuit Court of Appeals addressed some of the issues left open by Hubbell in holding that the Fifth Amendment was implicated in a compelled document production.¹⁴⁰² Focusing on the spectrum usually encountered between the frames of the two cases – Fisher where the documents were reasonably known to exist (no Fifth Amendment privilege) and Hubbell where the Government was just fishing (Fifth Amendment privilege) – the court said (pp. 320-321):

Although the Supreme Court did not adopt the "reasonable particularity" standard in affirming our decision, it emphasized that the applicability of the Fifth Amendment turns on the level of the government's prior knowledge of the existence and location of the produced documents. See Hubbell, 530 U.S. at 44-45. Post-Hubbell, another circuit has applied the reasonable particularity standard to determine whether an act of production is sufficiently testimonial to implicate the Fifth Amendment. See In re Grand Jury Subpoena Dated April 18, 2003, 383 F.3d 905, 910 (9th Cir. 2004). Because that standard conceptualizes the Supreme Court's focus in a useful way, so do we.

The Court of Appeals found that, under the facts, the prosecutors did not have the required particularity of knowledge as to some of the documents and, accordingly, that the subpoenaed party had a Fifth Amendment right to not produce the documents.

Reasonable particularity as to what? Is it the level of reasonable particularity to support a search warrant? I am not sure that the imperatives of the Fifth Amendment guarantee against self incrimination are coterminous with the imperatives of the Fourth Amendment guarantee of unwarranted searches and seizures. Go back to Hubbell where the Court asked a more particular type of particularity than required for a search warrant. The Ninth Circuit had previously decided a case on a reasonable particularity analysis,¹⁴⁰³ but in a later case focused back on the "foregone conclusion" requirement without mentioning the "reasonable particularity" standard and said:

For this foregone conclusion exception to apply, the government must establish its independent knowledge of three elements: the documents' existence, the documents' authenticity and respondent's possession or control of the documents. See United States v. Hubble, 530 U.S. 27, 40-41 (2000). The government bears the burden of

¹⁴⁰² United States v. Ponds, 454 F.3d 313 (D.C. Cir. 2006).

¹⁴⁰³ In re Grand Jury Subpoena, Dated Apr. 18, 2003, 383 F.3d 905 (9th Cir. 2004). See generally Mark A. Cowen, The Act-of-Production Privilege Post-Hubbell: United States v. Ponds and the Relevance of the "Reasonable Particularity" and "Foregone Conclusion" Doctrines, 17 Geo. Mason L. Rev. 863 (2010).

proof and must have had the requisite knowledge before issuing the summons or subpoena. See In re Grand Jury Subpoena, 383 F.3d at 910.¹⁴⁰⁴

At least arguably, as articulated, this might be a tighter standard of particularity that in the search warrant context. Still, I have to ask the question of whether a tighter standard would just force the Government to obtain a search warrant. Certainly, in at least some of these cases, the Government had enough evidence to obtain a search warrant. It seems to me to be somewhat counterproductive to permit the Government to obtain by search warrant that which it cannot obtain by subpoena, but again the imperatives of the Fifth Amendment and the Fourth Amendment are not coterminous.

I do want to make clear the whole point of this analysis – that the contents of documents, although not privileged per se by current Fifth Amendment analysis, can get the benefits of privilege via the act of production doctrine. In other words, the safety net given by the act of production doctrine also protects the contents of the documents simply because the Government cannot get to the contents except through an act of production which implicates the Fifth Amendment. Hubbell thus held that, having obtained the documents by immunity after the party properly asserted the Fifth Amendment privilege under the act of production doctrine, the prosecutors could not use the contents of the documents despite the fact that the contents of the documents were per se not subject to the Fifth Amendment privilege.

Finally, practitioners should be aware of the “required records” exception that, when applicable, will trump the Fifth Amendment Act of Production doctrine. The required records doctrine is variously formulated, perhaps because of its tenuous logic in view of contemporary Fifth Amendment jurisprudence. Here is a good statement of the rule and its predicates in a tax setting:

However, there is an important exception to the “communicative aspects” doctrine when the documents in question are “required records.” In re Two Grand Jury Subpoenae Duces Tecum, 793 F.2d 69, 73 (2d Cir.1986) (“[T]he [required records] exception overrides the privilege against self-incrimination in situations in which the privilege would otherwise apply; that is, even if the compelled act of producing the required records might be testimonial and incriminating.”). To constitute “required records,” documents must satisfy a three-part test. In re Doe, 711 F.2d 1187, 1191 (2d Cir.1983) (quoting Grosso v. United States, 390 U.S. 62, 67-68 (1968)). “(1) [T]he requirement that they be kept must be essentially regulatory, (2) the records must be of a kind which the regulated party has customarily kept, and (3) the records themselves must have assumed ‘public aspects’ which render them analogous to public documents.” *Id.* Courts in the Second Circuit have held that “required documents” include “W-2 forms, 1099 statements, tax returns, and employee earnings statements.” United States v. Barile, No. 1:06mc137 (LEK/RFT), 2007 U.S. Dist. LEXIS 84393, 2007 WL 3534261, at *3 (N.D.N.Y. Nov. 13, 2007); see also In re Doe, 711 F.2d at 1191 (“We have little difficulty applying the required records exception to the W-2 and Schedule II prescription forms.”); United States v. Edgerton, 734 F.2d 913, 918 (2d Cir.1984) (There is precedent for holding that W-2s

¹⁴⁰⁴ United States v. Bright, 596 F.3d 683, 692 (9th Cir. 2010).

and Forms 1099 are required records.”). Those are among the documents the IRS seeks from Mr. Whitehouse.¹⁴⁰⁵

I offer this for what it may be worth. The required records exception is often criticized because its stated underpinnings are inconsistent with the Fifth Amendment: If the subpoenaed or summoned party has a Fifth Amendment privilege under the act of production concept, why should it matter that the documents may be required records for some administrative scheme?¹⁴⁰⁶

You will recall that there is a general Code and Regulations requirement that the taxpayer keep records sufficient to calculate and report his or her tax obligations.¹⁴⁰⁷ Does this mean that all of the taxpayer’s records relevant to tax liabilities are required records?¹⁴⁰⁸ Fortunately, the Government has not pressed that argument and has disavowed intent to do so,¹⁴⁰⁹ so the cases have not had to deal with it except episodically for certain types of documents – e.g., Forms W-2 and 1099 as mentioned in the quote. I can’t predict where this might go if the Government were to get more aggressive. Maybe the courts would embrace the idea, but also maybe they would rethink the required records exception altogether.

A tax crimes related context for the Government assertion of the required records exception to the Fifth Amendment is for the records required to be maintained with respect to the FBAR reporting obligations. The regulations underlying the statute require the maintenance of records.¹⁴¹⁰ The Courts of Appeals consistently hold that, given the regulatory nature of the FBAR requirement,

¹⁴⁰⁵ United States v. Whitehouse, 2010 U.S. Dist. LEXIS 122979 (D. Conn. 2010).

¹⁴⁰⁶ See e.g., Akhil Reed Amar and Renee B. Lettow, Fifth Amendment First Principles: The Self-Incrimination Clause, 93 Mich. L. Rev. 857, 869-873(1995) (noting the logical inconsistency and the ad hoc and inconsistent holdings in the cases); but see Michael J. Zydner Mannheim, Toward a Unified Theory of Testimonial Evidence Under the Fifth and Sixth Amendments, 80 Temp. L. Rev. 1135, 1181 (2007) (“The best reading of these cases is that the Court utilizes this consideration to determine whether, at the time of compulsion, it was the government’s objective purpose to create evidence for a potential criminal proceeding.”).

¹⁴⁰⁷ § 6000 and underlying regulations.

¹⁴⁰⁸ See Shapiro v. United States, 335 U.S. 1, 51 (1948) (Frankfurter, J., dissenting) (“If records merely because required to be kept by law ipso facto become public records, we are indeed living in glass houses.”)

¹⁴⁰⁹ DOJ Tax has disclaimed that it will seek such expanded application. Shamik Trivedi, No Intention to Expand Required Records Doctrine, Keneally Says, 2013 TNT 44-3 (3/6/13), discussed in my Federal Tax Crimes blog entry, DOJ Tax Disavows Intent to Expand Required Records Exception to Act of Production Fifth Amendment Privilege (3/8/13). But, a court faced with the issue may be hard-pressed to articulate a rationale that would exclude application of the required records exception to some required records tax schemes.

¹⁴¹⁰ 31 C.F.R. § 103.32 and .24.

the required records doctrines applies to overcome the claim of the Fifth Amendment Act of Production Doctrine.¹⁴¹¹

(3) Entity Records and the Act of Production.

A common context for the potential application of the Act of Production doctrine applies when entity records are summoned or subpoenaed. The entity itself has no Fifth Amendment privilege, but the custodian of the records may have a Fifth Amendment privilege. As we have noted in Hubbell, the act of compiling records complying with a compulsory process and producing them may have certain testimonial features. The Supreme Court addressed this issue in Braswell v. United States, 487 U.S. 99 (1988):¹⁴¹²

We note further that recognizing a Fifth Amendment privilege on behalf of the records custodians of collective entities would have a detrimental impact on the Government's efforts to prosecute "white-collar crime," one of the most serious problems confronting law enforcement authorities. The greater portion of evidence of wrongdoing by an organization or its representatives is usually found in the official records and documents of that organization. Were the cloak of the privilege to be thrown around these impersonal records and documents, effective enforcement of many federal and state laws would be impossible. If custodians could assert a privilege, authorities would be stymied not only in their enforcement efforts against those individuals but also in their prosecutions of organizations. In view of the inescapable fact that an artificial entity can only act to produce its records through its individual officers or agents, recognition of the individual's claim of privilege with respect to the financial records of the organization would substantially undermine the unchallenged rule that the organization itself is not entitled to claim any Fifth Amendment privilege, and largely frustrate legitimate governmental regulation of such organizations.

Petitioner suggests, however, that these concerns can be minimized by the simple expedient of either granting the custodian statutory immunity as to the act of production, 18 U. S. C. §§ 6002, 6003, or addressing the subpoena to the corporation and allowing it to choose an agent to produce the records who can do so without incriminating himself. We think neither proposal satisfactorily addresses these concerns. Taking the last first, it is no doubt true that if a subpoena is addressed to a corporation, the corporation must find some means by which to comply because no Fifth Amendment defense is available to it. The means most commonly used to comply is the appointment of an alternate custodian. But petitioner insists he cannot be required to aid the appointed custodian in his search for the demanded records, for any statement to the surrogate would itself be testimonial and incriminating. If this is correct, then petitioner's "solution" is a chimera. In situations such as this --

¹⁴¹¹ United States v. Chabot, ___ F.3d ___, 2015 U.S. App. LEXIS 12367 (3d Cir 2015), the most recent in the unanimous decisions in the Courts of Appeals, citing all of those decisions.

¹⁴¹² Footnotes, some internal quotes and case citations omitted for readability.

where the corporate custodian is likely the only person with knowledge about the demanded documents -- the appointment of a surrogate will simply not ensure that the documents sought will ever reach the grand jury room; the appointed custodian will essentially be sent on an unguided search.

This problem is eliminated if the Government grants the subpoenaed custodian statutory immunity for the testimonial aspects of his act of production. But that “solution” also entails a significant drawback. All of the evidence obtained under a grant of immunity to the custodian may of course be used freely against the corporation, but if the Government has any thought of prosecuting the custodian, a grant of act of production immunity can have serious consequences. Testimony obtained pursuant to a grant of statutory use immunity may be used neither directly nor derivatively. 18 U. S. C. § 6002; Kastigar v. United States, 406 U.S. 441 (1972). And one raising a claim under the federal immunity statute need only show that he testified under a grant of immunity in order to shift to the government the heavy burden of proving that all of the evidence it proposes to use was derived from legitimate independent sources. Even in cases where the Government does not employ the immunized testimony for any purpose -- direct or derivative -- against the witness, the Government's inability to meet the “heavy burden” it bears may result in the preclusion of crucial evidence that was obtained legitimately.

Although a corporate custodian is not entitled to resist a subpoena on the ground that his act of production will be personally incriminating, we do think certain consequences flow from the fact that the custodian's act of production is one in his representative rather than personal capacity. Because the custodian acts as a representative, the act is deemed one of the corporation and not the individual. Therefore, the Government concedes, as it must, that it may make no evidentiary use of the “individual act” against the individual. For example, in a criminal prosecution against the custodian, the Government may not introduce into evidence before the jury the fact that the subpoena was served upon and the corporation's documents were delivered by one particular individual, the custodian. The Government has the right, however, to use the corporation's act of production against the custodian. The Government may offer testimony -- for example, from the process server who delivered the subpoena and from the individual who received the records -- establishing that the corporation produced the records subpoenaed. The jury may draw from the corporation's act of production the conclusion that the records in question are authentic corporate records, which the corporation possessed, and which it produced in response to the subpoena. And if the defendant held a prominent position within the corporation that produced the records, the jury may, just as it would had someone else produced the documents, reasonably infer that he had possession of the documents or knowledge of their contents. Because the jury is not told that the defendant produced the records, any nexus between the defendant and the documents results solely from the corporation's act of production and other evidence in the case. n11

n11 We reject the suggestion that the limitation on the evidentiary use of the custodian's act of production is the equivalent of constructive use immunity barred under our decision in Doe, 465 U.S., at 616-617. Rather, the limitation is a necessary concomitant of the notion that a corporate custodian acts as an agent and not an individual when he produces corporate records in response to a subpoena addressed to him in his representative capacity.

[Continuation of footnote] We leave open the question whether the agency rationale supports compelling a custodian to produce corporate records when the custodian is able to establish, by showing for example that he is the sole employee and officer of the corporation, that the jury would inevitably conclude that he produced the records.

(4) Other Issues.

There are still other Fifth Amendment issues potentially at play in the IRS information gathering process.

(a) Handwriting Exemplars.

Building on the Supreme Court's holdings that compulsory police line ups and even compulsory blood samplings are not Fifth Amendment violations, the Supreme Court has held that handwriting exemplars are also not Fifth Amendment violations.¹⁴¹³ Handwriting exemplars are simply samples of the witness's handwriting. The typical drill is for the IRS to issue a summons for or the grand jury to subpoena the handwriting exemplars. The witness will then be required to appear at the time and place designated and produce by writing in the presence of witnesses his or her signature¹⁴¹⁴ and other words from documents relevant to the case. There will usually be multiple iterations of each in order to guard against the possibility that, if only one were acquired, the witness might have changed his handwriting.

(b) Consent Directives to Foreign Banks.

We have noted elsewhere that people often use foreign bank accounts in so-called Tax Haven jurisdictions to hide their income and protect their assets from reach of creditors. In a U.S. tax setting, these people are U.S. taxpayers (or, more accurately, nontaxpayers) who seek to hide their income and thus not report or pay tax on that income, on the notion that the secrecy laws of the Tax

¹⁴¹³ United States v. Euge, 444 U.S. 707, 714-717 (1980).

¹⁴¹⁴ Section 6064 treats a signature on a return as “prima facie evidence for all purposes that the return, statement, or other document was actually signed by him.” A taxpayer can overcome that evidence, but may have a heightened burden to do so. However, where the IRS has the burden of proof (e.g. in a criminal case or a civil case involving fraud), at least arguably § 6064 may have limited benefit for the IRS (but see United States v. Kim, 884 F.2d 189 (5th Cir. 1989)), and the IRS may well want to obtain signature exemplars where there is any doubt as to the authenticity of the signature.

Haven jurisdiction will prevent the IRS from discovering the income. Alternatively, if the IRS has claims (i.e., tax assessments or potential tax assessments) against these U.S. taxpayers, they may desire to put their assets beyond the IRS's reach. Of course, the IRS can summons any person within the U.S. jurisdiction to answer questions and among those questions may be questions about hidden income or secreted assets. The taxpayer thus summoned can assert the Fifth Amendment privilege if it is otherwise available, and in the case of omitted income it almost certainly would be available. The privilege probably could be asserted both as to testimony pursuant to summons or grand jury subpoena and also as to documents under the Act of Production doctrine.

The IRS's retort to that Fifth Amendment assertion is to request a court to order the taxpayer to sign a consent directive (sometimes called a disclosure directive) which is a document authorizing foreign parties (such as a Tax Haven bank) to divulge information about accounts which the taxpayer owns or has signatory authority over.¹⁴¹⁵ The consent directive on its face does not contain an admission that the taxpayer actually has a foreign bank account; it simply says that, if he does, the bank is authorized to disclose information about the account. A court either in a summons enforcement proceeding or pursuant to a grand jury subpoena may recognize the taxpayer's assertion of the Fifth Amendment for compelled production of the documents but order the taxpayer to sign the consent directive or be held in contempt. Doe v. United States, 487 U.S. 201 (1988) (involving a grand jury subpoena and holding that the court may order the taxpayer to sign such a consent directive over a Fifth Amendment privilege assertion because but the target is not doing anything of testimonial significance and the only testimonial act will be the bank's implicit statement by its production that the records are the target's records).

In light of Doe, a taxpayer subjects himself or herself to almost certain contempt sanctions, including incarceration, for refusing to sign a consent directive. As is often the case in Supreme Court jurisprudence, however, shifts occur in constitutional analysis. Doe is the law now, at least for the lower courts who will impose contempt sanctions. But, the Supreme Court can always shift the analysis and arguably reach another result based on subsequent refinements in its analysis of the Fifth Amendment and other constitutional protections, such as the right of privacy, that were not addressed in Doe. Consider the following:

In summary, an individual or company facing a government demand that they consent to the release of foreign bank account information need not necessarily acquiesce. The correct course of action will depend on many factors, but declining to sign the releases should be part of the discussion, as there may be a sound legal basis to resist the government's efforts. If the DOJ has no other mechanism to get the information, then declining to "consent" may effectively derail the prosecution.¹⁴¹⁶

Of course, merely the possibility of derailing the prosecution at the cost of suffering contempt charges may not be the most appetizing alternative for a taxpayer. So the taxpayer is between a rock and a hard place. And, most taxpayers are not going to be willing to suffer contempt in order to see

¹⁴¹⁵ See IRM 5.21.2.3 (02-17-2009); see also IRM 34.6.3.7 (08-11-2004).

¹⁴¹⁶ See Timothy P. O'Toole, Dawn E. Murphy-Johnson, and George M. Clarke III, Can a Prosecutor Make you Cough Up Your Offshore Account?, 130 Tax Notes 1313 (Mar. 14, 2011).

if they can chase the issue of the continuing viability through the courts when there is significant chance that the Supreme Court would not agree to re-consider and, even if it did, might reach the same bottom-line decision to order the taxpayer to sign over the various objections that might be mounted.

The IRS's ultimate ability to get to the underlying records is wholly dependent upon the foreign person complying with the consent directive. Here too, the foreign person may take the position that it is prohibited from complying with such a compelled consent directive.¹⁴¹⁷ And, if a person to whom the consent directive is addressed is beyond the U.S. summons or subpoena power, no further effective steps can be taken. Certainly, the taxpayer cannot be jailed because the foreign person refuses to comply.

The following is an example of a consent directive in a prior version of the IRM.¹⁴¹⁸

AFFIDAVIT

JOE BLOW, having first been duly sworn, deposes and says:

I, Joe Blow, a resident of Houston, Texas, and the United States of America, address the following Consent Directive to any bank or trust company at which I have a bank account of any kind and to any bank or trust company at which a corporation has a bank account of any kind over which I have signature authority, specifically including, Tax Haven Bank, Ltd. Cayman Islands, and its officers, directors, employees and agents:

CONSENT DIRECTIVE

You are hereby authorized and directed to disclose all information and deliver copies of all documents of every kind and nature in your possession or control which relate to each of my bank accounts, and to each corporate bank account over which I have signature authority, for the period of [Insert Beginning Date], through [Insert Ending Date], to [Insert IRS Agent Name], or his/her designee, an officer of the Internal Revenue Service, Department of the Treasury, United States of America, and to give evidence relevant thereto in any court of competent jurisdiction, and this shall be irrevocable authority for so doing.

I do hereby further authorize and direct you to disclose all information and deliver all documents of every kind and nature in your possession or control which relate to any transaction in which I was involved, and which relate to any transaction in which a corporation over whose bank account I have signature authority was involved, during the period from [Insert Beginning Date], through [Insert Ending

¹⁴¹⁷ See Id. fn. 16; See also In re Grand Jury Proceedings (Marsoner), 40 F.3d 959, 966 (9th Cir. 1994), cert. denied, 515 U.S. 1132 (1995).

¹⁴¹⁸ IRM Part 42 - International 42(280).

Date] to the aforesaid [Insert IRS Agent Name], or his/her designee, and to give evidence relevant thereto in any court of competent jurisdiction, and this shall be irrevocable authority for so doing.

The documents, if they exist, which you are authorized and directed to deliver hereunder relate to the period of , through , and include, but are not limited to, the following:

1. Signature cards, bank statements, canceled checks, deposit tickets and items deposited, all relating to checking accounts.
2. Signature cards, bank statements, deposit tickets, items deposited and withdrawal slips, all relating to savings accounts.
3. Applications for credit and financial statements.
4. Liability ledger sheets for all loans.
5. Certificates of Deposits.
6. Safety deposit box records for each safety deposit box maintained by _____, and by each corporation over whose bank account he/she has signature authority, including entry records and signature cards.
7. Correspondence to or from _____ and to or from each corporation over whose bank account he has signature authority.
8. Cashier's checks and money orders purchased by _____ and by each corporation over whose bank account he has signature authority.
9. All collaterals and securities.
10. Collection records.
11. Transfer records.

This Consent Directive has been executed pursuant to that certain Internal Revenue Service Summons which was, according to its terms, issued over authority of the Internal Revenue Code of the United States on the day of _____, and which was served on me on that same date. /1/

[SENTENCE TO ADD IF THE TAXPAYER REFUSES TO VOLUNTARILY EXECUTE THE CONSENT] /1/ Accordingly, this Consent Directive is not to be interpreted to mean that any information or document it authorizes and directs to be divulged or delivered exists but rather that, if such information or document exists, such information shall be divulged and such document shall be delivered as specified herein.

Whether the foreign bank will honor the consent directive is a different issue and you may be assured that most tax haven jurisdictions will say that their law precludes them from complying with the consent directive unless it is totally voluntary for the taxpayer.¹⁴¹⁹

¹⁴¹⁹ See IRM 5.21.2.3(2) (02-17-2009); See also the unofficially reported decisions in United States v. Gippetti, 248 Fed. Appx. 382 (3d Cir. N.J. 2007) , and its predecessor case United Townsend Federal Tax Procedure 2015 - Textbook - 437 - Printed: 7/29/15

I discuss elsewhere (pp. 405 ff.) certain treaty and related procedures permitting the IRS to obtain foreign information and documents without the taxpayer's cooperation and without consent directives which may, as a practical matter, be ineffective anyway.

f. Work Product Privilege.

The work product privilege (also referred to as the work product doctrine) protects the work product and thought processes in preparing for litigation. The work product privilege was blessed in the Supreme Court case of Hickman v. Taylor, 329 U.S. 495 (1947) and is now contained in Rule 26(b)(3)(B) of the Federal Rules of Civil Procedure as follows:¹⁴²⁰

(3) Trial Preparation: Materials.

(A) Documents and Tangible Things. Ordinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent). But, subject to Rule 26(b)(4), those materials may be discovered if:

(i) they are otherwise discoverable under Rule 26(b)(1); and

(ii) the party shows that it has substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means.

(B) Protection Against Disclosure. If the court orders discovery of those materials, it must protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative concerning the litigation.

(C) Previous Statement. Any party or other person may, on request and without the required showing, obtain the person's own previous statement about the action or its subject matter. If the request is refused, the person may move for a court order, and Rule 37(a)(5) applies to the award of expenses. A previous statement is either:

(i) a written statement that the person has signed or otherwise adopted or approved; or

States v. Gippetti, 153 Fed. App. 2005, 2005 U.S. App. LEXIS 24054 (3d Cir. 2005), where the foreign bank did not respond.

¹⁴²⁰ This rule, applicable to district courts, is mirrored in the other fora (that is, courts) in which tax cases are litigated – the Tax Court and the Court of Federal Claims.

(ii) a contemporaneous stenographic, mechanical, electrical, or other recording—or a transcription of it—that recites substantially verbatim the person's oral statement.

Tax Court Rule 70(c)(3) now substantially tracks these provisions for work product.¹⁴²¹

Work product requires some nexus to litigation. Litigation need not be in progress at the time the work product is created but litigation must be more than a remote prospect.¹⁴²² Within those broad parameters, the work product must be “prepared in anticipation of litigation;” “[i]t is difficult to pinpoint the moment when a hypothetical possibility of litigation in the future becomes “anticipation of litigation” for purposes of the work product doctrine.¹⁴²³ Courts apply one of two principal tests to determine whether documents are prepared in anticipation of litigation. Most circuits apply the “because of” test asking whether the document was created “because of” anticipated litigation and was the subjective anticipation of litigation objectively reasonable.¹⁴²⁴ The other, more restrictive, test is the “primary purpose” test asking if the “primary motivating purpose behind the creation of the document was to aid in possible future litigation.”¹⁴²⁵

Work product subject to the privilege falls into two broad categories – (i) “opinion work product” such as the mental impressions, conclusions, etc. of the attorney or other representative in the litigation¹⁴²⁶ and (ii) other work product that relates to facts. All work product is subject to the required of showing substantial need and undue hardship, but opinion work product is discoverable only by (i) waiver by disclosure to the adverse party, (ii) if disclosed in a manner likely to become known to the adverse party, and (iii) by making an extraordinary showing of substantial need and undue hardship which, as to opinion work product would be almost impossible.¹⁴²⁷

¹⁴²¹ In criminal cases, FRCP Rule 16(b)(2)(A) denies discovery of “reports, memoranda, or other documents made by . . . the defendant's attorney or agent, during the case's investigation or defense.”

¹⁴²² E.g., Diversified Indus., Inc. v. Meredith, 572 F.2d 596, 604 (8th Cir. 1977), modified on other grounds on reh'g, 572 F.2d 606 (8th Cir. 1978) (en banc).

¹⁴²³ See e.g., Wells Fargo & Company v. United States, 2013 U.S. Dist. LEXIS 78714 (D. MN 2013)

¹⁴²⁴ E.g., United States v. Roxworthy, 457 F.3d 590 (6th Cir. 2006); United States v. Adlman, 134 F.3d 1194, 1205 (2d Cir. 1998).

¹⁴²⁵ United States v. El Paso Co., 682 F.2d 530, 542 (5th Cir. 1982), cert. denied, 466 U.S. 944 (1984).

¹⁴²⁶ The opinion work product concept incorporated in Rule 26(b)(3)(B) was approved in Upjohn Co. v. United States, 449 U.S. 383, 400-402 (1981).

¹⁴²⁷ As to the difficulty of overcoming the opinion work product privilege, see Wells Fargo & Company v. United States, 2013 U.S. Dist. LEXIS 78714 (D. MN 2013); In re Cendant Corp. Sec. Litig., 343 F.3d 658, 663 (3d Cir. 2003); and In re Murphy, 560 F.2d 326, 336 (8th Cir. 1977); and for the more extreme version, see Duplan Corp. v. Moulinage et Retorderie de Chavanoz, 509 F.2d 730, 734 (4th Cir. 1974) (opinion work product never discoverable). However, if mental

The work product privilege is sometimes wrongly conceived as an attorney work product privilege. The privilege is not limited to work done by or under the supervision of an attorney. Any work performed that is otherwise within the scope of the privilege may qualify. Thus, in United States v. Adlman,¹⁴²⁸ the Court recognized that work performed by an accountant may qualify for the privilege.¹⁴²⁹

Unlike the attorney-client privilege, the work product privilege is not absolute -- with a strong showing of need an opposing party (here the IRS) might be able to overcome the assertion of the privilege for non-opinion work product. Nevertheless, in most cases the Government likely will not be able to avoid the assertion of the privilege, if the privilege is otherwise well grounded. I should note in the case that I mentioned earlier (where the in house corporate lawyer engaged the regular accountants), the work product privilege was successfully asserted in part.

The work product privilege is often asserted along with the attorney-client privilege. Since the attorney-client privilege is absolute, it will be better to avoid disclosure on that grounds. Nevertheless where, for some reason, the attorney-client privilege is not available, the work product privilege is a good fall back.¹⁴³⁰

The work product privilege can be waived. The courts are not consistent as to the circumstances that will waive the privilege. A court held that the privilege is waived if the work product is disclosed intentionally to an opposing party but not if the disclosure is under circumstances that there was no intention to disclose to the opposing party.¹⁴³¹

impressions of an attorney are in issue in the case (e.g., in a malpractice case or perhaps in a civil penalty or criminal case involving the attorney's conduct), the opinion work product could be discoverable, but in that case, of course, it would not be the attorney's privilege to assert.

¹⁴²⁸ 114 F.3d 1194 (2d Cir. 1998). This Adlman case, often referred to as Adlman II, is actually the second round in the case. In the earlier case, United States v. Adlman, 68 F.3d 1495 (2d Cir. 1995), the Court had rejected an attorney-client privilege but then, after remand, held out the possibility that the work product privilege might apply.

¹⁴²⁹ See also United States v. Roxworthy, 457 F.3d 590 (6th Cir. 2006), nonacquiescence in AOD 2007-04 (10/1/07).

¹⁴³⁰ For a good application of this fall back, see United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998).

¹⁴³¹ Wells Fargo & Company v. United States, 2013 U.S. Dist. LEXIS 78714 (D. MN 2013) (disclosure to auditor is not a waiver); see also United States v. Deloitte LLP, 610 F.3d 129 (D.C. Cir. 2010) (same; not enough risk of adversarial relationship between financial auditor and client); In re Sealed Case, 676 F.2d 793 (D.C. Cir. 1982) (waiver to professional on same side); and United States v. MIT, 129 F.3d 681, 687 (1st Cir. 1997) ("work product protection is provided against 'adversaries,' so only disclosing material in a way inconsistent with keeping it from an adversary waives work product protection").

g. Spousal Privileges.

(1) General Justification for Spousal Privilege.

The general societal value supported by the spousal privileges is the integrity of the marriage unit. The justification for the particular subset of marital privileges is usually more fine-tuned than that, focusing on the nature of the testimony, its potential adverse effect on the marriage unit or marriage in general, and harm to society that justifies the privilege. For present purposes, readers should just recall that it is the marriage unit and the societal value of fostering the marital unit that justifies these privileges.

(2) Spousal Communications Privilege.

The spousal or marital confidential communications privilege covers “information privately disclosed between husband and wife in the confidence of the marital relationship” Trammel v. United States, 445 U.S. 40, 51 (1980).¹⁴³² The societal benefit is to ensure that spouses communicate confidentially without fear of exposure in court.¹⁴³³ Either spouse “may invoke the privilege to avoid testifying or to prevent the other from testifying about the privileged communication.”¹⁴³⁴

What are protected communications? We all know that people – including spouses specifically – communicate by words and actions. So, is everything one spouse learns about the other through words or actions communications? The answer is that general verbal communications are what is protected rather than actions. Consider the following:

[T]he protected subject matter includes only what one spouse communicates to the other, not what one spouse learns about the other in other ways, such as by observing the other's actions. In Mr. Brock's trial, the marital communications privilege could have applied to Mrs. Brock's testimony that he told her to take two guns from their home and put them in a car. It would not have applied to her testimony about Mr. Brock handling the guns or shooting possums.¹⁴³⁵

Not all communications between spouses, even if intended to be confidential are covered; there is an exception for communications in furtherance of joint participation in a crime.¹⁴³⁶

¹⁴³² See also Blau v. United States, 340 U.S. 332, 333 (1951).

¹⁴³³ United States v. Lofton, 957 F.2d 476, 477 (7th Cir. 1992).

¹⁴³⁴ United States v. Lea, 249 F.3d 632, 641 (7th Cir. 2001).

¹⁴³⁵ United States v. Brock, 724 F.3d 817, 821 (7th Cir. 2013) (case citation omitted).

Note that this inquiry has overtones of the concerns involved in the Fifth Amendment Act of Production Doctrine.

¹⁴³⁶ United States v. Ramirez, 145 F.3d 345, 355 (5th Cir. 1998); United States v. Chagra, 754 F.2d 1181, 1182 (5th Cir. 1985).

The privilege is waivable only by the spouse making the communication, and like the attorney-client privilege, the presence of some person other than the married parties who is capable of understanding the communications will waive the privilege.¹⁴³⁷ It is commonly stated that the waiver must be knowing and voluntary, but this means only that

the holder must realize that the once-confidential communication is being revealed. But if the holder intends to disclose the privileged material, even without realizing the impact of the disclosure on the privilege, then there is a waiver.¹⁴³⁸

The privilege survives the marriage.¹⁴³⁹

(3) Spousal Immunity (aka Adverse Testimony Privilege).

The spousal immunity privilege (sometimes called the adverse testimony privilege) protects a witness spouse from giving compelled testimony against the other spouse in a criminal proceeding. This is a privilege that must be asserted by the witness spouse; the defendant spouse is not permitted to assert it as a bar to the witness spouse's testimony if the witness spouse is willing to testify.¹⁴⁴⁰ The notion is that, if the witness spouse is willing to testify against the defendant or target spouse, the marriage is already in disarray and no societal benefit is furthered by permitting the defendant or target spouse to prevent the testimony of the witness spouse. The defendant spouse may, of course, assert the marital communications privilege to prevent the witness spouse from testifying about confidential communications during the marriage.

One important context in which the assertion of spousal immunity privilege created landmark constitutional law is in Crawford v. United States, 541 U.S. 36 (2003). In that case, the wife gave a taped statement to the police shortly after an assault on a third party. In the interview in which she made the statement, both the husband and the wife had been given standard Miranda warnings but neither asserted privileges of any sort, much less that spousal immunity privilege. At the husband's criminal trial, the husband invoked the spousal immunity privilege to prevent the wife from being compelled to testify. (Note that, under Washington state law, the husband could prevent the testimony, contrary to the rule in federal courts noted above that only the witness spouse may invoke this privilege.) The state then successfully moved, over the husband's objection, to enter the statement in evidence. The Washington Supreme Court sustained the use of the statement based on a hearsay analysis that then was materially coterminous with the right of confrontation -- i.e., the

¹⁴³⁷ Trammel v. United States, 445 U.S. 40 (1980). Thus, for example, the presence of a child of the marriage might waive the privilege if the child were of an age to be able to understand it. In Trammel, the communication was in writing which had been transcribed by a stenographer. Held, not a confidential marital communication. See also United States v. Brock, 724 F.3d 817 (7th Cir. 2013) (waiver at earlier stage of judicial proceeding is effective for later stage).

¹⁴³⁸ United States v. Brock, 724 F.3d 817 (7th Cir. 2013) (internal quotes and citations omitted).

¹⁴³⁹ United States v. Entrekin, 624 F.2d 597, 598 (5th Cir. 1980).

¹⁴⁴⁰ Trammel v. United States, supra.

statement had indicia, referred to as guarantees of trustworthiness, of reliability so as to clear a hearsay / Confrontation Clause hurdle. The issue upon which the Supreme Court digressed was whether the use of the statement violated the husband's Sixth Amendment right to be "confronted with the witnesses against him." Specifically, the Court reimaged and rewrote Confrontation Clause analysis. The right to confrontation where successfully asserted to prevent an out of court statement from coming in operates like a privilege – i.e., it results in denying the factfinder the right to otherwise available evidence in the truth finding process. The Confrontation Clause is nevertheless not normally perceived as a privilege, so I won't further digress here on the Confrontation Clause as a privilege. (Bottom line, the Court held that the use of the statement violated the Confrontation Clause.)

(4) Examples.

To use a stark nontax example, assume the unlikely case that (i) a wife observes her husband shoot and kill a person with a gun and (ii) later, after all the immediate events of the shooting are in the past, the husband tells her that he intended to kill the person when he shot him. If the wife were called to testify against her husband in a criminal proceeding, the wife could assert the spousal immunity privilege to avoid her compelled testimony but the husband could not assert the spousal immunity privilege if she were otherwise willing to testify. However, even if she were otherwise willing to testify, the husband could prevent her testimony about the subsequent communications between them.

To use a closer to home but analogous tax example, assume that (i) after signing a joint return, the wife gave the return to her husband, and the wife observed the husband writing his signature on the return, depositing the signed return in an envelope and dropping the envelope with the return in a mail box; and (ii) the husband later admitted to the wife that he had fraudulently omitted some income from the return. In a later criminal trial, the IRS wants to have the wife testify to these matters. The wife could assert the spousal immunity privilege to avoid her compelled testimony, but could testify if she chose to. The husband could prevent her from testifying as to the confidential communications about the his fraudulent intent in omitting income from the return.

I have used the combination of these privileges in a criminal investigation where I represented the husband who was the sole target of the investigation and also represented the wife who the IRS CI agent summoned to appear solely as a witness in the investigation of her husband. As my opening salvo monologue to the CI agents, I pronounced that (i) the husband and the wife each asserted the spousal communications privilege as to their respective communications to each other and (ii) the wife asserted the spousal immunity privilege to being forced to testify in a proceeding against her husband's criminal interests. I even instructed the witness not to answer any questions. Indeed, I did not even let her testify as to her name or other such nonincriminating information because the spousal immunity privilege is a blanket privilege. I "testified" to the fact that the person in the room with me and the CI Agents was the wife who had been summoned to appear, but I did not let her verbally testify to that effect. The CI agents present were not pleased, but could do nothing about it.

To put this anecdotal experience in perspective, in my experience, it is rare indeed that a spouse will be called in a criminal investigation of the other spouse where the parties are still married. In a tax setting, it may not at all be clear that the purported witness is or could not be at criminal jeopardy and thus have the additional privilege of the Fifth Amendment that would likely be asserted. But, even where it may be clear that a spouse might not have a Fifth Amendment privilege, the IRS in investigation usually does not call an existing spouse.

h. The Limits of Privileges - Tax Accrual Workpapers.

The Courts have resisted expanding the common-law privileges that are available even when strong policy arguments are made that privileges should be available. Courts thus routinely reject the existence of an accountant/client privilege even though one may exist under state law. Couch v. United States, 409 U.S. 322 (1973). In United States v. Arthur Young & Co., 465 U.S. 805 (1984), the IRS issued a summons to the taxpayer's independent certified public accountants to obtain the information and documents behind the tax reserve reported on the taxpayer's certified financial statements.

At this point, I should explain generally the jargon that helps explain the law and IRS policy and practice in this area.¹⁴⁴¹ Publicly held companies prepare and file public financial statements that report the financial results of their operations for a period. The financial statements include a profit and loss statement for a period (a year period for the major filings), as well as an ending balance sheet, and extensive notes to assist in making the statements comprehensible. In reporting a result for the period, a company must accrue as expenses liabilities that arose during the period and, on the ending balance sheet, must show any accrued but unpaid liabilities. Specifically, with respect to transactions with favorable tax aspects that might otherwise be reflected as a benefit on the financial statements, reserves must be accrued to reflect the probability that the benefits may not be ultimately sustained. In making a decision whether and how much to reserve for such unpaid potential liabilities, a company internally will prepare workpapers that back up its decisions. Similarly, when the independent auditor then attests the financial statements, the auditor prepares audit workpapers that back up the attestation. The company's and the auditor's workpapers underlying that type of liability or reserve are called "tax accrual workpapers" or some variation of that term.¹⁴⁴² The tax accrual workpapers should be distinguished from the "tax reconciliation

¹⁴⁴¹ See Wells Fargo & Company v. United States, 2013 U.S. Dist. LEXIS 78714 (D. MN 2013) for a detailed discussion of the jargon and application in a particular large and aggressive taxpayer setting.

¹⁴⁴² IRM 4.10.20.2 (07-12-2004), Audit Workpapers, Tax Accrual Workpapers, and Tax Reconciliation Workpapers Defined, offers the following:

The term "tax accrual workpapers" refers to those audit workpapers, whether prepared by the taxpayer, the taxpayer's accountant, or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax reserves on audited financial statements. These workpapers reflect an estimate of a company's tax liabilities and may also be referred to as the tax pool analysis, tax liability contingency analysis, tax cushion analysis,

workpapers” which reconcile the financial reporting to the tax return.¹⁴⁴³ The tax reconciliation workpapers are not audit workpapers, because they are not prepared by the company in making the financial statements or by the independent accountants in attesting them. “[T]ax reconciliation workpapers are within the scope of general information that may be routinely requested during an IRS examination.”¹⁴⁴⁴

The tax accrual workpapers should provide the detail behind the tax reserve on the audited financial statements and thus identify the taxpayer's material risky tax positions. Particularly since the combination of the Enron/Worldcom scandals and the abusive corporate tax shelters, companies preparing and independent accountants attesting company financial statements are paying greater attention to tax accrual work papers. Those workpapers could be the “mother lode” for IRS auditors, providing a much easier roadmap for audit.¹⁴⁴⁵ Although not presaging these developments, the accountants in Arthur Young argued that they should have a privilege from disclosing such information and documents because of the importance of certified financial statements to the market economy. Denying a privilege, they urged, would result in important information being withheld from the auditors and the quality of and public confidence in financial statements would suffer, with potential dramatic impact on public markets. In other words, the accountants urged, there were countervailing public policy arguments for allowing a privilege in this limited situation even if there were federally recognized accountant/client privilege generally. The Supreme Court rejected the argument, simply because the courts could not create a new privilege not allowed at common law or allowed by Congress.

Although Arthur Young was a taxpayer defeat in the Supreme Court, I commend the case to you for two reasons. First, it illustrates the lawyers' creativity in urging a new privilege with some degree of success before the Supreme Court. The Supreme Court does not take many tax cases, so success prior to that stage is usually the end of the matter. Second, it illustrates that despite a seeming loss in Court, the policy arguments made can still have an impact in administrative practice. An IRS agent concerned about efficiency could simply take Arthur Young at face and routinely request or summons the tax accrual workpapers as the first order of business in an audit. The audit plan and resulting audit would be far more efficient. On the other hand, as the taxpayers' lawyers urged in Arthur Young, that easy access would discourage corporate taxpayers from making

or tax contingency reserve analysis. The name given the workpapers by the taxpayer, the taxpayer's accountant, or the independent auditor is not determinative.

¹⁴⁴³ Tax reconciliation workpapers are defined by IRM § 4.10.20 (3) (07-12-2004) as workpapers that are used in assembling and compiling financial data preparatory to placement on a tax return. These papers typically include final trial balances for each entity, a schedule of consolidating and adjusting entries, and information used to trace financial information to the tax return. Any tax return preparation documents that reconcile net income per books or financial statements to taxable income are also tax reconciliation workpapers.

¹⁴⁴⁴ Bret Wells, Voluntary Compliance, This Return Might Be Correct, But Probably Isn't, 29 Va. Tax Rev. 645, 675 (2010).

¹⁴⁴⁵ See Wells Fargo & Company v. United States, 2013 U.S. Dist. LEXIS 78714 (D. MN 2013) (citing Arthur Young for the proposition that they can be helpful to the IRS).

adequate disclosures to their public auditors and the public market system would be negatively impacted because the quality of financial statements would suffer. The IRS realized that, should it exploit its victory in Arthur Young by routine request for tax accrual workpapers, Congress might well act to take away its victory if it felt the public markets would be negatively impacted. Accordingly, the IRS has adopted policies exhibiting considerable restraint with respect to tax accrual workpapers.¹⁴⁴⁶

Since the high profile financial accounting disasters leading to the Sarbanes-Oxley Act¹⁴⁴⁷ and not unrelated corporate tax shelter disasters, the IRS has relaxed its policy of restraint. Sarbanes-Oxley (sometimes referred to as SOX) requires increased independent accountant due diligence for attested financial statements, which means more detailed audit workpapers (including tax accrual workpapers). For example, focusing on the adequacy of corporation's tax reserves, auditors have begun demanding to see legal advice rendered to the corporation regarding their liabilities. I discussed above the interpretation known as Fin 48 that governs financial reporting of uncertain tax positions. Obviously, this quantification process required to underlying make the Fin 48 disclosures is part of the tax accrual workpapers and can be the mother lode to the IRS.

Exercising its discretion in this area, the IRS generally requests tax accrual workpapers – including Fin 48 documents treated as tax accrual workpapers¹⁴⁴⁸ – only in “unusual circumstances” standard¹⁴⁴⁹ which requires:

- (a) A specific issue has been identified by the examiner for which there exists a need for additional facts;
- (b) The examiner has sought from the taxpayer and available third parties all the facts known to them relating to the identified issue; and

¹⁴⁴⁶ Announcement 84-46, 1984-18 I.R.B. 18, cited in IRM 4.10.20.3.2(1) (7/12/04). Indeed, the IRS reinforced its policy of restraint incident to approval of Schedule UTP. Announcement 2010-76, 2010-41 IRB 432 announces that the IRS will not assert in examinations that disclosures to the independent auditor waive the attorney-client, the FATP or the work product privileges that would otherwise apply so long as (i) the privileges have not otherwise been waived or (ii) the a request for tax accrual workpapers has been made because unusual circumstances exist or the taxpayer has claimed the benefit of one or more listed transactions.

¹⁴⁴⁷ Sarbanes-Oxley Act of 2002, P.L. No. 107-204, 116 Stat. 745.

¹⁴⁴⁸ Chief Counsel Memo AM 2007-0012, reproduced at 2007 TNT 112-15. The vice-president of taxation for the AICPA is quoted as saying that the FIN 48 workpapers, if obtained by the IRS, will not only serve as a compass for the IRS, but will actually “take [the Service] to the destination,” thus turning auditors into “deputized members of the IRS.” Thomas Jaworski and Jeremiah Coder, Panel Debates Effect of Fin 48 on Transparency, Compliance, 2007 TNT 136-1.

¹⁴⁴⁹ IRM 4.10.20.3.1(2) (07-12-2004).

(c) The examiner has sought a supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue and the examiner has performed a reconciliation of the taxpayer's Schedule M-1 or M-3 as it pertains to the identified issue.¹⁴⁵⁰

This IRM provision is referred to as a “policy of restraint.”¹⁴⁵¹ However, in response to the tax shelter abuses of the 1990s and early 2000s, the IRS issued a revised policy of restraint in 2002. Under the revised policy, the IRS will request audit workpapers if the taxpayer has claimed the tax benefits of a listed transaction. Generally, if the transaction was disclosed on the return, the IRS will limit the request to the accrual workpapers for the transaction; if the listed transaction was not disclosed on the return, the IRS will request all tax accrual workpapers.¹⁴⁵²

As noted above, tax reconciliation workpapers serve a different, less sensitive function than tax accrual workpapers. Accordingly tax reconciliation workpapers may be routinely requested by auditors.¹⁴⁵³

Although the Supreme Court in Arthur Young declined to create a new privilege, it left the existing privileges in tact. A large taxpayer, Textron, resisted an IRS summons of its accrual workpapers. In the ensuing summons enforcement proceeding, the district court held that (1) the corporation had waived any attorney-client privilege for its tax accrual workpapers prepared by or under the direction of the corporation's lawyers because it had shown the workpapers to its auditors, but (2)(a) the work papers qualified for the work product doctrine / privilege and (b) Textron had not waived the work product “privilege” by showing its tax accrual workpapers to the auditors because that showing did not defeat the purpose of the work product doctrine / privilege.¹⁴⁵⁴ On the Government's appeal, the First Circuit panel (three judges) originally hearing the case held that the work product doctrine could prevent compelled disclosure since the workpapers were prepared “in anticipation of litigation,” adopting a more taxpayer friendly approach to the work product doctrine

¹⁴⁵⁰ IRM 4.10.20.3.2 (07-12-2004).

¹⁴⁵¹ Wells Fargo & Company v. United States, 2013 U.S. Dist. LEXIS 78714 at ¶ 140 ff. (D. MN 2013). In its conclusions of law, the court in Wells Fargo noted that this policy is just an internal statement and is not intended as an interpretation of the law for purposes of testing whether the IRS has a legitimate purpose for a summons under Powell.

¹⁴⁵² IRM 4.10.20.3.2.3 (07-12-2004). The revised policy is discussed in Wells Fargo & Company v. United States, 2013 U.S. Dist. LEXIS 78714 at ¶¶ 142 and 142 (D. MN 2013). The relationship of listed transactions is discussed in Wells Fargo at ¶¶ 144-155.

¹⁴⁵³ Chief Counsel Advice AM 2007-012 and CC-2007-015 (regarding effective tax rate reconciliation workpapers).

¹⁴⁵⁴ United States v. Textron Inc., 507 F. Supp. 2d 138, 142-143 (D.R.I. 2007), which was subsequently reversed in United States v. Textron, 577 F.3d 21 (1st Cir. 2009)(en banc), cert. denied 176 L. Ed. 2d 1219 (5/24/10); see also Regions Financial Corp., et al. v. United States, 2008 U.S. Dist. LEXIS 41940 (SD AL 2008), which the Government appealed but the taxpayer settled before the court of appeals decided the case.

than the Fifth Circuit.¹⁴⁵⁵ The First Circuit panel further held that the company's disclosure of the tax accrual workpapers to its auditor did not per se constitute a waiver of the work product privilege, because the auditor itself was not a potential adversary; the panel, however, would have remanded for the district court to make further findings as to whether disclosure to the auditor would make the auditor a conduit to a potential adversary which might defeat the work product doctrine. The panel finally held that, since per Arthur Young the auditor's tax accrual workpapers were not subject to any privilege or the work product doctrine, the district court on remand should determine whether the company had the right to obtain the auditor's tax accrual workpapers so that a summons to the company for tax accrual workpapers included compulsion to obtain and produce the auditor's workpapers.

This Textron panel decision was viewed as a major defeat for the IRS because it appeared to offer taxpayers in the Circuits with the more lenient work product test a roadmap to insulate their workpapers from the IRS. This defeat for the Government's policies on obtaining work papers appeared to offer an end-run around the Government victory in Arthur Young. For that reason, the Government petitioned for rehearing en banc and the petition was granted.¹⁴⁵⁶ On rehearing en banc, the First Circuit reversed, holding that the workpapers did not qualify for the work product privilege because they were prepared not for the litigation but for the audit certification.¹⁴⁵⁷ The decision, rendered en banc in a 3 - 2 split by the full court, reverses the prior panel's decision (a 2 - 1 split). I eschew a technical analysis here, but note the quote from the majority en banc decision pretty much sums it up:

Textron apparently thinks it is "unfair" for the government to have access to its spreadsheets, but tax collection is not a game. Underpaying taxes threatens the essential public interest in revenue collection. If a blueprint to Textron's possible improper deductions can be found in Textron's files, it is properly available to the government unless privileged.¹⁴⁵⁸

Bottom-line in terms of technical analysis, the Textron en banc decision determined that the tax accrual workpapers were not work-product – “the Textron workpapers were independently required by statutory and audit requirements and [therefore] that the work product privilege does not apply.”¹⁴⁵⁹

¹⁴⁵⁵ United States v. Textron, 553 F.3d 87 (1st Cir. 2009), reversed 577 F.3d 21 (1st Cir. 2009)(en banc), cert. denied 176 L. Ed. 2d 1219 (5/24/10). In the panel opinion, the panel rejected the Fifth Circuit's stricter test – the “because of” test – in United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982).

¹⁴⁵⁶ 560 F.3d 513 (1st Cir. 2009).

¹⁴⁵⁷ United States v. Textron, 577 F.3d 21 (1st Cir. 2009)(en banc), cert. denied 176 L. Ed. 2d 1219 (5/24/10).

¹⁴⁵⁸ *Id.*, at p. 31.

¹⁴⁵⁹ *Id.* at p. 26

Then, in *United States v. Deloitte*, 610 F.3d 129 (D.C. 2010), the Court of Appeals took a more taxpayer-friendly approach to the work product privilege in the context of tax accrual workpapers. The court concluded that the work product privilege could apply even if the memorandum in question was prepared by the outside auditor rather than the client and “was generated as part of the routine audit process, not in anticipation of litigation.” The memorandum in question was an auditor memo of a meeting among the client, the client’s outside attorneys and the auditor to discuss litigation which, of course, must be reserved and attested on the financial statements. Applying the “because of” standard, the Court said that the memorandum did include the thoughts and analyses of outside counsel which existed because of the litigation and that would likely qualify for the work product privilege, but the memorandum also might include information that would not qualify for the privilege. The Court further held that the disclosures of documents to the auditors that would, except for the disclosure, constitute work product with respect to the client’s dispute with the IRS were not the type of disclosures to an adversary that would waive the work product privilege. In pungent language, the Court said that “we conclude that [the auditor] is not a conduit to [the client’s] adversaries.”¹⁴⁶⁰ Accordingly, the privilege had not been waived by the disclosures to the auditor, but the Court remanded the case for the district court to determine whether any portion of the memorandum contained information that did not qualify for the work product privilege.

The interplay between these discovery rules and the IRS’s new initiative to require disclosure of uncertain tax positions (discussed above beginning on p. 149) is itself not now certain and will have to be developed after the initial position is finalized and the inevitable administration and any resulting litigation fleshes out the rules. In floating and finalizing the proposal, IRS representatives have asserted that its policy of restraint in seeking workpapers will remain.

Finally, privileges are not important where the client has an incentive to waive them. In the post-Enron environment where major organizations (whether corporations and otherwise formed (such limited liability noncorporate entities used by major law and accounting firms) are the vehicles for major fraud, the organization can often be indicted for the misconduct of its officers and the indictment can be a major detriment to the viability to the corporation or other entity. For example, indictment brought down the venerable accounting firm of Arthur Andersen. Will an entity under this type of risk and pressure waive its attorney-client privilege, at the expense of individuals, even those with high positions in the entity?

2. Protecting Information Developed in the Audit (Kovel).

In delivering legal services, an attorney will often need the assistance of non-lawyers who will become privy to confidential information. At its most basic level, non-attorney personnel in the lawyer’s firm – paralegals and other assistants, secretaries, etc. – will become privy to the information. Disclosures of such information to these personnel will not constitute a waiver of any privileges that may otherwise apply. Often, however, the attorney will find it helpful to engage personnel outside the firm. For example, often in a tax engagement, an attorney will hire an outside accountant to assist the lawyer in delivering legal services to the client. The lawyer may need to

¹⁴⁶⁰ *United States v. Deloitte LLP*, at p. 141.

pass privileged information to the accountant to perform the needed services. The lawyer may also want the accountant to meet with the client and obtain information directly from the client, and cloak that information in the attorney-client privilege just as if the lawyer obtained it directly rather than through the accountant. The traditional method by which that is done, at least in a tax practice, is through an arrangement whereby the lawyer engages the outside personnel – accountant in the present example – to become part of the team delivering legal services to the client.

This procedure was approved early on in a case called **United States v. Kovel, 296 F.2d 918 (2d Cir. 1961)**. Kovel is now shorthand for the concept. The engagement for such legal related services is now commonly called a Kovel engagement, and the service provider is called a Kovel accountant or whatever is appropriate for the nature of the services. Here, as in many areas of the law, it is imperative to do it and do it right.¹⁴⁶¹

The Kovel arrangement is just a logical subset of the attorney-client privilege. So, its parameters are set by the attorney-client privilege we have discussed above. However, the following key points to keep in mind in using the arrangement.

First, it is better form for the attorney to engage the Kovel expert rather than having the client do so. Some cases will honor the Kovel claim for client-engaged experts,¹⁴⁶² but establishing the required nexus between the Kovel expert and the attorney can be dicier where the attorney is not involved in the engagement. The better part of wisdom is to avoid this issue by doing it right in the first place. Good lawyers will formally engage the expert, often in a three-way agreement among the lawyer, the expert and the taxpayer. A nuance of this consideration is how the Kovel expert's billing is handled. Some attorneys have the Kovel expert to bill the law firm, with the law firm then passing the cost to the client. Others have the Kovel expert bill the client for direct payment by the client, but only after the lawyer reviews and approves the bill first. Either way should work. However, under a lawyer's state bar ethical rules, the lawyer usually has responsibility to insure that the expert's fees – which are fees for legal services under the construct – are appropriate. So, I always require that the expert present the proposed fees to me for review and approval before they are billed.

Second, a valid Kovel expert can involve any type of expert needed for legal representation – not just the accountant. For example, media experts used by the attorneys in providing representation can qualify for the privilege under a Kovel agreement.¹⁴⁶³ I have engaged experts for

¹⁴⁶¹ See generally John A. Townsend, The Accountant's Role – and Risks – in Kovel, 2 Tax Practice & Procedure No. 4 p. 20 (Aug-Sept. 2000); for an example of doing it wrong in a case where the parties could have well afforded to do it right, see Cavallaro v. United States, 284 F.3d 236 (1st Cir. 2002); see also United States v. Adlman, 468 F.2d 1495 (2d Cir. 1995) which is discussed below in this section.

¹⁴⁶² E.g., United States v. Judson, 322 F.2d 460 (9th Cir. 1963).

¹⁴⁶³ In re: Grand Jury Subpoenas Dated March 24, 2003, 265 F. Supp. 2d 321 (SDNY 2003).

translation and even effective communication purposes where the client had another primary language.¹⁴⁶⁴

Third, as in Kovel, the attorney need not be present when the Kovel expert and the client are meeting in furtherance of the expert providing the assistance to the lawyer.¹⁴⁶⁵

Fourth, potential problems are encountered in the Kovel engagement of an accountant that has been a long-term accountant for the taxpayer or provides ongoing non-legal services for the taxpayer. The threshold problem is that it might be difficult to distinguish between what the accountant knows outside the Kovel engagement and what he or she knows only within the Kovel engagement. Using the historical accountant requires that extra steps be taken to assure that the information related to the Kovel engagement is clearly separate from the information learned in the accountant's other engagements. Consider a prominent case from the 1990s¹⁴⁶⁶ involving a large corporation that engaged a large accounting firm to render advice on a sensitive reorganization issue. The officer in the corporation who engaged the accountants was a lawyer who, of course, rendered legal services to the corporation. By having clear understandings and clear responsibilities, the lawyer could have "Kovelized" the accountants. He did not do that, however, and the engagement was treated as just a continuation of the accountant's historical accounting services for which there is no privilege. When the IRS audited, the IRS wanted to look at the planning memoranda. Bottom-line, the Second Circuit held that the taxpayer had not satisfied its burden to establish that the accountants had been engaged in the rendering of legal services through an attorney for the taxpayer. Like I say, with a little attention to detail, for that type of planning transaction, the accountant could have easily been Kovelized. The attention to detail would have been to prepare a Kovel agreement clearly delineating that the services would be rendered to the corporate attorney for legal advice to the corporation, to require the accountants to treat the engagement separately (e.g., separate billing and maintenance of separate privileged files within the accounting firm), and have the corporate attorney as the conduit through which all advice flowed.

Fifth, one of the most nettlesome issues in dealing with the attorney-client privilege in a tax practice, exemplified by Judge Posner's visceral reaction in Frederick, is to distinguish between providing legal services that qualify for the privilege and providing other types of services which do not qualify for the privilege. It is always the client's obligation to establish the privilege. This means that where an attorney or an expert serves in more than the capacity of just serving as lawyer or as an expert rendering advice to assist in the legal representation, respectively, the client may not

¹⁴⁶⁴ In one case, I engaged a family member who was an effective communicator both in English and Spanish, where the client was the mother whose native language was Spanish, could not speak English well, and straight or literal translation would have been less effective. The son's services assured me that the client was communicating with me as effectively as possible and that I was communicating with her as effectively as possible.

¹⁴⁶⁵ In re: Grand Jury Subpoenas Dated March 24, 2003, 265 F. Supp. 2d 321, 331 (SDNY 2003).

¹⁴⁶⁶ United States v. Adlman, 68 F.3d 1495 (2d Cir. 1995); subsequent opinion United States v. Adlman, 114 F.3d 1194 (2d Cir. 1998).

be able to establish the privilege. This issue often arises in a situation of the filing of an amended return. If an accountant is engaged by the attorney to prepare the amended return that, after review by the attorney, may be filed by the client, does the filing of the amended return waive the privilege for all communications to the accountant or alternatively, at least as to information that flowed from the client to the accountant /return preparer that is put on the return, was there ever an expectation of confidentiality, a basic requirement for the privilege? This is just to say that, just as the lawyer who appears in a dual role a la Frederick and Bornstein must be careful what he does, so too must the lawyer pay close attention to the Kovel expert's services. The lawyer may not want everything the accountant learns to be an open book to the IRS if it inquires. This particularly should be considered where the lawyer engages an accountant under a Kovel arrangement to prepare amended or delinquent returns in order, for example, to qualify for the voluntary disclosure policy. The filing of the returns will mean that the Kovel expert's kimono is opened a bit, at least as to the items on the return, under the traditional attorney-client analysis. The question is whether the IRS can then force the full Monty. (OK, I recognize I am mixing my allusions, but you get the point.) A court willing to slice and dice the relationship a la Bornstein may save the day for the client, but an unwilling court (or apparently unwilling court) such as Frederick may not. Careful practitioners with clients with large budgets may solve the problem by engaging two separate accountants – one to serve as a pure Kovel accountant to gather the information and analyze it and then, in consultation with the attorney, to deliver to the second accountant, not a Kovel accountant, only the information for inclusion on the return. The second accountant then prepares the return with knowledge only of that information. So the theory goes, if the IRS presses, it will only learn from that second accountant only what he knows which is already presented on the return. Whether or not this will work remains to be seen, but in appropriate cases (high risk and sufficient resources) it should be considered.

Finally, the IRS is noising about taking a more aggressive stance toward accountants in IRS criminal investigations.¹⁴⁶⁷ It is too early in the cacophony – to date it is just noise – to figure out precisely what the IRS' attack may be. Obviously, however, the IRS will want to interview accountants who are not wearing a Kovel assistant sign on their foreheads, just because they often have information relevant to a tax investigation and, at least in their status as accountant or return preparer, they have no privilege that can be asserted in a criminal investigation. (Remember the FATP does not apply in criminal investigations.) Indeed, that is precisely why one of the first CI summonses or grand jury subpoenas that are issued are to the accountants. But, once that accountant is summoned or subpoenaed, the lawyer engaging the accountant (or the accountant) may spring the attorney-client privilege in its Kovel iteration. The Government will not be pleased because the very nature of any privilege – particularly an absolute one like the attorney client privilege – is to bar the Government from getting the information. From the reported cases, the Government does not seem to have aggressively tested the validity of the assertion of the privilege in the Kovel context. I think the warnings now issuing forth are that the Government will pick out some very extreme cases to test the limits of the Kovel privilege.¹⁴⁶⁸

¹⁴⁶⁷ See Sam Young, Government Will Subpoena Accountants in Criminal Tax Prosecutions, Official Warns, 2010 TNT 91-4.

¹⁴⁶⁸ One context of the Kovel privilege has bothered some practitioners. The context is to hire a Kovel accountant (either the historical one or a new one) to handle an “egg-shell” civil tax

Townsend Federal Tax Procedure 2015 - Textbook - 452 - Printed: 7/29/15

G. Financial Status Inquiries.

Earlier in the 1990s the IRS made a big deal of so-called financial status audits, also sometimes referred to as “fraud” audits. At some time in an audit, often early on, the agent would do a financial check from the IRS's and third party sources to see if the taxpayer's assets were consistent with what was reported on the return. For example, let's assume the taxpayer has reported about \$30,000 of taxable income per year for the last five years. Let's further assume that the agent quickly checks with the Department of Motor Vehicles and determines that the taxpayer owns a Rolls Royce, a Mercedes, and a Maserati. This would suggest that something may be amiss. And this is not even a full bore economic status audit reconstructing the taxpayers net worth and income.

Many practitioners were upset with this type of audit – particularly when full bore and intrusive -- because it assumed criminal misconduct virtually from the get-go. Congress listened and prohibited such audits unless “the IRS has a reasonable indication that there is a likelihood of such unreported income.”¹⁴⁶⁹ The type of initial nonintrusive inquiry I noted above is not prohibited “to determine whether such a reasonable indication exists to permit the IRS to implement its Financial Status Audit procedures.”¹⁴⁷⁰ But an opening audit inquiry to the taxpayer to produce detailed financial statements (net worth and income), along with supporting documents would certainly violate the prohibition.

audit – one having the potential to turn criminal if the agents asks the right questions or stumbles on the right documents. Managing the audit so as to mitigate that risk – provided that no inappropriate action (such as deception) is undertaken in the process – is what skilled attorneys do. But, the attorney might believe that he or she can best mitigate the risk by not becoming visible to the IRS agent, but instead deputizing an accountant via Kovel to be the representative of the client in the investigation. Many attorneys will enter a Kovel agreement with the accountant and then have the accountant file a Form 2848, power of attorney, to represent the client in the audit, without disclosing that the accountant is really acting as the deputy – or agent – of the attorney. The concern some practitioners have over this behavior is that it may be deceptive conduct. Be sure and think this through before doing it. Indeed, if you do think it through, you just might not do it.

¹⁴⁶⁹ § 7602(e).

¹⁴⁷⁰ IRM 4.10.4.2.8 (08-09-2011), Indirect Method; and IRS web page titled [“Cash Intensive Businesses Audit Techniques Guide - Chapter 4 Minimum Income Probes](#) (Revision Date of April 2010 but indicating Page Last Reviewed or Updated: 19-Mar-2015) (discussing financial status analysis and financial status audit techniques). The quoted text is from the Written Statement of Nina E. Olson, National Taxpayer Advocate, Before the Senate Subcommittee on Federal Financial Management, Government Information, and and International Security on October 26, 2005), reproduced at 2005 TNT 207-25.

H. Search Warrants and Covert Activities.

The IRS may develop information in an administrative investigation that justifies seeking a search warrant. This type of investigation will be a criminal investigation conducted by CI, although it may have started as a regular audit investigation. The IRS will have to seek the search warrant from a district court under Rule 41, Federal Rules of Criminal Procedure, which requires the showing of probable cause to believe that a crime has been committed.

In addition, the IRS's CI may conduct stings or other covert activities (such as mail drops). These types of activities are generally thought to be too intrusive for normal audit operations.

I. International Evidence Gathering.

1. Introduction.

The explosive growth of international business – the global economy, if you will – has been accompanied with an explosive growth in tax fraud across international boundaries. The simple model, used since virtually the inception of the modern income tax, is the use of an offshore bank account in a country whose secrecy laws place a premium upon hiding the existence and ownership of the account and thus the taxable income that is in the account. An infinite number of more complex cross-border tax fraud models exist, including concealing the existence of foreign investment accounts, reporting foreign sham transactions where the IRS's ability to discover the sham is more limited than if the transactions occurred in the U.S., manipulating the complex foreign tax deferral regimes for foreign corporations controlled by U.S. persons and manipulating transfer pricing so that income is pushed from the United States into foreign tax haven countries. I shall address here the common IRS tools to gather evidence of the U.S. tax fraud and U.S. taxable income that might otherwise go untaxed even in the absence of fraud.

2. Prototypical U.S. International Tax Fraud.

As I mentioned above, the prototypical cross-border tax fraud is the use of a foreign bank account in a tax haven. We addressed this fraud in the discussion of FBARs and the use of the John Doe Summons procedure to get information from the credit card companies whose cards were used by tax haven banks to give their secret depositors access to the hidden cash. A simple model is for a taxpayer with a cash business to divert some portion of the cash to the foreign bank account so that the IRS will not be able to discover the diverted income. In terms of the tax offense, this is just the cross-border analog to burying the unreported cash in the back yard.

The advantage of the foreign bank account is that the cash is not subject to the ravages of weather and critters (worms, etc.) and can draw some extra return (e.g., interest, dividends and capital gain, depending upon how invested) that the taxpayer also will not report for tax purposes. Of course, merely spiriting the cash out of the country may be a separate criminal act (e.g., failing to file the currency reports required on departing the U.S. with more than \$10,000 of cash). But we

are focusing here upon the mere act of hiding the cash representing taxable income in a place that, if it works, the IRS is unlikely to discover.

The taxpayer will then effectuate his or her tax fraud by not reporting the income on the return and, in order to conceal the existence of the foreign bank account, answering no to -- or cleverly failing to answer -- the question on the tax return (Schedule B) about ownership interest in or signatory control over foreign bank accounts. (The latter question and instructions advise the taxpayer of his or her responsibility to file the FBAR, FinCEN Form 114. At that point, the taxpayer has violated §§ 7201 (tax evasion) and 7206(1) (tax perjury), and upon failure to file the FBAR has also violated another statute for which there are substantial civil and criminal penalties. Of course, if the taxpayer had some assistance in effecting the transaction (e.g., a business partner or even a family member who actually took the cash to the tax haven), that other person may be guilty of a conspiracy or aiding and abetting. And, as noted there could be a host of related problems (such as getting the cash out of the country, etc.).

A variation of this offshore secrecy gambit, perhaps with elements of more sophistication, came to the surface in the late '70s and '80s as many taxpayers invested in various tax shelter schemes, some of which depended upon the secrecy laws of foreign countries and the IRS's relative inability to discover and investigate the tax fraud. One such scheme, with various iterations, used foreign trusts in such exotic places as the Isle of Mann. The foreign trusts, which the promoters and the taxpayer hoped could not be pierced for information, would acquire property or assets with the view toward the taxpayer not reporting the income or, if the taxpayer had large debts (including tax debts), the creditor not discovering the taxpayer's real interest in the trust.

The Government's initiatives involving Swiss banks gives at least a public appearance that the ability to evade through use of offshore entities claiming secrecy is in the process of being curbed.

More sophisticated evasion or at least aggressive avoidance is often encountered in the transfer pricing arena where many large corporate enterprises use their related foreign companies to push income from the U.S. to another tax jurisdiction where the effective tax rate is significantly less than in the United States.

The IRS needs the ability to investigate by gathering information that would be outside its normal powers (e.g., the IRS summons which is effective generally only within the U.S.). We consider in this section the tools that may be available for the IRS to investigate offshore.

3. Tax Treaties and International Comity.

a. Introduction.

We covered above the tools that are generally available to tax investigations. The IRS administrative summons and the grand jury subpoena require U.S. jurisdiction over the person summoned or subpoenaed in order to establish the constitutional nexus for contempt sanctions for

failure to comply. That means that, for example, a Swiss bank with no U.S. nexus (such as a branch office in the U.S.) is beyond the summons power and the subpoena power – or at least beyond the compulsion for defying a summons or subpoena. Is the U.S. stymied from developing the facts?

The principal avenue to obtain tax related information from foreign sources such as foreign banks has come through treaties. Tax treaties have several goals. One important goal is to facilitate cross-border trade by minimizing the adverse effect of double taxation. Another major goal of the U.S. tax treaty system is to obtain information to protect the integrity of each treaty partner's tax system.

b. Double Tax Treaty Exchange of Information Provision.

The major U.S. tax treaties are so-called “Double Tax” treaties.¹⁴⁷¹ In very broad strokes, the most important enforcement provision in these treaties is establishing a procedure to eliminate double taxation of the same quantum of income, so that, at least in theory, any given quantum of income is taxed only by the source jurisdiction or, if taxed in both the source jurisdiction and non-source (usually residence) jurisdiction, the non-source jurisdiction tax credits the tax paid to the source jurisdiction so that the source jurisdiction is given priority and the taxpayer is not subject to higher tax than the non-source jurisdiction imposes. There are other provisions in the treaty to avoid rough edges in the commerce between the treaty states, but eliminating double taxation is the principal driver. U.S. double tax treaties have an exchange of information provision. The current U.S. Model Double Tax Treaty,¹⁴⁷² which (in the version then applicable) is the starting point for the

¹⁴⁷¹ The treaties are usually named “Convention Between the United States of America and [Foreign Country Name] for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.” I shall refer to these treaties as “Double Tax Treaties.”

¹⁴⁷² The current U.S. model is the 2006 model which is available here:

<http://www.irs.gov/pub/irs-trty/model006.pdf>

The technical explanation of the 2006 model double tax treaty is here:

<http://www.irs.gov/pub/irs-trty/temod006.pdf>

The U.S. Model Treaty is based significantly on the OECD Model. For an explanation of how these tax treaties are negotiated, ratified and interpreted, see John A. Townsend, Tax Treaty Interpretation, 55 Tax Law. 219 (2001) (also arguing for a Chevron-type deference for the executive branch’s treaty interpretations, most particularly those in the technical explanation accompanying the particular treaty and other submissions that inform the Senate Finance Committee in its ratification of the treaty); but see Michael S. Kirsch, The Limits of Administrative Guidance in the Interpretation of Tax Treaties, 87 Tex. L. Rev. 1063 (2009). I think the conceptual confusion in the area of how a U.S. court interprets a treaty, particularly a tax treaty, arises from a focus on a contract model a treaty to meet the “shared expectations of the parties,” rather than the executive branch interpretation of the treaty it negotiated and the Senate’s understand of the treaty it ratified. Those interpretations where clear should, in my view, inform U.S. courts’ interpretation and application of the treaty rather than any search for how the treaty partner interpreted the treaty. Of course, the treaty partner’s reasonable interpretations not shared by the executive branch or the Senate may mean that the U.S. and the treaty partner did not have a meeting of the minds on the treaty and that, in some

U.S. treaty negotiations on income tax treaties, has the exchange of information provision in Article 26. (The U.S. treaty generally and the exchange of information provision is substantially similar to the OECD model treaty which is the starting point for most developed country treaty negotiations.) Under that provision, one treaty partner may request the other partner to use its internal evidence gathering processes to obtain information relevant to tax administration of the requesting treaty partner. This provision is found in virtually all U.S. income tax treaties.

In pertinent part, the language of the current Model Treaty (not necessarily treaties negotiated earlier than the current 2006 model), Article 26, permits requests for

information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, such taxes.

Such taxes are defined in the treaty, but for present purposes let's focus on income taxes of the two treaty partners. The authority is fairly broad as worded and requires a restriction, not unlike the Powell summons restriction, that it be for a need in the assessment, collection, enforcement or prosecution.

U.S. treaty partners may request the U.S. to use its evidence gathering authority -- principally the IRS administrative summons -- to gather information for use in the treaty partner's tax administration. The IRS views its authority to gather information for the treaty partners quite broadly, and the U.S. courts do also. For example, although the IRS administrative summons may not be used for U.S. purposes when the criminal investigation has reached the DOJ referral stage (see § 7602(d)), the IRS administrative summons may be used to obtain information for a treaty partner regardless of the stage of the treaty partner's investigation. See United States v. Stuart, 489 U.S. 353 (1989). Furthermore, the Powell IRS summons analysis must be modified in order to have the relevancy and scope determined by reference to the treaty partner's taxes, rather than U.S. taxes.

By the same token, the treaty gives the IRS the right to request that a treaty partners use its internal processes to gather information for the IRS. A treaty partner's requests and negotiations about the scope of the other treaty partner's responses are often off the radar screen and rarely surface in the U.S. The typical pattern for the exchange of information treaty provision is invoked by the requesting treaty country notifying the requested treaty country to use its internal tax information gathering process to obtain evidence related to a specifically named person over whom

international court, the treaty partner may be entitled to hold the U.S. to the treaty partner's reasonable interpretation. But, from a U.S. law perspective and in U.S. courts, it is the treaty that the executive branch negotiated and the Senate ratified that alone is the law of the land and what should control the law of the land is the executive branch's and Senate's understandings of the treaty. This is, of course, my BS and I am sticking to it even in the face of apparent lack of acceptance of my BS. And, then you get to the issue of Chevron deference, and I would suggest that in the treaty area, Chevron deference is particularly appropriate, but I must end this footnote. Perhaps, if the "shared expectations" model is accepted, Chevron deference could still be applied if the shared expectations are ambiguous.

the requesting treaty country has tax jurisdiction. Only a legitimate tax enforcement need is generally required.

Some older treaties, some still in existence, predicated the exchange of information as required “tax fraud.” The 1996 Swiss treaty, still in effect, requires a showing of “tax fraud and the like.” Focusing on the Swiss treaty, there were two problems with the Swiss double tax treaty which the Swiss exploited to protect its financial services industry which, in part, was involved in assisting U.S. persons in hiding financial assets and U.S. taxable income. The Swiss did that through two techniques. First, and historically, it interpreted the treaty provision “fraud or the like,” very restrictively, although in negotiating the treaty the U.S. apparently thought a restrictive interpretation would not be applied by the Swiss.¹⁴⁷³ As thus interpreted restrictively, the U.S. had to virtually prove a criminal case against a specific named individual or taxable entity to get the Swiss competent authority to respond to a treaty request. By contrast, the exchange of information provision is viewed by most treaty partners (including the U.S.) as including merely a legitimate tax administration need (as opposed to tax fraud). Practically speaking, that meant that the U.S. rarely got any information from the Swiss via a treaty request. Second, and the problem that surfaced in a big way in 2008, was the U.S. difficulty in identifying the U.S. depositors in the Swiss banks so as to formulate the traditional request under the Swiss treaty when the Swiss insisted upon names. The U.S. did not know the names of the U.S. persons but the Swiss banks did. At least conceptually, the treaty did not require specific names and, from the U.S. perspective might permit so-called “group requests” where the identities are not given but characteristics are given – such as, for example, in this case, U.S. persons owning through a nominee foreign entity a bank account (or related bank accounts) exceeding \$500,000. These characteristics might not be proof of tax fraud and the like, but at least could permit a not unreasonable inference. But, wanting to avoid impediments to the U.S. tax evasion industry/franchise (a big industry in Switzerland), the Swiss competent authority pushed back on that and declined to respond to group requests even when they might arguably meet the tax fraud and the like standard. I sometimes refer to these group requests

¹⁴⁷³ “The Protocol contains a broad definition of tax fraud that should ensure that more information will be made available to U.S. authorities.” See the President’s 5/29/97 letter of submittal of the Swiss double tax treaty to the Senate. The protocol definitions were:

The parties agree that the term "tax fraud" means fraudulent conduct that causes or is intended to cause an illegal and substantial reduction in the amount of the tax paid to a Contracting State.

Fraudulent conduct is assumed in situations when a taxpayer uses, or has the intention to use, a forged or falsified document such as a double set of books, a false invoice, an incorrect balance sheet or profit and loss statement, or a fictitious order or, in general, a false piece of documentary evidence, and in situations where the taxpayer uses, or has the intention to use a scheme of lies (“Lügengebäude”) to deceive the tax authority. It is understood that the acts described in the preceding sentence are by way of illustration, not by way of limitation. The term “tax fraud” may in addition include acts that, at the time of the request, constitute fraudulent conduct with respect to which the requested Contracting State may obtain information under its laws or practices.

as “John Doe” treaty requests because the concept is similar to the concept used for John Doe summonses where the identity of the taxpayer is not known.

Accordingly, at the beginning of the Swiss bank juggernaut in 2008, the IRS and DOJ had to adopt other measures, specifically the John Doe summons issued to or through a Swiss bank affiliate within U.S. jurisdiction coupled with threat of criminal prosecution of the Swiss banks. The U.S. started with UBS and, through that combination of tools, brought UBS into a mode of cooperation and, given UBS’s role in Switzerland, the Swiss Government had to cooperate as well. UBS delivered up some identities and account information and obtained approval to deliver another batch of perhaps 4,500 U.S. persons. The U.S. kept the pressure on and, as a result, got Switzerland to agree to a less strict interpretation of protocol that permits group requests (John Doe treaty requests). Switzerland complied.

Then, with continuing pressure on Swiss banks, Switzerland agreed to a protocol to the treaty that would allow such group requests for other banks information. The U.S. Senate has yet to confirm the protocol because of a senatorial hold by Senator Rand Paul, a singular outlier from politics (and rationality) in the U.S. Senate. Nevertheless, the expectation is that Senator Paul will yield at some point soon and approve the protocol. It is expected that a flood of group requests generated by aggregate data supplied by Swiss banks joining the U.S. Department of Justice Swiss Bank initiative will be processed.

This scenario may play out in other tax haven jurisdictions with older treaties having similar tax fraud requirements. Of course, most developed countries even with such older treaty provisions do not have the financial incentive to read the treaty quite so restrictively as did the Swiss.

In an increasingly global economy, it may fairly be expected that the U.S. will enter more such double tax income tax treaties.

c. OECD Convention on Tax Administrative Assistance.

The U.S. is a signatory to the OECD Convention on Mutual Administrative Assistance in Tax Matters, a multilateral tax treaty among members of the OECD who have ratified it.¹⁴⁷⁴ The U.S. has ratified the treaty subject to certain reservations which, in effect, exempt the U.S. from obligations under the treaty to the extent of the reservations.¹⁴⁷⁵ The provisions of this convention are solely procedural. As explained in the Technical Explanation accompanying the treaty:

¹⁴⁷⁴ To review the documents related to this multi-lateral treaty, see the OECD’s site here: http://www.oecd.org/document/14/0,3746,en_2649_33767_2489998_1_1_1_1,00.html

The status of countries joining the treaty is here:

http://www.oecd.org/ctp/exchange-of-tax-information/Status_of_convention.pdf

¹⁴⁷⁵ In determining each state’s obligations under multilateral treaties, both the treaty text and that state’s reservations, if any, must be considered.

Although the United States has with most OECD member States bilateral income tax treaties that contain exchange of information provisions, the Convention provides a comprehensive and uniform framework for exchanges of information that is broader, in some respects, than the provisions in some bilateral treaties to which the United States is a party. In this connection, the Convention contains, in Article 20(3), more explicit requirements concerning the form in which information will be transmitted than do some of the United States' bilateral treaties. Requirements concerning the form of the information provided are routinely incorporated into our Tax Information Exchange Agreements (TIEAs), which are executive agreements concluded under the authority of section 274(h)(6)(C). Also, Article 5(2) of the Convention requires the requested State to do more than some States are currently doing under bilateral treaties to which the United States is a party by requiring a requested State that cannot satisfy a request from information in its own tax files to take relevant measures to obtain the information necessary to fulfill the request. This requirement is also consistent with our TIEAs.

The Convention does not override any bilateral treaties to which the United States is a party. In this regard, Article 27 of the Convention provides that the forms of assistance as well as procedures specified in the Convention do not limit, nor are they limited by, the provisions of existing or future agreements between the Contracting States. The application of this Convention and of other instruments are to be considered independently; the Parties may invoke whichever instrument they think will be most effective in a particular case.

The Convention contains strong and explicit protections of taxpayer rights. For example, Article 21(1) states that the Convention does not affect any taxpayer safeguards secured by a requested State's laws or administrative practices.¹⁴⁷⁶

Due to intervening developments in tax enforcement for cross-border transactions, particularly related to offshore financial institutions, this treaty has been amended by protocol, before the Senate for approval.¹⁴⁷⁷ The following is a brief explanation of the effect of the protocol from the U.S. perspective, focusing on the key portions of the treaty:

As amended, those chapters now reflect the OECD standards requiring that mechanisms for exchange of information upon request exist; that exchange of information is available for purposes of domestic tax law in both criminal and civil matters; that there are no restrictions of information exchange caused by application of the dual criminality principle **n3** or a domestic tax interest requirement; respect for safeguards and limitations; strict confidentiality rules for information exchanged;

¹⁴⁷⁶ For more information on the Convention, see the [OECD website](#).

¹⁴⁷⁷ As of the latest information, the protocol has been approved by the Senate Foreign Relations Committee but, along with other treaties and protocols, is being from approval by the full Senate by Senator Paul. How long Senator Paul will play that game is unclear.

and availability of reliable information (in particular bank, ownership, identity and accounting information) and powers to obtain and provide such information in response to a specific request. It also opens the multilateral treaty to participation by States that are not members of either Council of Europe or OECD and thus were previously ineligible.

n3 The principle of dual criminality derives from the law regarding extradition and grounds for refusal to grant a request. Extradition is generally permitted only if the crime for which a person is to be extradited is treated as a similarly serious offense in the state in which the fugitive has sought refuge. Restatement (Third) of the Foreign Relations Law of the United States, sec. 476 (1987). The principle is relevant to a request for exchange of tax information only if the treaty in question limits the scope of its permitted exchanges to criminal tax matters.¹⁴⁷⁸

Because of developments in offshore evasion, more countries – even tax haven countries under considerable pressure – have joined the treaty.¹⁴⁷⁹ The G-20 finance members are solidly behind the treaty, urging other countries to join the treaty and similar initiatives for more transparency in cross-border tax matters.¹⁴⁸⁰

As a practical matter, there is substantial overlap administrative assistance in the double tax treaties and the administrative assistance in this treaty, but the signatories to this treaty include countries with whom the U.S. does not have a double tax treaty.¹⁴⁸¹

d. IRS Summons and the Hague Convention.

The IRS takes the position that it may serve the IRS administrative summons abroad under the Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters.¹⁴⁸² The IRS will apparently use this process, which is probably less effective than under specific treaties, only where the specific treaties do not apply for some reason.¹⁴⁸³ Of

¹⁴⁷⁸ JCT Staff Report, Explanation of Proposed Protocol Amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, JCX-9-1 (2/21/14).

¹⁴⁷⁹ Only recently, due principally to the push against offshore tax evasion, have traditional tax havens joined the treaty. Thus, the current list includes British Virgin Islands, the Cayman Islands, Luxembourg, and Switzerland.

¹⁴⁸⁰ Stephanie Soong Johnston, G-20 Endorses OECD's Common Reporting Standard for Automatic Information Exchange, 2014 TNT 37-5 (2/15/14).

¹⁴⁸¹ E.g., the U.S. has no double tax treaty with Singapore, but Singapore has signed this treaty (although Singapore's approval has not yet entered into force).

¹⁴⁸² ILM 200143032 reprinted in 2001 WTD 210-29 (10/30/01).

¹⁴⁸³ For example, in ILM 200143032, supra, the IRS indicated that it would use the process only because the treaty partner took the position that the exchange of information provision of the double tax treaty applied only where it had a "tax interest" in the information sought and there

course, for those foreign persons and entities enabling U.S. taxpayers to stash untaxed money overseas, the IRS summons has no teeth because its ultimate force is the contempt power of a U.S. court, which has no contempt power over foreign persons or at least no power to enforce any holding of contempt so long as they stay outside the U.S.

e. Other Treaties.

In addition to the income tax treaties, there may be other treaties having information exchange as a principal focus.

(1) MLATs.

One such treaty is the mutual legal assistance treaty (often acronymed to “MLAT”) for criminal and related matters.¹⁴⁸⁴ MLATs generally deal with broader information exchanges than just for tax matters. A good summary of the process is:

The MLAT is a treaty-based mechanism for seeking foreign law enforcement cooperation and assistance in support of an ongoing criminal investigation or proceeding. The MLAT process, and its benefits, are available only to government officials, typically prosecutors. MLATs do not apply to civil litigants or proceedings. Supervising the execution of incoming MLATs—requests for assistance from foreign jurisdictions—requires direct federal district court oversight and involvement. In contrast, the courts play no part in initiating or processing outgoing MLAT requests. That is the province of the executive branch.

Generally, the MLAT process is much more efficient to U.S. investigators than the alternative letters rogatory process (discussed below).

appeared to be no treaty partner tax interest. In that situation, the U.K. was the treaty partner and the ILM notes that the negotiated tax treaty which was not yet in force, did eliminate the “tax interest” requirement for invocation of the exchange of information provision.

¹⁴⁸⁴ See generally, [T. Markus Funk, Mutual Legal Assistance Treaties and Letters Rogatory: A Guide for Judges 1 \(Federal Judicial Center 2014\)](#); and IRM 4.60.1.1.3.8 (09-19-2014), Mutual Legal Assistance Treaty (MLAT) Program.

(2) TIEAs.

Another type of contract or agreement with a similar goal to allow each treaty partner access to information in the jurisdiction of the other treaty partner is a Tax Information Exchange

Agreement (also referred to as a “TIEA”).¹⁴⁸⁵ TIEAs are executive branch agreements entered under some other authorization (such as a statute or treaty). TIEAs do not require Senate approval.

(a) Caribbean Basin Initiative TIEAs.

TIEAs have been most prominent in the so-called Caribbean Basin Initiative (the popular name for the Caribbean Basin Economic Recovery Act).¹⁴⁸⁶ Some Caribbean countries have been notoriously uncooperative in sharing information with the U.S. for tax purposes and indeed have built major economies by promoting that noncooperation. In some of these countries, financial industries with secrecy as their main attraction are a large component of the local economies. As a result, these countries have been unwilling to enter into agreements or relationships that would undermine their local financial industries. Under the CBI, countries that enter into TIEAs with the United States gain certain trade benefits, thus giving them a financial incentive that may override their financial interest in maintaining strict secrecy for foreign customers of their financial institutions.¹⁴⁸⁷

In 2014, a Senate subcommittee described TIEAs as follows:

The United States has . . . signed dozens of TIEAs with other countries containing information exchange provisions similar to those in the model Article 26. Those TIEAs typically include more detailed provisions on exchanging tax information, including what information must be provided by the requesting country and as well as the responding country. The United States began entering into TIEAs after enactment of a 1983 law authorizing the U.S. Treasury Department to negotiate bilateral or multilateral tax information exchange agreements with certain countries in the Caribbean and Central America. TIEAs became increasingly popular after the OECD published a model TIEA in 2003, encouraged countries around the world to use bilateral and multilateral TIEAs to combat cross border tax evasion, and increasingly used the willingness of a jurisdiction to enter into TIEAs as an indicator for avoiding its designation as an uncooperative tax haven.¹⁴⁸⁸

¹⁴⁸⁵ IRM 5.21.2.2 (12-17-2013), Exchange of Information. For the State Department’s list of TIEAs, see its [Resource Center: Treaties and TIEAs](#). The discussion in section is largely drawn from these authorities.

¹⁴⁸⁶ See the web page for the Office of the United States Trade Representative titled “[Caribbean Basin Initiative \(CBI\)](#).”

¹⁴⁸⁷ The discussion in this section is substantially drawn from the IRM discussion previously appearing at IRM 42.2.6.

¹⁴⁸⁸ Report of the Senate Committee on Homeland and Governmental Affairs Permanent Subcommittee on Investigations, titled [Offshore Tax Evasion: The Effort to Collect Unpaid Taxes on Billions in Hidden Offshore Accounts 12 \(8/20/14\)](#).

The CBI TIEA provides for the exchange of such information “as may be necessary or appropriate to carry out and enforce the tax laws of the United States and the beneficiary country (whether criminal or civil proceedings) including information which may otherwise be subject to nondisclosure provisions of the local law of the beneficiary country such as provisions respecting bank secrecy and bearer shares.”¹⁴⁸⁹ That is the general goal of the TIEA, but TIEAs are still negotiated documents that may vary in their specific provisions – and thus scope – depending upon the negotiating stance of the treaty states involved.¹⁴⁹⁰ Thus, the statute permits the U.S. to enter TIEAs that will limit the exchange of information for civil tax purposes if (1) the Secretary of Treasury, after making reasonable efforts to negotiate an agreement which includes the exchange of such information, determines that such an agreement cannot be negotiated but that the agreement was negotiated will significantly assist in the administration and enforcement of the U.S. tax laws, and (2) the President determines that the agreement as negotiated is in the national security interest of the U.S.¹⁴⁹¹ The determination of whether information is sought only for civil tax purposes is made by the requesting party.¹⁴⁹²

A TIEA provides for the exchange of information pursuant to specific requests, as well as routine and spontaneous exchanges of information. If a party specifically requests, information shall be furnished in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings) in a form admissible into evidence in the courts of the requesting country.¹⁴⁹³ The authority and obligation to exchange information extends to information with respect to persons who are not residents or nationals of one of the contracting states.¹⁴⁹⁴ The officials of each country have a duty not to disclose information obtained under a TIEA other than to those involved in the country's tax administration.¹⁴⁹⁵ The CBI TIEAs are treated as income tax conventions for purposes of section 6103(k)(4) of the Code which allows the U.S. to disclose information to tax treaty partners pursuant to the exchange of information provision of such treaties.

U.S. enforcement at the request of the other party to a TIEA is discussed in Barquero v. United States, 18 F.3d 1311 (5th Cir. 1994) involving the TIEA between the U.S. and Mexico. In that case, the Mexican tax authority (through its treaty office referred to in treaty speak as the competent authority) requested the U.S. counterpart (the U.S. competent authority) to obtain tax information relating to a Mexican national. Pursuant to that request, the IRS served a U.S. bank with an IRS summons. The Mexican national filed a motion in the district court to quash the summons.

¹⁴⁸⁹ § 274(h)(6)(C)(i).

¹⁴⁹⁰ The discussion draft to commence negotiations for a TIEA and the related Technical Explanation are reproduced in the IRM at Exhibit 42.2.6-1.

¹⁴⁹¹ § 274(h)(6)(C)(ii).

¹⁴⁹² § 274(h)(6)(C)(iv).

¹⁴⁹³ § See H.R. Rep. No. 266, 98th Cong., 1st Sess. 30 (1983).

¹⁴⁹⁴ Id at 29.

¹⁴⁹⁵ Id .

The U.S. counterclaimed to enforce the summons. The Fifth Circuit upheld the constitutionality of the TIEA and said that the IRS had authority to issue the summons. The Fifth Circuit also rejected the taxpayer's argument that the IRS issued the summons in bad faith, applying the Powell standard (minimum relevancy showing and absence of bad faith) to TIEA requests.

The United States has recently entered several TIEAs with Caribbean countries and more will undoubtedly be entered.

(b) Other TIEAs.

TIEAs may also be entered independent of the Caribbean Basin Initiative. For example, the United States entered a TIEA with Bermuda in order to implement the Mutual Assistance in Tax Matters provisions of a treaty between the U.S. and the U.K. TIEAs have thus recently been entered with a number of non-Caribbean jurisdictions that are perceived as tax havens.¹⁴⁹⁶

f. Letters Rogatory.

Another form of request from one country to another for assistance in gathering information is in the form of letters rogatory. The following is a good introduction to the process:

Letters rogatory are formal requests for judicial assistance made by a court in one country to a court in another country. Once issued, they may be conveyed through diplomatic channels, or they may be sent directly from court to court. Letters rogatory are often used to obtain evidence, such as compelled testimony, that may not be accessible to a foreign criminal or civil litigant without judicial authorization. They are used primarily by non-government litigants who do not have access to the MLAT process. "While it has been held that federal courts have inherent power to issue and respond to letters rogatory, such jurisdiction has largely been regulated by congressional legislation."¹⁴⁹⁷

28 U.S.C. § 1781 permits the U.S. Secretary of State to receive such requests from foreign countries and to make such requests on behalf of a tribunal in the U.S. The Convention on the Taking of Evidence Abroad in Civil or Commercial Matters of March 18, 1970 (the "Hague Evidence Convention"), to which the U.S. is signatory, provides procedures for making a "letter of request" (the equivalent of a letter rogatory). For requests not within the Hague Evidence Convention (as would be criminal investigative requests), letters rogatory may still issue but the procedures are not set out and whether or not the requested country honors the letters rogatory will depend upon the existence of other agreements, other internal laws of the requested country, or that country's belief that important national interests, including its interest in international comity, compel honoring the request.

¹⁴⁹⁶ E.g., TIEAs with Jersey and the Isle of Man since October of 2002.

¹⁴⁹⁷ See generally, [T. Markus Funk, Mutual Legal Assistance Treaties and Letters Rogatory: A Guide for Judges 17 ff. \(Federal Judicial Center 2014\)](#).

For outgoing letters rogatory (in the current context of IRS investigations desiring evidence in a foreign country), here is a good summary:

The letter rogatory process is less formal than pursuing evidence through an MLAT, but its execution can be more time-consuming. Outgoing letters rogatory—requests for assistance with obtaining evidence abroad, made by counsel through the U.S. court—are issued by the U.S. State Department pursuant to 28 U.S.C. § 1781, and provided for under Federal Rules of Civil Procedure 28(b) and 4(f)(2)(B). Section 1781(b), however, also allows for a district court (and, for that matter, a foreign court) to bypass the State Department and transmit the outgoing letter rogatory directly to the “foreign tribunal, officer, or agency.” In most cases, foreign courts honor requests issued pursuant to letters rogatory. However, international judicial assistance is discretionary, based upon principles of comity rather than treaty, and is also subject to legal procedures in the requested country. Compliance with a letter rogatory request is left to the discretion of the court or tribunal in the “requested” jurisdiction (that is, the court or tribunal to which the letter rogatory is addressed). For example, if a request for compelled testimony is granted by a foreign court, the taking of that testimony may not necessarily follow procedures similar to those of the United States, such as through depositions

As a result letters rogatory will be used in U.S. tax investigations only where there is not an available treaty.¹⁴⁹⁸ And, in a criminal case, are generally effective only post-indictment.¹⁴⁹⁹

For incoming letters rogatory, 28 U.S.C. § 1782 permits U.S. district courts to order a person within the district to give testimony or produce documents “for use in a proceeding in a foreign or international tribunal, including criminal investigations conducted before formal accusation.” The order may issue “pursuant to a letter rogatory issued, or request made, by a foreign or international tribunal or upon the application of any interested person.” This is broad and sweeping authority for district courts to order discovery at the request of foreign governments (both courts and investigators) and even private parties.¹⁵⁰⁰ Under § 1782, the party subject to the order may assert privileges.

4. Non-Treaty Techniques.

Let’s assume the prototypical situation where the taxpayer has a Swiss bank account that, somehow, the IRS has discovered. The IRS then serves a summons upon a New York branch of the

¹⁴⁹⁸ IRM 9.4.2.6.4 (03-15-2007), Letters Rogatory.

¹⁴⁹⁹ IRM 9.4.2.6.4 (03-15-2007), Letters Rogatory, but noting that “ There also exists case law that recognizes a district court's authority to issue letters rogatory for criminal cases that have not yet been indicted.”

¹⁵⁰⁰ For an example of the use of § 1782 to obtain a discovery order at the request of Russian criminal tax investigators, see United States v. Sealed I, 231 F.3d 484 (9th Cir. 2000).

Swiss bank. Clearly the New York branch is within the U.S. summons power. Will the U.S. get the information? This turns upon how much punishment (fines) the Swiss bank is willing to stand in order to avoid giving up the information. Of course, the Swiss bank's first line of defense will be that it cannot give up the information because to do so would violate Swiss law. That defense usually fails, based upon a balancing of interests test.¹⁵⁰¹

Note in this regard that the Balsys case,¹⁵⁰² although not dealing directly with this issue, indicates that U.S. legal imperatives are sufficiently important to trump foreign law at least in the context of the constitutional Fifth Amendment privilege, so that certainly the possibility of violating foreign law will not be a strong imperative here. Assuming the court concludes in favor of the U.S., the court will enforce the summons which, in the case of a corporate summonsee, means that, should it fail to honor the summons, it will suffer monetary contempt penalties that can be great indeed.¹⁵⁰³

This means, of course, that the smart evader will not use a foreign institution with sufficient U.S. presence to suffer this risk. Where that happens, the IRS will resort to the court-ordered consent directive ordering the U.S. taxpayer to sign a consent form directing the foreign institution (bank, brokerage concern, etc.) to disclose information to the U.S. authorities. (See pp. 434 ff.).

VII. Joint International Audits and Simultaneous Examinations.

Related to international evidence gathering is a recent initiative, particularly for OECD countries to perform joint international audits of multinational companies where the tax authorities of two or more countries can coordinate their audit efforts to maximize the effect of limited audit resources.¹⁵⁰⁴ The Commissioner embraced the concept in prepared comments in June 2010 as follows:

Last year, when I had the opportunity to address this gathering, I told you that we planned to try to take international cooperation to the next level and that I thought this should include joint examinations. A year later, we are now working on developing a protocol for joint audits with other countries. And before I go any further, let me be clear on a critical distinction. A joint audit is not a simultaneous exam. Rather, it is a process where two or more countries join together to carry out a single audit of a company with cross-border business activities.

¹⁵⁰¹ See, e.g., In re Grand Jury 81-2, 550 F. Supp. 24, 27 (W.D. Mich. 1982); but see United States v. First Nat'l Bank, 699 F.2d 341, 342 (7th Cir. 1983).

¹⁵⁰² United States v. Balsys, 524 U.S. 666 (1998).

¹⁵⁰³ See In re Grand Jury Proceedings (United States v. Bank of Nova Scotia), 691 F.2d 1384 (11th Cir. 1982), cert. denied, 462 U.S. 1119 (1983); and the companion case In re Grand Jury Proceedings (United States v. Bank of Nova Scotia), 740 F.2d 817, 832-33 (11th Cir. 1984), cert. denied, 469 U.S. 1106 (1985).

¹⁵⁰⁴ [Prepared Remarks of Commissioner of Internal Revenue Douglas H. Shulman before the OECD/BIAC \(6/8/10\)](#).

As we envision it, the joint audit will be more sensible and efficient for the participating business because the business will not have the burden of two exam teams conducting two audits, and it will make sure both countries receive the same information and presentations from the taxpayer.

If fully realized, the joint audit could have the potential of both boosting international tax compliance and improving service. In theory, if all the parties were in the same room, two or more tax authorities would hear the same facts, agree on the issues more quickly, jointly characterize a transaction, and agree on a treatment. It could reduce taxpayer burden – especially for large multinational corporations that must face audits in multiple jurisdictions on the same set of transactions. For a big multinational company, juggling multiple audits now comes with the territory. But a joint audit process may provide taxpayers with a timesaving and less resource intensive way to address the tax consequences of a transaction on a bilateral or even multilateral basis.

So, in a very real way, coordinated action among countries could improve both compliance and the quality of service we deliver to taxpayers. And that's very important to the IRS where we have a dual mission of taxpayer service and enforcement.

Joint audit could also provide tangible benefits to tax authorities. Often, it can take years to resolve double-tax cases through the Competent Authority process. However, if a joint audit could allow us to identify the issue and understand the facts quickly and on a bi- or multi-lateral basis, we should be able to adjudicate these disagreements right away and reach a resolution through a much more efficient and effective process.

So as you can see, we're moving from just cooperation and sharing of information to the very early stages of planning actual coordinated efforts among countries.

Of course, we're still feeling our way through the process and a lot more work remains. And to assist countries wishing to pursue a joint audit, the FTA is developing a guide... a how-to, practical approach that highlights pitfalls to avoid, and possible best practices to employ.

It will be based on a wealth of country experience in the predecessors to the joint audit: simultaneous exams, bilateral advanced pricing agreements, and mutual assistance agreements, to name some of the more prominent. We hope that it will improve international tax compliance while providing taxpayers with more efficient and timely resolution of tax disputes – a potential win-win for all.

The IRS had earlier joined a joint effort with the tax authorities of the U.K., Canada and Australia, called the Joint International Tax Shelter Information Centre (“JITSIC”).¹⁵⁰⁵ This effort is more narrowly focused than joint audit initiative, focusing on cross-border strategies of the tax shelter variety. For example, JITSIC is reported to have found foreign tax credit generators involving U.S. and British Banks.¹⁵⁰⁶

As noted, the Simultaneous Examination Program is not a joint audit but rather one that occurs simultaneous with some mutual cooperation between the taxing authorities pursuant to exchange of information provisions of treaties and TIEAs.¹⁵⁰⁷ “Simultaneous examinations involve the United States and one or more of its foreign partners conducting separate, independent examinations of selected taxpayer(s) within their respective jurisdictions in which the partners have a common or related interest.”¹⁵⁰⁸ The two jurisdictions do not share personnel as might be the case in joint audits.¹⁵⁰⁹

There is a parallel Simultaneous Criminal Investigation Program (“SCIP”) also relying on exchange of information provisions of treaties and TIEAs.¹⁵¹⁰ These are also “separate, independent criminal income tax investigations of selected taxpayer(s) within their respective jurisdictions in which the partners have a common or related interest.”¹⁵¹¹ There is no case authority regarding these SCIP investigations, but there have been referred to occasionally in the other sources.¹⁵¹² It is not clear yet whether the SCIP program has made a material contribution to U.S. criminal tax prosecutions.

¹⁵⁰⁵ JITSIC and the IRS’s role is described on the IRS web site [here](#) with links to other information.

¹⁵⁰⁶ Lee A. Sheppard, Foreign Tax Credit Generator Disallowed, 133 Tax Notes 400 (Oct. 24, 2011) (discussing an abusive foreign tax credit generator case, Pritired 1 LLC v. United States, No. 4:08-cv-00082 (S.D. Iowa 2011)).

¹⁵⁰⁷ IRM 4.60.1.5 (09-19-2014), Simultaneous Examination Program (SEP).

¹⁵⁰⁸ IRM 4.60.1.5.1 (09-19-2014), SEP Objectives and Benefits. For an illustration of the SEP, see Aloe Vera of Am., Inc. v. United States, ___ F. Supp. 3d ___, 2015 U.S. Dist. LEXIS 16605 (D. AZ 2015) (a case involving the improper disclosure of false return information by the IRS to Japanese tax authorities in the course of an SEP).

¹⁵⁰⁹ IRM 4.60.1.5.1 (09-19-2014), SEP Objectives and Benefits.

¹⁵¹⁰ IRM 4.60.1.6 (09-19-2014), Simultaneous Criminal Investigation Program (SCIP).

¹⁵¹¹ IRM 4.60.1.6.1 (09-19-2014), SCIP Objectives and Benefits.

¹⁵¹² E.g., a press release reporting that law firm and a South Korean bank collaboration to help South Koreans comply “with disclosing overseas holdings to the IRS * * * in response to the United States (‘U.S.’) and Korean Governments partnering on Simultaneous Criminal Investigation Program (‘SCIP’) to combat tax evasion.” Business Wire Press release dated 11/2/2011, at <http://www.bloomberg.com/apps/news?pid=conewsstory&tkr=0003:KS&sid=aS58lhZTSfHk> viewed on 2/28/15.

VIII. IRS Methodology for Determining Additional Tax Liability.

A. Specific Items.

In the examination, the IRS may focus on specific items such as specific deductions or specific omitted income and determine from its investigation (including submissions by the taxpayer) that the taxpayer owes additional taxes with respect to those items. These determinations will be reflected in the Revenue Agent's Report ("RAR").

B. Indirect Methodologies.

The IRS also has several indirect methodologies to determine that the taxpayer has underreported his tax liability and owes additional tax. The common theme in the use of these indirect methodologies is that (i) direct methodologies do not work and (ii) the particular indirect methodology used in a particular case is persuasive to provide a reasonable estimate of a tax liability. This is key – the use of an indirect methodology will not be perfect and will produce only an estimate that is the best under the circumstances or, state alternatively, produces a more reasonable result than if no methodology were used. These methodologies, if accurately and persuasively applied and reasonable under the circumstances, will be sustained by the courts.

1. Net Worth Method.

The net worth method is used often when there is reason to believe that such records as the taxpayer maintains do not accurately reflect his or her taxable income (and components thereof). Basically, the net worth method develops taxable income from the following components:

Taxpayer's net worth at the beginning of the period (one or more years)

Less: Taxpayer's net worth at the end of the period

Plus: Taxpayer's nondeductible expenditures during the period

Less: Income (or asset receipts) from nontaxable sources (such as gifts)

Yields: Taxpayer's income during the period

There are variations on this formula, but the methodology is highly factual and depends upon whether the IRS did sufficiently reasonable work, including tracing leads, to fairly -- even if not precisely -- measure taxpayer's income in the absence of more correct calculations. Where several years are included in the period, the IRS must have some method to allocate the income among the years so that the annual tax can be computed.

2. Bank Deposits and Expenditures Method.

This method uses bank deposits on the opening premise that all unexplained bank deposits are taxable income. Depending upon the facts involved, the method then proceeds to reconstruct income. An example of a formula that might be used is as follows:

All of the deposits to the taxpayer's bank account(s) during the period

Less: Deposits shown to be nontaxable income (such as gifts)

Plus: All known expenditures which were not from the bank account(s)

Less: All expenditures which are deductible

Yields: Taxpayers' taxable income during the period

3. Others.

There are other methodologies, such as a percentage mark up method for gross income relative to costs, but all are used and ultimately sustained only if reasonable under the circumstances of the particular case.

4. General Problems with Indirect Methods.

Such indirect methods are inherently fraught with inaccuracy and are justified only where the books and records maintained by the taxpayer, if any, are found to be inadequate for a fair determination of his or her tax liability. Then an indirect methods is allowed only if it persuasively and rationally and fairly, based upon the unique facts of the taxpayer's case, reconstructs the taxpayer's tax liability. If the IRS has done a sloppy job in performing the indirect method analysis or used a methodology that does not fit under the taxpayer's circumstances, a court may throw it out altogether or give the taxpayer all benefit of the doubt despite the supposed burden of proof being on the taxpayer.

And don't forget that these methodologies can be available to the taxpayer to try to prove that his or her tax liability is less than claimed by the Government.¹⁵¹³

IX. Settlement at Examination.

Generally speaking, in the past, Examination had little delegated authority to settle cases. Examination could propose adjustments, and the taxpayer was limited, in theory, to convincing the agent not to make any adjustment. The taxpayer and the agent could not just "split the baby" or, at least theoretically, engage in other more subtle forms of splitting the baby. Examination and the taxpayer could not make a "hazards of litigation" settlement -- meaning a settlement that reflected the risks to each side of litigating the issue. Thus, for example, if the issue were one that the IRS felt should be asserted but the IRS had lost it consistently in the courts, Examination could not settle on a basis reflecting doubt as to its ultimate ability to sustain the adjustment. The Appeals Office (the next level in the administrative process after Examination completes its examination and proposes its adjustments) does have the authority, generally, to settle on the basis of hazards of litigation.

¹⁵¹³ See Kikalos v. United States, 408 F.3d 900 (7th Cir. 2005) (Posner, J.); and John A. Townsend, Judge Posner's Opinion in Kikalos, 108 Tax Notes 593 (Aug. 1, 2005).

Initiatives to make the IRS more user friendly have somewhat relaxed this historical limitation on Examination's ability to settle cases, but not much in most cases. The future may and probably will bring more relaxation of these strictures, provided that some safeguards are instituted to assure that Examination can make the proper assessments for hazard of litigation settlements and safeguards against abuses are adopted.

Even in the current environment, there are some issues that are inherently susceptible of settlement on an effective hazards of litigation basis at examination. Let's take a valuation issue such as the valuation of a closely held business for estate tax purposes. There is usually no significant principle of tax law involved, the "willing buyer, willing seller" standard having been entrenched for many years now. The only issue is what is a fair valuation and ultimately the issue is what a court would say is a fair valuation. Examination and the taxpayer can reach a settlement on valuation that, from a practical standpoint, is a hazards of litigation settlement. The tax law is shot-through with similar fact issues that control the tax results and that are susceptible of settlement at Examination. By contrast, as suggested above, legal issues are not susceptible of settlement. Either a complex business re-adjustment is a tax-free reorganization or it is not, depending upon how the law is applied to the facts that are undisputed. For such issues, Examination is to propose the Government's position without regard to the hazards of litigation. Then, at the next level, the Appeals Office can assess the hazards of litigation and reach a settlement if the parties make consistent assessments of the hazards of litigation.

It may be helpful to analogize the IRS Examination and Appeals functions as an advocacy role (for Examination) and a mediator role (for Appeals). The analogies are not perfect, but may help you understand the process. Examination is to identify issues and assert the Government's position with respect to those issues, without settling them on the basis of the hazards of litigation. Then, after Examination concludes its business, the Appeals Office comes in to attempt to reach a settlement based on the hazards of litigation. I deal in more detail with the Appeals function below.

In negotiating with the IRS, as with any governmental organization, the practitioner must be concerned with who has authority to perform the action being negotiated. We consider settlements at the examination level here, so the practitioner must determine who has authority to settle. Settlements are delegated in Commissioner delegation orders. Attempts to settle with an IRS agent who has no authority to settle are generally rejected.¹⁵¹⁴

¹⁵¹⁴ Dorl v. Commissioner, 507 F.2d 406, 407 (2d Cir. 1974); and Gardner v. Commissioner, 75 T.C. 475, 477-478 (1980).

X. Closing Out the Examination.

A. General.

The Agent concludes the examination by preparing a Notice of Proposed Adjustment (“NOPA”) and Revenue Agent's Report (“RAR”) and providing it to the taxpayer. The Agent will request the taxpayer to file a **Form 870, Waiver of the Restrictions on Assessment**,¹⁵¹⁵ or **Form 4549, Income Tax Examination Changes**,¹⁵¹⁶ with similar waiver language in order to permit the IRS to assess without sending a notice of deficiency. The waiver merely waives the requirement in § 6213(a) that a notice of deficiency be issued prior to an assessment. It is not an agreement that the taxpayer owes the taxes and penalties stated therein.¹⁵¹⁷ There is some potential benefit to the taxpayer in filing a waiver because, if the IRS then does not assess within 30 days, interest on the deficiency will not accrue from the 30th day through the date of the ultimate assessment. § 6601(c). The IRS thus has an incentive for prompt assessment. The downside to the taxpayer in filing the waiver is that he will not get the notice of deficiency and thus foregoes his opportunity to litigate in the Tax Court.¹⁵¹⁸

If the taxpayer does not file the waiver, the IRS will send a 30-day letter provided 120 days remain so that the matter can be processed in Appeals. The 30-day letter is the taxpayer's ticket to Appeals which the taxpayer invokes by filing a protest.¹⁵¹⁹ The taxpayer may be requested to sign

¹⁵¹⁵ The Form 870 waiver language is:

I consent to the immediate assessment and collection of any deficiencies (increase in tax and penalties) and accept any overassessment (decrease in tax and penalties) shown above, plus any interest provided by law. I understand that by signing this waiver, I will not be able to contest these years in the United States Tax Court, unless additional deficiencies are determined for these years.

¹⁵¹⁶ The Form 4549 waiver language is:

Consent to Assessment and Collection - I do not wish to exercise my appeal rights with the Internal Revenue Service or to contest in the United States Tax Court the findings in this report. Therefore, I give my consent to the immediate assessment and collection of any increase in tax and penalties * * * * It is understood that this report is subject to acceptance by [named IRS officials].”

¹⁵¹⁷ See Smith v. Commissioner, 328 F.3d 760 (5th Cir. 2003), citing Daugette v. Patterson, 250 F.2d 753, 755-57 (5th Cir. 1957). One collateral consequence of signing the waiver, which allows the IRS to make an assessment without issuance of a notice of deficiency, is that upon assessment the IRS can invoke its various collection remedies (discussed below beginning on p. 657) and the taxpayer will be denied the Collection Due Process remedy as a means of contesting the underlying tax liability. See Aguirre v. Commissioner, 117 T.C. 324, 327 (2001).

¹⁵¹⁸ As to the Form 4549 with the waiver language, see Aguirre v. Commissioner, 117 T.C. 324 (2001). Aguirre holds that, in addition to losing their right to go to the Tax Court, the taxpayers also lose their right to a collection due process proceeding in the Tax Court. (See the discussion of the collection due process rights below beginning at p. 657.)

¹⁵¹⁹ See IRS Publication 5 on Filing a Protest.

a consent to extend the statute of limitations in order to permit Appeals processing; if the taxpayer refuses, the taxpayer may not get a “30-day letter” and the IRS will proceed to issue a notice of deficiency (colloquially called a “90-day letter” because the taxpayer then has 90 days in which to petition the Tax Court for redetermination of the proposed deficiency). The notice of deficiency is issued under § 6212.

Under § 7430(g), after receipt of the “30 day” letter offering an opportunity for administrative appeal, the taxpayer may make a “qualified offer” to settle. I will deal more with “qualified offers” later (pp. 565 ff.), but the key point here is that it should be considered as soon as the 30-day letter is received if the taxpayer can make a reasonable projection of how the case may ultimately be resolved.

B. Substitute for Return.

At the conclusion of the examination of a taxpayer who has failed to file a return, the IRS may prepare what is called a substitute for return (“SFR”) under Section 6020(b).¹⁵²⁰ Although, the SFR is statutorily called “prima facie good and sufficient for all legal purposes,” in fact for many purposes it is not treated as the taxpayer’s return. Some examples of an SFR not being treated as a return are:

- The SFR does not allow immediate assessment, as with the case of a return, requiring that the IRS must follow the deficiency procedures.¹⁵²¹
- The SFR is not treated as a return that starts the running of the statute of limitations for assessment.¹⁵²²
- The SFR is not treated as a the taxpayer’s return for purposes of bankruptcy proceedings which permit a discharge for returns filed more than three years before bankruptcy.¹⁵²³
- The SFR is not subject to the accuracy related penalties for returns, so that the failure to file penalties will continue to apply and will continue to accrue after the date of the SFR.¹⁵²⁴

¹⁵²⁰ The § 6020(a) document signed by the taxpayer is sometimes also called an SFR. Since that document is treated as a return for all Code purposes, I will refer to it as the § 6020(a) return and limit the use of SFR to the § 6020(b) document not signed by the taxpayer.

¹⁵²¹ Spurlock v. Commissioner, 118 T.C. 155 (2002).

¹⁵²² § 6501(b)(2).

¹⁵²³ 11 U.S.C. § 523(a)(3), flush language at end, sometimes called the hanging paragraph, specifically stating that § 6020(a) SFRs (those signed by taxpayers, thereby becoming returns) are returns for discharge but § 6020(b) SFRs (those not signed by taxpayers) are not returns for discharge). (This flush language in § 523(a)(3) is often called the “hanging paragraph,” and often referenced as § 523(a)(*) .)

¹⁵²⁴ § 6651(g)(1).

- Since these returns are not signed by the taxpayers under penalties of perjury, they are not eligible for the tax benefits of joint return treatment.¹⁵²⁵

C. The Closing Agreement.

As we noted above, a taxpayer subjected to audit will normally not be subjected to further audits for the year because of the second audit prohibition we discussed above (pp. 375 ff.). IRS Policy Statement 1.2.13.11 (12-21-84) provides that the IRS will not open a closed case after examination except in the following cases:

1. there is evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material fact;¹⁵²⁶
2. the prior closing involved a clearly defined substantial error based on an established Service position existing at the time of the previous examination; or
3. other circumstances exist which indicate failure to reopen would be a serious administrative omission.

So, upon the conclusion of the audit, the taxpayer will be reasonably assured, barring some most unusual circumstance, that will conclude the matter for the year(s) audited. Nevertheless, there is no assurance that the IRS will not exercise its authority to undertake a second audit. A taxpayer desiring to have finality thus must consider the alternatives available to achieve finality.

If the taxpayer litigates the liability for the year (as in a Tax Court case), the finality rules for litigation may, in all but rare cases, close out the tax liability for the year with finality.¹⁵²⁷ However, litigation raises some risks that the IRS may be able to assert additional matters in the litigation or even reverse positions it agreed to in audit. Achieving finality through litigation may not be exactly what the client wants.

The Code provides only one administrative method for finalizing tax liabilities with some degree of certainty. That is the closing agreement under § 7121(a) which authorizes the IRS to agree in writing as to the liability of any taxpayer. The statute provides that a closing agreement is “final and conclusive, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact.” § 7121(b). The usual Closing Agreement forms are Form 866, Agreement as to Final Determination of Tax liability, or Form 906, Closing Agreement On Final Determination Covering Specific Matters. Both specifically state the requirement of the statute that the agreement is final and conclusive except for “fraud, malfeasance, or misrepresentation of material fact.” Thus, subject

¹⁵²⁵ Rev. Rul. 2005-59, 2005-37 I.R.B. 505.

¹⁵²⁶ These triggers for opening up a closed case require some level of culpability except in the case of misrepresentation which does not normally convey culpability. See NPR Invs., L.L.C. v. United States, 740 F.3d 998 (5th Cir. Tex. 2014) (interpreting a similar provision in § 6223(f)).

¹⁵²⁷ See § 6212(c)(1) providing that a Tax Court decision would not be conclusive for the year if there are items of fraud for the year.

to the foregoing caveat, the closing agreement may be used to close out a period (for income taxes, the period is a year) with some degree of finality.¹⁵²⁸

Further, closing agreements may be used to settle both past years and future periods (although settlements for future periods will be with respect to specific issues rather than the tax liability for the future year).¹⁵²⁹ Closing agreements affecting future periods, however, are “subject to any change in, or modification of, the law enacted subsequent to the date of the agreement and made applicable to such taxable period.”¹⁵³⁰

¹⁵²⁸ I fuzz this because the IRS has some ways to avoid finality for the reasons stated in the closing agreement - “fraud or malfeasance, or misrepresentation of a material fact.” A taxpayer will likely know whether fraud or malfeasance are risks at the time of entering the agreement. Misrepresentation, though, is obviously something different from and less egregious than fraud. Similarly worded provisions are contained in other Code sections and misrepresentation may include even innocent misrepresentations. For example § 6532(b) provides a 5 year limitations period for erroneous refund suits in the erroneous refund was induced by fraud or misrepresentation. Courts have noted that Government's position that misrepresentation is something less than fraud or culpable misrepresentation. Lane v. United States, 286 F.3d 723 (4th Cir. 2002); United States v. Northern Trust Company, 372 F.3d 886 (7th Cir. 2004). See also NPR Invs., L.L.C. v. United States, 740 F.3d 998 (5th Cir. Tex. 2014) (interpreting § 6223(f); misrepresentation does not require culpability). The issue then is whether the misrepresentation must be from statements in negotiating the closing agreement or earlier with respect to the return?

Consider also the following: assume the taxpayer filed a return underreporting tax by \$1,000,000. Upon audit, the IRS suspects fraud as to the underreporting of \$600,000 of the \$1,000,000 but does not think it can prove fraud by clear and convincing evidence. The IRS and the taxpayer enter a closing agreement for the taxpayer to pay the \$1,000,000 underreported tax plus a 20% accuracy related penalty on the \$600,000. The IRS thereafter stumbles upon evidence that shows conclusively the taxpayer's fraud for and the IRS is now certain that it can prove that fraud by clear and convincing evidence. Is the IRS bound by the closing agreement? Specifically, does the exception for “fraud or malfeasance, or misrepresentation of a material fact” apply. Let's say that, during the course of the negotiations, the taxpayer committed no fraud and made no misrepresentations of fact, and the only fraud the IRS can identify relates to the initial fraud in reporting the items resulting in the \$600,000 portion of the underreported tax. Some cases suggest that the required fraud or misrepresentation must be in the inducement to enter the agreement rather than with respect to the underlying tax liability. See Ingram v. Commissioner, 32 B.T.A. 1063 (1935), aff'd Commissioner v. Ingram, 87 F.2d 915 (3d Cir. 1937). The IRS, however, nonacquiesced Ingram. See 1935-2 C.B. 34. And, compare § 6212(c)(1) providing that a Tax Court decision would not be conclusive for the year if there are items of fraud for the year. Is there any basis for giving more finality to the closing agreement than to a Tax Court decision?

¹⁵²⁹ Regs. § 301.7121-1(b)(3).

¹⁵³⁰ Regs. 301.7121-1(c)(2). In Hopkins v. Commissioner, 120 T.C. 451 (6/30/03), the Tax Court has held that, despite this general proposition, a spouse previously entering a closing agreement before the existence of the expanded innocent spouse relief provision (§ 6015) may

Closing agreements are contracts.¹⁵³¹ As contracts, both the IRS and the taxpayer must make sure that the agreement covers the ground they expect it to cover.¹⁵³²

Note, that although we discuss closing agreements at the conclusion of the audit section of this book, closing agreements are not available only incident to audits. Indeed, as in the steel cases just discussed, there was no controversy between the IRS and the taxpayer. The closing agreement process was used simply to establish a procedure for the taxpayers to obtain quick refunds based on their claims as to the amounts they were entitled to. The IRS neither agreed nor disagreed as to whether they were actually entitled to the refunds.¹⁵³³ You may want to think creatively for your clients about how closing agreements can be used at various times, whether in audit or not, to assist your clients in achieving their objectives.

If the taxpayer appeals administratively, the taxpayer will have an opportunity to achieve some degree of finality by entering a **Form 870-AD, Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment**, with the IRS. The use of this Form is discussed below in the Chapter on Appeals. This Form requires only the approval of the Appeals Officer and supervisor and may close out the year or years or specific issues in the year or years before the Appeals Office. This requires, however, that the taxpayer pursue the appeals remedy within the IRS, which is generally no big deal. The Form 870-AD, where available, is much

nevertheless obtain innocent spouse relief as to the liability in the closing agreement. The decision is based upon the retroactive policies clearly intended by Congress in the expanded version of innocent spouse relief and is thus viewed as limited exception to the general proposition that a liability included in a closing agreement is set in stone.

¹⁵³¹ United States v. National Steel Corp., 75 F.3d 1146, 1150 (7th Cir. 1996) (reasoning that they are contracts subject to federal contract law principles); Bethlehem Steel Corp. v. United States, 270 F.3d 135, 139 (3d Cir. 2001).

¹⁵³² Rev. Proc. 68-16, 1968-1 C.B. 770, provides the procedures applicable for processing closing agreements. This Revenue Procedure is must reading for those considering closing agreements.

¹⁵³³ The IRS could have agreed in the closing agreement that the taxpayers were entitled to the refunds or methodologies from which the refunds would necessarily follow, in which case the taxpayers would have prevailed. Under the circumstances, however, it is clear that the IRS would likely have wanted to audit or examine the entitlement to the refunds first and would not have been able to move expeditiously to a closing agreement. The time required to enter the more definitive agreement would probably have assured that it was not reached before the repeal. Further, under the facts, the IRS was likely aware of the possibility of repeal and would not have entered a more definitive closing agreement for that reason in any event. That is probably why the taxpayers did not insist that the IRS agree to amounts or methodologies—i.e., the taxpayers knew the IRS would not agree. The taxpayers were thus left with the need to argue that those unstated “agreements” should be implied by the courts. And with the large amounts involved, the taxpayers felt it was appropriate to run the argument up the flagpole to see if a court would salute.

more commonly used than the closing agreement which requires many more procedural hoops and higher level approvals within the IRS.

Finally, for supposed tax administration purposes, the IRS will sometimes want to disclose the resolution of a tax controversy via a closing agreement. This can happen, for example, if a taxpayer settles a hot tax issue with the settlement tilted in the Government's favor. Because of § 6103's prohibition on disclosure of return information – which a closing agreement surely is – the IRS would need the taxpayer's consent to the disclosure.¹⁵³⁴ That consent becomes an item of negotiation with the IRS. The taxpayer does not have to give the consent and, logically, in the bargaining process should achieve something for it that the taxpayer might not have been able to achieve.¹⁵³⁵ Thus, the taxpayer may obtain a waiver or significant concession on penalties with respect to the underlying tax being settled or may receive even some unrelated concession that is not publicized (although I think that, should the latter phenomenon occur and become known, the IRS would be perceived as having done nothing other than paid for the taxpayer "concession" it wishes to publicize and that is not much of a concession at all).

¹⁵³⁴ See CC-2008-014, reproduced at 2008 TNT 80-7, explaining the process for obtaining taxpayer consents to disclosure.

¹⁵³⁵ Cummings' Corporate Tax Insights (RIA 05/13/2008), Volume 06, No. 09.

Ch. 10. Appeals.

I. Appeals' Mission.

The IRS Appeals Office is an office designed to resolve taxpayer disagreement(s) with actions proposed by the IRS Examination (or Collections) short of litigation. The preceding chapter covered Examination (i.e., audits of returns) and most of the time in your practice that will be the way you will invoke your right to go to the Appeals Office for an opportunity to resolve the matter without litigation. But there will be other times that you will represent taxpayers before the IRS – most prominently in collection matters after the tax is assessed but unpaid – and you will usually have an opportunity to invoke the Appeals Office process to see if the matter can be resolved. For the present discussion of the Appeals Office function, I will assume unless otherwise noted that the process is invoked at the conclusion of an Examination (audit).

The IRS Appeals Office Mission Statement is:

The Appeals Mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.¹⁵³⁶

* * * *

A fair and impartial resolution is one which reflects on an issue-by-issue basis the probable result in event of litigation, or one which reflects mutual concessions for the purpose of settlement based on relative strength of the opposing positions where there is substantial uncertainty of the result in event of litigation.¹⁵³⁷

The related Policy Statement is:

1.2.17.1.6 (04-06-1987)

Policy Statement 8-47

1. Consideration to be given to offers of settlement

Appeals will ordinarily give serious consideration to an offer to settle a tax controversy on a basis which fairly reflects the relative merits of the opposing views in the light of the hazards which would exist if the case were litigated. However, no settlement will be made based upon nuisance value of the case to either party. If the

¹⁵³⁶ IRM 8.1.1.1 (02-10-2012), Accomplishing the Appeals Mission; see also IRM 8.6.4.1 (10-26-2007).

¹⁵³⁷ IRM 8.6.4.1.2 (10-26-2007), Fair and Impartial Settlements per Appeals Mission.

taxpayer makes an unacceptable proposal of settlement under circumstances indicating a good-faith attempt to reach an agreed disposition of the case on a basis fair both to the Government and the taxpayer, the Appeals official generally should give an evaluation of the case in such a manner as to enable the taxpayer to ascertain the kind of settlement that would be recommended for acceptance. Appeals may defer action on or decline to settle some cases or issues (for example, issues on which action has been suspended nationwide) in order to achieve greater uniformity and enhance overall voluntary compliance with the tax laws.

3. Appeals Settlement Authority

4. Except as provided in Policy Statement P-4-66, appeals is the only administrative function of the Service with authority to consider settlements of tax controversies, and as such has the primary responsibility to resolve these disputes without litigation to the maximum extent possible.

This basis for settlement is called the “hazards of litigation” standard. The key factors that the Appeals Office brings to the resolution of IRS disputes that Examination did not bring are (1) independence from Examination (or other IRS branch or office from which the Taxpayer appeals); (2) a mission that emphasizes objectivity,¹⁵³⁸ (3) a mission that emphasizes the importance to the system of settling the overwhelming number of tax disputes, and (4) a mission that permits settlement based on the litigating hazards.

II. Settlement Authority.

Appeals can settle on its own authority virtually all issues, even IRS public positions (e.g., Rev. Rul.), based on the litigating hazards.¹⁵³⁹ There are some exceptions requiring additional review and approval but they are not commonly encountered.¹⁵⁴⁰ Exceptions include (list not exclusive): certain controlled issues for nationwide responsibility; certain Compliance Coordinated Issues, and issues contrary to a TAM favorable to the taxpayer; and so-called Joint Committee cases where § 6405(a) requires a report for Joint Committee review of proposed refunds in excess of \$2,000,000; bankruptcy cases; religious or constitutional “defenses” to tax liability.¹⁵⁴¹

¹⁵³⁸ The 1998 Reform Act mandated that the Appeals Office, although within IRS, be independent of the Examination function so that it could serve and be perceived as serving the goal to resolve tax disputes fairly and expeditiously.

¹⁵³⁹ Within the Appeals Office, the persons who have settlement authority are determined by Commissioner Delegation Orders. Sec. 601.106(a)(1)(i) and (ii), Statement of Procedural Rules. Delegation Order No. 66 (as revised) set forth the current settlement authority within appeals.

¹⁵⁴⁰ IRM 8.1.1.2.1 (02-10-2012), Some Exceptions to Appeals Authority.

¹⁵⁴¹ Regs. § 601.106(b); see IRM 8.1.3.1 (10-23-2007).

In multi-issue cases, Appeals will usually settle each issue on its own merits, so that in theory there are no cross-issue settlements.¹⁵⁴² Rarely will there be a global settlement that is not justified by the sum of its components. This process of considering and settling each issue on its own merits has been highlighted in the penalty area. Sometimes a taxpayer will have an incentive to avoid a penalty and may try to negotiate the IRS's concession of a penalty by conceding more of the merits of the substantive tax issue. For example, in the Sarbanes Oxley world, penalties become an item of required disclosure that are internally embarrassing for the internal tax function (specifically the Tax Director or even the CFO) and are embarrassing for the corporation before the public and its shareholders. In my practice, I have found that Appeals Officers rarely do that anyway, but the IRS specifically prohibited Appeals Office settlement of the penalty on any basis other than the merits of the penalty.¹⁵⁴³

III. Tickets to Appeals.

A. The Usual Case – After Audit.

1. 30-Day Letter and Protest.

The taxpayer may get to Appeals after an audit by filing a protest to a 30-day letter. IRS Publication 5, titled *Your Appeal Rights and How To Prepare a Protest If You Don't Agree*, should have accompanied the 30-day letter and describes the appeal rights and procedure for handling the appeal. Similar procedures are available for IRS action denying a claim for refund in whole or in part and for other IRS proposed actions (such as collection actions).

2. After Filing a Tax Court Petition (“Docketed Appeal”).

The filing of a petition in the Tax Court will result in automatic referral to Appeals if Appeals has not previously considered the matter.¹⁵⁴⁴ This will happen where the taxpayer did not seek appeals review after the audit (i.e., upon receipt of the 30-day letter), so that the notice of deficiency then issues with no Appeals review. If the taxpayer then files a petition in the Tax Court, the case will be referred to Appeals. Because the case is then docketed in the Tax Court, it is referred to as a “Docketed Case” or “Docketed Appeal.” A case that proceeds via the protest route discussed above is often referred to as a “Non-Docketed Appeal.”

¹⁵⁴² IRM 8.6.4.1 (10-26-2007), Fair and Impartial Settlements per Appeals Mission.

¹⁵⁴³ IRM 8.6.4.1.2.6 (10-26-2007), Split-Issue Settlements, which provides: Penalty issues are not traded in Appeals. Penalties are settled, but the settlement is based on the merits and hazards surrounding each penalty issue standing alone.

¹⁵⁴⁴ Rev. Proc. 87-24, 1987-1 C.B. 720.

3. Strategies as to Route to Appeals.

Thus, the taxpayer has two avenues to Appeals after Examination proposes action (such as a proposal to assert additional tax liability or deny a refund). The taxpayer can invoke the Appeals Office jurisdiction by filing a protest upon receiving the 30-day letter (Non-Docketed Appeal); the taxpayer also invokes the Appeals Office jurisdiction, at least in most cases where the taxpayer has not previously gone to Appeals on the issue, by Tax Court petition after receiving the notice of deficiency (Docketed Appeal). Either way, the case gets to Appeals, and most cases settle in Appeals.

Some practitioners believe that better and quicker Appeals settlements are achieved via a Docketed Appeal. The notion is that, because of the risk of the Tax Court calendaring the case soon after the case is at issue (usually the filing of the IRS's answer), Appeals will put the docketed cases at the top of the stack. Then, the thinking goes, because Appeals may have less time to deal with that type of case, it may miss or not pursue things it might otherwise have pursued to the taxpayer's detriment. But, keep in mind that some time is already lost going the Docketed route, because the IRS has to issue a notice of deficiency after the 30-day letter, the taxpayer then has to file a petition and the IRS has to answer, all of which will chew up several months just getting to Appeals in a Docketed Appeal, whereas a protest would have gotten the taxpayer there earlier. So, from a pure time standpoint, I doubt that a strong case can be made for the Docketed Appeal rather than the protest route.

And, I think, it is problematic as to whether the Appeals Officer will give a better settlement simply because there may be a short fuse before the case is calendared. Human dynamics, particularly in a bureaucracy, is to do nothing when time is too short rather than to give away the store.

There might be an advantage in the Docketed Appeal, for example, if there are lurking unspotted issues in the audit or issues which the Agent conceded during the audit. The thinking is that the Appeals Officer may be less likely to deal with them in a Docketed Appeal than in a Non-Docketed Appeal because of the time factor. My experience is that this factor is probably marginal, but should be considered. More importantly, if Appeals does spot new issues which it wants to pursue, there is an advantage in the Docketed Appeal. In a Non-Docketed Appeal, the IRS just adds the new issue to the list in the ensuing notice of deficiency, and the taxpayer will bear the burden of proof at trial. By contrast, if the new issues pop up in a Docketed Appeal, the IRS can pursue the matter only with the permission of the Court to file an amended answer. Such permission is not always given, and, if given, the IRS will bear the burden of proof. As I note elsewhere, it is unclear whether the burden of proof has any real significance in most tax cases, but it is possible that as to an undeveloped issue, the burden of proof allocation will control. So there might be some benefit from a Docketed Appeal where there are material issues that have not yet been set up by the IRS.

Some practitioners tout yet another supposed benefit of going the Docketed Appeal route. The Non-Docketed Appeal requires a protest (except in small cases). As I develop elsewhere, the protest should be drafted to persuade the Appeals Officer and thus should lay out the facts and law

in a persuasive fashion. A protest is not technically required in a Docketed Appeal, and the only writing technically required is the petition which is simply a “notice” pleading that sets forth the facts and law in highly summary fashion that is not likely on its face to persuade anyone that the taxpayer is entitled to prevail on the issue. The notice pleading just puts the opposing party on notice; in Appeals, the taxpayer must do more – he or she must persuade. Many Appeals Officers will request or practitioners will find it in their client's best interest to submit a position paper in a Docketed Appeal that substantially tracks what they would have put in a protest. I have always found it in my client’s interest on significant issues to submit position papers in a Docketed Appeal. Particularly with significant issues, an Appeals Officer is not likely to be moved by a simple conference without supporting arguments and documentation. Hence, this touted benefit is marginal except in the simplest and smallest of cases where preparing a protest or position paper is not cost-justified.

Section 6673(a)(1)(C) gives the Tax Court authority to award up to \$25,000 in damages against a taxpayer who unreasonably failed to pursue administrative remedies. The Tax Court has said that the underlying purpose of this provision is “to penalize taxpayers who needlessly involve the Tax Court in a dispute that should have been resolved in the Appeals Division of the IRS.”¹⁵⁴⁵ Should you be concerned about this provision if you choose the Docketed Appeal route? The IRS has not sought and the Tax Court has not imposed damages simply for pursuing the Docketed Appeal, but one cannot state for certainty that it won't.

In my view, however, the taxpayer can avoid the problem by meaningfully participating in the Appeals proceeding in the Docketed Case. And, in any event, the Tax Court usually asserts and the Tax Court imposes this penalty only in extreme cases such as tax protestor cases raising totally frivolous arguments.¹⁵⁴⁶

Finally, the Tax Court has warned tax practitioners of another cost of going the docketed route without pursuing an available Appeals hearing. The taxpayer will be foreclosed from recovering attorneys fees under § 7430. (See discussion of that provision on pp. 558 ff.)

So, bottom line, I suggest that, in advising your client to forego the Non-Docketed Appeal, you must be able to articulate some affirmative good reason which simply won't exist in most cases.

B. Other Avenues to Appeals.

There are miscellaneous other ways a taxpayer may get to Appeals. For example, Appeals review can be achieved upon denial of a claim for refund and, as we shall note in the Collection

¹⁵⁴⁵ Birth v. Commissioner, 92 T.C. 769, 774 (1989).

¹⁵⁴⁶ E.g., Pierson v. Commissioner, 115 T.C. 576 (12/14/2000) (warning that these sanctions will be imposed under the collection due process (“CDP”) cases brought under the procedures discussed below under Collections (p. 657)); and Philips v. Commissioner, T.C. Memo. 1995-540. (Significant sanctions are available in other courts for raising frivolous arguments.)

discussion below, upon the IRS's taking of certain actions.¹⁵⁴⁷ However, the Appeals function and process is basically the same – the taxpayer takes some action to appeal the IRS action to Appeals and Appeals attempts to resolve the matter on an objective basis. For the balance of this Chapter on Appeals, we shall present the discussion in the context of the historical appeals route – going to appeals after an audit, either in a Non-Docketed Appeal or a Docketed Appeal.

The IRS announced that it will permit Appeals Office prepayment review for certain types of international penalties that previously offered no prepayment Appeals Office review. The opportunity is available for the international penalties under Chapter 61, such as for failure to file Forms 5471, 5472, or 8865.¹⁵⁴⁸

IV. Examination's Rebuttal; Other Examination Communications with Appeals.

Examination will have an opportunity to respond to the assertions the taxpayer makes to Appeals in the protest. If the taxpayer gets to Appeals by filing a protest (whether in an audit or in response to a proposed disallowance of a claim for refund), the protest is filed with Examination which may prepare a **rebuttal letter** to be submitted to Appeals along with the protest.¹⁵⁴⁹ The rebuttal letter, usually just called rebuttal, is Examination's "last opportunity to counter a taxpayer's arguments" before the case is forwarded to Appeals. The scope of the rebuttal is:

A proper rebuttal addresses each disputed fact, argument of law, and the position of the taxpayer. The rebuttal only addresses the protest. Do not introduce new issues not raised by the taxpayer. If necessary, issue a revised formal report.

* * * *

Some protests include negative comments as to the professional conduct of the audit. Do not address these comments. The taxpayer has the option of holding a conference with the manager, and the manager may address these assertions in the conference.¹⁵⁵⁰

If a taxpayer gets to Appeals by filing the petition in the Tax Court, Appeals may ask the taxpayer to file a position paper. Appeals will often ask Examination to respond to arguments the taxpayer makes in the petition or in a position paper. This also is called a rebuttal.

¹⁵⁴⁷ For example, one of the staples of tax practice is defending clients against the trust fund recovery penalty. Rev. Proc. 2005-34; 2005-24 IRB 1 provides procedures related to appeals of trust fund recovery determinations.

¹⁵⁴⁸ IRM 8.11.5.

¹⁵⁴⁹ IRM 4.75.15.12 (03-31-2014), Rebuttals to Formal Protests.

¹⁵⁵⁰ IRM 4.75.15.12 (03-31-2014), Rebuttals to Formal Protests.

Examination is supposed to provide a copy of the rebuttal to the taxpayer.¹⁵⁵¹ A good practice point is to specifically request the rebuttal in the cover letter submitted the protest. And, if a rebuttal has not been received by the time you are contacted by Appeals, be sure and ask the Appeals Officer whether there is a rebuttal and, if so, ask for a copy.

The 1998 Restructuring Act directed reforms to insure the independence of Appeals. A significant form was the “prohibition * * * of ex parte communications between appeals officers and other Internal Revenue Service employees to the extent that such communications appear to compromise the independence of the appeals officers.”¹⁵⁵² The public perception and reality of an independent Appeals is vital to its functioning in the system to settle disputes without litigation. Congress believed that circumscribing ex parte communications will further the public's confidence in the system. The IRS has issued a revenue procedure governing ex-parte communication and IRM provisions governing those communications.¹⁵⁵³ You should be familiar with Revenue Procedure and IRM incident to representing a client in an appeals hearing, so that you can be sensitive to the possibility of impropriety. Generally, those procedures prohibit communications about the substance of the issues or positions in the case, but not about “matters that are ministerial, administrative or procedural in nature.”¹⁵⁵⁴

The Appeals Officer may ask that the taxpayer (through the representative) informally waive the bar against ex parte communications. If the taxpayer agrees, the Appeals Officer will require that the taxpayer send a letter confirming the agreement. The confirming letter should address the breadth of the waiver (e.g., for a single or identified number of communications) and the scope of the waiver (e.g., subjects to be discussed, time period for the waiver). In addition, the letter should condition the waiver on the Appeals Officer communicating to you the substance of the information disclosed or arguments made to the Appeals Officer. In this regard, however, the IRS has analogized the Appeals Officer's role with respect to such ex parte communications to a mediator and mediators do not necessarily find it helpful to the settlement process to have to repeat back everything that was said in a private conference with an opposing party.

One issue that has arisen but is not yet finally settled is whether the entire administrative file sent to the Appeals Officer constitutes an ex parte communication that should or must be disclosed to the taxpayer. As I note elsewhere, at least in some areas (including my own), the taxpayer can usually have access to the file by simply request to the Appeals Officer. In all events, it will be better practice to ask for access to the administrative file early on in order, at a minimum, to flush out whether the IRS might deny access and, if so, ascertain why it is doing so.

¹⁵⁵¹ IRM 4.10.8.12.10.3.8 (09-12-2014), Request for Appeals Conference (“If a rebuttal is prepared, a copy **must** be provided to the taxpayer.”)

¹⁵⁵² Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 1998), Pub. L. No. 105-206, § 1001(a)(4), 112 Stat. at 689. RRA 1998 § 1001(a)(4).

¹⁵⁵³ Rev. Proc. 2012-18, 2012-10 I.R.B. 455; IRM 8.1.10 Ex Parte Communications (in Appeals); IRM Chapter 2. General Examination Procedures, Section 7. Ex Parte Communications.

¹⁵⁵⁴ Hotchkiss v. Commissioner, T.C. Memo. 2010-32.

So what's the remedy to violation of this prohibition on ex parte communications? The taxpayer appears to have no relief, at least absent some demonstrable harm independent of the mere violation of the ex parte communication prohibition.¹⁵⁵⁵

V. Taxpayer Discovery.

Consider filing a FOIA request so that you are certain you know as much as possible about the case. In the Houston District, Appeals has a policy of allowing the taxpayer or his representative access to the documents in the file that the taxpayer could have obtained via a FOIA request. So the hassle of a FOIA request was avoidable. Confirm in your Appeals Office proceeding whether that policy is available and consider a FOIA request if it is not. And, as the Appeals Office consideration proceeds (some span long periods of time and many meetings), be sure to ask periodically whether any additional submissions have been made by Examination.

VI. Conferences.

The taxpayer will have at least one conference with the Appeals Officer. The conference will be either in person at the Appeals Officer's office, by telephone or sometimes by correspondence.¹⁵⁵⁶ Depending upon the complexity of the case and amount in issue, there may be many conferences stretching over several years. For example, I represented a taxpayer in a Docketed Appeal involving complex transfer pricing and foreign tax credit issues over a 4 year tax period. We had probably 8-10 in-office conferences and many telephone conferences and sharing of information and position papers over several years before the case was finally settled. The Tax Court accommodated the ongoing settlement process by continuing the cases (multiple years) at the request of the parties.

In less complex cases, there will be only one conference. Often, the Appeals Officer will make an offer toward the conclusion of the conference, and the taxpayer and/or his representative should be well enough prepared to respond to the offer, pending final approval by the taxpayer (who often does not attend the Appeals Office conference).

¹⁵⁵⁵ In Robert v. United States 364 F.3d 988 (8th Cir. 2004), the Appeals Officer had an ex parte communication with the examining auditor suggesting that the auditor obtain an outside appraisal. The IRS issued summonses for information for the outside appraisal. The taxpayer moved to quash the summons on the ground that the communication violated the ex parte communication prohibition. The IRS conceded the violation, but the Court held that the summonses were nevertheless enforceable under the Powell standard. The Court said: "[W]e generally will not fashion a remedy where Congress creates a right but fails to create an accompanying remedy." In denying relief, however, the Court did consider whether the taxpayer had been harmed beyond the fact of the violation of the ex parte communication prohibition, suggesting that it might fashion some appropriate relief if the taxpayer were really harmed.

¹⁵⁵⁶ IRM 8.6.1.1 (06-25-2015), Introduction to Discussion on Conferences.

VII. New Issues.

A. Raised by Appeals.

One of the most important concerns the taxpayer and the practitioner may face in considering whether and when to go to Appeals is whether Appeals may raise issues other than the ones for which Appeals is sought. This can happen in two contexts. First, Examination has not spotted an issue at all but Appeals discovers it in reviewing the files. Second, Examination spotted the issue but resolved it in favor of the taxpayer (either in a taxpayer favorable settlement or by dropping the issue). The concern is that the Appeals Officer, often a more seasoned and experienced IRS employee, may raise the issue sua sponte as a “new issue.” If the statute of limitations is still open for assessment, this can be a real concern.

Historically, Appeals was permitted to raise a new issue sua sponte if “the ground for such action is a substantial one and the potential effect upon the tax liability is material.”¹⁵⁵⁷ However, even this limited right to raise new issues seemed inconsistent with Appeals broader role to resolve disputes between the taxpayer and Exam. Recently, the IRS conducted an Appeals Judicial Approach and Culture (“AJAC”) Project which has resulted in significant limitations its role to resolving disputes and thus not raising new issues. Consistent with AJAC, IRS revised the policy statement to foreclose raising new issues. As currently approved, the new Policy Statement is:¹⁵⁵⁸

IRM 1.2.17.1.2 (08-13-2014), Policy Statement 8-2 (Formerly P-8-49)

(1) New issues not to be raised by Appeals.

(2) Appeals will not raise new issues. Appeals also will not reopen an issue on which the taxpayer and the Service are in agreement.¹⁵⁵⁹

¹⁵⁵⁷ Policy Statement P-8-2, approved 1/5/07. The Policy Statement gave the following example of one in which a new issue could be raised: “The existence of unreported income, deductions, credits, gains, losses, etc. stemming from a tax shelter which is a listed transaction constitutes such a substantial ground with a material effect upon the tax liability.”

¹⁵⁵⁸ AP-08-0713-03 (7/18/13), 2013 TNT 141-15.

¹⁵⁵⁹ See also IRM 8.6.1.6.2 (11-14-2013), General Guidelines Immediately; and IRM 8.6.1.6 (11-14-2013), New Issues and Reopening Closed Issues. Immediately after the policy statement quoted above in the text, the following appears:

Exception:

See IRC 7121

There is no other explanation of the Exception. Section 7121 is the provision for closing agreements. Closing agreements would seem only to relate to the second sentence in the quote in the text regarding not reopening. Section 7121(b) deals with finality of closing agreements “except upon a showing of fraud or malfeasance, or misrepresentation of a material.” I discuss that language elsewhere in the text. I gather that the Appeals Officer handling a case that has Examination level closing agreements on specific issues can raise a new issue if he finds those conditions present. That would likely be an incredibly rare case unless the Appeals Officer were to do a sufficient investigation into the presence of the conditions. The IRM goes farther than this and says that

Consistent with this new policy statement, the IRS has revised its instructions to Appeals Officers in various contexts – including Collection Due Process, Offers in Compromise, Collection Appeals Program, and Examination Cases.¹⁵⁶⁰ I focus on Examinations. Key facets of the instructions for examinations appeals are:¹⁵⁶¹

- Appeals will not raise new issues or reopen issues closed in Examination.¹⁵⁶²
- “A new issue is a matter not raised during Compliance's consideration.”¹⁵⁶³
- “Where, however, Appeals identify “systemic issues” requiring “change or modification to an established procedure, process or operation,” Appeals may notify appropriate officials.¹⁵⁶⁴
- Although Appeals “will not return cases to Examination for further development,” it may return cases to Examination in some cases, including (i) “Appeals discovers potential fraud, malfeasance or misrepresentation of a material fact” or (ii) the taxpayer provides “new information or evidence” or raises on appeal “new issue(s) that the originating function has not considered.”¹⁵⁶⁵ In the latter regard, since the Appeals officer is not conducting an examination, they “ will not take investigative

Mutual concession cases will not be reopened based on action initiated by the Service except when the disposition involved fraud, malfeasance, concealment or misrepresentation of a material fact, an important mistake in mathematical calculation or discovery that a return contains unreported income, unadjusted deductions, credits, gains, losses, etc., resulting from the taxpayer's participation in a listed transaction.

IRM 8.6.1.6 (11-14-2013), New Issues and Reopening Closed Issues.

¹⁵⁶⁰ Some of the instructions are already included in the IRM and some are scheduled for inclusion. Those scheduled for inclusion are discussed in two memoranda as follows:

1. Memo dated 7/2/14 from John V. Cardone, titled Implementation of the Appeals Judicial Approach Culture (AJAC) Project: Examination and General Matters - Phase 2, viewed here:

<http://www.irs.gov/pub/foia/ig/spder/AP-08-0714-0004%20REDACTED%5B1%5D.pdf>.

2. Memo dated 7/2/14 from John V. Cardone, titled Implementation of the Appeals Judicial Approach Culture (AJAC) Project: Collection- Phase 2, with attachment be viewed here:

<http://www.irs.gov/pub/foia/ig/spder/AP-08-0714-0005%5b1%5d.pdf>

¹⁵⁶¹ IRM provisions already implement are cited in the footnotes with a date (the IRM format lists the date included in the IRM). IRM provisions not yet formally adopted but scheduled are not listed with a date. These scheduled IRM provisions are in the memoranda identified in the immediately preceding footnote.

¹⁵⁶² IRM 8.6.1.6 (11-14-2013), New Issues and Reopening Closed Issues.

¹⁵⁶³ IRM 8.6.1.6.1 (11-14-2013), Defining a New Issue.

¹⁵⁶⁴ IRM 8.6.1.6 (11-14-2013), New Issues and Reopening Closed Issues. See also 8.6.1.6.2 (11-14-2013), General Guidelines.

¹⁵⁶⁵ IRM 8.2.1.5, Returning a Case to the Originating Function..

actions or perform analysis of new information or new issues” but must return the case to Examination if appropriate.¹⁵⁶⁶

Basically, under this approach, the job of Appeals Officer is not to investigate but “to appraise the facts, the law, the litigating prospects -- the legal landscape as I call it -- and use his or her judgment to determine the hazards of litigation in a case.”¹⁵⁶⁷

B. Raised by the Taxpayer.

Although there are policy considerations against Appeals raising new issues, there are no such considerations against a taxpayer raising a new issue. If such new issue is “based upon important evidence, such evidence is ordinarily referred to IRS Compliance for verification.”¹⁵⁶⁸ The one exception is that, in a Docketed Appeal, the Appeals Officer must coordinate any new taxpayer-generated issues with the IRS trial attorney and the taxpayer will be required to amend the pleadings to assert the new issue.

VIII. Special Alternative Dispute Resolution-Type Procedures.

A. General.

The general processing of appeals is for the Appeals Officer to review the protest, the agent’s rebuttal (if the agent prepares one), and the portions of the file the Appeals Officer deems appropriate. The Appeals Officer will schedule an appeals conference and such additional conferences as appropriate (in most cases there is but a single appeals conference). The parties (through counsel, if represented) will then negotiate to see if settlement of some or all issues can be achieved.

In this section, I discuss some special procedures within Appeals. Generally, these special procedures are available and make sense only in larger cases. I don’t go into detail on these procedures because the specifics of their implementation will change over time; it is more important that the student be aware that there are such opportunities available short of proceeding through the normal administrative process, with only litigation as the alternative.¹⁵⁶⁹

¹⁵⁶⁶ IRM 8.2.1.8.3, Verification of New Information.

¹⁵⁶⁷ Amy S. Elliott, Phase II of Appeals' Judicial Approach and Culture Project Is in Clearance, 2014 TNT 57-2 (3/25/14)

¹⁵⁶⁸ IRM 8.6.1.6.4 (06-25-2015), Taxpayer Raises New Issue

¹⁵⁶⁹ I am very light on citations for the discussion because this is being prepared just before preparing the 2014 edition for final proofing. I just don’t have time right now. I will remedy that in the next edition.

B. Alternative Dispute Resolution (“ADR”).

Although Appeals functions much like the mediation form of alternative dispute resolution (“ADR”), Appeals is not truly independent. I have noted above some mechanisms designed to insure Appeals' independence (e.g., circumscribing ex parte communications with Examination). Nevertheless, Appeals Officers are still employees of the IRS, a party to the dispute before the Appeals Office. For this reason, the IRS has been testing the mediation form of ADR for several years and has had some success in fact intensive cases such as valuation where legal issues are not critical.

The ADR types employed are arbitration and mediation. In arbitration, the arbitrator makes a final decision. In mediation, the mediator works with the parties to help them reach an agreement to settle the issue(s); the mediator does not make the decision. At the inception, both processes require the agreement of the parties as to the terms (such as the identity or identities of the arbitrator or mediator, who pays for the process, etc.). The parties may agree upon one or more Appeals Officers unrelated to the case or even one or more outside mediators or arbitrators.

The IRS has Appeals mediation and arbitration processes beyond the historical function of the Appeals Officer.¹⁵⁷⁰ They are not useful for most cases. For example, arbitration is generally available only for cases with a limited number of unresolved factual issues. Thus, valuation disputes involving no significant or unresolved legal issues may be good issues for ADR.¹⁵⁷¹ The Appeals mediation process, referred to as the “Post Appeals Mediation,” can be invoked in appropriate cases after the taxpayer and the Appeals Officer have failed to reach agreement as to an issue or issues, but before the Appeals Office closes the case.¹⁵⁷² Issues eligible and ineligible for mediation are listed in the IRM; thus, for example, legal and factual issues are eligible for mediation.¹⁵⁷³

C. Fast Track Settlement (“FTS”) and Mediation Programs (“FTM”).

FTS is an expedited issue resolution program that, after development of a disputed issues in examination, an Appeals Officer may participate at the examination level to mediate the dispute.¹⁵⁷⁴

¹⁵⁷⁰ See generally IRM 8.26.6 Appeals Arbitration Procedures (Non-Collection Cases); and IRM 8.26.5 Post Appeals Mediation (PAM) Procedures for Non-Collection Case, citing Revenue Procedure 2009-44, 2009-40 I.R.B. 462.

¹⁵⁷¹ IRM 8.26.6.3.1 (06-17-2008), Cases/Issues Eligible for Arbitration; IRM 8.26.6.3.2 (06-17-2008), Cases/Issues Not Eligible for Arbitration (noting inter alia that legal issues are not eligible for arbitration).

¹⁵⁷² See IRM 8.26.5 Post Appeals Mediation (PAM) Procedures for Non-Collection Case, citing Revenue Procedure 2009-44, 2009-40 I.R.B. 462.]\]

¹⁵⁷³ IRM 8.26.5.3.3 (08-27-2010), Cases/Issues Eligible for Mediation; 8.26.5.3.4 (10-01-2012), Cases/Issues Not Eligible for Mediation

¹⁵⁷⁴ The FTS is described in the IRM, principally in IRM Chapter 51, Section 4, 4.51.4 LMSB/Appels Fast Track Settlement Program (FTS). The presentation in this section of the text is summarized from that IRM provision.

FTS is usually invoked in large case LB&I, examinations. The examination function retains jurisdiction over the examination, with the Appeals Officer as a mediator to resolve factual and legal differences for issues that are sufficiently developed. The goal is to resolve issues at the lowest possible level. The process is designed to be completed in 120 days (60 days in SB/SE). FTS is best done for all unagreed issues, rather than piecemeal. As noted, the process is usually for LB&I audits, but may be used in the other divisions where smaller cases raised significant issues that might benefit from the program. As with any mediation, the parties (the taxpayer and examination) should have attempted settlement on their own and failed, hence the need for mediation.

FTM is an SB/SE mediation process which appears to functions much as FTS except within SB/SE.¹⁵⁷⁵

D. Rapid Appeals Process (“RAP”).

The RAP is an elective Appeals Procedure (unlike FTS where Appeals participates at the examination level).¹⁵⁷⁶ All parties must agree to the process. The purpose is to settle issues as efficiently and quickly as possible through a mediation type process. Examination, the taxpayer and Appeals participates. (Note, normally, in Appeals outside RAP, examination is not an active participant and, indeed, communications with examination is limited.) Often more than one Appeals officer is assigned to divide up the responsibility for more efficient processing. Decision makers for both examination and the taxpayer must participate.

E. Early Referral.

Normally, the audit is fully resolved, with the taxpayer disputing issues filing a protest to get to Appeals. However, issues get fully developed at various stages of the examination process. Sometimes, it would be more beneficial to the parties to have an early referral of a developed issue to Appeals. In these cases, the taxpayer may request early referral to transfer the developed issues to Appeals while Examination continues to work on undeveloped issues.¹⁵⁷⁷ The IRS is not required to grant the request; there is no appeal if the request is denied.¹⁵⁷⁸ The Early Referral differs from FTS and FTM in that Appeals acquires settlement authority over the issues referred without an effective veto from Examination.

¹⁵⁷⁵ See IRS Publication 3605, Fast Track Mediation.

¹⁵⁷⁶ The RAP is explained in IRM Part 8, Chapter 26 (Alternative Dispute Resolution) Section 11. Rapid Appeals Process (RAP), 8.26.11. The summary in this chapter is drawn from the IRM.

¹⁵⁷⁷ IRM 8.26.4 Early Referral Procedures.

¹⁵⁷⁸ IRM 8.26.4.2 (10-26-2007), Initiating the ER Process.

IX. Settlement in Appeals.

A. Issue by Issue Approach.

Appeals settles cases two ways as suggested in the quote at the beginning of the chapter, which I repeat here to set up the discussion:

A fair and impartial resolution is one which reflects on an issue-by-issue basis the probable result in event of litigation, or one which reflects mutual concessions for the purpose of settlement based on relative strength of the opposing positions where there is substantial uncertainty of the result in event of litigation.¹⁵⁷⁹

Note the “or” in this quote.

Appeals **generally** settles cases on an issue-by-issue basis as stated in the policy statement quoted at the beginning of this chapter.¹⁵⁸⁰ In other words, by way of illustration, assume a \$3,000,000 proposed deficiency based on three adjustments each of which has a tax effect of \$1,000,000. Adjustment 1 is \$3,000,000 of additional income; Adjustment 2 is \$3,000,000 disallowed deduction; and Adjustment 3 is \$1,000,000 of disallowed credit. In Appeals, the taxpayer is protesting all adjustments. The Appeals Officer assesses Adjustment 1 at 50% for the IRS, Adjustment 2 at 15% for the IRS and Adjustment 3 at 70% for the IRS. Although there may be some sparring back and forth, the Appeals Officer may settle as follows: Adjustment 1 by including in income \$1,500,000 (50% of the proposed income inclusion); Adjustment 2 at \$0 denied deduction (because the IRS has a policy of conceding adjustments of less than 20%); and Adjustment 3 by denying \$700,000 of credit (70% of the proposed credit disallowance). The IRS does not approach settlement on a global basis.

If there is no other method of settlement (specifically issue by issue), “Appeals may consider and accept proposals for settlement which are based on a percentage or on a stipulated amount of the tax in controversy.”¹⁵⁸¹ These alternative settlements are called “split issue” settlements.¹⁵⁸²

If there is a proposed penalty on any or all of the proposed adjustments, the Appeals Officer will also address each penalty separately.¹⁵⁸³

In some cases, an issue by issue settlement may not work. In those cases, the IRS can settle other than issue by issue (such as by trading positions). But, in my experience these are rare.

¹⁵⁷⁹ See IRM 8.6.4.1(2) (10-26-2007).

¹⁵⁸⁰ IRM 8.6.4.1 (10-26-2007), Fair and Impartial Settlements per Appeals Mission (“A fair and impartial resolution is one which reflects on an issue-by-issue basis the probable result in event of litigation.”)

¹⁵⁸¹ IRM 1.2.17.1.7 (12-23-1960), Policy Statement 8-48.

¹⁵⁸² Id.

¹⁵⁸³ CC-2004-036 (9/22/04), reproduced at 2004 TNT 186-9.

B. Effecting the Settlement - Form 870-AD.

Settlement with Appeals is usually accomplished in income tax cases by executing a Form 870-AD, Offer of Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and of Acceptance of Overassessment (and in other types of cases by signing an equivalent form with a different number). The title of the Form is the same as the Form 870. However, the “AD” suffix means that it serves a larger purpose than simply waiving the restrictions on assessment. When executed by both sides, the Form 870-AD is supposed to commit the parties to the settlement. The IRS will not reopen the case except for fraud, concealment, misrepresentation or similar conduct,¹⁵⁸⁴ the taxpayer will not seek a refund of any tax paid pursuant to the agreement. The form is a contract and is construed by the courts by using contract interpretation principles.

There is a split of authority among the circuits as to the binding effect of the Form 870-AD. The controversy arises because the only settlement agreement contemplated by the express language of the Code is a **closing agreement** under § 7121 (pp. 476 ff.). A Form 870-AD is not a closing agreement.¹⁵⁸⁵ The question is then whether either of the parties can pursue claims for the year involved after executing a Form 870-AD? Can the taxpayer claim a refund, or the IRS assert additional tax? Since the IRS resource allocation and imperatives to live by its agreement would rarely permit it to pursue a claim for a matter otherwise closed by a Form 870-AD,¹⁵⁸⁶ the issue has come up only in the context of a taxpayer pursuing a claim for refund beyond any refund that might be allowed by the Form 870-AD (which usually asserts a deficiency rather than recognizing a refund). The older cases are not consistent. Some cases held that, since the Form 870-AD is not a settlement in the manner authorized by the Code, the taxpayer is free to pursue by claim for refund any matter he or she wishes for the year. Other cases – lately the trend – applying contract-like analysis hold that contract, equitable estoppel and/or perhaps duty of consistency principles preclude the taxpayer from going around the parties’ expressed intent in the Form 870-AD to close out the year.¹⁵⁸⁷ The IRS synthesized the essence of these holdings by focusing on the equities as to whether the taxpayer knew or should have known of the claim when the Form 870-AD was reached.¹⁵⁸⁸ Thus, as to matters that were actually considered in reaching the settlement or, perhaps which

¹⁵⁸⁴ The events permitting the IRS to reopen require some level of taxpayer culpability except in the case of misrepresentation which does not normally mean culpability. In an analogous context, a court has held that misrepresentation does not require culpability. NPR Invs., L.L.C. v. United States, 740 F.3d 998 (5th Cir. Tex. 2014) (interpreting § 6223(f)).

¹⁵⁸⁵ Some cases refer to the Form 870-AD as an “informal agreement” to distinguish it from the more formal and statutorily authorized closing agreement. Shafmaster v. United States, 707 F.3d 130 (1st Cir. 2013).

¹⁵⁸⁶ In Shafmaster v. United States, 707 F.3d 130 (1st Cir. 2013), the First Circuit said (emphasis supplied): “Even assuming arguendo that an informal IRS settlement such as the Form 870-AD could ever have estoppel effects against the government -- **a proposition of which we are skeptical** -- the Shafmasters' argument would fail.”

¹⁵⁸⁷ See e.g., Kretchmar v. United States, 9 Cl. Ct. 192 (1985); and Ihnen v. United States, 272 F.3d 577 (8th Cir. 2001).

¹⁵⁸⁸ ILM 200738010 (6/5/07), reproduced at 2007 TNT 185-12.

reasonably should have been considered at that time, the Form 870-AD will be binding and foreclose the taxpayer from seeking a refund for the years covered by the Form 870-AD. However, as to matters which were discovered after the settlement by Form 870-AD, the Form 870-AD would not bar the taxpayer from filing a claim for refund.¹⁵⁸⁹ Practitioners should, however, be aware that this synthesis, while satisfying at an equitable level, has not been reached by the courts and may not be; hence there may be an ongoing opportunity or risk in the Form 870-AD; accordingly, all known claims should be dealt with in reaching the settlement behind the Form 870-AD.¹⁵⁹⁰

Because of this potential problem as to which there is no certainty, Appeals Officers are encouraged to consider a formal closing agreement (which requires more work and extra levels of review) if they are concerned that the taxpayer might not abide by the Form 870-AD.¹⁵⁹¹

A related question is whether the IRS would be bound by the Form 870-AD. As a practical matter, since the IRS does intend to be bound and has limited systemic resources to keep looking back, it is hard to contemplate that the IRS would attempt to avoid the intended binding effect of the Form 870-AD. But, the types of arguments that would bind the taxpayer (particularly estoppel) may not apply with the same force to the IRS. One court has expressed skepticism that the Form 870-AD could be binding on the IRS, particularly if the claim is some type of estoppel rather than the terms of the Form 870-AD.¹⁵⁹² Thus, at least in terms of estoppel, there may not be a reciprocal application.

Note, however, that if either the IRS or the taxpayer desires not to totally close out the year but to reserve one or more issues, they can do so by expressly stating the reservation on the “contract” – i.e., the Form 870-AD. This is not a solution for later discovered matters, but is a solution for known matters. Of course, as to a known matter, it should be on the table, discussed and resolved in the settled resulting in the Form 870-AD if that is possible. And, if the taxpayer does file a refund as to the reserved unsettled issues in the Form 870-AD, although the settled issues will

¹⁵⁸⁹ Presumably, in this narrow circumstance, the matters actually settled in reaching the Form 870-AD would be binding and only “new” matters considered in determining whether the taxpayer is entitled to a refund. Since the IRS could, under this scenario, also raise new matters to offset the claim and even assert a new deficiency, taxpayers recognizing this problem may try to time their filing of the claim for refund (which clearly signals their attempt to avoid the Form 870-AD), when the IRS still has time to make an assessment but administratively would likely not be able to do so in the time remaining. See Raby, The Finality of Settlements with the IRS, 2001 TNT 235-43 (12/6/01).

¹⁵⁹⁰ Furthermore, clarity as to matters affected by the Form 870-AD should be considered and, if possible, dealt with in the Form 870-AD. For an interesting case where the Form 870-AD was found to be ambiguous as to a related item (thus permitting extrinsic evidence as to the interpretation of the Form 870-AD), see Schortmann v. United States, 82 Fed. Cl. 1 (2008).

¹⁵⁹¹ IRM 8.6.4.5.3 (10-15-2005), Closing Agreement Form 866 and Form 906.

¹⁵⁹² Shafmaster v. United States, 707 F.3d 130 (1st Cir. 2013).

remain settled (barring fraud, etc.), the IRS can consider the settled issues in determining whether the taxpayer is entitled to a refund on the reserved, unsettled issues.¹⁵⁹³

¹⁵⁹³ CCA 2011120714125 (12/7/11) (concluding that such reconsideration is not a reopening (citing Rev. Proc. 2005-32, 2005-1 C.B. 1206) and going back to settled law that the issue on a refund is whether the taxpayer overpaid the tax for the year, as to which the IRS can consider everything (even previously settled issues) bearing on whether there was an overpayment (citing Lewis v. Reynolds, 284 U.S. 281 (1932))).

Ch. 11. Notice of Deficiency.

I. The Notice of Deficiency and its Role in the System (A Reprise).

A. General.

The notice of deficiency will be issued after the audit if the taxpayer does not pursue appeals or after the Appeals Office consideration if the taxpayer does appeal and settlement is not reached in Appeals.¹⁵⁹⁴ The notice of deficiency is issued under § 6212. In the notice of deficiency, the IRS must notify the taxpayer that the IRS believes (i) that there is a deficiency, identifying the type of tax and period involved, and (ii) that the taxpayer has a right to bring suit in the Tax Court before assessment and payment. § 6213(a). The taxpayer has 90 days from the date of the notice of deficiency in which to petition the Tax Court, hence the notice of deficiency is often referred to as a 90-day letter. This period is extended to 150 days if the notice is “addressed to a person outside the United States.”¹⁵⁹⁵

B. What is a Notice of Deficiency?

1. A Deficiency.

Section 6211 defines a deficiency. For present purposes, a deficiency is the taxpayer's correct tax liability less the amount the IRS has previously assessed. Usually, the previous assessment is the amount the taxpayer reported on his or her return.¹⁵⁹⁶ The definition can be a little more complex than that, but for most of the situations you encounter, the only critical components will be the correct tax liability as determined by the IRS less the amount assessed pursuant to the taxpayer's reporting of the liability on his or her original or amended returns. Where the taxpayer files no return, the deficiency will be the correct amount of the tax as determined by the IRS less any tax the taxpayer has paid (e.g., via withholding).

¹⁵⁹⁴ As noted above, if settlement is reached in appeals and a deficiency is agreed upon, the settlement will be reflected in a Form 870-AD which will permit the IRS to make an assessment without issuing a notice of deficiency.

¹⁵⁹⁵ § 6213(a). The quoted language, as applied, is not quite so straightforward as might otherwise be assumed. See Smith v. Commissioner, 140 T.C. 48 (2013), reviewed opinion (discussing many of the nuances in the application of this text which the majority found to be ambiguous, but holding generally that “the critical inquiry has generally been whether the taxpayer fell within the categories of taxpayers Congress intended to benefit: foreign residents or U.S. residents temporarily absent from the country.”). Thus, as interpreted, a foreign resident will qualify for the 150 day period even if that person is in the U.S. on the day the notice of deficiency is mailed or delivered. The Smith majority holding drew vigorous dissents because of the unique facts.

¹⁵⁹⁶ A so-called substitute for return prepared by the IRS under § 6020(b) is not the equivalent of a return for this purpose. Spurlock v. Commissioner, 118 T.C. 155 (2002).

2. The Notice.

a. The Determination and Explanation.

The IRS is authorized to issue a deficiency notice “If the Secretary determines that there is a deficiency.” § 6212(a). The notice of deficiency should “describe the basis for, and identify the amounts (if any) of, the tax due, interest, additional amounts, additions to the tax, and assessable penalties included in such notice,” § 7522(a). Frequently, the notice of deficiency will be somewhat sparse in its explanation, but usually the taxpayer will have been given an agent’s report that explains the IRS position. And, in any event, the same statute provides: “An inadequate description under the preceding sentence shall not invalidate such notice.”

b. Procedural Requirements.

(1) The Date to File a Petition.

The 1998 Restructuring Act imposed a requirement that the notice of deficiency state the latest date for the taxpayer to file the Tax Court petition.¹⁵⁹⁷ The provision is not codified into the Code. It is still the law, however. The courts have held that the IRS’s failure to meet this requirement does not render the notice of deficiency fatally defective,¹⁵⁹⁸ so a taxpayer actually receiving the notice within the ninety day period takes a substantial risk if he or she does not file the petition timely.¹⁵⁹⁹

(2) Notice of Taxpayer Advocate’s Contact Information.

The notice should advise the taxpayer of the right to contact the Taxpayer Advocate's Office and the location and phone number of the office. § 6212(a). The IRS's form has been changed to meet this requirement, so it is unlikely that it will not be met. If and when this notice is not given,

¹⁵⁹⁷ § 3463(a) of the 1998 Restructuring Act. Though not codified, this section of the statutes at large has the force of law. 1 U.S.C. § 112.

¹⁵⁹⁸ Fatally defective in this sense would mean that, if it were not a notice of deficiency, the Tax Court would have no jurisdiction but, more importantly, the IRS would not have met the requirement of § 6213(a) that a notice of deficiency precede the assessment of the tax and the suspension statute of limitations under § 6503(a)(1) would not apply. If that were the consequence, of course, the statute of limitations may well have expired before the IRS has time correct the problem.

¹⁵⁹⁹ Rochelle v. Commissioner, 116 T.C. 356 (2001), aff’d 293 F.3d 740 (5th Cir. 2002) (timely petition not filed); Smith v. Commissioner, 114 T.C. 489 (2000), aff’d 275 F.3d 912 (10th Cir. 2001) (timely petition filed); and Elings v. Commissioner, 324 F.3d 1110 (9th Cir. 2003) (timely petition filed).

the Courts are split as to whether the notice is valid, depending upon the courts' assessment of whether the defendant is harmed by the failure to give the notice.¹⁶⁰⁰

(3) The Last Known Address Requirement.

The notice must be sent by certified or registered mail to the taxpayer's last known address. § 6212(a) & (b).¹⁶⁰¹ The Code does not require the taxpayer to actually receive the notice of deficiency.¹⁶⁰² The Fifth Circuit explained the rationale for this rule as follows:

[t]he statutory scheme . . . provides a method of notification which insures that the vast majority of taxpayers will be informed that a tax deficiency has been determined against them without imposing on the Commissioner the virtually impossible task of proving that the notice actually has been received.¹⁶⁰³

What if the notice of deficiency is returned to the IRS so that the IRS has actual notice that the taxpayer did not receive it? Consider the following:

¹⁶⁰⁰ Compare John C. Hom & Assoc. v Commissioner, 140 T.C. 210 (2013) (notice valid; no prejudice) and Marangi v. Government of Guam, 319 F.Supp. 2d 1179, 1184 (D. Guam 2004) (notice invalid; taxpayer prejudiced).

¹⁶⁰¹ The Government may also send a duplicate mailing by registered mail. See the following in Pagonis v. United States, 575 F.3d 809, 813 n. 2 (8th Cir. 2009) (emphasis supplied): Counsel for the government represented at oral argument that the IRS now goes beyond the requirements of § 6212 and **also** sends a notice to the taxpayer by regular mail. Counsel stated that this practice has been in effect since 2001 and is set forth in a Revenue Procedure, albeit one that has not been cited in the briefs.

¹⁶⁰² See e.g., Keado v. United States, 853 F.2d 1209, 1211 (5th Cir. 1988) (“Code does not require that the taxpayer receive the notice of deficiency”); Pomeroy v. United States, 864 F.2d 1191, 1992 (5th Cir. 1989) (“The relevant statutes simply require that the deficiency notice be mailed to the taxpayer's last known address, not that it be received.”). In Pagonis v. United States, 575 F.3d 809, 815 (8th Cir. 2009), the taxpayer attacked the system because, she alleged, she did not receive the notice of deficiency. Without receipt of the notice, she alleged, the assessment was like a seizure without due process. The Court responded:

This case, however, concerns the IRS's assessment of a tax deficiency, which is “little more than the calculation or recording of a tax liability.” Galletti, 541 U.S. at 122 [United States v. Galletti, 541 U.S. 114, 122-23 (2004)]; see 26 U.S.C. § 6203. Jones [Jones v. Flowers, 547 U.S. 220 (2006)] does not require additional efforts at notice before the government establishes a tax deficiency, because no deprivation of property has occurred.

We shall cover below the limited effect of the assessment as a recordation of a tax liability and predicate action to permit use of collection tools, such as levy, but the assessment itself is simply an assessment and not a levy. Jones-type issues may be presented in how the IRS uses its collections tools, but the assessment itself does not present those issues.

¹⁶⁰³ Jones v. United States, 889 F.2d 1448, 1450 (5th Cir. 1989).

Another question in this case is whether the IRS should have exercised diligence and located an additional address for petitioner after the statutory notice of deficiency was returned undelivered. Whether the Commissioner has exercised reasonable care and diligence is a question of fact. The relevant facts are those known before the notice of deficiency was mailed, such as return of letters sent to the taxpayer on earlier dates. In Pomeroy v. United States, 864 F.2d 1191, 1195 (5th Cir. 1989), the Court of Appeals for the Fifth Circuit stated: “The relevant statutes simply require that the deficiency notice be mailed to the taxpayer's last known address, not that it be received.” The Code does not require re-mailing the notice, and nothing in the statute suggests that respondent would be obligated to take additional steps to effectuate delivery if the notice is returned. A notice that is returned undelivered is still valid as long as it was sent to the last known address. Thus, respondent was not required to investigate further when the notice of deficiency was returned undelivered..¹⁶⁰⁴

Obviously the key to the system is the requirement to send¹⁶⁰⁵ to the last known address. The Code does not define last known address, but the Regulations based on the substantial case authority in this area does deal in some detail with the last known address requirement.¹⁶⁰⁶

Why is the last known address requirement so important? The notice of deficiency is the jurisdictional prerequisite to the Tax Court in most cases. If the taxpayer does not receive the notice or does not receive it timely, the taxpayer cannot file a timely petition in the Tax Court, and this historic legal predicate to a prepayment judicial remedy will fail simply because the IRS will then assess and require payment because no timely petition was filed to continue § 6213(a)'s prohibition on assessment. Accordingly, Congress imposed the requirement that the IRS send to the taxpayer's last known address so as to increase the likelihood – but not the certainty – that the taxpayer will actually receive the notice. (Caveat: Under CDP provisions enacted in 1998, a taxpayer not actually receiving the notice of deficiency may be able to obtain a CDP litigation remedy without first paying; I discuss that remedy in Chapter 14 dealing with Collection Procedures.)

We have an increasingly mobile society, however, and taxpayers on the move – particularly in between return filings – are at risk that the IRS may not know their addresses. What happens, for example, if a taxpayer is dealing with a Revenue Agent from an address and then, prior to completion of the audit, moves without telling the Agent? So far as the Agent's files show, the last known address is the old address. Will sending the notice there suffice? What happens if, in the interim, the taxpayer filed the most current return showing the old address, so that even a check of the current year return would not show the new address? What if the most current return showed the new address? There have been many cases over the years addressing these and related issues.

¹⁶⁰⁴ Blocker v. Commissioner, T.C. Memo 2005-279 (most case citations omitted).

¹⁶⁰⁵ As to the types of proof required for the IRS to meet the requirement that the notice of deficiency be sent, see O'Rourke v. United States of America, 587 F.3d 537, 541-542 (2d Cir. 2009).

¹⁶⁰⁶ Regs. § 6212-2.

Bottom line, given the importance of the notice of deficiency and the last known address requirement in assuring that generally a taxpayer will receive the notice, the courts have required the IRS to check its most recent computer records to determine the last known address. The IRS has incorporated the requirements of the cases and added some procedures designed to insure that the notice is sent to a good address. Generally, the last known address will be the address on the taxpayer's latest properly filed and processable tax return.¹⁶⁰⁷ Shortly after receipt of a return, the IRS will compare the address to the address in its master computer database and, if the address is different, will enter into the computer system the address on that return as its master address. The IRS office that issues notices of deficiency section will access the master database to determine that last known address.

There are exceptions. First, the last known address will be another address if the taxpayer provides clear and concise notification after the date the last return was filed.¹⁶⁰⁸ The Regulation cites Rev. Proc. 90-18 (1990-1 C.B. 491) for the requirements of such clear and concise notification.¹⁶⁰⁹ Second, the IRS periodically coordinates with certain Postal Service databases to determine if a taxpayer has changed addresses from the one used on the last filed tax return and to correct IRS records accordingly.¹⁶¹⁰

In addition, there are other ways that might constitute notice to the IRS of a change of address.¹⁶¹¹ The Courts have thus held that the taxpayer's address on a power of attorney, Form 2848, that is different than the previous last known address (determined under the foregoing rules) will be deemed the last known address.¹⁶¹²

The IRS still makes mistakes in this area. It may fail to check the master database (although that is becoming less frequent), it may do an improper check, or some other failure in the system causes the mailing to be to an address other than the "last known address." In that case, the notice of deficiency is invalid and any ensuing assessment is invalid.

¹⁶⁰⁷ Regs. § 301.6212-1(a).

¹⁶⁰⁸ Id.

¹⁶⁰⁹ See Rev. Proc. 2010-16, 2010 IRB 664; 4.8.9.8.2.1 (07-09-2013), Last Known Address. The IRS does provide Form 8852 where the taxpayer can provide notice of a change of address.

¹⁶¹⁰ Regs. § 301.6212-1(b). See Rev. Proc. 2010-16, supra; and IRS PMTA 2012-028 (11/19/12), reprinted 2013 TNT 168-25. The databases are National Change of Address ("NCOA") and Address Correction System ("ACS"). The PMTA notes that NCOA updates are received weekly and noting that the IRS is exploring alternative ways to interface with the Postal Service system, including use of ACS).

¹⁶¹¹ IRM 4.8.9.8.2.5 (07-09-2013), Establishing the "Last Known Address," providing steps that the agent should follow to verify the last known address.

¹⁶¹² Hunter v. Commissioner, T.C. Memo 2004-81 (discussing cases). 4.8.9.8.2.5 (07-09-2013), Establishing the "Last Known Address," requires that the agent inter alia "scrutinize the power of attorney for a different address."

The IRS does require that, in the event of uncertainty as to the last known address, duplicate notices to all possible last known addresses be sent.¹⁶¹³

There is one exception to the invalidity of the improperly addressed notice of deficiency. The courts have held that, even if the address would otherwise fail the last known address requirement, if the taxpayer actually or constructively receives the notice within sufficient time to petition the Tax Court, then the notice of deficiency will not fail.¹⁶¹⁴ Technically, § 6212(b) seems to command that an improperly addressed notice of deficiency fails. But, in an extrapolation of the statute grounded in the purpose of the notice of deficiency, the courts have held that actual in-time receipt gives the taxpayer the protection afforded by the notice of deficiency requirement and suffices. What is adequate time to file the petition? The Tax Court explained some of the parameter as follows:

In general, we have held that when a notice of deficiency is actually received by the taxpayer with at least 30 days remaining in the filing period, the taxpayer had sufficient time to petition this Court for review. [Citing cases where the days remaining after actual receipt were: 74, 69, 60, 52, 45, 30, and 30.]

However, when a notice was received with only 17 days remaining in the filing period, we held that the taxpayer had insufficient time to petition this Court. Similarly, the Court of Appeals for the Eleventh Circuit held as a matter of law that receipt of a notice of deficiency with only 8 days remaining in the filing period was insufficient to permit the timely filing of a petition.¹⁶¹⁵

Let's explore this issue in a little more detail, however. I set up this discussion by using examples:

Example 1: Taxpayer files his Year 1 return on April 15 of Year 2. The normal three year statute of limitations applies, making the last day the IRS may assess April 15 of Year 5. On January 1 of Year 5, the IRS sends Taxpayer a notice of deficiency but sends it to an address other than Taxpayer's last known address within the meaning of § 6212(b). The IRS also sends a copy of the notice to Taxpayer's attorney who represented Taxpayer in the audit. Taxpayer's attorney, being a careful sort, routinely forwards a copy of his copy to Taxpayer at this correct address. On February 1 of Year 5, Taxpayer receives a copy of the notice from his attorney.

¹⁶¹³ IRM 4.8.9.8.2.1 (07-09-2013), Last Known Address.

¹⁶¹⁴ E.g., St. Joseph Lease Capital v. Commissioner, 235 F.3d 886 (4th Cir. 2001); Erhard v. Commissioner, 87 F.3d 273, 274 (9th Cir. 1996) (notice of deficiency is valid if “the taxpayer actually receives the notice, regardless of where the IRS mails the notice”); Scheidt v. Commissioner, 967 F.2d 1448, 1450-1451 (10th Cir. 1992); Borgman v. Commissioner, 888 F.2d 916, 917 (1st Cir. 1989). See Sarkassian v. Commissioner, T.C. Memo. 2012-278 for a good synthesis of cases finding timely actual or constructive receipt sufficient even if the notice was not sent to the last known address.

¹⁶¹⁵ Kuykendall v. Commissioner, 129 T.C. 77 (2007) (case citations omitted).

In Example 1, the taxpayer does receive the notice in time to file a petition. In the discussion above, I cited cases holding that the notice will be deemed valid in that case. Only if the taxpayer does not receive the notice of deficiency in reasonable time to petition the Tax Court will the notice be deemed invalid and therefore incapable of meeting § 6213(a)'s requirement that a notice of deficiency precede the assessment. Note in this regard that § 6213(a) requires that before the IRS may assess it must first issue a notice meeting the requirements of all of § 6212 which includes the requirement in § 6212(b) that the notice be sent to the last known address.

Example 2: This example is the same except that the notice is sent toward the end of the three year period. Taxpayer files his Year 1 return on April 15 of Year 2. The normal three years statute of limitations applies. On April 14 of Year 5, with one day remaining on the assessment period, the IRS sends Taxpayer a notice of deficiency but sends it to an address other than Taxpayer's last known address within the meaning of § 6212(b). The IRS also sends a copy of the notice to Taxpayer's attorney who represented Taxpayer in the audit. Taxpayer's attorney, being a careful sort, routinely forwards a copy of his copy to Taxpayer at his correct address. On May 15 of Year 5, Taxpayer receives the copy of the notice forwarded by his attorney. On July 1 of Year 5, the Taxpayer petitions the Tax Court and promptly moves the Tax Court to dismiss the petition on the basis that, because no valid notice of deficiency was issued (i.e., it was not mailed to the last known address), no valid assessment could be made and therefore the Tax Court proceeding was moot.

The key difference between Example 2 and Example 1 is that Example 2 requires also an extension of the statute of limitations under § 6503(a). Should there be a different result -- i.e., should the taxpayer who receives a notice of deficiency in time to petition the Tax Court timely be able to assert that the statute of limitations was not extended because the notice of deficiency is invalid? The courts addressing this issue have held that, if the notice is valid by virtue of its actual receipt in time to petition the Tax Court, it is valid for purposes of extending the statute of limitations under § 6503(a).¹⁶¹⁶

c. Explanation of the Basis for the Deficiency.

As noted above, the deficiency notices must describe the basis for the deficiency but failure to do so will not invalidate the deficiency. Thus, the taxpayer appears to have a statutory right to the information in the notice of deficiency, but no statutory remedy if he does not receive it in the notice of deficiency. As we note, however, there may be some remedies short of invalidity of the notice for failure to meet this requirement of § 7522(a).

Usually, there will be some explanation. It may be summary or even cryptic because the determination usually follows an audit in which the taxpayer participated and was aware of the issues the IRS was raising. Indeed, in such cases, usually the taxpayer will have been provided some type of report (often referred to as a Revenue Agent's Report ("RAR")) that explains the proposed

¹⁶¹⁶ St. Joseph Lease Capital Corp. v. Commissioner, 235 F.3d 886, 888-889 (4th Cir. 2000); Scheidt v. Commissioner, 967 F.2d 1448, 1450-51 (10th Cir. 1992).

adjustments. But again, although the Code provides that the taxpayer be notified of the basis for the deficiency, there is no Code remedy if one is not provided.

Where the IRS satisfies the Code requirement of an explanation, there are some practical pressures to force the IRS to make it a reasonably good explanation. As noted above, the statute does require that the IRS determine a deficiency. One court has held that where the notice of deficiency explains the deficiency based on facts that patently do not exist for the taxpayer, then the IRS has not met the requirement that it make a deficiency determination. In that case, Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987), the notice of deficiency said that it was disallowing a deduction for certain tax shelter partnership items with respect to a named partnership. The taxpayer was not a partner in the named partnership. The taxpayer was a partner in a tax shelter partnership with another name, and it is likely that the IRS just plugged in the wrong name on the notice of deficiency. Moreover, the notice of deficiency indicated that the IRS had not actually examined the taxpayer's return but just calculated the tax proposed in the notice at the highest marginal rate rather than the progressive income tax rates. The Ninth Circuit held that, on these facts on the face of the notice of deficiency, the IRS had made no determination as required by § 6212. The result was that the notice of deficiency was invalid. The invalidity of the notice of deficiency meant that the statute of limitations on assessment was not suspended under § 6503 and, by the time the IRS realized the error (i.e., when the Court of Appeals pronounced the notice invalid), the statute of limitations on assessments had likely expired. Cases since Scar have read the holding narrowly; a notice of deficiency will be not honored "only where the notice of deficiency reveals on its face that the Commissioner failed to make a determination."¹⁶¹⁷ As a result, Scar is an outlier, with its analysis and holding rarely invalidating a notice of deficiency.

There is still another incentive on the IRS to provide an explanation for the notice of deficiency. Even where a court is unable to find as the case discussed in the prior paragraph that the notice of deficiency is so deficient (pardon the pun) that the notice is invalid, the IRS's failure to provide an explanation or its providing of a poorly worded explanation may force on the IRS the burden of proof when in the course of Tax Court litigation it sharpens its focus in a way that might

¹⁶¹⁷ Clapp v. Commissioner, 875 F.2d 1396, 1402 (9th Cir. 1989); Kantor v. Commissioner, 998 F.2d 1514, 1521-1522 (9th Cir. 1993); Meserve Drilling Partners v. Commissioner, 152 F.3d 1181, 1183 n.3 (9th Cir. 1998); and Campbell v. Commissioner, 90 T.C. 110, 112-113 (1988). For good discussions of the narrow limits of Scar, see Anderson v. Commissioner, T.C. Memo. 2009-44 (holding notice of deficiency valid although it relied on bare allegations in a criminal tax evasion indictment; dismissal avoided even though the notice of deficiency did not have the benefit of the underlying grand jury records because Rule 6(e), F.R.Cr.P., prohibited them from disclosure to the IRS at the time the notice of deficiency was issued). The court distinguished Scar as a case in which the IRS facially had not made the required determination, whereas in Anderson the IRS clearly had made the precise determination contained in the notice (albeit, perhaps, without the underlying support); and Cross v. Commissioner, T.C. Memo. 2012-344 (sustaining adjustments made without a review of the return itself but a review of the IRS's RTVUE transcript which is a computerized record of the information which is input at the Service Center when the return is originally received and processed; see Whittington v. Commissioner, T.C. Memo. 1999-279).

be considered “new matter” because the notice of deficiency did not fairly put the taxpayer on notice. Note that, although this “new matter” issue may put an incentive on the IRS to be inclusive in the notice or perhaps to use broad language that may not be helpful, counterbalancing that incentive is the concern that the IRS may be so inclusive or broad that a Court might hold that it has not made a determination and invalidate the notice of deficiency altogether.

The Tax Court has held that, although there is no statutory remedy for violating § 7522(a), the Court would in fairness impose a procedural one that any position relied upon by the IRS that is not described in the notice will be treated as new matter upon which the IRS bears the burden of persuasion.¹⁶¹⁸ In effect, the Court simply imposed its historic position on new matters raised by the IRS to positions which were taken but not adequately described in the notice of deficiency.

d. Consequences of Invalidity of the Notice.

If the notice of deficiency is invalid or never sent for any reason, any assessment requiring a notice as a predicate is likewise invalid. This means, for example, if the taxpayer did not receive the notice of deficiency because it was not sent to the last known address, he can assert that a subsequent assessment is invalid.

How does the taxpayer do that? First, he can ask the IRS kindly to abate the assessment because the notice was invalid. Second, if the IRS refuses to abate or does not act timely, the taxpayer has judicial options.

- The taxpayer can pursue two avenues for Tax Court review. The avenue traditionally pursued is for the taxpayer to file a petition in the Tax Court after the 90 day period has expired. There is no statutory authority for this. The Tax Court filing procedure then has the following procedural steps: (i) the taxpayer moves to dismiss the petition for lack of jurisdiction because the notice of deficiency was not valid; (ii) the IRS moves to dismiss because the petition was not timely filed; and (iii) the court dismisses and, if it bases the dismissal on the invalidity of the notice of deficiency, the IRS must issue a new notice of deficiency if the deficiency statute of limitations is still open.¹⁶¹⁹ The taxpayer can alternatively await a collection action that invokes the Collection Due Process (“CDP”) procedure that offers an administrative appeals-type review and, failing satisfaction administratively, permits Tax Court review.¹⁶²⁰

¹⁶¹⁸ Shea v. Commissioner, 112 T.C. 183 (1999).

¹⁶¹⁹ For examples showing the Tax Court procedural moves of cross-motions for dismissal and their consequences, see Edwards v. Commissioner, ___ F.3d ___, 2015 U.S. App. LEXIS 10323 (D.C. Cir. 2015) (remanding so that the Tax Court could state in the final order of dismissal on which basis it dismissed); and Estate of Rule v. Commissioner, T.C. Memo. 2009-309.

¹⁶²⁰ I discuss the CDP Procedure below beginning on p. 657, but a case recognizing this procedure is Hoyle v. Commissioner, 131 T.C. 197 (2008).

- The taxpayer may file an injunction suit in the district court because both (i) § 6213(a) so provides and (ii) the general anti-injunction statute, § 7421(a) expressly excepts § 6213(a) from its scope. Either way, the taxpayer if successful obtains a judicial determination that the notice of deficiency was not valid, thus invalidating the assessment predicated on a valid notice of deficiency.
- The taxpayer can pay the tax and sue for refund to test whether the notice of deficiency and resulting assessment were valid.
- The taxpayer can do nothing and, if able to avoid payment until the Government feels it must file a collection suit, contest the validity of the assessment in the collection suit.

Merely having an invalid notice will not necessarily carry the day for the taxpayer. In order to win, the statute of limitations on assessment must have expired by the time the IRS becomes aware of the problem. If the statute is still open when the IRS learns of the problem, the IRS can simply issue a new notice of deficiency.¹⁶²¹ I previously discussed through the rules for the statute of limitations, and you should be able to figure out the statute of limitations.

For another wrinkle, consider what would happen if the taxpayer extended the statute of limitations with Form 872-A, the unlimited extension. You will recall that this extension is terminated only in one of three ways. In this circumstance, if the notice of deficiency had been valid, it would have terminated the statute of limitations as prescribed in Form 872-A. However, I have posited here that the notice of deficiency is not valid because not sent to the last known address, so the unlimited extension has not been terminated. What is the taxpayer to do? Well, he could send in the termination form, Form 872-T, but if he does that while the 90-day Tax Court petition is due, that might suggest that the taxpayer was aware of the invalid notice of deficiency in time to petition the Tax Court. The taxpayer could send the Form 872-T in when he receives the notice of assessment, because by then he should have some idea that the notice may not be valid and, when the IRS receives the Form 872-T, it will check and see that the tax has been assessed and may think no more of it. It is not at all certain that the mere receipt of a Form 872-T after assessment will alert the IRS to potential problems in the notice of deficiency. The taxpayer can then pursue the remedies noted above.

¹⁶²¹ For a cautionary discussion about using the alternative to file a Tax Court petition and move to dismiss, see Andy R. Roberson and Kevin Spencer, 11th Circuit Allows Invalid Notice to Suspend Assessment Period, 136 Tax Notes 709 (Aug. 6, 2012) where the statute of limitations is still open on the date the Tax Court petition is filed. In the case there discussed, Shockley v. Commissioner, 686 F.3d 1228 (11th Cir. 2012), the Eleventh Circuit held that a Tax Court petition filed in response to an invalid notice of deficiency will have the effect of suspending the statute of limitations as of the date the petition is filed. Thus, before filing the petition, the taxpayer will want to make sure the statute has closed.

3. Prohibition on Assessment.

a. General - No Assessments.

If the taxpayer decides to litigate in the Tax Court, the IRS is prohibited from assessing (except in certain jeopardy cases under § 6861) while the litigation in the Tax Court is proceeding. If the taxpayer does not litigate in the Tax Court, the IRS will make the assessment after the 90 (150) day period expires.

b. Exceptions to Prohibitions on Assessment.

Section 6213(b) contains certain exceptions to the prohibition on assessment contained in § 6213(a). The principal ones you will encounter are: (1) mathematical or clerical errors on the return may be assessed despite the prohibition;¹⁶²² (2) improper carrybacks that have previously resulted in refunds may be assessed despite the prohibition;¹⁶²³ (3) amounts paid as a tax may be assessed despite the prohibition;¹⁶²⁴ and (4) amounts imposed as restitution for tax in a criminal tax case may be assessed despite the prohibition.¹⁶²⁵

4. Effects of Prepayments and Deposits on Notices.

I noted earlier that interest accrues on deficiencies from the date of the return. During the course of an audit, taxpayers will sometimes want to stop that interest from running. We also noted that the taxpayer can stop the accrual of interest by sending in an advance payment or a deposit. If the taxpayer sends in a deposit to stop the running of interest, there will still be a deficiency because the taxpayer has not made a payment on the tax liability and the IRS will be required to issue a notice of deficiency which will give the taxpayer the option of litigating in the Tax Court. The deposit mechanism simply stops the accrual of interest to the extent of the deposit. However, if in advance of the IRS's issuance of a notice of deficiency, that taxpayer sends a payment that fully covers the deficiency, the payment will be assessed immediately;¹⁶²⁶ there will thus be no deficiency

¹⁶²² § 6213(b)(1).

¹⁶²³ § 6213(b)(3).

¹⁶²⁴ § 6213(b)(4).

¹⁶²⁵ §§ 6401(a)(4) & 6213(b)(5), as added by P.L. 111-237, effective August 16, 2010. There is a twist here to keep in mind. Normally restitution is not available for Title 26 offenses. However, courts may impose restitution if a Title 18 offense, such as the ubiquitous *Klein* / defraud conspiracy under 18 U.S.C. 371(a) is involved. Equally commonly, in tax cases, in pleading guilty, a defendant often agrees to “contractual” restitution in the plea agreement that the sentencing court then incorporates as a restitution order in the criminal judgment. The net effect of this exception is to preclude the issuance of a notice of deficiency. A taxpayer wishing to litigate the tax liability underlying the restitution order will thus be forced to do so by refund suit, but in the author’s experience, the restitution amount is usually a solid amount for which the taxpayer likely could not successfully contest.

¹⁶²⁶ § 6213(b)(4).

and no notice of deficiency. The taxpayer making full payment of the deficiency thus will be precluded from litigating in the Tax Court because, as we have noted, the notice of deficiency is the jurisdictional prerequisite.

However, once the IRS issues the notice of deficiency, the taxpayer can then make full payment without foreclosing his Tax Court remedy.¹⁶²⁷

5. Rescinding Notices of Deficiency.

With the consent of the taxpayer, the IRS may rescind a notice of deficiency.¹⁶²⁸ The IRM cautions IRS personnel to consider the unique facts and circumstances, particularly the statute of limitations implications, in each case.¹⁶²⁹ The IRM provides bases for rescission in three categories – (1) administrative error (such as notice issued to wrong taxpayer, for wrong period or prematurely); (2) incorrect or insufficient amount; and (3) “an appeals conference is requested in a 90-day case and no petition was mailed or filed with Tax Court.”¹⁶³⁰ The last alternative is further explained:

4. If a taxpayer specifically requests a conference with Appeals for the purpose of entering into settlement negotiations, the notice may be rescinded. However, the notice will be rescinded only if Appeals is confident the case will result in an agreement. Appeals may request that the taxpayer submit, in writing, a protest or similar document that explains his or her position on the unagreed issues. See IRM 8.4.1, Processing Docketed Cases, for further 90-day case procedures.¹⁶³¹

Practitioners will recall that, a matter not previously having Appeals Office consideration, generally gets transferred to the Appeals upon filing the petition in the Tax Court. Hence, this last reason to rescind the notice may not be of practical significance when there is still time to file the petition in the Tax Court. However, the language is so cryptic that it might conceivably permit the rescission if the taxpayer has failed to file the petition in the Tax Court in the 90-day period.

6. Second Notices of Deficiency.

Section 6212(c)(1) bars the IRS from issuing a second notice of deficiency, except in the case of fraud, if the IRS has mailed a notice of deficiency **and** the taxpayer has petitioned the Tax Court. Section 6512(a) provides, in effect, that the Tax Court proceeding is preclusive as to credit or refund claims that the taxpayer may make. In the case of the income tax, these prohibitions generally close out the year once except to effect the decision that is entered by the Tax Court; the

¹⁶²⁷ § 6213(b)(4).

¹⁶²⁸ § 6212(d). The IRS Form used for rescinding a notice is Form 8626.

¹⁶²⁹ IRM 8.2.2.4 (05-29-2014), Statutory Notice of Deficiency Rescinded Under Rev. Proc. 98-54; IRM 8.2.2.4.1 (05-29-2014), Criteria for Rescinding a Statutory Notice of Deficiency.

¹⁶³⁰ IRM 8.2.2.4.2 (03-09-2012), Basis for Rescission.

¹⁶³¹ IRM 8.2.2.4.2 (03-09-2012), Basis for Rescission.

issue presented to the Tax Court when a petition is filed is whether the taxpayer owes a deficiency, owes nothing or is entitled to a refund. This necessarily requires a determination of the taxpayer's correct tax liability for the year. The Tax Court proceeding thus generally will close out the year under these prohibitions and under principles of res judicata.¹⁶³² Any matter as to which the IRS has concerns after the taxpayer petitions the Tax Court must be raised affirmatively in the answer or, if raised later, in an amended answer if allowed by the Tax Court in the management of its docket.

There are some exceptions to this general rule prohibiting claims for the year. The fraud exception is perhaps the most important. Res judicata for the year (as opposed to an issue resolved) will not bar the IRS from issuing a second notice of deficiency for fraud.¹⁶³³ § 6212(c)(1) ("except in the case of fraud"). Most practitioners will almost routinely advise the taxpayer that the entry of the Tax Court decision will end all matters for the year involved. That is not true for fraud.¹⁶³⁴ As

¹⁶³² See Zackim v. Commissioner, 887 F.2d 455, 458 (3d Cir. 1989). The history of claim preclusion in the predecessor of the Tax Court is interesting. That original predecessor was the Board of Tax Appeals. Prior to 1926, the appeals to the Board of Tax Appeals were not preclusive; either of the parties could present the issue again in appropriate district court actions (such as refund suit or, presumably, collection action). See Hemmings v. Commissioner, 104 T.C. 221, 227-228 (1995) (reviewing this history).

¹⁶³³ § 6212(c)(1); see Zackim v. Commissioner, 887 F.2d 455 (3d Cir. 1989); and Burke v. Commissioner, 105 T.C. 41, 47 (1995).

¹⁶³⁴ Practitioners should at least be curious as to whether the other traditional ways of closing out tax cases will also be subject to some risk that the IRS may seek to open up the year after the closing. Usually, this will be a risk only for fraud because the normal three-year or, where applicable, the six-year statute of limitations will have closed so as to preclude further notices. Fraud has no statute of limitations under § 6501(c)(1). Although there is no refund suit parallel to § 6212(c)(1) that directly denies res judicata / claim preclusion, there seems to be authority that the IRS can issue a notice of deficiency after a refund suit. See Hemmings v. Commissioner, 104 T.C. 221 (1995) (suggesting that there is no such limitation, but holding open the issue that, if the assessment occurred prior to or during the refund litigation, the assessment might be a compulsory counterclaim in the litigation that would foreclose later litigation on the issue). As to administrative closings by way of Form 870-AD and Form 906 Closing Agreement, each of those except from the settlement "fraud, malfeasance or misrepresentation of a material fact." See also § 7121(b). It is not clear whether these exceptions extend only to "fraud, malfeasance or misrepresentation" as inducements for entering of the closing agreement or, on the other hand, can be other "fraud, malfeasance or misrepresentation," specifically in this context a fraudulent return for the year settled in the Form 870-AD or the closing agreement. Certainly, by analogy to § 6212(c)(1), it might be argued that the closing agreement so worded should permit the issues not to be settled, so that, if the issue were still open and the statute of limitations is open (say due to fraud), then the IRS might assert the additional tax and civil fraud penalty. Cf. Hemmings. I have to say that I was concerned that claim preclusion might arise in a civil refund suit that actually determined a refund to be due because, from the bottom-line perspective, no refund could be due if the Government had a valid claim for additional tax. However, given the Hemmings's compulsory counterclaim analysis, that may not be the case.

a practical matter except in the most unusual of cases, the IRS will not revisit the issue of additional liability for a year in which the Tax Court has rendered a decision. Still, § 6212(c)(1) gives the IRS the possibility of doing so, and the careful practitioner who is aware of a potential fraud problem in a year before the Tax Court that the IRS has not spotted should advise the taxpayer of the potential for the IRS pursuing it even after the Tax Court decision is otherwise final.¹⁶³⁵

There are also other exceptions listed in § 6213(b)(1) mathematical errors and for termination and jeopardy assessments. And courts may piggyback an exception in certain cases. For example, a court found that an exception for carry-backs is appropriate even though the year to which the carryback is taken has been decided by the Tax Court.¹⁶³⁶ From a policy and administration perspective, why did the Court reach that result?

C. Non-Deficiency Cases.

Finally, remember that a deficiency is not required in all cases where the IRS determines that the taxpayer owes additional taxes. The notice of deficiency is required only with respect to taxes imposed by subtitles A and B (i.e., income taxes and estate and gift taxes). § 6212(a). This means that the foregoing internal administrative processes (including an opportunity for Appeals Office consideration) could have been followed and, at the end of them, the assessment will be made without a notice of deficiency because the prohibitions on assessment in § 6213(a) apply only to taxes for which a notice of deficiency is required.

This type of non-deficiency notice tax most frequently encountered in private practice is the responsible person penalty tax under § 6672. In non-deficiency notice tax cases, the IRS will proceed to make the assessment and the taxpayer will have refund suit remedies in the district courts or the Court of Federal Claims. (As we will note below, procedures for partial payment are usually provided in order to mitigate the harsh effects -- even due process problems -- that might otherwise be encountered if the taxpayer were required to prepay the entire amount of the tax before having a judicial forum to litigate liability for the tax.)

II. Jeopardy and Termination Assessments.

A. Introduction to the Issues.

The notice of deficiency procedure, where applicable, plays the central role in affording the taxpayer a prepayment litigating forum. The linchpin to the prepayment remedy is § 6213(a)'s prohibition on assessment. The deficiency cannot be assessed until the Tax Court proceedings are concluded, and the IRS cannot take collection measures until the assessment is made. The system

¹⁶³⁵ Indeed, as I note later in this book, most Tax Court decisions are agreed decisions signed by counsel for the parties after the Tax Court has resolved all issues which the parties disputed and could not otherwise resolve. One ethical issue that has been presented is whether counsel can sign an agreed decision when that counsel knew that the decision understates the liability because of some item the IRS did not discover.

¹⁶³⁶ Jefferson Smurfit v. United States, 439 F.3d 448 (8th Cir. 2006).

places ultimate collection at jeopardy, for the taxpayer's financial situation can deteriorate between (i) the tax due date or even the later date that the IRS determines the taxpayer owes additional taxes and (ii) the date, after the Tax Court litigation, that the IRS can then assess and collect. What happens if the IRS determines there are additional taxes due and is aware of circumstances that put ultimate collection at jeopardy?

To put this in some perspective, in our fast moving world, it follows inevitably that there is some risk to the fisc inherent in the prepayment litigation system where assessment and collection is deferred. Any taxpayer's situation can change to impact adversely the IRS's ultimate ability to collect any tax found due. Certainly, if the prepayment remedy is to be effective at all, this risk just must be tolerated in most cases. Quite a different circumstance exists, however, where the taxpayer takes deliberate steps to avoid having assets that the IRS can ultimately collect upon.

Example 1 - after the IRS determines the taxpayer owes more taxes and sends the taxpayer a notice of proposed adjustment (the predicate to a notice of deficiency) the taxpayer liquidates all his assets and prepares to move to a country that will not extradite for tax crimes and will not enforce U.S. tax liabilities in its administrative and judicial systems.

Example 2 - a suspected drug dealer is picked up with \$10,000,000 cash. The Government does not have enough proof to pursue forfeiture under the general criminal laws, and the Government knows that, if the cash is returned to the person, it will not be available to pay any tax liability that may be due.

In both cases and other egregious cases, Congress believed that special assessment and collection measures were appropriate. However, because of the serious Constitutional issues inherent in any process whereby the Government summarily seizes assets,¹⁶³⁷ the Code sets forth elaborate safeguards -- the Government may assess and collect if collections are in true jeopardy (as defined) but the taxpayer must be afforded a virtually immediate right to a judicial review of the bases for the assessments.

B. Jeopardy Assessments.

Section 6861 allows the IRS to make a jeopardy assessment, notwithstanding the prohibition on assessment in § 6213(a), if the IRS determines that assessment or collection “will be jeopardized by delay.”¹⁶³⁸ The safeguards against abuse of this extraordinary power are set forth in § 7429 as follows:

¹⁶³⁷ Commissioner v. Shapiro, 424 U.S. 614 (1976).

¹⁶³⁸ Jeopardy assessments are not the same as “quick assessments,” an internal IRS procedure to implement an assessment when a period of limitations will soon expire. IRM 4.4.25.2.2 (02-08-1999). The predicate acts for jeopardy assessments are not required for quick assessments, but any other statutory predicate to assessment (e.g., notice of deficiency in the case of tax liabilities requiring a notice of deficiency) is required. See McCall v. Commissioner, T.C. Memo. 2009-75 (discussing the difference between quick assessment and jeopardy assessment in a trust fund penalty context).

(1) The Chief Counsel or his delegate must approve if there is to be a levy pursuant to the assessment in less than 30 days after the notice and demand for payment.¹⁶³⁹

(2) Prompt administrative and judicial review is available as follows:

(a) Within 5 days of the jeopardy assessment or levy, the IRS must provide the taxpayer a written statement of the basis upon which it was made.¹⁶⁴⁰

(b) The taxpayer may request IRS administrative review within 30 days of being furnished the statement or, if not furnished, the end of the 5 day period.¹⁶⁴¹

(c) The IRS must then determine:

(1) the circumstances of jeopardy justified the assessment;

(2) the amount is reasonable (note that the requirement is that it be reasonable, not that it be correct);¹⁶⁴² and

(3) whether any levy is reasonable under the circumstances.¹⁶⁴³

(d) The taxpayer then has the right to bring suit in the district court within 90 days after the earlier of (i) the 16th day after requesting the determination in paragraph (2)(b) and (ii) 90 days after no later than the 90th day after actually being furnished the determination in 2(b).¹⁶⁴⁴ If the matter is already pending in the Tax Court, the Tax Court will have jurisdiction.¹⁶⁴⁵

(e) Within 20 days, the court must make a de novo determination of the same issues the IRS considered under (c) above.¹⁶⁴⁶ If the court finds the levy or assessment unreasonable (either in the making or in the amount), it can take such action releasing or abating the levy or assessment as appropriate.¹⁶⁴⁷ In this proceeding the burden of proof is on the IRS as to the reasonableness of making the jeopardy assessment or levy, but, provided the IRS has given the taxpayer a written statement of the basis for the amount of the assessment, the taxpayer then bears

¹⁶³⁹ § 7429(a)(1)(A).

¹⁶⁴⁰ § 7429(a)(1)(B).

¹⁶⁴¹ § 7429(a)(2).

¹⁶⁴² Reasonable means something more than “not arbitrary or capricious” and something less than “supported by substantial evidence.” Varjabedian v. United States, 339 F. Supp. 2d 140, 144 (D. Mass. 2004).

¹⁶⁴³ § 7429(a)(3).

¹⁶⁴⁴ § 7429(b)(2)(A). The word “earlier” means just that, so that the suit may be filed upon and after the 16th day period after the request for administrative relief is filed even if the matter is still under consideration by the IRS. See Fernandez v. United States, 704 F.2d 592, 593 (11th Cir. 1983); and Green v. Commissioner, 121 T.C. No. 18 (2003). Also, if you parse the language carefully, you will see that either a request for the determination is required for judicial review; this is an exhaustion of administrative remedies requirement (or deemed exhaustion if the a timely request is made and a determination is not made in 16 days) that may or may not be jurisdictional, but it must be met. Abraitis v. United States, 709 F.3d 641 (6th Cir. 2013).

¹⁶⁴⁵ § 7429(b)(2)(B).

¹⁶⁴⁶ § 7429(b)(3).

¹⁶⁴⁷ § 7429(b)(4).

the burden of showing that the amount was unreasonable.¹⁶⁴⁸ Discovery in the proceeding will necessarily be limited because of the limited scope of the issues and the accelerated time frame.¹⁶⁴⁹

Note the truly extraordinary time frames involved in this judicial remedy. The taxpayer can be in court as early as 21 days after the jeopardy assessment and/or levy and will have a judicial determination 20 days thereafter. Note also that the judicial determination is not as to whether or not the taxpayer owes the tax; the issue is whether or not the IRS acted reasonably. Obviously, in order to act reasonably, the IRS will have to make a persuasive showing to the court that taxes are likely due. But whether taxes are ultimately due is not the issue in the proceeding and it is possible for a court to determine that the IRS acted unreasonably, and the taxpayer still ultimately owes the tax. Or, alternatively, it is possible for the court to determine that the IRS acted reasonably and no taxes are ultimately due. (The latter scenario may not be likely in most jeopardy cases, but it is possible.)

(3) If the IRS has not yet sent the taxpayer a notice of deficiency setting forth the basis for its determination that additional tax is due, it must do so within 60 days.¹⁶⁵⁰ The taxpayer will have an opportunity to petition the Tax Court upon receipt of the notice of deficiency.

(4) The taxpayer may file a bond to stay collection.¹⁶⁵¹ In most jeopardy situations, this is not practical.

(5) The applicable court may stay sale of any seized property.¹⁶⁵²

Consistent with the clear purpose of this provision, the IRS's stated policy is to use this provision sparingly and to make the assessments reasonable in amount.¹⁶⁵³ And, given the potentially severe consequences of the jeopardy assessment, courts will exercise their review power to be sure that the IRS has established the foundations for the jeopardy assessment.¹⁶⁵⁴

In addition to this remedy, although for obvious reasons, the taxpayer is specifically denied a pre-jeopardy levy collection due process hearing, the taxpayer may obtain a collection due process

¹⁶⁴⁸ § 7429(g).

¹⁶⁴⁹ For a discussion of discovery, see Steve Johnson, Discovery in Section 7429 Proceedings, 2001 TNT 200-65 (10/16/01). This article also appears as Steve Johnson, Discovery in Summary Assessment Proceedings, 32 Tax Practice 129 (11/2/01).

¹⁶⁵⁰ § 6861(b).

¹⁶⁵¹ § 6863.

¹⁶⁵² § 6863(b)(3) and (c).

¹⁶⁵³ Policy 4-88, IRM 1.2.13.1.27 (01-06-1999).

¹⁶⁵⁴ E.g., Fumo v. United States, 2014 U.S. Dist. LEXIS 77082 (E.D. PA 2014) (exhaustively reviewing the evidence and holding that the IRS had not met the burden of proving the reasonableness of the jeopardy assessment).

hearing within a reasonable time after the levy.¹⁶⁵⁵ We discuss the collection due process procedure below (pp. 657 ff.).

C. Termination Assessments.

There are parallel provisions applicable where the tax return is not yet due and hence technically a deficiency could not be determined but there are circumstances which suggest collection of a tax liability is in jeopardy.¹⁶⁵⁶ This section is somewhat differently worded -- i.e., the IRS must determine:

- (1) the taxpayer “designs quickly”
 - (a) “to depart from the United States or to remove his property therefrom;” or
 - (b) “to conceal himself or his property therein;” or
 - (c) “to do any other act (including in the case of a corporation distributing all or a part of its assets in liquidation or otherwise).”

- (2) which act tends “prejudice or to render wholly or partially ineffectual proceedings to collect the income tax for the current or the immediately preceding taxable year unless such proceeding be brought without delay.”

The procedures and remedies are roughly parallel in the authority statute (§ 6851) and are basically the same in the judicial remedy statute (§ 7429). So, not surprisingly, IRS policy here is also to use the assessment authority sparingly and to make the assessments reasonable in amount.¹⁶⁵⁷

D. Comments on Procedures.

The judicial review procedures are designed only to determine whether the ultimate collection of any tax liability is in jeopardy and such summary administrative procedures are therefore appropriate. The judicial review procedures are not designed to determine finally the amount of any tax that the taxpayer may owe. The taxpayer will have a right later in the process to contest the IRS's determination of tax liability in the standard judicial forums that we discuss elsewhere. For this reason, findings made in the summary judicial proceedings are not fact preclusive in later judicial proceedings where the correct amount of the tax liability is in issue.¹⁶⁵⁸

¹⁶⁵⁵ § 6330(f).

¹⁶⁵⁶ § 6851.

¹⁶⁵⁷ Policy P-4-89, IRM 1.2.13.1.28 (Approved 01-06-1999).

¹⁶⁵⁸ See Sykes v. Commissioner, T.C. Memo. 2001-169.

Ch. 12. Litigation.

I. Introduction.

My focus here is civil tax litigation. I do not discuss criminal tax litigation, although I do expect you to know the more commonly encountered tax crimes discussed above (pp. 295 ff.). Further, within civil tax litigation, I focus principally on civil tax litigation regarding the merits of whether a taxpayer owes a tax. There are types of civil litigation where the merits of the underlying tax liability are not in issue. I will discuss in the collections chapter (Chapter 14) the principle types of litigation affecting the collection function. I cover only key points of tax litigation appropriate for this type of survey text.¹⁶⁵⁹

II. Choices of Courts.

A. United States Tax Court.

1. Introduction.

The United States Tax Court is a court under the Constitution, albeit an Article I court rather than an Article III court; the Tax Court does have the judicial powers and jurisdiction conferred upon it by the Code.¹⁶⁶⁰ Most tax litigation is handled by the Tax Court.¹⁶⁶¹ In litigating the merits of a tax liability, taxpayers generally have two other judicial forums – the district court and the Court of Federal Claims where refund suits may be pursued. Overwhelmingly, taxpayers choose to litigate in the Tax Court because they can litigate the issue of whether and how much they owe the IRS without first paying the tax. In addition, the Tax Court has a range of jurisdiction related to other aspects of the tax system – principally collection matters via its Collection Due Process (“CDP”) jurisdiction. The combination of these proceedings in the Tax Court make it the principal forum for tax litigation.

Focusing on the issue of whether the taxpayer owes tax and, if so, how much, let’s do a quick review: what is the Code structure that makes the Tax Court a prepayment forum? **Section 6213(a)** prohibits an assessment before sending a notice of deficiency and, if the taxpayer files a petition in the Tax Court, further prohibits assessment until the Tax Court decision becomes final.¹⁶⁶² Without an assessment, the taxpayer is not required to pay and the IRS may not undertake any collection

¹⁶⁵⁹ For a detailed analysis, see Thomas D. Greenaway, Choice of Forum in Federal Civil Tax Litigation, 62 Tax Lawyer 311 (2009).

¹⁶⁶⁰ Freytag v. Commissioner, 501 U.S. 868 (1991).

¹⁶⁶¹ See Harold Dubroff & Brant J. Hellwig, The United States Tax Court: An Historical Analysis (2d ed. 2014), available on the U.S. Tax Court site [here](#).

¹⁶⁶² This is the deficiency jurisdiction of the Tax Court which was the original basis for jurisdiction in the Tax Court. Over the years, Congress has added other jurisdiction to the Tax Court, but deficiency jurisdiction constitutes the bulk of the work. I shall conclude the discussion of the Tax Court with a summary of its other jurisdiction.

measures. Keep in mind that, particularly as to some large corporate taxpayers, the large corporate underpayment rate of § 6621(c) may give those taxpayers an economic incentive to pay the amount they project they will ultimately owe even while litigating in the Tax Court; but there is no requirement for a prepayment. And the amount the taxpayer will ultimately owe may be quite substantially less than the IRS asserts in the notice of deficiency.

The Tax Court is a national court, meaning that its home base is in Washington, D.C., but Tax Court Judges come out – “ride the circuit”, if you will – to the local areas (usually the larger cities) for trials.¹⁶⁶³ For example, the Tax Court regularly comes to Houston, Dallas, and San Antonio, and less regularly to cities such as Austin, El Paso and Lubbock.

The Tax Court has two types of judges. The first is the Tax Court Judge who is a presidential appointee and serves a 15 year term.¹⁶⁶⁴ These are often referred to as “regular” Tax Court judges. There are nineteen slots for regular judges,¹⁶⁶⁵ although one or more may be vacant from time to time. These judges are sometimes re-appointed after the conclusion of their first terms. Those who are not re-appointed take senior status and may be assigned cases to handle as a senior retired judge.¹⁶⁶⁶ The second type of Tax Court Judge is a Special Trial Judge who is appointed by the Court and serves somewhat the same role as magistrates in the federal district court system.¹⁶⁶⁷

As with all courts, the Tax Court has rules that litigants must follow for the orderly progress of the litigation. Parties desiring to litigate in any court must be thoroughly familiar with the court’s rules, and the Tax Court is no exception although the Tax Court’s rules are the most lenient and leniently administered of all the courts. The Tax Court’s procedure rules are styled “Tax Court Rules of Practice and Procedure” and are available on the Tax Court’s web site.¹⁶⁶⁸ The Tax Court applies the Federal Rules of Evidence applicable in other federal courts, but looks to the District of Columbia Circuit for interpreting the evidence rules.¹⁶⁶⁹ (Readers should check the status on

¹⁶⁶³ § 7445.

¹⁶⁶⁴ § 7443(b) & (e).

¹⁶⁶⁵ § 7443(a).

¹⁶⁶⁶ § 7443(c).

¹⁶⁶⁷ § 7443A. In Ballard v. Commissioner, 540 U.S. 40 (2005), the Court noted that, prior to 1983, the Tax Court process involving the interface between the regular Judges review of the Special Judges decisions “resembled” the process whereby, in district courts, the district court reviewed the magistrates decisions. In 1983, the Tax Court amended the Rule and thereafter interpreted it differently. I shall discuss that decision in more detail below. Suffice it to say now that the decision in Ballard effectively interprets that amended rule consistently with the pre-1983 Rule, so that the parallel to the magistrate and district court roles is appropriate, although not perfect.

¹⁶⁶⁸ [Tax Court Rules of Practice and Procedure](#).

¹⁶⁶⁹ § 7453 (“the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia”); Tax Court R. 143(a) (same). The Federal Rules of Evidence (“FRE”) are applicable in all federal district courts, including the district court in District of Columbia. But, since there may be important differences among the circuits as to the

legislation pending as of the date this edition is published that would require that the Tax Court apply in each case apply the Federal Rules of Evidence as applicable (meaning interpreted and applied) for the Circuit to which the case is appealable.¹⁶⁷⁰)

2. User Friendly Court.

a. General.

In setting up the predecessor to the Tax Court (the Board of Tax Appeals) in the 1920s, Congress envisioned the Tax Court as a user friendly court in which citizens would be encouraged to get a fair and impartial resolution of a tax dispute without the expense and technical traps that all too frequently were encountered in Article III Courts. The Tax Court administers cases in a manner that reflects this congressional purpose. Taxpayers can represent themselves – “pro se” in litigators’ jargon – and receive quality justice in the Tax Court with a minimum of hassle.¹⁶⁷¹ Pro se taxpayers

interpretation of the rules, it may be important to know the interpretations applicable by district court or appellate court interpretation in the District of Columbia. Of course, where there is no interpretation controlling in the district court for the District of Columbia, the Tax Court is free to make its own interpretation of the FRE. For a general discussion of the application of the FRE in the Tax Court, see Joni Larson, Tax Evidence: A Primer on the Federal Rules of Evidence as Applied by the Tax Court, 66 Tax Lawyer 733 (2013), which is excerpted from the author’s larger book A Practitioner’s Guide to Tax Evidence: A Primer on the Federal Rules of Evidence as Applied by the Tax Court (ABA Tax Section 2013).

¹⁶⁷⁰ See Joni Larson (Guest Blogger), Proposal to Amend Section 7453 to Provide that the Tax Court Apply the Federal Rules of Evidence (Procedurally Taxing Blog 3/24/15). One consequence is that Tax Court judges who often are not experienced trial lawyers before becoming a Tax Court judge will have to not only study the FRE but also the various Circuit’s interpretation and application of the FRE. Of course, rules of evidence are not so critical in bench trials (trials by judge rather than jury), and if a judge becomes aware of an erroneous evidentiary decision before final decision in the case, the judge can – theoretically anyway – make the mental recalibration so that the effects of the erroneous decision are eliminated or mitigated.

¹⁶⁷¹ A study based on factors that the authors believe permit measuring results achieved by pro se taxpayers and represented taxpayers in the Tax Court found (1) no measurable difference between pro se taxpayers and represented taxpayers in settled cases (the large majority of cases in the Tax Court) and (2) a measurable difference when the case is tried, with represented parties achieving better outcomes. Leandra Lederman & Warren B. Hrungr, Do Attorneys do their Clients Justice? An Empirical Study of Lawyers’ Effects on Tax Court Litigation Outcomes, 41 Wake Forest L. Rev. 1235 (2006). The institutional bias for the IRS attorney in Tax Court cases is to achieve a settlement if at all possible and thus reasonable taxpayers, whether represented or pro se, will settle rather than go to trial. In this settlement process, my observation is that IRS attorneys do not favor represented taxpayers over pro se taxpayers and just want to do the right thing. So I am not surprised by the conclusions for settled cases. In other words, they do not insist upon settlements in the IRS favor because they think the pro se taxpayer will not go to trial or will be outgunned if he or she does. Cases that do not settle, however, are often the result of unreasonable

now comprise about 70% of the Tax Court's docket,¹⁶⁷² a substantial increase due principally to the collection due process ("CDP") cases (discussed below pp. 657 ff.). And even represented taxpayers can achieve quality justice in the Tax Court with less procedural hassle – meaning usually less cost – than would ordinarily attend litigating in the other fora for tax cases (the district court or the Court of Federal Claims).

b. Small Tax Case Procedure.

Consistent with Congress's goal to make the Tax Court "user-friendly," Congress established a small tax case procedure. § 7463. The non-tax world analogy is the small claims court where justice is meted out, quite fairly in the aggregate, with great informality, less stress and less cost (and fewer lawyers!). As with the general concept of small claims courts, there are maximum jurisdictional limits. Where the Tax Court proceeding arises from a notice of deficiency, the taxpayer's claims as to a disputed deficiency and penalty must not exceed \$50,000 and, if the taxpayer claims that there is not only a disputed deficiency but there is an overpayment, the claim of the overpayment must not exceed \$50,000 for any one taxable year.¹⁶⁷³ Analogous \$50,000 limits are prescribed for other types of tax liabilities that may be contested in the Tax Court (e.g., innocent spouse claims and collection due process cases).¹⁶⁷⁴ This small tax case procedure is at the taxpayer's election. Its key features are that the proceeding is much less formal than the regular Tax Court proceeding (which itself is not very formal as compared to district courts). The opinions in the cases are not precedential.¹⁶⁷⁵ And these cases are not appealable.¹⁶⁷⁶ These cases are usually heard by the Tax Court's Special Trial Judges.

3. Attorneys for the IRS.

In the Tax Court, the IRS is represented by attorneys from the office of Chief Counsel. By contrast, in other courts where tax issues are litigated, the IRS is represented by DOJ Tax. The

parties; pro se taxpayers do not have an attorney help them reasonably predict the outcome if they go to trial and thus are more likely to unreasonably force a trial rather than settle. In other words, in the prototypical case going to trial, pro se taxpayers are more likely to bring the losers than represented taxpayers and, of course, even with the IRS attorneys and the courts giving the taxpayers a lot of leeway, pro se taxpayers still will lose more often.

¹⁶⁷² William R. Davis, Wilkins Offers Warning for Large Tax Evaders, 2015 TNT 109-4 (6/8/15). The 70% is based on number of taxpayers, not the amount in issue.

¹⁶⁷³ § 7463(a).

¹⁶⁷⁴ Unlike the deficiency limit where it is the amount in dispute, the collection due process limit is based on the "unpaid tax." Leahy v. Commissioner, 129 T.C. 71 (2007).

¹⁶⁷⁵ § 7463(b).

¹⁶⁷⁶ *Id.*

reason for these differences in counsel for the IRS is historical dating to the 1930s, but not otherwise currently important.¹⁶⁷⁷

4. Court of Limited Jurisdiction and Authority.

The Tax Court is an Article I Court¹⁶⁷⁸ which exercises only specifically delegated aspects of the judicial power. Congress has conferred upon the Tax Court power to litigate certain federal tax controversies.¹⁶⁷⁹ Historically, the principal one has been the power to “redetermine” deficiencies (including overpayments) in response to an IRS notice of deficiency. **§ 6214(a)**.¹⁶⁸⁰ The Tax Court can also determine overpayments where no deficiency is owed, provided only that a deficiency notice was initially issued so as to confer jurisdiction. § 6512(b)(1).

In order to redetermine the “deficiency” for the open year before the Tax Court, the Tax Court can look to years that are otherwise closed. **§ 6214(b)**. Thus, if in the open year before the Tax Court, the taxpayer claims a carryover deduction or credit, the Tax Court can look to the year from which the deduction or credit is carried in order to determine whether there is really a carryover to the year before the court.¹⁶⁸¹ Let’s use an example. Assume that the taxpayer claims in year 3 an unused credit carryforward from year 1 and then, after the statute of limitations on year 1 has expired, the IRS disallows the carryover to year 3 because, the IRS asserts, the taxpayer had sufficient unreported tax liability in year 1 to use up the credits in year 1 so that they are not available to carry to year 3. The IRS is redetermining the year 1 tax in order to redetermine properly the tax for year 3, the year actually before the Court.¹⁶⁸²

The Tax Court also has jurisdiction to hear a potpourri of nondeficiency cases. Examples of such nondeficiency jurisdiction include actions for redetermination of employment status (employment/independent contractor issues, including Section 530 relief) under § 7436 and certain Collection Due Process (“CDP”) cases which now represent a high percentage of the cases before

¹⁶⁷⁷ For a general discussion of the history, see Keith Fogg, End of SAUSA Program at Chief Counsel’s Office (Procedurally Taxing Blog 6/3/15), noting that, at the time litigation in other courts was assigned to DOJ and then DOJ Tax, “The DOJ apparently felt that the Tax Court was essentially an administrative agency for deciding disputes that did not need its lawyers to represent the government.”

¹⁶⁷⁸ § 7441.

¹⁶⁷⁹ See generally §§ 7481-7487.

¹⁶⁸⁰ The jurisdiction to redetermine deficiencies does not include jurisdiction to determine whether a tax deficiency so determined has been properly discharged in bankruptcy. Ferguson v. Commissioner, 568 F.3d 498 (5th Cir. 2009) (noting, however, that the Tax Court does have that jurisdiction in a collection due process proceeding under § 6330).

¹⁶⁸¹ Hill v. Commissioner, 95 T.C. 428 (1990).

¹⁶⁸² This rule applies as well in refund suits. R.H. Donnelly Corp. v. United States, 641 F.3d 70 (4th Cir. 2011).

the Tax Court. CDP cases relate principally to collection issues and therefore I defer discussion until we reach that point in the Collections Chapter (pp. 657 ff.).

Unless otherwise specifically noted, the balance of the discussion of the Tax Court will assume a context of deficiency jurisdiction since that is the type most commonly encountered in a tax practice. With respect to deficiency jurisdiction, although the Court's statutory authority is limited to determining the deficiency or overpayment for the year or years of the notice deficiency which confers jurisdiction, a substantial jurisdictional issue arose as to whether the Tax Court had equitable recoupment jurisdiction to mitigate the amount of a deficiency otherwise proper for a year when that deficiency somehow related to an overpayment in a year barred by the statute of limitations. The history of this issue are presented in **Estate of Branson v. Commissioner, 264 F.3d 904 (9th Cir. 2001)** which you should now read again. In summary, the Tax Court assumed for most of its existence (since the 1920s) that it had no such authority and but the Tax Court and the Courts of Appeals re-thought that issue and decided that the Tax Court did have jurisdiction exemplified by Branson. The Code amended after the Branson decision to provided: "the Tax Court may apply the doctrine of equitable recoupment to the same extent that it is available in civil tax cases before the district courts of the United States and the United States Court of Federal Claims." **§ 6214(b)**.

And query whether the Tax Court's equitable jurisdiction is limited to just equitable recoupment. That might be one inference from its statutory codification. In Branson, however, the Ninth Circuit made the more general statement that the Tax Court had "the authority to apply the full range of equitable principles generally granted to courts that possess judicial powers."¹⁶⁸³ I don't think this means that the Tax Court has general equitable jurisdiction such as district courts, but certainly in the context of, for example, resolving deficiency disputes, the Tax Court is authorized to do equitable justice as to the tax liability before it just as a district court could do. Certainly, of course, the Tax Court cannot exercise equitable jurisdiction to order equitable remedies such as injunctions, but in terms of doing justice with regard to the jurisdiction it does have to redetermine a tax deficiency or order a refund, it may consider equitable concepts that previously might not have been considered.

5. Opinions and Decisions.

After the case has been submitted (i.e., after trial and post-trial briefing of any issue requiring a trial or after submission on motion for summary judgment), the Tax Court makes a "report" which is the form of a **judicial opinion**.¹⁶⁸⁴ There is usually a single opinion in a case resolving all open issues for the years before the Tax Court. Sometimes, however, in complex cases, the Court may issue multiple opinions. When all issues have been decided, the Tax Court renders its **decision**

¹⁶⁸³ See Zapara v. Commissioner, 652 F.3d 1042, 1045-1046 (9th Cir. 2011) (citing and quoting Branson, p. 1046 & n. 11. Zapara involved a collection due process case where the Tax Court did justice by forcing the IRS to reduce the tax liability by the amount that the IRS should have been able to realize by selling the assets subject to jeopardy levy at the client's direction under § 6335(f). So, the Tax Court with the blessing of the courts of appeals is feeling its equitable oats.

¹⁶⁸⁴ § 7459(a); see § 7460(a).

which is the bottom-line redetermination of the amount of the deficiency or overpayment for the years. § 7459. The decision is the Tax Court analog of the judgment in the district court,¹⁶⁸⁵ the decision closes the Tax Court case and is the action from which an appeal is taken. § 7483.¹⁶⁸⁶ The opinion(s) that precede the decision set forth the Court's reasoning for its resolution of the issues that are not settled.

Tax Court opinions are of three types. First, there is the division opinion which is formally published by the Government Printing Office (often acronymed to GPO) in Tax Court Reports.¹⁶⁸⁷ These opinions are often referred to as regular or reported decisions (the latter refers to the fact that the Government publishes them in a book volume but does not similarly publish other types of opinions); I usually refer to them as regular opinions. These regular opinions are supposed to address the more important issues, at least if the Tax Court has not previously resolved those issues or they otherwise make significant expansions, extrapolations or limitations of prior precedents.¹⁶⁸⁸ These regular opinions are cited with the T.C. designation to show the official Tax Court reporter. (See e.g., Estate of Branson, discussed above at pp. 251 ff.) Regular opinions may be opinions of a single “division” of the court (i.e., an opinion of a single judge that is the opinion of the Court) or opinions of the full Court, so-called reviewed opinions, wherein all judges have the opportunity to express their views in majority, concurring and dissenting opinions. Reviewed Tax Court opinions are analogous to en banc review in the Courts of Appeals, except that there is no procedure to request review by the full Tax Court and there is no oral argument on the review or separate briefing independent of the briefing before the division judge.

Second, the Court issues Memorandum Opinions, not officially published, which are generally considered less important precedentially because they are not supposed to set new precedent, but rather apply or expand logically old precedent or resolve complex fact issues considered so unique as to be of no material precedence.¹⁶⁸⁹ That is the articulated dividing line between regular and memorandum opinions – precedent value. Nevertheless, important issues are resolved in memorandum opinions. Although the Tax Court continues to pay lip service to the proposition that they are not binding precedent,¹⁶⁹⁰ in truth they are frequently cited by the Tax Court

¹⁶⁸⁵ FRCP 54(a) (“‘Judgment’ * * * includes a decree and any order from which an appeal lies.”).

¹⁶⁸⁶ See also Tax Court Rule 190(a).

¹⁶⁸⁷ § 7462.

¹⁶⁸⁸ See Judge Mary Ann Cohen, How to Read Tax Court Opinions, 1 Hou. Bus. and Tax L.J. 1, 7 (2001).

¹⁶⁸⁹ See *Id.* at 5-6.

¹⁶⁹⁰ In McGah v. Commissioner, 17 T.C. 1458, 1459 (1952), the Tax Court cited “our practice * * * that memorandum decisions are not cited.” Then in Nico v. Commissioner, 67 T.C. 647, 654 (1977), *revd.* in part on other grounds 565 F.2d 1234 (2d Cir. 1977), the Tax Court said that Memorandum Decisions are not binding precedent. Nico’s formulation continues to be cited by the Tax Court. E.g., Dunaway v. Commissioner, 124 T.C. 80, 87(2005) (citing Nico).

and other courts in support of propositions decided in the opinion.¹⁶⁹¹ They are thus at least persuasive authority, even if (in the Tax Court's view) not controlling.¹⁶⁹²

Third, the Court issues Summary Opinions in the small tax case proceedings. These opinions have no precedential value¹⁶⁹³ and serve only to resolve the particular matter before the court. These opinions are written by the Special Trial Judge before whom the cases were tried.

Fourth, although relatively rare, the Tax Court may issue bench opinions where the findings of fact and legal issues can be resolved quickly and orally, by reading the findings and legal conclusions into the record produced as a transcript after the trial or hearing.¹⁶⁹⁴ Such bench

¹⁶⁹¹ Bardahl Mfg. Co. v. Commissioner, 24 T.C.M. 1030 (1965), a leading case on the accumulated earnings tax is cited as an example of a memorandum decision that is frequently cited and relied upon. Mark F. Sommer and Anne D. Walters, Tax Court Memorandum Decisions -- What are they "Worth", 98 TNT 138-96 (1998).

¹⁶⁹² My comment in the text is influenced by two strains. First is the firestorm created by the original panel decision in Anastasoff v. United States, 223 F.3d 898 (8th Cir. 2000), vacated en banc 235 F.3d 1054 (8th Cir. 2000), holding unconstitutional the practice in the Eighth Circuit of issuing unpublished decisions which were not intended to be precedent. But see Hart v. Massanari, 266 F.3d 1155 (9th Cir. 2001) (rejecting the Anastasoff analysis). The practice rejected in Anastosoff or a variation thereof was in place in a number of the circuits. The practice was based on reasons analogous to the Tax Court's decision to issue Memorandum Opinions. Like the Tax Court's Memorandum Opinions, the court of appeals' unpublished decisions are easily available to the public via sources like LEXIS and Westlaw and are intended not to be precedential and in some cases not even citable to or by the court deciding them. The Anastasoff decision was vacated for reasons unrelated to the merits of the constitutional holding. However, the issue which had percolated before the original Anastasoff holding heated up afterwards and has resulted in a change to the Federal Rules of Appellate Procedure permitting the citing of appellate opinions designated "unpublished," "not for publication," "non-precedential," "not precedent," or the like. FRAP Rule 32.1; see for a good succinct discussion, Peter A. Lowy, Juan F. Vasquez, Jr., and Jaime Vasquez, Citing Unpublished Opinions in Tax Court Proceedings, 114 Tax Notes 171 (Jan. 15, 2007) and 2007 TNT 11-52 (1/16/07). Second, Memorandum Opinions (like unpublished circuit court opinions) are still opinions in actual litigated cases and may be persuasive. Thus, hearkening back to the issue of the appropriate deference to be given administrative determinations (the Chevron / Mead issue), certainly decisions in actual decided cases should be given at least Skidmore deference rather than being nothing except to the parties involved in the actual case.

¹⁶⁹³ § 7463(b).

¹⁶⁹⁴ § 7459(b) (statutory requirements are "met if findings of fact or opinion are stated orally and recorded in the transcript of the proceedings."); see Tax Court Rule 152. For an explanation of the process, along with statistics as to the frequency of its use, see Keith Fogg, Tax Court Bench Opinions (Procedurally Taxing Blog 1/26/15); and Andy Grewal, The Un-Precedented Tax Court: Bench Opinions (Procedurally Taxing Blog 5/19/15).

opinions do not have precedential effect “except as may be relevant for purposes of establishing the law of the case, res judicata, collateral estoppel, or other similar doctrine.”¹⁶⁹⁵

A controversy erupted over the process whereby opinions drafted by Special Trial Judges (STJs) in cases other than small tax cases¹⁶⁹⁶ are reviewed and adopted by the Tax Court as its opinion. The process was that the STJ would hear the testimony, review the exhibits and otherwise conduct trial proceedings just as any other trial judge. The STJ would then draft an opinion which is adopted by a regular Tax Court Judge, subject to any changes the regular Tax Court Judge makes or requires the STJ to make. As it then interpreted its rules, the Tax Court treated the STJs’ initial opinions as advisory and not as public documents available even to the parties. The public and the parties would not know if the final opinion entered by the Court contained any changes by the Tax Court regular judge. (By contrast, the district court’s magistrate judges, a conceptual analog to STJs, routinely release their opinions and any changes made by the district judges are easily discerned by the parties and the interested public.) Perhaps the most sensitive area in which such “secret” changes are important is with respect to findings influenced by credibility issues. In the only released opinion (the one finally approved by the Tax Court Judge after any changes he or she requires are incorporated), the Tax Court Judge who did not actually hear any witness conceivably could make witness credibility fact findings different than the STJ who did hear the witnesses. Thus, in a case where civil fraud is an issue (for penalty and statute of limitations purposes), the STJ who hears the witnesses (e.g., the taxpayer, the accountants and lawyers who advised the taxpayer, etc.) may make a finding that the taxpayer’s return reporting position was not attributable to fraud. Then, it is conceivable that a Tax Court Judge on review of the bare record (including a transcript of the testimony which, of course, excludes demeanor testimony that is so important in the truth finding process) might determine that the taxpayer’s return reporting position was fraudulent and change the STJ’s draft opinion to include the finding of fraud.

In Ballard v. Commissioner,¹⁶⁹⁷ the Supreme Court held that the Tax Court Rules, properly interpreted, do not permit the STJ draft opinion to be kept secret, so that the parties will be able to determine what changes, if any, are made by the regular Tax Court Judge. The Supreme Court was clearly influenced in reaching that interpretation by the serious potential due process issues that might be presented if the Tax Court Rules were interpreted to allow the practice that the Tax Court had adopted.¹⁶⁹⁸

¹⁶⁹⁵ Tax Court Rule 152(c).

¹⁶⁹⁶ For a discussion of the role of Special Trial Judges, see Kathleen Pakenham, You Better Shop Around: The Status and Authority of Specialty Trial Judges in Federal Tax Cases, 2004 TNT 120-42 (6/9/04).

¹⁶⁹⁷ 540 U.S. 40 (2005).

¹⁶⁹⁸ One of the significant issues chewed on by Justice Rehnquist in Ballard was the proper deference to be given to the Tax Court’s own interpretation of its Rules to allow the practice it had adopted of keeping the STJ drafts secret. This raises in a judicial setting the deference issue presented in an administrative setting in Chevron and Mead that we discussed earlier. For further discussion on that issue (if not enlightenment), see the opinions in Ballard, although Justice Rehnquist’s dissenting opinion (joined by Justice Thomas) is the only opinion directly addressing

In response to the firestorm surrounding Ballard, the Tax Court has changed its practice to comply with the Supreme Court's holding, so that STJ opinions are available to the parties.¹⁶⁹⁹

Finally, if the Tax Court has jurisdiction and the case is not adjudicated on the merits, a dismissal of the proceeding (say, on motion of the petitioner) will constitute a decision that the amount determined by the IRS in the notice of deficiency is correct. § 7459(d).

6. Tax Court Pleadings.

a. Petition.

A Tax Court case is started by the taxpayer filing a **petition** with the Tax Court for a redetermination of the deficiency. § 6213(a).¹⁷⁰⁰ Consistent with federal court pleading practice since the first Federal Rules of Civil procedure were adopted in the 1930s, the petition is a “notice” pleading that should be summary statement to fairly notify the IRS as to the matters the taxpayer contests.¹⁷⁰¹ (Note that when I say “notice” pleading I am using pleading jargon to refer to the summary nature of the pleading and not to the fact that this pleading really is in response to the **notice** of deficiency.) The Tax Court Rules provide in effect a checklist of the matters the petition should contain¹⁷⁰² and, further, contain an addendum with a form for the petition.¹⁷⁰³ Since the notice of deficiency is the “ticket” to the Tax Court's jurisdiction, the form requires that the notice of deficiency be attached to the petition. You should be able to see how summary the petition may be (although some practitioners file very detailed petitions). Keep in mind that a summary petition

the issue.

¹⁶⁹⁹ Tax Court Rule 183(b).

¹⁷⁰⁰ Tax Court Rule 20(a) (“A case is commenced in the Court by filing a petition with the Court, inter alia, to redetermine a deficiency set forth in a notice of deficiency issued by the Commissioner * * *.”) To state the obvious, the opening pleading must be filed in the Tax Court rather than some other court. Although 28 U.S.C. § 1631 does permit transfers between most federal courts in the case of filing in the inappropriate venue or court, it is generally held that transfers to the Tax Court are not permitted under this statute because the Tax Court is not a court for purposes of § 1631. Clark v. United States, 2014 U.S. Claims LEXIS 56 (Fed. Cl. 2014); Mobley v. Commissioner, 532 F.3d 491, 495 (6th Cir. 2008).

¹⁷⁰¹ Tax Court Rule 31(a) & (b). The parties in the proceeding are the taxpayer(s) in the plaintiff position (but referred to as petitioner(s)) and the Commissioner of Internal Revenue in the defendant position (referred to as respondent). The Commissioner, of course, is only a nominal party and, institutionally, the IRS is the party defending the case.

As with cases in other judicial forums, opening pleadings – petition, answer and reply – do not normally inform the judge. Usually, the judge does not pay substantive attention to the pleadings unless directed to them by the parties because of some subsequent issue – e.g., one party has diverted inappropriately from those pleadings.

¹⁷⁰² Tax Court Rule 34(a) & (b).

¹⁷⁰³ Tax Court Rules, Appendix 1, Form 1.

works because the IRS has the notice of deficiency for detail and, beyond that, the RAR and the underlying files, so the IRS is rarely unable to understand the issues raised in a summary petition and prepare a proper answer to the petition. More detail might be required where the taxpayer not only seeks to redetermine the deficiency to zero but have the court consider some new matter not addressed in the audit (such as unclaimed deductions to mitigate the deficiency or even claim a refund). In the latter case, the IRS may not have previously “audited” the issues that give rise to the right to the overpayment and thus may require more detail to give it notice than would be required for issues that it has audited.

The Tax Court Rules protect taxpayer privacy by excluding from the public record a taxpayer’s Social Security Number or Employer Identification Number and other private information (such as date of birth, children’s names, etc.).¹⁷⁰⁴ These changes parallel changes in the Federal Rules of Civil Procedure.

Along with the petition, the taxpayer will file a **Designation of Place of Trial**.¹⁷⁰⁵ In a Houston case, for example, the taxpayer can designate Houston as the place of trial. So long as the case has some reasonable nexus to the place designated by the taxpayer, the Tax Court will honor the place of trial designated by the taxpayer. The Tax Court may, however, hold the trial somewhere else upon good grounds shown.

The original petition is filed with the Court.¹⁷⁰⁶ The Court delivers the petition – “serves” the petition in litigation jargon – on the Commissioner.¹⁷⁰⁷

b. Answer.

The Commissioner must file an answer to the petition.¹⁷⁰⁸ The purpose of the answer is to notify the petitioner (the taxpayer) which of the issues raised in the petition are in dispute. Like the petition, the answer is a notice pleading that only requires a summary answer to the allegations of the petition. As in pleadings in other courts, the answer may assert some affirmative defense which must be asserted in the answer or will be deemed waived unless the IRS moves timely to amend the answer.¹⁷⁰⁹

¹⁷⁰⁴ See Tax Court Rules 20(b) and 27. Since the IRS needs the taxpayer identification number in order to retrieve the administrative record for cases filed in the Tax Court, the taxpayer at the time of filing the petition must file a Form 4 which will not be publicly filed and will instead be served on the IRS when the Tax Court serves the petition and designation of place of trial on the IRS. Documents that contain such information should be either redacted (with an unredacted copy filed under seal) or filed under seal without filing a redacted copy.

¹⁷⁰⁵ Tax Court Rules, Appendix 1, Form 5.

¹⁷⁰⁶ Tax Court Rule 34(e) (only the signed original; no copies).

¹⁷⁰⁷ Tax Court Rule 21(b)(1).

¹⁷⁰⁸ Tax Court Rule 36.

¹⁷⁰⁹ Tax Court Rule 39.

c. Reply.

The taxpayer then may or should file a reply to the Commissioner's answer.¹⁷¹⁰ The taxpayer is required to reply to matters asserted in the Commissioner's answer as to which the Commissioner bears the burden of proof.¹⁷¹¹

d. Filings After Petition On Line.

Filings after the petition are now required to be on line.¹⁷¹²

7. New Matters.

The IRS can raise new matters in its answer that seek to increase the amount of the deficiency on a basis not asserted in the notice of deficiency or to justify the deficiency asserted (or part thereof) on some basis not asserted in the notice of deficiency. Jurisdictionally, the Tax Court case is a case to redetermine the correct amount of tax liability for the year(s) involved. So the IRS can seek additional taxes not previously asserted. The statute of limitations will be open because, to reprise what we learned earlier, the statute is suspended during the period the Tax Court case is pending. **§§ 6213(a) and 6503(a)**. This is one of the dangers in proceeding in the Tax Court where the IRS has not previously spotted an issue.¹⁷¹³ Since the statute of limitations is suspended upon issuance of the notice of deficiency, all new matters may be raised, assuming that the statute of limitations did not bar the notice of deficiency in the first place.

The IRS's ability to raise new issues after its original answer is, however, limited by rules of fairness. If the IRS does assert new matters after filing its original answer, it will formally do so by moving to amend the original answer. Although the Tax Court (and other federal courts) generally allow liberal amendment of pleadings and thus allow liberal amendment to assert new issues, new issues cannot be inserted too late in the process so as to deny the taxpayer the effective opportunity to respond. And, as to new matters, the IRS bears the burden of proof.¹⁷¹⁴

¹⁷¹⁰ Tax Court Rule 37.

¹⁷¹¹ Tax Court Rule 37(b).

¹⁷¹² Tax Court Rule 26.

¹⁷¹³ See Burgess J.W. Raby and William L. Raby, "Other" Issues When a Tax Court Case Goes to Court, 2003 TNT 227-7 (11/25/03), discussing in part an extreme example in Ferguson v. Commissioner, 47 T.C. 11 (1966).

¹⁷¹⁴ Tax Court Rule 142(a). In Illinois Tool Works v. Commissioner (unpublished order dated 12/2/14, published at 2014 TNT 232-10), the Tax Court denied a taxpayer motion to strike the IRS's assertion, for the first time in the answer, of a substantial understatement penalty. The Court affirmed its prior holdings and Tax Court rule allowing the raising of new matters not previously asserted in the notice of deficiency. The Court said the "sanction" for raising new matters after the notice of deficiency is to shift the burden of persuasion to the IRS on the matter. A related issue not definitively decided is whether Section 6751(b)(1)'s requirement for supervisor

The IRS is allowed to raise a new theory or ground in support of an issue raised in the notice of deficiency without the theory or ground being a new matter.¹⁷¹⁵ Depending upon how much variance the new theory or ground has with the notice of deficiency, the variance might be considered a new matter subject to the foregoing new issues discussion. Certainly, if it is raised so late that the taxpayer cannot fairly respond with evidence addressing the new issue, the Court should deny the IRS's attempt to assert the new issue.

If the IRS asserts an affirmative defense (such as estoppel), it will be deemed denied and the taxpayer need not file a responsive pleading, which is usually called a "reply."¹⁷¹⁶ If, however, the IRS raises "new matter" either in an answer or an amended answer, the taxpayer should file a reply providing the IRS notice as to the taxpayer's position on the new matter. This is frequently done via a simple denial of the various matters pled with respect to the new matter.

The Tax Court rules, like the Federal Rules of Civil Procedure applicable in district courts and the Court of Federal Claims' Rules, permit amended pleadings, usually requiring the approval of the Court which is liberally granted to promote justice on the underlying merits.¹⁷¹⁷

8. From Petition to Trial.

a. Appeals Office Review.

If the case has not had Appeals Office review by the time the petition is filed, it is automatically referred to Appeals after the IRS files its answer and, in most cases, Appeals generally has jurisdiction in conjunction with Counsel to settle the case.¹⁷¹⁸ As a practical matter, this means that if a settlement is reached with the Appeals Officer, it will be implemented.

If the matter has already had Appeals Office review prior to issuance of the Notice of Deficiency, it will not be automatically referred but may be referred if there is some reason to believe that further Appeals Office consideration would be helpful to settle some or all of the issues.

approval of the initial determination of a penalty might require such approval **before** the IRS asserts the penalty, whether initially or by new matter in litigation. See Ajay Gupta, How Late is Too Late for Slapping on a Penalty?, 2014 TNT 238-1 (12/11/14).

¹⁷¹⁵ In Estate of Kanter v. Commissioner, 337 F.3d 833, 851 (7th Cir. 2003), rev'd on other grounds, 125 S. Ct. 1270 (2005), the Court said:

The Commissioner is allowed the latitude to amend his pleadings and even adopt entirely new theories supporting assessed deficiencies without triggering Rule 142's shift in burden, so long as the new theory is not inconsistent with the original allegation, does not require new evidence in its support, nor increases the amount of the deficiency.

¹⁷¹⁶ Tax Court Rule 37(c).

¹⁷¹⁷ Tax Court Rule 41.

¹⁷¹⁸ Rev. Proc. 87-24, 1987-1 C.B. 720; see IRM Part 8 Appeals, Chapter 4 Appeals Docket Cases; see specifically IRM 8.4.1.4 (10-26-2007), Appeals Authority Over Docketed Cases.

b. Informal Discovery.

Informal discovery is encouraged and required by the Tax Court prior to undertaking formal discovery requests.¹⁷¹⁹ Informal discovery is as simple as calling up the opposing counsel and requesting information. The request should be documented in formal written correspondence, but it is informal in the sense that it is not a pleading. The informal discovery procedure is often referred to as a Branerton procedure because the case of that name put practitioners on notice that the Tax Court viewed the informal discovery process as critical.¹⁷²⁰ A Tax Court judge stated the guts of the informal discovery requirement under Branerton as “asking the other party nicely first.”¹⁷²¹ The IRS district counsel will usually write a letter – referred to as a Branerton letter, citing the case by name – requesting the informal discovery. The taxpayer or practitioner must also use an equivalent procedure – perhaps with a letter citing Branerton – so as to preserve the right to pursue formal discovery if the informal discovery is not satisfactory.

It is important not to undertake formal discovery without first using the informal Branerton procedure.¹⁷²² The IRS may refuse to respond to the discovery, and may even move to quash, which will make the practitioner look stupid before the judge. Even worse, by the time the matter gets straightened out, the time to even undertake discovery may have expired.

c. Formal Discovery.

The Tax Court has formal discovery procedures which substantially parallel those found in the other litigation forums.¹⁷²³ Thus, generally, the scope of discovery includes “any matter not privileged and which is relevant to the subject matter involved in the pending case.”¹⁷²⁴ The key differences are that (i) formal discovery must be preceded by informal discovery under the Branerton procedure and (ii) deposition discovery is the least favored form of discovery. Indeed, generally the taking of depositions requires the consent of the parties.¹⁷²⁵ Non-consented discovery depositions may be taken only upon permission of the Court after the notice of trial is issued or the case has been assigned to a judge and, if opposed by the other party or the nonparty witness, may

¹⁷¹⁹ Tax Court Rule 70(a)(1).

¹⁷²⁰ Branerton Corp. v. Commissioner, 61 T.C. 691 (1974).

¹⁷²¹ Tax Court Judge Mark Holmes as quoted in Sam Young, Tax Court Judge, IRS Attorneys Discuss Impact of Changes to E-Discovery Rules, 2010 TNT 44-13 (3/8/10).

¹⁷²² See Schneider Interests, L.P. v. Commissioner, 119 T.C. 151 (2002).

¹⁷²³ Tax Court Rules 70 - 104. These include admissions and stipulations which are often used like discovery devices but technically are not, for in order to frame a request for admission or a request for stipulation, presumably the party already knows the fact(s) in question.

¹⁷²⁴ Tax Court Rule 70(b),” which substantially tracks Federal Rule of Civil Procedure Rule 26.

¹⁷²⁵ Tax Court Rule 74.

be taken only with the permission of the Court.¹⁷²⁶ And in the exercise of self-restraint, parties rarely ask the Court to allow non-consented depositions.

The Tax Court Rules have been changed to permit discovery of work product under scope rules similar to the Federal Rules of Civil Procedure.¹⁷²⁷ As noted earlier in the text in discussing the work product privilege, the Federal Rules of Civil Procedure permit the work product discovery upon showing of substantial need and undue hardship, with a opinion work product being very difficult to discover.

d. Expert Witnesses.

The Tax Court rules require an expert to render an expert's report stating the expert's qualifications, opinions and facts and data upon which they are based.¹⁷²⁸ Provided that the expert is qualified, the report is introduced into evidence and may serve as the expert's direct testimony, unless there is some reason to elicit oral testimony on direct.¹⁷²⁹

The parties must exchange copies of expert witness reports expected to be introduced at trial. The parties may not, however, discover drafts of the expert witness's reports or communications between the opposing party and the expert regarding the report, except for communications which (i) relate to the expert's compensation; (ii) identify facts or data that the expert was provided to form the opinions; and (iii) identify assumptions provided to and relied upon by the expert.¹⁷³⁰

e. Other Limitations on Discovery.

As noted, the Tax Court's discovery opportunities are limited. This is not so bad as to the taxpayer who usually has control of the facts. The IRS does not usually have easy access to the facts, but the IRS is expected to have developed the fact using its broad summons power, if necessary, during the audit. Hence, the limitations on discovery are important to the process.

What happens, however, when the IRS has not adequately developed its case during the audit in the case before the Court and needs broader discovery than the Tax Court rule might comfortably permit? The IRS has been known (or suspected) to use other audits -- either a subsequent year audit or even a third party audit -- to develop information for a case pending in the Tax Court. Suppose a large corporate taxpayer has a case before the Tax Court in which it contests a transfer pricing (§ 482) adjustment for years 1 and 2. The IRS has not adequately developed the issue in the audits of years 1 and 2, and finds that the Tax Court discovery rules are "limiting." It needs more information and broader discovery -- e.g., from the taxpayer's competitors and other industry sources. Many large corporate taxpayers are subject to continuous audits, so let's suppose that this taxpayer is then

¹⁷²⁶ Tax Court Rule 74.

¹⁷²⁷ Tax Court Rule 70(c).

¹⁷²⁸ Tax Court Rule 143(g)(1).

¹⁷²⁹ Tax Court Rule 143(g)(2).

¹⁷³⁰ Tax Court Rule 70(c)(3) and (c)(4)(A) & (B).

undergoing an audit for years 3 and 4 while its Tax Court case for years 1 and 2 is pending. Can the IRS use the summons process to develop the same issue in years 3 and 4? If the taxpayer is not otherwise subject to audit in years 3 and 4, can the IRS commence one for this purpose? Alternatively, the information the IRS needs in the case before the Court may be from third parties, such as taxpayer's competitors. Can the IRS use a third party audit as a fulcrum for issuing summons for information needed in the Tax Court case of a different taxpayer?¹⁷³¹

Certainly, in a transfer pricing audit, relevant information is not limited to just the years in audit, since a whole range of years' information can reasonably bear on the issue, nor just to the taxpayer involved since third parties may have relevant information. Hence, the IRS agents in the taxpayer's years 3 and 4 audit and in third parties' audits could responsibly assert under the Powell standards that the information it seeks is relevant and use the IRS summons -- far more powerful than Tax Court discovery devices -- to get the information.

These issues and variations on them have troubled the Tax Court, and it has found no easy answer to the issues. The Tax Court has developed the following general guides to resolve the problems: (1) for IRS summonses to the same taxpayer issued before the petition was filed in the pending Tax Court case, it will not interfere at all with the IRS's subsequent enforcement of the summonses; and (2) if the IRS summons relates to the same taxpayer for a year not before the court or to another taxpayer for a year before the court, normally the Tax Court will not issue a protective order, but will do so if the taxpayer can show, essentially, that the audit discovery process in issue is pretextual to gather evidence for the Tax Court case.¹⁷³²

f. Alternative Dispute Resolution.

The parties may move to resolve “any factual issue in controversy” by “voluntary binding arbitration.”¹⁷³³ The parties may also move to resolve “any issue in controversy” by “voluntary nonbinding mediation.”¹⁷³⁴ Finally, these rules do not “exclude use by the parties of other forms of voluntary disposition of cases.”¹⁷³⁵

¹⁷³¹ I hope you have spotted a potential § 6103 problem with this scenario, but set that aside here. See John A. Townsend, Section 6103 and the Use of Third Party Tax Return Information in Tax Litigation, 46 Tax L. Rev. 923 (Summer 1993).

¹⁷³² Ash v. Commissioner, 96 T.C. 469 (1991); see Burgess J.W. Raby and William L. Raby, IRS Summons Power and the Tax Court, 34 Tax Practice (Tax Analysts) 193 (5/31/02). And, as to the Government's power to seek judicial enforcement of a summons in the district court, see United States v. Administrative Enterprises, 46 F.3d 670 (7th Cir. 1995).

¹⁷³³ Tax Court Rule 124(a).

¹⁷³⁴ Tax Court Rule 124(b).

¹⁷³⁵ Tax Court Rule 124(c).

g. Piggyback Agreements.

The parties in a docket case involving issues similar to issues presented in another docket case, may stipulate to be bound by the resolution of the issue in the other case.¹⁷³⁶ The procedure was developed particularly for issues presented in a large number of cases (often found with widely promoted tax shelters).¹⁷³⁷ This procedure will then permit one or more “test cases” to be litigated and resolve the issue in the other cases. Obviously, care needs to be taken if the outcome can be affected by different Circuit precedents in the courts of appeals to which the cases could be appealed.

9. The Stipulation Process.

Stipulations represent the parties’ agreement as to the facts and law in the case. Rule 91(a)(1) states (emphasis supplied):

The parties are **required** to stipulate, to the fullest extent to which complete or qualified agreement can or fairly should be reached, all matters not privileged which are relevant to the pending case, regardless of whether such matters involve fact or opinion or the application of law to fact.

Stipulations should be comprehensive.¹⁷³⁸

The Tax Court views the stipulation process as critical to its orderly functioning. By undertaking the stipulation process to the maximum extent, the resulting actual courtroom trial is minimized. This permits the average Tax Court trial to be concluded in a fraction of the time it takes trials in the district courts where stipulations can also save trial time but tend to be less comprehensive. The Tax Court expects the parties to have conducted the stipulation process diligently and to have concluded it by a signed stipulation document for filing by the docket day or by the trial date.

A party may move to compel the other party to stipulate.¹⁷³⁹ However, the motion must be filed sufficiently in advance of trial for it to be dealt with. The Rules require that it be filed not later than 45 days before trial. Thus, it is important that the parties move to stipulate well before that 45 day cutoff. In practice, however, the stipulation process often does not commence in earnest until after that 45 day cutoff and thus the practical ability to force stipulations may be limited.

¹⁷³⁶ Obviously, as with any stipulation, care must be exercised to assure the process being stipulated. See Monahan v. Commissioner, 321 F.3d 1063, 1068 (11th Cir. 2003) (stipulating that the resolution of the referenced case will resolve all of the remaining issues in the stipulated case).

¹⁷³⁷ For example, in the infamous “Kersting” cases, it is reported that 1,300 taxpayers signed piggyback agreements. See Hongsermeier v. Commissioner, 621 F.3d 890, 893 (9th Cir. 2010).

¹⁷³⁸ Tax Court Rule 91(a)(2).

¹⁷³⁹ Rule 91(f).

Notwithstanding that, of course, the Tax Court Judge will be mightily disappointed if the parties fail to stipulate as to matters that they really don't dispute – for that takes up his time in the courtroom listening to those uncontested matters. You don't want the Judge to be unhappy, so you don't want to be perceived by the Judge as the party who refused to stipulate as to such matters and thereby wasted his time.

Some cases may be fully stipulated, requiring no trial.¹⁷⁴⁰ Fully stipulated cases do not, however, alter the burden of proof or Practitioners should recall, however, in fully stipulated cases (as well as in trials) that “the burden of proof, or the requirements otherwise applicable with respect to adducing proof, or the effect of failure of proof.”¹⁷⁴¹

10. PreTrial Memorandum.

Pursuant to the Tax Court's Standing Pretrial Order sent to the parties several months before a trial session (referred to in the Rules as a trial calendar), the case will be calendared for a date at the start of a trial session. In advance of the docket call on the first day of the trial calendar, each party will submit a relatively short pretrial memorandum alerting the Court as to the general issues to be tried and any problems that the party anticipates to develop at trial.

11. The Trial.

The trial calendar will commence with a docket call. Prior to the docket call, the Tax Court will have sent notice for counsel or pro se litigants to appear at the opening of docket call, often 10am on a Monday. Such notices will have gone out in a number of cases, and there will be a list of cases that the judge will, starting at the opening of the docket, move through sequentially from oldest to newest. Counsel or pro se litigants will advise the court of the status of the case (settled, will be settled shortly, ready for trial, not ready for trial, etc.) The Judge will determine which cases are to be tried during the session and the timing of the trials. The judge will then, in the following days, handle the trials scheduled and deal with various motions parties may present.

In some cases that the parties know will not settle and may require special trial dates (e.g., witnesses coming in from out of town), the parties may have arranged a special trial date in advance. A special trial setting should be discussed with the court well in advance of the docket call at the general calendar. And, while special settings can be in the place originally designated in the Designation of Place of Trial filed with the Petition, it is not uncommon for the parties to agree to trial at the Tax Court in Washington in large high stakes cases that will require many days to try. This is done principally for the convenience of the Tax Court judge who would otherwise have to spend that time working out of a hotel room in another city. The judge is likelier to be a happier judge when he or she can sleep in his or her own bed at night. That is not to say that the judges begrudge having to go out across the country on the normal trial sessions to try cases. I don't think they do. But in appropriate cases, it might be worth at least considering a Washington trial

¹⁷⁴⁰ Rule 122(a).

¹⁷⁴¹ See Rule 122(b).

setting.¹⁷⁴² This decision is usually not made at the inception of the case but after much or all of the discovery has been done and the stipulation process has at least started, so that the parties will have some idea of shape and length of the trial.

Trials are relatively informal (at least as compared to trials in district courts). The parties will (or should), as noted, stipulate as much as possible, leaving only the critical unstipulated facts, if any, to be tried. Because of the Tax Court's insistence on the fullest possible stipulations, many cases require no trial and most of those that are tried are fairly summary, often being concluded in a matter of hours.

Trials are conducted pursuant to the Tax Court's own Rules of Procedure and under the Federal Rules of Evidence.¹⁷⁴³

At the end of trial, the judge will set a briefing schedule for the parties and take the case under advisement.¹⁷⁴⁴ Except in relatively easy cases, the Judge will rarely indicate which way he is inclined to rule.

12. Briefing.

The parties will then brief the case according to the schedule set by the Judge. The briefing will include detailed proposed findings of fact (with references to the trial record, including the exhibits and transcript) and legal arguments.¹⁷⁴⁵

13. Opinion and Decision.

Upon receiving the briefs, the Judge will consider the matter for as long as it takes (several months, or even years) and then render an opinion resolving the issues presented to him for resolution. Setting aside the small tax cases, the opinion will be a Tax Court Regular Opinion (T.C.) or a Memorandum Opinion.

After the opinion is issued, the parties will translate all of their agreements and the Tax Court's rulings into a bottom-line number and incorporate it into a decision document (the Tax Court equivalent of a judgment in the District Courts). If the parties cannot agree upon the bottom-line

¹⁷⁴² Although I have not heard of it being done, I certainly can at least imagine / dream of a special setting in Honolulu. That would make everybody happy, but may not be as productive in terms of the efficiency of the trial.

¹⁷⁴³ § 7453; and Tax Court Rule 143(a) (providing that any rule of evidence contained in the FRCP will also apply).

¹⁷⁴⁴ Tax Court Rule 151(a).

¹⁷⁴⁵ Tax Court Rule 151(e).

number because of disputes as to the calculations, the Tax Court has a procedure to resolve their differences.¹⁷⁴⁶

The Tax Court's Regular Opinions are printed in official volumes by the Government Printing Office. The Memorandum Opinions are not printed by the Government, but are printed by private services, such as CCH and Tax Analysts. All opinions (including Summary Opinions) are published on the web at <http://www.ustaxcourt.gov/>. As to Summary Opinions, the Web site cautions: "Pursuant to Internal Revenue Code Section 7463(b), these opinions [Summary Opinions] may not be treated as precedent for any other case."

14. Appeals and Precedent.

a. Appellate Review.

Appeals are taken to the court of appeals. § 7482(a). The court of appeals has "exclusive jurisdiction to review the decisions of the Tax Court* * * in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury." *Id.* Basically, and at a risk of oversimplification, factual findings are reviewed for clear error, legal conclusions are reviewed de novo, and mixed questions of fact and law are reviewed under either standard or a blend, depending upon the particular court of appeals' jurisprudence.¹⁷⁴⁷

¹⁷⁴⁶ Tax Court Rule 155. Technically, the "starting point for the [Rule 155] computation is the statutory notice of deficiency from which the parties compute the redetermined deficiency based upon matters agreed by the parties or ruled upon by the Court." Home Group, Inc. v. Commissioner, 91 T.C. 265, 269 (1988), *aff'd* 875 F.2d 377 (2d Cir. 1989).

¹⁷⁴⁷ A case illustrates this phenomenon of a different approach employed by two circuit courts to review of Tax Court appeals – the Second Circuit and the Seventh Circuit. In Diebold Found. v. Commissioner, 736 F.3d 172 (2d Cir. 2013), the Second Circuit reversed its earlier holding that the clear error standard for fact findings also applied to mixed questions of fact and law. The Second Circuit opinion candidly noted that its earlier precedent adopting the clear error standard erroneously relied upon Seventh Circuit law where that is, and remains the standard. Upon reflection, the Second Circuit said that it had erred but now held that "mixed questions of law and fact are reviewed de novo, to the extent that the alleged error is in the misunderstanding of a legal standard." I think the key point is that Tax Court decisions are reviewed like district court decisions. There is no unanimity among the circuits as to which standard applies to mixed questions of fact and law. Even this is substantially summarized at the expense of nuance for a large subject. For possible other interpretations, consider § 7482(c)(1) and scholarly debate over whether there is some vestige of the so-called Dobson rule that the Courts have not fully resolved. Dobson v. Commissioner, 320 U.S. 489, 500-01 (1943) held that the courts of appeals had limited review in Tax Court cases. Section 7482(a) was enacted to overrule Dobson by adopting the same standard as for district court cases. Section 7482(c)(1), however, is not a perfect fit because it can be read as limiting review to legal issues (I don't think that is the majority view). See Leandra Lederman, (Un)Appealing Deference to the Tax Court, 63 Duke L.J. 1833 (2014).

b. Appellate Timing and Venue.

Appeal from a Tax Court decision is taken by filing the notice of appeal with the Tax Court within 90 days of the decision.¹⁷⁴⁸ Venue for the appeal from the Tax Court in redetermination cases (i.e., notice of deficiency cases) is to the Court of Appeals in which the taxpayer resides (if an individual) or has its principal place of business (if a corporation or a partnership subject to the TEFRA procedures) at the time of filing the petition.¹⁷⁴⁹ This is why one of the first items in the findings in a Tax Court opinion in a redetermination case is the residence or principal place of business at the time of filing the petition. Some other types of cases (listed in § 7482(b)(1)) have venue in the Court of Appeals based on residence or principal place of business. However, for cases not listed (such as CDP cases where the liability is not challenged, innocent spouse, employment status and whistleblower awards) venue is to the Court of Appeals for the D.C. Circuit.¹⁷⁵⁰ If a

¹⁷⁴⁸ There is a trap for the unwary here. Taxpayers will sometimes file an appeal with the Court of Appeals rather than the Tax Court itself. In that case, since the statute commands that the notice of appeal be filed with Tax Court and filing with the Court of Appeals will not suffice. § 7483; see also FRAP Rule 13(a)(1). By contrast, an appeal from district court judgments filed with the court of appeals will be sent to the district court where it should have been filed and will be deemed filed with the district court on the date it was filed with the Court of Appeals. FRAP Rule 4(d); see FRAP Rule 14 excluding Rule 4 and other rules from application to appeals from Tax Court decisions.

¹⁷⁴⁹ § 7482(a)(1), (b)(1)(A), (B) and (E). Appeals to the Court of Appeals for the Federal Circuit are specifically excluded by the parenthetical in the first sentence of § 7482(a)(1). See also 28 U.S.C. § 1295 (stating the jurisdiction of the Court of Appeals for the Federal Circuit). However, an appeal improvidently filed in the Court of Appeals for the Federal Circuit can be transferred to the appropriate Court of Appeals under 28 U.S.C. § 1631. Heintz v. Commissioner, 2012 U.S. App. LEXIS 17357 (Fed. Cir. 2012).

The statute does not address venue for a trust or estate appeal where the co-fiduciaries of trusts or estates reside in different circuits. Apparently, § 7482 looks to the residence of the co-trustees rather than the residence or principal place of business of the entity. The Sixth Circuit held that appellate venue could lie in the Court of Appeals appropriate for any of the fiduciaries. Julia R. Swords Trust v. Commissioner, 2014 U.S. App. LEXIS 24746 (6th Cir. 2014) (unpublished order) (reproduced at 2014 TNT 245-7) (case involved an IRS appeal that the IRS could have appealed to Fourth or Sixth Circuits but IRS preferred Sixth Circuit because of unfavorable precedent in Fourth Circuit (this IRS forum shopping may have irritated the Sixth Circuit); holding that, based on all the facts (including notions of convenience to taxpayer (taxpayer favorable precedent is certainly convenient to the taxpayer), notions of waiver of Sixth Circuit venue and reliance by the trust and its fiduciaries), the Fourth Circuit was the more proper forum (close reading of the cryptic facts recited in the Order is necessary) and therefore case transferred to Fourth Circuit). I question this holding, but developing the position would require many pages and not appropriate for this book.

¹⁷⁵⁰ See § 7482(b)(1), flush language. Byers v. Commissioner, 740 F.3d 668 (D.C. Cir. 2014). Carl Smith (Guest Blogger), Chief Counsel Rejects Byers v. Comm'r D.C. Circuit Collection Due Process Appellate Venue Ruling (Procedurally Taxing Blog 7/22/15) (discussing CC-2015-006 (6/30/15) which provides IRS attorneys guidance for applying Byers).

timely appeal is filed to the wrong Court of Appeals, the appeal may be transferred to the correct Court of Appeals if the transfer “is in the interest of justice.”¹⁷⁵¹

In all cases, the parties may, however, stipulate to venue in a different circuit, although this is rarely used.¹⁷⁵²

The foregoing paragraph sets appellate venue for most of the cases that practitioners deal with. However, for certain types of Tax Court proceedings, venue may be in the Court of Appeals for the District of Columbia.¹⁷⁵³

c. **The Golsen Rule.**

The Tax Court follows the law of the Court of Appeals to which an appeal would be taken. This is referred to in tax litigator jargon as the **Golsen rule**, named after the Tax Court case establishing the rule.¹⁷⁵⁴ Accordingly, in determining whether the Tax Court is a favorable or

¹⁷⁵¹ 18 U.S.C. § 1631. I infer from the cases I have observed (anecdotal) is that the authority is liberally applied “in the interest of justice,” particularly pro se appeals from Tax Court decisions.

¹⁷⁵² § 7482(b)(2). For an odd case in which normal venue was in the Eleventh Circuit but the parties apparently stipulated to venue in the Sixth Circuit and the taxpayer attempted unsuccessfully to assert that precedent from Eleventh Circuit controlled the outcome, see Maloof v. Commissioner, 456 F.3d 645, 652 (6th Cir. 2006) (“That he volitionally filed this challenge to the Tax Court’s decision in the Sixth Circuit, not the Eleventh Circuit, makes this something of a bewildering argument.”)

¹⁷⁵³ § 7482(b) (flush language). For more on the venue choices in the D.C. Circuit, see James Bamberg, A Different Point of Venue: The Plainer Meaning of Section 7482(b)(1), 61 Tax Lawyer 445 (2008).

¹⁷⁵⁴ Golsen v. Commissioner, 54 T.C. 742, 756-58 (1970), aff’d, 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971). The Tax Court articulated the Golsen rule as follows: “We follow a decision of the Court of Appeals to which an appeal from our disposition of a case lies so long as that decision is squarely in point and a failure to follow that decision would result in an inevitable reversal.” Rauenhorst v. Commissioner, 119 T.C. 157, 162, fn. 3 (2002) The Tax Court reasons that, while it is not required to follow the applicable court of appeals holding in point, it does so because it would be wasteful to do otherwise, but cautions that the Golsen rule should apply only where “where the holding of the Court of Appeals is squarely on point.” Robinson v. Commissioner, 54 T.C. 742, 757 (1970). We encountered the Golsen rule above in discussing the proper deference to be given Revenue Rulings and noted that the Tax Court does not apply a circuit court’s holdings on deference to Revenue Rulings because such holdings are not substantive. Consider that issue as you consider the Golsen rule above. Consider specifically whether approaches to statutory interpretation – which is what deference is all about – that can produce different interpretations of the statute and results in the case at hand are not substantive? Must the Government be forced to appeal to have the court of appeals hold in its favor under its application of the concept of deference?

unfavorable forum, you look not only to the precedent of the Tax Court but also the precedent of the Court of Appeals to which an appeal may be taken. Unfavorable Tax Court precedent but favorable appellate court precedent will produce a winner in the Tax Court; favorable Tax Court precedent but unfavorable appellate court precedent will produce a loser in the Tax Court, in which case relief will come only if you can convince the Court of Appeals that it messed up in its earlier precedent (usually unlikely).

What if there is no precedent in the Court of Appeals for the circuit in which the taxpayer resides? Well, if the matter is important enough, presumably the taxpayer could change residence (or, if a corporation, its principal place of business) before filing the petition and thereby secure the favorable precedent.¹⁷⁵⁵ This is unlikely to be a satisfactory alternative for most taxpayers. The taxpayer might still be able to obtain the benefit of the favorable precedent in other circuits, however, even if the Tax Court precedent is not consistent with that favorable precedent. Note that the usual formulation of the Golsen rule would permit the Tax Court to follow its own precedent if the Circuit of the taxpayer's residence has not yet spoken, despite contrary precedent in other circuits. Consider the following argument. Some courts of appeals take the position that, in the absence of that court having spoken on the issue, that court should give respectful consideration to other circuits' decisions. For example, the Seventh Circuit said:

As a general matter, “[r]espect for the decisions of other circuits is especially important in tax cases because of the importance of uniformity, and the decision of the Court of Appeals of another circuit should be followed unless it is shown to be incorrect.”¹⁷⁵⁶

In this circumstance, the taxpayer should argue to the Tax Court that, indeed, the Tax Court is bound to follow the decision of another circuit or, at a minimum, give substantial deference to that decision, even if the Tax Court has a prior different position on the matter.

Finally, I noted above that, at present, some Tax Court appeals are to the Court of Appeals of residence or principal place of business and some are to the Court of Appeals for the District of Columbia Circuit. This dichotomy can and, should it continue, over time will affect the interpretation and application of the tax law. Where the appeals are not defaulted to the Court of Appeals for the District of Columbia Circuit, as apparent from the foregoing discussion, conflicts among the circuits can develop in the various Courts of Appeals to which Tax Court appeals can be taken. Those conflicts are not always resolved by the Supreme Court and certainly not quickly resolved. So taxpayers in different parts of the country can be treated differently. However, where the appeal must be taken under the default provision to the Court of Appeals for the District of

¹⁷⁵⁵ But, the change of residence or principal place of business must be real and substantial rather than gossamer solely to affect the legal consequences (here the Court of Appeals' precedents). See e.g., Uviado LLC v. United States, 2010 U.S. Dist. LEXIS 131678 (SD TX 2010) (in the case of the TEFRA rules for partnership district court proceedings).

¹⁷⁵⁶ Square D. Company v. Commissioner, 438 F.3d 739 (7th Cir. 2006). This notion that, in federal tax matters, the need for uniformity in taxation across the circuits justifies deference to other circuits has been echoed in opinions of circuits other than the Seventh Circuit.

Columbia, a uniform rule will apply. For example, if the taxpayer pursues a CDP remedy in the Tax Court, the Golsen result for the Court of Appeals for the District of Columbia will apply to all – taxpayers and the Government alike. In some ways, on this issue, the Court of Appeals for the District of Columbia will become the court of tax appeals that various practitioners and scholars have argued for and against over many years.¹⁷⁵⁷

15. Nondeficiency Jurisdiction of the Court.

The foregoing discussion of litigation in the Tax Court has dealt principally with its deficiency jurisdiction – i.e., its jurisdiction requiring a timely petition to redetermine the tax liability asserted in a notice of deficiency. Congress has, however, added jurisdiction over other tax

¹⁷⁵⁷ Thanks for the inspiration for this paragraph goes to [Keith Fogg, Appellate Venue in Tax Court cases – Taking Care in Applying Golsen in non-deficiency cases \(Procedurally Taxing Blog 11/26/13\)](#).

The concept of a single court of appeals, variously formulated, for tax cases has been around for many years, with many proponents and opponents. Although there are any number of articles on the subject, I cite only one because it sets up the issue nicely. Ruth Bader Ginsburg and Peter W. Huber, The Intercircuit Committee, 100 Harv. L. Rev. 1417, 1429 n. 61 (1987):

There may be a few discrete bodies of law so arcane and complex that no other solution will do. The Federal Circuit now satisfies the need for early appellate declaration of national law in certain areas, notably, patent disputes. See 28 U.S.C. § 1295 (1982) (assigning to the United States Court of Appeals for the Federal Circuit exclusive jurisdiction over enumerated matters, including appeals from the district courts in patent cases, appeals from the Merit Systems Protection Board, appeals from the agency boards of contract appeals, and appeals from the district courts in certain cases against the United States); see also S. REP. NO. 275, 97th Cong., 2d Sess. 3, 4, reprinted in 1982 U.S. CODE CONG. & ADMIN. NEWS 11, 13, 14. Congress believed that the federal judicial system lacked sufficient capacity "to provide reasonably quick and definitive answers to legal questions of nationwide significance." *Id.* at 13. It therefore established the Federal Circuit to adjudicate definitively in areas where the legislators found "special need for nationwide uniformity." *Id.* at 14.

A single court of tax appeals could promote uniformity and coherence in another federal law domain populated by specialist advocates and rarely benefitted by the labors of generalist judges, including those on the Supreme Court. See H. FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 161-71 (1973); Ginsburg, Making Tax Law Through the Judicial Process, 70 A.B.A. J. 74 (1984); Griswold, The Need for a Court of Tax Appeals, 57 HARV. L. REV. 1153 (1944).

In the course of the research I picked up that two leading legal authorities, Roger Traynor and Stanley Surrey had also proposed such a single court of tax appeals. See Mirit Eyal-Cohen, Preventive Tax Policy: Chief Justice Roger J. Traynor's Tax Philosophy, 59 Hastings L.J. 877 (2008). Readers may recall that, earlier in this text, I cited an article which Traynor and Surrey co-authored two other prominent scholars as the best tax procedure law review article ever.

issues over the years. I shall just summarize some of these to give you a flavor for the Tax Court's nondeficiency jurisdiction.

a. Collection Due Process Proceedings.

A major addition to Tax Court jurisdiction is the collection due process proceeding ("CDP"). I discuss CDP and the Tax Court jurisdiction below (pp. 657 ff.). As will be noted, this promises to be a frequently used process and to produce many Tax Court opinions, as the Court struggles with this new area of litigation and establishes and interprets the procedures applicable to it.

b. Declaratory Judgment.

The Tax Court is given jurisdiction to issue declaratory judgments (i) as to the qualification and continuation of qualification of certain retirement plans,¹⁷⁵⁸ (ii) as to the value of a gift disclosed on a return,¹⁷⁵⁹ (iii) as to the qualification for certain governmental bonds for exclusion from income under § 103;¹⁷⁶⁰ and (iv) as to eligibility for installment payment of estate tax under § 6166.¹⁷⁶¹ The IRS has special rules for such declaratory judgments.¹⁷⁶²

c. Employee - Independent Contractor Disputes.

The Tax Court has jurisdiction to determine whether the IRS has properly characterized a person providing services to a taxpayer as an employee or an independent contractor or whether the taxpayer is entitled to so-called "Section 530 relief" which provides a safe harbor to permit such service providers to be characterized as independent contractors even if they might otherwise be treated as employees.¹⁷⁶³ Paralleling the procedure for deficiency determinations for income and estate and gift tax, the IRS will send the taxpayer a Notice of Determination of Worker Classification ("NDWC") and the taxpayer has 90 days to petition for redetermination.¹⁷⁶⁴ A small case procedure is provided, again paralleling the small case procedure for deficiency determinations.¹⁷⁶⁵ Finally, in order to make this remedy a prepayment remedy, the statute provides that "The principles of" the various Code sections assuring the prepayment remedy for deficiency proceedings (e.g., § 6213(a)'s prohibition on assessment) apply as if the IRS's determination were a notice of deficiency.¹⁷⁶⁶

¹⁷⁵⁸ § 7476.

¹⁷⁵⁹ § 7477.

¹⁷⁶⁰ § 7478.

¹⁷⁶¹ § 7479.

¹⁷⁶² Tax Court Rules of Practice Title XXI.

¹⁷⁶³ § 7436(a). See Tax Court Rules Title XXVIII.

¹⁷⁶⁴ § 7436(b)(2).

¹⁷⁶⁵ § 7436(c). For procedures generally, see John Tuzyinski Memo titled "Officer Compensation and IRC Section 3509, 7436 and Section 530 of the Revenue Act of 1978" (3/22/07).

¹⁷⁶⁶ § 7436(d).

The Tax Court held that this jurisdiction includes the jurisdiction to determine the amount of liability as well as the proper additions to tax and penalties.¹⁷⁶⁷

d. Disclosure Disputes.

Section 6110 provides that written determinations by the IRS be disclosed to the public. Congress's concern was that there was a body of "hidden" law in various IRS determinations – the most prominent of which are private letter rulings – and that the taxpaying public should have reasonable access to that hidden law. The tension, however, was to insure that sensitive taxpayer return information be kept confidential. The solution in § 6110 is to require that the determination be disclosed, but to require redactions of information that would identify the taxpayer.

Two problems may come up with such disclosures. First, the taxpayer to whom the determination relates may feel that the IRS's proposed disclosure is not sufficiently redacted to delete unique information that might identify the taxpayer. Second, the public at large or particular taxpayers may feel that a determination has not been disclosed or that too much information is redacted in violation of Congress's desire to have the public know the bases for such written determinations.

The solution to the first problem is to provide the taxpayer an administrative and judicial remedy before disclosure if the taxpayer believes too much identifying information is being disclosed. Before making the disclosure, the IRS must send the taxpayer a notice of intention to disclose showing the part of the written determination that will be redacted and the part that will be disclosed. If the taxpayer feels that not enough information is being redacted, the taxpayer may pursue an administrative remedy and thereafter, if still not satisfied, may bring a proceeding in the Tax Court.¹⁷⁶⁸

The solution to the second problem is that members of the public may bring a proceeding in the Tax Court or in District Court for additional disclosure.¹⁷⁶⁹

The Tax Court is specifically granted authority to make rules to close the portions of the record necessary to maintain secrecy of sensitive information.¹⁷⁷⁰

e. Partnership Proceedings.

As we discuss below (pp.748 ff.), the Code has unified audit and litigation procedures. Disputes regarding partnership level items are resolved in unified audits and litigation. The litigation procedures include a Tax Court remedy similar to the deficiency proceedings. The IRS

¹⁷⁶⁷ Ewens and Miller Inc. v. Commissioner, 117 T.C. 263 (2001).

¹⁷⁶⁸ § 6110(f).

¹⁷⁶⁹ § 6110(f)(4).

¹⁷⁷⁰ § 6110(f)(6).

makes a determination and the partnership or the partners may institute or participate in the litigation. I discuss these procedures in more detail below in Chapter 15.

f. Supplemental and Related Proceedings.

Miscellaneous jurisdiction is given for certain supplemental proceedings – to enforce an overpayment determination,¹⁷⁷¹ to redetermine interest on assessments resulting from Tax Court decisions or overpayments determined by the Tax Court,¹⁷⁷² and proceedings to modify decisions in § 6166 dealing with deferred payment of estate taxes.¹⁷⁷³

g. Recovery of Administrative Costs.

Similarly, the Tax Court may hold supplemental proceedings to determine the amount of administrative costs to be awarded under § 7430.¹⁷⁷⁴ If the matter were litigated in the Tax Court, the Court could award such costs incident to the pending Tax Court litigation. However, if the matter is resolved administratively in appeals, there will be no Tax Court case and this confers the necessary jurisdiction to permit a judicial remedy for recovery of these costs.

h. Proceedings to Abate Interest.

Section 6404 permits the IRS to abate interest in certain cases (pp. 273 ff.). The Tax Court has jurisdiction to review the IRS's determination.¹⁷⁷⁵

B. District Courts.

1. The Judges.

District Court judges are Article III judges – i.e., have life tenure. Vis-a-vis the tax law, they are generalist judges who at any given time will have civil tax cases as a very low percentage of their dockets. And, civil tax cases are not priority items in terms of scheduling trials; criminal cases take priority. Hence, pursuing tax cases in busy district courts can take much more time than in the other available fora.

District Judges may use Federal Magistrate Judges for certain functions in the litigation before the court, and in civil cases (such as tax cases) the parties may consent to trial by the Magistrate Judge. Like the District Judge, the Magistrate Judge will be a generalist vis-a-vis the tax

¹⁷⁷¹ Tax Court Rule 260.

¹⁷⁷² Tax Court Rule 261.

¹⁷⁷³ Tax Court Rule 262.

¹⁷⁷⁴ Tax Court Rules Title XXVI.

¹⁷⁷⁵ § 6404(i).

law. The principal reason to consent to trial before the Magistrate Judge is to obtain a more timely trial.¹⁷⁷⁶

2. Types of Tax Litigation In District Courts.

District courts are courts of general jurisdiction and thus generally may hear cases related to tax matters, subject to any jurisdictional limitations imposed by Congress. The typical tax cases heard by the district court are (1) refund suits involving the merits of whether the taxpayer owes the tax or penalty (or sometimes a procedural issue like assessment beyond the statute of limitations); (2) summons enforcement actions; and (3) collection suits when the IRS chooses to go beyond its administrative enforcement powers or merge the lien into a judgement for a new judgement statute of limitations. I focus in this discussion upon the first type of case. I have previously discussed the summons enforcement suit along with the summons discussion in Ch. 9.

Although I deal here mostly with **refund suits**, I should note the **collection suit**.¹⁷⁷⁷ The Government may bring a collection suit in the district court to reduce an assessment to judgment and to obtain judicial remedies with respect to the tax liability. If the taxpayer has not by that time judicially contested the underlying tax liability, he or she can do so in that collection suit. Sometimes a collection suit is combined with a refund suit. The classic case is the so-called divisible tax case -- best exemplified by the fairly common trust fund recovery penalty under § 6672. As I shall note elsewhere (pp. 704 ff.), this penalty is litigated usually by a refund suit. The putative responsible person will pay a small amount to meet the jurisdictional prerequisite that there be a payment which could be refunded. In the resulting refund suit, the Government will typically file a counterclaim for the balance of the amount that has been assessed. That counterclaim is nothing more than a collection suit that could have otherwise been brought independently by the Government to obtain a judgment for the unpaid tax. The Government will pursue the matter as a counterclaim in order to get the putative responsible person's liability for all quarters concluded in one litigation.

In addition, the district courts have a potpourri of other jurisdiction, examples of which include jurisdiction to quash a formal document request,¹⁷⁷⁸ to order more disclosure of a written determination,¹⁷⁷⁹ to consider petitions for readjustment of partnership adjustments,¹⁷⁸⁰ jurisdiction to approve a levy on a principal residence,¹⁷⁸¹ general jurisdiction to enter orders and judgments

¹⁷⁷⁶ For a discussion of the role of the Magistrate Judge in tax cases, see Kathleen Pakenham, You Better Shop Around: The Status and Authority of Specialty Trial Judges in Federal Tax Cases, 2004 TNT 120-42 (6/9/04).

¹⁷⁷⁷ For a summary of the process, including authority, jurisdiction, etc., for such suits, see IRM 5.17.4 Suits by the United States.

¹⁷⁷⁸ § 982(c)(2)(B).

¹⁷⁷⁹ § 6110(f)(4)(A) (concurrent jurisdiction with the Tax Court).

¹⁷⁸⁰ § 6226(a) (concurrent jurisdiction with Tax Court).

¹⁷⁸¹ § 6334(e)(1)(B).

necessary or appropriate for the internal revenue laws,¹⁷⁸² jurisdiction over summons enforcement proceedings,¹⁷⁸³ actions to enforce a lien and declare a sale,¹⁷⁸⁴ certain injunctions against persons abusing the tax system,¹⁷⁸⁵ wrongful levy suits where a third party claims his or her property was levied upon to pay another taxpayer's taxes,¹⁷⁸⁶ declaratory judgments for § 501(c)(3) organizations,¹⁷⁸⁷ review of jeopardy assessments and levies,¹⁷⁸⁸ and so on and on.¹⁷⁸⁹ For purposes of this course, please focus your attention on the refund suit jurisdiction and its collection suit counterpart. I shall not expect you to know this potpourri of miscellaneous jurisdiction.

3. Refund Suits.

a. Prerequisites for Refund Suits.

In order to bring a refund suit, the taxpayer must first file a claim for refund and, upon its denial by the IRS or the IRS's failure to act within six months, must then file a suit for refund. § 7422. I have discussed these requirements above (p. 221 ff.). Please review that discussion at this point.¹⁷⁹⁰

The refund suit must be brought by the taxpayer whose liability was paid. If some other person actually remitted the tax to the IRS in payment of the taxpayer's taxes, the remitter cannot bring the suit because the remitter is not the taxpayer. In cases where the IRS may have acted egregiously in collecting the amount involved, there may be work arounds that will give the remitter some relief permitting some type of legal action, but they are very limited instances. Thus, the Court of Federal Claims has a narrow exception that permits a remitter to file a suit in the Court of Federal

¹⁷⁸² § 7502.

¹⁷⁸³ § 7402(b).

¹⁷⁸⁴ § 7403.

¹⁷⁸⁵ §§ 7407 & 7408.

¹⁷⁸⁶ § 7426.

¹⁷⁸⁷ § 7428.

¹⁷⁸⁸ § 7429.

¹⁷⁸⁹ For collection due process ("CDP") determinations issued prior to 10/17/06, the district court had certain residual jurisdiction. § 6330(d)(1), prior to amendment by the Pension Protection Act of 2006, Pub. L. No. 109-280, § 855(a), 120 Stat. 780, enacted on August 17, 2006. That Act amended § 6330(d)(1) to give the Tax Court exclusive jurisdiction for judicial review of all CDP determinations issued after 10/17/06.

¹⁷⁹⁰ The Sixth Circuit held that where the Government has refunded an overpaid tax and all that is in issue is the interest on the overpaid tax, the taxpayer may sue for refund rather than being relegated to a Tucker Act contract claim in the Court of Federal Claims. The E.W. Scripps Company v. United States, 420 F.3d 589 (6th Cir. 8/19/05). For a discussion of the perceived importance of this case, see James V. Heffernan and Mary E. Monahan, Alternate Forum for Overpayment Interest Litigation, 2005 TNT 186-29.

Claims to recover tax where the IRS has coerced the remitter to pay another's tax liability.¹⁷⁹¹ The theory of the suit is not a refund suit, however, but an implied contract on the part of the United States to make restitution. In addition, the Supreme Court stretched the refund suit notion to cover a nontaxpayer remitter in United States v. Williams, 514 U.S. 527 (1995). Williams too may be a very narrow situation, made even more narrow by subsequent legislation giving persons in Mrs. Williams' situation a remedy without having to distort the requirement that the plaintiff in a refund suit be the taxpayer. I discuss Williams below beginning on p. 669, and direct the reader to that discussion.

There is a special rule where the taxpayer has brought a refund suit in either the district court or the court of Federal Claims and the IRS thereafter issues a notice of deficiency (on the theory that the taxpayer is not only not entitled to a refund but owes more taxes). **Section 7422(e)** imposes a stay on the refund suit to give the taxpayer the option of filing a petition in the Tax Court, whereupon the entire case is transferred to the Tax Court. If the taxpayer does not file a petition in the Tax Court, the IRS is then given the opportunity to counterclaim in the refund suit and everything gets resolved there.¹⁷⁹²

¹⁷⁹¹ The seminal case in the predecessor court to the present Court of Federal Claims is Kirkendall v. United States, 31 F. Supp. 766, 769, 90 Ct. Cl. 606 (Ct. Cl. 1940). Kirkendall and the subsequent cases are collected and discussed in Robinson v. United States, 2011 U.S. Claims LEXIS 1 (2011).

¹⁷⁹² There is one nuance here that practitioners should be aware of. The question is whether the Government **must** assert its claim in the refund suit by way of counterclaim. The statute says that the Government "may" assert the counterclaim. Apparently seizing on that language, the cases seem to permit the IRS to forego asserting a counterclaim and pursue the administrative collection measures after the refund suit is concluded. The cases speak in terms of the compulsory counterclaim under FRCP 13(a) and conclude in broad strokes that this seems to be permitted by the statutory scheme and the use of the permissive word "may." I am skeptical, but it is a skepticism in the face of significant at least dicta. Let me posit 2 situations: In each case, assume (i) the taxpayer has filed a refund suit; (ii) the refund suit is pending; (iii) the IRS issues a notice of deficiency for additional taxes for the same year. If the taxpayer loses in the refund suit, the holding is that the taxpayer has not shown that he has overpaid the tax for the year; the holding is not that the taxpayer does not owe additional tax. There should be nothing preclusive about that holding unless there were something in the statute that prohibits (like the prohibition on notices of deficiency once a case is pending in the Tax Court). If, by contrast, the taxpayer prevails in the refund suit, the holding is that the taxpayer has in fact overpaid his tax liability for the year; this holding implicitly but necessarily is a holding that the taxpayer does not owe additional tax liability otherwise the Court could not find that he has made an overpayment. Those wishing to pursue this issue might want to start with Hemmings v. Commissioner, 104 T.C. 221 (1995) which reviews much the authority up to the date of that decision and note particularly footnote 14 on page 235:

n14 We need not decide whether, if an assessment had been made, the claim of the United States would then constitute a compulsory counterclaim. See Crocker v. United States, 323 F. Supp. 718 (N.D. Miss. 1971). But cf. Pfeiffer v. United States, 518 F.2d at 129-130 n.11. There had been no assessment at the time of the MDL [the refund] proceedings in this case.

b. Claim for Refund and Variance.

As noted above (pp. 221 ff.), there are strict statutes of limitations on filing the claim for refund and then bringing a refund suit. Furthermore, jurisdictionally, the taxpayer will be limited to litigating the claims asserted in the claim for refund.¹⁷⁹³ Accordingly, it is critical to identify all the issues that might be raised and raise them in the claim for refund in a manner that fairly puts the IRS on notice of the claims.

c. The Full Payment Rule and its Mitigation.

(1) Claim for Refund Predicate.

Before filing a suit for refund, the taxpayer must first file a claim for refund and have it either denied or not acted upon during the six month period after filing the claim. This requirement is designed to allow the IRS to pass first upon matters that it may not have previously considered, so that the refund can be granted without court proceedings if the claim has merit sufficient that the IRS does not wish to contest it. Of course, in most cases where a claim for refund is filed, the IRS will have already considered the issue (e.g., in the audit) and the filing of a claim for refund is a mere formality, for the IRS has no intention of granting the claim. In a case where it is unlikely that the IRS will act favorably because they have previously refused the relief requested, the taxpayer desiring to litigate expeditiously can do so by sending with the claim a request for prompt disallowance of the claim. The IRS usually will grant a prompt disallowance if the taxpayer requests it and the matter has indeed been previously considered by the IRS.

The Code allows the taxpayer to waive notice of disallowance under § 6532(a)(3). You must be careful not to file that waiver and then sue for refund before the 6 month period elapses. The waiver is not the equivalent of notice of disallowance. I see no reason to file such a waiver.

(2) The Prepayment Rule.

In order to file a claim for refund and then sue for refund, the taxpayer must be able to assert that he or she overpaid taxes. The critical question has been how much the taxpayer must pay in order to assert an overpayment. The historical answer was that the taxpayer must have fully paid the assessment (which includes penalties and interest) in order to bring a refund suit. This is referred to as the prepayment requirement which tax practitioners sometimes refer to as the Flora rule, after the Supreme Court case, **Flora v. United States, 362 U.S. 145 (1960)**.

Why is a prepayment rule important? As the Supreme Court in Flora viewed the history and fabric of the procedures Congress adopted for tax litigation, any other rule would be counterproductive to those procedures. Congress created the Tax Court as the forum for litigating most tax controversies. The Tax Court is a prepayment judicial forum, and is the only prepayment judicial forum we have for resolving the merits of tax liabilities (excepting of course collection suits

¹⁷⁹³ United States v. Felt & Tarrant Mfg. Co., 283 U.S.269 (1931).

in the district courts). If the IRS could assert a deficiency of, say, \$100,000 and the taxpayer could get a prepayment remedy simply by paying \$1 against the assessment that follows, the taxpayer could effectively turn the district courts or Court of Federal Claims into prepayment fora.

Of course, this highlights one of the problems with the prepayment rule. A taxpayer who does not have the money to pay (the \$100,000 assessed amount in the above example) doesn't really have a choice. He or she must pursue the prepayment remedy in the Tax Court. Is that fair? Do citizens get better choices solely because they have substantial resources? That is a policy question, and of course the answer is yes (just as substantial resources open up better and more choices throughout the law and life).

Many authorities and commentators felt that *Flora* required full payment of not only the principal amount of tax liability, but also any penalties and interest assessed by the IRS. This, of course, makes the cost of entry to refund litigation more expensive, particularly if distant years are involved where the interest can be more than the tax or penalties. It is not unusual in tax cases involving old years to have the interest alone, because of the passage of time, cause the total bill with interest to triple or quadruple the principal amount involved. With this “cost” of refund litigation, many taxpayers are forced to pursue the Tax Court route if it is available to them, as it is when income tax, estate and gift tax and certain types of miscellaneous tax liabilities are in dispute.

(3) Mitigating the Prepayment Rule.

(a) Express Statutory Mitigation.

The Code allows certain portions of the estate tax to be paid in installments.¹⁷⁹⁴ The prepayment rule if not relaxed would not permit a refund suit until the final installment is paid and, worse, the 2 or 3 year limitation would result in denials of refunds properly due. Accordingly, the Code specifically provides that a refund suit may be brought even if the tax is not fully prepaid, provided that the installments have not been accelerated and no installments are overdue.¹⁷⁹⁵

(b) Divisible Tax Mitigation.

Taxes which are divisible can permit the taxpayer to fully pay one or more portions but not all. A divisible tax has been described as follows:

Where a tax is considered a “divisible tax,” the taxpayer need only pay a portion of the tax before instituting suit (assuming other jurisdictional prerequisites are met). A divisible tax is one that represents the aggregate of taxes due on multiple transactions (e.g., sale of items subject to excise taxes). It is a tax the assessment

¹⁷⁹⁴ See § 6166.

¹⁷⁹⁵ § 7422(j); see *Hansen v. United States*, 248 F.3d 761 (8th Cir. 2001) (holding that a taxpayer behind on the installments may not sue for refund under this provision).

of which reflects the cumulation of several separable assessments based on separate transactions.¹⁷⁹⁶

Hence, on rehearing, in Flora, the Court said excise taxes "may be divisible into a tax on each transaction or event, so that the full-payment rule would probably require no more than payment of a small amount."¹⁷⁹⁷

The most frequently encountered divisible tax I have encountered in practice is the trust fund tax penalty ("TFRP") imposed under § 6672 upon persons who are responsible to collect and pay over the employees share of withholding taxes and FICA but who fail to do so.¹⁷⁹⁸ These taxes are reported and taxed on a quarterly basis. Although these withholdings are accounted for, in the aggregate, quarterly for all employees, they are separate liabilities for each employee (so the theory goes). A taxpayer wishing to contest the IRS' assertion of responsible person penalty tax liability need only pay for one taxpayer for the quarter. I discuss the responsible person penalty litigation in a subsequent portion of this book. Although I discuss the TFRP in some detail, many of the principles may apply to other divisible taxes.¹⁷⁹⁹

In divisible tax cases, the refund litigation from the payment of the divisible portion of the tax and denial (or deemed denial by inaction) of the claim for refund proceeds as follows: (i) the taxpayer sues for refund of the divisible taxes paid, putting in play his or her liability for the taxes paid and, by operation of principles of res judicata or collateral estoppel, his or her liability for the taxes not paid; and (ii) the Government will then counterclaim for the unpaid taxes putting in play his or her liability for the unpaid taxes.¹⁸⁰⁰ For example, in the TFRP situation, a party against

¹⁷⁹⁶ ILM 201150029 (11/9/11), reproduced at 2011 TNT 243-31 (citations and some quotation marks omitted); see also ILM 201315017 (12/20/12, reproduced at 2013 TNT 72-23 ("hallmark of a divisible tax is that the gross tax imposed is composed of the accumulation of discrete assessments based on separate underlying transactions, rather than being one assessment flowing from a single underlying event."). Section 6331(i) provides that there will be no levy or collection suit on the unpaid portion of certain divisible tax during the pendency of a refund suit for the paid portion in certain cases.

¹⁷⁹⁷ Flora v. United States, 362 U.S. 145, 175 n.38 (1960).

¹⁷⁹⁸ §§ 6672 and 3505.

¹⁷⁹⁹ See e.g., ILM 201315017 (12/20/12, reproduced at 2013 TNT 72-23, concluding that penalties arising from failure to report transactions in the aggregate and failure to issue forms 1099s to independent contractors are divisible, thereby permitting the party against whom the penalties are asserted to bring a refund suit with respect to the discrete underlying transactions (e.g., payment of the penalty attributable to only one of many independent contractors).

¹⁸⁰⁰ Univ. of Chicago v. United States, 547 F.3d 773, 785 (7th Cir. 2008) (citing Korobkin v. United States, 988 F.2d 975, 976 (9th Cir. 1993) (per curiam); and Ruth v. United States, 823 F.2d 1091, 1093 (7th Cir. 1987).

Peppers v. United States, 2012 U.S. App. LEXIS 12498 (6th Cir. 2012) illustrates the conceptual difficulty. There, the taxpayer paid a small amount of a divisible tax sufficient that would have given a district court jurisdiction (\$150), filed a claim for refund of that portion and

whom the TFRP may pay the penalty for a single employee for a single quarter regardless of how many quarters were assessed to start this process.¹⁸⁰¹

Being able to pay less than all tax, penalties and interest assessed would be of little benefit if the IRS could continue collection activity for the unpaid balance of the assessed tax, penalties and interest. **Section 6331(i)** prohibits levy or collection suit for that balance during the pendency of the refund suit if the decision in the refund suit would be res judicata or collateral estoppel as to the balance. This works fine for the assessments to which it applies – employment taxes under subtitle C of the Code and the TFRP. However, other taxes may be divisible as well, and there is no prohibition on levy during the pendency of the case. Back in the old days when I was with DOJ Tax, when there was no prohibition on levying for the TFRP, a request from the attorney representing the taxpayer in a TFRP would be passed on to the IRS which would voluntarily hold off on levies. That might work. Alternatively, if the IRS attempts a levy, the taxpayer or other person assessed might invoke a collection due process proceeding.

(c) **Judicial Interpretation Mitigation.**

Cases from the Court of Federal Claims have mitigated strict reading of the full payment rule by holding that, where the taxpayer is contesting only the principal amount of the tax liability, he or she need only fully pay the principal amount of the tax liability and not the interest (which can be substantial where extensions to the statute of limitations are involved). I discuss these cases under the discussion of the Court of Federal Claims below, but there is no reason that the holdings would not equally apply in federal district courts.¹⁸⁰²

The concept developed in these cases must, of course, work around Flora's full payment rule. So the concept goes, if the taxpayer is urging overpayment of all or part of the underlying principal tax liability (and not contesting the determination and assessment of penalties and interest separate

abatement of the unpaid portion (Form 843), but filed suit for refund untimely after denial of the claim. The taxpayer then paid a small amount (this time \$200) for another divisible portion of the tax, filed another claim for refund and abatement, and, upon its denial, filed a timely suit for refund. The district court dismissed on the basis that the failure to file timely suit on the first claim precluded the second claim. The Sixth Circuit affirmed in a cryptic per curiam nonprecedential opinion. I am not sure this was a correct holding. The original claim for refund was for different tax than the subsequent one and hence the failure to sue timely for denial of the original tax should not foreclose a subsequent claim and suit unless the unpaid portion of the divisible tax is put in issue by filing a suit through either res judicata or collateral estoppel or by the Government counterclaiming.

¹⁸⁰¹ See Todd v. United States, 2009 U.S. Dist. LEXIS 90096 (S. D. Georgia, Sept. 29, 2009) (held a taxpayer need only pay the withholding tax of one employee for one quarter to meet the jurisdictional requirements for all quarters at issue for that employer).

¹⁸⁰² I understand from informal discussions with representatives of DOJ Tax which represents the IRS in refund litigation cases that it will not contest jurisdiction on the basis of Flora where these rules are met.

and apart from overpayment of the principal tax), the taxpayer may meet Flora by paying the amount of the assessed tax with a designation that the payment is to be applied to the assessed tax alone and not to assessed penalties and interest. I hope you have already spotted that, in this posture, the taxpayer succeeding as to all or part on the principal tax liability will also succeed in wiping out the assessment for the unpaid ad valorem penalties (such as the accuracy related and fraud penalties) and interest attributable to the principal tax, but the taxpayer will not be able to contest whether the penalties were erroneously assessed (either because the elements of liability other than the existence of a principal tax liability to which the penalty attaches do not exist or a reasonable cause exception applied). Similarly, if the taxpayer is contesting only the application of penalties, the taxpayer can fully pay the penalties with an appropriate designation and Flora is then satisfied in a refund suit to recover the overpaid penalties. (In either case, where there are unpaid assessments of either principal tax liability, penalties or interest, the Government will likely counterclaim in the refund suit.) Of course, the Government is likely to counterclaim for the unpaid balance (whether principal, penalties or interest) and put those liabilities in play.

d. Jury Trial.

Although Congress usually conditions a waiver of sovereign immunity upon the plaintiff's relinquishing a jury trial,¹⁸⁰³ the key exception for tax purposes is the refund suit.¹⁸⁰⁴ Either side may request a jury. Although we focus here on refund suits, it is useful – even though redundant – to state also that, in nonrefund suits, actions against the United States, including other types of actions in tax cases, do not permit a jury trial.¹⁸⁰⁵

e. Setoffs.

(1) The Setoff Concept.

Since the issue in a refund suit is whether a taxpayer has overpaid his liability, the Government is permitted to raise issues that have not previously been asserted but that would tend to show that, even if the taxpayer is correct on the issue for which he is asking a refund, the taxpayer nevertheless has not overpaid his tax liability for the period in issue. This is called a setoff (or offset). It does not force open an otherwise closed statute of limitations and permit the Government to collect additional taxes; all it does is to permit the Government to defend against having to pay a refund because for reasons not previously asserted the taxpayer has not overpaid his tax and thus is not entitled to a refund for the year in question.¹⁸⁰⁶ The case establishing this right of setoff is

¹⁸⁰³ Lehman v. Nakshian, 453 U.S. 156, 161 (1981); see 28 U.S.C. § 2402.

¹⁸⁰⁴ 28 U.S.C. § 2402 (providing the exception that “any action against the United States under section 1346 (a)(1) [the refund provision] shall, at the request of either party to such action, be tried by the court with a jury.”)

¹⁸⁰⁵ 28 U.S.C. § 2402. Examples would include FOIA suits, wrongful levy suits, suits for damages under § 7433, etc.

¹⁸⁰⁶ A court may deny the Government the right to assert the offset if the Government failed to assert the claim timely in the orderly course of the litigation. See e.g., Principal Life Ins.

Lewis v. Reynolds, 284 U.S. 281 (1932), and that case name should be part of the tax lawyer's jargon.¹⁸⁰⁷

(2) Procedural Predicates for Setoffs in Refund Cases.

The Government's right to setoff means, practically, that, upon the taxpayer filing the refund suit, the Government might do a re-audit in order to avoid having to pay a refund on the basis of the taxpayer's claims in the claim for refund and resulting suit for refund.¹⁸⁰⁸ Obviously, should the Government do so, the resulting audit via discovery and trial of new issues could substantially affect and disrupt the orderly progress of litigation. For that reason, the courts generally require that the Government meet some procedural burdens to assert and pursue the setoff in the litigation.

First, the Government should assert the right to setoff in its answer in the case. While technically it might be argued that the right to setoff is not technically an affirmative defense,¹⁸⁰⁹ Courts have treated it as an affirmative defense that must be pled under FRCP Rule 8(b)(1)(A).¹⁸¹⁰

Co. v. United States, 77 Fed. Cl. 2007 (2007).

¹⁸⁰⁷ In Pacific Gas & Electric Co. v. United States, 417 F.3d 1375 (Fed. Cir. 2005), the Court found limits on Lewis v. Reynolds. The taxpayer earlier received an erroneous refund of "statutory interest" (i.e., interest calculated on a refund for the year in question) for 1982. The IRS just had miscalculated and overpaid the statutory interest. The taxpayer thereafter filed a refund claim for the same year (1982) based upon carrybacks from a subsequent year (1984). In considering the claim, the IRS discovered the overpayment of statutory interest. By this time, however, the period during which the IRS could have sued for erroneous refund (2 years under §§ 7405 and 6532(b)) had expired. The IRS therefore sought to set off the erroneous overpayment of statutory interest against the refund otherwise due on the other items. The Court rejected the IRS setoff based on a close (perhaps too thin) reading of the "overpayment" analysis developed in Lewis v. Reynolds and its progeny.

In an interesting and perhaps aberrational decision, a majority on a panel of the Fourth Circuit perhaps in dicta found some limits to Lewis v. Reynolds, but the facts are so aberrational and the decision so questionable as to its application of the Anti-Injunction statute, I do not discuss it further here. See Estate of Michael v. Lullo, 173 F.3d 503 (4th Cir. 1999). I do however, discuss the case further below in the part of the text dealing with the Anti-Injunction statute and the judicially created Enochs v. Williams Packing exception to the Anti-Injunction statute.

¹⁸⁰⁸ The Supreme Court so recognized this potential based on its holding in Lewis v. Reynolds.

¹⁸⁰⁹ This may depend upon how one defines affirmative defense. An affirmative defense is something that defeats an otherwise valid claim. The setoff does not defeat an otherwise valid claim. The setoff is just a claim that the taxpayer, as plaintiff, has not met his burden to prove he is entitled to a refund. However, in the context, it functions and has the attributes of a defense and perhaps an affirmative defense.

¹⁸¹⁰ Lockheed Martin Corp. v. United States, 973 F. Supp. 2d 591 (D. Md. 2013); see also Wells Fargo & Company v. United States, 750 F.Supp.2d 1049 (D. Minn. 2010). As to timely identification of the set off offense, see Principal Life Ins. Co. v. United States, 77 Fed. Cl. 2007

There is an issue of the level of factual specificity, if any, required to plead the set off in the answer, but there is no question that the Government has the right to plead the setoff.¹⁸¹¹ The pleading burden is not much of a burden, particularly if, as at least one court has held, all the Government must assert is the general legal proposition that it has the right to assert an offset without identifying any offset or any factual basis for that general legal proposition.¹⁸¹²

Second, the Government must then undertake the “re-audit” allowed by the setoff concept approved in Lewis v. Reynolds. That would be done through discovery in the litigation. Courts can control the discovery process and prevent fishing expeditions in search of the setoff.¹⁸¹³

Finally, if the setoff issue(s) then get to the trial stage, courts that have addressed the issue require that the Government meet some sort of production burden to put the offset issue in play.¹⁸¹⁴ If that production burden is met, then, of course, the defendant will have to meet its ultimate burden of persuasion to prove that it has made an overpayment and thus is entitled to a refund.

(3) Statutes of Limitations and Offsets.

One of the traditional strategies in refund suits is to time the suit so that the statute of limitations for additional assessments has expired. If this is done adeptly, even if the taxpayer does not prevail in the refund suit on the issue the taxpayer presents in the claim, the taxpayer at least will not be subject to more tax than already assessed. Litigating in the Tax Court does not offer this opportunity since the issue in such litigation is the taxpayer's correct liability for the year, an issue that will necessarily allow the IRS to raise new issues that bear upon the correct liability for the year.¹⁸¹⁵ By contrast, the issue in a refund suit is whether the taxpayer overpaid his liability for the year. Whether the taxpayer has **underpaid** his tax liability is not technically the issue, and thus so long as the statute of limitations has expired on additional assessments, the refund suit offers less risk than a Tax Court suit.¹⁸¹⁶

(2007).

¹⁸¹¹ Lockheed Martin Corp. v. United States, 973 F. Supp. 2d 591 (D. Md. 2013).

¹⁸¹² Lockheed Martin Corp. v. United States, 973 F. Supp. 2d 591 (D. Md. 2013).

¹⁸¹³ Lockheed Martin Corp. v. United States, 973 F. Supp. 2d 591 (D. Md. 2013) (noting general limitations on discovery, such as limited number of interrogatories and the Court’s ability to fashion an appropriate order to deal with onerous discovery requests).

¹⁸¹⁴ See e.g., Missouri Pac. R. Co. v. United States, 338 F.2d 668 (Ct. Cl. 1964); see also Dysart v. United States, 340 F.2d 624, 638 (Ct. Cl. 1965). For an interesting case addressing the issue of whether this must be done before the Government may assert the offset in its responsive pleading or at a later stage in the trial development, see Wells Fargo & Company v. United States, 750 F.Supp.2d 1049 (D. Minn. 2010).

¹⁸¹⁵ See § 6214(a).

¹⁸¹⁶ See R.H. Donnelly Corp. v. United States, 641 F.3d 70 (4th Cir. 2011) for an example of what the court viewed as a too slick – and thus failed – attempt to exploit the closing of the statute of limitations. In that case, the taxpayer underreported its tax liability for 1994 thus permitting it

A related issue is whether the taxpayer can assert setoffs not asserted in the claim for refund when and if the Government asserts setoffs to deny the refund for the claims made in the claim for refund. These are sometimes referred to as “counter-setoffs,”¹⁸¹⁷ but are really setoffs to setoffs. This is important because the statute of limitations for additional claims may have expired and the taxpayer will have not stated the new offset claim in the original claim for refund. Courts allow the taxpayer to raise a new setoff claim to the Government’s offset.¹⁸¹⁸

to carryback tax credits to 1991 and 1992. The claims for refund for the carryback years was filed 2 days before the statute closed on the 1994 year. In investigation the claims for refund for 1991 and 1992, the IRS investigated 1994 and, despite the fact the 1994 year was otherwise closed for additional 1994 assessments, the IRS made adjustments to 1994 for the sole purpose of determining that there were no available credits to allow for 1991 and 1992 and denied the carryback claims. The taxpayer sued for refund arguing that the closing of the assessment statute of limitations prevented the IRS from decreasing the credits for carryback. The Fourth Circuit disagreed, relying on a straight-forward reading Lewis v. Reynolds and stating that “It takes real chutzpah for Donnelley to demand a refund under the circumstances.”

¹⁸¹⁷ See Cencast Services, LLP v. United States, 94 Fed. Cl. 425 (2010) (citing Gerald A. Kafka & Rita A. Cavanagh, Litigation Of Federal Civil Tax Controversies § 16.03 (2009), aff’d 729 F.3d 1352 (Fed. Cir. 2013).

¹⁸¹⁸ See Charter Co. United States, 971 F.2d 1576 (5th Cir. 1992); Cencast Services LLP v. United States, 94 Fed. Cl. 425 (2010) (citing and discussing cases), aff’d 729 F.3d 1352 (Fed. Cir. 2013). Cencast presented an interesting nuance on the issue. Cencast involved a so-called “divisible” tax which permitted the taxpayer to pay a limited amount of the total assessment and sue for refund without having to meet the Flora requirement of full payment of the assessment. The Government then, as is typical, counterclaimed for the balance of the assessment. Under traditional tax procedure theory, the suit therefore consisted of a refund suit and a collection suit which were joined in one litigation. Although not crisply discussed in the case, I think the question was whether the taxpayer in the collection suit could not raise a new issue not previously asserted in the refund claim but could still assert that defense in the collection suit (the counterclaim). The court melded the two suits together in terms of applying the variance doctrine, but it seems to me that the Court did not come to grips with the issue and, indeed, was wrong. I think there is no question that, had the Government pursued the collection suit in a stand-alone case, the taxpayer could have asserted any defense to the Government’s claims. I am aware of no theory that, by joining the collection suit with the refund suit, the Government can limit the taxpayer’s defenses. By contrast, the IRS claims that this setoff to setoff reasoning is not applicable where a taxpayer carries back an NOL to an otherwise closed year where the taxpayer attempts to claim otherwise unclaimed deductions in the barred carryback year to increase the amount of NOL going forward. See ECC 201215008, 2012 TNT 73-51.

(4) Venue for Refund Suits in District Courts.

Refund suits may be brought in the district court for the district where the taxpayer resides.¹⁸¹⁹ If a taxpayer has no residence in a district – e.g., a nonresident alien – that taxpayer cannot sue for refund in the district court, but must bring the refund suit in the Court of Federal Claims.¹⁸²⁰

4. Department of Justice Tax Division (“DOJ Tax”) Role.

Suits in the District Court involving tax issues are handled by DOJ Tax. On those occasions in which, in the allocations of the Government's resources, IRS attorneys appear in district court, they are designated as a special category of DOJ representative, such as Special Assistant United States Attorneys.¹⁸²¹

Settlement of the issues is controlled by DOJ Tax. § 7122(a)¹⁸²² In settling the more important cases, DOJ Tax solicits the IRS's views, but DOJ Tax has ultimate control of the case.¹⁸²³ This is, of course, not true for example in Tax Court litigation where the DOJ is not involved at all and the IRS has complete settlement authority.

¹⁸¹⁹ 28 U.S.C. § 1346(a)(1) (refund suits may be brought in district court or Court of Federal Claims); and 18 U.S.C. § 1402(a)(1) (suits, including refund suits, brought in the district court against the U.S. may only be pursued in the district of residence). See Malajalian v. United States, 504 F.2d 842, 843-45 (1st Cir. 1974) (holding in tax refund suit by nonresident alien that, under Section 1402(a)(1), Congress intended that “an alien not ‘residing’ in any judicial district could not sue the United States in any district court”).

¹⁸²⁰ Id.

¹⁸²¹ In the past, IRS attorneys have been designated Special Assistant United States Attorneys (SAUSAs) to handle certain matters in bankruptcy courts, but apparently that program has ended. See Keith Fogg, End of SAUSA Program at Chief Counsel’s Office (Procedurally Taxing Blog 6/3/15).

¹⁸²² See Executive Order No. 6166, § 5 (June 10, 1933), reprinted in 5 U.S.C. § 901, transfer all authority to “compromise” a dispute from the IRS to the Department of Justice once a lawsuit regarding the dispute is filed in court other than the Tax Court. DOJ’s authority over compromise apparently continues after its role in reducing an assessment to judgment in a collection and the case is returned to the IRS. See United States v. Jackson, 2013 U.S. App. LEXIS 1674 (3d Cir. 2013), a nonprecedential decision, collecting and discussing the authority.

¹⁸²³ The division is currently made by the designation of the IRS when the files are forwarded to DOJ Tax. Settlements of cases designated “Standard” required that DOJ seek the IRS’s views of proposed settlements; settlement of cases designated Settlement Option Procedure (“SOP”) do not require that DOJ Tax seek the IRS’s views. The settlement authority remains with DOJ even under the Standard designation. Internal procedures require higher level approvals when the IRS disagrees with DOJ’s proposed settlement.

5. Discovery.

Discovery is generally much broader in the district courts than in the Tax Court. Discovery is controlled by the Federal Rules of Civil Procedure and the district court's local rules.¹⁸²⁴ The Tax Court rules and the Court of Federal Claims Rules generally parallel the FRCP. In the Tax Court, the key difference between the district court and the Tax Court is that depositions are more widely used in district courts than in the Tax Court. The other discovery devices (such as interrogatories and requests for production) are available as they are in the Tax Court, again, however, subject to local rules that may limit the quantity of these discovery devices. Requests for admission, although not technically a discovery device, are also available as they are in the Tax Court.

C. Court of Federal Claims.

1. Nature of the Court.

The Court of Federal Claims is an Article I Court that Congress authorizes to hear tax refund suits which after all are “claims” against the United States.¹⁸²⁵ The judges hear cases other than tax cases, such as customs and patent cases. Thus, they tend to specialize in tax cases less than Tax Court judges but more than district court judges. In its general attitude as to how to proceed (efficiently and informally), the Court is more akin to the Tax Court. However, being a more generalist court, the Court of Federal Claims will often produce results that could not be achieved in the highly specialized Tax Court.

The judges in the Court of Federal Claims are appointed by the President with the consent of the Senate. Since they are not Article III judges, they do not have lifetime tenure; they are appointed for 15 year terms.

The Court of Federal Claims is a relatively informal Court, and operates much like the Tax Court in this regard.

¹⁸²⁴ FRCP Rules 26-37.

¹⁸²⁵ 28 U.S.C. § 1491(a)(1), which is commonly referred to as the Tucker Act and grants the Court of Federal Claims jurisdiction over “any claim against the United States founded either upon the Constitution, or any Act of Congress or any regulation of an executive department,” including tax refund actions authorized by § 7422(a). (Section 7422 provides a specific waiver of sovereign immunity that permits suit for a tax refund.) The Court of Federal Claims sometimes adds to this statement of jurisdiction, the further statement that it does not derive jurisdiction in refund suits under § 1346(a), the provision conferring refund jurisdiction on district courts. See Ferguson v. United States, 2014 U.S. Claims LEXIS 1068 (Fed. Cl. Oct. 6, 2014) (citing inter alia Hinck v. United States, 64 Fed. Cl. 71, 74-76 (2005), aff'd, 446 F.3d 1307 (Fed. Cir. 2006), aff'd, 550 U.S. 501 (2007); and M. Carr Ferguson, Jurisdictional Problems in Tax Controversies, 48 Iowa L. Rev. 312, 346 n. 175 (1962-1963) (“The jurisdiction of the Court of Claims in tax cases is conferred by 28 U.S.C. § 1491 Although the Court of Claims is mentioned in 28 U.S.C. § 1346 ... , it is only mentioned in passing by this younger statutory provision, reference being made to the jurisdiction already extended under the other sections.”).

2. Refund Jurisdiction.

The same rules apply for refund jurisdiction as apply in the district court.

3. Court's Spin on the Prepayment (Flora) Rule.

You will recall that the Flora rule requires prepayment of the assessment prior to bringing a refund suit. The Court of Appeals for the Federal Circuit has held that, in order to contest the principal amount of a federal tax liability, the taxpayer need only pay the principal amount of the tax liability assessed.¹⁸²⁶ The taxpayer need not pay the interest or penalties assessed. If the taxpayer is successful in contesting the principal amount, any ad valorem penalties based on the amount of the principal tax liability will be reduced and, of course, any interest on the principal will be reduced pro tanto with the reduction of the principal. If a taxpayer is separately contesting the penalty (e.g., asserting that he is entitled to avoid the penalty on reasonable cause grounds even while owing the tax liability), the taxpayer will have to pay the amount of the penalty in order to contest it. In other words, the components of the aggregate tax liability (principal, penalty and interest) may be fragmented, with payment required of only the fragment that the taxpayer desires to contest. (If the taxpayer does not pay the uncontested amount, the Government can pursue collection or even bring a counterclaim.)

4. Appeals and Precedent.

Appeals are to the United States Court of Appeals for the Federal Circuit in Washington, D.C. That Court is composed of Article III Judges, even though the trial level court, the Court of Federal Claims, is composed of Article I Judges. Although the Court is Washington-based, many of the judges come from geographically diverse areas of the country, based upon the relative political influence of their political “champions” for the office. This is good in giving the Court a national balance rather than a purely Washington outlook. It is, of course, different to that extent than the regional courts of appeals to which Tax Court and district court (including bankruptcy) cases are appealed. And, a large part of the Court of Appeals docket is in nontax cases, such as Government contract cases and patent cases, which subtly affect the way the Court approaches tax cases.

Just as the Court of Appeals to which appeals in Tax Court and district court cases establish the controlling precedent for Tax Court and district court cases, so the Court of Appeals for the Federal Circuit establishes controlling precedent for the Court of Federal Claims.

5. Discovery.

Discovery in the Court of Federal Claims parallels that in the district court.¹⁸²⁷ The key, of course, is that depositions are more widely used than in the Tax Court. The other discovery devices are equally available.

¹⁸²⁶ Shore v. United States, 9 F.3d 1524 (Fed. Cir. 1993).

¹⁸²⁷ See Rules of the United States Court of Federal Claims, Rules 26-37.

6. Trials.

Trials in the Court of Federal Claims may be anywhere the Court directs. The Court will usually allow trial in a place convenient to the parties or the witnesses. In tax litigation this means that the parties will usually have the trial in the location of the taxpayer, since that is usually where the documents and witnesses are. Depending upon the needs of the case, portions of the trial may occur in different cities.

For strategy reasons, large taxpayers who can afford the logistics of a Washington trial will have the trial in Washington in order to accommodate the judge who lives in Washington and would be substantially inconvenienced by a long trial away from home. This is why the Court of Federal Claims bar has historically been centered in Washington, D.C. which seemed for so long to have a franchise on at least the good Court of Claims business. Nevertheless, since the Court of Claims will accommodate smaller taxpayers, taxpayers and their practitioners from the boondocks should not be reluctant to pursue smaller cases; there is no real need for a Washington lawyer to handle the case. Equal justice is dispensed by the Court.

Without the formalities required by a jury trial, the Claims Court like the Tax Court can be more relaxed in its trial proceedings.

D. Bankruptcy Courts.

Federal tax issues may arise in a bankruptcy proceeding. For example, a common federal tax issue in bankruptcy proceedings is the debtor's failure to pay over withheld taxes on employee wages (the trust fund taxes). The debtor/employer is, of course, responsible for those taxes. (I discuss below (pp. 704 ff.) the potential liability for these withheld taxes of persons in the employer's organization -- commonly referred to as "responsible persons.") Similarly, a debtor may owe income taxes. The following are some key points related to tax issues arising in the bankruptcy court.

1. The bankruptcy courts have some jurisdiction to determine tax issues, such as liability for the taxes¹⁸²⁸ (if liability has not previously been litigated)¹⁸²⁹ and dischargeability. The tax issues

¹⁸²⁸ For a discussion of the limits of the bankruptcy courts jurisdiction to litigate the Trust Fund Recovery Penalty ("TFRP") under § 6672, see *Johnston v. City of Middletown*, 2012 Bankr. LEXIS 5956 (SD OH 2012) (dealing with a no asset Chapter 7 bankruptcy proceeding, and discussing a split among the bankruptcy courts, and concluded that, in such a proceeding, the bankruptcy court has no jurisdiction but that, even if it had jurisdiction, it should abstain from deciding the issue. Note in this regard that, although the TFRP may not be discharged in bankruptcy, the goal is to see whether the bankrupt taxpayer can litigate the liability there.

¹⁸²⁹ § 505(a)(1) of the Bankruptcy Code provides that the bankruptcy court may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.

may arise from the IRS's assertion of tax claims or from the debtor/bankrupt estate's assertion of the rights to a refund. As to the tax liability issues, the jurisdiction is not compulsory and thus the bankruptcy court may forego deciding the liability if determining the liability will not assist in resolving the bankruptcy issues.¹⁸³⁰ Although bankruptcy courts have the initial and principal jurisdiction to determine dischargeability, if in a later case unrelated to the bankruptcy, a relevant issue is whether the taxpayer was in fact discharged in the bankruptcy proceeding, the court properly hearing that case can make that determination.¹⁸³¹ I cover the rules that govern dischargeability in discussing IRS collection activity below (pp. 648 ff.).

2. The filing of bankruptcy will impose an automatic stay of:

the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title.¹⁸³²

The question has arisen whether this automatic stay applies to Tax Court proceedings. The Circuit Courts are split on the issue based on differing interpretations of the nature of Tax Court proceedings with respect to the textual requirement that the stayed proceeding be a proceeding “against the debtor.”¹⁸³³ Courts focusing on the taxpayer as the initiator of the Tax Court proceeding itself, hold that the Tax Court proceeding is not a case “against the debtor” and thus deny the stay.¹⁸³⁴ This is

¹⁸³⁰ Internal Revenue Service v. Luongo (In re Luongo), 259 F.3d 323, 330 (5th Cir. 2001). Perhaps the classic case would be a no asset bankruptcy where the taxpayer is not discharged from tax debt. In that case, there is nothing relevant to the bankruptcy proceeding to decide because determining liability only affects the taxpayer’s liability outside bankruptcy. See In re Perry v. United States, 2014 Bankr. LEXIS 1031 (Bankr. MD AL 2014), discussed in Keith Fogg, When Should Bankruptcy Court Hear a Tax Case (Procedurally Taxing Blog 7/31/14).

¹⁸³¹ For example, a court such as the Tax Court properly considering a collection due process case where collection of an allegedly discharged liability is in issue can determine whether the bankruptcy proceeding discharged the tax liability in issue. See Washington v. Commissioner, 120 T.C. 114 (2003); and Swanson v. Commissioner, 121 T.C. 111(2003). By contrast, in a deficiency proceeding where only the amount of the tax liability (and not its collection) is at issue, the Tax Court does not have jurisdiction to determine whether the bankruptcy proceeding discharged the tax liability. Neilson v. Commissioner, 94 T.C. 1, 9 (1990); Graham v. Commissioner, 75 T.C. 389, 399 (1980); Swanson v. Commissioner, 65 T.C. 1180, 1184 (1976).

¹⁸³² 31 U.S.C. § 362(a)(1).

¹⁸³³ The split is discussed, with citation to competing authorities, in Schoppe v. Commissioner, 711 F.3d 1190 (10th Cir. 2013), cert. den. 134 S. Ct. 365 (2013).

¹⁸³⁴ The Tenth Circuit so held in Schoppe, citing as more persuasive authority Freeman v. Commissioner, 799 F.2d 1091 (5th Cir. 1986); Roberts v. Commissioner, 175 F.3d 889, 894 (11th Cir. 1999); Rhone-Poulenc Surfactants and Specialties, L.P. v. Commissioner, 249 F.3d 175, 177-178 (3d Cir. 2001); and Haag v. United States, 485 F.3d 1, 2 (1st Cir. 2007).

the majority holding. The Ninth Circuit, however, takes a broader view of the Tax Court case as being a continuation of a tax assessment proceeding commenced by the IRS against the debtor via the audit and imposes the stay.¹⁸³⁵

3. The bankruptcy code establishes the priority of tax liens relative to other creditors in the estate. I do not expect you to know those priority rules.

The bankruptcy court has a different culture and different focus than the other available tax fora discussed above. Thus, results in the bankruptcy court may differ from the results that might be obtained in the other fora, and may be more taxpayer-friendly results. As the ubiquitous Lee Sheppard has said pithily in contrasting bankruptcy court to the Tax Court as a taxpayer-friendly litigation forum:

Readers, the Tax Court is not a court of equity. Federal bankruptcy court is a court of equity. A bankrupt taxpayer that wants to throw itself on the mercy of a court of equity can ask the bankruptcy court to adjudicate its tax questions. Bankruptcy judges usually empathize with debtors -- that's why they became bankruptcy judges -- and do not feel constrained by the fine points of the tax code.¹⁸³⁶

Of course, in tax matters, the district courts and the Court of Federal Claims are not equity courts as to the tax matters that are commonly litigated, but district courts particularly sometimes flex their equity muscle in tax cases (implicitly, if not explicitly) and, in respect to equity, may be viewed as somewhere on the spectrum between the Tax Court and the bankruptcy courts. Many taxpayers are unwilling or unable to seek bankruptcy court refuge to litigate their tax issues, but for the right taxpayer, this forum choice should be considered.

III. Miscellaneous Trial Related Matters Applicable to All Forums.

A. Recovery of Attorneys Fees & Costs from the Government - § 7430.

1. The Setting.

Section 7430 of the Code provides that a taxpayer who is a “prevailing party” may recover “reasonable administrative costs” and “reasonable litigation costs,” including attorneys fees, incurred in most forms of tax litigation.¹⁸³⁷

¹⁸³⁵ Delpit v. Commissioner, 18 F.3d 768 (9th Cir. 1994).

¹⁸³⁶ Lee A. Sheppard, Tax Court Decision Allows Guarantees for Income Stripping, 126 Tax Notes 1010 (Mar. 1, 2010).

¹⁸³⁷ Attorneys or even others who represent themselves pro se do not “incur” such costs and thus are not entitled to recover notional fees for their time. See United States v. Hudson, 2010 U.S. App. LEXIS 23338 (2d Cir. 2010) (unpublished).

2. Some Issues Regarding Recovery of Costs.

a. Eligible Taxpayers.

The following taxpayers are denied relief under § 7430 – (1) individuals with a net worth exceeding \$2 million or (2) taxpayers with unincorporated businesses, corporations, trusts, and partnerships whose net worth exceeds \$7 million **or** has more than 500 employees.¹⁸³⁸

b. Costs Recoverable.

(1) Administrative and Litigation Costs.

Administrative and litigation costs are recoverable. However, recoverable administrative costs include only costs incurred after the earlier of (1) the date the taxpayer receives the Appeals Office decision, (2) the date of the notice of deficiency and (3) the date of the 30-day letter allowing the taxpayer access to Appeals.¹⁸³⁹ The latter will usually be the starting point for recovery of administrative costs in the normal processing of most cases you will handle.

The determination for administrative costs is based on the substantial justification of the position in the earlier of the date of notice of the Appeals Office decision or the notice of deficiency.¹⁸⁴⁰ The determination for litigation costs is based on the substantial justification for the position taken by the IRS in the judicial proceeding.¹⁸⁴¹

(2) Fees Paid by Third Party.

In some tax proceedings fees may be paid by a third party – an employer. For example, I have represented a line-level employee with an issue common to other employers arising out of employment, where the employer paid the fees. Although the statute requires that the fees be incurred, which impliedly meant by the taxpayer before the court seeking recovery, the Ninth Circuit held that the word “incur” is broader than the implication. The taxpayer before the court is incurring the fees even though they may be advanced by a third party. And, this is true even if the taxpayer’s obligation to repay the third party advancing the fees is contingent upon and to the extent that the taxpayer obtains judicial recovery of the fees.¹⁸⁴² The court thus summarized: “We hold instead that a taxpayer can “incur” attorneys’ fees if he assumes either: (1) a non-contingent obligation to repay the fees advanced on his behalf at some later time; or (2) a contingent obligation to repay the fees in the event of their eventual recovery.” In such cases, presumably, the dollar limitations for eligible taxpayers discussed above would be the taxpayer before the court and not the party actually advancing the attorneys fees.

¹⁸³⁸ See § 7430(c)(4)(A)(ii) & (D), and, by reference, 28 U.S.C., § 2412(d)(2)(B).

¹⁸³⁹ § 7430(c)(2)(B).

¹⁸⁴⁰ § 7430(c)(7)(B).

¹⁸⁴¹ § 7430(c)(7)(A).

¹⁸⁴² *Morrison v. Commissioner*, 565 F.3d 658 (9th Cir. 2009).

(3) Exception for Protracting Proceedings.

Costs are not recoverable “with respect to any portion of the administrative or court proceeding during which the prevailing party has unreasonably protracted such proceeding.”¹⁸⁴³

c. Prevailing Party (Position Substantially Justified).

The taxpayer must be the prevailing party in order to recover costs. The prevailing party is the party who substantially prevailed either with respect to the amount in controversy or the significant issues or set of issues presented.¹⁸⁴⁴

A taxpayer will not be deemed a prevailing party on issues or amounts where the Government’s position was substantially justified.¹⁸⁴⁵ Substantially justified means that the IRS has a reasonable basis as to both fact and law.¹⁸⁴⁶ As covered in discussing the accuracy related penalties, reasonable basis is substantially less than more likely than not. Thus, the mere fact that the taxpayer prevails is not proof per se that the IRS’s position was not substantially justified.¹⁸⁴⁷

Portillo v. Commissioner,¹⁸⁴⁸ represents perhaps an extreme case, but illustrates the requirement that the IRS position be substantially justified in order to avoid award of costs to an otherwise prevailing party. In that case, the IRS asserted in the notice of deficiency that the taxpayer, a laborer, received additional income paid in cash by a contractor. The contractor had issued a Form 1099 in that amount. The IRS relied solely on the contractor’s allegation in the Form 1099, even though the taxpayer denied receiving the income. In this circumstance, it is at least possible that the contractor may have overstated the Form 1099 amount in order to justify deductions to which it was not entitled. In the case involving the substantive issue, the Fifth Circuit held that the IRS could not prevail solely on the basis of the employer’s Form 1099 and was required to come forward with some further evidence which it had not done. In the subsequent appeal involving recovery of litigation costs under § 7430, the IRS asserted that it had been substantially justified based on its reliance upon the payor’s allegations in the Form 1099. The Court rejected the argument, awarding costs to the taxpayer. The Court reasoned that it had previously held that the IRS position lacked any fact basis and was clearly erroneous as a matter of law.

¹⁸⁴³ § 7430(b)(3).

¹⁸⁴⁴ § 7430(c)(4).

¹⁸⁴⁵ § 7430(c)(4)(B).

¹⁸⁴⁶ Regs. § 301.7430-5(c)(1); Portillo v. Commissioner, 988 F.2d 27, 28 (1993). For an application of Portillo, see Owens v. Commissioner, 2003 U.S. App. LEXIS 12481 (5th Cir. 2003) (unpublished opinion).

¹⁸⁴⁷ Portillo v. Commissioner, supra; Nalle v. Commissioner, 55. F.3d 189, 192 (5th Cir. 1995).

¹⁸⁴⁸ See footnote 1846, supra.

The statute creates a rebuttable presumption that IRS position is not substantially justified if the IRS fails to follow applicable published guidance in the administrative proceeding.¹⁸⁴⁹ Such published guidance are of two categories: (1) publicly issued precedential guidance (“regulations, revenue rulings, revenue procedures, information releases, notices, and announcement”) and (2) certain guidance issued to the taxpayer in issue (“any of the following which are issued to the taxpayer: private letter rulings, technical advice memoranda, and determination letters”).¹⁸⁵⁰ For review, you should ask yourself why Congress made this distinction in applicable published guidance.

For legal positions, the requirement that the IRS’s position be substantially justified is reminiscent to the standard applying for the substantial understatement penalty – i.e., that the position be based upon substantial authority. As with the substantial authority escape from the substantial understatement penalty, the issue of substantial justification can also turn upon the facts and whether, based on reasonable inquiry into the facts, the IRS did not have substantial justification for the position it takes. For example, in valuation cases where both sides are prone to take extravagant positions fortified by expert opinion, the issue will be whether the IRS was substantially justified or reasonable in taking the position.¹⁸⁵¹

In a multiple issue case, the costs allocable to issues as to which the IRS was not substantially justified may be recovered.¹⁸⁵²

d. Exhaustion of Administrative Remedies.

The taxpayer must have pursued available administrative remedies, including most critically the Appeals procedure we discussed above if it is available to the taxpayer.¹⁸⁵³ The Tax Court has sent clear warning to taxpayers and their representatives about foregoing their Appeals opportunities before commencing litigation:

¹⁸⁴⁹ § 7430(c)(4)(B)(ii).

¹⁸⁵⁰ § 7430(c)(4)(B)(iv).

¹⁸⁵¹ See Estate of Baird v. Commissioner, 416 F.3d 442 (5th Cir. 2005) (holding the IRS valuation position not substantially justified); Smith v. United States, 850 F.2d 242, 246 (5th Cir. 1988); and Fair v. Commissioner, T.C. Memo. 1994-602 (when deciding if respondent's position on valuation is substantially justified, the Court “must consider the facts of the case, the nature of the asset to be valued, the qualifications of the expert, the soundness of the valuation methods, the reliability of the expert's factual assumptions, and the persuasiveness of the reasoning supporting the expert's opinion”).

¹⁸⁵² Regs. § 301.7430-5(c)(2); see Swanson v. Commissioner, 106 T.C. 76, 87-92 (1996).

¹⁸⁵³ § 7430(b)(1). Courts describe this requirement as “jurisdictional,” so that dismissal of any suit for the remedy is required. E.g., Kuhl v. United States, 467 F.3d 145, 147 (2^d Cir. 2006) (“Failure to exhaust [administrative] remedies deprives the federal court of jurisdiction over the suit.”).

For years, many tax practitioners, on behalf of their clients, have adopted a strategy to bypass a protest of respondent's proposed audit adjustments to respondent's Appeals Office. This strategy is based on the perceived risk that filing a protest and "going to" appeals might result in new issues [sic] being raised by the Appeals Office and on a perceived advantage of getting into court as soon as possible. See for explanations of this strategy, Saltzman, IRS Practice & Procedure, par. 9.04[1] (2d ed. 1991), and Shafiroff, Internal Revenue Service Practice & Procedure Deskbook, sec. 4.1, at 4-6 (3d ed. 2001). * * * *. In light, however, of the exhaustion-of- administrative-remedies requirement of section 7430, if counsel wish to preserve the opportunity to seek a recovery of litigation costs, continued use of this strategy carries with it its own new risks evident in the instant cases.¹⁸⁵⁴

You may recall from the discussion of the Appeals function that, in order to pursue Appeals, Appeals will need sufficient time on the statute of limitations. The IRM states that a statutory notice will issue without a 30-day letter if "Expiration of the statute of limitations is imminent and no extension can be obtained."¹⁸⁵⁵ Given the length of time for effective Appeals processing any time shorter than 120 days is likely to result in a notice of deficiency. Generally, on a short statute date, the IRS will insist upon extension on the statute of limitations to pursue the appeal. The taxpayer is not required to agree to an extension of the statute of limitations in order to meet the requirement that he or she have exhausted administrative remedies.¹⁸⁵⁶ Accordingly, in this situation, it appears that the taxpayer should file the protest and let the IRS refuse the Appeals hearing by issuing the notice of deficiency without the hearing.

Finally, what if the taxpayer does not receive a 30-day letter which, as we have noted, is generally the "ticket" to Appeals? In that case, the taxpayer will not be deemed to have failed to exhaust his administrative remedies if (1) the failure to receive the letter was not due to his fault (e.g., the taxpayer failed to give the IRS a proper address for mailing the 30-day letter) and (2) the taxpayer then participates in an Appeals conference at the next critical opportunity (e.g., while in docketed case if the taxpayer files a petition in the Tax Court).¹⁸⁵⁷

e. Amount of Attorneys Fees.

Usually in administrative and judicial proceedings, the taxpayer's costs are principally attorneys fees. There may also be associated costs, such as expert witness fees and miscellaneous other costs. But the lion's share will usually be attorneys fees.

¹⁸⁵⁴ Haas & Associates Accountancy Corp. v. Commissioner, 117 T.C. 48, 62 (2001); see also Covert v. Commissioner, T.C. Memo. 2008-90.

¹⁸⁵⁵ IRM 4.75.20.6(07-01-2003).

¹⁸⁵⁶ § 7430(b)(1).

¹⁸⁵⁷ Regs. § 301.7430-1(e)(3).

Attorneys are expensive. In Houston, attorneys fees can easily range from \$150 to even \$700 per hour. The amount recoverable is limited to \$200 per hour for the year 2015,¹⁸⁵⁸ unless the court determines that a special factor, such as “the limited availability of qualified attorneys for such proceeding, the difficulty of the issues presented in the case, or the local availability of tax expertise, justifies a higher rate.”¹⁸⁵⁹ Since the statute assumes competency to file the proceeding at the adjusted hourly rate, some special expertise beyond capability of handling an IRS administrative proceeding or tax litigation is required in order to recover fees in excess of that rate.¹⁸⁶⁰

Fees of nonattorneys authorized to practice before the Tax Court or the IRS are treated as services of an attorney for § 7430.¹⁸⁶¹ Also courts may award reasonable attorneys fees in cases where the attorney is serving pro bono.¹⁸⁶²

This limitation applies to attorneys, but not to experts engaged by the attorney in the litigation or for technical reports necessary for trial preparation.¹⁸⁶³

f. Government Circuit Shopping.

One of the features of our tax litigation system is that, until and unless the Supreme Court resolves an issue, that issue may be resolved differently among the various courts of appeals and taxpayers in different parts of the country may be taxed differently. Taxpayers frequently take advantage of this opportunity by litigating in a circuit that has not yet resolved an issue that has been

¹⁸⁵⁸ Rev. Proc. 2014–61, ¶ 3.43. The statute provides for \$125 per hour, but it is adjusted for inflation. This amount changes, so you should check the current iteration of the Rev. Proc. issued annually for inflation adjusted items.

¹⁸⁵⁹ § 7430(c)(1)(B)(iii).

¹⁸⁶⁰ In Cervin v. Commissioner, 200 F.3d 351 (5th Cir. 2000), the court interpreted this “special factors” requirement narrowly, suggesting that only “non-legal or technical abilities” met the requirement. Thus, mere expertise and experience in the law would not qualify. That does not appear consistent with the wording of the statute that permits consideration of local availability of tax expertise as well as limited availability of “qualified attorneys for such proceeding.” Why wouldn’t the best tax litigators qualify in an especially difficult tax case? At least in the Fifth Circuit, they don’t qualify because the Court said they don’t. But see Ragan v. Commissioner, 210 F.3d 514, 521 (5th Cir. 2000) (specialized security industry expertise is not enough).

The proposed regulations issued in 2009 provide, in the case of tax expertise, “[t]he hourly rate charged by representatives in the geographical area is not relevant in determining whether tax expertise is locally available.” Prop. Regs. § 301.7430-4(b)(3)(iii)(D).

¹⁸⁶¹ § 7430(c)(3)(A); for a discussion of this requirement, see Ragan v. Commissioner, supra.

¹⁸⁶² § 7430(c)(3)(B).

¹⁸⁶³ E.g., § 7430(c)(1)(B)(i) (imposing only a limit that the fees not be “in excess of the highest rate of compensation for expert witnesses paid by the United States”); & § 7430(c)(1)(B)(ii) (technical reports); See also Ragan v. Commissioner, supra.

resolved unfavorably in other circuits. For example, if a taxpayer has the traditional litigating choices noted above and the Court of the Appeals for the Circuit (governing the Tax Court and the district court) has rendered an unfavorable decision but the Court of Appeals for the Federal Circuit has not yet addressed the issue or has rendered a favorable decision, the taxpayer should pursue the matter in the Court of Federal Claims. The Government does not have this opportunity since the taxpayer generally controls the forum for litigation.

However, the Government does have a forum shopping opportunity as among the circuits after it loses an issue in one or more of the circuits. In that case, although the Government is bound in the circuit(s) in which the unfavorable precedent(s) exist, it may continue to set up taxpayers on the issue in the other circuits, force them into litigation in the other circuits, and thereby attempt to prevail in other circuits. If the Government could then prevail in one or more of the other circuits, it would either seek to have the Supreme Court resolve the issue nationwide or, alternatively, try to use the new court of appeals precedent in its favor to build toward a reversal in the other circuit courts of appeals (including the ones previously rendering unfavorable precedents). However, when the Government continues to litigate in the face of unfavorable precedents in other circuits, obviously there is unfairness to the taxpayers in those other circuits who are to bear the costs of the Government's search for favorable precedents, particularly when the Government is unsuccessful in the other circuits. The courts are directed to consider such Government forum shopping in determining recoverable costs.¹⁸⁶⁴

Moreover, although not dealt with specifically in the statute, the courts will also award attorneys fees where the Government forces litigation in a circuit in an unsuccessful attempt to reverse a prior court of appeals opinion in the same circuit.¹⁸⁶⁵

g. Sanctions for Litigation Abuses.

Taxpayers and / or their counsel may be sanctioned for inappropriate action with respect to litigation.

In Tax Court proceedings, Section 6673 authorizes:

- a taxpayer may be sanctioned up to \$25,000 for proceedings (i) “instituted or maintained by the taxpayer primarily for delay,” (ii) “frivolous or groundless” position, or (iii) the taxpayer’s unreasonable failure to pursue administrative remedies.¹⁸⁶⁶
- counsel for a taxpayer may be sanctioned up to \$10,000 where he or she “multiplied the proceedings in any case unreasonably and vexatiously.” Sanctions may also be awarded against an IRS attorney, and the Tax Court has given substantial attorneys

¹⁸⁶⁴ § 7430(c)(4)(B)(iii).

¹⁸⁶⁵ Foster v. United States, 249 F.3d1275 (11th Cir. 2001).

¹⁸⁶⁶ For example, advancing frivolous arguments risk being given short shrift by the Tax Court and drawing this sanction. Wnuck v. Commissioner, 136 T.C. 498 (2011).

fees in the case of a truly aberrational situation where it found the IRS attorneys actions, amounting to a fraud on the court, unreasonable and vexatious.¹⁸⁶⁷

In other proceedings in the district court or claims court, the courts have other authority to sanction misconduct (e.g., Rule 11(c), FRCP),¹⁸⁶⁸ but § 6673 provides special sanctions for proceedings under § 7433 and special authority to assess such sanctions as a tax and, upon notice and demand, collect the assessed sanctions in the same manner as a tax.

h. Qualified Offer (“QO”).

(1) General.

If the taxpayer makes a settlement offer qualifying under § 7430(c)(4)(E) (“QO”) that the IRS rejects and the judgment¹⁸⁶⁹ in the case is equal to or worse than the offer, the taxpayer may recover costs.¹⁸⁷⁰ The offer must:

- (a) be in writing;
- (b) specifically state that it is a qualified offer;
- (c) be for an amount that will fully resolve the tax liability for the year (i.e., must cover all issues);¹⁸⁷¹
- (d) be made in the period between (i) the 30-day letter is received or, if no 30-day letter is received, the date of the 90-day letter and (ii) 30 days before the case is first set for trial; and
- (e) remain open until the earliest of (i) the date the offer is rejected, (ii) the date the trial begins, or (iii) 90 days from the date of the offer.¹⁸⁷²

¹⁸⁶⁷ Dixon v. Commissioner, 132 T.C. No. 5 (2009).

¹⁸⁶⁸ See e.g., Szopa v. United States, 460 F.3d 884 (7th Cir. 2006), an opinion by Judge Easterbrook, imposing sanctions on a taxpayer based on the estimated cost to the Government of responding to the appellate brief filed by the taxpayer. What is particularly interesting is how the court calculates that estimated cost.

¹⁸⁶⁹ In the Tax Court, the judgment for this purpose is the decision document which serves the equivalent role in the Tax Court to judgments in the district court.

¹⁸⁷⁰ The taxpayer must meet the other requirements, including specifically exhaustion of administrative remedies discussed earlier. See Haas & Associates Accountancy Corp. v. Commissioner, 117 T.C. 48 (2001); and Covert v. Commissioner, T.C. Memo. 2008-90.

¹⁸⁷¹ For this reason, if the taxpayer makes a qualified offer that does not take into account a net operating loss carryover to the year (usually a carryback) and the IRS accepts the offer as made, the taxpayer cannot thereafter seek the further benefit of the carryback. Johnston v. Commissioner, 122 T.C. 124 (2004), affd. 461 F.3d 1162 (9th Cir. 2006) (2004).

¹⁸⁷² § 7430(c)(4)(E) and (g).

The judgment must not be entered “pursuant to a settlement.”¹⁸⁷³ Thus, in a multi-issue case, there must be at least one unsettled issue the Court is required to resolve. Then, costs with respect to settled issue(s) are not subject to the QO rules, but may be recovered under § 7430 generally if the requirements are met.

If the IRS accepts the QO, the taxpayer and the IRS are contractually bound to the settlement thus reached.¹⁸⁷⁴ This points out a danger of settlements generally, not just QOs. Settlements are contracts and bind the parties. Thus, if the taxpayer settles a suit, whether by QOs or otherwise and fails to take into account other favorable adjustments that might potentially apply, the taxpayer will be out of luck (just as in the reverse, the IRS would be out of luck. This danger was presented in the context of a QO that failed to mention that the taxpayer might have NOL carrybacks that could potentially reduce the contractual amount of the accepted QO. The courts held that the taxpayer is out of luck. If the taxpayer wanted the benefit of the carryback, he should have mentioned it in his QO and thus made it a term of the contract that the IRS agreed to by accepting the offer.¹⁸⁷⁵

QOs may be revised – via new QOs – as the ebb and flow of the pre-trial work requires. Indeed, multiple QOs offer good opportunities and should be considered.¹⁸⁷⁶

(2) Costs Covered.

The costs covered are the costs incurred on or after the date of the offer.¹⁸⁷⁷ A taxpayer can make multiple QOs as the process continues. But the amount subject to the QO rules is based on the last offer and the taxpayer can only recover costs incurred after the last offer.¹⁸⁷⁸ In a multi-issue case, so long as one issue is left for trial, QOs can be recovered but only as to the issue that is in fact tried. The costs of the settled issues may be recovered under the other rules of § 7430, but not under the QOs special rules. This puts a premium on detailed time and cost records so that the taxpayer can meet the burden of showing costs of the issue(s) that was tried.

¹⁸⁷³ § 7430(c)(4)(E)(ii)(I). However, the Tax Court has held that, where the final decision is reached by settlement after the substantial issues are litigated (in that case through appeal, with the settlement then being reached on remand), this exception to QO liability will not apply. Gladden v. Commissioner, 120 T.C. 446 (6/27/03). The IRS’s unilateral concession is not a settlement disqualified from recover of attorneys fees. Knudsen v. Commissioner, 2015 U.S. App. LEXIS 12183 (9th Cir. 2015), reversing Knudsen v. Commissioner, T.C. Memo. 2013-87.

¹⁸⁷⁴ See e.g., Johnston v. Commissioner, 461 F.3d 1162 (9th Cir. 2006) (holding that contract analysis applies to accepted QOs).

¹⁸⁷⁵ See Johnston v. Commissioner, supra.

¹⁸⁷⁶ See Burgess J.W. Raby and William L. Raby, Qualified Offers and Settlement of Tax Controversies, 113 Tax Notes 455 (2006).

¹⁸⁷⁷ § 7430(e)(4)(E)(iii)(II).

¹⁸⁷⁸ § 7430(e)(4)(E)(iii)(I).

Recoverable costs include costs incurred to deal with the substantive issue and costs incurred in pursuing the claim for recovery of such costs (so-called “fees on fees”).

(3) Thoughts and Strategies.

Strategizing the QO requires careful analysis. Let’s use two examples.

Example 1: Suppose a case involves a single issue with a proposed additional tax of \$100,000. The issue is a valuation issue that a court may resolve to produce additional tax anywhere between 0 and \$100,000. Taxpayer’s aggressive position is that the right result is 0, but believes that a court might find a range of values that would produce additional tax of between \$30,000 and \$40,000. The Appeals Officer, however, assesses the range of potential values differently, to produce say from \$60,000 to \$70,000 additional tax. (FYI, I have chosen a valuation issue first because, by the time the IRS refines its position for trial, it is likely that, absent a QO, a Court would find that the IRS’s position was substantially justified, thus precluding recovery under the general § 7430 rules; in this example, if the IRS refines its position in the notice of deficiency to \$70,000, the upper end of the Appeals Officer’s range, then presumably the Court will find that the IRS was substantially justified.)

If the taxpayer were comfortable with his assessment of the range, the taxpayer might make an offer of \$35,000 (middle of the taxpayer’s range). The taxpayer does not think the Appeals Officer would accept that offer, and they will go to trial. The taxpayer’s risk, of course, would be that the Court would determine a higher value than the taxpayer’s mid-range, thus producing a tax in excess of \$35,000. The taxpayer might therefore be more conservative and propose additional tax of \$40,000 (which represents the top end of his range). The Appeals Officer is not likely to accept this offer either, and it would give the taxpayer a better chance at recovering § 7430 costs. Still, there is some risk that the Court might come up with a higher value than even the taxpayer predicted as the top of the range. The taxpayer thus might consider an offer of \$50,000 which is the mid-point between the respective mid-points of their two assessments. The taxpayer really does not want to settle for that amount (because he still believes the \$30,000-\$40,000 range is right), but the higher amount will better situate him to recover § 7430 costs which will be substantial and, if accepted, will at least avoid the further costs of litigation which will substantially exceed the amount recoverable under the qualified offer concept.

The tension, of course, is created because the QO works best when the taxpayer is conservative (i.e., offers the higher proposed additional tax). An aggressive taxpayer offer (e.g., one producing say \$20,000 of tax in this example) is unlikely to be accepted, and in this example it may not be likely that an ultimate court holding would sustain that small a tax liability. A conservative taxpayer offer (i.e., one producing higher tax) better situates the taxpayer to recover § 7430 costs. The risk, of course, is that, if the offer is too conservative, the IRS may accept the offer and thus lock the taxpayer into a significantly worse result than the taxpayer could achieve at trial. Thus, the taxpayer must factor into his offers what he thinks he can get on the merits at trial and whether what he is risking in a conservative offer may be greater than the prospective benefits of recovering § 7430 costs at trial. The taxpayer must keep in mind that, even if he does recover § 7430 costs, the recovery will be less than his real additional costs (e.g., his attorneys fees will be higher than

allowed). It may thus be that, given those additional costs, the taxpayer would be willing to offer \$45,000 or even \$50,000 which is beyond his estimate of the top end of the range in the hope that the IRS would accept it. Or that point may be his point of indifference as to whether the IRS accepts the offer or rejects it, with the result that, if he has assessed the case correctly, he will recover attorneys fees.

Example 2: Assume a single issue case also involving \$100,000 in additional tax. The issue is an either/or issue. At trial, either the IRS prevails 100%, or the taxpayer prevails 100%. There will be no point in between as is usually involved in valuation issues. This appears to be a no-brainer in terms of a QO. The taxpayer should offer \$1.

What happens if, in the ensuing litigation, the IRS offers the taxpayer an 80% victory to settle? If the taxpayer accepts, judgment will be entered at \$20,000, which of course exceeds the QO of \$1. Settled issues do not qualify for the QO anyway, so the taxpayer appears no worse off for having offered only \$1. The taxpayer can still seek recovery under the general rules of § 7430, and the substantial concession made by the IRS might at least suggest that its position was not substantially justified, although a 20% settlement might suggest at least reasonable basis. What happens if the IRS trial attorney concedes in full after receiving the QO (or, alternatively, accepts the QO of \$1)? Again, there is no issue left for trial and the QO is irrelevant. However, barring unusual circumstances in which the taxpayer's lack of cooperation led to the IRS's assertion of the worthless position, it would appear that the taxpayer would have a strong case under the general § 7430 rules for recovery of costs.

Example 3: Now assume that a single case for a single year involves both of the issues and amounts in Examples 1 and 2. Pull out your crystal ball, and have fun thinking through all the permutations of this one!

B. Recovery of Costs from the Taxpayer - 28 USC 2412(b).

Section 7430, discussed in the prior section, is the fee-shifting provision normally encountered in tax litigation, and it works in favor of the taxpayer. However, I do caveat for readers (particularly those representing taxpayers or others in tax litigation) that there is a general fee-shifting provision – 28 U.S.C. § 2412(b) -- that permits a court to award to a prevailing litigant costs, including attorneys fees, if the losing party misbehaves – the words are some variant of acting in bad faith, vexatiously, wantonly, or for oppressive reasons. Section 2412(b) applies to all litigants, but as to misbehavior by the Government, such costs are already covered by § 7430. Where § 2412(b) can be a problem in tax litigation is when the private party – usually the taxpayer as litigant – misbehaves. Taxpayer misbehavior is not uncommon, and the Government rarely presses the issue, so long as the private litigant does not egregiously misbehave.¹⁸⁷⁹ Even when it

¹⁸⁷⁹ I could have said unreasonably misbehave, but I do think that even unreasonable misbehavior so long as not egregious might not draw a Government request for fees. I do have a picture (a reprint) by William Weekes titled “I SMELL A RAT.” [Link here](#). My line is that RAT is not a rodent but an acronym for a Reasonably Aggressive Taxpayer. I like to represent RATs. It is the unreasonably – or egregiously – aggressive taxpayer that I do not like to represent. I also

does seek recovery, the Government will be restrained in the costs it wants to shift to the taxpayer.¹⁸⁸⁰

C. Burden of Proof (Including Presumption of Correctness).

1. Context and Concepts.

a. Context.

Burden of proof concepts set a conceptual framework for finding facts at trial or, sometimes, before trial in a summary judgment context.¹⁸⁸¹ The classic model to analyze the role of the burden of proof concepts is the jury trial. In a jury trial, the jury is the ultimate trier of fact. However, prior to submitting the fact for the jury's determination, the judge must determine whether the evidence is of sufficient quality that a reasonable jury could find either way on the fact issue. If the evidence is of sufficient quality that a reasonable jury could reach only one result, the judge will decide the case without submitting the case to the jury. This can happen either during the course of or at the end of trial or, before trial, on motion for summary judgment if the summary judgment evidence is so strong that the judge concludes there is no fact reasonably in dispute for a jury to resolve. In this discussion, I shall use the jury trial model because it best teaches the function of burden of proof concepts, but the concepts are equally applicable (although sometimes less evident) in trials in which the judge is the ultimate fact finder (called "bench trials").¹⁸⁸²

There are two principal burden of proof concepts -- the burden of production and the burden of persuasion. There is a significant related concept, called a presumption, that can affect the burden of production and possibly also the burden of persuasion.

do not like to represent taxpayers who egregiously misbehave during the litigation process.

¹⁸⁸⁰ See Heger v. United States, 2014 U.S. Claims LEXIS 18 (Fed. Cl. 2013) (noting, citations omitted, "The court does not reach this conclusion lightly. Its discretion to award fees for bad faith is exercised with restraint. Such fee-shifting is only invoked when compelling considerations in the interests of justice so require.).

¹⁸⁸¹ In the footnoted version of this text, since I am dealing with basic burden of proof principles that have interested me since with DOJ Tax Appellate in the mid-1970s, I have footnote citations to only sparsely and not always consistently. I try to footnote with authority those propositions that may be outside the mainstream for practitioners or may be controversial or may be of special interest to tax procedure enthusiasts. Any good procedure or evidence book will cover these concepts. One that I have found particularly helpful since in law school in its earliest edition is Fleming James, Jr. & Geoffrey C. Hazard, et al., Civil Procedure (5th ed. 2001).

¹⁸⁸² In Cook v. United States, 46 Fed. Cl. 110, 116 n.13 (2000), the court said that in a non-jury trial, the production burden (which is the burden being addresses when a court decides whether there is sufficient evidence to go to a jury) is meaningless. In a technical sense it is because it does not serve the critical gate-keeping role it serves in a jury trial, but the concept is I think still present with its role being hidden. The concept is to produce enough evidence so that you can get to the judge's function of deciding whether the evidence is persuasive.

The following introductory discussion for these concepts is not a substitute for a deeper study of the subject. This introductory discussion paints in broad strokes, at the risk of missing details and not developing exceptions. I simply want you to have a general understanding before moving to the burden of proof rules in tax cases.

b. Burden of Production.

The first burden of proof concept is the burden of production (also sometimes referred to as the burden of going forward). The burden of production means that the party bearing this burden as to a fact must produce some evidence tending to prove the fact in order to avoid a directed verdict on the fact. The quantum of evidence is an amount sufficient to permit the trial judge to determine that a reasonable juror could be persuaded as to the existence of the fact. If the trial judge assesses the evidence as not sufficient to convince a reasonable juror, the trial judge will direct a verdict on that fact against the party bearing the burden of production. The quantum of evidence to meet the burden of production is not that the fact must be found in favor of the party bearing the burden; rather it is only that a reasonable juror could find in favor of the that party. Stated alternatively, a directed verdict will be rendered if no reasonable juror could find in favor of the party bearing the burden of production on that fact. A directed verdict on the fact simply means that the jury will not decide the fact. The judge determines whether the burden of production has been met. In trial procedure theory, the burden of production is also referred to as the risk of nonproduction – meaning that the party bears the risk that the quality of evidence is not sufficient to get to the jury. Assuming that sufficient evidence is produced to avoid a directed verdict on the issue, the second burden of proof concept -- the burden of persuasion -- is reached.

c. Burden of Persuasion.

The Supreme Court has explained the burden of persuasion (referring to it as the burden of proof) as follows:

The function of a standard of proof, as that concept is embodied in the Due Process Clause and in the realm of factfinding, is to instruct the factfinder concerning the degree of confidence our society thinks he should have in the correctness of factual conclusions for a particular type of adjudication. The standard serves to allocate the risk of error between the litigants and to indicate the relative importance attached to the ultimate decision.

Generally speaking, the evolution of this area of the law has produced across a continuum three standards or levels of proof for different types of cases. At one end of the spectrum is the typical civil case involving a monetary dispute between private parties. Since society has a minimal concern with the outcome of such private suits, plaintiff's burden of proof is a mere preponderance of the evidence. The litigants thus share the risk of error in roughly equal fashion.¹⁸⁸³

¹⁸⁸³ Addington v. Texas, 441 U.S. 418, 423-425 (U.S. 1979) (some internal quotation marks omitted and all citations omitted).

The role of the burden of persuasion is to produce an outcome when the trier of fact is not persuaded as to the fact. The party bearing the burden of persuasion bears the risk of loss that that party's evidence is not ultimately persuasive to the degree required in order to prevail. This burden is often referred to as the risk of nonpersuasion. As suggested, normally, in a civil trial, the quality of the evidence required to meet the burden of persuasion is that the evidence persuade the trier of fact (the jury in the jury trial model) that the fact in question is more likely than not true. Many people attempt to quantify this burden as a likelihood of more than 50% (51% or, conceptually, 50.1% or some other iteration with zeroes after the decimal) will theoretically suffice). I suppose that this is a rough and ready (not perfect) model for the normal civil burden of persuasion. In certain contexts a higher quality of evidence is required to persuade and thereby to prevail. We noted above that, in a case involving the issue of whether civil fraud penalty is applicable, the IRS bears the burden of persuading as to fraud by clear and convincing evidence.¹⁸⁸⁴ In a criminal trial, of course, the Government will bear the burden of persuading beyond a reasonable doubt.

Who determines whether the evidence is persuasive? In our jury trial model, the jury does. The presiding judge need not agree with the jury's verdict; the judge cannot change the verdict simply because the judge was persuaded differently than the jury's verdict indicates it was persuaded. The judge may only change the verdict if he or she concludes that, given the state of the proper evidence before the jury, no reasonable juror could have reached the result.¹⁸⁸⁵

The waters are muddied a bit in terms of crisp analysis when the trial judge is both judge and ultimate fact finder, as where a jury trial is not available (as is the case in Tax Court cases and Court of Federal Claims cases) or the parties waive a jury trial. The same phenomena occur, but the dual role served by judge without a jury does not require crisp differentiation of the functions of the burdens. As to a party bearing a burden of production and a burden of persuasion, the judge is likely to just say that party has not persuaded when really the party did not enter sufficient evidence to even meet a production burden. (This is just a truism that evidence that is not produced cannot persuade.)

d. Shifting Burdens.

Under classic procedure theory, the burden of production can shift during trial but the ultimate burden of persuasion cannot. Let's see how that happens. Remember that the burden of production concept is a concept that deals with the issue of whether there is enough evidence to permit a trier of fact (the jury in the jury trial model) to determine whether the burden of persuasion has been met. The judge determines whether a party has a burden of production and whether it has been met. Thus, for example, at the conclusion of the plaintiff's case where the plaintiff started with both the production and persuasion burdens, the judge may conclude that the plaintiff has not met his production burden and dismiss the case right there. The ultimate trier of fact (the jury) will not

¹⁸⁸⁴ See § 7454(a).

¹⁸⁸⁵ In that event the judge may enter what is referred to as judgment for the other party *j.n.o.v.* – Latin for judgment notwithstanding the verdict. The Latin is *judgment non obstante veredicto*.

determine the fact. Alternatively, the judge may determine that the plaintiff's evidence is so strong that a reasonable trier of fact (here the jury) could not find that the critical fact does not exist. Does that mean that the judge directs verdict for the plaintiff? No, for the defendant has not yet presented his case. In that posture, it can be said that the defendant has a burden of production. The defendant will lose if he does nothing. Then, in theory, the defendant's evidence can not only tend to disprove the plaintiff's evidence (thus meeting the production burden and avoiding direct verdict) but could, depending on its quality, convince the judge that a reasonable trier of fact (the jury) could not find against the defendant's proof. The burden of production would then shift back to the plaintiff to rebut the defendant's evidence, so that, if at the end of trial and before submission to the jury, the plaintiff has not met that burden of production, the judge will direct verdict for the defendant on that fact. So, in this simple model, you can see that the burden of production might shift two times during the trial. But, in this simple model, the burden of persuasion – the burden that must be met if the matter is submitted to the jury – does not shift.

Classic procedure theory has it that the burden of persuasion once assigned by law at the commencement of trial does not shift. Thus, in a simple negligence case where the plaintiff must prove the defendant's negligence, the plaintiff will always bear the burden of persuasion and will initially bear the burden of production, but the burden of production may shift during the trial.

e. Presumptions.

A related concept is the presumption. Simply, a presumption exists when the law says that, if Fact A is proved, then Fact B, otherwise unproven, is presumed to exist.

Generally speaking, presumptions under the substantive law are based on one or more of the following rationales: (1) one party has superior access to proof; (2) social or economic policies warrant a presumption; (3) experience indicates the high probability of a given conclusion from a given set of facts; (4) a presumption will promote efficiency and convenience.¹⁸⁸⁶

Take a classic presumption. Proof of mailing is presumed proof of receipt.¹⁸⁸⁷ The issue addressed here is the procedural effect of presumptions.

In classic procedure theory, the presumption serves to shift the burden of production to a party who does not otherwise bear the burden of persuasion as to a fact issue. This classical function for the presumption is codified in FRE 301 as follows.

¹⁸⁸⁶ Federal Rules of Evidence Manual § 301.02.

¹⁸⁸⁷ Loubriel v. Fondo Del Seguro Del Estado, 694 F.3d 139, 142-143 (1st Cir. 2012). Readers may recall also that § 7502 provides a special application of a rule for timely-mailing, timely filing. One of the important issues not yet fully resolved is whether § 7502 replaces the common-law rule or supplements it. See e.g., Phila. Marine Trade Ass'n-Int'l Longshoremen's Ass'n Pension Fund v. Commissioner, 523 F.3d 140 (3d Cir. 2008).

Rule 301. Presumptions in General Civil Actions and Proceedings.

In all civil actions and proceedings not otherwise provided for by Act of Congress or by these rules, a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast.

The classic operation of the presumption is as follows: “if a basic fact (Fact A) is established, then the fact-finder must accept that the presumed fact (Fact B) has also been established, unless the presumption is rebutted.”¹⁸⁸⁸ In this example, the person against whom the presumption of Fact B is invoked, has a production burden to show the nonexistence of Fact B and if that person meets that production burden, the case proceeds to resolution under whatever the burden of persuasion is, in which case Fact A may be relevant and even logically persuasive as to Fact B but it does not compel the trier to find Fact B because the conclusive effect of the presumption has been rebutted. This is the classic procedure model, the one embraced by FRE Rule 301. Under this model, the presumption addresses only the judge’s gatekeeper role for production burdens, so that the presumption should not be mentioned to the jury.¹⁸⁸⁹ If the presumption was created and the opponent failed to meet a production burden, the judge should instruct the jury that Fact B exists or, if that is the only fact left in dispute, direct a verdict for the proponent of the presumption. If the presumption was created and the opponent met production burden, the judge should not mention the presumption but may instruct the jury that it **may** – but not **must** – infer from the proof of Fact A that Fact B exists.

The foregoing describes the classic operation of the presumption codified in FRE 301. There are other models that apply in particular situations for special reasons. FRE 301 itself allows that Congress can prescribe a different effect for presumptions.¹⁸⁹⁰ I am not aware that Congress has done that in any situations relevant to tax litigation. Second, although not expressly allowed by FRE 301, apparently some judicially recognized – usually common law – presumptions that operate differently are still allowed to so operate.¹⁸⁹¹

Furthermore, for completeness, there are some who argue that presumptions, at least in some cases, should shift the burden of persuasion. Since this is not the classic model reflected in FRE 301, I do not address it further here.¹⁸⁹²

¹⁸⁸⁸ Weinstein's Federal Evidence § 301.02[1], Presumptions in Civil Cases.

¹⁸⁸⁹ Weinstein's Federal Evidence § 301.04, Court Should Avoid Using Word “Presumption” in Jury Instruction.

¹⁸⁹⁰ See also Weinstein's Federal Evidence § 301.05[1] Rule Controls Unless a Federal Statute Provides Otherwise.

¹⁸⁹¹ Weinstein's Federal Evidence § 301.06[1] Common-Law Presumptions Can Override Rule.

¹⁸⁹² The Advisory Committee originally proposed that presumptions could shift the burden of persuasion. Congress rejected that proposal. Federal Rules of Evidence Manual § 301.02.

f. The Limits of Burden of Proof.

Cases are replete with burden of proof discussions as if burden of proof played a role in case outcomes. Of course, in criminal cases, burden of proof beyond a reasonable doubt is critical and a constitutional requirement. But in civil cases the assignment of the ultimate burden of proof -- the burden of persuasion -- merely determines who wins and who loses if the trier of fact is in equipoise -- i.e., is unable to find that the fact more likely than not existed or didn't exist. If the trier believes that the evidence establishes that the fact more likely than not existed, then it doesn't matter which of the parties had the burden of proof or any component of it. Similarly, if the trier believes that the evidence establishes that the fact more likely than not did not exist, then it also doesn't matter which of the parties had the burden of proof or any component of it. It is only where the trier is unable to make the affirmative finding that the case is affected by which party bore the burden of proof (or any component).¹⁸⁹³ Most trial observers feel that it is rare that a trier -- whether judge or jury -- is in this state of equipoise so that the assignment of the burdens of proof may not ultimately be that important an issue, but it is important in framing and trying a case, of course.¹⁸⁹⁴ In fact, in judge tried cases, it is common for the trial judge to discuss in the opinion the burden of proof (i.e., the burden of persuasion) to a greater or lesser extent, but then to say that, after all, the discussion is irrelevant because he is not in a state of equipoise as to any issue.¹⁸⁹⁵

¹⁸⁹³ An interesting case illustrates the phenomenon where the trier is in equipoise so that the resolution turns upon the assignment of the burden of proof, meaning in this case the burden of persuasion. In Forste v. Commissioner, T.C. Memo 2003-103, the issue was whether the taxpayer could exclude \$45,615 from income under a prior version of § 104. The court first determined that then recently enacted § 7491 which we discuss in more detail below applied to assign the burden of proof to the IRS as to \$25,130. The Court held that the IRS had failed to meet that burden and thus, without an affirmative finding, held that that portion was excluded under § 104. As to the balance of the payment, the Court held that the taxpayer bore the burden of proof and held for the IRS because the taxpayer had not met his burden of proof. In other words, as to both components, the Court was in equipoise so that the assignment of the burden of proof controlled the result. For an application of this type of analysis in a criminal sentencing, see United States v. Safiedine, 2013 U.S. Dist. LEXIS 179364 (ED MI 2013) (where the preponderance of the evidence standard applied to tax loss and restitution issues; as to tax loss, the taxpayer bore the burden of persuasion on unclaimed deductions and as to restitution, the Government bore the burden of persuasion; since the court was in equipoise on unclaimed deductions, the tax loss was computed without the unclaimed deductions but as to restitution, the amount was determined with the unclaimed deductions).

¹⁸⁹⁴ Cigaran v. Heston, 159 F.3d 355, 357 (8th Cir. 1998) (“The shifting of an evidentiary burden of preponderance is of practical consequence only in the rare event of an evidentiary tie”); see also Polack v. Commissioner, 366 F.3d 608, 613 (8th Cir. 2003) (citing the Cigaran case); Blodgett v. Commissioner, 394 F.3d 1030, 1039 (8th Cir. 2004); and Knudsen v. Commissioner, 131 T.C. 185, 188 (2008); Estate of Bongard v. Commissioner, 124 T.C. 95, 111 (2005) (declining to decide who has the burden of proof (persuasion) because the Tax Court decides the case on the preponderance of the evidence).

¹⁸⁹⁵ In doing so, the judges often cite the cases cited in the preceding footnote to this text or whatever their circuit’s variation of this theme. Estate of Jorgensen v. Commissioner, 2011 U.S.

2. The General Tax Rule - Taxpayer Bears the Burdens.

The general rule is that the taxpayer bears the burden of persuasion as to fact issues that must be resolved in deciding a civil tax case. As noted above, the party bearing the burden of persuasion usually bears the burden of production -- if there is no evidence for the key fact, there is nothing to submit to the trier of fact. Accordingly, the burden of persuasion is normally the key burden. The reasons for assigning the burden of persuasion to the taxpayer are variously stated, and I do not review them here. The burden of persuasion in a civil tax case means that the trier of fact (judge or jury) must find the fact in issue to be more likely than not, otherwise the bearer of the burden of persuasion loses.

3. The Key Cases and Nuances.

I have just stated what I think is the general rules in traditional burden of proof terms. Now, I will introduce you to the key cases where the Courts have sallied forth on burden of proof in tax cases. In broad strokes, the Courts have divided tax litigation into two categories which are based upon who seeks judgment against whom. The first category is Tax Court litigation which, as you will recall, is prepayment litigation. In Tax Court litigation, the taxpayer nominally brings the suit (taxpayer is the petitioner, the role of plaintiff in normal civil litigation), but does so only in response to the IRS's first move – the notice of deficiency. In Tax Court litigation, the IRS seeks to have the Tax Court enter a decision document for a deficiency so that the IRS can then assess that deficiency amount against the taxpayer. So, the IRS seeks, in effect, a judgment against the taxpayer so that it can collect the amount of the “judgment” (to wit, the amount in the decision that is assessed) from the taxpayer. The second category is refund litigation where the taxpayer, not only the nominal plaintiff but the real plaintiff, seeks a judgment against the United States so that the taxpayer can get money from the United States.

Prior to the modern income tax in 1916, refund suits were the only way to litigate tax controversies with the Government. Refund suits essentially assert that the Government has the taxpayer's money and is not entitled to it because the taxpayer does not owe the tax. Such suits are classic common law “had and received” law suits. In such suits, the plaintiff – the taxpayer suing the Government – must prove his right to recover – which means both liability to return money and the amount to be returned, as the Supreme Court held early on in the seminal case of Lewis v. Reynolds, 284 U.S. 281 (1931).

App. LEXIS 9203 (9th Cir. 2011) (“When, as here, the tax court decides the case based on the preponderance of the evidence and without regard to presumptions of correctness, § 7491's burden-shifting is simply not relevant”); see also Scheidelman v. Commissioner, 755 F.3d 148 (2d Cir. 2014) (burden of proof shift under § 7491 is immaterial because the position sustained is “more persuasive, regardless of the burden of proof”). Moreover, if a trial judge does not expressly say that he is not in equipoise, a court of appeals may effectively so determine by saying that the allocation of the burden of persuasion did not affect the decision. See e.g., Whitehouse Hotel Ltd. Partnership v. Commissioner, 615 F.3d 321, 332-333 (5th Cir. 2010) (“there is no indication that the tax court's decision turned on the allocation of the burden”).

Congress early recognized that the refund suits with the prepayment requirement and the then procedural traps for the unwary in district court litigation prior to the modern rules of civil procedure were ill suited to orderly and fair litigation of tax controversies under the modern tax codes. In the early 1920s, therefore, Congress created the Board of Tax Appeals, the predecessor to the Tax Court, and established the deficiency procedures whereby the taxpayer could invoke a prepayment remedy in the Tax Court. Moms and Pops running the corner grocery store could come forward, even without benefit of counsel, in a user-friendly forum to get justice in their disputes with the IRS. That prepayment remedy requires the IRS to issue a notice of deficiency asserting the amount of tax the IRS intends to assess and then, upon the taxpayer's petition, have the Tax Court redetermine the amount of the deficiency, if any, before the assessment is made. The Tax Court litigation thus seeks to determine the amount of tax that the IRS will collect from the taxpayer. The taxpayer is the nominal plaintiff (or petitioner, as used in the Tax Court), but the Government is really the moving party and seeks to collect money from the taxpayer. If the classic common law "had and received" analogy were applicable, one could argue that perhaps the Government should have the burden of proof in Tax Court cases because it wants to quantify an amount that it is entitled to get from the taxpayer. However, Congress established the Tax Court as a prepayment and less technical forum alternative to the refund suit in the district court and apparently did not intend to make that radical a change in proof, specifically the burden the taxpayer would bear in refund litigation. Accordingly, the Tax Court early on adopted the rule that the taxpayer bears the burden of proof – meaning the burden of persuasion – in Tax Court cases.¹⁸⁹⁶ In other words, it appeared early on as if the Tax Court would have a burden of proof rule patterned on that applying in the district courts in refund suits. Stated in the context of a prepayment remedy, that rule would be that the taxpayer bears the burden of reducing the amount asserted in the notice of deficiency and, in risk of nonpersuasion terms, would bear the risk that the Tax Court were not persuaded as to any lesser amount.¹⁸⁹⁷

¹⁸⁹⁶ The rule is now Rule 142, Tax Court Rules of Practice and Procedure.

¹⁸⁹⁷ The relationship of Tax Court and refund suit proof rules was addressed in the context of the burden of proof for fraud in refund suits in Paddock v. United States, 280 F.2d 563 (2d Cir. 1960), a delightful decision by Judge Henry Friendly, one of the leading jurists of all time. Section 7454 imposes upon the IRS the burden of proof as to fraud in Tax Court proceedings. The Government argued nevertheless that the rule did not apply in refund suits for money had and received where the taxpayer bore the burden of proving the amount of the refund. On this concept, the Government argued, the taxpayer must disprove fraud if the taxpayer wanted a refund of a civil fraud penalty he had paid. Judge Friendly rejected the argument, citing both general pleading and proof concepts imposing the burden of proving fraud upon the proponent of fraud (here the Government) and reasoning that the burden imposed by Section 7454 should not be different in a refund suit than in the Tax Court. The court said (p. 567):

We see no sufficient practical basis for a difference in the rule as to burden of proof in a taxpayer's attack upon a fraud penalty by petition to the Tax Court and in a suit for refund under 28 U.S.C. § 1346(a)(1). In either the taxpayer has the burden on most issues, in the Tax Court because he is attacking an administrative determination of presumed correctness and in a refund suit because he must show it would be inequitable for the government to retain monies that he has paid. If this general rule as to burden of proof is subject to an exception when the issue relates to fraud, as Congress has directed it to be in the Tax Court for the past 32 years, why should it

In Helvering v. Taylor, 293 U.S. 507 (1935), the Court held that Tax Court proceedings would have a slightly different burden of proof rule than was imposed in refund suits. Specifically, whereas in refund suits the taxpayer bore the burden of showing entitlement to a refund and the amount thereof, in Tax Court suits the taxpayer need merely show that the IRS's determination in the notice of deficiency was "arbitrary and excessive" whereupon the IRS would lose unless the evidence were sufficient to establish that amount of deficiency that could be incorporated into the decision document that is then the basis for assessment and collection. In burden of persuasion and risk of nonpersuasion terms, upon the required showing, the IRS would bear the burden of persuasion or risk of nonpersuasion that a deficiency is due and the amount thereof.

The Supreme Court's pronouncement in Helvering v. Taylor has led to some confusion in the Courts as to precisely how to apply the "arbitrary and excessive" predicate to the shift of the burden of persuasion. I do not expect you to know the nuances of the confusion thus spawned, but let me illustrate the genre of confusion in the context Estate of Paul Mitchell v. Commissioner, 250 F.3d 696 (9th Cir. 2001). In an estate tax case, the IRS valued the stock owned by a slightly less than 50% shareholder. An unrelated shareholder owned 50% and other unrelated shareholders owned small percentages. Apparently ignoring the unrelated shareholder's 50% ownership, the IRS valued the decedent's shares as a controlling interest. Indeed, the IRS's own expert initially had not valued the shares as a controlling interest and, for some unexplained reason, the IRS directed him to do so. Valuing the less than 50% interest in these circumstances as a controlling interest was just stupid – in the language of Helvering v. Taylor, it was "arbitrary." Moreover, it resulted in a plain and grossly excessive asserted deficiency. The Tax Court held that the taxpayer still bore the burden of persuasion, but on appeal the Ninth Circuit easily found that the circumstances of Helvering v. Taylor were present and reversed for reconsideration with the IRS bearing the burden of persuasion as to the amount of the deficiency, if any.¹⁸⁹⁸

Judge Posner made the same point succinctly in a refund suit. In Kohler v. United States, 468 F.3d 1032 (7th Cir. 2006), the parties fought over a valuation issue. The Government's valuation proffered at trial – \$19.5 million – was simplistic and clearly excessive, at least Judge Posner for the panel so concluded in his inimitable fashion of bringing pure logic to the task.¹⁸⁹⁹ The taxpayer's valuation proffered at trial – \$11.1 million – was clearly too low. The record offered no persuasive evidence as to a point in between these two erroneous extremes. In traditional refund suit theory, requiring the taxpayer to show not only that the IRS erred but the amount of the refund to which it is entitled, this lacuna should theoretically have permitted to the IRS to prevail. However, perhaps perceiving the Government's erroneous position as more outrageous than the taxpayer's erroneous

not be in a refund suit?

¹⁸⁹⁸ I have severely summarized the issues swirling around Helvering v. Taylor in this illustration. For more reading on this, see Leandra Lederman, Arbitrary Stat Notices in Valuation Cases, or Arbitrary Ninth Circuit?, 92 Tax Notes 231 (2001); and John Townsend, Burden of Proof in Tax Cases: Valuation and Ranges, 93 Tax Notes 101 (2001).

¹⁸⁹⁹ The Davis rule of thumb (from United States v. Davis, 370 U.S. 65 (1962)) that what is paid is the value is something otherwise incapable of valuation sets the value was inapt under the facts of the case as perceived by Judge Posner.

position,¹⁹⁰⁰ Judge Posner side-stepped the traditional refund theory by declaring the assessment to be a “naked assessment” “without any foundation whatsoever.” (Citing United States v. Janis, 428 U.S. 433, 440 (1976); and Taylor.) Where the IRS is plainly excessive even in a refund suit, the taxpayer has no burden. The IRS loses. Judge Posner concluded his opinion:

The Service could have justified a more modest estimate yet one well above \$11.1 million, but clinging stubbornly to its untenable valuation it suggested no alternative to \$19.5 million. It played all or nothing, lost all, so gets nothing.

So, the taxpayer wins, even though the taxpayer’s affirmative proof at trial was not persuasive or even credible simply because the Government was more off base than even the taxpayer.

But, let’s test what Judge Posner was saying. Let’s say that the IRS had asserted an \$18 million valuation in Kohler, with at least some modicum of basis for that amount. Then, at trial, the trier of fact finds that the taxpayer’s proffered valuation of \$11.1 million is too low, that IRS’s proffered valuation of \$18 million is too high, that the real valuation is somewhere in between, but that the evidence is so inconclusive that it does not permit the trier to pick the in-between point by a preponderance of the evidence. Would or could Judge Posner have applied the naked assessment side-step to shut the IRS out? Wouldn’t the IRS then have prevailed under the standard formulation for refund suit burden of proof? Isn’t Kohler just a specific adaptation in a litigation context of the adage that “bulls make money, bears make money, pigs get slaughtered?”

Kohler does help in a discussing the warp and woof of tax burden of proof theory, but the circumstances will rarely be present in the real world. At a trial on a valuation issue, even if the IRS original assessment were excessive the IRS is unlikely to rest on an excessive valuation and will get reasonable – at least somewhat reasonable – in order to maintain credibility before the court. So, in the above example, even if the original assessment were based on \$19.1 million, if at trial the IRS admitted that the value did not exceed \$18 million and offered some basis for that amount, the court would not dump the IRS out simply because of the admission that the original \$19.1 million was wrong.¹⁹⁰¹ Rather, the \$18 million would be the number from which to measure and the above

¹⁹⁰⁰ This perhaps was a sub silentio variation of the baseball decision method.

¹⁹⁰¹ See Silverman v. Commissioner, 538 F.2d 927, 930 (2d Cir. 1976) (where IRS makes partial concession in taxpayer’s favor, the burden of proof remains on the taxpayer as to the unconceded adjustments, citing Tax Court Rule 142(a) that imposes the burden on the taxpayer except inter alia for increases in deficiency); and Cavallaro, Donor v. Commissioner, T.C. Memo 2014-189 (citing Silverman). In Cavallero, the issue was whether the taxpayers received less value in a merger than the value of the company they contributed, thereby making a gift to the other shareholders (their children). The key fact upon which valuation turned was whether the parent’s company or the children’s company owned valuable technology. If the parents company owned the technology, the parents made a gift; if the children’s company owned the technology, the parents did not make a gift. The Court held that the parent’s company owned the technology, meaning that a gift had been made. Before trial, the IRS reduced its valuation, but still stuck to the factual argument that excess value was contributed. At trial, the taxpayers (the parents) entered only a valuation claim based on expert reports which assumed as a fact that the children’s company owned

analysis would apply because, even if wrong, the IRS's position was not arbitrary. In other words, it appears that the DOJ Tax's counsel in Kohler just botched it and suffered the consequences of irritating Judge Posner in the process.

4. The Presumption of Correctness.

Judicial opinions routinely, almost without any thought, pronounce that IRS determinations, such as notices of deficiency, have a presumption of correctness or regularity.¹⁹⁰² What does the presumption of correctness or regularity mean? I noted above in discussing the general concepts that, under classic theory now embodied in the Federal Rules of Evidence, a presumption serves only to assign a burden of production. In a tax case, the taxpayer already bears the burden of persuasion as to the underlying tax liability and, since the taxpayer bears the burden of persuasion, the taxpayer performs already bears the burden of production. Assigning a presumption of correctness to the IRS's actions thus assigns to the taxpayer a burden of production that the taxpayer already has by virtue of bearing the burden of persuasion. Accordingly, one case has said that the presumption of correctness merely covers with a handkerchief something that is already covered by a blanket.¹⁹⁰³ Although conceptually the presumption of correctness has limited and indeed no real function in tax cases where the burden of persuasion is assigned to the taxpayer, the cases seem to have given the presumption a life of its own.¹⁹⁰⁴

But the same question is presented in tax cases as noted above in discussing Rule 301, FRE. That is whether the presumption has some potential effect beyond the mere assignment of burdens of production. I noted above that Rule 301 as finalized by Congress does permit the trier of fact to "infer" the fact even if it may not preclusively presume it. In the mail delivery presumption discussed above, based on persuasive evidence that party A mailed the notice the jury would be able to infer that party B received the notice, thereby satisfying A's burden of persuasion. The jury can simply disbelieve B's testimony that he did not receive the notice. Can a trier of fact in a tax case infer that the IRS is correct because of the presumption of correctness said to attach to the notice of deficiency even when the taxpayer has met his burden of production on the issue? The answer is no. The reason is that in the mail delivery instance the burden of production for policy reasons is shifted to the party who does not bear the burden of persuasion -- party B. In the tax case, the presumption of correctness merely assigns to the party who does bear the burden of persuasion a production burden that the party already had anyway. There is no need to assign any ultimate force

the technology. The court found as a fact that the parent's company owned the technology, thus rendering the taxpayers' expert reports not relevant to the issue of the value of the parent's stock inclusive of the value of the technology. The taxpayers thus had a failure of proof and not meet their burden of proof to show the IRS's revised valuation wrong. Even with questions about the IRS's expert's report, the Court had no basis for a lower finding because of the failure of proof.

¹⁹⁰² E.g.,

¹⁹⁰³ See Chicago Stock Yards Co. v. Commissioner, 129 F.2d 937, 948 (1st Cir. 1942).

¹⁹⁰⁴ The presumption of correctness is most often cited in Tax Court cases, but the burden of proof rules in Tax Court cases is established by Helvering v. Taylor which does not even mention the word presumption or the concept of the presumption of correctness.

to the presumption in assessing whether the taxpayer's burden of persuasion has been met. If the taxpayer's evidence is persuasive (50+%), the taxpayer wins wholly apart from the presumption of correctness which has then been shown persuasively to be erroneous.

One of the confusing uses of the term presumption in tax cases is the claim, very often made, that an IRS determination is presumed or presumptively correct. The Supreme Court thus said: "It is well established in the tax law that an assessment is entitled to a legal presumption of correctness -- a presumption that can help the Government prove its case against a taxpayer in court."¹⁹⁰⁵ That notion is often made in the abstract but is often coupled with the statement that the taxpayer must prove the determination to be false, suggesting a linkage between the presumption and the burden of persuasion.¹⁹⁰⁶ In this sense, the presumption may be viewed as the basis for the taxpayer having the burden of persuasion in tax cases. Given the limited role of a presumption in the classic procedure model, however, the presumption could not have that effect; even though Congress could recognize the presumption of correctness and give the presumption the effect of assigning the burden of persuasion to the taxpayer, Congress has done neither. The assignment of the burden of persuasion to the taxpayer in most tax cases is done for other reasons than the existence of a presumption (such as the taxpayer is more often in the best position to prove facts relevant to the taxpayer's tax obligations). Those other reasons may parallel the reasons a presumption might exist, but the existence of the presumption is not the reason for the assignment of the burden of persuasion. Accordingly, in truth, the presumption of correctness really serves no role in tax cases, yet it is parroted incessantly by the parties – particularly the Government – and by the courts. I think that is inappropriate.¹⁹⁰⁷

5. What About Collection Suits?

In a collection suit where the Government seeks to reduce a tax assessment to judgment, the Government will have an initial burden of production and persuasion as to the fact of the tax assessment. The Government will introduce an official certified summary of IRS Service Center records of assessment. There is also a general "presumption" that Government acts are regular and

¹⁹⁰⁵ United States v. Fior D'Italia, 536 U.S. 238, 242-243 (2002).

¹⁹⁰⁶ Trinity Indus. v. United States, 757 F.3d 400, 413 (5th Cir. 2014) ("The taxpayer has the burden of proving by a preponderance of the evidence that the Commissioner's assessment—its final determination of the taxpayer's liability—was erroneous, since the assessment is presumed to be correct.").

¹⁹⁰⁷ While with DOJ Tax Appellate in the early 1970s, because of my interest in burden of proof issues, I was tasked with writing a memo that, after reviewed by my superiors, would serve as a guide for DOJ Tax personnel in discussing burden of proof issues in tax cases. One of my conclusions was that DOJ Tax attorneys should avoid even mention the presumption. Upon approval, the memorandum was circulated to all DOJ Tax attorneys. After circulation, as best I can tell, the memorandum – and this recommendation in particular – was largely ignored. I did receive a few favorable comments, but that was it.

proper (referred to as the presumption of regularity).¹⁹⁰⁸ That will then both meet the Government's production burden and entitle the Government to judgment on the assessment (shift the burden of production to the taxpayer) unless the taxpayer does something.

The taxpayer's defense might be that the assessment was not made properly (such as not made by the properly delegated official) or that it was untimely. Those are issues as to which the Government bears the burden of persuasion (and keeps it during trial), but after the introduction of the certified summary record of assessment, the taxpayer will bear a production burden on these issues. The taxpayer must do something to make sure the record puts the issues in play. If the issues are in play (i.e., the evidence does not compel a result one way or the other), the trier of fact then must determine whether the Government has met its burden of persuasion or not. In such a collection suit, the taxpayer's defense may be that the assessment might otherwise be legally regular and proper but the taxpayer does not owe the tax that was assessed. If the taxpayer has not previously judicially contested his or her underlying liability for the tax, the taxpayer can do that in the collection suit.

As to the issue of liability for the underlying tax, however, which burden of proof rule applies? Keep in mind that Lewis v. Reynolds is not applicable because a collection suit is not a refund suit – even if it is combined with a refund suit as it often is, for example, in a trust fund penalty case where the IRS assesses a large amount, the taxpayer pays a small amount of the assessment, the taxpayer sues for refund of the small amount paid, and the Government counterclaims for the unpaid balance of the assessment. Nor can the reasoning of Lewis v. Reynolds – money had and received – be extrapolated to a collection suit. Arguably, the collection suit better fits the Tax Court model in terms of burden of proof.¹⁹⁰⁹

6. Exceptions to the General Rule.

There are exceptions to the general rule. Various constitutional requirements, statutes or court rules assign the burden of proof differently for various policy reasons. The key exceptions that you will encounter are as follows.

a. Criminal Cases.

In criminal cases (of which criminal tax cases are a subset), constitutionally, the Government must prove its case beyond a reasonable doubt. If we wanted to use the same percentage methodology to describe the burden, we might say that the trier must be 95+%, or even 98%, persuaded. This means that the trier of fact (usually a jury in a criminal case) must be persuaded beyond a reasonable doubt. And, to use the burden of production concept, the trial judge may direct

¹⁹⁰⁸ This presumption of regularity is probably the same thing in concept and effect as the “presumption of correctness” discussed earlier. See Leandra Lederman, “Civil”izing Tax Procedure: Applying General Federal Learning to Statutory Notices of Deficiency, 30 U.S. Davis L.Rev. 183, 201 n. 97 (1996).

¹⁹⁰⁹ Bar L Ranch, Inc. v. Phinney, 426 F.2d 995, 998-9 (5th Cir. Tex. 1970); see United States v. Janis, 428 U.S. 433, 441-442 (1976).

a verdict of acquittal if the trial judge determines that no reasonable jury could find beyond a reasonable doubt that the defendant was guilty of the crime charged.

b. Civil Fraud.

Where the tax issue is civil fraud (i.e., only whether the taxpayer is subject to a civil penalty), the IRS must prove fraud by clear and convincing evidence.¹⁹¹⁰ If we used the same methodology, we might say that the trier must be 75+% or perhaps even 80% persuaded. And, to use the burden of production concept, the trial judge may direct a verdict for the taxpayer if the trial judge determines that no reasonable jury could find fraud by clear and convincing evidence.

c. Omitted Income.

One problem that has bedeviled the courts over the years is the fairness of imposing the burden of persuasion, along with the burden of production, full bore to the taxpayer in the case of unreported income determinations by the IRS. The problem is that the taxpayer has to prove a negative. The IRS says the taxpayer had income; the taxpayer says he didn't. Particularly in cases where the IRS is alleging the taxpayer was paid in cash, it might be virtually impossible for the taxpayer to meet the burden of persuasion. This problem of having to prove the negative is a problem in many burden of proof contexts, not just tax. But the tax area has produced certain unique solutions.

Some of the cases hold that once the taxpayer meets some production burden which can be a simple denial that is reasonable under the circumstances, the IRS must then meet at least a production burden – described sometimes as a “minimal evidentiary foundation” – by introducing evidence that, if believed, indicates that the taxpayer had the unreported income.¹⁹¹¹ Under this line of cases, the taxpayer would still bear the normal burdens of production and persuasion once the IRS made the required showing. Other cases suggest that once the taxpayer meets his burden of

¹⁹¹⁰ § 7454(a). For an example of a case showing just how substantial the clear and convincing burden is, see Sakkis v. Commissioner, T.C. Memo. 2010-256.

¹⁹¹¹ Procedurally, a court may describe this as denying the IRS the benefit of the presumption of correctness, but requiring the IRS then to do something that rises to the level of the presumption which may meet a burden of production. See e.g., Weimerskirch v. Commissioner, 596 F.2d 358 (9th Cir. 1979) (describing the required showing as a “minimal evidentiary foundation.”); United States v. Besase, 623 F.2d 463, 465 (6th Cir. 1980) (where a taxpayer must make a “negative assertion” that he did not receive the income the IRS claims, “[r]easonable denials of the assessment's validity have sufficed in such cases to shift the burden back to the government.”); and Anastasato v. Commissioner, 794 F.2d 884, 887 (3d Cir. 1986) (entitled to presumption of correctness only if IRS makes some predicate showing of income producing activity; must introduce evidence linking the taxpayer to the tax generating activity). But, as the quote from Weimerskirch indicates, the required burden on the government is minimal. See e.g., Banister v. Commissioner, T.C. Memo 2008-201 (“This is not to say that the requirement in Weimerskirch is difficult to satisfy. The requisite evidentiary foundation is indeed minimal and need not include direct evidence linking the taxpayer to an income-producing activity.”)

production that he or she did not receive the unreported income, the IRS bears the burden of production and the burden of persuasion on the issue. The IRS's position is that the former line of authority is correct.¹⁹¹² And, a credible argument can be made that there is no shift of burdens at all.¹⁹¹³

There is a further wrinkle in this area. Many courts recognizing that the burden of production and possibly the burden of persuasion shift to the Government in unreported income cases seem to limit that shift to illegal income cases. Other cases would apply the rule even in cases of legal source income.

One of the leading cases in this area is a Fifth Circuit case that illustrates the problem of unreported income. In Portillo v. Commissioner, 932 F.2d 1128 (5th Cir. 1991), the taxpayer was a painting contractor who was hired by general contractors. One of the general contractors issued a Form 1099 to the taxpayer claiming an amount that was substantially in excess of the amount the general contractor could produce checks made payable to the taxpayer. The taxpayer denied that he received income in excess of the amount of the checks. The Court found that the Scar analysis (discussed above) did not apply; this was not a naked notice of deficiency because the IRS did link the determinations to the taxpayer. The problem, the Court found, was that the determinations had no substance because the IRS had failed to do anything other than rely upon the 1099s in the face of the taxpayer's denial of receipt of the income. The Court thus held:

Therefore, before we will give the Commissioner the benefit of the presumption of correctness, he must engage in one final foray for truth in order to provide the court with some indicia that the taxpayer received unreported income. The Commissioner would merely need to attempt to substantiate the charge of unreported income by some other means, such as by showing the taxpayer's net worth, bank deposits, cash expenditures, or source and application of funds. * * * In these types of unreported income cases, the Commissioner would not be able to choose to rely solely upon the naked assertion that the taxpayer received a certain amount of unreported income for the tax period in question.

The courts thus would require that the IRS at least show that the taxpayer had some income producing source. Can the IRS do that inferentially? For example, from the fact that the taxpayer had known expenses during the taxable year, can it be inferred that the taxpayer had income during the taxable year and does this meet whatever burden (production or persuasion) that is imposed upon the Government? The answer is, of course, yes. The traditional methods of proving a tax liability (the net worth and cash expenditures methods) rely significantly upon this inference, and those methods subject to appropriate safeguards have been approved by the Supreme Court. See Holland v. United States, 348 U.S. 121 (1954). Thus, for example, if taxpayers deny that they had income for the year but had known expenses, the IRS can use Bureau of Labor Statistics, with adjustments

¹⁹¹² See LGM TL-100 (July 15, 1994), reproduced by Tax Analysts at Doc 1999-27958 (this document has a good discussion of the various authorities).

¹⁹¹³ See Curtis v. Commissioner, T.C. Memo. 2001-308, at fn. 2.

for known expenses, to extrapolate the income and meet any burden on the IRS, thus imposing upon the taxpayers the burden of establishing that the IRS's determinations are arbitrary.¹⁹¹⁴

There is one statutory fix that, in the circumstances to which it applies, provides a parallel solution when the IRS asserts that the taxpayer has omitted income that has been reported to the IRS via information return such as a W-2 or Form 1099. **Section 6201(d)** provides that in such cases if the taxpayer asserts a reasonable dispute as to the income and the taxpayer otherwise has cooperated, the IRS will bear a production burden as to the item in addition to the information return itself.¹⁹¹⁵ This covers a large part of the problem addressed by the judicial solutions noted above, but for the areas not covered by the statute, the judicial solutions might provide some procedural protections for the taxpayer

d. § 7491 - Real or Phantom Shift.

The 1998 Restructuring Act added § 7491 to provide that three key shifts of the burden of proof to the IRS.

(1) Taxpayer Has Done What's Right.

As to facts relevant to the substantive tax issue, the burden of persuasion will be on the IRS if three conditions are present: (1) the taxpayer introduces credible evidence to support his position on the fact in issue (i.e., meets a burden of production on the fact issue); (2) the taxpayer has maintained the required records with respect to the matter and has cooperated during the audit; and (3) the taxpayer has complied with any specific requirements of the Code that he substantiate an item. **§ 7491(a)**.

The rule has two key requirements:

1. The taxpayer must introduce credible evidence. The Committee Reports explain the concept:

Credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness). A taxpayer has not produced credible evidence for these purposes if the taxpayer merely makes implausible factual assertions, frivolous claims, or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that it is worthy of belief. If after evidence from both

¹⁹¹⁴ See Hanel, et al. v. Commissioner, 2001 U.S. App. LEXIS 8095 (7th Cir. 2001) (unpublished opinion).

¹⁹¹⁵ The statute described this production burden as “the burden of producing reasonable and probative information concerning such deficiency in addition to such information return.” See Del Monico v. Commissioner, T.C. Memo. 2004-92.

sides, the court believes that the evidence is equally balanced, the court shall find that the Secretary has not sustained his burden of proof.¹⁹¹⁶

The Eighth Circuit, after dallying with the notion that uncontradicted testimony of the taxpayer will per se shift the burden of proof if the other elements are present, has retreated to the more mainstream position that uncontradicted testimony which the trier of fact does not find credible is not the quality of evidence required to shift the burden of proof.¹⁹¹⁷ The following is a fair summary of the state of play on this issue (case citations omitted):

Credible evidence is evidence the Court would find sufficient upon which to base a decision on the issue in favor of the taxpayer if no contrary evidence were submitted. We have previously found unsupported assertions or testimony insufficient to constitute credible evidence under section 7491.¹⁹¹⁸

2. The taxpayer must have cooperated with reasonable requests by the IRS for meetings, interviews, witnesses, information, and documents (including providing, within a reasonable period of time, access to and inspection of witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the IRS). Cooperation also includes providing reasonable assistance to the IRS in obtaining access to and inspection of witnesses, information, or documents not within the control of the taxpayer (including any witnesses, information, or documents located in foreign countries). A necessary element of cooperating with the IRS is that the taxpayer must exhaust his or her administrative remedies (including any predocting appeal rights provided by the IRS). The taxpayer is not required to agree to extend the statute of limitations to be considered to have cooperated with the IRS.

(2) Statistical.

The IRS has the burden of proof with respect to income items which the IRS proves solely through the use of statistical data from unrelated taxpayers. § 7491(b). Sometimes the IRS will be faced with a situation where it is clear that the taxpayer had income but has no way to derive an estimate of the income. We discuss elsewhere indirect methods (such as the net worth method and the bank deposits and expenditures method) that take data directly related to the taxpayer and estimates the taxpayer's income. But, where there are no reasonably ascertainable indications of the taxpayer's income (usually because the taxpayer was in some form of cash business and did not maintain records or did not maintain records that the IRS successfully obtained), the IRS rather than simply retreating may resort to some method such as a purely statistical method designed to

¹⁹¹⁶ H. Conf. Rept. 105-599, at 240-241 (1998), 1998-3 C. B. 747, 994-995.

¹⁹¹⁷ Blodgett v. Commissioner, 394 F.3d 1030 (8th Cir. 2004), rejecting the earlier holding in Griffin v. Commissioner, 315 F.3d 1017 (8th Cir. 2003). In Blodgett, the court pungently reasoned: “incredible testimony, axiomatically, cannot constitute credible evidence” and the credibility determination by the trier is subsumed in the requirement that the evidence be credible after “critical analysis.” (394 F.3d at 1036.)

¹⁹¹⁸ Kornhuser v. Commissioner, T.C. Memo. 2013-230.

extrapolate some reasonable amount of income based on the income from similarly situated taxpayers or using industry statistics. For example, if the taxpayer is a waiter or waitress at a certain type of club and the IRS may have a regional statistic that shows, in broad strokes, the average tip for a particular type of restaurant, the IRS may attempt some extrapolation.¹⁹¹⁹

(3) Penalties.

The IRS has “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.” § 7491(c).¹⁹²⁰ Burden of production is discussed above and is something less than burden of persuasion. The IRS meets this burden by producing some reasonable evidence that it is appropriate to impose the relevant penalty, although it need not be evidence that establishes liability for the penalty by a preponderance of the evidence.¹⁹²¹ If the IRS meets the burden, the taxpayer then has the burden of persuading the Court that he or she is not liable for the penalty.

The IRS does not have to meet the burden with respect to accuracy related penalty defenses of reasonable cause or substantial authority, as to which the taxpayer bears both the burden of production and persuasion.¹⁹²² And, on the other hand, although § 7491 also covers the civil fraud penalty, it has no practical meaning to the civil fraud penalty because the IRS is required to persuade the court to apply the fraud penalty by clear and convincing evidence.¹⁹²³ Since the IRS must thus persuade, it must perform produce and thus has a production burden independent of § 7491(c).

¹⁹¹⁹ Fior D'Italia Inc. v. United States, 536 U.S.238 (2002) (sustaining such estimates for determining the aggregate tip income for the employer’s FICA tax computation).

¹⁹²⁰ Higbee v. Commissioner, 116 T.C. 438, 446-447 (2001). This burden applies, however, only if the taxpayer in the petition contests the penalty on its merits. Swain v. Commissioner, 118 T.C. 358 (2002); Wheeler v. Commissioner, 127 T.C. 200 (2006). Similarly, if the petition is so deficient that it does not state a claim upon which relief can be granted (other than a nonspecific allegation of error), the burden does not apply. Funk v. Commissioner, 123 T.C. 213 (2004). In view of the summary nature of pleadings allowed, I believe that a pleading that is not sufficient to state a claim has to be funky indeed.

¹⁹²¹ One case has suggested this burden is minimal where the taxpayer concedes the underlying deficiency without introducing some evidence to avoid the penalty. See Perry Funeral Home, Inc. v. Commissioner, T.C. Memo. 2003-340. Query whether this is a correct application of burden of production principals?

One issue not yet resolved is whether this burden extends to the procedural requirements as well as the substantive requirements for the penalty. For example, § 6751(c) requires supervisor approval for the assertion of a penalty. Is the approval within the scope of the burden of production so that the IRS’s failure to enter proof on the issue is fatal to the assertion of the penalty? See Chai v. Commissioner, T.C. Memo. 2015-42 (reserving the issue because the taxpayer did not timely raise it).

¹⁹²² See Higbee v. Commissioner, 116 T.C. 438, 446 (2001)

¹⁹²³ We noted above the shifting burdens that can apply as to the quantum of the deficiency subject to the fraud penalty. See discussion beginning on p. 332.

(4) Comments.

The “relief” provision that has received the most public discussion is the first -- relating to the shift of the burden of persuasion to the IRS where the taxpayer has maintained records and cooperated. It is too early to tell whether this new burden of proof rule will really be a benefit to many taxpayers. I and other observers believe that the shift is rarely outcome determinative for three reasons:¹⁹²⁴

First, although many cases discuss the burden of persuasion and presumptions, in truth most cases are resolved by the judge (or jury) making an affirmative finding (i.e., is persuaded) as to the existence or nonexistence of each key fact. The burden of persuasion is only relevant if the Court is in a state of equipoise – i.e., it cannot find the existence of the fact or the nonexistence of the fact more likely than not. Courts usually make their factual determinations based on a finding that the facts found are more likely than not. Courts (or juries, if they are the triers) are usually not in a state of equipoise. Careful courts will state the burden of proof rules, but will then state that, even if they have stated those rules incorrectly, they are making their findings of fact based on affirmative persuasion and not based upon burden of proof default rules. The burden of persuasion thus only rarely has a real bottom-line effect.

Second, if indeed the taxpayer fully cooperates and the records he is required to maintain and produce show that he is right on the issue, it will not be incorporated in a notice of deficiency and will not be an issue at a trial. That's the way it was before. The IRS did not have a practice of setting up issues where the taxpayer cooperated and produced reasonable records showing that he was right.

Third, of course, the taxpayer must introduce credible evidence. As noted from the committee report quoted above and the Eighth Circuit's retreat, if the Court finds the taxpayer's factual assertions not credible, he loses. That's the way it always was. And, even before this “relief” provision, if the Court found the taxpayer's factual assertions credible, the Court would have found the facts in the taxpayer's favor.

Has the “relief” provision affected much in the tax litigation landscape? Not much.¹⁹²⁵

e. The Strong Proof Rule.

The courts have fashioned a judicial “strong proof” requirement when a party to a contract seeks to avoid the tax consequences that apply to a provision in the contract as to which the parties to the contract have opposing tax interests. The classic instance is a contract selling a business with

¹⁹²⁴ See e.g. Philip N. Jones, The Burden of Proof 10 Years After the Shift, 121 Tax Notes 287 (Oct. 20, 2008), a comprehensive discussion of the cases and citing *inter alia* my earlier article, John A. Townsend, Burden of Proof in Tax Cases: Valuation and Ranges, Tax Notes, Oct. 1, 2001 and 2001 TNT 187-37.

¹⁹²⁵ See Janene R. Finley and Allan Karnes, An Empirical Study of the Change in the Burden of Proof in the United States Tax Court, 6 Pitt. Tax Rev. 61 (2008).

an allocation of some of the purchase price to a covenant not to compete and/or to good will. All other things being equal, the portion of the purchase price allocable to the covenant not to compete is ordinary income to the seller and is an ordinary deduction to the purchaser. Similarly, the portion of the purchase price allocable to good will is capital gain or return of capital to the seller and is a capital expenditure to the purchaser who amortizes that cost over a period of years rather than deducting immediately. In these cases, so long as the parties report consistently with the contract provision, the Government is not whipsawed¹⁹²⁶ by, for example, the seller claiming capital gain and the purchaser claiming an ordinary deduction. The parties themselves are in the best position to know what the real deal is and, when they make the allocation in the contract, the purpose of the “strong proof” rule is to permit the IRS to rely upon the parties’ allocation without concern that one or the other will unilaterally seek to change the tax consequences and whipsaw the Government. Although there is a general tax theory that a party’s tax consequences is determined by the real deal rather than words in a contract that do not reflect the real deal, the strong proof rule is designed to encourage the parties to state the real deal in the contract rather than seeking to disavow unilaterally their own contract terms. In these circumstances, a court will require the party seeking such unilateral relief to go beyond the preponderance of the evidence standard and show “strong proof” that some allocation other than provided in the contract should control.

There are at least two formulations of the strong proof rule. The first formulation of the rule is that “proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.”¹⁹²⁷ (This is sometimes referred to as the Danielson rule, named for the first major case in which it applied.)¹⁹²⁸ Other courts impose a perhaps less rigorous but still quite substantial version of the rule – that the proponent must prove that both parties actually intended a different allocation than they put in the contract.¹⁹²⁹ (I must confess that they appear to be the same, but courts do not think

¹⁹²⁶ A whipsaw against the Government has been illustrated as follows:

A whipsaw situation occurs in the tax field when two different taxpayers take positions with respect to a particular transaction which are so inconsistent with each other than only one should logically succeed – and yet, because of jurisdictional or procedural reasons, first one and then the other prevails against the government.

Remarks by Phillip R. Miller at the Court of Claims Judicial Conference, October 14, 1971 on Whipsaw Problems in Tax Cases, 25 Tax Lawyer 193 (1972), cited in Gerardo v. Commissioner, 552 F.2d 549, 555-556 (3d Cir. 1977).

¹⁹²⁷ Commission v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967).

¹⁹²⁸ Some courts treat the Danielson rule as separate from the strong proof rule. E.g., United States v. Bergbauer, 602 F.3d 569, 577 n. 10 (4th Cir. 2010). I treat them as variations of a strong proof rule arising from the same considerations.

¹⁹²⁹ Muskat v. United States, 554 F.3d 183, 188-189 (1st Cir. 2009). The contract reformation standard is perhaps a good one, but that would leave the issue up to state law. I would think that the strong proof formulation to require clear and convincing evidence is consistent with tax burden of proof rules that come only in three flavors – preponderance of the evidence, clear and convincing, and beyond a reasonable doubt. To say that there is yet another standard that must be added does not make sense. So, when you concede that it means more than preponderance of the

they are.) I have stated only the parameters of the rule, and cannot in this text develop its nuances in application. One nuance, however, that was addressed by a court applying the second formulation is that the party's evidence must have persuasive power closely resembling the "clear and convincing" evidence required to reform a written contract on the ground of mutual mistake.¹⁹³⁰

The bottom line is that the practitioner should caution the client to insure that the real deal is stated in the agreement and that he will likely be bound by the provisions of the agreement. The real deal for this purpose has two layers – first the contract should certainly state the parties' actual agreement; that is, they should have no side oral, wink-wink or other types of agreement inconsistent with the contractual provision. (Indeed, under the second version of the rule a taxpayer may be admitting a crime if he were to assert that the intent of the parties as to a contract provision having tax consequences was different than the parties stated in the contract.) The real deal second layer is an objective test apart from the parties' intent and meeting of the minds – what does the real objective economic circumstance indicate that the real deal was? For example, if there is no reason whatever for the seller to stay involved in a business or to possibly compete against the purchaser, the parties' allocation of a material portion of the purchase price to a consulting contract or covenant not to compete will lack economic substance even apart from having to discern their subjective intent and meeting of the minds. Of course, these separate aspects of the real deal tend to converge in the real world, but they are different conceptual aspects that may come into play.

Note that the rule applies to the **parties** to the contract. The rule does not apply to the IRS. The IRS may, upon review of the overall context, decide that the contract does not state the real deal and tax one or both parties consistent with the IRS determination of the real deal. A moment's reflection should show why that has to be the case; otherwise, parties could manipulate the tax consequences of their contract. When the IRS challenges the contract provision, the party seeking to have the provision govern for tax purposes will be required to show under the regular preponderance of the evidence rule that the contract correctly states the real deal.

As a further nuance, if the IRS does propose to adjust the tax consequences of one party and the other party is aware of the IRS proposal, the other party should protect his ability to claim the refund that would result from a consistent adjustment. I hope you have spotted a conceptual problem where these rules could overlap to create an injustice that might permit the IRS to tax both sides inconsistently. For example, say the IRS asserts a deficiency against a buyer, denying his deductions as payments are made because the covenant not to compete lacks economic effect. If the IRS is successful, provided the seller reported consistently with the contract (ordinary income), the seller has likely over-paid his tax because the income should be capital gain or return of capital rather than ordinary income to him. So, assuming the seller has protected his refund statute of limitations, must the seller meet the strong proof rule in order to get a refund and, if he cannot, can the parties be whipsawed and the Commissioner collect tax twice on inconsistent theories? That may conceptually be an issue, but the IRS will work to avoid whipsawing taxpayers. (You should note that this possible whipsaw of taxpayers can conceptually occur even under the normal burden of proof rules where the taxpayer bears that burden; the trier – whether the IRS or a court or jury –

evidence, you get to clear and convincing.

¹⁹³⁰ Id., p. 191.

would be in a state of equipoise, not knowing who should win; under the formulation of the burden of persuasion rules, both parties could conceptually lose,¹⁹³¹ but I suspect that under those circumstances the first deciding court would strive to make a decision on the basis of the burden of persuasion, thus avoiding the inequity.¹⁹³²)

Finally, the context of this discussion is where the taxpayer seeks to disavow the consequences of a form he or she has chosen and argue that the substance – and thus the tax consequence – is different than the form. However, in many tax contexts the form determines the substance and different forms can have different tax consequences even if they might, practically, be substantively similar. In any event, in some contexts when the issue is raised, close analysis will show that in fact the substance – at least the substance for tax purposes – is sufficiently consistent with the form that the taxpayer’s argument fails for that reason alone.¹⁹³³

D. Injunctions in Tax Litigation.

1. General Rule.

Injunctions or injunction substitutes to prohibit the assessment or collection of tax (including penalty or interest) are generally not allowed. § 7421(a) (also called the Anti-Injunction Act, and acronymed to “AIA”).¹⁹³⁴ The reasons are (1) there is a strong governmental imperative in avoiding

¹⁹³¹ When I was with DOJ Tax’s Appellate Section, I made a whimsical attempt to convince a fellow attorney who was handling both parties’ appeal from two different trial courts but in the same circuit that he should argue on burden of proof grounds that the Government should win both cases. He did not like that idea, and the Government took sides to obtain a consistent result in the cases. Note, though, that the Government can be whipsawed with no relatively neutral party there to resolve the whipsaw. For example, I was involved with a widow-bonus case involving the issue of whether a cash payment to the widow of a valued employee was compensation (which would be taxable to the widow and deductible by the corporate employer) or a gift (which would not be taxable to the widow and would not be deductible to the corporate employer). The widow prevailed in court before a jury who, sympathetically held that the payment was a gift from the corporate employer, and the court of appeals affirmed on the basis that, although the court of appeals did not think that was the right result, it could not find that a rational jury could not so hold. The corporation prevailed in its deduction of the payment because, in truth that was the correct result.

¹⁹³² As noted above in the discussion of burden of proof, it is the rare case indeed that is decided based on a state of equipoise.

¹⁹³³ See Fletcher v. United States, 562 F.3d 839 (7th Cir. 2009) (where Judge Easterbrook masterfully logics his way to the right answer).

¹⁹³⁴ The AIA provides that, except for enumerated exceptions, “no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed.” Tax, for this purpose, includes tax penalties and interest. See § 6665(a)(2) (“any reference in this title to ‘tax’ imposed by this title shall be deemed also to refer to the additions to the tax, additional amounts, and penalties provided by this chapter”); Prisco v. IRS, 2013 U.S. Dist. LEXIS 161356, 9-10 (N.D.N.Y.

interference with the revenue function and (2) there are adequate procedures otherwise provided in which taxpayers can contest tax liabilities without undue burden.¹⁹³⁵

2. Exceptions.

The key exceptions that I will expect you to know are (i) certain exceptions specifically stated in § 7421(a), and (ii) The Enochs v. Williams Packing Company¹⁹³⁶ judicial exception.

a. Failure to Issue a Notice of Deficiency.

I address first the failure to issue a notice of deficiency. **Section 7421(a)** contains a flat prohibition against a “suit for the purpose of restraining the assessment or collection of any tax.” This means, of course, no injunctions. Section 7421(a), however, enumerates certain exceptions. I shall expect you to know certain exceptions for this class, and encourage you to think about why the exceptions exist.

Let me start off with the enumerated exception for § 6213(a). You certainly recall that § **6213(a)** is a key Code Section in this class. Briefly, it is the section that creates restrictions on assessment -- specifically a prohibition on assessment until the IRS has first issued a notice of deficiency and waited 90 days during which the taxpayer can petition the Tax Court and then further prohibits assessment during the period a Tax Court case is pending. This prohibition on assessment, as we have discussed, is an essential feature of an effective prepayment remedy, without it the IRS could assess and begin collection measures. What is the taxpayer's remedy if the IRS, despite the prohibition on assessment, makes the assessment and begins collection measures? The remedy appears in § 6213(a)'s specific provision for an injunction suit (including an order for a refund for taxes paid pursuant to an improper assessment) and § 7421(a)'s carving out of § 6213(a) from the general flat prohibition on injunctions.

2013); J.J. Re-Bar Corp. v. United States (In re J.J. Re-Bar Corp.), 644 F.3d 952, 956 (9th Cir. 2011) (as to TFRP under § 6672).

¹⁹³⁵ Enochs v. Williams Packing & Nav. Co., 370 U.S. 1, 7 (1962) (“The manifest purpose of § 7421(a) is to permit the United States to assess and collect taxes alleged to be due without judicial intervention, and to require that the legal right to the disputed sums be determined in a suit for refund.”); and Alexander v. Americans United Inc., 416 U.S. 752, 769 (1974) (§ 7421(a) reflects “appropriate concern about the ... danger that a multitude of spurious suits, or even suits with possible merit, would so interrupt the free flow of revenues as to jeopardize the Nation's fiscal stability.”). As to the availability of alternative remedies for tax disputes, when enacted in 1867, the remedy was the refund suit. As I note in this text, Congress has provided several alternative remedies to address the potential fairness and due process concerns inherent in refund suits. The remedies include the prepayment Tax Court remedy for the types of tax requiring a notice of deficiency, the remedies for jeopardy assessment and termination, etc. In addition, judicial interpretation of the so-called full pay rule in Flora has mitigated its impact via the divisible tax concept and other interpretations that make the refund remedy more accessible.

¹⁹³⁶ 370 U.S. 1 (1962).

But, those of you who are both familiar with the law of remedies and the federal tax scheme allowing refund suits to contest tax liabilities, should easily spot that there is a further issue lurking here. What if the taxpayer in an injunction suit alleges only that the IRS assessed without issuing a notice of deficiency -- a clear violation of § 6213(a) -- but cannot allege or has not alleged the traditional bases for equitable injunction relief - irreparable injury and lack of adequate remedy at law? For example, what if the taxpayer has ample money to pay the taxes wrongfully assessed and thus could litigate in a refund suit? Can the taxpayer sue for injunction under § 7421(a)? The taxpayer has a remedy at law - pay the amount assessed and sue for refund. There is a split in the circuits. However, given the importance of the Code's scheme to allow a prepayment remedy which requires the issuance of a notice of deficiency, the better view is that the injunctive remedy is allowed by § 7421(a).¹⁹³⁷

Examples of other exceptions in § 7421(a) are: (1) injunctions to allow the special Tax Court proceeding for innocent spouse claims to proceed without the threat of assessment and collection actions; (2) injunctions to allow the partnership unified audit proceedings to work at the partnership level before assessment and collection action is taken at the partner level (for discussion of these procedures, see below (pp. 748 ff.)); and (3) injunctions in responsible person penalty cases (also referred to as trust fund penalty cases) where the IRS has not given the required notice under § 6672(b).

For purposes of this course, I want you to focus on the exception for failure to satisfy § 6213(a)'s restrictions on assessment. In your subsequent practice, of course, you should think about the other exceptions in § 7421(a) where the need arises.

b. Enochs v. Williams Packing Exception.

As mentioned above, there is a nonstatutory exception to § 7421(a)'s general prohibition on injunctions. This is the Enochs v. Williams Packing exception, named after Enochs v. Williams Packing & Navigation Co., 370 US 1, 6 (1962). The case holds that if the situation is quite extreme and it is clear, virtually on the face, that the IRS cannot prevail, a court may enjoin. The court stated the predicates for such a suit as follows: (1) it must be “clear that under no circumstances could the government ultimately prevail...on the basis of information available to it at the time of the suit. [taking] the most liberal view of the law and the facts” and (2) “equity jurisdiction otherwise exists” -- meaning there must be irreparable harm and no adequate legal remedy exists.¹⁹³⁸ With regard to the latter, note that the comprehensive system for litigating tax liabilities (the notice of deficiency and Tax Court procedure) without paying and the opportunities to litigate in the district court (with the mitigations of the Flora rule), will often make it very difficult for taxpayers to satisfy the requirement that equity jurisdiction otherwise exists. Even where there is no prepayment remedy,

¹⁹³⁷ Gardner v. United States, 211 F.2d 1305 (D.C. Cir. 5/19/2000) (discussing holdings in other circuits to the contrary).

¹⁹³⁸ See Bob Jones Univ. v. Simon, 370 U.S. 1, 6-7 (1974) (citing Williams Packing, the Supreme stated: “Only upon proof of the presence of two factors could the literal terms of § 7421(a) be avoided: first, irreparable injury, the essential prerequisite for injunctive relief in any case; and second, certainty of success on the merits.”)

the mitigations to the full payment rule (e.g., in the case of employment taxes, paying for one employee for one quarter) results in an adequate remedy.

I noted that it is usually difficult to clear the hurdles of Enochs v. Williams Packing. However, the potential for success is illustrated in a case that is not without controversy. In Estate of Michael v. Lullo, 173 F.3d 503 (4th Cir. 1999), involving the estate tax, the estate had been audited, received a closing letter (not a closing agreement), and paid the amount (i) by a credit for tax paid to England and (ii) by check for the balance. The statute of limitations expired. The IRS then discovered that it had omitted from its calculations in the closing letter certain assets in certain schedules and, recognizing that the statute of limitations prevented further assessments, sought a partial solution by denying the credited English tax, thus, if it worked, reinstating that amount of the assessment to which the foreign credit had been applied. In other words, no new assessment was made, just a reversal of part that had been paid by the English tax credit. The taxpayer then sued for mandamus to order the IRS to acknowledge the amount of English tax claimed as a credit. The district court denied the mandamus action based on the Anti-Injunction Statute. On appeal, the Fourth Circuit reversed, ordering the mandamus under the Enochs v. Williams Packing exception. The Court said “The Estate’s action is precisely the rare type of suit for which this exception was crafted.” The Court got to that conclusion based on the following steps (which I highly summarize at the risk of misstating the nuances): (i) the IRS conceded that the taxpayer was entitled to the English tax credit that it was seeking to reduce; (ii) the statute of limitations was closed for any further assessments; (iii) since the IRS did not assess the taxes it now sought to collect, whether or not in an academic sense the taxpayer owed additional taxes is irrelevant, for the statute not only bars the IRS from a remedy, it affirmatively extinguishes liability for taxes not assessed timely (hence the taxes resulting from the IRS omission of assets on the schedules are simply nonexistent); (iv) the Lewis v. Reynolds right to offset in refund suits is inapplicable because that case only permitted the IRS to retain additional otherwise due taxes but did not give it the right to go out and collect them as it was attempting to do here; and, (v) even apart from Lewis v. Reynolds, the IRS gambit short-circuited general procedure for notice of deficiency and right to contest in the Tax Court and thus relegating the IRS to a refund suit that was inconvenient and where the IRS would eventually lose. So reasoned the majority on the panel.

The dissenter in Estate of Michael excoriated the majority’s holding based on “frontier instincts.” The dissenter says, in part, that Enochs v. Williams Packing required that it be clear or certain that the taxpayer would prevail in any otherwise adequate proceedings, but in a refund suit that is otherwise adequate Lewis v. Reynolds makes it far from certain that the taxpayer could prevail. (It is black letter law that the mere inability to prevail in a subsequent otherwise adequate proceeding does not meet the Enochs v. Williams Packing exception.)

But don’t get hung up on the scope of Lewis v. Reynolds at this point, and think about why the taxpayer’s case in Estate of Michael was so compelling to persuade at least a majority on the panel to invoke the Enochs v. Williams Packing exception.

c. Declaratory Judgments and Other Injunction Substitutes.

The law of remedies offers potential remedies that might have an equivalent effect to interfere with the revenue function much as an injunction would. Hence, it is not surprising that such other remedies are prohibited, either expressly in the statute or by court interpretation, except in certain narrowly prescribed contexts in which Congress intended those other remedies to apply.

The most obvious similar remedy is the declaratory judgment remedy which could have the same practical effect even though it would be just a pronouncement of legal rights. The statute expressly excepts tax matters from the declaratory judgment remedy.¹⁹³⁹ Notwithstanding this general prohibition, Congress has provided certain limited authority for courts to confer declaratory judgment relief. The Tax Court is given certain declaratory judgment authority with respect to, for example, certain exempt organization qualification. I discuss these limited grants of declaratory judgment authority elsewhere.

Other remedies that might achieve a similar revenue-inhibiting effect are similarly prohibited except where expressly allowed by statute.¹⁹⁴⁰

E. Class Actions in Tax Litigation.

Federal tax litigation rarely presents the opportunity for class actions. Class actions are not available at all in the Tax Court, since the Tax Court has jurisdictional prerequisite notices from the IRS to the individual taxpayer (e.g. notice of deficiency or notice of determination). Some of the practical procedural effects of class actions can be achieved via the Tax Court's procedures for handling cases with common issues,¹⁹⁴¹ but that is not a class action. For this reason, the Tax Court's rules do not even address the issue of class actions. The district courts and the Court of Federal Claims do have procedures that allow class actions. However, in tax litigation, refund suits are the usual method of contesting tax liabilities and, as we have noted, require a predicate claim

¹⁹³⁹ See 28 U.S.C. § 2201(a) (denying declaratory judgments in tax matters); and *Cohen v. United States*, 650 F.3d 717, 729 (2011) (The declaratory judgment tax exception “serves a critical but limiting purpose in stripping courts of jurisdiction to circumvent the AIA by providing declaratory relief in cases restraining the assessment or collection of any tax.”)

¹⁹⁴⁰ For example, enterprising plaintiff's lawyers might consider the possibility of a False Claims Act suit under 31 U.S.C. § 3729 ff against abusers of the tax system, but will find that there is a bar to litigating tax issues (referred as the “Tax Bar”). 31 U.S.C. § 3729(e); see *United States ex rel. Lissack v. Sakura Global Capital Markets, Inc.*, 377 F.3d 145 (2d Cir. 2004) (citing also § 7401 for the proposition that the IRS has exclusive jurisdiction over tax matters).

¹⁹⁴¹ For example in large tax shelter cases not subject to the TEFRA unified partnership procedures the Tax Court, working with counsel for the parties, first tries a limited number of representative cases. After the test case litigation, the taxpayers who have stipulated in advance to be bound by the test cases will have their cases resolved accordingly and taxpayers who have not so stipulated will have their cases called to show cause why their cases are sufficiently different that a separate trial should be held.

for refund and either denial or deemed denial (by inaction for 6 months).¹⁹⁴² Many taxpayers will not have met this requirement; nevertheless, in an appropriate case, a class action might be framed.¹⁹⁴³ And if that won't work, still other esoteric forms of class action like work arounds may be found, although they are not intuitive in the tax law.¹⁹⁴⁴

¹⁹⁴² Some functional equivalents of class actions do exist. For example, in CSX Corporation v. United States, 52 Fed. Cl. 208 (2002), the employing corporation filed on behalf of its employees with respect to both the employers and employees shares of FICA.

¹⁹⁴³ See Oatman v. Department of Treasury, 34 F.3d 787 (9th Cir. 1994); see generally, Burgess J.W. Raby and William L. Raby, Class Action in Income Tax Litigation, 2002 TNT 206-47 (10/24/02).

¹⁹⁴⁴ For example, with respect to allegedly overpaid FICA taxes, the employer which paid ½ the FICA and withheld the other ½ from the employees' wages may be able to file a collective claim for refund and even pursue a collective refund suit, provided that appropriate consents are obtained from the employees before any refund is paid. See 31.6402(a)-2(a)(2)(i), Rev. Rul. 81-310, 1981-2 C.B. 241, and Chicago Milwaukee Corp. v. United States, 40 F.3d 373 (Fed. Cir. 1994).

Ch. 13. Assessment Procedures.

I. Introduction and a Review.

The assessment is the key event that records on the IRS's books the taxpayer's liability for a tax. The Supreme Court explained in general terms the concept of the assessment for a taxing agency:

Some machinery must be provided for applying the rule to the facts in each taxpayer's case, in order to ascertain the amount due. The chosen instrumentality for the purpose is an administrative agency whose action is called an assessment. The assessment may be a valuation of property subject to taxation, which valuation is to be multiplied by the statutory rate to ascertain the amount of tax. Or it may include the calculation and fix the amount of tax payable, and assessments of federal estate and income taxes are of this type. Once the tax is assessed, the taxpayer will owe the sovereign the amount when the date fixed by law for payment arrives. Default in meeting the obligation calls for some procedure whereby payment can be enforced. The statute might remit the government to an action at law wherein the taxpayer could offer such defense as he had. A judgment against him might be collected by the levy of an execution. But taxes are the lifeblood of government, and their prompt and certain availability an imperious need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection. The assessment is given the force of a judgment, and if the amount assessed is not paid when due, administrative officials may seize the debtor's property to satisfy the debt.¹⁹⁴⁵

As we shall see, the assessment is the administrative act that is the fulcrum to the IRS's actions to collect the amount assessed but unpaid.

But first, let's review matters we have previously covered – often more than once. We do have a system that, for income and estate and gift taxes, permits a taxpayer to obtain a prepayment remedy if he disputes the amount of tax the IRS proposes to assess. Of course, if the taxpayer reports the liability on his return, the IRS can assess immediately. But, where the taxpayer does not report the liability and does not agree with it, the policy decision to give a prepayment remedy means that the taxpayer must have a pre-assessment remedy.¹⁹⁴⁶

You will recall that a deficiency is, generally, the tax due less the tax previously assessed. § 6211(a). For the types of taxes that most concern us here, before the deficiency can be assessed,

¹⁹⁴⁵ Bull v. United States, 295 U.S. 247, 259-260 (1935).

¹⁹⁴⁶ All right, it would be possible to design a system permitting assessment first and then stay of the assessment while the taxpayer litigates. But our system does it otherwise, thus preserving the act of assessment after the taxpayer is given a pre-assessment remedy as the act from which the IRS's collection authority springs into existence unimpeded by stays.

the IRS must issue a notice of deficiency. §§ 6212 & 6213(a). Only thereafter can the IRS assess the tax.

There are three key exceptions to the predicate notice of deficiency.

First, § 6213(b) provides certain exceptions to § 6213(a)'s general requirement that a notice of deficiency precede assessment. The key exceptions generally applied are: (1) the IRS may assess the amount of tax the taxpayer reports to be due on the return;¹⁹⁴⁷ (2) amounts paid as a tax or in respect of a tax;¹⁹⁴⁸ and (3) correction of mathematical or clerical errors on the face of the return, provided the IRS notifies the taxpayer of the correction.¹⁹⁴⁹

Second, the taxpayer can sign a waiver of the restrictions on assessment (Form 870 or Form 4549 in the case of income taxes)¹⁹⁵⁰ which, for review, waives the Section 6213(a) prohibition on assessment before issuance of a notice of deficiency and the expiration of the ninety-day Tax Court petition time. § 6213(d). The effect of this waiver is to deny the waiving taxpayer the right to petition for Tax Court redetermination of a proposed deficiency.¹⁹⁵¹ A taxpayer signing such a

¹⁹⁴⁷ § 6213(b)(4).

¹⁹⁴⁸ § 6213(b)(4).

¹⁹⁴⁹ § 6213(b)(1). Section 6213(b)(2) requires the IRS to abate the assessment if the taxpayer objects in writing within 60 days, in which case the IRS must proceed by notice of deficiency. For a good article on these mathematical assessments, see Robert B. Nadler, Math Error Notices: in Search of Taxpayer Rights, 2003 TNT 131-6 (7/9/03). In Rev. Rul. 2005-51, 2005-31 IRB 1, the IRS ruled that the IRS may not make a mathematical adjustment to assess a tax based upon a wage amount shown on a W-2 attached to the return that exceeds the amount the taxpayer reported on the return.

¹⁹⁵⁰ Other forms are used, depending on context. IRM 4.8.9.23.3 (07-09-2013), Waivers of Restriction on Assessment (listing the Forms). All of the forms have some variation of this language which tracks the following language (drawn here from the Form 870):

I consent to the immediate assessment and collection of any deficiencies (increase in tax and penalties) and accept any overassessment (decrease in tax and penalties) shown above, plus any interest provided by law. I understand that by signing this waiver, I will not be able to contest these years in the United States Tax Court, unless additional deficiencies are determined for these years.

A waiver may be filed after a notice of deficiency is issued, in which case the waiver permits immediate assessment (and invokes the other features for a waiver, such as suspension of interest after 30 days). Rev. Rul. 66-17, 1966-1 C.B. 272 (waiver "filed within the 90-day period of suspension provided by sections 6213(a) and 6503(a)(1) of the Code, has the effect of terminating the running of such 90-day period and starting the running of the 60-day period provided by section 6503(a) of the Code on the date it is filed.")

¹⁹⁵¹ In the absence of a waiver for the type of assessments requiring a predicate notice of deficiency under § 6213(a), any assessment and collections without a notice of deficiency would appear from the statute to be facially invalid. The predicate requirement for a notice of deficiency is to give the taxpayer some opportunity for prepayment contest in the Tax Court. However, where

waiver is not precluded from contesting the amount of the tax liability in some judicial forum other than the Tax Court (such as a refund forum), but the taxpayer will be precluded from contesting the amount in the Tax Court.¹⁹⁵²

Third, the IRS can make a jeopardy or termination assessment permitting the IRS to make prompt assessments and collections where the taxpayer appears to be doing something deliberately intended to defeat the IRS's ability to collect taxes ultimately found to be due (pp. 510 ff.).

For the balance of the discussion in this section, I will assume compliance with the predicates for assessment, so that the IRS has authority to make an assessment.

II. Assessment.

A. Procedures for Assessment.

The act of assessment is the formal recording on the IRS's books that the taxpayer has a tax due that has not been previously assessed. § 6203.¹⁹⁵³ Historically, the assessment occurs at the

the taxpayer signs a closing agreement – thus admitting the tax liability – the question has arisen whether the statutory predicate should be required unless the taxpayer also expressly waives the notice of deficiency. The IRS has taken the position that, where the taxpayer signs a closing agreement as to the assessment, the purpose and need for a notice of deficiency is moot and thus the predicate requirement of a notice can be dispensed with. E.g., Rev. Proc. 68-16, 1968-1 C.B. 770 (although noting that an express waiver can be ordinarily be submitted with a closing agreement). One court has agreed with the IRS view. Marathon Oil Co. v. United States, 42 Fed. Cl. 267 (1998), affd. 215 F.3d 1343 (Fed. Cir. 1999). While this issue is only infrequently litigated, the Courts seem to be troubled by a taxpayer walking away from an admitted liability where the footfault of an unneeded notice of deficiency exists. One court has thus suggested that, where the closing agreement closes out the whole year rather than just certain issues for the year, the predicate notice of deficiency is not required, but if it only settles certain issues and not the whole year, a predicate notice of deficiency is required. Manko v. Commissioner, 126 T.C. 195 (2006) ((finding the assessment invalid).

¹⁹⁵² We will discuss below the collection due process (“CDP”) procedures as a way to get disputes to the Tax Court after the assessment, but suffice it to say for now that, in a CDP case, the Tax Court may not review the merits of a tax liability if the taxpayer previously had the right to contest the merits. A taxpayer signing such a waiver would have had the opportunity to contest and thus will be foreclosed from contesting in the merits in the CDP proceeding in the Tax Court.

¹⁹⁵³ Laing v. United States, 423 U.S. 161, 171 n.13 (1976). In Hibbs, Director, Arizona Dept. Of Revenue v. Winn, 542 U.S. 88 (2004), the Supreme Court described assessments as follows:

As used in the Internal Revenue Code (IRC), the term “assessment” involves a “recording” of the amount the taxpayer owes the Government. 26 U.S.C. §6203. The “assessment” is “essentially a bookkeeping notation.” Laing v. United States, 423 U.S. 161, 170, n. 13 (1976). Section 6201(a) of the IRC authorizes the Secretary

Service Center on a master or summary record, a Form 23C (Summary of Assessments),¹⁹⁵⁴ The Form 23C is a summary of assessments that does not identify on its face the names of the taxpayers who are assessed. The records underlying the summary identify the taxpayer and the amounts involved and permit the IRS to work back to the detail underlying the assessment.¹⁹⁵⁵ The assessment roll must be signed by an authorized delegate.¹⁹⁵⁶ The assessment certificate is often referred to as the 23C, and the date of the assessment is referred to as the 23C date. The IRS has been moving from the preparation of a manually prepared 23C to the general use of RACS 006 which is an electronic system that is signed electronically.¹⁹⁵⁷

We refer later to a **Form 4340, Certificate of Assessments and Payments**, which is not the assessment itself, but merely summarizes the assessment information, including the 23C date, as

of the Treasury “to make . . . assessments of all taxes . . . imposed by this title.” An assessment is made “by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary.” §6203.n. 2 See also M. Saltzman, *IRS Practice and Procedure* ¶10.02, pp. 10-4 to 10-7 (2d ed. 1991) (when Internal Revenue Service signs “summary list” of assessment to record amount of tax liability, “the official act of assessment has occurred for purposes of the Code”).

n. 2 Section 301.6203-1 of the Treasury Regulations states that an assessment is accomplished by the “assessment officer signing the summary record of assessment,” which, “through supporting records,” provides “identification of the taxpayer, the character of the liability assessed, the taxable period, if applicable, and the amount of the assessment.” 26 CFR §301.6203-1 (2003).

¹⁹⁵⁴ March v. IRS, 335 F.3d 1186, 1188 (11th Cir. 2003).

¹⁹⁵⁵ See Regs. § 301.6203-1 (providing that the assessment is on the summary record which, through supporting records, “shall provide identification of the taxpayer, the character of the liability assessed, the taxable period, if applicable, and the amount of the assessment.”) See also Bryan T. Camp, The Mysteries of Erroneous Tax Refunds, 114 Tax Notes 231 (Jan. 15, 2007) & 2007 TNT 11-55 (1/16/07).

¹⁹⁵⁶ Id. See also, Brafman v. United States., 384 F.2d 863, 865-66 (5th Cir. 1967) (assessment invalid where officer does not sign).

¹⁹⁵⁷ See Camp, *supra*, at n 9. The RACS 006 report is a summary record of the assessment. See United States v. Rupe, 308 Fed. Appx. 777, 779 (5th Cir. 2009) (unpublished) (citing March v. IRS, 335 F.3d 1186, 1188-189 (10th Cir. 2003); Roberts v. Commissioner, 329 F.3d 1224, 1228 (11th Cir. 2003).) “The RACS report, like the Form 23C, provides, when coupled with ‘supporting records,’ the information set forth in Treasury Regulation § 301.6203-1.” Rev. Rul. 2007-21, 2007-1 C.B. 865, 866.

Section 6203 requires the IRS to furnish the taxpayer a copy of the “record of assessment.” Under this provision, the IRS is not required to provide either the 23C originals or the RACS to the taxpayer, but may furnish some other document such as the IRS transcript or Form 4340. See Best v. Commissioner, T.C. Memo. 2014-72 (citing authority and holding (i) sanctioning the taxpayer for arguing otherwise and issuing a show cause order for possible sanction of the taxpayer’s attorney).

well as other information (such as payments against the assessment).¹⁹⁵⁸ In trials, the Government will often use the Form 4340 to prove the assessment, the amount due after application of payments and other matters related to the amount due.¹⁹⁵⁹ Courts will often hold that the Form 4340 is presumptive evidence of an assessment or other acts it purports to summarize.¹⁹⁶⁰ If, however, the Form 4340 is not regular on its face or, as to one of its component items (e.g., it states an assessment but does not provide the 23C date), a court might well require the IRS to prove the assessment by more direct evidence than the Form 4340.¹⁹⁶¹

Finally, we have described the federal income tax system as a “self-assessment” system. As the Supreme Court noted “[t]he word ‘self-assessment,’ however, is not a technical term; as §6201(a) indicates, the Internal Revenue Service executes the formal act of income-tax assessment.”¹⁹⁶² The taxpayer simply reports the amount on the return, and the IRS routinely assesses that amount.¹⁹⁶³

B. Effect of Assessment.

1. Assessment Does Not Determine Liability.

An assessment does not mean that the taxpayer owes the tax. It just means that, administratively, the IRS acts as if the taxpayer owes the assessed tax (as well as interest and penalties). Most importantly, this means that the IRS will send the taxpayer a bill (called a notice and demand for payment) and, failing payment, will undertake collection measures. If the taxpayer litigated the issue in the Tax Court prior to assessment, the taxpayer owes the tax, and that is the end of the matter in terms of his liability for the tax. If, however, by the time of assessment, the taxpayer has not yet litigated the liability for the tax, the taxpayer can still litigate the liability if he can meet jurisdictional requirements for litigation. Of course, except in the case of jeopardy and termination assessments, the taxpayer can't litigate in the Tax Court because, generally, the Tax Court is a preassessment remedy (i.e., a remedy made in response to a notice of deficiency which precedes the assessment). The taxpayer subject to an unpaid assessment may litigate liability in a refund action,

¹⁹⁵⁸ March v. IRS, 335 F.3d 1186, 1188 (10th Cir. 2003).

¹⁹⁵⁹ The Form 4340 is “presumptive proof of a valid assessment.” United States v. White, 466 F.3d 1241, 1248 (11th Cir. 2006).

¹⁹⁶⁰ See discussion in Davis v. Commissioner, 115 T.C. 35 (2000); see also March, supra.

¹⁹⁶¹ For a good discussion of the general issues see ILM 200048043 (10/16/2000).

¹⁹⁶² Hibbs, Director, Arizona Dept. Of Revenue v. Winn, 542 U.S., supra, n. 3 (2004).

¹⁹⁶³ As Justice Kennedy noted in his Hibbs dissent (a point as to which there was no disagreement with the majority):

Whether the Secretary or his delegate (today, the Commissioner) makes the recording [of the assessment] on the basis of a taxpayer's self-reported filing form or instead chooses to rely on his own calculation of the taxpayer's liability (e.g., via an audit) is irrelevant. The recording of the liability on the Government's tax rolls is itself an assessment.

provided he meets the payment and claim for refund requirements. He may also litigate liability in a collection suit filed by the Government when and if the Government chooses to bring one.

In order to encourage taxpayers to litigate in the Tax Court, § 6404(b) prohibits claims for abatement of assessments in the types of cases where a Tax Court remedy was available (here, income and estate and gift taxes). Although the statute prohibits claims for abatement in these cases, the IRS is authorized to abate if it determines an assessment to be excessive¹⁹⁶⁴ and thus may consider a claim for abatement.¹⁹⁶⁵ Accordingly, although not preferred, formal or informal claims for abatement (e.g., on **Form 843, Claim for Refund and Request for Abatement**) may actually grab the IRS's attention and result in an abatement of the assessment if clear error is shown, despite the statutory prohibition on claims for abatement. Furthermore, for some of the divisible taxes offering easy access to a minor payment and claim for refund (employment and excise taxes), if the assessment was made after an examination, the IRS generally will not consider a claim for abatement except in unusual circumstances.¹⁹⁶⁶ Generally, if the IRS denies a claim for abatement there is no remedy for the denial. The taxpayer will then have to posture his or her grievance as a refund suit or, if possible, await a collection suit by the Government. Alternatively, the taxpayer can file an offer to compromise an outstanding unpaid assessment asserting doubt as to liability as a basis for compromise. (We will cover offers in compromise in the next chapter, so I defer detailed discussion here.) Finally, if the tax assessed arose from an audit, the taxpayer may be able to obtain audit reconsideration relief that might result in an abatement of the assessment.

You will have noticed that I said the taxpayer can litigate in a collection suit brought by the Government. So, you may ask, why doesn't a taxpayer who feels the IRS assessment was erroneous simply sit back and await a collection suit and then get his or her remedy? The reason is that the IRS has a vast arsenal of nonjudicial remedies to collect on the assessment. We study these below, but for here just know that they include, with little more than a stroke of the pen (OK, several pens, all within the IRS), the power to levy – i.e., seize or require the taxpayer or third party to turn over – most all of the taxpayer's property (e.g., financial accounts and other tangible and intangible assets) and place a lien which, particularly in the case of real estate, will effectively deny the taxpayer the power to alienate the property without settling with the IRS. Given these nonjudicial remedies, the Government pursues a collection suit only toward the end of the collection statute of limitations (10 years) in order to refresh the collection statute of limitations by obtaining a judgment that then, as a judgment, has a separate and new statute of limitations. Those of you who read and

¹⁹⁶⁴ The assessment that may be abated may include tax, penalty and interest and may even include a paid assessment. CCA 201520010 (5/15/2015).

¹⁹⁶⁵ § 6404(a)(1).

¹⁹⁶⁶ IRM 1.2.1.4.31 P-4-103, 4.24.8.9 (08-13-2008) (Generally claims for abatement in employment and excise taxes assessed after examination will not be considered except in unusual circumstances; taxpayer will have to pay and file claim for refund). Where the assessment results from a substitute for return under § 6020(b), if the taxpayer thereafter files a return indicating less tax than assessed and the IRS agrees, the IRS will abate the assessment down to the amount of tax to which it agrees. See IRS CCA 200149032 (10/22/01), republished at 2001 IRS CCA LEXIS 222 (12/7/01).

understood the foregoing materials will also remember that the Government will bring a collection suit as a counterclaim to a refund suit in divisible penalty cases such as the responsible person or trust fund penalty cases under § 6672 where the IRS will generally not pursue its nonjudicial collection remedies pending the outcome of the case. But, except in those cases, the IRS will pursue its nonjudicial collection remedies before filing a collection suit; hence, a taxpayer faced with an unpaid assessment as to which he has a basis for claiming that he is not liable for the underlying tax, should explore the alternative methods – offer in compromise and, although less favored and not certain to work, claim for abatement or audit reconsideration.

Finally, the IRS may consider claims for abatement of interest and, in some cases, there are judicial remedies available for the denial, although prepayment may be required. We have discussed the abatement of interest above at pp. 273 ff.

2. Permits Collection Measures.

The Supreme Court has tied the importance of the assessment to the Government's collection measures:

“[T]he IRS may employ administrative enforcement methods such as tax liens and levies to collect the outstanding tax,” see 26 U.S.C. §§6321-6327, 6331-6344; and “the time within which the IRS may collect the tax either administratively or by a 'proceeding in court' is extended [from 3 years] to 10 years after the date of assessment,” see §§6501(a), 6502(a). Brief for United States in United States v. Galletti, O. T. 2003, No. 02-1389, pp. 1516. The Government thus made clear in briefing Galletti that, under the IRC definition, the tax “assessment” serves as the trigger for levy and collection efforts.¹⁹⁶⁷

The Court of Federal Claims (Judge Allegra) summarized this law as follows:

Cases analyzing these provisions have characterized assessments as serving a "collection-propelling function," Hibbs, 542 U.S. at 102 – one that facilitates the collection of unpaid taxes. Whereas the IRS may enforce a taxpayer's tax obligations in various ways, its broadest enforcement powers, such as the use of liens and levies, are available only when an assessment is made. See 26 U.S.C. §§ 6331(a), 6322 (lien shall arise "at the time the assessment is made"), 6502; Hibbs, 542 U.S. at 102 (“assessment' serves as the trigger for levy and collection efforts”). Moreover, “[w]here the assessment of any tax imposed by this title has been made within the period of limitation properly hereto,” the period in which “such tax may be collected by levy or by a proceeding in court” is extended from three years to “10 years after the assessment.” 26 U.S.C. § 6502; cf. 26 U.S.C. § 6501(a); see also Hibbs, 542 U.S. at 102; Galletti, 541 U.S. at 119. Ascribing further significance to the concept, the Supreme Court has long held that “[t]he assessment supersedes the pleading, proof, and judgment necessary in an action at law, and has the force of such a judgment.”

¹⁹⁶⁷ Hibbs, Director, Arizona Dept. Of Revenue v. Winn, 542 U.S., *supra* (2004).

Bull v. United States, 295 U.S. 247, 260 (1935). And because an assessment is entitled to a legal presumption of correctness, it "can help the government prove its case against a taxpayer in court." United States v. Fior D'Italia, Inc., 536 U.S. 238, 242 (2002); see also United States v. Janis, 428 U.S. 433, 440 (1976).¹⁹⁶⁸

Although the assessment is the predicate to the use of a formidable set of administrative collections measures (which I discuss in detail in the next chapter), I should caution that the Government has other common law types of collection measures. The administrative collections measures will likely concern you more in the typical private practice.

III. Erroneous Refunds.

See discussion of erroneous refunds above at p. 243.

¹⁹⁶⁸ Principal Life Insurance Co. v. United States, 95 Fed. Cl. 786 (2010) (parallel citations omitted).

Ch. 14. Collection Procedures.

I. Introduction.

We have considered previously the various procedural facets of determining a tax liability and assessing the tax. Once assessed, the tax is shown on the IRS's books as due and owing. The focus of this chapter is on the procedural aspects of collecting a tax that is shown on the IRS's books as due and owing.

As you can imagine, the IRS collection function is big and complex. For example, as of the end of the fiscal year 2011, the **unpaid tax debt inventory** was \$373.2 Billion.¹⁹⁶⁹ Meaningful action to collect that amount with limited resource allocation can be quite daunting, and will require significant potential interaction between the IRS and taxpayers. I will present in this Chapter some of the details of the collection function that the practitioner needs to know. At this point, however, I want you to see the big picture. This is just a debt collection process that must be managed as efficiently as possible, balancing costs of collecting against benefits to be derived. Imagine the functional steps the IRS would need to go through to collect a tax debt. For this purpose, I shall set aside quantifying the amount of the debt and assume that the tax debt assessed is the debt properly due and owing.

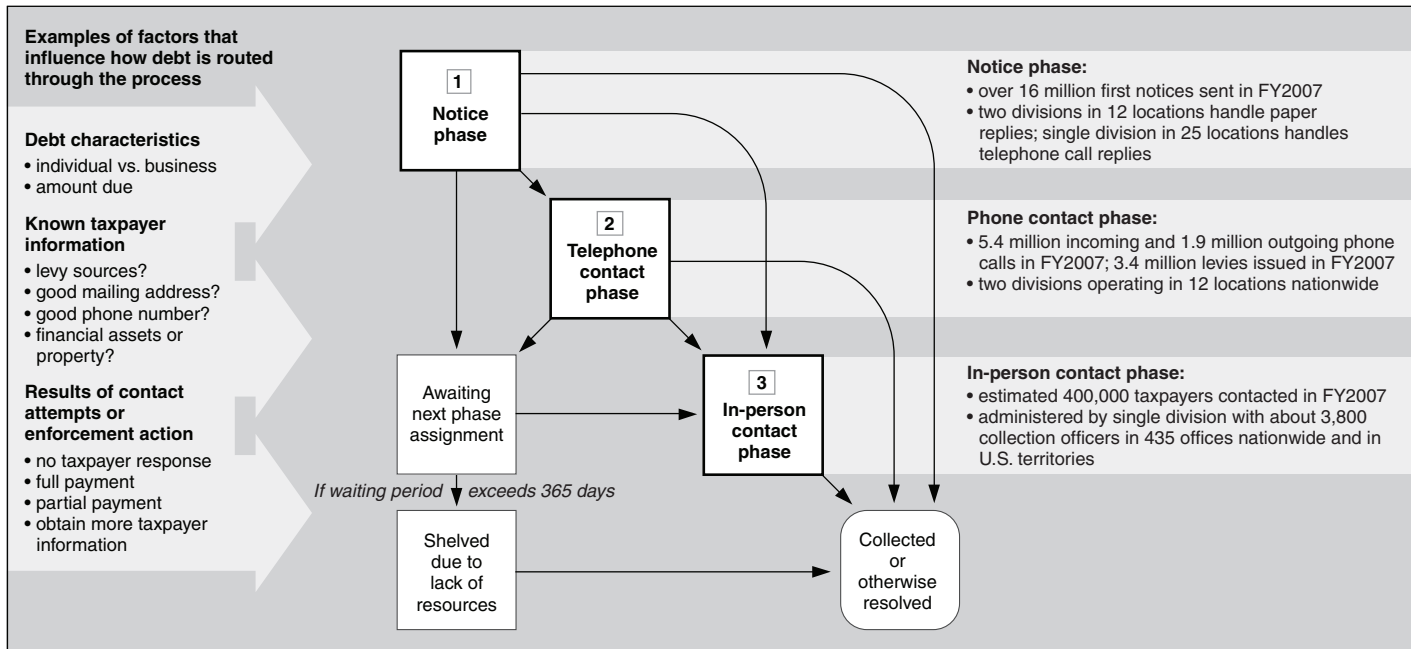
- Request / Demand Payment from the Taxpayer. Given the large number of the delinquent accounts, you can imagine that the IRS needs to do this with the least commitment of limited resources, with levels of resource commitment ratcheting up thereafter on an as needed basis. The initial requests / demands are followed by a series of letters, then by telephone contact, and then in person contact by a person commonly referred to as a collection officer (or revenue officer). Some of these contacts will advise the taxpayer of the IRS tools that might be employed to collect the tax due and owing if the taxpayer does not pay promptly or work with the IRS in determining a fair resolution of the tax liability. During this phase, there is little need for active practitioner activity, because these are just requests and there is no immediate compulsory action that might prejudice a taxpayer. The practitioner might be called upon to advise of consequences of not paying and what action might be taken to mitigate the damage.
- Collection Tools. If the foregoing series of requests / demands do not resolve the matter, then the IRS will consider its array of collection tools, including liens and levies. During this phase, there often is need for active practitioner involvement in order to mitigate the damage.

¹⁹⁶⁹ GAO Report, Federal Tax Debts: Factors for Considering a Proposal to Report Tax Debts to Credit Bureaus, p. 12 Table 4 (GAO-12-939 9/2012).

These functional steps have been illustrated graphically in a GAO report on Tax Debt Collection.¹⁹⁷⁰ Note that the graphic does not deal with the second step noted above. I deal with the details in this chapter. The graphic is:

¹⁹⁷⁰ GAO-08-728 (June 13, 2008).
Townsend Federal Tax Procedure 2015 - Textbook - 605 -

Figure 2: IRS's Three-Phase Process for Attempting Collection of Unpaid Tax Debt



Source: GAO analysis of IRS information.

Note: Figure 2 shows key routes a case can take but not all possible routes.

Finally, the key IRS line player with whom taxpayers and their representatives deal in the collection function is usually referred to as the **collection officer**. Because of certain risks in the collection of taxes, some collection officers may be identified via pseudonyms rather than with their real names.¹⁹⁷¹

II. Notice and Demand for Payment.

As soon as practicable and within 60 days after the assessment, the IRS must send notice to the taxpayer of the assessment and demand payment. § 6303(a).¹⁹⁷² (This is often referred to as “**the notice and demand for payment**” or simply “**notice and demand**”)¹⁹⁷³ Like the requirement discussed earlier for the notice of deficiency, the notice and demand must be sent properly to the taxpayer; it need not be received by the taxpayer.¹⁹⁷⁴

The IRS has administrative procedures that insure that the notice and demand is automatically sent contemporaneously with the assessment. These procedures sometimes fail, and the notice and demand is sometimes not sent within the required 60 days. Does that mean that the assessment is invalid? The answer is no. The assessment is valid. The “cost” or “penalty” to the IRS for failure to satisfy the statutory command for timely notice and demand is that the IRS may not use the administrative collection remedies (most prominently levy and filed lien, that I discuss below), but the IRS can sue to reduce the assessment to judgment and then collect on the judgment.¹⁹⁷⁵ In most cases, this procedural limitation is irrelevant, because the IRS procedures work as they are supposed to -- i.e., the notice and demand is sent contemporaneously with the assessment and, even where that is done, I suspect most taxpayers pay upon an untimely notice of assessment and demand for payment or do not contest the IRS’s use of the administrative remedies.

¹⁹⁷¹ IRM 10.5.7 Use of Pseudonyms by IRS Employees. The taxpayer and the representative will not be advised of the use of the pseudonym, but there is really no reason to advise because the actions taken and consequences are not affected by the name used. If the agent using a pseudonym testifies in court or signs court documents, the document or testimony must indicate that the name is a pseudonym. IRM 10.5.7.9 (11-19-2010), Pseudonym Holders, the Courts and Legal Matters.

¹⁹⁷² The IRS sends Publication 594 with its notice of tax due and demand for payment. That publication advises the taxpayer of the collection process in straightforward nontechnical manner.

¹⁹⁷³ The notice and demand requirement is satisfied by IRS notice of a balance due. Craig v. Commissioner, 119 T.C. 252, 260-61 (2002).

¹⁹⁷⁴ Hansen v. United States, 7 F.3d 137, 138 (9th Cir. 1993).

¹⁹⁷⁵ See generally Howard Gordon, Failure to Give Notice and Demand: Enjoining the IRS from Administrative Collections, 98 TNT 100-100 (5/26/98); and United States v. McCallum, 970 F.2d 66 (5th Cir. 1992); and United States v. Berman, 825 F.2d 1053 (6th Cir. 1987); and cf. Jersey Shore State Bank v. United States, 479 U.S. 442 (1987) (involving third party lender liability under § 3505).

The notice and demand for payment triggers three key consequences. First, a lien arises in favor of the IRS.¹⁹⁷⁶ This lien is sometimes referred to as the general tax lien, the automatic tax lien or even the secret or silent tax lien, because it arises upon the mere assessment, demand for payment, and nonpayment of the tax and requires no other filing anywhere or even specific notice to the taxpayer or to third parties.¹⁹⁷⁷ Second, the notice and demand permits the IRS to use its administrative collection measures, including levy. I discuss those measures in this chapter: they are formidable indeed. Note that the notice and demand is not a predicate for other actions, particularly judicial actions for the tax liability in a collection suit (or its equivalent, a counterclaim in a refund suit).¹⁹⁷⁸ Third, the failure to pay penalty discussed earlier will accrue from the date of notice and demand unless the assessed amount is paid within 21 days.¹⁹⁷⁹ The failure to pay penalty may be avoided by showing that the failure to pay is due to reasonable cause and not willful neglect. § 6651(a)(2).

If the issue of timely notice and demand for payment arises in litigation, the IRS will usually rely upon a **Form 4340, Certificate of Assessments and Payments**, which is a formal certification by an IRS official reporting the key events in underlying IRS records related to the liability (e.g., the assessment, notice and demand for payment, all payments made, etc.). The Form 4340 is not the underlying record itself, but simply summarizes the underlying records. To rebut the Form 4340, the burden will then be upon the taxpayer to introduce that the notice and demand was not sent.¹⁹⁸⁰

¹⁹⁷⁶ §§ 6321 & 6331. See United States v. Coson, 286 F.2d 453 (9th Cir. 1961); United States v. Berman, 825 F.2d 1053 (6th Cir. 1987) (but holding that, despite the nonexistence of the lien because no notice of deficiency, the IRS may sue on the tax liability and obtain judgment, although it could not use its administrative powers); United States v. Chila, 871 F.2d 1015 (11th Cir. 1989), cert. denied, 493 U.S. 975 (1989) (same). There is an issue of whether sending of a notice and demand outside the 60-day window is sufficient to create the lien to permit administrative enforcement via filing a notice of federal tax lien and levy. See Program Manager Technical Assistance Memorandum, POSTS-103745-11 (8/3/11), [here](#), concluding "notice and demand provided outside the 60-day period is still valid, and administrative collection can still proceed."

¹⁹⁷⁷ § 6321.

¹⁹⁷⁸ E.g., Anuforo v. Commissioner, 614 F.3d 799, 805 (8th Cir. 2010) and cases cited therein.

¹⁹⁷⁹ § 6651(a)(3) (discussed at pp 357 ff.).

¹⁹⁸⁰ The Government would have the burden of proof on the issuance of a proper notice and demand for payment. The use of the Form 4340 serves to do that by, in effect, shifting from the Government to the taxpayer some burden to prove that the notice and demand was not sent. The precise burden shifted to the taxpayer is not clear in my mind. Some courts say that the Form 4340 indication of timely mailing prevails unless the taxpayer establishes affirmatively that the notice and demand required by § 4340 was not sent. E.g., United States v. Chila, 871 F.2d 1015, 1019 (11th Cir. 1989). This would suggest that the Form 4340 shifts the burden of persuasion to the taxpayer. Other courts suggest that the Form 4340 is presumptive or prima facie proof of notice and demand, which uses language that something like a production burden on the issue is shifted to the taxpayer. E.g., Davis v. Commissioner, 115 T.C. 35, 40 (2000). It seems to me that the latter nuance is the proper one, since it is the Government's burden to prove proper notice and demand under § 6303.

After assessment and not less than annually, the IRS must send the taxpayer a notice of the balance due as of the date of the notice.¹⁹⁸¹

III. Payment Issues.

If the taxpayer can pay after receipt of the notice and demand, the taxpayer should do so. Paying will avoid (i) the late payment penalties from accruing, (ii) further accrual of interest and (iii) the taxpayer being subject to IRS collection measures. Payment will pretty much conclude the matter except, as we discussed earlier, where the taxpayer desires to file a claim for refund and, if denied, then sue for refund.

Most of this chapter will deal with the taxpayer who is unable to pay the assessment in full.

Some taxpayers otherwise able to pay some or all may seek your advice on how to hold off payment so that they can use their funds in what they perceive as more rewarding adventures. You will have to advise them of the costs of doing so – most specifically, the failure to pay penalty and the interest costs discussed in earlier chapters. You might also warn them that the Government and ultimately a jury may believe that the taxpayer's perception of more rewarding adventures was really just an attempt to evade payment, which as we noted above is a felony crime with significant penalties. Neither you nor the client will want to take that risk if you can avoid it.

I focus now on the issues confronting the taxpayer in making the payment of less than the amount of the IRS assessment. The question here is whether the taxpayer can designate as among the various components of aggregate tax owed (e.g., as among years or within the same year as among taxes, penalties and interest).

The taxpayer is permitted generally to so designate a voluntary payment to the IRS.¹⁹⁸² Voluntary for this purpose means any payment not resulting from the Government's compulsory

¹⁹⁸¹ § 7524.

¹⁹⁸² Rev. Proc. 2002-26, 2002-1 C.B. 746. See Muntwyler v. United States, 703 F.2d 1030, 1032 (7th Cir. 1983); and Davis v. United States, 961 F.2d 867, 878 (9th Cir. 1992). See Dixon v. Commissioner, 141 T.C. No. 5 (2013) (for an extreme application of this concept to permit the taxpayer to designate the application of the payment); but see nonacquiescence to the holding in Dixon, AOD 2014-01; 2014-38 IRB 1).

This voluntary payment rule does not apply to an overpayment which, pursuant to § 6402(a), the IRS credits to another tax liability rather than refunds to the taxpayer. Bryant v. Commissioner, T.C. Memo. 2009-78.

collection measures (e.g., levy) discussed later in this chapter.¹⁹⁸³ If, however, the taxpayer fails to designate the application of the payment, the IRS can apply the payment as it sees fit.¹⁹⁸⁴

Designation may be critical in certain cases. I give examples which are by no means exhaustive, but should illustrate the concepts:

Example 1: We considered above that a taxpayer unable to pay the total amount assessed (tax, penalties and interest) may be able to satisfy the jurisdictional prerequisite for refund litigation by paying only the tax or only the penalty. When that “partial” payment for the year is employed to establish jurisdiction, it is important for the taxpayer to designate the application of the payment to the tax or penalty to meet Flora’s full payment requirement.

Example 2: A taxpayer subject to a trust fund tax recovery penalty under § 6672 (“TFRP”) who desires to contest the liability with the minimum payment must insure that he meets the required minimum payment for at least one quarter. The standard technique is to pay for one quarter, with a specific payment designation (see text at pp. 704 ff.). If he fails to do so, the IRS may apply any payment as it sees fit, and, as applied, the minimum jurisdictional amount paid may not be satisfied.

Example 3: In planning at the employer level to minimize the potential application of the TFRP, the employer in making payments to the IRS should designate that the payments are for the trust fund taxes rather than any other taxes or penalties (even employer penalties for failure to pay the trust fund taxes) the employer may owe.¹⁹⁸⁵ To illustrate, if a corporate employer owes delinquent corporate income taxes and penalties as well as trust fund taxes, the corporate employer should designate payments to the trust fund taxes. The reason is that, if the corporation goes belly up, its nontrust fund taxes will be collectible only from the corporate assets based upon bankruptcy priorities (and thus may not be collectible at all), but its trust fund taxes will follow and be collectible from the responsible persons.¹⁹⁸⁶

¹⁹⁸³ See Amos v. Commissioner, 47 T.C. 65 (1966). See IRS Policy Statement P-5-60(7) (“The taxpayer, of course, has no right of designation of payments resulting from enforced collection measures.”)

¹⁹⁸⁴ See Estate of Baumgardner v. Commissioner, 85 T.C. 445 (1985); United States v. Schroeder, 900 F.2d 1144, 1149 (7th Cir. 1990); and Sotir v. United States, 978 F.2d 29, 30 (1st Cir. 1992).

¹⁹⁸⁵ See as to trust fund taxes, IRS Policy Statement P-5-14(10) (“Any payment made on the business account is deemed to represent payment of the nontrust fund portion of the tax liability (e.g., employer's share of FICA) unless designated otherwise by the taxpayer.”).

¹⁹⁸⁶ Barring some other consideration, in a single type of tax situation (e.g., income tax), the IRS generally applies payments first to tax, penalty and interest, in that order, for the earliest year involved, and then to tax penalty and interest, in that order, for each successive period. Rev. Proc. 2002-26, 2002-1 C.B. 746. However, where the IRS may maximize the revenue by some other allocation, it may make that allocation. *Id.* Undesignated payments may be applied as the IRS deems in its best interest with the payments first going to the non trust fund portion. Furthermore,

Example 4: The taxpayer may desire to designate some or all of the payment as interest rather than as principal. One reason the taxpayer may do so is in order to get a current deduction for the interest.¹⁹⁸⁷

Example 5: The taxpayer may desire to designate the years to which the payment is to be applied. To use an extreme example, a taxpayer owing taxes for years 1 and 2 which were assessed 9 and 8 years ago, respectively, might consider making a payment of the Year 2 tax in the hope that the IRS will allow the statute of limitations to lapse on Year 1 without pursuing a collection suit to reduce the assessment to judgment.

How does the taxpayer make the designation? The designation should be in a written transmittal letter accompanying the payment, as well as being indicated on the check.¹⁹⁸⁸

In the foregoing discussion, I have assumed that the payment occurs after assessment. As we discussed above, however, a taxpayer facing an audit may desire to make a pre-assessment payment. Can the taxpayer designate how a pre-assessment payment is made? Generally, advance payments should be applied according to the taxpayer's instructions.¹⁹⁸⁹

IV. Administrative Follow-Throughs.

If the taxpayer does not pay promptly after the notice and demand is sent, the IRS's computers generate a series of letters reminding the taxpayer that he or she owes the tax debt and should pay. The final of the series of three or four letters advises the taxpayer that the IRS intends to use its nonjudicial remedies (e.g., levy) to collect the tax liability. Except in case of jeopardy, the

even if the payment is designated to trust fund taxes without designating the quarters, the IRS may allocate among the quarters in a way to maximize its collection potential and even may re-allocate if its first allocation did not achieve the best result for the IRS. See Davis v. United States, 961 F.2d 867 (9th Cir. 1992) (noting that the taxpayer waived any interest in the allocations because of his failure to designate the quarters); Thomas v. United States, No. 961488, 1998 WL 892617, at 14-*6 (C.D. Ill. Sept. 16, 1998). For an example of the IRS applying undesignated payments to the employer's penalties rather than the trust fund taxes, see In re: Southeast Waffles, LLC v. United States, 2012 U.S. App. LEXIS 24991 (6th Cir. 2012) (although not discussed, the net effect of this is to expose the responsible persons to the § 6672 penalty where by designating to paying the trust fund taxes they could have avoided that penalty); Westerman v. United States, 718 F.3d 743 (8th Cir. 2013) (no legal or equitable requirement to apply undesignated payments to the trust fund penalty portion).

¹⁹⁸⁷ Deficiency interest is not deductible to the individual taxpayer, but would be to the corporate taxpayer.

¹⁹⁸⁸ Verbal designations are risky. Kinnie v. United States, 994 F.2d 279 (6th Cir. 1993). The IRM states that the designation "must be in writing and made at the time of the payment." IRM 8.25.2.6(6) (10-19-2007).

¹⁹⁸⁹ See e.g., Rev. Proc. 84-58, 1984-2 C.B. 501 (relating to payment/deposit designations).

formal written notice of intent to levy is a condition precedent to an actual levy. § 6331(d). The IRS must also notify the taxpayer that certain administrative rights are available in appropriate cases to avoid the levy. Suffice it to say at this point, the administrative effort is designed to encourage the taxpayer to pay without further action by the IRS.

In addition to the series of letters, the IRS has an Automated Collection System (“ACS”) which automates telephone contacts with taxpayers. I won’t get into the mechanics of that system, but it is designed to have the taxpayers talk with live IRS employees who have their information on a screen when the taxpayers answer the call.

As we will see, the IRS has several collection measures that it can marshal against the taxpayer and make the taxpayer uncomfortable, if not miserable. The goal in collection representation is to encourage the IRS not to be draconian and to be as nice as possible to the taxpayer. The best thing the taxpayer can do is to present himself or herself as a reasonable person, seriously concerned about this liability but simply unable to pay it. Accordingly, although the series of demand letters are for payment and not for excuses, the taxpayer is well advised to write the computer back asking that the case be assigned to a real live Revenue Officer to discuss the matter. The letter likely will not be read at the Service Center by anyone who really cares, but it may be part of the files when it gets to a Revenue Officer. The Revenue Officer will see that this taxpayer is concerned enough to try to do the right thing even though he or she cannot now pay the liability. By contrast, Revenue Officers are used to seeing taxpayers who ignore the demand letters and that gives a bad taste from the start. The simple act of writing back may set a helpful tone for the collection activity.

And, of course, that same tone should be set throughout the collection activity after a Revenue Officer contacts the taxpayer. In all dealings with the Revenue Officer, the taxpayer or his or her representative should respond timely, should not be evasive, and should be cooperative. If the Revenue Officer ever begins to believe that the taxpayer or the representative is not acting in good faith, there are a host of responses the Revenue Officer can take, many of which are not in the taxpayer's best interest.

V. The Tax Lien.

A. General “Secret” Lien Upon Assessment and Failure to Pay.

A tax lien arises by operation of law against all of the taxpayer's property, including after-acquired property, upon assessment, notice of assessment and failure to pay. § 6321.¹⁹⁹⁰ The amount of the lien is the unpaid tax plus “any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto.”¹⁹⁹¹ The scope of the lien “is broad and reveals on its face that Congress meant to reach every interest in property that a

¹⁹⁹⁰ This act and related provisions are often referred to as the Federal Tax Lien Act.

¹⁹⁹¹ Id.

taxpayer might have.”¹⁹⁹² This lien is frequently referred to as the “general tax lien,” in order to distinguish it from the special subcategory of the filed tax lien – i.e., the general tax lien that has been filed so as to give it preference from most claimants. The general tax lien continues until the tax giving rise to the lien is paid or becomes unenforceable pursuant to the statute of limitations (which we discuss below). § 6322.

The tax lien must be “choate”¹⁹⁹³ to be valid. A lien is choate if the following are known: (1) the identity of the lienor, (2) the property subject to the lien, and (3) the amount of the lien.¹⁹⁹⁴ Generally, tax liens easily meet this requirement. The assessment itself identifies the taxpayer and the amount. All of the taxpayer’s property is subject to the lien. There is no requirement that the taxpayer’s property be identified in the assessment or in the IRS’s records. All that is required is that it be identifiable.

What does the general tax lien do in the real world? In order to address that issue, we must understand the difference between an unfiled tax lien and a filed tax lien. The automatic lien upon assessment, notice of demand and nonpayment is an unfiled tax lien. Third parties have no notice of this lien. For this reason, the general, unfiled lien is sometimes referred to as a secret lien.¹⁹⁹⁵ Only the IRS and the taxpayer know about it (assuming of course that the taxpayer actually receives the notice and demand for payment). Another consequence is the potential for the perception of stigma to existence of a tax lien – because it arises only after a taxpayer has failed to meet its obligation to pay. Most of the familiar liens in the creditors’ universe – such as purchase money mortgages – arise before the debtor has failed in meeting his payment obligations. But the mere existence of the tax liens indicate a debtor in default, which may have a certain stigma. So long as the lien is secret, this may not be that much of a problem. So, we turn to the filed tax lien placing the public on notice, should it check the lien records or the credit bureau reports drawn from the lien records.¹⁹⁹⁶

B. The Filed Tax Lien.

A filed tax lien is one that has been filed in the appropriate county or state records to put third parties on notice of the IRS’s claim so as to protect the IRS from the claims of parties who reasonably could have been on notice of the IRS’s lien by checking the records. Third parties, at

¹⁹⁹² United States v. Nat’l Bank of Commerce, 472 U.S. 713, 719-720 (1985).

¹⁹⁹³ The term choate has become a term of art in the law, although Judge Posner has pithily noted that it “is a barbarism.” Bloomfield State Bank v. United States, 644 F.3d 521 (7th Cir. 2011) (providing the etymology and use and misuse of the word).

¹⁹⁹⁴ United States v. City of New Britain, 347 U.S. 81(1954).

¹⁹⁹⁵ See Wadleigh v. Commissioner, 134 T.C. 280, 289-290 n. 8 No. 14 (2010), citing Hult v. Commissioner, T.C. Memo. 2007-302.

¹⁹⁹⁶ Shu-Yi Oei, The Uneasy Case Against Tax Lien Subordination, 11 Pitt. Tax Rev. 241, 249 at n. 19 (2014) (citing “numerous adverse effects on a taxpayer’s financial viability (in terms of job applications, loan applications, ability to rent property, or ability to refinance) that follow an NFTL filing.”)

least in some cases, do have constructive notice of the filed tax lien.¹⁹⁹⁷ The principal significance of filing the lien relates to priorities between the IRS and third parties as to the taxpayer's assets. I cover priorities later in the text (pp. 635 ff.).

I discuss below the role of tax lien filings in the system. Suffice it to say here that public filing can have serious effects on a taxpayer's credit and business reputation generally because the fact of the tax delinquency is available to creditors and others (e.g. credit services) willing to check the records. Given these consequences, which can be serious, Congress has given taxpayers certain rights with respect to the filing of tax liens. The taxpayer must be notified of the filing of the tax lien and the right to a hearing with respect to whether the filing of the lien should be withdrawn. § 6320. I deal in more detail with these rights below under the heading Collection Due Process.

Where is the filing made? That is determined by state law.¹⁹⁹⁸ Most states have adopted the Uniform Federal Tax Lien Registration Act, but there may be some differences among the states. Generally, notices of tax liens for real property are filed in the county in which the real property is located; notices for other property are generally filed in the county of the individual taxpayer's residence or, in some cases, the office of the state's Secretary of State (or equivalent state office) or other central filing office designated by state law. State law should be consulted. For the rights secured to the IRS by filing the tax lien, the tax lien is deemed filed and perfected by filing whether or not the office in which it is filed properly files it (meaning that, if misfiled, it does not put the public on notice, but the public is deemed to have notice).¹⁹⁹⁹ This hodge-podge of state law and the

¹⁹⁹⁷ § 6323(f). Normally, state law governs the adequacy of the notice to the public via a lien filing. However, the adequacy of federal tax liens is governed by federal law rather than state law. Regs. § 301.6323(f)-1(d); and United States v. Union Cent. Life Ins. Co., 368 U.S. 291, 296 (1961). For example, in United States v. Crestmark Bank, 412 F.3d 653 (6th Cir. 2005), the state had a computer based search system for its lien filings. The search system was an exact name search that did not take into account common variations in spelling or common abbreviations. The creditor searched only for the exact name. Had the creditor searches for common variations and abbreviations, the creditor would have discovered the tax lien. Apparently, for state law purposes, the creditor's search would have been adequate to avoid notice of the prior lien. For federal tax law purposes, it was not. Here, of course, the question was whether the search under the circumstances was reasonable and the court found it lacking. This particular problem will likely be unimportant into the future as database search systems now usually permit fuzzy searching. See United States v. Montesinos, 2012 U.S. Dist. LEXIS 134328 (SD NY 2012) (sustaining the priority of the federal tax lien where only minor misspelling that would have been picked up via multiple field searches and "sounds like" searches that was avail and would have put the creditor on noticeable; this is a well written opinion of substantial compliance). However, the point is that federal law, not state law, will govern the adequacy of the search.

¹⁹⁹⁸ § 6323(f)(1).

¹⁹⁹⁹ Tracey v. United States, 394 B.R. 635 (1st Cir. Bkr. Panel 2008) (citing inter alia Hanafy v. United States, 991 F. Supp. 794 (S.D. Tex. 1998) (involving failure to properly index a filed tax lien; IRS not required to insure that lien is properly indexed); and Adams v. United States, 420 F. Supp. 27 (S.D.N.Y. 1976)).

resulting inefficiencies to both the IRS and to third parties who have to check the public filings have generated a call for a National Tax Lien Registry that would be more easily accessible – e.g., over the internet.²⁰⁰⁰ As envisioned, the National Tax Lien Registry would achieve significant efficiencies that will result in savings to the IRS and to third parties having to check for such public notices. From my perspective, this proposal seems like a “no brainer” to improve the efficiency of the system, but then there will be politics involved that may interfere with efficient decision making on the subject.

C. Lien is Not Self-Executing.

A lien is not self-executing; it simply represents a claim against property and the IRS must take further action to enforce the lien, such as a levy (i.e., a seizure of property subject to the lien) or a judicial action to foreclose on the lien.²⁰⁰¹ In the meantime before such further action, however, the existence of a lien can impair the taxpayer’s ability to deal with the property, although as we shall note certain persons acquiring an interest in a taxpayer’s property after the lien arises may be able to stand ahead of the IRS’s claim pursuant to the lien.

VI. Statute of Limitations.

We have previously covered the statute of limitations on collections (pp. 213 ff.). The general rule is that the statute of limitations is **10 years** from the date of assessment. As with the statute of limitations on assessment, the statute of limitations on collection is suspended by certain events, the most significant of which are:

1. Filing of an offer in compromise.²⁰⁰² We discuss offers in compromise below. During the pendency of the offer, the IRS generally is prohibited from taking collection measures, so there is a corollary suspension of the statute of limitations while an OIC is pending.²⁰⁰³
2. Filing of a CDP Proceeding. The collection statute of limitations is suspended on while a CDP proceeding and any appeals are pending and for a period of 90 days after the proceeding become final.²⁰⁰⁴
3. Extended absence from the United States. If the taxpayer is outside the United States for a period of at least 6 continuous months, the statute is extended during the period of absence.²⁰⁰⁵

²⁰⁰⁰ See Levin Announces Bill to Modernize Lien System, 2007 TNT 75-38; and T. Keith Fogg, National Tax Lien Registry, 120 Tax Notes 783 (Aug. 25, 2008)

²⁰⁰¹ EC Term of Years Trust v. United States, 550 U.S. 429, 430 (2007).

²⁰⁰² Regs. § 301.7122-1T(h)(2).

²⁰⁰³ § 6331(k)(1).

²⁰⁰⁴ § 6330(c), (d) and (e) and § 6320(c).

²⁰⁰⁵ § 6503(c).

Further, in order to provide the IRS time to act upon the taxpayer's return after such absence from the United States, the statute of limitations will not expire before 6 months after his or her return.²⁰⁰⁶

4. Filing for bankruptcy. To the extent that the taxpayer's tax liability is not discharged in the bankruptcy proceeding, the statute of limitations is suspended (a) during the period the IRS may not collect outside the bankruptcy and (b) 6 months thereafter.²⁰⁰⁷

5. Extended Estate Tax Payment Period. As discussed elsewhere, the Code in some instances permits an extended period for paying the estate tax. The most commonly encountered instance is under § 6166 permitting deferral of the portion of the estate tax attributable to closely held businesses where they are a major asset of the estate. The collection period of limitations is suspended during the period of the extended payout period.²⁰⁰⁸

6. Extensions by Agreement. The IRS and taxpayers may extend by agreement if the extension is (1) agreed to at the same time as an installment agreement between the taxpayer and the Service, or (2) agreed to prior to a release of levy under § 6343 which occurs after the expiration of the statutory ten-year period for collection.²⁰⁰⁹

After the application of the foregoing rules, the IRS can further extend its ability to collect by obtaining judgment on the lien, whereupon the underlying liability is then subject to the 10 year statute of limitations for judgment liens.²⁰¹⁰ The suit to obtain judgment must be filed within the collection period of limitations under the foregoing rules.²⁰¹¹ Note that, technically, this does not extend the collection of the tax but creates a new debt – the judgment which has an independent statute of limitations.

VII. Set-Offs.

A. Statutory Right to Set-Off Overpayments / Refunds.

The Code specifically gives the IRS authority to credit refunds, referred to as overpayments, otherwise due to the taxpayer against tax liabilities that the taxpayer owes. **§ 6402(a)**. An example of the most commonly encountered situation is where the IRS applies a refund from one year to an

²⁰⁰⁶ Id.

²⁰⁰⁷ § 6503(h).

²⁰⁰⁸ § 6503(d).

²⁰⁰⁹ § 6502(a) (after amendment). In Jordan v. Commissioner, 134 T.C. 1 (2010), the Tax Court held that the taxpayer seeking to assert the bar on collection bears the ultimate burden of persuasion as to the nonexistence or non-validity of a consent, but affirmed the procedural rules in Adler v. Commissioner, 85 T.C. 535, 541 (T.C. 1985) as to the procedural and production burdens encountered at trial where the issue of the bar on collection is in play.

²⁰¹⁰ § 6502(a).

²⁰¹¹ Id.

unpaid tax assessment for another year. To illustrate, where a taxpayer has an unpaid assessment for Year 1 and files a return for Year 3 claiming a refund, the IRS may apply the claimed refund against the assessed tax due. The offset is an administrative collection activity.²⁰¹²

This right of offset is in the discretion of the IRS regardless of any directions the taxpayer may have given as to the application of the refund being applied. For example, where the taxpayer makes a voluntary payment of tax, the taxpayer can ordinarily designate how the taxes are to be applied, but that rule does not apply where the IRS applies a refund otherwise due the taxpayer.²⁰¹³

The IRS takes the position that the right to credit does not require an actual assessment for the year to which the credit is applied (Year 1 in the example); rather, the IRS asserts it can make the credit in at least two such cases – (i) if a notice of deficiency has been issued for the year to which the credit is applied and (ii) if it has filed a proof of claim asserting the tax liability in a bankruptcy proceeding.²⁰¹⁴ The Tax Court sustained the position with respect to an unassessed tax where the notice of deficiency had been issued (thus assuring the taxpayer a Tax Court remedy).²⁰¹⁵ This position raised interesting statutory issues. Section 6213(a) plays a central role in the tax system by prohibiting tax assessments until the notice of deficiency has been issued and the lapse of a period of 90 days or until a Tax Court decision becomes final. Making the credit prior to assessment is the functional equivalent of making an assessment before the time allowed under § 6213(a); correspondingly, since the assessment is the predicate to levy and the credit by offset is the equivalent to levy, this seems to violate the structure of the Code. In the ruling, the IRS mitigates the § 6213(a) concern in part by applying the credit only after issuance of a notice of deficiency that gives the taxpayer a ticket to the Tax Court. But that does not address the issue of whether the action flies in the face of the express prohibition in § 6213(a). The Tax Court’s answer was that an offset was not a levy. The position is controversial.²⁰¹⁶

One question is whether the right of set-off applies independently of the statutes of limitations that would otherwise apply. I pose some examples to frame some of the issues that might arise. Assume for all examples that the taxpayer has a refund due for Year 10.

²⁰¹² Campbell v. Commissioner, 121 T.C. 290, 292 (2003); and McGee v. Commissioner, 123 T.C. 314 (2004),

²⁰¹³ The statute explicitly states that the IRS may credit against “any tax liability” without any limitation; the underlying regulations are consistent. The IRS thus is given the IRS “discretion to apply overpayments to any tax liability.” N. States Power Co. v. United States, 73 F.3d 764, 767 (8th Cir. 1996). Application of overpayments is not voluntary payment for this purpose. In re Ryan, 64 F.3d 1516, 1523 (11th Cir. 1995).

²⁰¹⁴ Rev. Rul. 2007-51, 2007-37 IRB 573 (notice of deficiency) and 2007-52, 2007-37 IRB 575 (proof of claim). See also IRS CCA 200217005 (no offset against unagreed, proposed deficiency without a stat notice).

²⁰¹⁵ Perry v. Commissioner, T.C. Memo. T.C. Memo. 2010-219.

²⁰¹⁶ Sam Young, Tax Court Opinion on Individual Overpayments Brings Practitioner Fears to Life, 2010 TNT 201-3.

Example 1: On January 1 of Year 06, the IRS discovers that the taxpayer underpaid his or her Year 01 tax in the amount of \$100 that has not yet been assessed. Assume that the normal 3-year statute of limitations on assessment applies and that the taxpayer timely filed his Year 01 return on April 15 of Year 02, so that the Year 01 tax is now time barred for assessment. The IRS is aware that the taxpayer has a Year 04 overpayment. Can the IRS nevertheless apply the Year 04 overpayment to the Year 1 unassessed tax? I hope that you instinctively understand that the system is not suited to opening up a barred year upon the mere fortuity of an overpayment of tax in a later year. Keep in mind that, under the common law right of offset, what is sauce for the goose is sauce for the gander; the taxpayer could make the same equitable argument for the right to offset a tax in an open year with an unclaimed refund in a barred year. Accordingly, neither the IRS nor the taxpayer can use the right of offset to open up a barred year.

Example 2: Same example, but for some reason Year 01 remains open for assessment (e.g., the taxpayer has given consents to extend the statute of limitations). The IRS is sure that the taxpayer owes the additional amount for Year 01 but has not yet assessed the tax. Can the IRS offset? Yes, at least if the IRS has issued a notice of deficiency.

Example 3: In a variation of Example 1, assume that the IRS had assessed the unpaid \$100 for Year 01 on April 15 of Year 02 (as a result of the taxpayer reporting the liability on his return but not paying it). Can the IRS offset the Year 04 overpayment against the Year 01 assessment? The IRS can make the offset so long as the collection statute of limitations has not run. Since the collection statute of limitations is 10 years, the IRS can offset until April 15 of Year 12.

Finally, tricky questions of state law apply where an overpayment of a community property refund is used to offset the separate liability of one of the spouses. I do not require you to know these rules but do cite authority in the footnote.²⁰¹⁷

B. General Equitable Right of Set-Off.

The common law long recognized a debtor's right to set-off against the debt any amounts that the debtor owed the creditor. Section 6402(a) is just a codification of that right in the limited context of setting off taxpayer tax overpayments against taxpayer liabilities.²⁰¹⁸ Accordingly, the IRS may set-off non-tax debts that the United States (including any agency thereof) owes the taxpayer against a tax liability.²⁰¹⁹

²⁰¹⁷ See Rev. Rul. 2004-74; 2004-30 IRB 84 (Texas); Rev. Rul. 2004-71; 2004-30 IRB 7 (Arizona & Wisconsin); Rev. Rul. 2004-72; 2004-30 IRB 77 (California, Idaho & Louisiana); Rev. Rul. 2004-73; 2004-30 IRB 80 (Nevada, New Mexico & Washington).

²⁰¹⁸ United States v. Munsey Trust Co., 332 U.S. 234, 239 (1947).

²⁰¹⁹ This statement perhaps sweeps too broadly for every situation. Nuance is important. In Stanley v. United States, 140 F.3d 1023, 1028 (Fed. Cir. 1998), involving an erroneous refund, the taxpayer had made a deposit in the nature of a bond to mitigate the interest if the Government prevailed on the erroneous refund claim. The court held that, because the IRS held the funds under bond rather than in a debtor-creditor relationship, there was no right of offset because there was no

C. Procedural Issues.

The set-off is an administratively enforced collection measure. As we see in the next sections, Congress has provided significant safeguards of prior notice and right to judicial review of IRS collection measures – called levies – against third persons. The question has arisen whether set-offs are subject to these safeguards.

The law is sparse on the question. The case authority is consistent that a set-off of a tax overpayment against a tax liability under § 6402(a) is not a levy and thus not subject to the safeguards attaching to levies.²⁰²⁰ Thus, the IRS may set-off overpayments by just making the determination to do so.

Courts have divided as to whether a set-off of a non-tax debt which the United States owes a taxpayer against a tax liability is a levy subject to the safeguards.²⁰²¹ This is a conceptual debate about the interface between the historical equitable nature of the set-off remedy and its interface with the safeguards for levies and how or if the courts should flesh out Congress' failure to directly address the issue. Suffice it to say here, however, that the IRS by practice does serve a levy upon other United States agencies that owe the taxpayer money when it proceeds,²⁰²² so given this practice the debate may be principally an intellectual exercise.

VIII. Administrative Levy and Judicial Enforcement.

A. Administrative Levy and Sale.

1. General Rules of Levies.

Levy includes the power to seize²⁰²³ and sell the taxpayer's property (including interests in property and personal service compensation, such as wages). **§ 6331(b) (levy); § 6335 (rules for sale)**. A levy – often referred to as a seizure – is a “summary, non-judicial process, a method of self-help authorized by statute which provides the Commissioner with a prompt and convenient method

mutuality.

²⁰²⁰ See e.g., Boyd v. Commissioner, 451 F.3d 8 (1st Cir. 2006).

²⁰²¹ See e.g., Boyd v. Commissioner, 451 F.3d 8 (1st Cir. 2006) (equitable set-off does not invoke procedural safeguards attaching to levies); and United Sand and Gravel Contractors, Inc. v. United States, 624 F.2d 733(5th Cir. 1980) (when IRS levies another agency to effect the equitable set-off, the safeguards attaching to levies apply). As noted in the text immediately below, the IRS practice is to proceed by levy when seeking to set-off an amount owed by another United States agency. United Stand did not address the issue of whether the IRS was required to proceed by levy against the other agency. Hence the two decisions may not be as far apart as first appears.

²⁰²² See Boyd v. Commissioner, *supra*.

²⁰²³ See Wagner v. United States, 545 F.3d 298 (5th Cir. 2008) (and cases cited).

for satisfying delinquent tax claims.”²⁰²⁴ The Supreme Court has said: “The IRS need never go into court to assess and collect the amount owed; it is empowered to collect the tax by non-judicial means . . . without having to prove to a court the validity of the underlying tax liability.”²⁰²⁵

The IRS levy can involve a direct seizure of the property but more often the levy is accomplished by notice of levy to the taxpayer or third parties requiring them to turn over the taxpayer’s property in their possession. Thus, the IRS can serve notice of levy a bank to obtain the funds in the taxpayer’s bank account or can levy a brokerage firm to obtain the investments in the taxpayer’s bank account. The IRS can also levy persons or entities who appear to be third parties, asserting that they are nominees or alter egos of the taxpayer. (I cover nominee and alter ego liability later in the text.)

As noted, the IRS often levies on third parties by issuing “notice of levy,” which, like the IRS summons studied earlier, is simply a form that the IRS collection officer fills out and delivers to the person upon whom levy is made.²⁰²⁶ Once the person is given the notice of levy, the United States has the right to the property levied.²⁰²⁷ As to the property, the person receiving the notice of levy holds the property in a form of custodial relationship to the United States.²⁰²⁸

The person receiving the notice of levy takes substantial risks in not responding to the levy. The person receiving a levy is liable for the value of the property levied upon and not turned over, plus a penalty of 50%. **§ 6332(d)**. The defenses available to the party levied to avoid the levy are quite limited.²⁰²⁹ Non-possession of the taxpayer’s property is a defense.²⁰³⁰ However, the “validity of the levy and competing claims to the ownership of the funds are not valid reasons for refusing to

²⁰²⁴ United States v. Sullivan, 333 F.2d 100, 116 (3d Cir. 1964) (citations omitted), quoted in United States v. Ryals, 480 F.3d 1101 (11th Cir. 2007).

²⁰²⁵ United States v. Baggot, 463 U.S. 476, 481 (1983).

²⁰²⁶ A levy upon property is effected “by the sole act of serving notice of levy upon the third party holding the property.” Kane v. Capital Guardian Trust Co., 145 F.3d 1218 (10th Cir. 1998) (citing G.M. Leasing Corp. v. United States, 429 U.S. 338, 350 (1977); Resolution Trust Corp. v. Gill, 960 F.2d 336, 340 (9th Cir. 1992) (“[A] levy is effective upon the IRS’s service of the notice of levy.”); see also United States v. Rodgers, 461 U.S. 677, 682 (1983) (the notice of levy “does not require any judicial intervention.”)).

²⁰²⁷ United States v. Eiland, 223 F.2d 118, 121 (4th Cir. 1955). Although until it is turned over to the IRS, the property may be in the physical possession of the third party, it is deemed to be in the constructive possession of the IRS. Phelps v. United States, 421 U.S. 330, 334 (1975).

²⁰²⁸ Phelps v. United States, 421 U.S. 330, 334 (1975).

²⁰²⁹ In order to avoid the liability, the party levied must act quickly to freeze the property. See United States v. JPMorgan Chase Bank NA, 2014 U.S. Dist. LEXIS 113896 (CD CA 2014) (levied bank’s central processing unit did not act promptly, and the taxpayer withdrew funds; held bank liable for the amount levied, but apparently did not get the 50% penalty).

²⁰³⁰ United States v. Sterling Nat’l Bank & Trust Co., 494 F.2d 919, 921 (2d Cir. 1974),

honor a levy.²⁰³¹ The person can be relieved from the 50% penalty for reasonable cause, which would be something beyond the person's control that prevents compliance.²⁰³² The IRM advises the agent to be judicious in assertion of the penalty,²⁰³³ and courts also may give a liberal application of reasonable cause where the taxpayer is already penalized by liability for the value of the property that he may have turned over to the taxpayer.²⁰³⁴ In order to protect the levied party, the levied party responding to the levy by delivering the property to the IRS is “discharged from any obligation or liability to the delinquent taxpayer and any other person with respect to such property or rights to property arising from such surrender or payment.” § 6332(e). As a result, practically speaking, the levied party “has two, and only two, possible defenses for failure to comply with the demand: that it is not in possession of property of the taxpayer, or that the property is subject to a prior judicial attachment or execution.”²⁰³⁵

What if a third party upon whom a levy is served claims to have an interest in or even ownership of the property or, alternatively, is aware that some other third party (other than the taxpayer) claims ownership of the property? In the nontax world when there are two or more claimants on property, the possessor can interplead the property²⁰³⁶ and let the claimants duke it out. Interpleader is generally not an option to an IRS levy since § 6332(d) offers no relief for the penalty if the person levied interpleads the property. In appropriate cases, the IRS will consider interpleader to be reasonable cause. The reason interpleader may not avoid the penalty is the person levied upon is otherwise protected from liability to the taxpayer or third parties. § 6332(e). And, if the possessor

²⁰³¹ United States v. Daccarett, 6 F.3d 37, 59 (2d Cir. 1993).

²⁰³² § 6332(d)(2). For example, in United States v. Sterling National Bank, 494 F.2d 919 (2d Cir. 1974), the court determined that a bank could not set off a taxpayer deposit against a taxpayer debt to the bank after receiving a levy. The court nevertheless declined to impose the penalty, but warned that, in the future, reasonable cause would not exist for such self-help offset to an IRS levy.

²⁰³³ IRM 5.17.4.12.4(3) (11-26-2007) (“In view of the severity of the 50-percent penalty, the recommendation for its assertion should generally be made only when the failure or refusal to surrender the property levied upon is arbitrary or capricious, or when the alleged dispute over the amount owing or the legal effectiveness of the levy is frivolously raised.”)

²⁰³⁴ See Keith Fogg, Imposition of an Extra 50% Penalty for Failing to Honor Levy – Is the Levy Form Inadequately Descriptive (Procedurally Taxing Blog 3/12/14).

²⁰³⁵ United States v. Nat'l Bank of Commerce, 472 U.S. 713, 727 (1985), citing United States v. Sterling National Bank & Trust Co. of New York, 494 F.2d 919, 921 (2nd Cir. 1974). Even if the levy is or is arguably invalid, the party levied must turn over the property. E.g., United States v. Moskowitz, Passman & Edelman, 603 F.3d 162, 166 (2d Cir. 2010) (“[q]uestions about the validity of the levy are not valid reasons for refusing to honor a levy.” (internal quotation marks and citation omitted)).

²⁰³⁶ True interpleader involves a person in possession of property but having no claim to the property suing so that the claimants can duke it out. If the person in possession of property also has a claim, that person may bring suit in the nature of interpleader to establish his or her claim.

who is levied also claims an ownership interest in the property, the possessor has a post-levy remedy via the wrongful levy suit that we shall discuss later.

Normally an administrative levy on a third party reaches only the property of the taxpayer that the third party has on the date that the levy is made. For example, if the IRS levies a bank account, the bank must turn over the balance on the date of the levy.²⁰³⁷ If the taxpayer makes a deposit the next day, that amount of the new deposit need not be turned over by the bank.²⁰³⁸ Notwithstanding this general moment in time nature of a levy, a levy on recurring “salary or wages” and personal service compensation (often called garnishments in other contexts) are continuing from the date of levy until the levy is released. § 6331(e). The Regulations define the statutory terms “salary or wages” very broadly to include “compensation for services paid in the form of fees, commissions, bonuses, and similar items.”²⁰³⁹ The courts have blessed this broader reading, sustaining, for example, continuous levies on payments to (i) independent contractors, such as commissioned agents,²⁰⁴⁰ (ii) partners as distributions,²⁰⁴¹ and (iii) members of an LLC as distributions.²⁰⁴² Similar continuing levies, subject to restrictions in amount, may be made with respect to some other federal payments.²⁰⁴³ The IRS can, of course, make successive levies where the original levy is not a continuing levy and thereby reach the property of the taxpayer as of each levy. § 6331(c).

There is an important nuance to the normal levy (not the continuing levy authorized by statute) in the case of future payments. The normal levy reaches an existing right to future payments if the right is fixed and determinable on the date of the levy.²⁰⁴⁴ For example, if the taxpayer has the

²⁰³⁷ Regs. § 301.6331-1(a)(1).

²⁰³⁸ Id.

²⁰³⁹ Regs. § 301.6331-1(b)(1).

²⁰⁴⁰ United States v. Jefferson-Pilot Life Ins. Co., 49 F.3d 1020 (4th Cir. 1995) (reasoning that the underlying purpose of the provision is to permit levy upon the recurring remuneration to the taxpayer for personal services).

²⁰⁴¹ United States v. Moskowitz, Passman & Edelman, 603 F.3d 162 (2d Cir. 2010)..

²⁰⁴² United States v. 911 Mgmt., LLC, 2014 U.S. Dist. LEXIS 289 (D. OR. 2014) (although not discussing the issue, but assuming that such a continuous levy was proper); see also CCM 20836002 (4/23/08) (taking the position that LLC distributions to member are subject to continuous levy).

²⁰⁴³ § 6331(h). The levies on “specified payments” may be continuous. § 6331(h)(1). A specified payment includes most periodic federal payments other than some type of means tested payment. (See the statute for the precise enumeration.) § 6331(h)(2) The continuous levy may apply only up to (i) 15% of the payment or (ii) 100% in case of a vendor to the government. § 6331(h)(1) and (3).

²⁰⁴⁴ Regs. § 301.6331-1(a)(1) (provide that a levy “extends only to property possessed and obligations which exist at the time of the levy” and that “[o]bligations exist when the liability of the obligor is fixed and determinable although the right to receive payment thereof may be deferred until a later date.”)

current right to a payment or payments in the future, the IRS can serve the levy on the payor who then must pay to the IRS as the future payment(s) fall due. Say I have a right to receive \$10,000 a year from now and the payor does not have to pay until that year period is up. The IRS can levy today on the payor and, when the payment is due, the payor would have to pay the IRS pursuant to the levy. The key requirement is that the rights are fixed and determinable on the date of the levy; if so, that right to future payments is property within the scope of the levy on the date of the levy. Perhaps the classic example is a simple note or obligation to pay in the future, consistent with the example. Another common example is a **vested** right in a pension or retirement plan (**including Social Security**) that is fixed and determinable on the date of the levy, albeit paid in the future and over time. The IRS levies on the payor and the payor pays the retirement benefits to the IRS as they are otherwise payable under the plan.²⁰⁴⁵ For certain types of retirement payments, the IRM has discretionary rules advising collection officers to use them in moderation and as a last resort.²⁰⁴⁶ A related consequence of levy on such fixed and determinable rights to future payments being effective as of the date of the levy rather than the later payment is that the levy remains effective as to those future payments even after the collection statute of limitations expires.²⁰⁴⁷

Unlike the other enforced collection tool – the judicial suit for foreclosure – the levy is a provisional remedy. It does not determine that the Government is entitled to the property levied vis-a-vis other claimants or even the taxpayer. It simply seizes the property and prevents the property from dissipation while parties, including the taxpayer, claiming an interest in the property have the opportunity to pursue remedies available to them to determine the priority of their claims as against the Government. The levy power is “an essential part of our self-assessment tax system,” for it “enhances voluntary compliance in the collection of taxes.”²⁰⁴⁸ “Among the advantages of

²⁰⁴⁵ IRM 5.11.6.1 (01-22-2010), titled Retirement Income, stating that “This often means that a levy on retirement income reaches future payments.”

²⁰⁴⁶ The following are excerpts from the Taxpayer Advocate web page regarding the Federal Payment Levy Program, :

All taxpayers with outstanding tax debts are subject to a levy on assets and income sources, including Social Security benefits. There are two ways the IRS may levy upon your Social Security benefits:

- Automated Federal Payment Levy Program (FPLP) – The IRS is able to levy up to 15 percent of your Social Security benefits each month.
- Manual (non-FPLP) levy – There is no restriction to how much the IRS can take from manual levies, however they take into account money for reasonable living expenses.

IRS levies on Social Security payments may include: retirement payments, survivor payments or disability insurance program payments.

IRS levies on Social Security payments will not include: children’s benefits, supplemental security income payments or lump sum death benefits.

See <http://www.taxpayeradvocate.irs.gov/Individuals/Federal-Payment-Levy-Program> (visited 4/2/14).

²⁰⁴⁷ Id.

²⁰⁴⁸ G. M. Leasing Corp. v. United States, 429 U.S. 338, 350 (1977).

administrative levy is that it is quick and relatively inexpensive,²⁰⁴⁹ and it has easily cleared constitutional challenges.²⁰⁵⁰

2. Exemptions or Limitations on Levies.

State law provides debtor-protections preventing creditors from enforcing their claims against certain types of assets. For example, in Texas, we have the famous homestead exemption designed to protect the family from a profligate husband's excesses. These protections do not prevent the IRS from collecting tax debts, via levy or judicial enforcement, as appropriate.²⁰⁵¹

The Code provides exemptions from levy for certain types of property Congress deemed to be bare essentials that should not be subject to levy. § 6334. Thus, the IRS may not seize wearing apparel or school books, fuel, furniture or personal property up to a value of \$6,250, business assets up to a value of \$3,125, and so forth.²⁰⁵² Similarly exempt are wages and salaries up to an amount equaling the standard deduction and deductions for personal exemptions pro-rated to the wage or salary payment period involved.²⁰⁵³

Residences and businesses are not generally exempt from levy. However, the 1998 Restructuring Act exempted residences from levy for small deficiencies (\$5,000 or less).²⁰⁵⁴ Moreover, principal residences are exempt unless the IRS exhausts other payment options and a district court approves.²⁰⁵⁵

Also, although retirement-type assets (e.g., pension plan, IRAs) are exempt or partially exempt under state and federal laws from **ordinary** creditors' claims,²⁰⁵⁶ they are not exempt from

²⁰⁴⁹ United States v. Rodgers, 461 U.S. 677, 699 (1983).

²⁰⁵⁰ Phillips v. Commissioner, 283 U.S. 589, 595. See G. M. Leasing Corp. v. United States, 429 U.S. 338, 352 n. 18 (1977).

²⁰⁵¹ See e.g., United States v. Rodgers, 461 U.S. 677, 699 (1983).

²⁰⁵² See the list in § 6334(a).

²⁰⁵³ § 6634(a)(9) & (d).

²⁰⁵⁴ § 6334(a)(13).

²⁰⁵⁵ § 6334(a)(13) and § 6334(e)(1).

²⁰⁵⁶ This is a large subject, but generally, as I understand the rules, they are: (i) Employer-sponsored individual retirement accounts (IRAs) are protected without dollar limit in bankruptcy proceedings, but other traditional and Roth IRAs are protected up to an inflation-adjusted \$1 million; Owner-only plans may be subject to attachment by creditors outside bankruptcy; (ii) Eligible rollover distributions from qualified retirement plans retain their protection, but required minimum distributions and hardship distributions may not; (iii) an IRA inherited by an heir other than a surviving spouse is part of the bankruptcy estate and is not exempt from creditor's claims (Clark v. Rameker, 134 S. Ct. 2242 (2014)); and (iv) a prohibited transaction may cause an IRA to lose its status and become subject to attachment by creditors. The foregoing summary is cut and paste (hence verbatim except for layout) from the AICPA Tax Adviser page. Richard A.

IRS levy. The levied party's remittance pursuant to the levy will be deemed a taxable distribution to the taxpayer.²⁰⁵⁷

Business assets are not subject to levy except upon determination of a high level IRS official and the Secretary or his delegate finds that collection of the tax is in jeopardy.²⁰⁵⁸

Finally, most retirement plans are subject to levy, notwithstanding ERISA's Anti-Alienation provision that exempts such plans from enforced collection for many types of debts.²⁰⁵⁹

3. Notice of Levy and Sale of Levied Assets.

The IRS is required to give the taxpayer notice of the seizure of assets and then, upon giving notice of sale of the property, may sell the property it obtains by levy.²⁰⁶⁰ The IRS must apply the net proceeds (after costs of the sale) to the taxpayer's liability and refund any excess. The problem is that an administrative sale by the IRS may not produce buyers willing to pay anything near the fair market value of the property interest being sold.²⁰⁶¹ In particularly troublesome cases, the IRS may invoke the judicial sale remedy²⁰⁶² rather than the administrative sale remedy, because buyers may be more willing to buy with the protections perceived for the judicial remedy.

The taxpayer has the right to redeem all property before sale and to redeem real estate even after sale.²⁰⁶³

Naegele, Mark P. Altieri, and Donald W. McFall Jr., Protection From Creditors for Retirement Plan Assets (The Tax Adviser 1/1/14).

²⁰⁵⁷ IRS levies are exempt from the 10% tax on early distributions, but not from the income tax on the distribution resulting from the levy. § 72(t).

²⁰⁵⁸ § 6331(e)(2).

²⁰⁵⁹ See for further discussion my Tax Procedure Blog entry titled, [Restitution And Tax Collection from Retirement Accounts - Anti-Alienation \(11/28/12\)](#). As noted in the blog, certain specific but very limited plans are exempted under § 6334(a). It appears that the House and Senate have approved separate legislation permitting levy on Federal Thrift Savings Plan accounts; the legislation thus appears uncontroversial and will likely pass in 2013. See Meg Shreve, Senate Passes Bill Permitting Levies on Thrift Savings Plans, 2013 TNT 2-7 (1/3/13).

²⁰⁶⁰ §§ 6335 & 6336. See Grable & Sons Metal Products, Inc. v. Darue Engineering & Manufacturing, 126 S.Ct. 2363 (2005) (holding that the issue of whether the IRS gave proper notice to the taxpayer under § 6335 is a sufficient federal issue to justify removal to federal court in a state court quiet title action commenced against the purchaser in the IRS).

²⁰⁶¹ If the property interest is indivisible, a classic case where buyers would not be willing to pay a pro rata amount for the interest, the IRS is given the power to sell the whole property. § 6335(c).

²⁰⁶² §§ 7401, 7402, and 7403.

²⁰⁶³ § 6337.

The taxpayer must be notified of the amount applied from the sale to the taxpayer's liability and the balance due.²⁰⁶⁴

The IRS asserts that its power to levy and sell apply regardless of certain restrictions on transfer that would otherwise be binding on the taxpayer.²⁰⁶⁵

4. Discovery of Leivable Property.

The IRS can use the summons power to discover leivable property.²⁰⁶⁶ We have noted above that the IRS can summons the taxpayer to attempt through a Q&A to discover the taxpayer's leivable property.

In addition, the Code requires that persons having custody of the taxpayer's records relating to property "exhibit" them to the IRS upon demand.²⁰⁶⁷

5. Constitutional Limitations on Levies.

The IRS's ability to enter into private areas to seize assets is subject to the Fourth Amendment's prohibition of unreasonable searches and seizures. The question generally is whether the individual (as opposed to the artificial corporate entity) has a reasonable expectation of privacy with respect to the area. Certainly, for example, an individual generally has a reasonable expectation of privacy in his or her home. Similarly, for those portions of business premises not generally open to the public, an occupant may have a reasonable expectation of privacy.²⁰⁶⁸ Accordingly, the IRS may not enter these areas to locate and seize property unless a warrant, often referred to as a writ of entry, is first obtained. Only the private areas in which there is a reasonable expectation of privacy implicate the Fourth Amendment's guarantee.

²⁰⁶⁴ § 6340(c).

²⁰⁶⁵ For example, Chief Counsel Advice Memo 200926001 (6/29/09), reproduced at 2009 TNT 122-27, reasoned the IRS could seize and sell certain options free of contractual and even statutory restrictions. The stock options were employee non-qualified stock options which were subject to contractual restrictions and incentive stock options including transfer restrictions required under § 422.

²⁰⁶⁶ § 6331(g), however, precludes the IRS from levying on the day that the taxpayer (or officer of taxpayer) has been summoned in connection with collection.

²⁰⁶⁷ § 6333. See IRM 5.11.2.1.8(1) & (2) (06-02-2007), noting that a summons can be used for this purpose but the more proper form is Form 2270, Notice to Exhibit Books and Records. However, if the party served the demand does not comply, there is no express authority to seek judicial enforcement of the demand; hence, the IRS apparently will then follow through with a summons which can be judicially enforced. See ECC 201447029 (10/30/14), reproduced at 2014 TNT 226-78 (11/21/14).

²⁰⁶⁸ G. M. Leasing Corp. v. United States, 429 U.S. 338 (1977).

What if the property is in an area where there is no such reasonable expectation of privacy? The IRS takes the position that an automobile may be seized by administrative levy without a search warrant if the automobile is parked in an unobstructed driveway or front yard, and the courts have sustained that position.²⁰⁶⁹ Under the doctrine of curtilage, however, if the automobile were within and completely enclosed by a fence and gate, the automobile may be within a zone of privacy requiring a judicial writ of entry prior to seizure.

The precise standard that must be met to obtain a writ of entry to seize assets is not settled. Some courts use the standard for search warrants (probable cause) and others use the less strict standard for administrative searches.²⁰⁷⁰ Then, of course, as in the case of search warrants, the question of scope of the search upon entry by writ arises. The IRS takes the position that, once it is lawfully on the premises by virtue of the writ of entry, § 6331 authorizes it to levy on any property determined to be the taxpayer's property.²⁰⁷¹ Some courts, however, in issuing the writ will specify the property that the IRS is authorized to seize.²⁰⁷² And, the documents seeking the writ of entry and representations the Government makes to the Court may, practically, limit what it may seize under the writ. The IRS illustrates as follows:

If the discovery of or entry into these items was not contemplated by the court when it authorized the initial entry into the warehouse, the officer should not search the items without further permission. A writ authorizing entry into an office to search for bearer bonds probably does authorize the Revenue Officer to search any locked containers, e.g., desks, filing cabinets, brief cases or safes, that might contain the assets that are the subject of the authorized search.²⁰⁷³

I shall discuss below the issue of constitutional protections potentially applicable when the IRS levies against property nominally titled to persons other than the taxpayer.

6. Procedural Predicates to Levy.

The IRS may not levy until it has given the taxpayer 30-days notice that it intends to make a levy unless collection is determined to be in jeopardy. **§ 6331(d)**. The notice of levy occurs at the end of a series of demand letters automatically generated by computer and sent to the taxpayer from the Service Center. The final automatic letter will advise of the IRS's intent to levy and the taxpayer's rights with respect thereto (which we shall discuss in more detail below under Collection Due Process, pp. 657 ff.), thus meeting the statutory predicate when the IRS finally does get around

²⁰⁶⁹ United States v. Roccio, 981 F.2d 587 (1st Cir. 1992); and Rogers v. Vicuna, 264 F.3d 1 (1st Cir. 2001).

²⁰⁷⁰ Compare e.g., United States v. Condo, 782 F.2d 1502 (9th Cir. 1986) (probable cause) with Carlson v. United States, 580 F.2d 1365 (10th Cir. 1978).

²⁰⁷¹ LGM GL-40 (June 27, 1996).

²⁰⁷² E.g., In re Stubblefield, Inc., 810 F. Supp. 227 (E.D. Cal 1992).

²⁰⁷³ LGM GL-40 (June 27, 1996). This LGM is quite useful for its discussion of other subtleties related to the writ of entry for IRS collection efforts.

to actually levying. Further, before making a levy, the IRS is required to complete “a thorough investigation of the status of such property.”²⁰⁷⁴ Some courts have held that the seizure of a third party's property implicates serious Fourth Amendment issues and some have held that in a subsequent proceeding contesting the levy the Government is required to show probable cause. I shall return to this issue below (pp. 657 ff) in addressing remedies for wrongful levy.

If the collection of the tax is in jeopardy, the IRS may with a determination of jeopardy make an immediate levy, often referred to as a jeopardy levy.²⁰⁷⁵

B. Judicial Enforcement.

1. Civil Collection Suits.

In addition to or as an alternative to levy, the Government may bring judicial enforcement proceedings to obtain property or extend the period for collection.²⁰⁷⁶ The judicial proceeding is a collection suit. If it is against the taxpayer and the taxpayer has not yet litigated his or her liability for the tax, the liability issue can be litigated in the collection suit. And, if the Government obtains judgment in the case, it will then have a judgment lien against the taxpayer that can then be judicially enforced against after-acquired property or property subsequently located.

If the suit is against a third party who the Government alleges to hold property of the taxpayer, the third party can raise the defense that the taxpayer has no interest in the property upon which collection is sought or, if the taxpayer does have such interest, the third party's interest is superior to the taxpayer's. In the latter event, the Government might be trying to force a sale of the taxpayer's interest in order to realize as much as it can. United States v. Rodgers is a case where the Government used this type of suit. I discuss Rodgers in the next section.

²⁰⁷⁴ § 6331(j).

²⁰⁷⁵ § 6331(a) provides:

If the Secretary makes a finding that the collection of such tax is in jeopardy, notice and demand for immediate payment of such tax may be made by the Secretary and, upon failure or refusal to pay such tax, collection thereof by levy shall be lawful without regard to the 10-day period provided in this section.

In Prince v. United States, 133 T.C. 270, 276-277 (2009), the Court cited the jeopardy assessment regulations for the predicate of a jeopardy levy (which is logical because the jeopardy assessment is made coincident to a levy). Regs. § 1.6851-1(a)(1).

²⁰⁷⁶ §§ 7401, 7402, and 7403. For a summary of the collection suit process, including authority, jurisdiction, etc., for such suits, see IRM 5.17.4 Suits by the United States.

2. Writ of Ne Exeat Republica - Constraining the Person.

The United States does not generally allow imprisonment – or, more broadly, constraining a person’s liberty -- for the nonpayment of debt.²⁰⁷⁷ The exception for purposes of tax matters is the statutory approval in § 7402(a) for the writ of ne exeat republica. The Latin is “let him not go out of the republic,” and was developed in England as a chancery writ. The writ is sometimes used in domestic relations contexts to restrain someone from leaving the jurisdiction. In tax collection contexts:

The writ ne exeat republica is an extraordinary remedy and should only be considered when all other administrative and judicial remedies would be ineffective. In appropriate cases, the writ ne exeat may be used as a collection device against a United States taxpayer who is about to depart from the territorial jurisdiction of the United States, or who no longer resides but is temporarily present in the United States and who has transferred his assets outside of the United States in order to avoid payment of his federal tax liabilities. The writ ne exeat is a court order which generally commands a marshal to commit to jail a defendant who fails to post bail or other security in a specified amount. The authority for the United States District Courts to issue writs ne exeat in tax cases is found in I.R.C. section 7402(a) and 28 U.S.C. section 1651.

The debt relied on to support the writ must be enforceable against the defendant, be of a pecuniary nature and be presently payable. Thus, in tax cases, an assessment should be outstanding against the taxpayer.

The purpose of the writ in tax cases is to prevent taxpayers from defeating the collection of tax liabilities by removing themselves and their assets from the territorial jurisdiction of the United States. As a practical matter collection by administrative means is ineffective where the taxpayer has either secreted his assets or removed them from the United States. If the taxpayer leaves the United States, judicial remedies may be likewise defeated since the court would then be powerless in most cases to enforce its orders or judgments against the taxpayer or his property, if located outside of the United States. Thus, the writ ne exeat ensures the continuing submission of the taxpayer to the jurisdiction of the court.²⁰⁷⁸

The writ may be used in conjunction with the appointment of a receiver.²⁰⁷⁹

²⁰⁷⁷ See generally Anthony E. Rebollo, The Civil Arrest and Imprisonment of Taxpayers: An Analysis of the Writ of Ne Exeat Republica, 7 Pitt. Tax Rev. 103, 145-153 (2010) (discussing some of the legal and constitutional issues specifically in the context of restraint for taxation.

²⁰⁷⁸ LGM Intl-2, reproduced at 1999 TNT 225-22 (case citations omitted).

²⁰⁷⁹ LGM Intl-3 (4/9/90), reproduced at 1999 TNT 225-23.

The writ is very, very rarely used. I have never encountered it in my practice nor, anecdotally, have I heard of my colleagues' encountering it. The cases are sparse.²⁰⁸⁰

IX. Property Subject to Lien and Levy - the Taxpayer's Property.

The tax lien applies to the taxpayer's property – all of the taxpayer's property.²⁰⁸¹ The taxpayer's property is determined under state law; federal law then determines whether the lien attaches to the property.²⁰⁸² The Supreme Court has characterized the inquiry as follows:

A common idiom describes property as a “bundle of sticks” -- a collection of individual rights which, in certain combinations, constitute property. State law determines only which sticks are in a person's bundle. Whether those sticks qualify as “property” for purposes of the federal tax lien statute is a question of federal law.²⁰⁸³

In most cases the taxpayer's property right to which the lien attaches is apparent, but in some cases it is less apparent. I attempt to give you a sense of the parameters from a brief discussion of key cases in the area.

First, let's consider a simple case. Assume a taxpayer owns a car that is titled in his name. The federal tax lien attaches to the car and, upon filing the tax lien, the IRS secures its rights against third parties. The IRS also has the right to seize the car as a means of collecting the underlying tax liability. The IRS can levy upon – i.e., seize – the car even if it is in the possession of a third party. This is the easy case.

Let's use variations on the easy case in order to set the tougher cases up. Take the same facts, except the car, although equitably owned by the taxpayer, is titled in another person's name – e.g., his spouse or girl friend. Under state law, the car is still the property of the taxpayer, and the mere nominal titling of the property in another's name will not deny the IRS the right to seize the car.²⁰⁸⁴ Practically, the IRS will not discover taxpayer's interest in the car by an automobile title search and thus will have to have some other way to determine that the taxpayer has the equitable ownership of the car. Then, take those facts and reverse them – the car is equitably owned by

²⁰⁸⁰ See e.g., Order in *United States v. Barrett* (D. Colo. 2010), unofficially reproduced at 2010 TNT 233-27 (2010). For a good article, see Anthony E. Rebollo, The Civil Arrest and Imprisonment of Taxpayers: An Analysis of the Writ of Ne Exeat Republica, 7 Pitt. Tax Rev. 103 (2010).

²⁰⁸¹ United States v. Nat'l Bank of Commerce, 472 U.S. 713, 719-720 (1985) (noting that § 6321's scope “is broad and reveals on its face that Congress meant to reach every interest in property that a taxpayer might have.”).

²⁰⁸² The Supreme has reiterated this formula in a line of cases culminating in United States v. Craft, 533 U.S. 274, 278 (2002).

²⁰⁸³ U.S. v. Craft, 535 U.S. 274, 279 (2002) (citations omitted).

²⁰⁸⁴ The IRS may levy via a nominee theory that we shall discuss later.

another, but is titled in the taxpayer's name. The IRS should not seize the property because the taxpayer has no beneficial property right in the property.²⁰⁸⁵ Practically speaking, however, if the car is titled in the taxpayer's name and the IRS happens to catch the taxpayer driving it, it is likely to levy and leave the equitable owner to his or her right to return of wrongfully levied property.

Now let's turn to tougher cases, principally illustrated by a series of Supreme Court cases which are presented in chronological order.

In **United States v. Rodgers, 461 U.S. 677 (1983)**, which you should read now, involving Texas' community property laws, the husband owed tax which was his separate liability. The IRS had, of course, the automatic lien against the taxpayer's property and had filed a tax lien thus putting third parties on notice should they attempt to acquire an interest the taxpayer's property. Prior to the IRS filing of the tax lien, the taxpayer and his wife (who was not liable for the tax) acquired a residence which, under Texas law, was both community property and a homestead. Under Texas law, each of the husband and wife owned a community property interest in the property (½ undivided interest), subject to the right of the survivor to reside in the homestead until the survivor's death. The IRS moved to foreclose on the taxpayer's interest in the homestead. The Supreme Court held, not surprisingly, that the IRS could collect a separate tax liability from the property of the spouse owing that separate tax liability. The Supreme Court further held that the IRS could generally force a sale of the jointly owned property (community or otherwise) and could do so in this particular case involving a homestead, even though, under Texas law, the husband through whom the IRS claimed had no right to force a sale of the property. Note that, based on federal law concerns to collect revenue, the IRS which stepped into the taxpayer's shoes acquired a right the taxpayer did not have – that is, to force a sale of the property. Then, finally, the Court focused on the economic value of the taxpayer-husband's property rights. The Supreme Court held, in the case of homestead community property, the husband's property interest was one-half **but** that one-half was burdened by the other spouse's right to live in the homestead for life. Using actuarial tables based on the wife's life expectancy, the husband's one-half interest in the property would be substantially diminished. (The Court gave some percentages as examples, depending upon life expectancy.) The key point of Rodgers, of course, is to focus carefully on what the taxpayer owns under state law and factor in any burdens on that property so as to achieve the maximum benefit for other claimants to the property.²⁰⁸⁶

²⁰⁸⁵ Cf. United States v. Williams, 514 U.S. 527 (1995). As discussed below (p. 669), the IRS's tax lien may cloud the title of a non-owner, but then the issue is one of remedies and not whether the IRS has the right collect the taxpayer's tax from a nontaxpayer's property.

²⁰⁸⁶ A variation on the Rodgers theme is where a taxpayer has pension benefits in which the wife, under state law, has an interest. Pension benefits, like the homestead, are often accorded protection from creditors under state law. But that does not accord protection from the IRS. In McIntyre v. United States, 222 F.3d 655 (9th Cir. 2000), the IRS assessed taxes only against the husband. The husband had a pension plan with accrued benefits. California law gave the wife a community property interest in the pension. The wife urged that she had a present interest in one-half the pension and that her interest at least was not subject to levy for the husband's tax liability. Rodgers, of course, usually makes that a viable argument. However, California law provides that community property is liable for the debt of either spouse incurred before marriage or

In **Drye v. United States** 528 U.S. 49 (1999), which you should read now, the taxpayer was the sole heir of his mother's intestate estate. The taxpayer also owed substantial federal taxes, as to which liens existed and had been filed. The taxpayer filed a written disclaimer under state (Arkansas) law in order to avoid having the estate dissipated to pay his outstanding federal taxes. Arkansas law imputes a legal fiction upon such a disclaimer – the fiction is that the disclaimant had died before the testator, so that the disclaimant is no longer entitled to take from the estate and the estate passes from the testator, through the estate to the alternative beneficiaries, the next in line who was the taxpayer's daughter. With the proceeds of the estate, the daughter created a trust, styled the Drye Family 1995 Trust, which had as its beneficiaries the daughter and her parents (one of whom was the taxpayer). However, the taxpayer was only a discretionary beneficiary of the trust and thus, looking solely to the terms of the trust, the IRS had no right to treat any portion of the trust as the taxpayer's property subject to levy. The IRS tried a different tack – treating the disclaimer as ineffective to defeat the IRS's ability to go against the estate and the transferee of the estate. In holding that the disclaimer could not defeat the IRS's interest, the Court reasoned that the characteristics of the interest are indeed determined under state law, but that whether those characteristics add up to “property” to which the lien attaches under § 6321 was a matter of federal law. As to the disclaimed interest, the Court noted that the disclaimant exercised dominion and control over the property after the decedent's death and that dominion and control added up to a property right for § 6321 purposes, despite the ex post facto characterization of the state legal fiction.

In **Craft v. United States**, 533 U.S. 274 (2002), the Supreme Court again visited the interface between state and federal law. The IRS sought to collect on a federal tax lien against real property held by the taxpayer and his wife under Michigan law as tenants by the entirety. The Court set up its analysis by first positing the “bundle of sticks” analysis quoted above. The Court then discussed the forms and characteristics (the sticks, if you will) of the types of ownership at common law – tenants in common, joint tenancies, and tenancies by the entirety. (I ask you to hearken back to your real property class, usually a required course in law school, and shall not discuss in detail the distinctions between such forms of ownership.) Basically, in part here pertinent, tenancies in common are a form of fractional ownership, whereas joint tenancies are deemed ownership of the whole subject to right of survivorship, meaning that the property passes to the survivor by virtue of the joint tenancy rather than by probate or other form of testamentary transfer. At common law, tenancies in common may be alienated by each of the tenants (because it is a fractional share

during marriage (here the husband was clearly liable for the federal taxes), whether or not the other spouse was independently liable for the debt (here the wife was not otherwise liable for the taxes). Based on this California law, the Court held that the Government like any other creditor could go against community property. The Court distinguished (as it had in an earlier case) contrary holdings under other states' laws where the state law did not permit a creditor to go against one spouse's share of community property in satisfaction of the other spouse's premarital debts. Ordinarily, of course, state law exempts retirement plans from creditors remedies, but the IRS is not an ordinary creditor. Once it was established that it was property subject to levy, the IRS could get it. This case illustrates the crucial importance of state law creditors rights upon which may assist or limit the IRS in collecting tax liabilities.

ownership), but joint tenancies could not be alienated without first being severed in a judicial proceeding or by deed. Tenancies by the entirety, by contrast to both, was like a joint tenancy in some respects, but rested on the fiction that husband and wife were one and therefore owned the property as a unity, thus initially requiring the consent of both to alienate but giving the husband such broad control (it was a man's world, after all) that eventually the common law recognized his right to alienate subject to the survivor's right to a survivorship interest. Michigan had statutorily changed some the features of the tenancy by the entirety. In pertinent part, each spouse was given an inseparable unified interest in the property with right of survivorship and, upon divorce, each acquired a divisible one-half interest subject to provision to the contrary in the divorce decree. The question, of course, was whether the husband had a property interest that could be levied upon.

The Court said it first looked to the husband's interest under state law which it characterized as follows:

According to Michigan law, respondent's husband had, among other rights, the following rights with respect to the entireties property: the right to use the property, the right to exclude third parties from it, the right to a share of income produced from it, the right of survivorship, the right to become a tenant in common with equal shares upon divorce, the right to sell the property with the respondent's consent and to receive half the proceeds from such a sale, the right to place an encumbrance on the property with the respondent's consent, and the right to block respondent from selling or encumbering the property unilaterally.

Thus, characterizing the husband's interest, the Court then looked to federal law to determine whether those characteristics added up to "property" under § 6321. The Court concluded that the husband's rights (as described in the quote above) were significant. The only material burden was that he did not have the right to unilateral alienation, but the right to unilateral alienation could not alone defeat federal "property" status (as Rodgers held). Accordingly, the husband's interest was property and, as in Rodgers, could be foreclosed upon. In so holding, the Court declined to express a view as to the valuation of the husband's interest, for which it remanded.²⁰⁸⁷

Finally, the Sixth Circuit addressed a situation like Craft but deciding the valuation issue for tenancies by the entirety in Michigan.²⁰⁸⁸ The husband had a separate property income tax debt for which the wife was not liable. They owned property as tenants by the entirety. Under Michigan law, each had a right of survivorship and a right to refuse to sell the property but, in a divorce situation, the interests of each spouse would be valued at ½ the value of the property. The issue in contention was not whether the Government could force a sale, but whether the wife's interest was greater than one-half. Reasoning that each had an equal and identical interest in the property, their interests must necessarily be equal in value, so that ½ of the whole sales value is the amount the

²⁰⁸⁷ For discussion of some valuation issues raised by Craft, see Steve R. Johnson, After Craft: Implementation Issues, 96 Tax Notes 553 (7/22/02); for the IRS's position on the application of Craft in various scenarios, see Notice 2003-60, 2003-39 I.R.B. 643.

²⁰⁸⁸ United States v. Barr, 617 F.3d 370 (6th Cir. 2010),

innocent spouse receives. The Court distinguished *Rodgers* because in that case state law conferred a life estate in the surviving spouse, reasoning (such as it is):

This kind of actuarial calculation is not appropriate in the present case. *Rodgers* used actuarial valuation only out of necessity: one cannot determine the value of a life estate – which is effectively what *Rodgers* possessed – without estimating the length of the measuring life. The Supreme Court thus based its choice of valuation method on the fact that "any calculation of the cash value of a homestead interest must of necessity be based on actuarial statistics." *Id.* at 704. No such necessity exists here, and Mrs. Barr presents no compelling reason why this court should not apply the presumption of equal spousal life expectancy implicit in Michigan law.²⁰⁸⁹

Now, consider the following scenarios.

Example 1: The taxpayer is the beneficiary of a trust established by his father. The taxpayer has the right to \$100,000 distribution per year during his life, with remainder to the taxpayer's heirs. The trust has the standard spendthrift clause preventing the beneficiary (taxpayer here) from alienating his interest and declining to recognize such an alienation if the beneficiary attempts to do so. The taxpayer has a federal tax lien of \$1,000,000. Can the IRS go against the property in the trust? Can the IRS go against the taxpayer's interest in the trust (i.e., his right to distribution of \$100,000 per year during his life)? How does the IRS do that?²⁰⁹⁰

Example 2: The taxpayer is the beneficiary of a trust established by his father. The trust agreement charges the trustee to distribute for the taxpayer's needs and welfare up to \$100,000 per year, with remainder to the taxpayer's heirs. The taxpayer has a federal tax lien of \$1,000,000. Can the IRS go against the property in the trust? Can the IRS go against the taxpayer's interest in the trust? In answering that question, you need to focus on what the taxpayer's interest in the trust is. Is the payment of the beneficiary's federal tax debts a valid need for purposes of the trustee making a distribution?

Example 3: The taxpayer in anticipation of the IRS assessing additional tax but before it does so creates a trust naming his wife as trustee and himself as the lifetime beneficiary with distributions, in the discretion of the trustee, for his needs and welfare. Can the IRS go against the property in the trust? Can the IRS go against the trust interest? What is the trust interest?

²⁰⁸⁹ The dissent forcefully attacks the reasoning, such as it is. The dissent would, I think, have given her substantially the same relief as the innocent spouse in *Rodgers*.

²⁰⁹⁰ In *Orr v. Commissioner*, 180 F.3d 656 (5th Cir. 1999), cert. denied, 529 U.S. 1099 (2000), the court held that the federal tax lien attached to the equitable interest of a beneficiary entitled to all of the net income of a trust despite the presence of a spendthrift trust provision, thus entitling the IRS to levy on future net income distributions despite the taxpayer's discharge of personal liability in bankruptcy.

X. Priority of Tax Liens.

Like other creditor liens, the § 6321 tax lien is designed to give the IRS as lienholder priority rights over the claims of some persons who, after creation of the lien, obtain an interest in property subject to the lien. Remember that the original § 6321 tax lien -- the unfiled lien -- is a silent one. Only the IRS knows about it originally and then, presumably, the taxpayer knows about it when he receives notice and demand for payment and does not pay. But third parties dealing with the taxpayer usually will not know about the lien.

This creates a problem that is not unique to the tax laws. When should third parties obtaining an interest in property subject to a pre-existing claim (such as a lien) be primed by (or subordinated to) that pre-existing claim? Anglo-Saxon jurisprudence has developed the concept of the bona fide purchaser (“BFP”) who may prime – stand ahead of – a pre-existing lien or other interest in property. A more elaborate, if somewhat redundant, statement of the BFP concept is that the subsequent acquirer of an interest must be a bona fide purchaser for value without notice of the prior claim. Notice may be actual notice or a deemed notice via filing in a local filing office. (Note that I am now summarizing our general concepts of notice; the Code does provide some counterintuitive divergences.) Section 6323 tells us when a third party may acquire an interest that primes the federal tax lien.

The tax rules may be summarized as follows:

First, the general tax lien arising upon assessment under § 6321 gives the IRS an interest prior to interests acquired after the lien comes into effect, except where the Code gives preference to such subsequently acquired interests. Section 6323(a) provides that the general tax lien under § 6321, before a public notice of federal tax lien is filed, is not valid against four preferred categories of creditors before the tax lien is publicly filed. These categories of creditors, sometimes called the “four horsemen,” are “(1) purchasers of the property for “adequate and full consideration”²⁰⁹¹ perfected under state law,²⁰⁹² (2) holders of security interests in the property acquired for value

²⁰⁹¹ “Adequate and full consideration” means a real relationship to true value – “the consideration and the property value in this equation [must] be relatively close.” United States v. McCombs, 928 F. Supp. 261, 268 (W.D.N.Y. 1995).

²⁰⁹² The Code says even a purchaser for adequate and full consideration must have an interest “which is **valid under local law** against subsequent purchasers without actual notice.” § 6323(h)(6) (emphasis supplied). So local law is a critical factor and the key determinant is when the purchaser gets priority against subsequent purchasers. For example, a purchaser has no priority over the IRS under the following facts: (i) the IRS assesses the tax, thus creating the quiet lien, (ii) the purchaser buys the real property for adequate and full consideration, (iii) the purchaser carries in filing the deed, (iv) the IRS files its tax lien, and (iv) the purchaser then files his deed. If the purported purchaser is not protected under local law against subsequent purchasers until the purported purchaser **files** his deed, then the IRS’s intervening filing of the tax deed will prime event that purchaser. See Moco Investments Inc. v. United States, 2010 U.S. App. LEXIS 1687 (3d Cir. 2009) (Not Precedential).

perfected under state law at the time the tax lien was filed,²⁰⁹³ (3) holders of judgment liens perfected against the property, and (4) holders of perfected mechanic's liens."²⁰⁹⁴ The priority granted such subsequent acquirer over the general tax lien applies even if the acquirer has actual notice of the unfiled general tax lien. This may be a divergence from general state law that might not accord priority to a third party claimant whose claim arose when he or she had actual notice. I want you to trace through the statutory language that justifies the foregoing conclusion that, for example, the purchaser for full and adequate consideration primes the seller's federal tax lien even if the purchaser is aware of the tax lien. Of course, persons who acquire without paying value (such as donees) stand behind the unfiled federal tax lien whether or not they knew of the tax lien.

Second, after the filing of the tax lien, the acquirer is generally charged with notice that he could have received by checking the appropriate records and therefore generally will have his interest subordinated to the filed lien of the IRS. There is a bit of an anomaly here. The IRS primes an acquirer for value on the basis of the constructive knowledge of the filed tax lien (whether or not

²⁰⁹³ See Equity Investment Partners LP v. Lenz, 594 F.3d 1339 (11th Cir. 2010) for a good discussion of the perfected lien requirement with the fight there being whether a mortgage lien acquired before the tax lien could take priority when the perfected mortgage lien was obtained to perfect a loan made well in advance of the signing of the mortgage. The Court said pungently that the mortgage owner (p. 1345):

need not show that the parties contemplated future execution of a security agreement at the time the loans were issued. Rather, to show past consideration, Equity must present evidence that the security agreement was executed for the purpose of repaying the loans.

²⁰⁹⁴ T. Keith Fogg, National Tax Lien Registry, 120 Tax Notes 783 (Aug. 25, 2008). A trap for the unwary judgment creditor is discussed Collier v. United States, 432 F.3d 300 (4th Cir. 2005). The majority and minority decision discuss some fine points of the English language as reflected in the Reg. § 301.6323(h)-1(g) which defines judgment lien creditors as "a person who has obtained a valid judgment, in a court of record and of competent jurisdiction, for the recovery of specifically designated property or for a certain sum of money," and who "has perfected a lien under the judgment on the property involved." Bottom line, the IRS lien in that case was filed after the foreign judgment was domesticated under state law but before the judgment lien was recorded. The state law generally gave the judgment lien priority from the date the judgment was obtained, but there was one class of creditors as to whom it did not give priority. The Court read the regulations as requiring that the IRS lien primes the state judgment lien. The dissent starts its analysis pungently:

I have no idea what the Treasury Department intended when it promulgated the regulation that is before us today. However, whatever its intent, I suspect the Department drafted the regulation against a background belief that state recordation laws do not generally distinguish among third-party creditors. But whether or not this was its belief, I am confident as to the most defensible reading of the language that the Department chose to effectuate whatever its intent was (and, incidentally or not, that reading is consistent with what I suspect was the Department's background belief).

the acquirer had actual knowledge), whereas, before filing, an acquirer may prime the IRS even though he had actual knowledge of the unfiled tax lien.

Third, even as to filed liens which can prime even acquirers for value, Congress legislated a number of exceptions in order to permit our economy to function. For example, purchasers of securities on stock exchanges do not check the filing records (even if they could identify the seller) and it would be an unacceptable burden on commerce to expect them to do so or to subject securities transactions to this risk. Accordingly, there is an exception.²⁰⁹⁵ Another exception: purchasers of retail goods do not have to check the records to insure that there is not a filed tax lien that might prime their interest in the property. See § 6323(b) for a laundry list of other exceptions.²⁰⁹⁶ These exceptions to the priority of the filed federal tax lien are often referred to as “superpriorities.” If you will consider the nature of the exception I hope you can conceptualize commercial reasons why Congress would subordinate the tax lien to third parties in such circumstances.

If the IRS believes that it has the right to collect a tax beyond the normal 10 year period from assessment, the IRS is required to re-file the notice of tax lien in order to secure its priorities. If the notice of tax lien is refiled after the 10 year period, there could be a gap in the priority offered by the lien unless the re-filing occurs within a one year period ending 30 days after the end of the 10-year period.²⁰⁹⁷ The bottom line is that creditors given priority as noted can treat a failure to refile plus the lapse of 10 years and 30 days from the assessment as offering them priority, even though the original tax lien is still on file. And, if the tax lien is refiled after that date, the re-filing will be prospective only (assuming the underlying general lien is still valid), so that creditors achieving their position between the date 10 years and 30 days after the original assessment and the date of the re-filing will be protected. Of course, the IRS will refile in any case only where something has caused the collection statute of limitations to extend beyond 10 years.

Finally, there may be special situations where, even if the IRS were entitled to priority under the foregoing rules, it might not exercise its priority rights when statutory liens are not involved. For example, a Tax Division Directive states certain instances where it “will recognize the priority of the claim of the investor or victim.”²⁰⁹⁸ The Directive is based on equitable principles, noting that courts may tend to favor the investor or victim if litigated, so the Tax Division will “endeavor to reach reasonable settlement in these cases, rather than presenting unsympathetic claims to the court.” Where statutory liens are involved, including liens for restitution, the Tax Division recognizes the general rule, consistent with the above priorities, that first in time is first in right.”

²⁰⁹⁵ § 6323(b)(1).

²⁰⁹⁶ One lawyer who particularly loves an exception for an attorney’s lien on proceeds recovered in settlement of a cause of action “to the extent of his reasonable compensation for obtaining such judgment or procuring such settlement.” § 6323(b)(8). See Keith Fogg, [How the Federal Tax Lien Prefers Lawyers over Doctors](#) (Procedurally Taxing Blog 3/6/14).

²⁰⁹⁷ § 6323(g)(3).

²⁰⁹⁸ [Undated Tax Division Memorandum titled “Tax Claims Against Embezzlers, Swindlers, Etc. v. Recovery By Investors, Dupes and Victims.”](#)

XI. Third Party Claimant Sales and IRS Right of Redemption.

Third parties having a claim to property may conduct judicial and nonjudicial sales of the property to protect their claims. If the IRS has filed its tax lien, the IRS should be given notice of the sale and given an opportunity to protect its interest according to the priorities set forth above.²⁰⁹⁹ Failure to give the notice will mean that the lien will continue despite the sale.²¹⁰⁰ If the IRS has a filed tax lien and either (i) the property is sold at such a proceeding to satisfy a claim prior to the IRS or (ii) the IRS was not given proper notice, the IRS has the right to redeem the property for up to 120 days for the amount paid by the purchaser,²¹⁰¹ plus interest since the date of payment, and plus the purchaser's expenses (net of income) from the property.²¹⁰²

XII. Alternatives to Immediate Full Payment.

A. Introduction.

If the taxpayer does not have the type of assets that will permit immediate payment or there is some other hardship factor, the IRS has several alternatives. I shall discuss these alternatives below, but the key issue in collection is what the taxpayer can afford to pay toward the debt due and owing to the Government for taxes (including interest and penalties).

The IRS usually determines the availability of alternatives to prompt full payment on the basis of information developed by using special forms -- **Forms 433-A (Collection Information Statement for Wage Earners and Self-Employed Individuals) and 433-B (Collection Information Statement for Businesses)**. These forms are combined financial statements showing assets, liabilities, income, expense, cash flow, etc. The forms show what assets the taxpayer has and how the IRS can get to them if it has to and attempt to project by the income and cash flow statements how much the taxpayer can pay over time on the liability. The IRS will ask the taxpayer to fill out the forms. If the taxpayer refuses to do so, the IRS may issue a summons to the taxpayer or third parties to develop the information that should be included on the forms.

The IRS will evaluate the information. If the forms indicate that the taxpayer has assets from which full payment can be made, the IRS will require the taxpayer to pay. If some of the taxpayer's assets are not liquid, the IRS will attempt to negotiate a plan whereby the taxpayer will take steps to turn the assets to cash on a reasonable time frame. Where the taxpayer cannot make full payment

²⁰⁹⁹ § 7425(b).

²¹⁰⁰ § 7425(b) & (c).

²¹⁰¹ If the purchaser was the creditor foreclosing on the property, then some states permit the debtor to have credit against the debt in the amount of the fair market value of the property foreclosed when the purchaser bids less than fair market value. In that circumstance, the creditor-purchaser is deemed to have paid the amount of the credit that the debtor is entitled to. This assures that, based on state law, the creditor's priority position is protected vis-a-vis the IRS.

²¹⁰² § 7425(d) and 28 U.S.C. § 2410(d).

from his then assets, the IRS must then carefully assess the information to determine when, if ever, the taxpayer can do so.

B. Currently Not Collectible or Collection Suspende.

If the information indicates that the taxpayer is currently unable to make any payments, the IRS can suspend collection activity if there are no reasonable immediate prospects for collection. IRS Policy Statement P-5-71 provides that collection may be suspended if, after taking “all steps in the collection process,” the account is “not collectible,” which includes when the taxpayer has no assets subject to levy or when the taxpayer has limited assets or income and collection would create a hardship (inability to meet current living expenses).²¹⁰³

Suspension or currently not collectible does not mean that the debt is forgiven. Rather, the IRS will pick up the case again at some future time to reassess whether the taxpayer can then make any meaningful payments toward the tax liability.

C. Installment Agreements.

1. Introduction.

In the real world, when debtors can't pay their creditors, debtors and creditors often enter installment payment agreements to work through the problem or forgive all or a portion of the debt, or do a combination of the foregoing. As a creditor, the IRS will also work with taxpayers in appropriate cases via installment payment agreements pursuant to which some or all of the taxes, penalties and interest are pad. The key difference between the IRS and ordinary creditors is that the IRS has a panoply of remedies unavailable to ordinary creditors and, as noted above, can reach assets (such as residence or retirement plan) that state law may make unreachable to ordinary creditors.

The IRS has several levels of agreement programs;²¹⁰⁴ I will discuss each – starting with the most basic. Before doing so, however, we note that the various installment agreements have certain common attributes. They are:

First, most of the installment agreements do not have to provide for full amount of accrued taxes, penalties and interest.²¹⁰⁵ Hence, the installment agreement may have some of the attributes

²¹⁰³ IRM 1.2.14.1.14 (11-19-1980), Policy Statement 5-71.

²¹⁰⁴ See IRS web paged titled “[Payment Plans, Installment Agreements](#)” (Page Last Reviewed or Updated: 26-May-2015).

²¹⁰⁵ Congress amended § 6159(a) in the 2004 Jobs Creation Act to permit installment agreements that do not necessarily provide for full payment. In the past, the IRS had read the Code as permitting installment agreements only where full payment was contemplated. Thus, for example, if the taxpayer owes \$1,000,000 in tax and his current and projected economic circumstances permit only a payment of \$1,000 per month, that taxpayer not pay off the tax liability

of an offer in compromise where it is expected that the statute of limitations on further collection will expire before full payment. This is referred to as a Partial Pay Installment Agreement (“PPIA”).

Second, the penalty for failure to pay under § 6651 (beginning on p. 357) is reduced to .2 % per month (rather than the general rate of .5% per month) during the period that an installment agreement is outstanding.²¹⁰⁶

Third, the IRS is authorized to collect a small fee on entering the agreement and for modifying the agreement if that becomes necessary. The fee for agreements or modifications after 2006 is \$105 and \$45, respectively.²¹⁰⁷

Fourth, during the period that an installment agreement request is pending, the IRS may not levy on the taxpayer’s property.²¹⁰⁸

Fifth, before applying for an installment agreement, the taxpayer must file all required tax returns.

2. Statutory or Guaranteed Agreements.

The Code requires the IRS to enter an installment agreement (i.e., the IRS cannot deny it) if the following conditions are met: (a) the tax liability does not exceed \$10,000 (excluding penalties and interest); (b) within the prior 5 years, the taxpayer has not failed to file, failed to pay or entered an installment agreement; (c) if the IRS requests financial statements, the IRS determines that the taxpayer is unable to pay in full; (d) the agreement is to pay in full in three years; and (e) the taxpayer agrees to comply with the tax laws and the agreement during the term of the agreement.²¹⁰⁹

The taxpayer does not have to complete the Collection Information Statement, which is the Form 433-A for individuals and the 433-B for businesses. For this reason, it may well be that some taxpayers who could fully pay the liability can obtain an installment payout.

(with accruing interest) even in 10 years. Previously, that taxpayer not able or expected to be able to pay the full amount could get relief only by an offer in compromise, but now some type of deferred payment having the practical effect of an offer in compromise is permissible. However, since in a deferred payout the IRS is not committed to collecting less than the full amount, the IRS is required to review the agreement and update the economic assumptions once every two years. § 6159(d). Assuming there is no material improvement in the taxpayer’s economic circumstances, the statute of limitations on collection will eventually wipe out the remaining unpaid liability.

²¹⁰⁶ § 6651(h).

²¹⁰⁷ 26 C.F.R. Part 300, ¶¶ 3.(b) and 4.(b).

²¹⁰⁸ § 6331(k)(2).

²¹⁰⁹ § 6159(c). See also IRM 5.14.5.3 (05-23-2014), Guaranteed Installment Agreements.

The IRM says that taxpayers qualifying for this type of agreement will also generally qualify for the Streamlined Agreement, to which we now turn.

3. Streamlined Agreements.

The IRS allows so-called “Streamlined Installment Agreements” where the total liability (taxes, penalties and interest) is less than \$50,000.²¹¹⁰ Financial statements are not required.²¹¹¹ The taxpayer agrees to fully pay in 72 months. The minimum acceptable payment is \$25 or the amount due (taxes, penalties and interest) divided by 72, provided it will fully pay the balance within the collection statute of limitations.²¹¹² If the taxpayer has the financial ability, he should pay in a lesser period, but taxpayers can qualify for streamlined installments even if they are able to fully pay.²¹¹³ So long as the taxpayer meets his or her obligations under the agreement, the IRS will not file liens or take other collection action. The taxpayer is required to pay a small fee.²¹¹⁴

This is an IRS initiated program and the contours of it can change without legislation. You should review the IRM as to the precise details of the program at any time.

4. Online Payment Agreements.

The IRS also has a type of streamlined payment agreement that can be obtained via an online application.²¹¹⁵ This program is available for individuals owing \$50,000 or less in combined taxes, penalties and interest and for businesses owing \$50,000 or less in combined taxes, penalties and interest. The program is for short-term extensions of payment in full and basic monthly payment plans. The financial information required is limited. The answer is given immediately.

5. Negotiated Agreements.

The IRS can enter installment agreements with the taxpayer as to other liabilities that do not fit the foregoing program.²¹¹⁶ Generally, other than noted above, the taxpayer has no right to an installment agreement and has to negotiate one with the IRS based on the facts and circumstances, including his current financial condition and future prospects. These agreements are referred to as negotiated agreements.

²¹¹⁰ See IRM 5.14.5.2 (05-23-2014), Streamlined Installment Agreements.

²¹¹¹ IRM 4.20.4.3 (02-26-2013), Streamlined Installment Agreements.

²¹¹² IRM 4.20.4.3 (02-26-2013).

²¹¹³ Id.

²¹¹⁴ Id.

²¹¹⁵ <http://www.irs.gov/Individuals/Online-Payment-Agreement-Application>

²¹¹⁶ § 6159. The installment agreement request is made on Form 9465. The installment agreement itself is on Form 433-D.

In negotiating the installment agreement, the IRS will start with the collection information statements (Form 433-A in the case of individuals). The drill is to give the taxpayer a minimum fair living amount, subtract that from income and require him to pay the bulk of the balance in installments. In allowing living expenses, the IRS Revenue Officer will generally be constrained by certain national and local standards for reasonable amounts of living expenses (food, housing, entertainment, etc.), although special circumstances (such as unique medical needs) may cause the IRS to deviate from those standards. Keep in mind that, ultimately, it is a negotiation process. If you are greedy as to the amounts, the IRS will tune you out. Make your case and you may be heard – by the Revenue Officer, his or her manager, or ultimately an Appeals Officer if it goes that far.

The negotiated installment agreement makes assumptions as to the taxpayer's cash flow over the period of the agreement. If there are material changes in the assumptions, the taxpayer should notify the IRS to make such adjustments as may be appropriate. The taxpayer (or taxpayer representative) and the Revenue Officer will negotiate regarding the amount the taxpayer needs to retain to live, based upon the standards and considerations noted above.

Negotiating how much the taxpayer can afford to pay in monthly installments is a real art form, even though the collection officer is generally constrained by the IRS's allowable expense rules. Still, if the taxpayer can show persuasive needs for assets and net cash flow, the IRS may well let him keep all or some material part of it. It is all a matter of negotiating to convince the IRS that (1) it would be inequitable to grab the asset now (e.g., force the taxpayer out of a homestead) or (2) the IRS has a good chance of being better off if the taxpayer is allowed to retain more of the assets or cash flow than the national standards would otherwise indicate (e.g., allow the taxpayer to retain valuable business assets if they appear to offer an opportunity for the taxpayer to earn money to pay the tax liability).

D. Offers in Compromise (“OICs”).

1. Concept and Goals of the Program.

The IRS is authorized to compromise tax liability. § 7122(a). Pursuant to this authority, the IRS has an Offer-in-Compromise” (“OIC”) program to settle tax liabilities. The IRS's policy goal for the program is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the government while providing taxpayers with a fresh start toward future voluntary compliance.²¹¹⁷ The IRS's acceptance of an offer in compromise conclusively settles the liability, absent fraud or mutual mistake.²¹¹⁸

The offer in compromise is submitted by Form 656, Offer in Compromise. The Offer in Compromise is often accompanied by a remittance that can be applied to the offer if it is accepted;

²¹¹⁷ Policy Statement P-5-100 (11/15/04). See also statement of objectives, IRM 5.8.1.1.4 (09-23-2008), Objectives.

²¹¹⁸ Estate of Jones v. Commissioner, 795 F.2d 566, 574 (6th Cir. 1986); Timms v. United States, 678 F.2d 831, 833 (9th Cir. 1982); sec. 301.7122- 1T(d)(5), Temporary Proced. & Admin. Regs, supra; and Dutton v. Commissioner, 122 T.C. 133 (2004).

that remittance is held as a deposit for payment applied to the offer if accepted and refund to the taxpayer if not accept.²¹¹⁹

2. OIC as Contract; Acceptance.

The offer in compromise is a contract between the IRS and the taxpayer. Hence, the scope of the compromise is determined under contract law principles.²¹²⁰

Normally, an offer is accepted by IRS written acceptance but applying general contract principles there might be an acceptance in some other manner so long as some writing is involved.²¹²¹

3. Bases for Compromise.

a. General.

OICs may be accepted only if there is doubt as to collectibility²¹²² or doubt as to liability,²¹²³ or sometimes a combination of both.²¹²⁴ In addition, the IRS provides for compromise when neither of the foregoing grounds are present but compromise is otherwise appropriate for effective tax administration.²¹²⁵ I discuss each of these bases for compromise separately.

b. Doubt as to Collectibility.

The general rule is that the payment contemplated via a doubt as to collectibility offer “must equal or exceed a taxpayer's reasonable collection potential in order to be considered for acceptance.”²¹²⁶ The IRS is required to publish national and local standards for determining basic

²¹¹⁹ § 7809(b)(1) and flush language at the end; see also Regs § 301.7122-1(h).

²¹²⁰ United States v. Begner, 428 F.3d 998, 1004 (11th Cir. 2005); United States v. Donovan, 348 F.3d 509 (6th Cir. 2003); Dutton v. Commissioner, 122 T.C. 133 (2004).

²¹²¹ The principal way a compromise is accepted without the formal document signed by the parties is a submitted offer that has not been acted upon within 24 months. § 7122(f); see [Keith Fogg, Aging Offers in Compromise into Acceptance \(Procedurally Taxing Blog 6/26/15\)](#) (noting importance of calendaring the two year period upon submitting an offer).

²¹²² Regs. § 301.7122-1(b)(1).

²¹²³ Regs. § 301.7122-1(b)(2).

²¹²⁴ IRM 5.8.1.1.2 (02-26-2013), Authority.

²¹²⁵ Regs. § 301.7122-1(b)(3). See also H.R. Conf. Rep. No. 105-599, 105th Cong., 2d Sess., 289 (1998) approving consideration of factors other than doubt as to collectibility or liability.

²¹²⁶ IRM 5.8.1.1.3 (02-26-2013), Policy.

living expenses that should be allowed in determining reasonable collection potential.²¹²⁷ These are, however, just guides and may be departed from if the facts and circumstances warrant.

c. Doubt as to Liability.

OICs may also be made for doubt as to liability. Usually, if the taxpayer has a good defense as to his or her liability, the taxpayer will have had an opportunity to present that defense before the IRS makes the assessment. We covered above the system whereby, through the requirement for a notice of deficiency, the taxpayer may contest liability in the Tax Court. The taxpayer also could have judicially contested liability in a refund, in a collection suit or in a CDP proceeding (discussed below). Once the liability is judicially contested, the IRS will not consider offers in compromise based upon doubt as to liability.²¹²⁸

Administratively, also, the taxpayer will have had some procedural avenues, including invoking Appeals Office consideration or audit reconsideration, to contest liability. Nevertheless, there are many taxpayers who have not had effective judicial reviews of their liabilities for the assessed taxes.²¹²⁹ They may not owe the taxes. Those taxpayers can use OICs to contest their liability for the underlying taxes.

Sometimes the taxpayer will make an OIC based upon a combination of doubt as to collectibility and doubt as to liability. The IRS will process the OIC first on doubt as to collectibility, because if the offer is acceptable on that basis, the issue of liability is moot.

d. Special Circumstances - Effective Tax Administration.

By regulation, the IRS is now authorized to compromise in order to promote effective tax administration.²¹³⁰ In the absence of doubt as to collectibility or liability, the IRS may settle (1) where collection of the full tax liability would create economic hardship, or (2) regardless of the taxpayer's financial condition, exceptional circumstances of compelling public policy or equity considerations exist such that collection of the full liability would be detrimental to voluntary compliance by taxpayers.²¹³¹ This is not a panacea for taxpayers, however, because the

²¹²⁷ § 7122(c).

²¹²⁸ Regs. § 301.7122-1(b)(1).

²¹²⁹ For example, I have used the OIC process based on doubt as to liability for so-called assessable penalties – penalties that may be assessed without any predicate notice of deficiency. That gambit worked even in a case where the taxpayer had full ability to pay the assessed penalty and sue for refund.

²¹³⁰ Regs. § 301.7122-1(b)(3).

²¹³¹ Regs. § 301.7122-1(b)(3)(i) & (ii); see IRM 5.8.11.; see also H.R. Conf. Rep. No. 105-599, 105th Cong., 2d Sess., 289 (1998).

circumstances would be rare that a taxpayer clearly owed the tax and could pay it, but some equitable factors would justify the IRS foregoing collection.²¹³²

4. Independent Review.

The IRS must provide for independent administrative review of a proposed rejection of the OIC and an appeal to the IRS's Appeals Office.²¹³³ The IRS may thus not reject an OIC until this independent administrative review has occurred.²¹³⁴ Then, if the IRS rejects the offer, the taxpayer may appeal to the Appeals Office.²¹³⁵

5. Administrative Procedures.

Section 7122(c) provides that the IRS “shall prescribe guidelines for officers and employees of the [IRS] to determine whether an offer-in-compromise is adequate and should be accepted to resolve a dispute.” The procedures require that that OIC not be for the purpose of delay and be otherwise processible (such as being on the required form with a good faith effort to complete and provide the information requested).²¹³⁶ An important requirement for business taxpayer is that employment tax return filing and payment obligations be met for two quarters prior to the submission of the OIC.²¹³⁷

6. IRS Counsel Review.

An opinion of IRS counsel is required in all cases where the unpaid tax (including interest, penalties and additions) is \$50,000 or more.²¹³⁸ The Counsel review consists of both legal and policy review. Counsel's review is, however, not a veto power, although few revenue offers would settle in the face of a negative Counsel review.

²¹³² See David M. Fogel, ‘The Effective Tax Administration’ Offer in Compromise, 2005 TNT 163-34 (8/24/05) (reporting inter alia that less than 1% of total offers accepted are based on this effective tax administration relief provision). See for an extreme example, Keller v. Commissioner, 568 F.3d 710 (9th Cir. 2009) (involving a number of partners in the Hoyt tax shelter cattle partnerships where Hoyt allegedly defrauded the investors; held, IRS determination of no relief sustained even though the taxpayers were victim of Hoyt's fraud and it took the IRS a long time to untangle the web of partnerships and process the audit and resulting litigation (20 years)).

²¹³³ § 7122(e).

²¹³⁴ Regs. § 301.7122-1(f)(2).

²¹³⁵ Regs. § 301.7122-1(f)(5).

²¹³⁶ Regs. § 301.7122-1(d)(2).

²¹³⁷ See Christopher Cross, Inc. v. United States, 461 F.3d 610 (5th Cir. 2006) (applying this requirement).

²¹³⁸ § 7122(b).

7. Collateral Agreements.

The IRS may condition acceptance of an OIC on a collateral agreement.²¹³⁹ For example, if a taxpayer has a potential to significantly increase his or her income over a relatively short period of time, the IRS may require that the taxpayer agree to pay over a certain percentage of future income in excess of a negotiated amount.²¹⁴⁰ Let's illustrate this with an example that some lawyers would care about: if the taxpayer were a lawyer having a major case on a contingency fee, the IRS might require that, if the case resolves within a certain number of years (e.g., 5 years), the IRS would get 25% or 50% of the amount in excess of say \$100,000.²¹⁴¹ The precise terms that such a collateral agreement would depend upon the unique facts.

8. Litigation Regarding OICs.

a. Compliance with Accepted OICs.

I noted above that OICs are contracts. This raises an issue of the nature of the judicial remedy, if any, for a dispute between the taxpayer and the IRS as to compliance with an OIC. Traditional analysis would suggest that, since the taxpayer's claim of compliance is a contract claim, the taxpayer must pursue that claim just as any other contractual claim against the United States. Under the Tucker Act,²¹⁴² contractual claims in excess of \$10,000 must be brought in the Court of Federal Claims. The Government's position is that such claims must be brought under the Tucker Act. However, a court of appeals held that, where, pursuant to the disputed interpretation, the taxpayer paid the additional amount claimed by the IRS, the taxpayer could pursue a refund remedy because, even though the dispute arose over a contract, the amount paid was still a tax and, given the broad reading of the refund remedy in United States v. Williams, 514 U.S. 527, 529 (1995) (discussed below), the amount could be viewed as a tax "erroneously * * * collected."²¹⁴³ For those seeking a judicial remedy, I would think that the better part of wisdom except perhaps in that circuit

²¹³⁹ Regs. § 301.7122-1(e)(2).

²¹⁴⁰ IRM 5.8.5.21 (09-30-2013), Future Income Collateral Agreements.

²¹⁴¹ For a case concerning the application of such a collateral agreement, see Begner v. United States, 428 F.3d 998 (11th Cir. 2005).

²¹⁴² 28 U.S.C. § 1491(a)(1) which is referred to as the Tucker Act. The Tucker Act grants jurisdiction to the Court of Federal Claims, but some other act must grant the necessary waiver of sovereign immunity. As the Court noted in Begner v. United States, 428 F.3d 998 (11th Cir. 2005), "The Tucker Act has a sibling, known as the Little Tucker Act, 28 U.S.C. § 1346(a)(2), which 'grants concurrent jurisdiction to both U.S. district courts and the Court of Federal Claims for contractual claims against the United States not exceeding \$10,000.'" The monetary limit on Little Tucker Act jurisdiction in the district courts make them irrelevant to the practice of readers of this text.

²¹⁴³ Begner v. United States, 429 F.3d 998 (11th Cir. 8/12/05).

would be to sue in the Court of Federal Claims, alleging jurisdiction under both the Tucker Act and the refund statute.²¹⁴⁴

b. IRS Rejection of an OIC.

There is no court review of the IRS's rejection of an OIC, except if the OIC is submitted in the CDP process in which case it will be considered in that process.²¹⁴⁵

9. Other Aspects of OICs

Although offers are not a part of my current practice (I refer them out to enrolled agents who regularly process OICs with the IRS), I have heard of some very good deals being struck by taxpayers in the offer in compromise process, so any time there is a tough collections process, it should seriously be considered.

There are some facets of OICs that taxpayers must understand. The statute of limitations on collection is suspended during the period the offer is pending while the IRS is prohibited from making a levy.²¹⁴⁶ In addition, in appropriate cases, the IRS may require the taxpayer to extend the period for assessment.²¹⁴⁷ Upon the IRS's acceptance of the OIC, the taxpayer may not thereafter contest the liability. Should the taxpayer default on his or her obligation under the OIC, the IRS can collect the entire amount that was compromised. The IRS may condition an OIC upon some form of collateral agreement requiring that, for example, if the taxpayer's income exceeds a certain amount within the next, say 2 years, the taxpayer will pay over some percentage of the excess. The OIC requires that the taxpayer comply with all provisions of the Code for 5 years.

²¹⁴⁴ 28 U.S.C. § 1346(a)(1).

²¹⁴⁵ See Keith Fogg, Oversight of Offers – Response to Comment raising Thornberry v. Commissioner (Procedurally Taxing Blog 12/6/13) (offer and denial can be considered in CDP process, but there is no such process for consideration outside the CDP process; moreover, the review is not de novo, but whether the IRS followed a valid rule; “That type of review, however, does not allow the Tax Court to substitute its own judgment regarding the decision to accept or deny an offer except where the IRS has abused discretion in following the guidelines established by the IRS itself.”).

²¹⁴⁶ § 6331(k)(3), referring to the provisions of § 6331(i)(5), except during the period an installment agreement is in effect. Note that, during the period the OIC is pending, the IRS is prohibited from levying. § 6331(k)(1). For a case holding that, pursuant to the terms of the OIC form (Form 656), the offer is pending through the date the IRS acknowledges that the taxpayer has withdrawn the offer (rather than the date of the withdrawal), see United States v. Donovan, 348 F.3d 509 (6th Cir. 2003).

²¹⁴⁷ Regs. § 301.7122-1(i)(2).

The IRS general procedures for offers in Compromise are in a Revenue Procedure²¹⁴⁸ and in the IRM.²¹⁴⁹ The IRS does charge a \$150 fee for processing OICs.²¹⁵⁰

Finally, the public is entitled to review certain information on accepted offers in compromise.²¹⁵¹

E. Audit Reconsideration.

The IRS has an audit reconsideration process for reconsidering the merits of tax deficiency assessments.²¹⁵² Generally, the taxpayer must have filed a return, including a delinquent return in response to a substitute for return. The IRS can consider information that was not previously considered during the original examination.

The IRS is not statutorily required to have this audit reconsideration process. You will recall that we discussed above the fact that, although the IRS is not **required** to consider claims in abatement in taxes subject to the deficiency procedure, it always has the discretionary authority to abate if the assessment exceeds the correct liability.²¹⁵³ The general denial of a claim for abatement for these taxes is designed to channel taxpayers into participation in the audit and appeals process and Tax Court litigation, with refund litigation as the only alternative. Nevertheless, the IRS has this audit reconsideration process based on its discretionary authority in order to provide relief to taxpayers who may have fallen through the cracks on the normal process.

F. Bankruptcy.

1. Introduction.

We discussed above the Bankruptcy Court's role as a determiner of tax disputes on the merits. (pp. 556 ff.) The Bankruptcy Court's principal role in tax disputes, however, is to determine whether tax debts are dischargeable.

The dischargeability rules are complex, so I shall offer some of the more frequently encountered rules and examples, so that you can get a flavor for the dischargeability rules for taxes.

²¹⁴⁸ Rev. Proc. 2003-71, 2003-2 C.B. 517; see IRM 5.8.1.1.5 (09-23-2008) (referring to this Rev. Proc.).

²¹⁴⁹ IRM 5.8 Offer in Compromise.

²¹⁵⁰ IRM 8.23.1.4.1 (10-10-2014), Application Fees, Offer Terms, Payments and Deposits (may waive the \$150 processing fee).

²¹⁵¹ § 6103(k)(1).

²¹⁵² See IRM 4.13., Audit Reconsideration. The information in this section is taken from this IRM provision.

²¹⁵³ IRM 4.13.1.6 (10-01-2006), Authority, citing § 6404(a).

I do caution students to treat this discussion as an introduction to the concepts and not as a definitive guide to the resolution of these problems.

2. The Automatic Stay.

The Bankruptcy Code imposes an automatic stay on certain proceedings by creditors against debtors upon filing the bankruptcy.²¹⁵⁴ For example, it does stay collection IRS actions such levy, and lien.²¹⁵⁵ It does not stay some actions, such as:

- to criminal proceedings;²¹⁵⁶
- to tax audits and related matters, such as the issuance of a notice of deficiency;²¹⁵⁷

3. Determination of Tax Liability.

A bankruptcy court can determine liability, and amount, of a tax unless it has been previously adjudicated.²¹⁵⁸ Even if the liability cannot be discharged, the debtor can request a bankruptcy court to determine the liability without a payment and a predicate filing of a claim for refund.

4. Discharge of Tax Liability.

a. Corporate Taxes.

Income taxes of corporations and some other business entities are not dischargeable.

b. Individual Taxes.

Income taxes of individuals are not discharged for taxes in the following categories:

(i) taxes where the due date for the return is within three years of the date the bankruptcy petition was filed;²¹⁵⁹

²¹⁵⁴ 11 U.S.C. § 362.

²¹⁵⁵ The IRS's right to setoff under § 6402 is apparently not subject to the stay. See 11 U.S.C. §§ 362(b)(26) and 553(a).

²¹⁵⁶ 11 U.S.C. § 362(b)(1).

²¹⁵⁷ 11 U.S.C. § 362(b)(9)

²¹⁵⁸ 11 U.S.C. § 505(b).

²¹⁵⁹ § 523(a)(1), by reference to § 507(a)(8)(A)(i). Note that this exception keys to the due date of the return, including extensions. You will recall that returns on extension that are received by the IRS before the extended due date are filed on that date and not on the extended date for tax purposes, but the wording of the bankruptcy provision apparently keys from the extended due date. For example, assume the taxpayer gets the extension and the IRS receives the year 01 return on 6/1/02. The 3 year tax statute of limitations closes on 6/1/05. However, the bankruptcy provision

(ii) taxes due for a year for which no return was filed;²¹⁶⁰

(iii) taxes for a year for which a “return, or equivalent report or notice” was filed after the due date and within 2 years of the bankruptcy petition date²¹⁶¹ (although this provision might be overridden by the flush language of § 523(a)²¹⁶² which, as some courts (perhaps the trend) read it, denies “return” status and hence discharge to tax reported on a delinquent return **other** than a subscribed § 6020(a) SFR and a written stipulation of tax in a judicial proceeding),²¹⁶³

(iv) taxes (but not penalties) attributable to a fraudulent return or an attempt to evade or defeat the tax,²¹⁶⁴ and

would deny discharge if the taxpayer files for bankruptcy before 10/15/05.

²¹⁶⁰ § 523(a)(1)(B)(i).

²¹⁶¹ § 523(a)(1)(B)(ii).

²¹⁶² This flush language in § 523(a)(3) is often called the “hanging paragraph,” and often referenced as § 523(a)(*).

²¹⁶³ See In re Fahey v. Mass. Dep't of Revenue, 779 F.3d 1 (1st Cir. 2015) discussing the cases and noting that one taxpayer raised the issue that, although not a “return” because of the hanging paragraph, the delinquent return might be an equivalent report or notice under § 523(a)(1)(B)(ii) but had failed to preserve that issue below. *Id.*, p. 4, n3. There is a strong dissent in Fahey that would coordinate the hanging paragraph with the clear intent of § 523(a)(1)(B)(ii) to permit a delinquent return filed before two years of bankruptcy to qualify for discharge.

²¹⁶⁴ § 523(a)(1)(C). If the issue is resolved in a bankruptcy proceeding, the Government apparently has the burden to prove this exception to discharge by a preponderance of the evidence rather than the usual burden of establishing fraud by clear and convincing evidence. See Grogan v. Garner, 498 U.S. 279 (1991); United States v. Storey, 640 F.3d 739, 743-744 (6th Cir. 2011) (although Storey shows how unwilling the court was to find a preponderance). Presumably, that same burden would apply in other proceedings outside bankruptcy where dischargeability is in issue. Cf United States v. Coney, 680 F.3d 365, 368-373 (5th Cir. 2012) (also holding that the exception applies to both attempts to evade payment as well as assessment).

An extravagant or wasteful life-style before assessment that diminishes the taxpayer’s ability to pay the assessment when made may cause this exception to apply. E.g., United States v. Mitchell (In re Mitchell), 633 F.3d 1319, 1329 (11th Cir. Ga. 2011); and In re Bryen, 2011 U.S. App. LEXIS 22349 (3^d Cir. 2011).

See e.g., McKay v. United States, 957 F.2d 689 (9th Cir. 1992) for the point that tax penalties may be discharged even when the tax is not under this exception. FBAR penalties appear not to be dischargeable because they are not tax penalties. See United States v. Simonelli, 614 F. Supp. 2d 241 (D. Conn. 2008). I do note in this regard that the offshore penalties imposed under the offshore bank voluntary disclosure programs may be dischargeable because, while they may be in whole or in part, in lieu of FBAR penalties, they are assessed as miscellaneous penalties under the Internal Revenue Code.

(v) taxes assessed within 240 days of the date of filing the bankruptcy petition, plus any time plus thirty days during which an offer in compromise was made within 240 days after the assessment was pending.²¹⁶⁵

Consider the following examples:

Example 1 (Category (i)). Taxpayer files a return for Year 1 on April 15 of Year 2 reporting a tax liability but not paying it. On April 15 of Year 4, taxpayer files bankruptcy. The tax debt for Year 1 is not discharged. The tax debt would be discharged if the taxpayer holds off the filing of bankruptcy until April 16 of Year 5.

Example 2 (Category (iv)). Taxpayer files a nonfraudulent return for Year 1 reporting substantial tax due but not paying the tax. The taxpayer earns substantial income in later years (years 2 through 6) but (i) keeps his taxes properly reported and paid in those years and (ii) lives extravagantly in those years accumulating no assets. The IRS attempts collection of the Year 1 taxes but is unsuccessful because the taxpayer spent what he made. At the end of Year 6, the taxpayer files bankruptcy and seeks discharge of the Year 1 taxes. The IRS can take and may prevail on the position that the taxpayer's extravagant lifestyle during Years 2 - 6 when the tax was due and owing was an attempt to evade or defeat the tax and thus is nondischargeable.²¹⁶⁶

Example 3 (Category (iii)). Assume that, on April 15 of Year 2, a taxpayer files a return reporting Year 1 income tax of \$100 but does not pay the tax. On April 14 of Year 5, just within the assessment statute of limitations, the IRS sends the taxpayer a notice of deficiency for an additional \$50 tax for Year 1. The taxpayer does not contest the notice, and the deficiency is duly assessed on September 1 of Year 5. The taxpayer files for bankruptcy on December 1 of Year 5. The taxpayer will be relieved of the \$100 tax originally reported and not paid; the taxpayer will not be relieved of the \$50 deficiency tax assessed within the 240 day period before bankruptcy.

Example 4 (Categories (ii) and (iii)). Assume the same facts as Example 3 except that the taxpayer files no return for Year 1, the IRS prepares a substitute for return ("SFR") under § 6020(b) on April 1 of Year 5, sends the taxpayer a notice of deficiency for \$150 tax on April 14 of Year 5, assesses the tax on September 1 of Year 5, and, before paying the tax, the taxpayer files for bankruptcy on April 10 of Year 8. The issue raised by this example addresses the requirements that the taxpayer have filed a return and that a late filed return be filed more than 2 years before the petition date. Is the SFR a return for these purposes? The answer is that it depends. If the SFR is prepared under § 6020(a) which is signed by the taxpayer, the SFR is a return that will permit bankruptcy discharge; if, however, the SFR is prepared under § 6020(b), the SFR is not a return.²¹⁶⁷

²¹⁶⁵ § 523(a)(1), by reference to § 507(a)(8)(A)(ii), (iii).

²¹⁶⁶ See e.g., In Re Fegely, 118 F.3d 979 (3d Cir. 1997).

²¹⁶⁷ See § 523(a) (flush language, added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA")). For cases involving pre-2005 years to similar

For purposes of this rule, even if the procedure the IRS uses appears not to qualify under § 6020(a) because the IRS bases the SFR assessment on information other than that provided by the taxpayer, the SFR may constitute a return if the taxpayer signs a Form 870 or Form 4549 when accompanied by schedules disclosing the data from which the tax was computed.²¹⁶⁸ But, if those special circumstances are not present, the IRS takes the position that the taxes assessed pursuant to the SFR are not dischargeable in bankruptcy because no return was filed.²¹⁶⁹

Example 5 (Category (ii)). Now what if, in the same example, after the IRS sends the § 6020(b) SFR on April 1 of Year 5 following which the assessment is made in Year 5, the taxpayer files a delinquent return on April 1 of Year 6 and then seeks discharge on April 10 of Year 8. In this case, the taxpayer has filed an untimely return and the bankruptcy filing is outside the two year period for delinquent returns. Is the taxpayer discharged? The trend in holdings seems to be that the late filed return will not qualify for discharge unless it is a § 6020(a) return.²¹⁷⁰

Students should also be aware that various events might toll or start new periods provided in Categories (i) through (iii). For example, the time in the bankruptcy proceeding itself tolls the periods and an offer in compromise will toll the 240 day assessment period.

Finally, the discharge does not apply to taxes that are still assessable after the date of discharge.²¹⁷¹ This can be a trap for the unwary for taxes due in prior years where the individual is

effect, see, e.g., Bergstrom v. United States, 949 F.2d 341 (9th Cir. 1991); In re Mathis, 87 AFTR2d Par. 2001-474 (S.D. Fla. 2001); Rev. Rul. 74-203. See also Spurlock v. Commissioner, 118 T.C. 155 (2002), holding that the SFR under § 6020(b) is not a return for purposes of the deficiency definition in § 6211(a). Some of the nuances of the statement in the text and the relationship between the two § 6020 subsections are discussed in Bryan T. Camp, The Never-Ending Battle, 2006 TNT 74-30.

²¹⁶⁸ ILM 200113026, reprinted in 2001 TNT 63-36; see also Bryan T. Camp, The Never-Ending Battle, 2006 TNT 74-30.

²¹⁶⁹ SBSE-05-1010-052, reprinted at 2010 TNT 192-8 (10/1/10).

²¹⁷⁰ As previously noted, the trend in cases seems read the flush language of § 523(a) – the so-called hanging paragraph – to require a timely return except, in the language of the hanging paragraph text, when the tax is pursuant to “a return prepared pursuant to section 6020(a)” or a “written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal.” See In re Fahey v. Mass. Dep’t of Revenue, 779 F.3d 1 (1st Cir. 2015), with a strong dissent that would not read the hanging paragraph to override the clear intent of § 523(a)(1)(B)(ii) to permit discharge for a late filed return filed more than two years before bankruptcy. Assuming a delinquent return can qualify, there is still the issue of whether delinquent filed after a § 6020(b) SFR can qualify as a return to the extent that it just reports tax determined in the § 6020(b) SFR or, alternatively, whether the discharge would be limited to the amount reported on the delinquent return in excess of the amount determined in the § 6020(b) SFR .

²¹⁷¹ United States v. Martinez, 564 F.3d 719 (5th Cir. 2009).

a partner in a TEFRA partnership that has effective consents to extend the statute of limitations well beyond the normal statute of limitations.²¹⁷²

c. Trust Fund Tax and Penalty.

The debtor's trust fund taxes are usually not dischargeable.²¹⁷³ For example, the trust fund recovery penalty (“TFRP”) (often also called the “responsible person” tax penalty) under § 6672 is not dischargeable.²¹⁷⁴ Can you articulate a policy rationale why trust fund taxes generally are not dischargeable and, specifically, why the TFRP penalty is not dischargeable? Please refer to the responsible person penalty materials (pp. 704 ff.).

d. What Must Happen for a Discharge of Federal Tax.

Some debts are discharged automatically in bankruptcy without a specific bankruptcy court determination that the debts are discharged. In those cases, the creditor desiring to collect the debt must request a specific determination of nondischarge. Federal tax debts, however, require a specific bankruptcy court determination that they are discharged and, therefore, in a later proceeding the IRS may assert the tax liability if the bankruptcy court did not determine specifically that they were discharged.²¹⁷⁵

e. Discharge and the Federal Tax Lien.

If taxes are discharged in bankruptcy, what is the effect, if any, of the federal tax lien on the taxpayer's property? The discharge only relieves the taxpayer of in personam personal liability for the tax, so that the lien against the taxpayer's property survives the discharge.²¹⁷⁶ Of course, to the extent that property goes into the bankruptcy estate, the IRS and other creditors may fight out their lien priorities among themselves and the taxpayer has no further interest in the matter. However, various property may be exempt or even excluded from the bankruptcy proceeding and, to the extent thereof, may remain with the taxpayer after the bankruptcy. The Tax Court summarized the law

²¹⁷² See United States v. Martinez, 564 F.3d 719 (5th Cir. 2009).

²¹⁷³ The principal trust fund tax that we deal with in this course of the trust fund taxes that the employer withholds from employee compensation for the employee's income tax and the employee's share of the FICA tax. The trust fund tax concept is broader than that and, thus, denial of dischargeability will apply to other types of tax including state tax that functions like a trust fund tax withheld from others. See In re: Calabrese, 689 F.3d 312, 2012 U.S. App. LEXIS 14897 (3d Cir. 2012) (treating state sales tax withheld from purchasers as a trust fund tax for purposes of denying dischargeability).

²¹⁷⁴ 523(a)(1)(A), referring to § 507(a)(8)(C).

²¹⁷⁵ Swanson v. Commissioner, 121 T.C. 111 (2003).

²¹⁷⁶ Bussell v. Commissioner, 130 T.C. 222, 235 (2008); and Iannone v. Commissioner, 122 T.C. 287, 292-293 (2004).

regarding the IRS's rights to the property remaining with the taxpayer even after his general personal liability has been discharged in bankruptcy:²¹⁷⁷

Title 11 U.S.C. sec. 522 allows a debtor to exempt from his bankruptcy estate a personal residence, a car, certain property used in a trade or business, retirement funds, and certain other assets, to ensure that the debtor has at least some property with which to make a fresh start. Exempt property initially is part of the debtor's bankruptcy estate, but is removed from the bankruptcy estate (and is therefore unavailable to satisfy creditors' claims) for the benefit of the debtor as a result of the debtor's exemption. Property that is exempt from the bankruptcy estate pursuant to 11 U.S.C. sec. 522 is not available to satisfy pre-petition debts during or after the bankruptcy, except debts secured by liens that are not avoided in the bankruptcy and section 6321 liens with respect to which an NFTL [Notice of Federal Tax Lien] has been filed. 11 U.S.C. sec. 522(c).²¹⁷⁸

Unlike exempt property, which is part of a debtor's bankruptcy estate but is unavailable to satisfy creditors' claims, excluded property never becomes part of the bankruptcy estate and is therefore never subject to the bankruptcy trustee's or the debtor's power to avoid the section 6321 lien. Thus, if a section 6321 lien [the secret unfiled lien] on excluded property has not expired or become unenforceable under section 6322, it survives the bankruptcy.

Petitioner was granted a discharge in bankruptcy on December 8, 2005. The discharge included petitioner's 2001 tax liability. On schedule C of his bankruptcy petition, petitioner contended that his pension was excluded from the bankruptcy estate pursuant to 11 U.S.C. sec. 541(c)(2) and Patterson v. Shumate, 504 U.S. 753 (1992). Alternatively petitioner claimed that his pension was exempt property, but only if and to the extent that his pension was includable in the bankruptcy estate. On the basis of the record before us and our review of 11 U.S.C. sec. 541, we conclude that petitioner's pension was properly excludable from his bankruptcy estate under 11 U.S.C. sec. 541(c)(2) and Patterson v. Shumate, supra at 765, and that petitioner excluded the pension from his bankruptcy estate. As a result, the section 6321 lien [the secret unfiled federal tax lien] that attached to the pension before bankruptcy continued to attach to petitioner's interest in his pension even after petitioner's personal liability for his 2001 tax liability was discharged in bankruptcy.

²¹⁷⁷ Wadleigh v. Commissioner, 134 T.C. 280, 292 (2010). In the quoted portion presented in the text, most case citations and the sole footnote appearing in the case itself has been omitted.

²¹⁷⁸ [Not in original case] The survival of the filed tax lien reflects the doctrine of lien pass through announced in Long v. Bullard, 117 U.S. 617 (1886). The filed tax lien survives the bankruptcy. See In re Wrenn, 40 F.3d 1162, 1164 (11th Cir. 1994) (citing Dewsnup v. Timm, 502 U.S. 410, 417-418 (1992)); In re Isom, 901 F.2d 744, 745 (9th Cir. 1990).

In Orr v. Commissioner,²¹⁷⁹ the Court held that the federal tax lien against the taxpayer's beneficial interest in a spendthrift trust created by his grandmother survived the taxpayer's bankruptcy. Under that trust, the taxpayer was entitled to the net trust income after he reached the age of 35. His right, however, was subject to a standard spendthrift provision denying the beneficiary the right to alienate his interest. The taxpayer was discharged from personal liability for past due taxes. In this case, the taxpayer sought to prevent the Government from levying on future income distributions. There was no question that the federal tax lien survived bankruptcy. The issue was whether the taxpayer had pre-bankruptcy property against which the lien could be enforced. Specifically, the issue presented, as formulated by the Court, was whether the taxpayer's equitable right to future income distributions was property within the federal tax lien's broad definition, thus permitting the IRS to levy on the distributions as the taxpayer became entitled to them. Under Texas law, the courts held that ordinary creditors could not use a pre-existing lien to go after post-bankruptcy discharge distributions from a spendthrift trust. But, the court reasoned, the Government is no ordinary creditor and the cases consistently held that the lien was to attached to a taxpayer's property broadly defined, without the limitations and peculiarities of state law. Accordingly, the court held, even though the taxpayer was no longer personally liable for the tax because of the discharge in bankruptcy, the tax lien could permit levies on the future net income distributions as they were made.

5. Priority Rules.

Debtors are vitally interested in the dischargeability rules. Creditors may be interested in the dischargeability rules, but often they perceive the possibility of any material ability to collect nondischargeable debts after bankruptcy as being remote. Creditors are usually much more interested in the priority rules (determining who gets paid from a pot of limited assets).²¹⁸⁰ Debtors and related parties may have some interest in priority, particularly if the pot is allocated to taxes that might otherwise not be dischargeable or, like the responsible person penalty, might be asserted against related parties.

6. Miscellaneous.

In addition to discharge and priority rules that can vitally affect the parties interested in the bankrupt estate, there are significant tax issues lurking in the bankrupt estate and these may affect the debtor. For example, the ability of a debtor to allocate payments required under a Chapter 11 or Chapter 13 plan can significantly affect the debtor. Under its broad discretion to promote the effectiveness of plans approved in bankruptcy, bankruptcy courts have some discretion to permit the debtor to allocate such payments in a debtor tax efficient way.²¹⁸¹

²¹⁷⁹ 180 F.3d 656 (5th Cir. 1999), cert. denied, 529 U.S. 1099 (2000).

²¹⁸⁰ The priority rules relevant to taxes are in § 507. Generally, the taxes which are dischargeable are given priority, although not the highest level of priority.

²¹⁸¹ United States v. Energy Resources Co., Inc., 495 U.S. 545 (1990) (chapter 11); and In re Fielding, 2014 Bankr. LEXIS 5201 (Bankr. N.D. Tex. 2014) (chapter 13).

XIII. Protection from Collection Abuses -- Appeals and Judicial Remedies.

A. Introduction.

The IRS has great powers. The IRS can file federal tax liens that have the practical effect of preventing a taxpayer from dealing with much of his property, except those lucky enough to be able to sell under the superpriority provisions of § 6323. Even more intrusively, the IRS can levy upon taxpayer's property and can garnish wages without judicial intervention in most cases. We have studied the prohibitions against injunctions (§ 7421(a) and ***Enochs v. Williams Packing***), and so there have been historically little effective and consistent judicial checks on these broad powers.

In this section of the chapter, I present procedures designed to mitigate the abuse of those powers.

B. Collection Appeals Program (“CAP”).

The IRS provides internal appeals from IRS Collection actions -- a Notice of Federal Tax Lien (“NFTL”), levy, seizure, or denial or termination of an installment agreement under these procedures. The appeal is taken under the

IRS Collection Appeals Program (“CAP”).²¹⁸² The IRS administratively requires first that the taxpayer request a conference with the Collection Manager.²¹⁸³ If the taxpayer does not get the conference upon request or disagrees with the results of the conference, the taxpayer may appeal to the Appeals Office.²¹⁸⁴

IRS Appeals Officers are generally expected to hold a conference with the taxpayer within 2 business days of receiving the appeal and to close the case within 5 business days.²¹⁸⁵ The IRS explains this short time frame as required “to give taxpayers an almost immediate decision on liens, levies, seizures, and rejection or termination of installment agreements” and to discourage taxpayers from appeals “solely to delay collection.”²¹⁸⁶

The key difference between the CAP and the CDP (discussed immediately below) is that a CAP appeal does not allow further appeal to a court from denial of the appeal, whereas the CDP appeal does allow court review.²¹⁸⁷ Furthermore CAP is available in more situations than CDP which is limited by statute.

C. Collection Due Process (“CDP”).

1. Introduction.

In 1998, Congress enacted certain collection due process rights to address perceived abuses in the IRS collection system as then implemented. The rights consist of administrative rights, principally an appeal to the IRS Appeals Office, and judicial rights in the Tax Court if the

²¹⁸² IRM 8.24.1 Collection Appeals Program (CAP). The IRS explains the collection appeals rights, including CAP, in IRS [publication 1660](#), titled Collection Appeals Rights. The publication addresses both CAP and CDP (discussed below). In Tucker v. Commissioner, 135 T.C. 114, 137 (2010), the Tax Court described the process (citations and quotation marks omitted for readability):

CAP is an administrative review program not required by statute. In 1996 the IRS created CAP to provide taxpayers with the right to appeal lien, levy, and seizure actions. In 1997 CAP was expanded to implement the Taxpayer Bill of Rights 2 in order to provide taxpayers with the right to appeal the proposed termination of installment agreements. Although Congress did not codify CAP, the legislative history of the RRA [IRS Restructuring and Reform Act of 1998] shows that Congress was aware of CAP when it enacted the CDP regime.

²¹⁸³ IRM 8.24.1.2 (12-02-2014), Collection Appeals Program (CAP).

²¹⁸⁴ See also § 6326(a). The Request is made on Form 9423.

²¹⁸⁵ IRM 8.24.1.2.4 (12-02-2014), Collection Appeals Program (CAP).

²¹⁸⁶ IRM 5.1.9.4.2 (03-22-2001).

²¹⁸⁷ The IRS explains the CAP Process in Publication 1660, at pages 3 and 4 thereof.

administrative rights do not produce relief. I summarize the key facets of the CDP procedures below.²¹⁸⁸

2. Types of CDP Review.

a. General.

An IRS notice that it intends to take certain action – filing of a tax lien or levy – triggers the taxpayer’s right to invoke the CDP process by filing a written request for CDP review.²¹⁸⁹ The review is initially an administrative review by the Appeals office.²¹⁹⁰ The Appeals Office will state its conclusions from that review in a Notice of Determination (or Determination Letter) which, if the taxpayer is unsatisfied, will constitute the taxpayer’s jurisdictional ticket to judicial review of the determination. The taxpayer invokes the review by making a request for a hearing.²¹⁹¹ We deal in this section with the administrative review. Discussion of the judicial review will be in the next section.

Section 6702(b)(2)(B) provides a penalty for a specified frivolous submission, which includes a request for CDP review.

²¹⁸⁸ The IRS explains those procedures in its Publication 1660, at pp. 1 and 2. The IRS further provides more detail of the administrative issues in Collection Due Process matters in a chief counsel notice, CC-2003-016, which may be found at the following web site: <http://www.irs.ustreas.gov/pub/irs-ccdm/cc-2003-016.pdf> For those practicing in this area, both of these are indispensable. The chief counsel notice will undoubtedly be updated from time to time to address developments in this new area of the law.

Congress eliminated the right to pre-levy review for federal contractors, thus allowing pre-CDP levies by the Federal Levy Payment Program. See ECC 201044009, reprinted at 2010 TNT 215-54 (10/15/10); IRS web page: <http://www.irs.gov/individuals/article/0,,id=100551,00.html>.

²¹⁸⁹ §§ 6330(b)(1) and 6320(b)(1). IRM 8.22.4 Collection Due Process Appeals Program. Note that other actions which have a cash flow effect like a levy may not be a levy per se. For example, the IRS upon determining that a taxpayer has a pattern of underpayment of withholding by virtue of incorrect W-4s may issue a “lock-in” letter to the employer of that taxpayer to withhold greater amounts. Both the employer and the taxpayer-employee are notified of the lock-in, but the lock-in is not a notice of levy giving rise to the CDP procedures. See Cleveland v. Commissioner, 600 F.3d 739 (7th Cir. 2010).

²¹⁹⁰ Note that the CDP Appeal is by the Appeals Office and not necessarily by an Appeals Officer. It is reported that most CDP appeals are handled by a “Settlement Officer” who is an employee within the Appeals Office, but is not an Appeals Officer. Carlton M. Smith, Settlement Officers Shouldn't Hold Collection Due Process Hearings, 121 Tax Notes 609 (Nov. 3, 2008) (urging that Congress did not approve CDP hearings by anyone other than Appeals Officers).

²¹⁹¹ § 6330(b)(1) and (a)(3)(B).

b. Notice of Tax Lien.

The IRS may file a tax lien. The tax lien exists before it is filed, but before it is filed, the tax lien is no great impediment to the taxpayer, for although the taxpayer cannot defeat the lien by giving away his property, he can deal with third party purchasers for value who can acquire the property free of the lien. The filing of the tax lien, however, can be quite burdensome to the taxpayer. As noted above with respect to priorities, even third parties acquiring an interest in the taxpayer's property for value may find their positions subordinated to the position of the IRS. Moreover, the filing of the tax lien will be reported by credit agencies and may adversely affect a taxpayer's credit. Bottom-line, this means that the taxpayer is substantially burdened by the filing of the tax lien.

The IRS is required to notify the taxpayer of the filing of the general § 6321 tax lien. § 6320(a). This notice requirement does not apply to tax liens arising under other sections.²¹⁹²

The IRS must give the notice in writing no later than 5 days **after** filing the tax lien.²¹⁹³ The notice must state in simple terms the amount of the tax and the taxpayer's appeals rights.²¹⁹⁴ The notice is left at the taxpayer's dwelling place or usual place of abode or sent to his last known address by certified or registered mail.²¹⁹⁵

The taxpayer invokes his right to a hearing -- referred to as a "due process hearing" -- by filing a request within 30 days after the expiration of the IRS's notice period after the filing (i.e., 5 days after the filing of the tax lien).²¹⁹⁶ If the taxpayer fails to request the CDP hearing in the 30-day period, he forfeits the right to the CDP hearing, but may obtain an "equivalent hearing" which is not subject to judicial review.²¹⁹⁷

²¹⁹² E.g., , §§ 6324A (special lien for estate tax) and 6324B (special lien for estate tax attributable to special valuation).

²¹⁹³ § 6320(a)(2).

²¹⁹⁴ § 6320(a)(3).

²¹⁹⁵ § 6320(a)(2). The form for filing the request is Form 12153, Request for a Collection Due Process or Equivalent Hearing .

²¹⁹⁶ § 6320(a)(3). A CDP hearing request may be made on Form 12153, but any reasonable written communication requesting the hearing should suffice (the better part of wisdom, of course, is to use the IRS Form). The request is filed with the IRS office that issued the notice, which office should appear on the notice itself. There is no extension of the base period if the notice is mailed outside the country. Sarrell v. Commissioner, 117 T.C. 122 (2001) (comparing this to Section 6213(a) which gives an additional 60 days for filing the petition if the notice of deficiency is sent outside the United States).

²¹⁹⁷ Graham v. Commissioner, T.C. Memo. 2008-129 (succinctly stating the rules and citing Craig v. Commissioner, 119 T.C. 252, 258-259 (2002) and Kennedy v. Commissioner, 116 T.C. 255, 261 (2001).

At the conclusion of the hearing, the Appeals Officer makes a determination. The determination, in the form of Notice of Determination, may give the taxpayer complete or partial relief or no relief from the action.²¹⁹⁸ Of course, even if the taxpayer prevails and the filing is reversed, the original filing will still be in the public records and can still have a negative impact on the taxpayer via its affect on persons potentially dealing with the taxpayer.

In terms of judicial review, the Notice of Determination serves the same purpose as a Notice of Deficiency in that it offers the taxpayer entre to an appropriate court for judicial review.²¹⁹⁹ I cover the judicial process below.

c. Notice of Intent to Levy.

The IRS must give the taxpayer notice of intent to levy.²²⁰⁰ The manner of notification is the same as for the notices for filing of tax liens.²²⁰¹ Significantly, the taxpayer must be notified of the taxpayer's right to a due process hearing on the levy action and other taxpayer rights with respect to levies.²²⁰²

In the normal case, the IRS's service center will generate a series of three or four automatic notices of balance due requesting payment. In the final notice, the IRS will notify the taxpayer that it intends to levy.

The taxpayer must request the hearing within 30 days after the required notice is given or sent. As with the federal tax lien notice, if the taxpayer does not request the hearing within 30 days, he or she forfeits the CDP hearing, but is entitled administratively to an equivalent hearing for which there is no judicial review.²²⁰³

At the conclusion of the hearing, the Appeals Office issues a Notice of Determination which, if the taxpayer remains unsatisfied, is the taxpayer's ticket to judicial review.

²¹⁹⁸ § 6330(C)(3).

²¹⁹⁹ Lunsford v. Commissioner, 117 T.C. 159 (2001).

²²⁰⁰ § 6330(a)(1). § 6331(d) provides that no levy may be made before giving the notice.

²²⁰¹ There may be some confusion as to what precisely is the required notice of intent to levy. The key document is a Notice of Intent to Levy (current Form L-1058 or LT11 FINAL NOTICE OF INTENT TO LEVY AND NOTICE OF YOUR RIGHT TO A HEARING) formally notifying the taxpayer of the intent and advising the taxpayer of his or her CDP rights. Less formal notifications are not the key Notice of Intent to Levy – e.g., Some earlier notifications in they cycle may refer to an IRS general intent to levy but do not advise that in a more formal sense and do not advise the taxpayer of his or her CDP rights and some oral communications from a collection officer might state a general intent to levy. See [IRS Collection Due Process \(CDP\) FAQs](#) (viewed as of 10/13/11).

²²⁰² § 6330(a)(3).

²²⁰³ CC-2001-038, p. 8.

Finally, it is important to emphasize that this right to a CDP hearing discussed in this section applies only to notice of levy. The IRS's offset of an overpayment for one year against an unpaid assessed liability for another pursuant to the IRS's common law right of offset or codification in § 6402(a) is not a levy, although it has the practical effect of a levy in the sense that it seizes property to which the taxpayer is entitled to apply against the taxpayer's unpaid tax liability.²²⁰⁴

d. Taxpayer Otherwise in Compliance.

The IRS may exercise discretion not to consider a CDP request if the taxpayer is not otherwise in compliance (e.g. filed all relevant tax returns) and the Courts may sustain that exercise of discretion, particularly where coupled with other footfaults in the CDP process.²²⁰⁵

e. Collection Suspended; Effect on Statute of Limitations.

From the taxpayer's perspective, the immediate benefit of filing the CDP hearing request is that further IRS collection action is suspended.²²⁰⁶ The downside is that the statutes of limitation are suspended on (1) collection suits, (2) criminal prosecution and (3) refund, erroneous refund, and wrongful levy suits, that would otherwise apply under §§ 6502, 6531, and 6532, respectively.²²⁰⁷ Those statutes are suspended until 90 days after: (i) if the taxpayer appeals the determination to the Tax Court, any final determination in any ensuing Tax Court CDP proceeding; or (ii) if the taxpayer does not appeal the determination to the Tax Court, 30 days after final determination in the Appeals hearing (which 30-day period is the period the taxpayer could have appealed).²²⁰⁸ Note that it is important that the IRS make a determination in every case, even if the taxpayer otherwise decides to withdraw the request, because otherwise the statutes of limitation will be suspended indefinitely.

Short of collection measures to actually collect the tax, the IRS takes the position that it may otherwise continue to work the case to locate assets -- e.g., by issuing summonses -- that can be levied upon when the suspension period lapses.²²⁰⁹

²²⁰⁴ Bullock v. Commissioner, T.C. Memo. 2003-5.

²²⁰⁵ Assured Source, Inc. v. Commissioner, T.C. Memo. 2010-243.

²²⁰⁶ § 6330(e).

²²⁰⁷ § 6320(c), referring to § 6330(c), (d) and (e). A legislative proposal to reform the bankruptcy code (11 U.S.C.) included a provision that would suspend the three year period for tax discharge in bankruptcy during the period of a collection due process proceeding. The suspension would be in the bankruptcy code rather than in the Internal Revenue Code. I would suspect that, at some point, this proposal would pass but would hope that there will be a reference in the Internal Revenue Code or, certainly, in the Regulations.

²²⁰⁸ § 6330(e)(1). As to the rule in (ii), see Regs. § 301.6330-1(g)(1); and United States v. Kollman, 2014 U.S. App. LEXIS 23676 (9th Cir. 2014) (unpublished) (sustaining the Regulation).

²²⁰⁹ ILM 199934019 (June 30, 1999).

f. Matters That May Be Considered.

The matters that may be considered at the meeting are set forth in § 6330(c) and are as follows:

(1) The appeals office employee (Appeals Officer or Settlement Officer) must receive an IRS “verification” that applicable law and administrative procedures have been met.²²¹⁰ For example, the verification includes in case of tax assessments requiring a predicate notice of deficiency or some other predicate notice (such as the Trust Fund Recovery Penalty notice given by Letter 1153) that the notice has been properly mailed to the taxpayer and that the assessment or other administrative action (such as assessment of the TFRP) was been properly made.²²¹¹

(2) The taxpayer may raise any appropriate defense, including spousal defenses, the propriety of IRS collection measures and alternatives to collection measures (posting bond, substitution of collateral, etc.). Virtually everything is on the table. The Appeals Office Employee (Appeals Officer or Settlement Officer) will not, however, consider any issue previously disposed of in a CDP hearing or in a prior administrative or judicial proceeding in which the taxpayer **could have** contested liability and participated meaningfully.²²¹² As to the underlying liability, the taxpayer can only contest in CDP if he “**did not receive any statutory notice of deficiency** for such tax liability or did not otherwise have an opportunity to dispute such tax liability.”²²¹³ The taxpayer

²²¹⁰ § 6330(c)(1); This verification is typically done by a MFRTX transcript or by Form 4340 from the Service Center. CC-2001-038, *supra*, pp. 12-13; see *Davis v. Commissioner*, 115 T.C. 35 (2000) (Form 4340).

²²¹¹ *Lee v. Commissioner*, 144 T.C. ___, No. 3 (2015), the Court held that the verification issue can and should be determined by the Court even if the petitioner does not raise the issue at the hearing. The required procedure in *Lee* was the issuance of the predicate Letter 1153 notifying the taxpayer of the proposed assessment of the TFRP and advising of the right to an Appeals hearing. Previously, in *Hoyle v. Commissioner*, 131 T.C. 197 (2008), the Court permitted the taxpayer to raise the issue of whether a notice of deficiency had been properly mailed. For internal guidance on how this showing of procedural regularity is made in a Trust Fund Recovery Penalty case, see PMTA 2009-163 (12/18/09), reproduced at 2010 TNT 60-22. IRM 8.22.8.3(5) (09-23-2014), provides that, if in a CDP appeal, the officer “determine[s] the SNOD was not properly mailed to the last known address by certified/registered mail and the taxpayer did not receive the SNOD in time to petition Tax Court, the assessment is invalid and must be abated.”

²²¹² § 6330(c)(4).

²²¹³ § 6330(c)(2)(B). See *Lewis v. Commissioner*, 128 T.C.48, 50-61 (2007). See also, *Kuykendall v. Commissioner*, 129 T.C. 77 (2007) (taxpayer must actually receive the notice of deficiency in sufficient time to petition the Tax Court); *Hoyle v. Commissioner*, 131 T.C. 197 (2008) (taxpayer may raise this issue because, under § 6330(c)(1), the IRS must verify that “that the requirements of any applicable law or administrative procedure have been met;” technically, this is not a defense but a requirement that the IRS perform this predicate act)). Of course, if the taxpayer did not receive a predicate notice of deficiency for a tax requiring a notice of deficiency, the taxpayer should be able to prevail. See, however, *Onyango v. Commissioner*, 142 T.C. No. 24

will also be considered to have had a previous opportunity to contest if he or she waives the right to a notice of deficiency on Form 870 or Form 4549.²²¹⁴ Other forms of administrative review of the underlying tax liability (e.g., pursuing an appeals remedy for a § 6672 penalty even if there is no prepayment court remedy) will prevent the contest of the underlying tax liability in the CDP hearing.²²¹⁵ What about taxes that the taxpayer reports on the original or an amended return? Self-reported tax is assessed without issuing a notice of deficiency. If the self-assessed tax is not paid with the return, the IRS will institute collection procedures. May the taxpayer contest the merits of the self-reported tax liability in a CDP proceeding? The Tax Court held that the taxpayer may.²²¹⁶ Finally, mere opportunity to pay tax and sue for refund in a refund forum appears, by itself, not to be an available remedy that defeats review of the underlying tax liability in CDP the proceeding.²²¹⁷

(2014) (holding that the taxpayer “may not decline to retrieve his Postal Service mail, when he was reasonably able and had multiple opportunities to do so, and thereafter successfully contend that he did not receive for purposes of section 6330(c)(2)(B) the 2006-2007 notice of deficiency.”); Campbell v. Commissioner, T.C. Memo. 2013-57 (holding that, where the taxpayer affirmatively refuses to receive the notice of deficiency, this requirement is met); and compare Lepore v. Commissioner, T.C. Memo. 2013-135 (receipt by taxpayer’s son at taxpayer’s last known address is not, under facts of case, receipt by taxpayer). Note that this requirement of receipt of the notice of deficiency is different than the requirement in § 6212(b)(1) that the notice of deficiency be mailed to the last known address in order for the notice to be valid. See JAG Brokerage, Inc. v. Commissioner, T.C. Memo. 2012-315 (addressing the issue of what is receipt and then proof of receipt by a corporation, an artificial person and concluding that “there is an unresolved question of law as to whether a corporate taxpayer has actually received a deficiency notice for purposes of section 6330(c)(2)(B) if it can show that the notice was not timely received by an individual authorized to act for the corporation.”). As to other types of proceedings that will be deemed to have given the taxpayer an earlier opportunity to contest liability and thus foreclose CDP relief, see Perrin v. Commissioner, T.C. Memo. 2012-22 (2012). Finally, the nonreceipt of the notice of deficiency simply permits the taxpayer to contest the merits of the underlying tax liability; as we noted in discussing the requirement that a notice of deficiency be mailed, nonreceipt does not invalidate the notice of deficiency. See also Gentile v. Commssioner, 2014 U.S. App. LEXIS 22435 n. 1 (11th Cir. 2014).

²²¹⁴ Aguirre v. Commissioner, 117 T.C. 324, 327 (2001) (Form 4549 waiver of restrictions on assessment which has the equivalent effect of the Form 870).

²²¹⁵ McClure v. Commissioner, T.C. Memo. 2008-136 (citing Lewis v. Commissioner, 128 T.C.48, 50-61 (2007)).

²²¹⁶ Montgomery v. Commissioner, 122 T.C. 1 (2004) (holding that in Tax Court proceeding for relief from denial of CDP relief, the Tax Court may consider liability for a self-reported tax liability); see CC-2006-005 (11/21/05), reproduced at 2005 TNT 229-7, and AOD 2005-03, reproduced at 2005 TNT 242-19, accepting Montgomery; see also Poindexter v. Commissioner, 122 T.C. 280 (2004). For a discussion of this CDP opportunity, see Burgess J.W. Raby, and William L. Raby, Challenging Substantive Tax Issues in Collection Due Process Cases, 2004 TNT 23-11 (2/4/04).

²²¹⁷ In Lindberg v. Commissioner, T.C. Memo 2010-67, at n. 15, the Court said:
Although Lindberg could have contested the penalty by paying the penalty and suing

(3) Whether the proposed collection action balances the need for efficient tax collection with the legitimate concern of the taxpayer that collection action not be more intrusive than necessary.²²¹⁸

What do you think the odds are of the IRS agreeing to release the lien where the taxpayer is otherwise not stepping up to his obligation? The lien filing CDP may, as a practicable matter, be no real remedy in all except the most unusual of cases.

g. Miscellaneous Features of the Hearings.

The following is a good introductory statement of the Appeals Office hearing:

Such a hearing -- known as a “collection due process” or “CDP” hearing -- is “held by the Internal Revenue Service Office of Appeals” (Appeals Office), 26 U.S.C. 6320(b)(1), 6330(b)(1), and is “conducted by an officer or employee who has had no prior involvement with respect to the unpaid tax” at issue. 26 U.S.C. 6320(b)(3), 6330(b)(3). If the only issue raised relates to collection, the person conducting the hearing will generally be a “Settlement Officer”; if the underlying tax liability is also disputed, that person will be an “Appeals Officer.” * * * *.

CDP hearings are informal and nonadversarial. They are often conducted by telephone or correspondence, and they need not be transcribed or recorded.²²¹⁹ The officer or employee who conducts the hearing is expected to verify that the prerequisites to collection (such as assessment, notice, and demand) have been satisfied. 26 U.S.C. 6320(c), 6330(c)(1); see 26 U.S.C. 6203, 6303. The taxpayer may raise “any relevant issue relating to the unpaid tax or the proposed levy,” including spousal defenses, challenges to the appropriateness of collection activities, and offers of collection alternatives (such as an installment agreement or an offer-in-compromise). 26 U.S.C. 6330(c)(2)(A). The determination whether the lien or levy is appropriate also depends on “balanc[ing] the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary.” 26 U.S.C. 6330(c)(3)(C).

If an Appeals or Settlement Officer sustains a collection activity, his decision is reviewed (and may be overruled) by an Appeals Team Manager.²²²⁰ The taxpayer

for a refund in District Court, this Court has implicitly held that the option of paying the penalty and filing a refund suit is not an opportunity to dispute liability for the penalty within the meaning of sec. 6330(c)(2)(B). See Stockton v. Commissioner, T.C. Memo. 2009186; Rice v. Commissioner, T.C. Memo. 2009-169.

²²¹⁸ § 6330(c)(3).

²²¹⁹ See, e.g., Murphy v. Commissioner, 469 F.3d 27, 30 (1st Cir. 2006); Living Care Alternatives of Utica, Inc. v. United States, 411 F.3d 621, 624 (6th Cir. 2005).

²²²⁰ Pet. App. 61; I.R.M. 8.22.4.5.4 (Mar. 29, 2012).

may seek review in the Tax Court of any adverse determination made by the Appeals Team Manager. 26 U.S.C. 6320(c), 6330(d)(1).²²²¹

Some other features of the hearing are:

- The hearing must be conducted by an impartial Appeals Office employee (Appeals Officer or Settlement Officer) with no prior involvement in the matter.²²²²
- The hearing may be at the Appeals office closest to the taxpayer's residence.²²²³
- The taxpayer has no right to subpoena or examine witnesses.²²²⁴
- The Appeals Office employee must verify the validity of the assessment. Note this verification is just that the assessment was proper and is not necessarily that the tax was due (unless that issue is otherwise properly under consideration).
- The taxpayer may record the hearing.²²²⁵

h. Disposition of Hearing.

At the conclusion of the hearing, if the taxpayer prevails in full, the collection action will be stopped or reversed, as appropriate. If the taxpayer does not prevail in whole or in part, the IRS sends the taxpayer "Notice of Determination Concerning Collection Action(s) under Section 6320 and/or 6330."

3. Judicial Review by the Tax Court.

The taxpayer has the right to judicial review by the Tax Court of the IRS's CDP determinations.²²²⁶ The judicial appeal must be taken within 30 days of the Appeals Office Notice

²²²¹ This excerpt is from the United States' Brief in Opposition to the Petitioner for Certiorari filed in Tucker v. Commissioner, 676 F.3d 1120 (D.C. Cir. 2012).

²²²² § 6320(b). The statute requires that the Appeals Officer have had "no prior involvement" with respect to the taxpayer's tax liabilities. § 6330(b)(3). See Cox v. Commissioner, 514 F.3d 1119 (10th Cir. 2008).

²²²³ Katz v. Commissioner, 115 T.C. 329 (2000).

²²²⁴ Davis v. Commissioner, 115 T.C. 35 (2000); Katz v. Commissioner, 115 T.C. 329 (2000); Konkel v. Commissioner, 86 AFTR2d 5545 (M.D. Fla. 2000).

²²²⁵ This entitlement is through the general requirement in § 7521. See Keene v. Commissioner, 121 T.C. 8 (2003).

²²²⁶ § 6330(d)(1). Prior to an amendment effective 10/17/06, the district court had some residual jurisdiction with respect to CDP determinations. In addition, the amendment expanded the Tax Court's review to include taxes and penalties not subject to the notice of deficiency requirement. Yari v. Commissioner, 143 T.C. No. 7 (2014) (citing Williams v. Commissioner, 131 T.C. 54, 58 n.4 (2008); Callahan v. Commissioner, 130 T.C. 44, 48 (2008)). For a discussion of these changes, see CC-2007-001, reproduced at 2006 TNT 201-7.

One result of this amendment was with respect to the trust fund recovery penalty ("TFRP") which I discuss later in this chapter. Prior to the change to allow CDP, the taxpayer could not

of Determination.²²²⁷ As with a notice of deficiency, in determining its jurisdiction, the Tax Court will not “look behind” the notice of determination to determine whether it was validly issued.²²²⁸

The Code itself offers no guidance on the standard of review. The legislative history did address the issue and the courts seem to follow the legislative history as follows: (1) if properly before the court,²²²⁹ the amount of the liability, if any, will be considered de novo, with the taxpayer bearing the usual burden of proof; and (2) as to the propriety of the collection activity, the court will review for abuse of discretion, a review designed not to correct mere error but to correct arbitrary action.²²³⁰

The Tax Court has cautioned taxpayers that it will impose the § 6673 penalty (up to \$25,000) for frivolous CDP cases.²²³¹

contest the TFRP in a Tax Court proceeding. See Ginsberg v. Commissioner, 130 T.C. 88 (2008).

²²²⁷ § 6330(d)(1).

²²²⁸ Lunsford v. Commissioner, 117 T.C. 183 (2001) (jurisdiction is based on the notice regardless of whether the required hearing was held).

²²²⁹ The Tax Court held in Giamelli v. Commissioner, 129 T.C.107 (2007) that, if the taxpayer did not raise the issue of the proper amount of the assessment in the CDP Appeals Hearing, the taxpayer cannot raise that issue in the Tax Court review of the CDP Hearing. The Court was careful to leave open the issue of whether the taxpayer, having raised the issue of the proper amount, could change theories or bases for redetermining the amount. 129 T.C. at 114 fn. 5.

²²³⁰ Dalton v. Commissioner, 682 F.3d 139 (1st Cir. 2012) (“In sum, a court's job is not to review the IRS's CDP determinations afresh. Rather, its job is twofold: to decide whether the IRS's subsidiary factual and legal determinations are reasonable and whether the ultimate outcome of the CDP proceeding constitutes an abuse of the IRS's wide discretion.”); and Sego v. Commissioner, 114 T.C. 604, 609-10 (2000). Perhaps the significant nuance to the abuse of discretion review is whether the Tax Court is limited to the record made from the CDP Hearing or may consider new evidence presented for the first time during the Tax Court CDP proceeding. Logically, it would not seem that the IRS did not abuse its discretion if the taxpayer failed to present evidence that, if it had been presented, might have affected the outcome. Nevertheless, the Tax Court originally held by reviewed opinion that its consideration of abuse of discretion was not limited to the record in the CDP administrative hearing. Robinette v. Commissioner, 123 T.C. 85 (2004) (reviewed opinion), revd. 439 F.3d 455 (8th Cir. 2006). The Eighth Circuit reversed the Tax Court on that point and at least one other court has held consistently with the Eighth Circuit. Keller v. Commissioner, 568 F.3d 710, 718 (9th Cir. 2009). Notwithstanding those appellate holdings, Robinette remains good law in the Tax Court except pursuant to the Golsen rule where the appeals are to those circuits. Kovacevich v. Commissioner, T.C. Memo 2009-160 (T.C. 2009).

²²³¹ Pierson v. Commissioner, 115 T.C. 576 (2000).

4. Retained Jurisdiction.

The Appeals Office retains jurisdiction with respect to the matter even after its determination.²²³² The retained jurisdiction relates to how the determinations are implemented and changed circumstances. The retained jurisdiction will not further suspend the statute of limitations and does not cause IRS collection action to be barred. The IRS also takes the position that there is no judicial review from the retained jurisdiction, of the type the taxpayer was entitled with respect to the original hearing.

5. Jeopardy.

Collection actions are normally suspended pending final determination of the hearings. However, there are two significant exceptions: (1) the IRS has determined collection of the tax to be in jeopardy (in much the way that it makes the determination for a jeopardy assessment or tax year termination under §§ 6851 and 6861), although the taxpayer will be provided a post-levy opportunity for hearing;²²³³ and (2) after a trial level CDP hearing, if the merits of the tax liability are not in issue and the court determines that the IRS has shown “good cause.”²²³⁴

6. Equivalent Hearing (“EH”).

If the taxpayer's appeal is not timely, the IRS may still grant the taxpayer an “equivalent hearing.”²²³⁵ Generally, the taxpayer must submit the EH request within one year of the CDP notice or NFTL.²²³⁶ The Appeals Office will provide the functional equivalent of a CDP hearing, but there are certain key distinctions:²²³⁷

(1) there will be no judicial review of the “equivalent hearing” except as to certain spousal defenses under §§ 6015(b) or (c);²²³⁸

²²³² § 6330(d)(2).

²²³³ § 6330(f). The Tax Court has jurisdiction to review jeopardy levy determinations under § 6330(f). Dorn v. Commissioner, 119 T.C. 356 (2002).

²²³⁴ § 6330(e)(2). The merits of the tax liability are not at issue merely because the taxpayer seeks to contest them if the court is otherwise without jurisdiction as, for example, where the taxpayer previously had an opportunity to contest. Burke v. Commissioner, 124 T.C. 189 (2005).

²²³⁵ IRM 5.1.9.3.2.2 (02-07-2014), Equivalent Hearing (EH) and Timeliness of EH Requests.

²²³⁶ IRM 5.1.9.3.2.2.2 (02-07-2014), Equivalent Hearing (EH) and Timeliness of EH Requests.

²²³⁷ See IRM 5.1.9.3.4 (06-16-2003) & 5.1.9.3.5. (12-15-2003).

²²³⁸ IRM 5.1.9.3.2.2 (02-07-2014), Equivalent Hearing (EH) and Timeliness of EH Requests.

(2) the IRS is not prohibited by statute from further levies during the time the appeal is pending, but it will generally forego such measures; and

(3) the statute of limitations is not suspended.

D. NonTaxpayer Remedies.

1. Wrongful Levy.

I noted above that the IRS has broad power to levy on the taxpayer's property administratively and without seeking the advance approval of a court. Sometimes the IRS levies on property belonging to third parties who do not owe the tax in question.

Example: the IRS levies on the Mercedes registered in the taxpayer's girl friend's name. The IRS bases this action on its conclusion that the taxpayer has beneficial ownership of the Mercedes which was titled in the girl friend's name. The IRS can seize the car by serving levy on the girl friend if it believes that the taxpayer is the beneficial owner of the car. (As we note below, the IRS can also file a nominee lien or sue to foreclose on the car.) Levy in this case would be by seizing the automobile.

Similarly, if the girl friend had a bank account in which the IRS believed taxpayer has beneficial ownership, the IRS can levy the girl friend's bank account by serving notice of levy on the bank. The bank who has no interest in the dispute will deliver pursuant to the notice of levy.

I hope you have sensed that there may be some Constitutional issues inherent in such seizures. We have addressed similar issues with respect to the jeopardy assessment and termination provisions (pp. 510 ff.). You may recall that those provisions were enacted after the Supreme Court expressed grave concerns about jeopardy assessments in the case of Commissioner v. Shapiro, 424 U.S. 614 (1976).

When the IRS makes a wrongful levy, the IRS may admit its error and return the property or the proceeds from sale of the property (plus interest).²²³⁹ But many times the IRS is not willing to return the property. Section 7426 provides a judicial remedy in the event the IRS levies on such property. You should note carefully the short limitations periods prescribed in § 6532(c)(1) – i.e., “9 months from the date of the levy,” although there is a split of authority as to whether that time period may be subject to equitable tolling.²²⁴⁰

²²³⁹ § 6343(b) & (c).

²²⁴⁰ The Courts of Appeals are not in agreement as to whether this nine-month period is subject to equitable tolling. See Volpicelli v. United States, 777 F.3d 1042 (9th Cir. 2015), applying equitable tolling and rejecting other Circuits’ contrary holdings (see Becton Dickinson & Co. v. Wolckenhauer, 215 F.3d 340, 351-52 (3d Cir. 2000) (collecting cases)).

The **Drye** case we covered above is a good example of a § 7426 case. There the third party did not prevail because the Court held the trust assets to be the taxpayer's property for purposes of the tax lien. But, still the procedure was correct.

The § 7426 action has the following features:

1. Elements of the Action.
 - a. The IRS levied against property held by a person who is not the taxpayer with respect to the liability (“nontaxpayer”).
 - b. The nontaxpayer owned the property or had an interest in the property that was superior to the taxpayer and thus superior to the IRS.

2. Proof Issues.
 - a. The nontaxpayer must show an interest in the property to establish standing.
 - b. The IRS must then show a nexus between the property and the taxpayer. This showing must be made substantial evidence.
 - c. The nontaxpayer must then show that the levy was wrongful.

3. Interest.
 - a. The taxpayer may recover interest by reference to the overpayment rates provided for taxes. We covered the overpayment interest rates above.²²⁴¹ The principal “gotcha” here is, of course, the special 2.5% reduction applying to corporate overpayments exceeding \$10,000. That reduction applies to corporate recoveries for wrongful levies.²²⁴²

2. Other Remedies.

In **United States v. Williams**, 514 U.S. 527 (1995), the Supreme Court created a refund remedy for a person other than the taxpayer simply because the circumstances were egregious and there was no other fix for the problem. The taxpayer desired to sell her house. There was, however, an outstanding tax lien against her ex-husband that clouded the title on the house. In order to make the sale, she had to make peace with the IRS and the cost of peace was to apply to her ex-husband's taxes a portion of the sales proceeds she was otherwise entitled to. In other words, she was forced to pay her ex-husband's taxes in order to complete the sale. She then filed a suit for refund of the taxes paid. The Government took the position that she could not sue because she was not the taxpayer to whose tax liability the taxes were applied. This has been the Government's position, always sustained, since the inception of the income tax laws. The district court held for the Government; the Court of Appeals reversed, holding for Mrs. Williams; and the Supreme Court also held for Mrs. Williams.

The decision contains esoteric statutory analyses. Bottom line, however, the Court seemed to be influenced by the equities (i.e., the IRS should not have collected these taxes) and the fact that there was no other readily apparent relief for this taxpayer who had been wronged. In this regard,

²²⁴¹ Beginning on p. 283.

²²⁴² Steven N.S. Cheung, Inc. v. United States, 545 F.3d 695 (9th Cir. 2008).

§ 7426 provides judicial relief for a person who is subject to an IRS levy to pay taxes of another person's tax liability, but here there was no levy. In this case, the IRS just forced the taxpayer to pay in order to release the cloud on title on sale of the house. The IRS did not technically “levy” on the funds, although its position was fully as forceful as a levy (given that Mrs. Williams needed to sell the residence). Therefore, Williams permitted a person to bring a refund suit for amounts collected and applied to another person's tax liability if there is no other available remedy.

In the 1998 Restructuring Act, however, Congress enacted an administrative and judicial remedy to solve the problem presented in Williams where there was no judicial remedy.²²⁴³ Although the legislation is relatively new, this remedy pre-empts the operation of Williams in situations where the remedy is otherwise available.²²⁴⁴ And the Supreme Court held that a Williams-type remedy will not apply in wrongful levy situations where the person could have brought a § 7426 wrongful levy action.²²⁴⁵ Nevertheless, it is conceivable that in cases not covered by the new legislation with equitable factors and no other specific remedy, a court might be willing to apply the Williams reasoning or even a due process analysis to create a refund remedy.²²⁴⁶

E. Fair Tax Collection Practices.

The Fair Debt Collection Practices Act imposes upon general creditors certain standards and prohibitions in pursuing debt collection.²²⁴⁷ Congress has made certain of these standards and

²²⁴³ § 6325(b)(4) (administrative remedy) and § 7426(a)(4) (judicial remedy).

²²⁴⁴ § 7426(a)(4) says that “no other action may be brought by such person for such a determination.” See e.g., Munaco v. United States, 522 F.3d 651, 657 (6th Cir. 2008) (“Munaco had access to a post-deprivation administrative remedy under § 6325(b)(4) and a judicial remedy under § 7426(a)(4),” thus pre-empting the field; and Rev. Rul. 2005-50, 2005-30 I.R.B. 124, citing §§ 6325(b)(4) and 7426(a)(4), enacted as part of the 1998 Restructuring Act in response to the inadequate remedy problem identified by the Supreme Court in United States v. Williams, 514 U.S. 527 (1995); and Portsmouth Ambulance, Inc. v. United States, 756 F.3d 494 (6th Cir. 2014) (affirming Munaco).

²²⁴⁵ EC Term of Years Trust v. United States, 127 S. Ct. 1763 (2007); see also First American Title Ins. Co. v. United States, 520 F.3d 1051, 1053 (9th Cir. 2008) (in light of EC Term of Years Trust, “there can no longer be a good argument for allowing a third-party challenge to an assessment, barred by § 7426, to be made under § 1346.”); and Wagner v. United States, 543 F.3d 298 (5th Cir. 2008).

²²⁴⁶ Cf. Begner v. United States, 428 F.3d 998 (11th Cir. 2005) (interpreting the refund suit broadly and reading Williams as “stating that section 1346(a)(1) contains ‘broad language,’ which the Court then applied to a person who paid a tax ‘even though the tax she paid was assessed against a third party.’”). In First American Title (preceding footnote), the Ninth Circuit construes the nontaxpayer refund suit narrowly in light of EC Term of Years Trust.

See also Scheafnocker v. Commissioner, 642 F.3d 428 (3d Cir. 2011) finding a due process remedy in a wrongful levy where the Government did not give the claimant notice of the levy and she did not discover it until after the period to file a § 7426 claim had expired.

²²⁴⁷ 15 U.S.C. §§ 1601 note, 1692-1692o.

prohibitions applicable to IRS collection efforts.²²⁴⁸ As they apply to the IRS, these provisions are often referred to as the Fair Tax Collection Practices. Congress felt that the IRS should be at least as considerate to taxpayers as private creditors are required to be with their customers.²²⁴⁹ Basically these require that debt collectors make their contacts at reasonable times without harassment and deal through the taxpayer's representative.

TIGTA is required to report to Congress semiannually regarding any administrative or civil actions regarding violations of the Fair Tax Collection Practices.²²⁵⁰

F. Monetary Damages for Unauthorized Collection Action.

Section 7433 gives taxpayers a damage action for unauthorized collection action defined as reckless or intentional violation of the statutory collection provisions or the regulations. The amount the taxpayer may recover is the lesser of (1) \$1,000,000 or (2) the actual damages and costs.

G. Release of Filed Tax Liens.

I discussed above that the filing of a tax lien is notice to the public of an unpaid tax debt. That public notice can not only impede a taxpayer's ability to sell or otherwise deal with his or her property, its existence in the public records can affect a taxpayer's credit rating. The problem addressed here is the taxpayer's remedy when the filed tax lien relates to a tax liability that is not legally collectible. The taxpayer may have paid the liability in full, in which case there is no liability behind the filed tax lien. Alternatively, the statute of limitations on collection of the underlying tax (the 10 year collection statute of limitations) may have expired. Still alternatively, the assessment underlying the lien may be invalid (e.g., for the IRS's failure to follow the required notice of deficiency procedures discussed above).

The filed tax lien is "self-releasing" on the date indicated in the NFTL (usually 10 years after the tax is assessed). In other cases where the taxpayer is entitled to release of the lien (e.g., upon payment or abatement of the tax, penalties or interest), the IRS will issue a certificate of release of tax lien upon the taxpayer's request. § 6325(a).²²⁵¹ The certificate of release is conclusive that the

²²⁴⁸ § 6304.

²²⁴⁹ See TIGTA Report titled Fair Tax Collection Practices Violations Did Not Result in Administrative or Civil Action, Ref. 2004-40-143v(July 2004), unofficially reproduced at 2004 TNT 149-15 (8/3/04).

²²⁵⁰ § 1102(d)(1)(G) of the 1998 Restructuring Reform Act. An example of such a report is cited in the preceding footnote.

²²⁵¹ The certificate of release may be revoked and the lien reinstated if it was "erroneously or improvidently" granted or the taxpayer has not met the conditions of the release, provided that the period of limitations on collection has not expired. § 6325(f)(2). The revocation is perfected by mailing notice to the taxpayer and filing the notice of revocation in the office where the original NFTL was filed. *Id.*

lien is extinguished;²²⁵² however, even though the lien is extinguished, the underlying tax liability is not extinguished if it is not paid, discharged or becomes uncollectible due to the expiration of the statute of limitations.²²⁵³ If the IRS fails to issue the certificate of release after proper notice or request, the taxpayer may bring a suit to compel the IRS to release the lien and a suit for actual damages suffered as a result of failure to release the lien and costs of the proceeding.²²⁵⁴

In addition, to a certificate of release, the taxpayer can request that the NFTL be withdrawn in certain cases.²²⁵⁵ This withdrawal seems to give a positive effect on credit scoring beyond that achieved by the release of the tax lien;²²⁵⁶ the Form for requesting withdrawal states that, if granted, the IRS will notify interested parties, including “credit reporting agencies, financial institutions, and/or creditors that you want notified.” Withdrawal is permitted if (i) the lien was improperly filed, (ii) the taxpayer has entered into an installment agreement permitting withdrawal, (iii) the IRS determines that withdrawal “will facilitate” collection, or (iv) with the consent of the taxpayer or the National Taxpayer Advocate, withdrawal is in “in the best interests of the taxpayer.”²²⁵⁷ Strictly read, the mere full payment of the tax and additions (interest, etc.) that wipes away the underlying federal tax lien is not a stated basis for withdrawing the federal tax lien. The safety valve here is the last category that, upon full payment, the lien can be withdrawn “in the best interests of the taxpayer.”²²⁵⁸

The IRS has authority also to release or, in some cases, modify the effect of liens in other situations, such as when the taxpayer provides adequate substitute collateral or bond or to subordinate the tax lien in certain cases.²²⁵⁹ This opportunity may be particularly helpful where, for example, a financially distressed property owner (including a homeowner) is attempting to refinance a loan on property to reduce money or lower the risk of forfeiture. In such cases, the IRS must “believe[] that the subordination of the tax lien to another interest will ultimately result in an increase in the amount realized by the United States from the property subject to the lien and will aid in the collection of the tax liability.”²²⁶⁰ The IRS recognizes that the decision to subordinate entails risk that the IRS will ultimately receive less than it would have otherwise, but still the

²²⁵² § 6325(f).

²²⁵³ Regs. § 301.6325-1(a)(1); Boyer v. Commissioner, T.C. Memo. 2003-322. Hence, the erroneous improvident release of the lien does affect the taxpayer’s obligation to pay the tax. And, for such erroneous or improvident release of the lien, the release may be revoked and the certificate reinstated. § 6325(f)(2).

²²⁵⁴ § 7432.

²²⁵⁵ § 6323(j)(1). The Form for this request is Form 12277, Application for Withdrawal of Filed Form 668(Y), Notice of Federal Tax Lien.

²²⁵⁶ I don’t know exactly how this positive affect is achieved, unless the scoring companies wipe the existence of the original NFTL from their scoring.

²²⁵⁷ § 6323(j)(1).

²²⁵⁸ See IRM 5.12.9.3.4 (10-14-2013), Best Interest Withdrawal Provisions.

²²⁵⁹ § 6325(d) and (d).

²²⁶⁰ IRM 5.17.2.8.6 (12-12-2014), Subordination of the Tax Lien.

authority should be exercised based on “good judgment” of the type exercised by an “ordinary prudent business person.”²²⁶¹

H. Taxpayer Advocate Assistance.

It is not uncommon in collection matters for a taxpayer to feel aggrieved by a collection officer pressing for payment or taking actions to effect payment. Many times, that taxpayer just does not want to pay or pay timely and has no legitimate complaint that the collection officer is using the tools Congress granted to collect. Still, sometimes an overly aggressive collection officer will employ those tools beyond the boundaries of fair and good judgment in manners that Congress probably would not have intended under the particular taxpayer’s facts. The taxpayer can request a **Taxpayer Assistance Order** (“TAO”) if the taxpayer is suffering or about to suffer a “significant hardship” from tax law administration, in particular levies and liens.²²⁶² The taxpayer seeks assistance by filing an **Application for Taxpayer Assistance Order, Form 911**. A TAO may require the IRS to release property of the taxpayer that has been levied upon, or to cease any action, take any action as permitted by law, or refrain from taking any action with respect to the taxpayer.²²⁶³ The TAO suspends the statute of limitations on collection.²²⁶⁴

XIV. Outsourcing the Collection Function.

Historically, the IRS has administered collection with its own personnel. In the past, the IRS outsourced some of the collection efforts to third party contractors.²²⁶⁵ The program was referred to as Private Debt Collection, with the ubiquitous initialism, “PDC.” The reasons for the PDC initiative are typical political show biz and muddled thinking. “Big government” detractors have the knee jerk reaction that private efforts are always more efficient than Government efforts, particularly IRS efforts. (Big government detractors tend to dislike the IRS immensely.) The truth is the opposite; the IRS could more cost effectively handle the collection efforts than private contractors, but Congress refuses to provide the IRS the funds to handle collection and requires that some of it be outsourced and pay more. So between big government detractors and lobbyists for the firms that stood to gain from the PDC, we had some level of private debt collection – for a time. Cooler heads prevailed; in 2009, the IRS abandoned the PDC program.²²⁶⁶

²²⁶¹ Id.

²²⁶² § 7811.

²²⁶³ § 7811(b).

²²⁶⁴ § 7811(d).

²²⁶⁵ There are all sorts of issues involved with outsourcing – how to manage the privacy issues imbedded in § 6103 being only one. See Announcement 2006-63; 2006-37 IRB 1.

²²⁶⁶ IR-2009-19 (3/6/09), reported at 2009 TNT 43-21. For a history of the outsourcing program and its demise, see Nicole Duarte, IRS Decision to Cancel Private Debt Collection May Remain Controversial, 2009 TNT 43-1.

XV. Innocent Spouse Relief.

A. Introduction.

We covered above (pp. 175 ff.) the inequities that may arise from the operation of the community property laws and from the joint return provisions of the Code. Please review those provisions now. Two Code sections provide some relief from the inequities.

First, § 6015 eliminates or at least mitigates some of the more egregious hardships of the joint liability that results from filing joint returns.²²⁶⁷ Second, § 66 provides analogous relief in the far less common situation where a spouse files a separate return in a community property state. For perspective, even in community property states, most spouses file joint returns, so as a practitioner you will more commonly be dealing with § 6015.

Both sections are generally referred to as the “innocent spouse” provisions; the relief provided is referred to as “innocent spouse relief;” the person qualifying for relief is referred to as the “innocent spouse.” The term innocent may be a bit of a misnomer because a spouse may qualify for relief even where not so innocent under a layman’s concept of innocence. Nevertheless, practitioners generally refer to that person as the innocent spouse to indicate that he or she has or claims relief under the innocent spouse provisions. The other spouse is sometimes referred to as the culpable spouse, and I use that term even though the other spouse may not be culpable in a blame sense of the word.

In this discussion, I often refer to the spouse seeking relief using a feminine pronoun. Given where we are in society, it is a fact that the woman in the marriage needs and qualifies for this relief more often than does the man.²²⁶⁸ However, men may qualify and do qualify.²²⁶⁹ You can substitute the male pronoun where appropriate.

Finally, estates of a deceased spouse can qualify for the relief provided that the decedent otherwise qualified.²²⁷⁰

²²⁶⁷ For good brief discussion of the relief intended and the various statutory changes to effect the relief, see Commissioner v. Neal, 557 F.3d 1262, 1264-5 (11th Cir. 2009); and Wilson v. Commissioner, 705 F.3d 980 (9th Cir. 2013).

²²⁶⁸ I confess that I have done no empirical study, nor am I aware of statistics that support this statement. The anecdotal evidence I have are the cases I read as they come out. In this nonscientific sampling, the spouse claiming the relief is generally the wife.

²²⁶⁹ Indeed, given the elements of the statute, it is possible in a single case for both husband and wife to qualify for relief. This is because of the focus of the statute on the components of tax liability (income and deductions). Thus, for example, the husband may qualify for relief as to tax on some or all of the wife’s income and the wife may qualify for relief from tax on some or all of the husband’s income. See e.g., Weiler v. Commissioner, T.C. Memo. 2003-255.

²²⁷⁰ Rev. Rul. 2003-36, 2003-18 I.R.B. 849.

B. Joint Liability Relief.

Joint liability arises from filing a joint return. Section 6015 provides relief from the joint liability.²²⁷¹ A good introductory roadmap to § 6015 may be found in the final regulations that were adopted on July 17, 2002.²²⁷² I remind you that regulations are entitled to great weight in interpreting the statute.

At the threshold for joint liability relief is that there be a valid joint return. Without a valid joint return, there is no joint liability and hence no need for relief from tax liability with respect to the other spouse's tax items. Thus, the IRS says:

If an individual signs a joint return under duress, the election to file jointly is not valid and there is no valid return with respect to the requesting spouse. The individual is not jointly and severally liable for any income tax liabilities arising from that return. In that case, section 6015 does not apply and is not necessary for obtaining relief.²²⁷³

For the following discussion, I assume that a valid joint return was filed and that one of the spouses is seeking relief from the joint and several liability.

1. Basic Relief - § 6015(b).

The basic relief is found in § 6015(b).²²⁷⁴ I break down the elements for this relief, all of which must be met, as follows:

a. a joint return and tax understatement;

A joint return must have been filed. And, the relief the putative innocent spouse seeks to avoid must not have been reported on the return. (For this reason, § 6105 provides no relief from liability in those situations where the spouses file a joint return and fail to pay the tax shown due on the return.)

²²⁷¹ To state the obvious, § 6015 provides no relief if the taxpayer did not file a joint return. Raymond v. Commissioner, 119 T.C. 191, 197 (2002).

²²⁷² See T.D. 9003; F.R. 47278-47296, reprinted at 2002 TNT 140-9 (7/18/02). This document also contains the IRS's textual explanation of the regulations and the key decisions in adopting the regulations.

²²⁷³ Rev. Proc. 2013-34, 2013-43 IRB 39, § 2.03.

²²⁷⁴ Prior to enactment of § 6015, this basic relief was found in former § 6013(e) which provided the only innocent spouse relief for joint filers. Section 6015(b) is basically the same as this prior provision, with one added element. Therefore the interpretation of § 6013(e) is helpful in the interpretation of § 6015(b).

These elements are not usually an issue. Either the spouse claiming relief did file a joint return or she did not. Further, if there is no tax understatement, the putative innocent spouse will need no relief.

b. understatement due to other spouse's items;

This element prevents a spouse from avoiding liability with respect to her own income, deductions or credits. A spouse may only obtain relief with respect to the understatement in tax arising from the other spouse's items.

c. spouse claiming relief did not know or have reason to know;

A spouse must establish that she had neither knowledge nor "reason to know" that there was an "understatement" in tax. There are some nuances on this straight-forward statutory element to the defense.

First, applying a plain meaning analysis, the requirement that the spouse have known or had reason to know of the "understatement" would mean that she meets this element of relief unless she knew the relevant details of the transaction and the law giving rise to the understatement. Under this interpretation, a spouse may meet the element by claiming ignorance – or at least reasonable ignorance -- of the facts or law or combination thereof. Courts have, however, not read the statute that literally and have adopted a "knowledge of the transaction" test "because it avoids 'acceptance of an ignorance of the law defense.'"²²⁷⁵ Thus, if the spouse claiming innocent spouse relief either knows or has reason to know of the transaction or item, she will fail this requirement.²²⁷⁶

Second, in cases where one or more erroneous deductions led to the understatement, the knowledge of the transaction test would lead to the nonsensical result that the relief would never be available because, as a matter of policy, each signatory of the return is charged with the responsibility to read the return. The deduction appears on the return and thus each spouse signing the return is charged with a knowledge of the deduction. Taken to the extreme, the claiming of a deductions on a joint return could never qualify either spouse. Accordingly, the Ninth Circuit adopted an interpretation that relief is unavailable under this element when "a reasonably prudent taxpayer in her position at the time she signed the return could be expected to know that the return contained the substantial understatement."²²⁷⁷ Some courts accepting this spin reason as follows: "if

²²⁷⁵ Cheshire v. Commissioner, 282 F.3d 326, 333 n. 17 (5th Cir. 2002), citing Sanders v. United States, 509 F.2d 162, 169 n.14 (5th Cir. 1975); see also Price v. Commissioner, 887 F.2d 959, 963 n.9 (9th Cir. 1989).

²²⁷⁶ See Summary of the Contents and Explanation of Revisions accompanying the final regulations, par. 2.A. Although the new § 6015 Regulations track the statutory language, the Summary indicates an intent to apply the same test as applicable to the same statutory language in prior § 6013(e). This means the knowledge of the transaction test or, as it is alternatively worded, knowledge of the item test.

²²⁷⁷ Price v. Commissioner, 887 F.2d 959, 965 (9th Cir. 1989).

the spouse knows enough about the underlying transaction that her innocent spouse defense rests entirely upon a mistake of law, she has ‘reason to know’ of the tax understatement as a matter of law.”²²⁷⁸ If, however, the spouse cannot be determined to have reason to know under the foregoing test, the court inquires factually “whether a reasonably prudent taxpayer in the spouse's position at the time she signed the return could be expected to know that the stated liability was erroneous or that further investigation was warranted.”²²⁷⁹ The test developed in this case has been summarized by the Tax Court as follows:

A spouse has “reason to know” of the substantial understatement if a reasonably prudent taxpayer in her position at the time she signed the return could be expected to know that the return contained the substantial understatement. Factors to consider in analyzing whether the alleged innocent spouse had “reason to know” of the substantial understatement include: (1) the spouse's level of education; (2) the spouse's involvement in the family's business and financial affairs; (3) the presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of living, and spending patterns; and (4) the culpable spouse's evasiveness and deceit concerning the couple's finances.²²⁸⁰

The Fifth Circuit’s decision in Cheshire illustrates the application of the foregoing spins on this element of relief. The husband received lump-sum distributions from qualified plans. He rolled a minor portion of it into another tax-deferred arrangement, but used much of the distribution to pay down his mortgage and purchase an automobile. The tax rules are that the distribution is taxable except for amounts rolled over into qualified deferred arrangements. In reporting the distributions, however, the taxpayer properly noted on the return that the distributions had been received but improperly claimed the amounts used for purchase of the home and automobile as amounts qualifying for further deferral. Upon reviewing the return, the wife saw the amount thus deferred and questioned her husband as to whether it was proper. Her husband explained that he had been advised by a CPA that amounts used for those purposes could be deferred in that manner. As it turned out, the husband actually misled the wife because he had not been so advised by a CPA, and, in any event, that was not the law. Accepting the husband’s explanation, however, the wife signed the return. The wife thus knew about the income item and the offset which might be analogized to a deduction, and claimed relief based essentially upon her claimed ignorance of the law. The Tax Court in a reviewed decision and the Fifth Circuit denied her relief. The Fifth Circuit reasoned that

²²⁷⁸ E.g., Cheshire v. Commissioner, *supra*, citing and applying upon Park v. Commissioner, 25 F.3d 1289, 129-4 (5th Cir. 1994) (noting that ignorance of the law cannot establish an innocent spouse defense to tax liability).

²²⁷⁹ Cheshire v. Commissioner, *supra*, citing and applying Reser v. Commissioner, 112 F.3d 1258, 1267 (5th Cir. 1997).

²²⁸⁰ Jonson v. Commissioner, 118 T.C. 106 (2002). I should note that, as the Tax Court noted in Jonson, the Tax Court may apply a slightly more stringent spin on this test that does the Ninth Circuit (citing Bokum v. Commissioner, 94 T.C. 126, 146 (1990), *affd.* 992 F.2d 1132 (11th Cir. 1993)), although in most cases the difference will not be material to the outcome.

it need not determine whether the case was an omitted income or an improper deduction case, because the wife failed in either event. The Court held:

This court has not previously determined if such facts present a case of omitted income or of erroneous deduction, and we need not do so here because the outcome under either standard is the same: Appellant knew or had reason to know of the tax understatement. Under the knowledge-of-the-transaction test applied in omitted income cases, Appellant fails to satisfy 6015(b)(1)(C) because she had actual knowledge of the retirement distributions and of the corresponding earned interest at the time she signed the return. In erroneous deduction cases, this court asks whether Appellant “knew or had reason to know” that the deduction in question would give rise to a tax understatement at the time she signed the return. The parties agree that Appellant did not have actual knowledge that the deduction was improper. However, because Appellant knew all the facts surrounding the transaction that gave rise to the understatement, including the amount of the retirement proceeds, the account where the proceeds were deposited and drawn upon, the amount of interest earned on the proceeds, and the manner in which the proceeds were spent, Appellant had “reason to know” of the improper deduction as a matter of law. Appellant’s defense consists only of her mistaken belief that money spent to pay off a mortgage is properly deductible from retirement distributions. Ignorance of the law cannot establish an innocent spouse defense to tax liability.²²⁸¹

d. imposing tax would be inequitable; and

This is an equitable test depending upon all the facts and circumstance. The most frequent factual issue addressed in determining whether joint liability would be inequitable is whether the spouse claiming relief benefitted from the understatement in issue.²²⁸² The issue can be illustrated by considering two extremes of the spectrum of equity. First, if the item were the husband’s and he used the tax savings from the understatement to support a hidden lifestyle with a mistress in violation of the marriage vows, a court would easily find joint liability inequitable. Second, by contrast, if the understatement were used to buy the spouse a mink coat or even pay their children’s college education, a court would be hard pressed to find joint liability inequitable.²²⁸³

Courts also often will consider “whether the failure to report the correct tax liability on the joint return results from concealment, overreaching, or any other wrongdoing on the part of the other spouse.”²²⁸⁴

²²⁸¹ Cheshire v. Commissioner, 282 F.3d 326 (5th Cir. 2002) (footnotes omitted).

²²⁸² See Reser v. Commissioner, *supra*, at 1270 (quoting Buchine v. Commissioner, 20 F.3d 173, 181 (5th Cir. 1994)); and Jonson v. Commissioner, 118 T.C. 106 (2002).

²²⁸³ See Jonson v. Commissioner, *supra*.

²²⁸⁴ See Jonson v. Commissioner, *supra*.

Prevailing on this issue requires that the practitioner marshal the facts and present them in the way that makes the spouse claiming innocent spouse relief a sympathetic person who has been wronged by his or her spouse.

e. election for relief by 2 years from first collection activity.

The putative innocent spouse must elect relief within two years from the date of the first collection activity.²²⁸⁵ A collection activity includes the computer-generated § 6330 notice of intent to levy and right to CDP hearing.²²⁸⁶ Because this two year time window begins to run on that notice, the taxpayer and practitioner must pay attention to that notice or lose the right to claim relief.²²⁸⁷

Even if the spouse may have had an earlier opportunity to claim this relief, the spouse may still do so within this statutory window. For example, if the husband and wife had earlier pursued a Tax Court proceeding in which innocent spouse was not in issue (although it could have been), a spouse's right to innocent spouse relief can be pursued later within this statutory time window provided that he or she did not meaningfully participate in the Tax Court proceeding.²²⁸⁸ As is often the fact pattern in these cases, the improper item giving rise to the understatement is the item of a domineering husband who manages the Tax Court proceeding without concern for his wife's potential right to separate relief and therefore does not permit the assertion of innocent spouse relief in the Tax Court proceeding. In such a case, the wife can assert relief later within this statutory window. If, however, the wife was the one who managed and thus "meaningfully participated" in the Tax Court proceeding, the wife will be unable to later claim innocent spouse relief.

What is a collection activity? Obviously, a levy or even a filing of federal tax lien would be a collection activity. In both cases, the taxpayer would know and would be put on notice to do something. Even before that, however, a notice of intent to levy and right to request a CDP hearing is collection activity starting the two year period; and, so long as the notice is sent to the requesting spouse's last known address, the notice starts the two year period.²²⁸⁹ And, other less obvious actions may constitute collection activity. For example, the IRS's offset of a refund from one year to an assessment for another year is a collection activity that triggers the two year period for electing innocent spouse relief.²²⁹⁰ But, since the offset is a "collection activity" the IRS must provide the

²²⁸⁵ The election is made by filing a Form 8857.

²²⁸⁶ Regs. § 1.6015-5(b)(2)(i).

²²⁸⁷ Tu Pham v. Commissioner, T.C. Memo. 2012-171.

²²⁸⁸ § 6015(e)(3)(B).

²²⁸⁹ As to the notice to last known addresses starting the period regardless of receipt, the proposed regs adopt holding in Mannella v. Commissioner, 132 T.C. 196 (2009), rev'd on other grounds, 631 F.3d 115 (3d Cir. 2011).

²²⁹⁰ Campbell v. Commissioner, 121 T.C. 290 (2003).

spouse notice and its failure to do so will mean that this statute of limitations does not commence running simply because of the offset.²²⁹¹

2. Special Relief for Spouses Who Are Separated, Divorced or Living Apart - § 6015(c).

A spouse can avoid joint and several liability if he or she is (i) no longer married to (including divorce or death),²²⁹² or (ii) legally separated from or was not a member of the same household as the other spouse for a period of 12 months ending on the date an election is filed with the IRS. § 6015(c).²²⁹³ If the spouse qualifies, any deficiency assessed with respect to the return is allocated between the requesting spouse and the other spouse with the requesting spouse liable only for the portion allocated to him or her. Tricky rules apply in determining the portion allocable to each spouse;²²⁹⁴ I will not expect you to know those, but will expect you to know that you should review them before giving advice.

Relief may be denied in the following situations:

(i) with respect to items attributable to the nonrequesting spouse if the requesting spouse had “actual knowledge” of the improper treatment on the joint return.²²⁹⁵ The IRS must prove that she had actual knowledge – not just what a reasonably prudent person would be expected to know – in order to deny relief.²²⁹⁶ As with the basic relief discussed above, the knowledge relates to the item on the return and not that the item was treated incorrectly.²²⁹⁷ Relief is available whether or not the spouse had reason to know and whether or not it would be inequitable to impose joint and several liability.²²⁹⁸

²²⁹¹ McGee v. Commissioner, 123 T.C. 314 (2004). See CC-2005-010 (5/20/05), reproduced at 2005 TNT 99-17 administratively implementing McGee.

²²⁹² Jonson v. Commissioner, 118 T.C. 106, 123-124 (2002), affd. 353 F.3d 1181 (10th Cir. 2003).

²²⁹³ This election is also made by filing Form 8857.

²²⁹⁴ § 6015(d). See Regs. § 1.6015-3(d); see also Hopkins v. Commissioner, 121 T.C. 73 (2003) and Andrews v. Commissioner, T.C. Memo 2010-230.

²²⁹⁵ § 6015(c)(3)(C).

²²⁹⁶ Culver v. Commissioner, 116 T.C. 189 (2001); the standard for actual knowledge is discussed in King v. Commissioner, 116 T.C. 198, 203 (2001); and Mora v. Commissioner, 117 T.C. 279 (2001).

²²⁹⁷ Cheshire v. Commissioner, *supra*, (applying a variation of the concern that, otherwise ignorance of the law would be a defense); see also King v. Commissioner, 116 T.C. 198 (2001).

²²⁹⁸ For this reason, the chief judge of the Tax Court has requested that parties cease using the term “innocent spouse relief” when referring to the elective relief under § 6015(c).

(ii) if the IRS establishes that assets were transferred between the spouses to avoid payment of the tax.²²⁹⁹

(iii) under rules established by the IRS, to the extent that the requesting spouse benefitted from the treatment of the item on the joint return.²³⁰⁰

(iv) under rules established by the IRS, if the allocation is inappropriate because of the fraud of one or both individuals.

The relief is not available simply because the parties are separated by death. The Tax Court has held that, in the case where the party claiming relief died, the proper test is made immediately before death and, if he or she did not then qualify, the separation by death will not be considered in applying § 6015(c).²³⁰¹

Finally, the claim for relief under this provision must be made within two years of the first collection activity.²³⁰² This is the same window for claiming relief as provided under § 6015(b) discussed above.

3. Equitable Relief - § 6015(f).

Section 6015(f) authorizes the IRS to grant equitable relief if relief is not otherwise available under the provisions discussed above. This relief is available where, “taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either).”²³⁰³ The Tax Court may review the IRS’s denial of relief and does so under an abuse of discretion standard in a de novo proceeding.²³⁰⁴

Applying the law developed under equitable element under the prior version of the innocent spouse provisions (the same as § 6015(b)(1) discussed above), the Fifth Circuit has noted that the most important consideration “is whether the spouse seeking relief ‘significantly benefitted’ from

²²⁹⁹ § 6015(c)(3)(A)(ii) and (4).

²³⁰⁰ § 6015(d)(3)(B). For an application of this rule, see Mora v. Commissioner, 117 T.C. 279 (2001).

²³⁰¹ Jonson v. Commissioner, 118 T.C. 106 (2002), aff’d 353 F.3d 1181 (10th Cir. 2003); Butler v. Commissioner, 114 T.C. 276, 292 (2000).

²³⁰² § 6015(c)(3)(B).

²³⁰³ § 6015(f).

²³⁰⁴ Commissioner v. Neal, 557 F.3d 1262 (11th Cir. 2009) and Wilson v. Commissioner, 705 F.3d 980 (9th Cir. 2013), both rejecting the IRS argument that the review is based solely on the administrative record rather than through a de novo trial proceeding in the Tax Court. Before the holding in Wilson but after the holding in Neal, the IRS instructed its attorneys to preserve the issue of whether review should be on the administrative record alone without a de novo consideration. CC-2009-021, reproduced at 2009 TNT 125-5. As of this writing, those instructions are still outstanding, but they may perhaps be revisited based on Wilson.

the understatement [or underpayment] of tax.”²³⁰⁵ The Fifth Circuit noted that the benefit can be indirect in order to disqualify the claiming spouse for relief. Thus, in Cheshire, discussed above, the income items in issue had been used to pay a home mortgage and purchase a car, and the wife was given those items in a subsequent divorce. The Court held that she had benefitted, thus making the IRS’s decision to deny equitable relief under § 6105(f) not an abuse of discretion.

In 2013, the IRS announced that more relaxed application of § 6015(f), as well as its separate return community property counterpart, § 66(c).²³⁰⁶ Key factors in relief include:

- “gives greater deference to the presence of abuse” than before.²³⁰⁷
- relief may even be available if the item is the requesting spouse’s item, provided that the nonrequesting spouse’s fraud gave rise to the understatement of tax or deficiency.”²³⁰⁸
- “the lack of a finding of economic hardship does not weigh against relief, as it did under [the prior procedure], and instead will be neutral.”²³⁰⁹
- the requesting spouse may be held to have not known or reasonably known that the tax would not be paid if that spouse reasonably expected the nonrequesting spouse to pay.²³¹⁰
- the nonrequesting spouse’s legal obligation to pay is a factor that may be considered.
- whether the requesting spouse significantly benefitted – a key disqualifier under prior procedures – “will not weigh against relief (will be neutral) if the nonrequesting spouse abused the requesting spouse or maintained financial control and made the decisions regarding living a more lavish lifestyle.”²³¹¹
- will not weigh against relief (will be neutral) if the nonrequesting spouse abused the requesting spouse or maintained financial control and made the decisions regarding living a more lavish lifestyle.
- “if only the nonrequesting spouse significantly benefitted from the unpaid tax or understatement, and the requesting spouse had little or no benefit, or the nonrequesting spouse enjoyed the benefit to the

²³⁰⁵ Cheshire v. Commissioner, supra (quoting Reser v. Commissioner, supra, 1270 (which, in turn, quoted Buchine v. Commissioner, 20 F.3d 173, 181 (5th Cir. 1994)).

²³⁰⁶ Rev. Proc. 2013-34, 2013-43 IRB 397. See Steven L. Walker, IRS Changes Policy, Relaxes Rules for Innocent Spouse Relief, 141 Tax Notes 871 (Nov. 25, 2013).

²³⁰⁷ Id. § 3.01.

²³⁰⁸ Id. § 3.03.

²³⁰⁹ Id. § 3.07.

²³¹⁰ Id. § 3.08.

²³¹¹ Id. § 3.10.

requesting spouse's detriment, this factor will weigh in favor of relief."²³¹²

Section 6015(f) is broader than the relief provided in the more specific sections discussed above because it may apply where a tax has been reported on the return signed by the putative innocent spouse. The statute thus permits relief for "any unpaid tax" as well as any deficiency, or shortfall, in tax paid.²³¹³ The IRS's Revenue Procedure thus notes:

Under section 6015(b) and (c), relief is available only from an understatement or a deficiency. Section 6015(b) and (c) do not authorize relief from an underpayment of income tax reported on a joint return. Section 66(c) and section 6015(f) permit equitable relief from an underpayment of income tax or from a deficiency. The legislative history of section 6015 provides that Congress intended for the Secretary to exercise discretion in granting equitable relief from an underpayment of income tax if a requesting spouse "does not know, and had no reason to know, that funds intended for the payment of tax were instead taken by the other spouse for such other spouse's benefit." H.R. Conf. Rep. No. 105-599, at 254 (1998). Congress also intended for the Secretary to exercise the equitable relief authority under section 6015(f) in other situations if, "taking into account all the facts and circumstances, it is inequitable to hold an individual liable for all or part of any unpaid tax or deficiency arising from a joint return." *Id.*²³¹⁴

The IRS's general procedures and factors the IRS will consider in reviewing a request for equitable relief under § 6015(f) are found in a Revenue Procedure.²³¹⁵ Obviously, the Rev. Proc. is key reading to taxpayers and practitioners attempting to convince the IRS of the application of § 6015(f). Under Chevron/Mead deference principles, the Revenue Procedure may also be entitled to some deference in ultimate litigation, should that become necessary.

The IRS, by regulation, imposed for § 6015(f) relief the same two-year period applicable to the other more specific forms of innocent spouse relief. The Tax Court invalidated the regulation on the ground that, since the statute did not impose the two-year period for this relief, the IRS exceeded its authority in the regulation;²³¹⁶ the Seventh Circuit and Third Circuit, however, reversed the Tax Court, holding the regulation valid under the broad mandate of Chevron and its progeny

²³¹² *Id.*

²³¹³ § 6015(f). See Commissioner v. Neal, 557 F.3d 1262, 1265 n. 1 (11th Cir. 2009).

²³¹⁴ Rev Proc. 2013-34, 2013-42 IRB 1, par. 2.04.

²³¹⁵ Rev Proc. 2013-34, 2013-42 IRB 1.

²³¹⁶ Lantz v. Commissioner, 132 T.C. 131 (2009), rev'd Lantz v. Commissioner, 607 F.3d 479 (7th Cir. 2010).

(which we discussed in Chapter 1).²³¹⁷ Notwithstanding its success, in the exercise of discretion, the IRS has announced that it will no longer apply the two year limitations rule.²³¹⁸

4. Disqualifiers.

There are several overarching disqualifiers to innocent spouse relief. They are:

a. Closing Agreement or Offer in Compromise.

A spouse is not entitled to relief if he or she has previously entered into (i) a closing agreement that disposes of the same liability that is the subject of the claim for relief or (ii) an offer-in-compromise for the liability.²³¹⁹

b. Fraudulent Transfers.

A spouse is not entitled to relief if he or she “transferred assets to the other spouse as part of a fraudulent scheme.”²³²⁰ Any scheme to defraud – whether related to taxes or to other creditors or potential claimant (including e.g., an ex-spouse) – is sufficient to deny relief.

c. Res Judicata and Collateral Estoppel.

A spouse is not entitled to relief under doctrines of res judicata or collateral estoppel if the innocent spouse was an issue and denied in a prior judicial proceeding or, if not an issue in the proceeding, the spouse meaningfully participated in that proceeding.²³²¹ The theory for the meaningful participation exception to relief is that, if the wife could have reasonably asserted her right to relief in the proceeding, he or she should have done so.²³²²

²³¹⁷ Lantz v. Commissioner, 607 F.3d 479 (7th Cir. 2010); and Mannella v. Commissioner, 631 F.3d 115 (3d Cir. 2011).

²³¹⁸ Rev Proc. 2013-34, 2013-42 IRB 1. Consistent with the Notice, the IRS issued proposed regulations to amend Regs. § 1.6015-5(a) to eliminate the two-year rule for § 6015(b).

²³¹⁹ Regs. § 1.6015-1(c). See Dutton v. Commissioner, 122 T.C. 133 (2004). The regulations provide a special exception for the special TEFRA partnership rules. Regs. § 1.6015-1(c)(2).

²³²⁰ Regs. § 1.6015-1(d).

²³²¹ Regs. § 1.6015-1(e); Deihl v. Commissioner, 134 T.C. 156, 162 (2010); Vetrano v. Commissioner, 116 T.C. 272, 278 (2001). The Regulation is based on § 6015(g)(2) which is interpreted to deny relief under § 6015(f) (general equitable relief) even though the § 6015(g)(2) expressly applies only to (b) and (c). Turner v. Commissioner, 121 T.C. 43, 51-52 (2003).

²³²² The Tax Court will not apply this test mechanically but will look to the nuance of all the facts to determine whether the putative innocent spouse meaningfully participated. See Harbin v. Commissioner, 137 T.C. No. 37 (2011) (relief grant despite the putative innocent spouse’s participation in the earlier case that was impaired by a conflicted counsel who represented both the husband and the wife in circumstances where the conflicted counsel had not explained the conflict

However, if the spouse claiming relief could not have requested § 6015(c) relief because she was married to and not legally separated from the other spouse and did not claim such relief in the prior proceeding, the spouse may thereafter claim the benefit of § 6015(c) even where that spouse is foreclosed from litigating under the other two relief provisions.²³²³

5. Collection Issues.

a. Statutes of Limitations Issues.

When a taxpayer elects relief under (b) or (c), the statute of limitations on collection of the requesting spouse's liability is suspended and the IRS may not pursue its collection remedies while the election is pending.²³²⁴ When a taxpayer requests relief under (f) (the equitable relief provision), the statute of limitations is not suspended and the IRS may pursue collection remedies. Accordingly, the IRS will not unilaterally consider (b) or (c) relief in processing an (f) relief request, but, if the IRS becomes aware of the potential for such other relief, it will notify the taxpayer in order to permit the requesting spouse the option of electing relief under those provisions. Relief under (f) is available only if the spouse fails to qualify under (b) or (c).²³²⁵

b. Community Property Issues.

Under community property laws some or all community assets may be available to apply against federal taxes. The issue therefore is whether a spouse otherwise qualifying for innocent spouse relief can nevertheless have his or her share of community assets subject to collection for the other spouse's liability. Obviously, this could negate innocent spouse relief. The IRS takes the position that innocent spouse relief does not negate the IRS's right under state community property law of the state to collect from the culpable spouse's share of community property even though that collection will affect the innocent spouse.²³²⁶ The IRS explained this position as simply a state law creditor position that it was entitled – indeed mandated – to pursue:

One commentator suggested that the regulations adopt a rule that the IRS would not look to community property as a collection source when a requesting spouse with an interest in such community property is granted relief under section 6015. A federal tax lien arising under section 6321 attaches to all property and rights to property of the taxpayer. Whether a taxpayer has an interest in property to which the lien can

and obtained waivers and the putative culpable spouse really controlled the shape of the litigation). See also Koprowski v. Commissioner, 138 T.C. 54 (2012) (innocent spouse issue litigated in earlier proceeding is res judicata in subsequent proceeding; taxpayer meaningfully participated in earlier proceeding, thus no out under § 6015(g)(2)).

²³²³ Diehl v. Commissioner, 134 T.C. 156 (2010).

²³²⁴ § 6015(e)(2).

²³²⁵ Regs. § 1.6015-1(a)(2).

²³²⁶ See Summary of the Contents and Explanation of Revisions accompanying the final regulations, par. 1.G. citing Regs. § 1.6015(h).

attach is determined by state law. Aquilino v. United States, 363 U.S. 509 (1960). Once that property interest is defined, federal law alone determines the consequences resulting from the attachment of the federal lien on the property. United States v. Drye, 528 U.S. 49 (1999). If under the law of the community property state in which the spouses reside, the IRS can look to community property to collect a liability of one of the spouses, the determination that the other spouse is entitled to relief under section 6015 does not affect the Service's ability to collect the nonrequesting spouse's liability from the community property. See, e.g., United States v. Stolle, 2000-1 U.S.T.C. 50,329 (C.D. Cal. 2000); Hegg v. IRS, 28 P.3d 1004 (Idaho 2001). The final regulations do not adopt this recommendation because it goes beyond the scope of the statute.²³²⁷

6. Judicial Review.

Taxpayers may claim and have the Tax Court rule on innocent spouse relief in the usual Tax Court proceeding arising from the IRS's issuance of a notice of deficiency to joint taxpayers.²³²⁸ In this type of proceeding, the normal Tax Court jurisdiction exists, and the taxpayer may contest the merits of the tax liability as well as his/her liability under the innocent spouse rules.

In addition, § 6015(e) grants Tax Court review to a spouse against whom a deficiency has been asserted and who elects relief under the basic relief provision (subsection (b)), the special relief provision for divorced or separated spouses (subsection (c)), or the residual equity provision (subsection (f)).²³²⁹ If the IRS denies the requested relief (wholly or partially), the Tax Court petition must be filed within 90 days of the denial.²³³⁰ During the pendency of the case, the IRS may not take collection measures²³³¹ but the statute of limitations is suspended.²³³² In a nondeficiency case, relief under subsections (b) and (c) is available only under the collection due process procedures in § 6330(d)(1), but relief under subsection (f) may be pursued as a stand-alone proceeding.²³³³

At least with respect to claims for relief under § 6015(f), which is the fall back equitable relief provision, the review in the Tax Court is de novo – meaning that the taxpayer and Commissioner are not limited by the prior administrative record with respect to the request for relief and that the review is not limited to IRS abuse of discretion.²³³⁴

²³²⁷ Id.

²³²⁸ The notice of deficiency is discussed in detail in Ch. 11.

²³²⁹ § 6015(e)(1), as amended in 2006.

²³³⁰ Regs. § 1.6015-7.

²³³¹ § 6015(e)(1)(B).

²³³² § 6015(e)(2).

²³³³ Kollar v. Commissioner, 131 T.C. 191, 193 n. 2 (2008).

²³³⁴ Commissioner v. Neal, 557 F.3d 1262 (11th Cir. 2009) (the majority and dissenting opinions provide an excellent summary of the arguments and law pro and con); Porter v.

7. The Culpable Spouse.

The other spouse suffers, at least theoretically, if the spouse claiming relief obtains relief. (I refer to this other spouse as the “culpable spouse,” solely to distinguish from the spouse obtaining relief who might not be exactly innocent.) To the extent of the relief, the culpable spouse must bear the tax liability alone. Hence, Congress provided that the putative culpable spouse – the one who would bear the economic consequence of a finding that the other spouse qualifies for relief – can participate in the proceedings leading to such a finding. First, the IRS is required to adopt regulations, and has issued Proposed Regulations and a Revenue Procedure, providing the putative culpable spouse the opportunity for notice and right to participate in the administrative proceedings.²³³⁵ Second, in any court proceeding instituted by the spouse claiming relief, the putative culpable spouse is entitled notice and the right intervene as a party.²³³⁶ As a party, presumably the putative culpable spouse has the right to appeal from any adverse decision (i.e., any decision in favor of the spouse claiming relief).²³³⁷

Whether the putative culpable spouse should exercise his or her rights is another issue that requires judgment beyond the scope of an introductory tax procedure book.²³³⁸

8. Miscellaneous Issues.

Although the basic relief under § 6015 carries forward the same elements from the prior innocent spouse provision which has been interpreted in many cases, the other provisions have not

Commissioner, 130 T.C. 115 (2008), affirming the Tax Court’s prior position in Ewing v. Commissioner, 122 T.C. 32 (2004), reversed on jurisdictional grounds previously changed by statute, Commissioner v. Ewing, 439 F.3d 1009 (9th Cir. 2006); Porter v. Commissioner, 132 T.C. 203 (2009); and AOD 2013-07 (6/4/13) (concluding that, in (f) cases, the IRS will no longer argue (1) that the Tax Court’s review is limited to determining whether IRS abused its discretion, or (2) that the court’s review is limited by the underlying administrative record.)

²³³⁵ § 6015(h)(2); Prop. Regs. § 1.6015-6; see also Rev. Proc. 2003-19, 2003-15 I.R.B. 371.

²³³⁶ § 6105(e)(4). See Tipton v. Commissioner, 127 T.C. 214, 217 (2006); see also Kovitch v. Commissioner, 128 T.C. 108 (2007) (holding that the automatic stay from the intervening spouse’s bankruptcy does not stay the proceeding as to the claiming innocent spouse since the intervening spouse’s liability is not at issue).

²³³⁷ The problem, which you may have spotted, is that, if the spouse claiming relief prevails in the administrative consideration of the claim, even though the putative culpable spouse is given notice and the opportunity to participate, the putative culpable spouse will have no right to appeal to the courts from an adverse decision (i.e., one granting the relief claimed). See Maier v. Commissioner, 119 T.C. 267 (11/20/02).

²³³⁸ See Jonathan T. Trexler, Contesting Innocent Spouse Relief: The Intervention Paradox, 126 Tax Notes 499 (Jan. 25, 2010) (noting that, based on analysis of statistics, a culpable spouse may be better off not intervening).

been rounded out through judicial interpretation. That process continues and will likely take several more years before the contours are fleshed out with reasonable certainty.

For some time, the Tax Court has been issuing precedential decisions interpreting the statute. For example, the Tax Court has ruled that, in a proceeding before it where the IRS was willing to stipulate that one of the spouses was an innocent spouse, the other spouse can contest whether the putative innocent spouse should get that relief.²³³⁹ Why would a spouse do that? Simple. Whatever liability the putative innocent spouse is relieved of, the other spouse is solely responsible for. If the two are no longer “as one” -- i.e., if they are divorced or separated -- the other spouse might well prefer that the putative innocent spouse stay liable (particularly if that spouse has assets, perhaps from the divorce) and thus may be motivated to argue against his or her qualification for relief. Stay tuned as the courts sort out this and other innocent spouse issues.

One issue that arises often is whether one spouse who might otherwise qualify for innocent spouse relief as to the original return that omits income or claims an improper deduction should agree with the culpable spouse to file an amended return correcting the problem. The amended return will pre-empt the IRS’s need to issue a deficiency, and thus the deficiency predicates for relief under subsections (b) and (c) will not exist if the spouse signs the amended return. The Tax Court has held that relief may still be available under the general equitable relief provision, subsection (f), with the putative innocent spouse’s relevant knowledge being measured at the time the original return was filed rather than at the time the amended return was filed.²³⁴⁰

C. Separate Liability Relief For Community Property Items.

Section 66 provides relief paralleling the innocent spouse relief should also be provided to so-called “innocent spouses” otherwise liable for tax on the income of the other spouse in community property states. I only summarize the § 66 relief which is rarely encountered because most spouses, even in community property states, file joint returns and thus must qualify for relief only under § 6015.

Remember that the prototypical inequity that concerned Congress is where one spouse – typically the wife – is otherwise required to pay tax on income of the other spouse – typically the husband – that the wife neither knew about nor benefitted from. Congress did not simply grant relief where those conditions were present, however. So it is important to focus on the conditions that Congress did place upon relief.

There are four types of relief to the general rule that each spouse must include one-half the community income and deductions. They are:

First, if the spouses live apart the entire year, one or both have earned income that is community income and no portion of each spouse’s earned income is transferred to the other, for tax purposes, the community income is divided between the spouses according to who earned the

²³³⁹ Corson v. Commissioner, 114 T.C. 354 (2000).

²³⁴⁰ Billings v. Commissioner, T.C. Memo. 2007-234.

income or whose property earned the income.²³⁴¹ The proposed regulations provide that de minimis transfers and transfers for the benefit of a child will not disqualify a claiming spouse from relief.²³⁴² Note that this provides relief only for earned income. Where, in the prototypical example, the husband abandoning his wife has income from property (e.g., dividends), the relief is not available because the income is not earned income.²³⁴³

Second, the IRS may disallow the community split with respect to any income that one of the spouses acted as if solely entitled to such income and, before the due date for filing the latter's return, failed to notify the other spouse of the nature and amount of the income.²³⁴⁴

Third, under regulations, a spouse may be relieved with respect to income attributable to another spouse if the claiming spouse establishes that (i) he or she did not know or have reason to know of the income and (ii) it would be unfair to tax that spouse.²³⁴⁵ The second and third requirements are the same as the third and fourth elements under § 6015(b)(1), and the interpretation of those elements should apply.²³⁴⁶

Fourth, there is a catch-all "equitable" relief provision under procedures set by the IRS. This provision parallels the similar provision in § 6015(f).²³⁴⁷

Section 66 relief generally extends to omitted income. There is generally no need for relief as to improper deductions because, at least in the worst cases, the putative innocent spouse would not have claimed any improper deductions attributable to the other spouse. Accordingly, the first, second, and third categories of relief apply only to omitted income. The last category – the catch all "equitable" relief provision – is not expressly limited to omitted income, saying instead that, in equitable cases, the IRS may simply relieve the individual from liability in equitable cases as "to any item for which relief is not granted under the preceding sentence." If the deduction is improper, the IRS could not allow the claiming spouse to have the deduction. But the benefit could come in such a case by taxing the claiming spouse on only the claiming spouse's income and deductions (thereby

²³⁴¹ § 66(a).

²³⁴² § 1.66-2(b).

²³⁴³ See definition of earned income in § 66(d)(1), referring to § 911(d)(2).

²³⁴⁴ § 66(b).

²³⁴⁵ § 66(c).

²³⁴⁶ See also Prop. Regs. § 1.66-4(a)(2) & (3).

²³⁴⁷ § 66(c) (final sentence) (added by the 1998 Restructuring Act); see Prop. Regs. 1.66-4(b). See Beck v. Commissioner, T.C. Memo. 2001-198 (relying upon its prior authority under § 6015(f), Butler v. Commissioner, 114 T.C. 276 (2000) and Fernandez v. Commissioner, 114 T.C. 324 (2000). Unlike § 6015(f) for which there is an independent grant of Tax Court jurisdiction, the taxpayer seeking judicial review of the IRS's denial of this equitable relief must have some other basis for Tax Court jurisdiction. Christensen v. Commissioner, 523 F.3d 957 (9th Cir. 2008); see also IRS AOD CC-2002-05 released 12/9/02 and unofficially reproduced at 2002 TNT 240-12 (12/13/02).

ignoring the community property split up and down), so that if the other spouse had the bulk of the income and hence the incentive to generate erroneous deductions, the wife's bottom line tax liability will be reduced by excluding her community share of both income and deductions.

To the extent one spouse is relieved of liability under these provisions, the other spouse must bear the tax liability. As with the joint liability relief provision under § 6105, the other spouse is given the opportunity to participate in proceedings related to a spouse requesting relief under § 66.²³⁴⁸ However, § 66(c) innocent spouse relief does not provide for "stand alone" judicial review in the Tax Court as provided for § 6015(e) joint return relief.²³⁴⁹

These rules do not avoid liability under some other provision, such as transferee liability (which we discuss below). They simply avoid liability by virtue of the marital status of the taxpayer in a community property state.²³⁵⁰ Accordingly, you should note the possibility discussed above that some community property law states may make one spouse liable, directly or indirectly, for the other's community debts – i.e., debts arising during the marriage – which could take away that which Congress conferred in § 66 as well as § 6015.

XVI. Collection from Third Parties.

A. Property Titled to Others (Nominee and Transferee Liability).

1. The Problem.

Taxpayers often have priorities that, in their minds, rank higher than paying taxes. Often taxpayers will want to transfer their property so that, they hope, the property will be available for them or their loved ones but beyond the IRS's ability to seize in payment of taxes. They may do that either by titling the property to third parties, but retaining beneficial interest, or by transferring both title and benefit ownership to third parties who they like better than the IRS.

Such maneuvers are not unique to the tax laws. There is a large body of state law for protecting creditors in these circumstances. The most prominent is the various fraudulent conveyance statutes. The IRS can rely upon the substantive provisions of these state law remedies applicable to creditors in general. (There are some potential criminal problems when transfers are intended to avoid payment of tax, but I deal here only with the IRS's civil remedies when that happens.)

Basically, the state creditors' remedies require a transfer for less than full value when the transfer either made the taxpayer insolvent or made him more insolvent. Obviously, if the taxpayer receives full and fair consideration, the assets he receives in the exchange are available to the creditor and the creditor should not be able to force the transferee to give the assets back. (Note that

²³⁴⁸ Prop. Regs. § 1.66-4(h).

²³⁴⁹ Bernal v. Commissioner, 120 T.C. 102 (2003).

²³⁵⁰ Proposed Regs. § 1.66-1(c).

this is different than the lien priority issue noted above; if the IRS has lien priority, transferee liability is irrelevant and whether the transferee paid full and fair value can be irrelevant.)

2. Nominee, Alter Ego, Agent and Related Concepts.

a. The Issue.

Under general legal concepts a debtor does not put his or her property beyond reach of creditors by artificial devices whereby title, but not beneficial ownership, is transferred to or otherwise appears in a third party. A third party thus may hold title as the nominee, alter ego, or agent of the debtor, and the property should be subject to the debts of the beneficial owner. So, too, in the tax law, such concepts may apply to subject property nominally titled to a third party to the tax liability of the taxpayer.²³⁵¹

b. Nominee and Agent.

Although the Code does not define the term nominee, the IRS and the courts define it as a person holding apparent or formal indicia of ownership – whether by title or otherwise -- of property that really belongs to another, in this case the taxpayer owing the tax.²³⁵² The Drye case which discussed above is a good application of the rules that govern. State law determines the characterization of the taxpayer's property interest in the property; federal law determine the application of the taxpayer's tax lien to the property.²³⁵³ The definition is heavily fact dependent.²³⁵⁴

²³⁵¹ G.M. Leasing Corp. v. United States, 429 U.S. 338, 350-51 (1977); United States v. Scherping, 187 F.3d 796, 801 (8th Cir. 1999); F.P.P. Enters. v. United States, 830 F.2d 114, 118 (8th Cir. 1987); see also IRM 5.17.2.5.2 (12-14-2007). for discussion of nominee liens generally.

²³⁵² IRM 5.17.2.5.2 (12-14-2007); and Fourth Investments LP v. United States, 720 F.3d 1058, 1066-1068 (9th Cir. 2013) (with an excellent discussion of the law of nominee liability). The ultimate inquiry, of course, is “whether the * * * [person] has engaged in a legal fiction by placing legal title to property in the hands of a third party while actually retaining some or all of the benefits of true ownership.” Holman v. United States, 505 F.3d 1060, 1065 (10th Cir. 2007). For a listing of factors that courts consider in making the nominee determination, see Dalton v. Commissioner, T.C. Memo. 2008-165 (referring to these factors as “a relatively well-defined body of Federal common law,” with case citations). See generally Stephanie Hoffer, Goldburn Maynard, Elizabeth Fate, Damon Kellar, Drienne Sneed, To Pay or Delay: The Nominee's Dilemma Under Collection Due Process, 82 Tul. L. Rev. 781 (2008) (hereafter in this section referred to as “Hoffer, et al, Nominee's Dilemma”).

²³⁵³ Exactly how the federal and state law interface in the ultimate determination is not certain. However, based on Drye, the courts have uniformly rejected the Government's attempts to have a Federal common law with a synthesized application of state law so that the common law as thus synthesized is applied uniformly in the states. See Fourth Investments LP v. United States, 720 F.3d 1058, 1068 (9th Cir. 2013) (“Accordingly, we adopt the interpretation of Drye advanced by the reasoning of our sister circuits and hold that questions of nominee status require a ‘fact-specific state-law inquiry’ prior to determining whether a nominee lien may lawfully be enforced as a matter

By way of contrast, the prototypical trust established by another for a benefit of a taxpayer owing tax is not a nominee situation, for the Trustee really does have ownership subject to the rights of the taxpayer beneficiary who does not and legally cannot exercise direct ownership rights with respect to trust property. Of course, if the trust is simply a front or the underlying state law confers a beneficiary the equivalent of direct ownership in the trust property, then the trustee might be a nominee of the beneficiary. In the sense used here, the nominee is thus like an agent for a principal, and the concepts discussed herein apply to agents as well as nominees.

The general federal tax lien attaches to the taxpayer's property interest in the property titled to such a nominee. Further, an IRS levy upon the nominee reaches that interest.²³⁵⁵ Can the IRS protect itself as to such property short of a levy? The general tax lien arising against the taxpayer and even a filed tax lien against the taxpayer would not put third parties on notice that the property appearing in the name of someone other than the taxpayer is subject to the tax lien. Thus, given the other rules of priority discussed above, the IRS may not have protection solely based on the filed tax lien against the taxpayer's property.²³⁵⁶ In such cases, the IRS may file a tax lien identifying the third party title holder or possessor as acting on behalf of the taxpayer with respect to identified property (a "**nominee lien**").²³⁵⁷

of federal law;" however, although rejecting the application of Federal common law to achieve intra-state uniformity, the Ninth Circuit noted that the Government's concern for lack of uniformity "has proven to be unfounded, because state law nominee doctrine is typically so similar to its federal common law counterpart that the distinction is of little moment.") Fourth Investments, 1068 (internal quotation marks omitted).

²³⁵⁴ See Fourth Investments LP v. United States, 720 F.3d 1058 (9th Cir. 2013). A typical statement of the factors considered in making a determination of nominee status are:

- (1) whether inadequate or no consideration was paid by the nominee;
- (2) whether the property was placed in the nominee's name in anticipation of a lawsuit or other liability while the transferor remains in control of the property;
- (3) whether there is a close relationship between the nominee and the transferor;
- (4) whether they failed to record the conveyance;
- (5) whether the transferor retains possession; and
- (6) whether the transferor continues to enjoy the benefits of the transferred property.

Porta-John of Am., Inc. v. United States, 4 F. Supp. 2d 688, 701 (E.D. Mich. 1998).

²³⁵⁵ G.M. Leasing Corp. v. United States, 429 U.S. 338 (1977); see also Oxford Capital Corp. v. United States, 211 F.3d 280 (5th Cir. 2001) (discussing differences between nominee and alter ego theories); Al- Kim, Inc. v. United States, 610 F.2d 576 (9th Cir. 1980); and United States v. Krause, 637 F.3d 1160, 1165-66 (10th Cir. 2011) (good summary of the differences).

²³⁵⁶ But see Berkshire Bank v. Town of Ludlow, MA, 708 F.3d 249 (1st Cir. 2013) (holding that the federal tax lien against the individual taxpayer primes a judgment lien against his sole member LLC that the Court found was his "nominee.")

²³⁵⁷ See Keith Fogg, Nominee Liens – the lis pendens of tax lien practice (Procedurally Taxing Blog 4/7/14).

The nominee lien is not specifically authorized by the Code but is authorized administratively and recognized by the courts.²³⁵⁸ The nominee lien names the third party who the IRS has determined is acting as nominee for the taxpayer and is filed to preserve the IRS's interest in the property allegedly so held. The effect of the nominee lien is to put the public on notice that the IRS believes the property may be property of someone other than the nominal title owner, thereby clouding title of the third party (the putative nominee) and effectively preventing that third party from dealing with the property.²³⁵⁹ Obviously, this could be a major problem to a third party who really owns the property and is not in fact acting as nominee.

The IRS may also proceed by foreclosure suit, in which case the taxpayer's interest in the property putatively owned by the nominee, alter ego or agent will be judicially determined.

c. **Alter Ego.**

The alter ego concept is slightly different.²³⁶⁰ The alter ego is a separate person (usually an entity) that is treated as the taxpayer because, in the IRS belief, it functions as an extension of the taxpayer without independent significance. For example, if a taxpayer is the shareholder of a corporation and fails to respect the corporate entity in dealing with the corporation, the IRS may assert that the corporation is an alter ego of the taxpayer and thus use collection tools against the corporation with respect to the individual shareholder's liability.²³⁶¹ Sometimes the IRS will use both nominee and alter ego concepts in the same collection action.²³⁶²

The alter ego concept is found in state law. Traditional application of this concept has often (not always) looked to the state law to determine the scope of its deployment by the IRS. However, the IRS takes the position that, given the nation-wide application of the tax law and the need for uniformity in its application, the alter ego concept should be a federal common law concept rather than dependent on the vagaries and uncertainties of state law.²³⁶³

Upon the assertion of alter ego or other theories such as agency, the IRS has the remedies discussed above for nominees.

²³⁵⁸ See G.M. Leasing, *supra*.

²³⁵⁹ See IRS Program Manager Technical Assistance on Nominee Lien, 2009 TNT 67-36 (citing Elliot, William D., *Federal Tax Collection, Liens & Levies* § 9.10).

²³⁶⁰ See Hoffer, et al, Nominee's Dilemma, p. 806.

²³⁶¹ I have seen this, for example, where the IRS wanted to make a continuing levy on personal service compensation payments made to a corporation. The statute permits a continuing levy only against an individual performing services. By treating the corporation as the alter ego of the taxpayer who fails to respect the corporate entity the IRS can bootstrap itself into the validity of a continuing levy on payments otherwise due to the corporation.

²³⁶² Oxford Capital Corp. v. United States, 211 F.3d 280, 283-84 (5th Cir. 2000) (levy on corporation as nominee and alter ego).

²³⁶³ See CC-2012-002, reproduced at 2011 TNT 235-14.

d. Other Theories.

Other general and state law theories may be invoked to impose liability upon a taxpayer other than the taxpayer against whom a tax liability has been determined or assessed. For example, under state law, if an entity is deemed a successor to a taxpayer, the successor entity may be subject to the taxpayer's tax liability.²³⁶⁴ In addition, if the IRS can assert a conversion under state law, it may be able to use the state law remedy.²³⁶⁵

e. Protections Against and Remedies for Wrongful Collection Activity.

You have already spotted the problem with these concepts – an “innocent” third party may be hit with collection action related to the liability of someone for whom that third party is not serving as nominee, alter ego or otherwise. We have previously noted that the IRS's collection tools – including nonjudicial levy or just the filing of a tax lien against property – are powerful and, in the context of proceeding against such a third party could be quite oppressive. The remedies for wrongful collection action against such a third party are not wholly satisfactory.²³⁶⁶

For this reason, the IRS requires extra internal administrative steps – including division counsel approval -- before these concepts may be used in collection action.²³⁶⁷ But, assuming that these internal steps are taken, the “innocent” third party has some but limited remedies.

If the IRS levies under these theories, the third party may pursue the wrongful levy action authorized by § 7426.²³⁶⁸ In that proceeding, the IRS must prove a nexus between the property levied upon and the taxpayer but ultimately the burden is on the party filing the action to show that the property is not beneficially owned by the taxpayer.²³⁶⁹

If the IRS takes action short of levy (most importantly, the filing of a nominee lien that impairs the third party's credit or ability to deal with the property), the third party has administrative

²³⁶⁴ See ILM 200847001 (7/24/08), reproduced at 2008 TNT 227-13.

²³⁶⁵ United States v. Boardwalk Motor Sports, Limited, 692 F.3d 378 (5th Cir. 2012) (with the majority rejecting the IRS's conversion claim because as it read state law, conversion required that the claimant (in the case, the IRS) have the right to immediate possession of the property which, on the facts, the IRS did not have). The dissenter disagreed, finding that the IRS by three party negotiated agreement had the right to possess the proceeds of sale of the property).

²³⁶⁶ See generally Hoffer, et al, Nominee's Dilemma; and Amy S. Elliott, Increased IRS Use of Alter Ego Liens Causing Problems for Taxpayers, 2012 TNT 154-2 (8/9/12).

²³⁶⁷ LGM GL-21 (Oct. 31, 1989), reproduced at 2000 TNT 121-35.

²³⁶⁸ See Hoffer, et al, Nominee's Dilemma, pp. 843-844.

²³⁶⁹ See Oxford Capital Corp. v. United States, 211 F.3d 280 (5th Cir. 2000) (noting split in cases on issue of how strong a showing the Government must make).

appeal rights, principally the CAP appeal which does not offer a judicial remedy. The third party can also bring a judicial action to quiet title.²³⁷⁰

3. Transferee Liability and Special Statutory Procedure.

a. General.

What happens, however, if the taxpayer has made a transfer in which the taxpayer did not retain beneficial interest? If the general federal tax lien existed before the transfer and the transfer was without full consideration, the lien attaches to the property in the transferee's hands.²³⁷¹ Further, the IRS has the rights allowed creditors by state or federal law of fraudulent conveyances.²³⁷²

Perhaps the most commonly encountered form of transferee liability remedy is the fraudulent conveyance suit under state law or under the Federal Debt Collection Practices Act ("FDCPA").²³⁷³ The following from the IRM are good summaries of the key facets of this remedy under state and federal law.

5.17.14.2.3.2.1 (01-24-2012)

Fraudulent Transfers Under Federal and State Law

1. The Federal Debt Collection Procedures Act (FDCPA) became effective in 1991. 28 USC § 3001 et seq. Prior to the FDCPA, the United States relied on applicable creditor and debtor law of the various states to attack fraudulent transfers.
 - A. The FDCPA gives the United States a uniform federal procedure for setting aside a fraudulent transfer to aid in the collection of federal debts, including tax debts. 28 USC § 3301 et seq. These sections of the FDCPA are based on the Uniform Fraudulent Transfers Act, 7A Pt. II Uniform Laws Annotated (ULA) 2.
 - B. The United States is not bound to use the FDCPA to collect its debts. If necessary, it can proceed under any cause of action provided by state or federal law. See United States v. Letscher, 99-2 USTC ¶ 50,947 (S.D.N.Y. 1999).
2. All states recognize a cause of action to set aside a fraudulent transfer. A majority of jurisdictions have adopted either the Uniform Fraudulent Conveyance Act (UFCA), 7A Pt. II ULA 246 (2 states & U.S. Virgin Islands) or its successor, the Uniform Fraudulent Transfer Act (UFTA), 7A Pt. II ULA 2 (43 states and the District of Columbia). The fraudulent transfer provisions found in the UFTA are similar to those in the FDCPA.

²³⁷⁰ 28 U.S.C. § 2410; See Hoffer, et al, Nominee's Dilemma, pp. 840-841.

²³⁷¹ § 6323(a).

²³⁷² See IRM 5.17.14.4.1(2) (10-19-2007).

²³⁷³ Title XXXVI of the Crime Control Act of 1990, Pub. L. No. 101-647, 104 Stat. 4789, 4933 (codified as amended in various sections of 28 U.S.C.).

3. The FDCPA, the UFCA and the UFTA recognize both actual fraud and constructive fraud as grounds for setting aside a transfer.

5.17.14.2.3.2.2 (01-24-2012)

Types of Fraud in a Fraudulent Transfer

1. Constructive fraud and actual fraud are the two principal kinds of fraud. At least one of them must be proven to set aside a transfer.
 - A. Proof of constructive fraud is sufficient to set aside a transfer that occurs after the debt arises. FDCPA § 3304(a); UFTA § 5; UFCA §§ 4 and 5.
 - B. Proof of actual fraud will defeat a transfer whether the debt arises before or after the transfer. FDCPA § 3304(b); UFTA § 4; UFCA §§ 6 and 7.
2. Constructive fraud exists when property is transferred for inadequate consideration (or for less than the reasonably equivalent value) and the transferor either is insolvent when the transfer occurs or is made insolvent by the transfer. FDCPA § 3304(a); UFTA §§ 4(a)(2) and 5; UFCA §§ 6 and 7. A transferor's intent is immaterial if constructive fraud is proven. See IRM 5.17.14.2.3.2.2.1 .
3. Actual fraud occurs when property is transferred with the actual intent to hinder, delay, or defraud a creditor in the collection of a debt owed it. FDCPA § 3304(b); UFTA § 4(a)(1).
 - A. It can be difficult to prove that a transfer was made with the actual intent to defraud a creditor. A fraudulent transfer usually is made without any verbal or written expression of the reason for the transfer.
 - B. Because of this, actual fraud is generally proved through circumstantial evidence known as the "indicators of fraud," such as lack of adequate consideration or a transfer to insiders. For other indicators of fraud, see IRM 5.17.14.2.3.2.2.2(3), below.
4. The fact that a taxpayer is in debt does not preclude the taxpayer from transferring property for adequate consideration. A transfer founded on adequate consideration and made with a bona fide intent is valid against the United States. But see the discussions of preferential transfers in IRM 5.17.14.2.3.2.2.1(6) and the trust fund doctrine in IRM 5.17.14.2.3.3, below.

The IRS has analyzed its remedies as follows:

Three of these FDCPA provisions for setting aside transfers fraudulent as to the United States involve variants of "constructive fraud," subsections 3304(a)(1), 3304(b)(1)(B)(i), and 3304(b)(1)(B)(ii). A fourth FDCPA provision addresses "actual fraud," subsection 3304(b)(1)(A). A fifth FDCPA provision, subsection 3304(a)(2), involves transfers to insiders of the Transferor for even bona fide antecedent debts if the insider had reasonable cause to believe the Transferor was insolvent. * * * [t]he Service may also consider alternative reliance on any of these five FDCPA provisions as potential grounds in this case for imposing personal transferee liability (under I.R.C. section 6901) or for filing a federal district court action to set aside a fraudulent transfer * * *. Subsection 3304(b)(2) describes

eleven, non-exclusive factors (badges of fraud) to be considered in determining the Transferor's "actual intent" to hinder, delay, or defraud a creditor for purposes of the FDCPA, including: (1) the transfer was to an insider; (2) the transfer was of substantially all the debtor's assets; (3) whether the value of the consideration received by the debtor was reasonably equivalent; (4) whether the debtor was insolvent or became insolvent shortly after the transfer was made; and/or (5) the transfer occurred shortly before or shortly after a substantial debt was incurred.²³⁷⁴

In the same analysis, the IRS concludes that, although the FDCPA statutes of limitations (as well as the state law remedy statutes of limitations) may have expired, the IRS could still invoke the procedures and special limitations periods of § 6901 (discussed below) to obtain a fraudulent transfer remedy.

In addition to fraudulent conveyance remedies against transferees, state law may also have other remedies against transferees. For example, many states have a provision making a shareholder receiving the assets of a liquidating corporation liable for the debts of the corporation, at least up to the value of the assets the shareholder received in the liquidation.²³⁷⁵ The IRS may take advantage of these remedies either in a separate collection suit or in the special transferee provision of § 6901, the Code's procedural transferee liability provision discussed below.²³⁷⁶

Most state or federal remedies, particularly those involving fraudulent conveyances, are pursued by bringing a law suit in an appropriate court. What administrative levy steps short of a suit can the IRS can take? The IRS position is that it must look to the fraudulent conveyance and related laws of the state. Some states permit a creditor to levy on property without a need for suit to set aside the conveyance, and in those states, the IRS may also do that. Other states do not permit such a levy, and the IRS will not levy in those states but will instead either pursue the transferee liability remedy or pursue a collection suit against the property in the hands of the transferee in which the IRS will rely upon the fraudulent conveyance and similar laws of the state.²³⁷⁷

²³⁷⁴ ILM 200136009 (released 9/7/2001).

²³⁷⁵ See the application of a Colorado provision in United States v. Holmes, 727 F.3d 1230 (10th Cir. 2013).

²³⁷⁶ The IRS is not required to pursue the § 6901 remedy permitting an assessment against the transferee and may pursue a collection suit by invoking a general state or federal remedy without a § 6901 assessment. See United States v. Holmes, 727 F.3d 1230 (10th Cir. 2013) (so holding and further holding, over a vigorous dissent, that the general tax statute of limitations applied to the suit; the dissent also vigorously contests the holding that there is no requirement for a predicate § 6901 assessment). See Lori McMillan, Transferee Shareholders and the Long Arm of the IRS, 141 Tax Notes 223 (Oct. 14, 2013),

²³⁷⁷ See LGM GL-21 reprinted at 2000 TNT 121-35 (6/22/00).

b. Transferee Liability Under § 6901.

Section 6901 gives the IRS special procedures in which to invoke its rights as a creditor of a taxpayer with regard to a transferee²³⁷⁸ paying less than fair value. Section 6901 “does not create a new liability but merely provides a remedy for enforcing the existing liability of the transferor.”²³⁷⁹

One key difference between this procedure and parallel state procedures is that the proceeding is not in rem involving the property but imposes personal liability in a dollar amount upon the transferee. Procedurally, under § 6901, the IRS may proceed against the transferee in the similar manner to the way it proceeds for the underlying tax liability (notice of liability, which is the § 6901 counterpart to the notice of deficiency, Tax Court litigation if the transferee petitions for redetermination, and assessment if the transferee fails to petition or loses in the Tax Court).²³⁸⁰ A special limitations period is provided – one year after the statute of limitations expires on the taxpayer-transferor.²³⁸¹ The statute of limitations may be extended by agreement.²³⁸² When the IRS sends a notice of liability to the transferee, the statute of limitations is tolled in a manner similar to the underlying tax liability when the taxpayer receives a notice of deficiency.²³⁸³

Under this procedure and the judicial proceedings that ensue, the IRS invokes creditors’ remedies otherwise available “at law” (such as third party beneficiary under a contract theory or a specific statute imposing transferee liability such as upon dissolution of a corporation) or “in equity” under state or federal law.²³⁸⁴ This is a key point – § 6901 does not create the remedy; all it does is

²³⁷⁸ A transferee is defined broadly. § 6901(h); Regs. § 301.6901-1(b).

²³⁷⁹ Commissioner v. Stern, 357 U.S. 39, 42 (1958); and Diebold Found. v. Commioner, 736 F.3d 172 (2d Cir. 2013). Prior to the creation of the predecessor of § 6901 in 1926, the IRS had the transferee remedies and procedures provided under state law, but the procedures were cumbersome; hence the enactment of § 6901 to create a new procedure. See Starnes v. Commissioner, 680 F.3d 417 (4th Cir. 2012).

One consequence of § 6901 being only procedural, but the state law supplying the substantive rules is that interest on the tax liability accruing from the date of the transfer is determined under state law, not under the Code’s interest provisions. Schussel v. Werfel, 758 F.3d 82 (1st Cir. 2014) (also noting that there may be an issue of the interest from the date of the notice of transferee liability).

²³⁸⁰ § 6901(a).

²³⁸¹ § 6901(c). Thus, for example, where the taxpayer’s tax liability involved fraud or the intent to evade, thus allowing an unlimited statute of limitations against the taxpayer, there will also be an unlimited statute of limitations against the transferee. See § 6501(c) (unlimited statute of limitations against taxpayer). The IRS will have the burden of proving fraud by clear and convincing evidence (§ 7454; see also Tax Court Rule 142(b)). For an application of these rules, see Pert v. Commissioner, 105 T.C. 370 (1995).

²³⁸² § 6901(d).

²³⁸³ § 6901(f).

²³⁸⁴ § 6901(a)(1).

create the procedure whereby the IRS invokes a federal or state law remedy against a transferee.²³⁸⁵ There is now a federal remedy, the Federal Debt Collection Practices Act (“FDCPA”), which is a federal remedy similar to the fraudulent conveyances acts in the various states. The IRS may rely upon either the federal remedy or the state law remedy.

One of the most common state law remedies invoked by the IRS is the state’s fraudulent conveyance statute, but as we have noted the FDCPA parallels state fraudulent conveyance remedies so the fraudulent conveyance judicial authority may apply to the FDCPA. These state statutes (which may vary from state to state) generally give a creditor remedies when a debtor transfers property to hinder or defraud creditors. For example, assume that a taxpayer expects to receive a notice of deficiency from the IRS for a tax liability that the taxpayer knows is due. Because the notice of deficiency is not yet issued, there has been no assessment and thus there is no lien against the taxpayer’s property. Can the taxpayer transfer his property to his children to avoid the IRS’s collection against the property when the inevitable assessment is made? The answer is that he can make a transfer in anticipation of the IRS’s subsequent assessment, but the IRS would likely find a remedy under the state fraudulent conveyance statute.²³⁸⁶ The IRS can pursue the remedies and procedures under the state fraudulent conveyances statute (or the FDCPA if it chooses), or pursue the same remedies in a § 6901 proceeding.

The Tax Court has cited the following as a “generalization of typical State law” as to a remedy in equity for fraudulent conveyances:

(1) That the alleged transferee received property of the transferor; (2) that the transfer was made without consideration or for less than adequate consideration; (3) that the transfer was made **during or after the period for which the tax liability of the transferor accrued**; (4) that the transferor was insolvent prior to or because of the transfer of property or that the transfer of property was one of a series of distributions of property that resulted in the insolvency of the transferor; (5) that all reasonable efforts to collect from the transferor were made and that further collection efforts would be futile; and (6) the value of the transferred property (which determines the limit of the transferee's liability).²³⁸⁷

²³⁸⁵ Commissioner v. Stern, 357 U.S. 39, 42-47 (1958); and Hagaman v. Commissioner, 100 T.C. 180, 183 (1993). Prior to the enactment of the predecessor of § 6901, the IRS could bring a civil suit just as creditors could under state law. See Gregory A. Byron, Transferee Liability Under Section 6324: Defining the Extent of a Transferee's Liability for Interest, 32 Idaho L. Rev. 383, 387-388 (1996). Whether the state law procedures previously available remain available as an alternative to the § 6901 procedure is not clear. *Id.*

²³⁸⁶ Hagaman v. Commissioner, 100 T.C. 180 (1993) (look to tax liability as it accrues rather than when assessed), citing inter alia Edelson v. Commissioner, 829 F.2d 828, 833-834 (9th Cir. 1987); and Updike v. United States, 8 F.2d 913 (8th Cir. 1925).

²³⁸⁷ Hagaman v. Commissioner, 100 T.C. 180 (1993), quoting Gumm v. Commissioner, 93 T.C. 475, 480 (1989) (emphasize supplied by author of this text), *affd.* without published opinion 933 F.2d 1014 (9th Cir. 1991).

The Tax Court cautioned, however, that this is just a generalized statement of typical state law and that the state may allow a creditor a remedy even when some of the elements are different or absent.²³⁸⁸ Often, for example, the key fact in dispute will be the taxpayer's insolvency at the time of the dispute (where insolvency, under the particular state law is required for the remedy). Insolvency is a balance sheet test as of the date of the transfer, but the IRS may consider subsequent related transfers.²³⁸⁹ The test is whether the transfer for less than fair consideration rendered the transferor insolvent, thus constituting constructive fraud even if he had no actual intent to defraud.²³⁹⁰

The Tax Court also cautioned that the general statement of the equitable remedy did not apply to state "law" remedies at law (as opposed to "equity" remedies).²³⁹¹ Examples of remedies at law are remedies under a corporate merger statute or bulk sales law.

The IRS has the burden of proving the existence and extent of transferee liability.²³⁹² The IRS must prove that the taxpayer transferor had a tax liability and the amount of the liability. The IRS assessment meets the IRS's initial burden, for the IRS is not required to prove that the taxpayer was actually liable for the tax.²³⁹³ In other words, just as the taxpayer in a court proceeding would have the burden of proof with respect to the liability asserted by the IRS, so the transferee seeking to avoid or mitigate transferee liability must prove that the taxpayer's tax liability is less than asserted by the IRS. If the taxpayer has previously contested the liability in a judicial proceeding, the taxpayer is bound by the results of the proceeding, and so is the transferee who is deemed to be in privity with the taxpayer.²³⁹⁴ Using similar reasoning, a transferee is bound by a taxpayer's closing agreement with the IRS under § 7121.²³⁹⁵

²³⁸⁸ Thus, in Hagamann v. Commissioner, the Court held that, under the applicable law (Florida and Tennessee), insolvency was not required so long as the transfer was made under circumstances indicating an intent to delay, hinder or defraud creditors (the key creditor being, in the case, the IRS). In applying the law, the Court also noted that state law in that case gave the creditor the benefit of a presumption that certain transfers are made with the required intent.

²³⁸⁹ Botz v. Helvering, 134 F.2d 538, 543 (8th Cir. 1943), affg. 45 B.T.A. 970 (1941); see also Hagaman v. Commissioner, supra; Gumm v. Commissioner, supra, p. 480 (1989).

²³⁹⁰ IRM 5.17.14.29(3) (10-19-2007).

²³⁹¹ Hagaman v. Commissioner, supra.

²³⁹² § 6902(a); see also Commissioner v. Stern, supra at 45; Hagaman v. Commissioner, supra at 183-184. As to Tax Court proceedings, see Tax Court Rule 142(d).

²³⁹³ § 6902(a).

²³⁹⁴ United States v. Davenport, 484 F.3d 321 (5th Cir. 2007); Baptiste v. Commissioner, 29 F.3d 1533, 1539 (11th Cir. 1994); Baptiste v. Commissioner, 29 F.3d 433 (8th Cir. 1994); First Natl. Bank v. Commissioner, 112 F.2d 260 (7th Cir. 1940); Krueger v. Commissioner, 48 T.C. 824, 830 (1967) (noting that "it would be a strange rule to confer upon the transferee broader rights than the transferor by allowing the transferee to relitigate an issue when a transferor is denied that privilege.").

²³⁹⁵ Pert v. Commissioner, 105 T.C. 370 (1995).

Does the taxpayer's liability include interest and penalties? The law seems clear that, at least the interest and penalties accrued as of the date of the transfer should be included in the transferee's liability.²³⁹⁶ What about subsequently accruing interest and/or penalties? The IRM says that the taxpayer is liable for interest on the transferee assessment from the date of the notice of the transferee liability,²³⁹⁷ but that whether the transferee is liable for penalties and interest incurred by the taxpayer/transferor from the date of the transfer to the date of the notice of transferee liability is a matter of the underlying remedy law (federal or state).²³⁹⁸ The Tax Court sustained this position as to interest, often referred to as prejudgment interest under state law.²³⁹⁹

Transferee liability requires two facets, referred to as "prongs."²⁴⁰⁰ First, the person must be a transferee. The transferee issue is determined by a federal law test in order apply a uniform standard.²⁴⁰¹ Second, the party must be subject to liability at law or in equity under state law (or federal creditor law if applicable). DOJ Tax says that transferee status (the first prong) is determined under federal law and, if transferee status is determined, then the state law determination must be made considering the person as a transferee.²⁴⁰² In other words, the state law determination

²³⁹⁶ See Gregory A. Byron, Transferee Liability Under Section 6324: Defining the Extent of a Transferee's Liability for Interest, 32 Idaho L. Rev. 383, 389-390 (1996) (regarding the parallel provision under § 6324).

²³⁹⁷ IRM 5.17.14.5.9(2) (10-19-2007); Patterson v. Sims, 281 F.2d 577 (5th Cir. 1960). In this regard, the Eleventh Circuit has reasoned that, although the § 6901 liability is an independent liability rather than a tax liability, § 6901(a) requires that the liability is "subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred," so that once the transferee liability provision is invoked, interest can then accrue under § 6601. Baptiste v. Commissioner, 29 F.3d 1533, 1541-2 (11th Cir. 1994). The Baptiste court distinguished the normal § 6901 case from the § 6901 case involving § 6324(a) which creates the transferee's liability for transfer tax at the time of the transfer or the time the tax is due (rather than when the IRS asserts transferee liability).

²³⁹⁸ IRM 5.17.14.5.9(2) (10-19-2007), citing Stansbury v. Commissioner, 102 F.3d 1088 (10th Cir. 1996).

²³⁹⁹ Rubenstein v. Commissioner, T.C. Memo 2010-274.

²⁴⁰⁰ Diebold Found. v. Commissioner, 736 F.3d 172 (2d Cir. 2013). The two prongs derive from Commissioner v. Stern, 357 U.S. 39, 44-45 (1958), so the two-pronged inquiry is sometimes referred to as the Stern test. Slone v. Commissioner, ___ F.3d ___, ___, 2015 U.S. App. LEXIS 9546 (9th Cir. 2015).

²⁴⁰¹ Id. See also Jeremiah Coder, ABA Meeting: Transferee Liability Cases Involve Federal Law and Substance Over Form, 2012 TNT 180-9 (9/17/12), which quotes a DOJ Tax official as reasoning that the courts say that the inquiry can be based on substance over form, an inquiry ubiquitous in the federal tax law (citing Frank Lyon Co. v. United States, 435 U.S. 561 (1978)). I am not sure that the conclusion necessarily follows from the articulated premise, but am not sure it would make much difference in most cases.

²⁴⁰² See Feldman v. Commissioner, 779 F.3d 448 (7th Cir. 2015) (summarizing the position and the state of the law).

(the second prong) is affected by the determination that the person is a transferee under the first prong; the use of the transferee determination in the second prong can make the transferee liable where he or she would not have been liable as a nontax creditor under state law. The courts that have addressed the issue, however, determine that the prongs are independent and that the state law prong is the same as applied to creditors generally under state law, unaffected by the transferee status determination under state law.²⁴⁰³ As the courts have reasoned pungently, since the prongs are independent, if there is no liability under state law (the second prong), it makes no difference that the person was a transferee under the first prong.²⁴⁰⁴ I am not sure that, except in rare cases, that nuance, whichever way it is finally determined, would be outcome determinative.²⁴⁰⁵

Under some fraudulent conveyance remedies, if the property is other than cash, the creditor can set aside the fraudulent conveyance, but that type of remedy must be pursued under the procedures of the remedy law (either state remedy law or the FDCPA). The liability under § 6901 is a dollar amount imposed personally upon the transferee (as opposed to an in rem liability against the property). The general cap on the liability is the value of the property on the date of the transfer. Thus, if the taxpayer owing \$1,000,000 to the IRS on the date of transfer transfers \$10,000 to his son and thereafter does not pay the tax, the son's liability will be capped at \$10,000. In the case of the cap in this example, it would seem that interest would only run from the date of notice of transferee liability, rather than from the date of the transfer.²⁴⁰⁶ Under the rules noted above, of course, that cap amount would be subject to interest from the date of notice of the transferee liability.

²⁴⁰³ See Feldman v. Commissioner, 779 F.3d 448 (7th Cir. 2015) (summarizing the position and the state of the law).

²⁴⁰⁴ Diebold Found. v. Commissioner, 736 F.3d 172, 186 (2d Cir. 2013) (“if Diebold New York did not receive a conveyance from Double D for purposes of the NYUFCA, ‘then whether or not it was a ‘transferee’ for purposes of § 6901 is irrelevant,’” citing and quoting Frank Sawyer Trust of May 1992 v. Commissioner, 712 F.3d 597, 605 (1st Cir. 2013) and Starnes v. Commissioner, 680 F.3d 417, 427 (4th Cir. 2012).

²⁴⁰⁵ For example, although rejecting DOJ Tax's argument that the prongs are interdependent, in Diebold Found. v. Commissioner, 736 F.3d 172 (2d Cir. 2013), the Second Circuit reversed the Tax Court's holding on the second prong, finding that “it is obvious that the parties knew, or at least should have known but for active avoidance, that the entire scheme was fraudulent and would have left Double D unable to pay its tax liability.” The Second Circuit remanded to the Tax Court to make the determination of transferee status under the first prong, to determine whether a transferee of a transferee could be liable, and what statute of limitations applied. See also Salus Mundi Found. v. Commissioner, 776 F.3d 1010 (9th Cir. 2014) (same); and Slone v. Commissioner, ___ F.3d ___, 2015 U.S. App. LEXIS 9546 (9th Cir. 2015).

²⁴⁰⁶ A similar issue arises for transferees, such as donees as to gift taxes, who are liable under some other provision of the Code (i.e., the Code gives the remedy). In this case, the donees are liable for the amount of the gift tax even if the property subsequently depreciates in value.

As with the trust fund recovery penalty (“TFRP,” which I discuss below), transferee liability is joint and several, so that more than one person can be subject to transferee liability.²⁴⁰⁷ The IRS can pick and choose which transferees to pursue. Certainly, the IRS should have the flexibility to determine where its resources are best spent in the protection of the fisc. Selective or disproportionate collection from less than all transferees potentially liable, however, presents a fairness issue as among the transferees. For example, assume that a taxpayer owed \$100,000 in tax and transferred \$100,000 to each of his sons, A and B (total of \$200,000). The IRS chooses to go against A and actually collects from A, after A has pursued all administrative and judicial remedies available to him. Is it fair that the IRS collected only from A who is left with nothing and B is left with his entire \$100,000? There may be state law contribution remedies available, but that varies from state to state.²⁴⁰⁸

Transferee liability must be distinguished from the IRS’s administrative remedy to levy on property. Transferee liability under § 6901 merely establishes the transferee’s personal liability “so as to obtain a general floating lien on the transferee’s property.”²⁴⁰⁹ It is different from levy where the IRS seizes the property itself but does not establish a general floating lien on the transferee’s property.

Finally, we have talked above of the first level transferee from the taxpayer – i.e., the one to whom the taxpayer makes the transfer. The problem of transfers to avoid the tax applies equally to other levels of transferees – i.e., the initial transferee seeking to avoid transferee liability may transfer to one or more other transferees. The statute applies also to those transferees and gives the IRS additional statute of limitations relief in pursuing those transferees.²⁴¹⁰

²⁴⁰⁷ See Steve R. Johnson, Unfinished Business on the Taxpayer Rights Agenda: Achieving Fairness in Transferee Liability Cases, 19 Va. Tax Rev. 403 (2000).

²⁴⁰⁸ See Steve R. Johnson, Unfinished Business on the Taxpayer Rights Agenda: Achieving Fairness in Transferee Liability Cases, 19 Va. Tax Rev. 403 (2000). Similar unfairness issues are presented in other circumstances where the tax law imposes joint and several liability. As we shall see below, with respect to the TFRP, a similar issue of fairness is presented and Congress provided in § 6672(d) a federal contribution remedy that is not dependent in any way upon the vagaries of state law contribution rights. Using § 6672 as a model, it has been suggested that Congress enact similar contribution remedy for transferee liability. Joint and several liability attending joint returns for married taxpayers also presents a potential for this type of unfairness, but some of the potential for unfairness is mitigated by the so-called innocent spouse provisions of the Code which may shift the burden from a spouse otherwise jointly liable to the more culpable spouse relative to the unpaid tax.

²⁴⁰⁹ IRS LGM GL-21, reprinted at 2000 TNT 121-35 (6/22/2000).

²⁴¹⁰ § 6901(c)(2).

B. Liability for Trust Fund Taxes - the Trust Fund Recovery Penalty (“TFRP”).

1. Introduction.

a. Withholding Taxes a/k/a Trust Fund Taxes.

As I noted above, the Code requires various payors of amounts to withhold for taxes dues or potentially due from the payee with respect to the amounts paid. The most commonly encountered example is where an employer must withhold from an employee’s wages for the employee’s federal income taxes and for the employee’s share of FICA taxes. The background for the withholding issue is as follows:

An employer is subject to federal taxes on wages paid to employees. An employer must pay a tax equal to 6.2% of wages for the Social-Security portion of the tax and 1.45% for the Medicare portion of the tax. Sec. 3111(a) and (b). Another tax, computed at the same rates (6.2% and 1.45%), falls on employees. Sec. 3101(a) (6.2% Social-Security tax on wages received by employees) and (b) (1.45% Medicare tax on wages received by employees). Both the tax on employers and the tax on employees are referred to as the FICA. In addition, an employer must withhold the employee share of FICA from the wages paid and must pay the withheld amount to the IRS. Sec. 3102(a) (the employee share of FICA must be collected by the employer by deducting and withholding the amount of tax from wages as paid) and (b) (every employer required to deduct the employee share of FICA is liable for payment of the employee share of FICA). Moreover, an employer is obligated to withhold from wages amounts for the income taxes owed by its employees and must pay the withheld amount to the IRS. Secs. 3402(a)(1) ("every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary [of the Treasury]"), 3403 (every employer that is required to deduct income tax is liable for payment of the deducted amount). Once net wages are paid to the employee, the IRS credits the employee with the taxes withheld, even if the employer does not pay over the withheld amount to the IRS. See *Slodov v. United States*, 436 U.S. 238, 243 (1978). The term "employment taxes" refers to all three of the employer's obligations that we have just discussed: (1) employer share of FICA, (2) employee FICA withholding, and (3) income-tax withholding. The term "trust-fund taxes" refers to the last two obligations.²⁴¹¹

²⁴¹¹ Romano-Murphy v. Commissioner, T.C. Memo. 2012-330 (portions of quote omitted for better readability). As noted in Romano-Murphy, there is yet another tax related to the employer-employee status – the federal unemployment tax, acronymed to “FUTA” or “FUTA tax.” That tax is a 6.2% excise tax imposed on the employer for remuneration paid up to \$7,000 per calendar year.

The following example²⁴¹² is illustrative:

Employee earns \$45,000 in wages, of which the Employer withholds \$4,000 in federal income tax. The trust-fund and non-trust-fund portions of the employment tax would be calculated as follows:

Income Tax Withholdings	\$4,000
Social Security (12.4% wages) Employee's Share (6.2% wages) Employer's Share (6.2% wages)	\$2,790.00 \$2,790.00
Medicare (2.9% wages) Employee's Share (1.45% wages) Employer's Share (1.45% wages)	\$652.50 \$652.50
Total Employment Tax	\$10,885.00
Trust Fund Portion (Income Tax + Employee's Share of Medicare & Social Security)	\$7,442.50
Non-Trust Fund Portion (Employer's Share of Medicare & Social Security)	\$3,442.50

I focus here on the portion referred to as the trust fund taxes. The theory is that the employer has in effect “paid” those amounts to the employee so that the employer is no longer entitled to the amounts and, by retaining the amounts, the employer holds them in trust for the Government until they are paid over to the Government to be applied to the employee’s tax accounts.²⁴¹³ Notwithstanding that the funds are designated “trust” funds, there is no requirement that, after withholding and prior to remitting to the Government, the funds actually be held in some type of segregated trust fund or account as is usually required for trust funds.²⁴¹⁴ Prior to remission to the Government, the employer holds the funds and can use them for any purpose it wants to, although the person or persons directing their use for purposes other than payment of the trust fund tax can

²⁴¹² The example is from Ross v. United States, 2013 U.S. Dist. LEXIS 83665 (D DC 2013).

²⁴¹³ § 7501 (“amount of tax so collected or withheld shall be held to be a special fund in trust for the United States”); see Slodov v. United States, 436 U.S. 238, 242-243 (1978).

²⁴¹⁴ Interfacing with the bankruptcy laws, the Supreme Court has held that, although the withheld tax is not a “trust fund” in the normal use of the term so that, prior to the remittance to the IRS there only an amount rather than a trust fund, the trust fund nature of the amount is, in effect, perfected by the payment to the IRS. Begier v. Internal Revenue Service, 496 U.S. 53 (1990) (in bankruptcy lingo this means that the payment is not a preference that can be avoided in bankruptcy).

be personally liable for this TFRP penalty²⁴¹⁵ or even a parallel criminal penalty (§ 7202). The Government must credit the employee with the amount withheld even if the employer does not remit the withheld amounts to the IRS.²⁴¹⁶ The following is a good example of the courts' view of the trust fund tax and the employer's responsibility:

The withholding taxes "are part of the wages of the employee, held by the employer in trust for the government"; the employer, as a function of administrative convenience, extracts money from a worker's paycheck and briefly holds that money before forwarding it to the IRS. * * * A delinquency in trust fund taxes thus is not simply a matter between the IRS and an employer, but rather involves employee wages. The significant responsibility * * * is summed up by then-Judge Cardozo's famous statement that "[a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."²⁴¹⁷

Even if employer does not pay to the IRS the withheld trust fund taxes representing, in effect, payments by the employee of the employee's tax liabilities, the employee will be given credit against his income tax and credit for payments into the Social Security system for FICA.²⁴¹⁸ In effect, therefore, the employer is the withholding agent for the Government with any failure in payment attributed to the Government vis-a-vis the employee.

Keep in mind that the employer has the primary obligation to remit the employment taxes, including the trust fund taxes, to the IRS. The person responsible under § 6672 has only a secondary obligation if the employer does not pay. One difference these two liabilities is with respect to interest. The employer's liability accrues on the date the tax becomes due (periodically as prescribed based on the number of employees) and interest on failure to pay plus any employer penalties runs from the due date. The responsible persons liability under § 6672 does not accrue until assessed and is in the principal amount of the trust fund taxes assessed without the employers' penalties; then, interest on that principal amount does not run until the assessment date.²⁴¹⁹

²⁴¹⁵ One court has said it is a form of piercing the corporate veil that would otherwise limit the liability of persons other than the corporation itself. Ross v. United States, 2013 U.S. Dist. LEXIS 83665 (D. D.C. 2013).

²⁴¹⁶ Slodov v. United States, 436 U.S. 238, 243 (1978) (the withheld taxes are credited to the employees "regardless of whether they are paid by the employer, so that the IRS has recourse only against the employer for their payment."); and Emshwiller v. United States, 565 F.2d 1042, 1044 (8th Cir. 1977) ("any failure by the employer to pay withheld taxes results in a loss to the government in that amount").

²⁴¹⁷ Bell v. United States, 355 F.3d 387 (6th Cir. 2004).

²⁴¹⁸ Slodov v. United States, 436 U.S. 238 (1978); Fiataruolo v. United States, 8 F.3d 930, 938 (2d Cir. 1993).

²⁴¹⁹ Ross v. United States, 2013 U.S. Dist. LEXIS 83665 (D. D.C. 2013) (noting that the employer's liabilities for the trust fund taxes will thus be substantially higher than the responsible person's § 6672 liability because the employer's liability includes penalties not included in the

Obviously, given the amount of dollars in the system for such trust fund taxes, the IRS has a critical interest in encouraging compliance with requirements for withholding and paying over to the IRS. Accordingly, the IRS has major compliance functions to deal with potentially delinquent withholders.²⁴²⁰

b. Trust Fund Recovery Penalty (TFRP) - § 6672.

The Internal Revenue Code requires employers to withhold social security and federal excise taxes from their employees' wages.²⁴²¹ The employer holds these monies in trust for the United States. § 7501(a). Accordingly, courts often refer to the withheld amounts as “trust fund taxes”; these monies exist for the exclusive use of the government, not the employer. Payment of these trust fund taxes is not excused merely because as a matter of sound business judgment, the money was paid to suppliers in order to keep the corporation operating as a going concern – the government cannot be made an unwilling partner in a floundering business.²⁴²²

The Code assures compliance by the employer with its obligation to pay trust fund taxes by imposing personal liability on officers or agents of the employer responsible for the employer's decisions regarding withholding and payment of the taxes. Slodov v. United States, 436 U.S. 238 (1978). To that end, § 6672(a) of the Code provides that “[a]ny person required to collect, truthfully account for, and pay over any tax . . . who willfully fails” to do so shall be personally liable for “a penalty equal to the total amount of the tax evaded, or not . . . paid over.” § 6672(a). Although labeled as a “penalty,” § 6672 does not actually punish; rather, it brings to the government only the same amount to which it was entitled by way of the tax.²⁴²³

Personal liability for a corporation's trust fund taxes extends to any person who (1) is “responsible” for collection and payment of those taxes, and (2) “willfully fail[s]” to see that the taxes are paid.²⁴²⁴

It is important to distinguish between the employer’s liability for trust fund taxes and the secondary TFRP liability under § 6672. The liabilities are related, but not the same. For example, the employer’s payment of delinquent trust fund taxes will extinguish any TFRP liability that has been assessed. But, the two assessments are different assessments and will be subject to separate

responsible person’s liability and will accrue interest for a longer period).

²⁴²⁰ See e.g., IRM 5.7 (“Trust Fund Compliance Handbook”).

²⁴²¹ §§ 3402(a), 3102(a) (2006).

²⁴²² Collins v. United States, 848 F.2d 740, 741-42 (6th Cir. 1988).

²⁴²³ Turnbull v. United States, 929 F.2d 173, 178 n.6 (5th Cir. 1991).

²⁴²⁴ This three paragraph quotation is from Erwin v. United States, 591 F.3d 313, 319 (4th Cir. 2010). I have deleted or put in the footnotes certain of the case and Code citations. I have also deleted quotation marks and otherwise to make it more readable for purposes of this text book.

collection procedures against both the employer and the person assessed TFRP liability until the underlying trust fund taxes are paid.

The phenomenon often giving rise to the penalty is that the employer becomes delinquent in turning over the trust fund taxes to the IRS and then is unable to pay them. Frequently when a business is experiencing cash flow difficulties, the principal person or persons managing the business will attempt to keep the business afloat by using the trust fund taxes to pay what he or they perceive as more demanding needs; usually the expectation is the cash flow shortfall will be resolved, so that the trust fund tax will be paid later. The withholding taxpayer (the employer in the case of employment taxes) will often view its interim use of the trust fund tax proceeds as only a temporary expedient to get past the rough spots, with every intention of ultimately paying. If the business succeeds or the withholding taxpayer otherwise pays the delinquent taxes (with interest on the delinquent payments), everything works out fine. Too often, however, the business goes under, with the IRS (as well as many other creditors) holding the bag because, as noted, the IRS must give the taxpayer-employee credit for the withheld amount just as if the IRS had received it.²⁴²⁵

Section 6672 imposes civil liability – the TFRP – for the unpaid trust fund taxes upon those persons who organizationally had the responsibility and power to insure that the withheld taxes were paid over to the Government for the trust fund taxes rather than being used for other purposes.²⁴²⁶ The person(s) subject to the TFRP are those persons²⁴²⁷ (1) who were “required to collect, truthfully account for, and pay over” and (2) who willfully failed to do so.²⁴²⁸ The statute refers to the liability as a penalty but in reality it is just a secondary tax collection mechanism if the employer fails to remit the withheld taxes to the Government.²⁴²⁹

²⁴²⁵ See Slodov v. United States, 436 U.S.238, 242-243 (1978).

²⁴²⁶ This civil “penalty” provision and the parallel criminal provision in § 7202 was enacted with the 1954 Code and were based on earlier criminal provisions. See Gerald P. Moran, Willfulness: The Inner Sanctum or Unnecessary Element of Section 6672, 11 U. Tol. L. Rev. 709, 723-751 (1980) (discussing the legislative history of section 6672).

²⁴²⁷ In the case of a corporation or partnership, person “includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.” § 6671(b).

²⁴²⁸ There are parallel criminal penalties for more egregious cases (§§ 7202 and 7215). Government initiatives starting around 2000 suggest that the Government will use these criminal penalties more aggressively in order to discourage those tempted to use trust funds in the business from doing so. See e.g., United States v. Evangelista, 122 F.3d 112, 121 (2d Cir. 1997); and United States v. Gilbert, 266 F.3d 1180 (9th Cir. 2001) for examples of prosecutions in really egregious cases (Evangelista) and far less egregious cases (Gilbert).

²⁴²⁹ See Slodov v. United States, 436 U.S. 238 (1978). See Jenkins v. United States, 101 Fed. Cl. 122 n. 17 (2011) (describing the history of the section). Interestingly, the penalty was initially described as a criminal penalty, even though the only sanction was liability for the unpaid withholding taxes. Congress thereafter moved the provision from the criminal penalties of the Code because the provision did not provide for imprisonment and included it in the Code alongside other civil penalties. Now there is a separate criminal penalty in § 7202 for egregious violations of the

A person who might or might not otherwise be subject to the TFRP may have direct liability for the trust fund tax (as well as other taxes of the employer). Thus, under most states' general partnership laws, a partner in a general partnership will generally be liable for the partnership's liabilities including tax liabilities generally and employment taxes specifically (including both the employer's employment tax and the trust fund taxes withheld from employees). This general partner state law liability is wholly apart from the TFRP, so assessing the TFRP might be a redundant and unnecessary act.²⁴³⁰ By contrast, an owner in a limited liability entity (limited partnership, corporation, LLC, etc.) will be liable only under the TFRP (or possibly under the transferee liability provisions discussed above).

The distinction between trust fund and non-trust fund taxes is important. In the employment context, the withholding from the employee for income tax and FICA tax are trust fund taxes. The employer's direct liability for the employer's portion of the FICA tax is not a trust fund tax and is thus not subject to the TFRP. Furthermore, delinquency penalties and accrued interest for unpaid trust fund taxes are not included in the liability. So the quantum of the TFRP is the amount withheld (not including the employer's penalties or interest). However, once the TFRP is assessed, the amount assessed then bears interest.²⁴³¹

Finally, more than one person can be and often is liable for the TFRP, and hence the IRS often makes multiple assessments.²⁴³² And, a responsible person liable for the tax is not relieved of the obligation to the Government because there is another responsible person who is more culpable

duty to withhold and pay over to the IRS.

The TFRP may not be a penalty for purposes of § 6751(b)(1)'s requirement that penalty assessment under the Code be approved in writing by the immediate supervisor of the agent or officer proposing the penalty. United States v. Rozbruch, 2014 U.S. Dist. LEXIS 91789 (SDNY 2014).

²⁴³⁰ United States v. Galletti, 541 U.S. 114 (2004) (holding that separate assessments against the partners are not required for the collection statute of limitations to apply as to them); and In re Pitts, 2014 U.S. Dist. LEXIS 111765 (CD CA 2014) (extending Galletti, held that the IRS can use administrative collection measures of lien and levy against a general partner liable for the partnership's tax). See CC-2005-003, unofficially reproduced at 2005 TNT 14-18. Also, under the check the box rules, an entity otherwise qualifying for limited liability but which is treated as a tax nothing (for single member entities) or partnership (for multiple member entities) could subject the owner to direct liability independent of the TFRP. See ILM 200235023 (released 8/30/02).

²⁴³¹ Economically, this gives the person who is potentially subject to the TFRP incentive to delay assessment of the TFRP as long as possible. This usually will mean taking advantage of internal appeals rights prior to assessment and taking advantage of all extensions that are reasonably available. Purely dilatory tactics solely for the sake of delay, however, will likely be counterproductive and not worth the interest that might be saved by delay.

²⁴³² E.g. Brown v. United States, 511 F.2d 1136 (5th Cir. 1979); Winter v. United States, 196 F.3d 339, 345 (2d Cir. 1999), citing Fiataruolo v. United States, 8 F.3d 930, 938 (2d Cir. 1993).

relative to the default.²⁴³³ As will be noted, however, the IRS is not required to make the TFRP assessment against a person otherwise liable, even if that person is in some equitable sense more culpable.

2. Elements of Liability.

a. Parsing the Elements of the Statute.

Section 6672 imposes liability upon:

Any person required to collect, truthfully account for, **and** pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax . . . (Emphasis supplied)

Focusing on emphasized “and,” persons facing this liability argued that they could be liable only if their role with the employer encompassed each of the three stated elements – collect, account and pay. If these various corporate functions are split up, they reasoned, no one could be liable for the TFRP. The Supreme Court rejected that argument, holding, effectively, that “and” really meant “or.”²⁴³⁴ Still, even with this holding, what is the gravamen of the liability? As we shall see, it is the person who has practical control of the financial decisions that result in the trust fund taxes being paid.

b. Gravamen - Control of Financial Decisions.

The key to the civil liability is:

control of finances within the employer corporation: the power to control the decision-making process by which the employer corporation allocates funds to other creditors in preference to its withholding obligations.²⁴³⁵

A more elaborate statement of the liability is:

To determine who within a company is a “responsible person” under § 6672, we undertake a pragmatic, substance-over-form inquiry into whether an officer or

²⁴³³ E.g., Thosteson v. United States, 303 F.3d 1312, 1320 (11th Cir. 2002) (which also notes that the jury appeal of less culpability may be a false hope: “being less culpable does not exonerate Thosteson from his responsibility, which he knowingly disregarded. As we have observed, ‘the seeds of common sense compassion sown by the jury find scant hospitality on this rock hard legal landscape.’”); and Erwin v. United States, 591 F.3d 313, 324 (4th Cir. 2010), citing Turnbull v. United States, 929 F.2d 173, 178 (5th Cir. 1991).

²⁴³⁴ Slodov v. United States, 436 U.S.238, 246-250 (1978).

²⁴³⁵ E.g., Godfrey v. United States, 748 F.2d 1568, 1574 (Fed. Cir. 1984), quoting Haffa v. United States, 516 F.2d 931, 936 (7th Cir. 1975).

employee so “participated in decisions concerning payment of creditors and disbursement of funds” that he effectively had the authority -- and hence a duty-- to ensure payment of the corporation's payroll taxes. Stated differently, the “crucial inquiry is whether the person had the ‘effective power’ to pay the taxes -- that is, whether he had the actual authority or ability, in view of his status within the corporation, to pay the taxes owed.”²⁴³⁶

In pertinent part, IRS Policy Statement P-5-60 says the following about the penalty:

(3) Determination of Responsible Persons: Responsibility is a matter of status, duty, and authority. Those performing ministerial acts without exercising independent judgment will not be deemed responsible.

(4) * * * In general, non-owner employees of the business entity, who act solely under the dominion and control of others, and who are not in a position to make independent decisions on behalf of the business entity, will not be asserted the trust fund recovery penalty. * * * *

Who made the decisions that resulted in the nonpayment of the trust fund taxes? Or who was responsible for those decisions, even if he or she abdicated the responsibility?²⁴³⁷

Courts look to certain objective indicia to assist in identifying the role of the person. The following is a typical statement of the relevant indicia:

(1) is an officer or member of the board of directors, (2) owns shares or possesses an entrepreneurial stake in the company, (3) is active in the management of day-to-day affairs of the company, (4) has the ability to hire and fire employees, (5) makes decisions regarding which, when and in what order outstanding debts or taxes will

²⁴³⁶ Plett v. United States, 185 F.3d 216, 219 (4th Cir. 1999) (case citations omitted from the quote above). See also Vinick v. United States, 205 F.3d 1 (1st Cir. 2000) (“the ‘crucial inquiry is whether the person had the ‘effective power’ to pay the taxes --that is, whether he had the actual authority or ability, in view of his status within the corporation, to pay the taxes owed.”, citing Barnett v. IRS, 988 F.2d 1449, 1455 (5th Cir. 1993); Raba v. United States, 977 F.2d 941, 943 (5th Cir. 1992) (“The crucial examination is whether a person had the effective power to pay taxes.” (internal quotation marks and citation omitted)); Morgan v. United States, 937 F.2d 281, 284 (5th Cir. 1991) (“The central question is whether an individual had the effective power to pay taxes.”); Hochstein v. United States, 900 F.2d 543, 547 (2d Cir. 1990) (“The central question, however, is whether the individual has significant control over the enterprise's finances.”) In Moulton v. United States, 429 F.3d 352 (1st Cir. 2005), the Court construed its precedent in Vinick (referred to there as Vinick II) to mean the power to control and not the actual exercise of the power.

²⁴³⁷ Johnson, v. United States, 734 F.3d 352 (4th Cir. 2013).

be paid, (6) exercises control over daily bank accounts and disbursement records, and (7) has check-signing authority.²⁴³⁸

However, these indicia are simply factors to be considered in determining who had the financial decision making power.²⁴³⁹

This test of a responsible person is quite broad. It usually covers key officers whose job responsibilities gave them power or a material role in making financial decisions. It may cover directors and shareholders of a corporate employer even when they are not officers or employees of the corporation. It may even cover persons who are not officers, employees, directors or shareholders, although it is rare that such a person would have effective decision making authority or even an incentive to participate in such decisions. But it does not cover persons with titles that would normally suggest authority for making such decisions but who the facts indicate were denied that authority.²⁴⁴⁰

One court has described liability as attaching to a person who “could have impeded the flow of business to the extent necessary to prevent the corporation from squandering the taxes.”²⁴⁴¹ A person thus need not have final control of the financial decision but must be a significant substantive participant in the decision.²⁴⁴²

Moreover, authority and power can change, so it is critical to focus on a person’s role during the quarters for which the TFRP is assessed.²⁴⁴³ Thus, for example, a person who becomes a responsible person after the trust fund tax payment obligation has accrued has liability under § 6672 only to the extent that there were unencumbered funds available to pay the accrued trust fund tax at the time he or she assumes that status; the subsequent receipt and use of unencumbered funds for other creditors does not make the person liable under § 6672 for the trust fund tax delinquent at the time he or she assumes that status.²⁴⁴⁴

²⁴³⁸ Vinick v. United States, 205 F.3d 1, 7 (1st Cir. 2000); for similar list of factors or indicia see also Logal v. United States, 195 F.3d 229, 232 (5th Cir. 1999); and Plett v. United States, 185 F.3d 216, 219 (4th Cir. 1999).

²⁴³⁹ See Vinick v. United States, *supra*, for a particular good discussion of the role – and limitations – of these factors in making the critical determination.

²⁴⁴⁰ See e.g., United States v. Bisbee, 245 F.3d 1001 (8th Cir. 2001); the phenomenon of the title outstripping actual authority is not at all unusual as indicated in also Glater, For Some Executives, Titles Surpass Power, *New York Times* (April 11, 2001) (discussing the phenomenon in context of ego-stroking and compensation substitutes).

²⁴⁴¹ Thomas v. United States, 41 F.3d 1109, 1113 (7th Cir. 1994).

²⁴⁴² Winter v. United States, 196 F.3d 339, 347 (2^d Cir. 1999); Howard v. United States, 711 F.2d 729 (5th Cir. 1983).

²⁴⁴³ See e.g., Vinick v. United States, 205 F.3d 1 (1st Cir. 2000).

²⁴⁴⁴ Slodov v. United States, 436 U.S. 238 (1978).

Cases are all over the lot on how the standards apply in particular factual circumstances, but the foregoing is the gist of it.

c. Willfulness.

Liability attaches to a person only if the failure to pay the trust fund taxes was his willful act. The concept of willfulness in the tax law is encountered in the criminal sections of the Code and is often equated in that context with *mens rea*. In a criminal tax context, the term means the intentional violation of a known legal duty. Even this strict requirement of specific intent is relaxed in the criminal area with the concept variously described as deliberate ignorance, willful blindness or conscious avoidance. The notion is that, even if the Government has not proved actual intent to violate the known legal duty, the willfulness requirement is met if the defendant consciously avoided learning the facts necessary for the intent when the facts were highly probable. (There are various formulas of the concept, all struggling with the problem that this should be punished as a crime even though the statute requires actual intent.)²⁴⁴⁵

Outside the criminal area, however, the concept is interpreted to include both specific intent and some notion paralleling and even expanding the concept of deliberate ignorance in a criminal context.²⁴⁴⁶ If specific intent to not pay the taxes cannot be shown, the person's actions must have been so grossly negligent that willfulness will be presumed. The following is the standard in the Court of Federal Claims (case citations omitted):

Limning the appropriate standards to be applied herein, the Federal Circuit has held that willfulness may be shown in at least two ways: (i) "a deliberate choice voluntarily, consciously and intentionally made to pay other creditors instead of paying the [g]overnment" **or** (ii) "reckless disregard of a known or obvious risk that the taxes may not be remitted to the government." Under the first of these prongs, a responsible person who pays net wages to employees with the knowledge that there are insufficient funds with which to pay the employment taxes commits a willful failure to collect and pay over under section 6672. Under the second of these prongs, a responsible person is reckless if he knew or should have known of a risk that the taxes were not being paid, had a reasonable opportunity to discover and remedy the problem, and yet failed to undertake reasonable efforts to ensure payment. Under this latter prong, "if the facts and circumstances of a particular case, taken as a whole, demonstrate that a responsible individual knew or should have known that there was a risk that the taxes would not be paid, and failed to take available corrective action, with the result being that the government is not paid taxes to which

²⁴⁴⁵ Further developing this concept is beyond the scope of this text. But, in a civil case, the Supreme Court seemed to bless the notion even in criminal cases (probably dicta, though). See *Global Tech Appliances, Inc. v. SEB*, ___ U.S. ___, 131 S. Ct. 2060 (2011).

²⁴⁴⁶ IRM 5.7.3.3.2 (04-13-2006)/

it is entitled, that individual will be found to have willfully failed to pay over withholding taxes under IRC § 6672(a).”²⁴⁴⁷

Is willfulness present where the employer owing trust fund tax taxes has no unencumbered funds to make the payment? There are some differences in the nuances of the appropriate test as articulated among the circuits, but the courts seem to distinguish between assets received and held by an employer subject to a legal restriction akin to a trust fund and assets held by an employer subject to a contractual term that the assets be used for purposes other than trust fund taxes. A responsible person whose employer holds assets under the former (akin to a trust fund under law) is not willful in failing to use the assets to pay delinquent trust fund taxes, but a responsible person whose employer holds assets subject to a mere contractual restriction that they be used for other purposes is willful in not using the assets to pay delinquent trust fund taxes. A court thus held:

funds are encumbered [and thus not available to pay trust fund taxes] only when certain legal obligations, such as statutes, regulations, and ordinances, impede the freedom of a company to use its funds to fulfill its trust fund tax debts. Voluntary contractual obligations, such as the lock-box arrangement at issue in this case, do not encumber funds so as to prevent a willful failure to pay trust fund taxes.²⁴⁴⁸

d. Reasonable Cause.

The statute provides no reasonable cause exception to TFRP liability.²⁴⁴⁹ Some Circuits, however, appear to recognize a reasonable cause exception, often treating it as implicit in the statutory requirement of willfulness.²⁴⁵⁰ Courts have noted that the concern is that, without the

²⁴⁴⁷ Jenkins v. United States, 101 Fed. Cl. 122, 134 (2011), aff’d 2012 U.S. App. LEXIS 11618 (Fed. Cir. 2012). In the appellate decision, the court truncated the concepts to: “In addition to encompassing a deliberate choice to pay other creditors instead of paying the trust fund taxes to the government, ‘[w]illful conduct may also include a reckless disregard of an ‘obvious and known risk’ that taxes might not be remitted.’”

²⁴⁴⁸ Bell v. United States, 355 F.3d 387, 394-95 (6th Cir. 2004), citing and relying on Honey v. United States, 963 F.2d 1083, 1090 (8th Cir. 1992); see also Nakano v. United States, 742 F.3d 1208 (9th Cir. 2014) (citing Honey as the leading authority and adopting the Honey test: that willfulness as to funds paid to creditors other than the IRS is absent only if “the taxpayer is legally obligated to use the funds for a purpose other than satisfying the preexisting employment tax liability and if that legal obligation is superior to the interest of the IRS in the funds.”).

²⁴⁴⁹ You may recall that there is a separate reasonable cause exception to some penalties, such as the accuracy related penalty. § 6664(c).

²⁴⁵⁰ Finley v. United States, 123 F.3d 1342, 1343 & 1348 (10th Cir. 1997) (en banc) (reasonable cause exists “(1) the taxpayer has made reasonable efforts to protect the trust funds, but (2) those efforts have been frustrated by circumstances outside the taxpayer’s control.”); Winter v. United States, 196 F.3d 339, 344-345 (2^d Cir. 1999); Logal v. United States, 195 F.3d 229, 233 (5th Cir. 1999); Newsome v. United States, 431 F.2d 742, 746-747 (5th Cir. 1970).

exception, “§ 6672(a) has become a strict-liability statute.”²⁴⁵¹ Thus, the Tenth Circuit said in an en banc opinion:

[W]e are troubled by the possibility the courts have transformed 26 U.S.C. § 6672 into a strict liability statute, outside the jury's realm, by (1) broadly defining the most likely fact scenarios leading to a failure to pay withholding taxes as "willful" conduct as a matter of law, and (2) closing the door on any opportunity for a responsible person to distinguish his case from those factual scenarios, or paradigms (i.e., demonstrate reasonable cause for failure to pay). As “maintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in our history and jurisprudence,” it is our duty to carefully scrutinize any apparent curtailment of that function.²⁴⁵²

The Tenth Circuit thus tied this defense into the overall concept of willfulness, which it viewed as the quintessential jury determination.²⁴⁵³ Although the Tenth Circuit did attempt to circumscribe the defense as follows:

We therefore conclude reasonable cause sufficient to excuse a responsible person's failure to pay withholding taxes should be limited to those circumstances where (1) the taxpayer has made reasonable efforts to protect the trust funds, but (2) those efforts have been frustrated by circumstances outside the taxpayer's control. By so limiting the elements of reasonable cause in the § 6672 context we avoid the temptation to inject notions of evil motive, bad faith or other improper factors into the determination of willfulness, and maintain the ability to zealously protect government revenue via the application of certain factual paradigms widely-recognized and accepted as “willful conduct.” Yet, consistent with the plain language of § 6672, this approach preserves a role for the jury to determine whether, based on all relevant evidence in a particular case, the responsible taxpayer's conduct reflects the requisite scienter.²⁴⁵⁴

Once § 6672 liability is recognized as the province of the jury under the element of “willfulness,” even with a limiting instruction such as suggested in the foregoing quote, the jury is more likely to be moved by the types of notions that would support a reasonable cause exception (if it were to exist). The key, of course, from the putative responsible person’s perspective is to get to the jury and avoid summary judgment from district judges who either do not recognize the defense or are not as easily swayed by it as jurors might be.

²⁴⁵¹ Bell v. United States, 355 F.3d 387, 398 (6th Cir. 2004).

²⁴⁵² Finley v. United States, 123 F.3d 1342, 1347 (10th Cir. 1997).

²⁴⁵³ Id., pp. 1347-8.

²⁴⁵⁴ Id., p. 1348.

Other courts have noted that, the defense, if it exists, is quite limited.²⁴⁵⁵ The Fourth Circuit summarized this defense, calling it a “putative” defense, as follows:

Courts that have recognized this defense have limited it to situations in which circumstances outside a taxpayer's control have thwarted his reasonable efforts to protect trust funds, and have not applied it in situations where the taxpayer made a conscious decision to pay other creditors.²⁴⁵⁶

Other Circuits, such as the Fifth, say that the factors that might bear upon a reasonable cause inquiry are just considerations to be considered in determining whether the person acted willfully.²⁴⁵⁷ Even as articulated, however, the key is to get enough evidence in the record so that the defense – whether separately recognized or imported into the willfulness element – can be presented to the jury.

A variation of a reasonable cause defense, although not called that, is that, at the time that the withheld amounts were due to be turned over to the IRS, the employer did not have the funds to pay and therefore the responsible person did not act willfully in not having the employer pay. A variation of this argument was accepted by the Supreme Court in Slodov v. United States, 436 U.S. 238 (1978) where the putative responsible person assumed control of the employers after the payments became due. The withholding payments were past due, but subsequent to his assumption of control the employers had sufficient unfettered funds that could have been used to pay those unpaid withholding amounts. The Supreme Court held that the person was did not act willfully in using those funds for other purposes because the funds were not traceable to the unpaid withholding taxes. However, where the person was a responsible person when the duty arose, Slodov does not apply and the person’s decision to use funds for other purposes with constitute willfulness.²⁴⁵⁸

e. Exception for Unpaid Volunteers to Charities.

Persons serving as unpaid volunteers for tax-exempt organizations are exempted from the TFRP if they meet the following conditions: (1) serve solely in an honorary capacity; (2) do not participate in the day-to-day business or financial operations of the charity; and (3) do not have

²⁴⁵⁵ E.g, the Fifth Circuit had recognized the possible defense but said that “no taxpayer has yet carried that pail up the hill.” Bowen v. United States, 836 F.2d 965, 968 (5th Cir. 1988).

²⁴⁵⁶ Erwin v. United States, 591 F.3d 313, 326 n. 8 (4th Cir. 2010) (citing Thosteson v. United States, 331 F.3d 1294, 1301 (11th Cir. 2003), Logal v. United States, 195 F.3d 229, 233 (5th Cir. 1999), and Greenberg v. United States, 46 F.3d 239, 244 (3d Cir. 1994) (“It is no defense that the corporation was in financial distress and that funds were spent to keep the corporation in business with an expectation that sufficient revenue would later become available to pay the United States.”)). See also Winter v. United States, 196 F.3d 339 (2d Cir. 1999).

²⁴⁵⁷ Newsome v. United States, 421 F.2d 215 (5th Cir. 1970); see also Conway v. United States, 647 F.3d 228 (5th Cir. 2011). A good summary of the circuit split on this issue is contained in Bell v. United States, 355 F.3d 387, 398 n. 8 (6th Cir. 2004).

²⁴⁵⁸ Oppliger v. United States, 637 F.3d 889 (8th Cir. 2011).

actual knowledge of the trust fund tax delinquency.²⁴⁵⁹ This important exception does not apply, however, “if it results in no person being liable” for the TFRP.²⁴⁶⁰

The statute has not yet been fleshed out, but consider this example. Suppose A, a prominent citizen of the community and, more importantly to the IRS, a very wealthy citizen of the community, serves on a charity’s board of directors in an honorary capacity,²⁴⁶¹ does not perform day-to-day or financial duties, but the facts are cloudy as to what A may have known about the charity’s delinquency in trust fund taxes. The president is clearly liable, since he was the principal participant in the decisions as to who got paid. The president asserts that he kept the board fully aware of the delinquency. A asserts that he was not aware of the delinquency. The board minutes are inconclusive. Everyone potentially liable for the tax except A has no money, so the IRS has no incentive to assert the TFRP against anyone but A. In this case, the IRS may well assert liability against A since he may fail the third test in the statute. What if A can show that he did not have actual knowledge of the trust fund tax delinquency, so that he meets all of the three numbered conditions of the statute? Is the IRS left holding the bag because the president, who is clearly liable, can’t pay but A who can pay meets the three conditions of the statute? The IRS may then try to invoke the savings clause in the flush language of the statute. How?

The IRS may choose not to assert the liability against the president. The IRS is not required to assert the TFRP against any person potentially or even actually liable. May the IRS assert the tax only against A and then rely upon the flush language of the statute to assert that § 6672(e) cannot help A because to hold otherwise no one would be liable for the TFRP? Can A invoke the protection of § 6672(e) by urging that the president was clearly liable (under these assumed facts, he was) and liability – not assertion of the liability by the IRS – is all that the statute requires? I don’t know the answer to the question, but I suspect that, given the purpose of the statute to give volunteers some relief from liability and comfort with respect thereto, a court would so hold.²⁴⁶²

²⁴⁵⁹ § 6672(e). This statutory language is, of course, controlling, but I do note that it is restated in the IRS policy statement P-5-14 which deals with trust fund taxes. See IRM 1.2.14.1.3 (Approved 06-09-2003).

²⁴⁶⁰ Id. (flush language).

²⁴⁶¹ Query whether members of a board, whether charitable or not, can really serve in an honorary capacity. They may serve without compensation and the position may be an honor, but a director position also carries with it considerable fiduciary obligations to the charity.

²⁴⁶² In this regard, in an analogous context involving the relief provision for contribution among jointly and severally liable responsible persons (§ 6672(d)), the statute imposes the contribution liability upon all persons “liable” whether or not the IRS chose to make an assessment against them. The same type of statutory language based on liability and not assessment is used in § 6672(e).

3. Administrative Procedures.

a. Audits and Appeals.

When trust fund taxes are delinquent, the IRS's first move is against the employer. If the IRS is unable to shake out payment from the employer in fairly short order, the IRS will conduct an investigation to determine whether the TFRP should apply. Unlike income and estate and gift tax examinations, the TFRP is investigated by a Revenue Officer who is already involved in the unsuccessful effort to shake the money out the corporation. The investigation will involve review of corporate records (e.g., corporate documents such as articles of incorporation, by-laws and minutes to see who has authority and checks to see who had check signing authority) and interviews of the persons in a position to observe the acts that would give rise to liability.

A key part of the investigation will be interviews of the persons either potentially liable for the TFRP or who were in a position to observe such persons. The interviews will be conducted in the format of Form 4180, Report of Interview With Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes, which the revenue officer will complete and ask the interviewee to sign.²⁴⁶³ Alternatively, the revenue officer may permit the interviewee to complete and sign the Form. If the interviewee declines to either submit to the interview or complete and sign the form, the revenue officer may summons the interviewee to appear and answer the questions subject to any privileges the person may assert. Since the information thus gathered (whether by form or interview) could be evidence potentially damaging to the person interviewed, the person will want to make sure that (i) the answers are fair and in that sense truthful, for the answers are given subject to potential criminal penalties for falsehoods,²⁴⁶⁴ and (ii) states his case to avoid the penalties in the best way in order to mitigate the possibility the IRS will assert the TFRP against the person.²⁴⁶⁵

²⁴⁶³ Although I would like to think that most revenue officers would not add information to the Form 4180 after the defendant signed without the interviewee initialing, it probably would be the better part of wisdom for the interviewee to immediately copy it and have the Agent to whom it is delivered initial and date his initials on the Form so that there is a control copy of the Form as submitted to the IRS. I have seen one criminal case where the defense attorney raised the possibility that information may have been added after the person signed.

²⁴⁶⁴ The Form itself does not have a penalty of perjury jurat, saying instead: "I declare that I have examined the information given in this interview and to the best of my knowledge and belief, it is true, correct, and complete." The statement thus could still be subject to the perjury-like criminal provision for false statements, 18 U.S.C. § 1001, or framed in a criminal proceeding as some type of attempt to impair or impede the lawful functions of the IRS subject to prosecution under § 7212(a) or 18 U.S.C. 371, the defraud conspiracy. And, these criminal penalties could apply even if the person does not sign the Form but provides the false information some other way.

²⁴⁶⁵ The revenue officer may also request the person to complete a Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals, which would be a tip off that the person is likely to be assessed the penalty. The Form 433-A usually comes later in the process, but some are collected earlier.

Upon conclusion of the investigation, the IRS will have identified at least one person potentially liable for the TFRP. The IRS must issue a notice of proposed assessment to each person so identified.²⁴⁶⁶ The notice gives the person the opportunity to invoke an administrative appeal to the IRS Appeals Office.²⁴⁶⁷ This appeal is similar to the appeal that can be taken from 30-day letters discussed above in the context of income and estate and gift taxes.²⁴⁶⁸

The standard collection procedures are available for TFRP assessments. The IRS can use the IRS summons to locate assets, the IRS can levy on assets, the IRS can file a tax lien to protect the IRS's interests in the taxpayer's assets, the IRS can file nominee liens, etc. Also, the IRS may enter installment agreements or OICs with either the employer or the person who has been assessed the TFRP. However, if the IRS receives an OIC from the employer, in assessing the adequacy of the offer based on doubt as to collectibility, the IRS will consider its collection alternatives from persons liable for the TFRP.²⁴⁶⁹ Moreover, if the IRS compromises the underlying liability, it would seem that the TFRP could not apply to the amount abated pursuant to the compromise.

I discuss below that, by filing a refund suit for a portion of a TFRP assessment, the IRS may be prohibited from levying for the unpaid TFRP.

b. Assessments and Predicates.

²⁴⁶⁶ See IRM 5.7.4.7 (09-23-2008). The notice is required by § 6672(b)(1) and is given by Letter 1153. The notice is given by mailed notice or personal service. The proper mailing of the notice to the taxpayer's last known address meets the notice required of § 6672(b)(1), even if the taxpayer does not receive the notice. Mason v. Commissioner, 132 T.C. 301, 323 (2009); and Hickey v. Commissioner, T.C. Memo. 2009-2. The taxpayer may waive issuance of this notice which, as with a 30-day letter, allows the IRS to make the assessment immediately. The Form for waiver is Form 2751.

For internal guidance as to the notice and, in CDP cases, confirming that proper notice was given, see PMTA 2009-163 (12/18/09), reproduced at 2010 TNT 60-22. Taxpayers and their practitioners considering signing a form 2751 should consider carefully Moore v. United States, 648 F.3d 634 (8th Cir. 2011), which holds that the signing of the Form 2751 permits the IRS in a subsequent responsible person case to admit the Form, not for its conclusive effect on the issue of whether the person is liable but, apparently (it is not a tightly reasoned opinion), to show that the person believed he was a responsible person at the time he or she signed the Form 2751. I think the Court is flat wrong on that one, but I suspect the error will be perpetuated.

²⁴⁶⁷ Although proper sending – regardless of receipt – of the notice establishes its validity for purposes of § 6672(b), it is not considered a prior opportunity to contest liability in a subsequent CDP proceeding unless the notice was received (or receipt was refused by the person). § 6330(c)(2)(B); Mason v. Commissioner, 132 T.C. 301, 317-318 (2009).

²⁴⁶⁸ IRM 8.11.1.8.; for procedures related to TFRP appeals, see Rev. Proc. 2005-34; 2005-24 IRB 1.

²⁴⁶⁹ IRM 5.8.4.8.2 (04-13-2006).

The TFRP is an “assessable penalty” under § 6671(a). Unlike income and estate and gift taxes, it requires no predicate notice that gives the taxpayer a pre-payment litigation forum in the Tax Court. Instead, as an assessable penalty, the only predicate to the assessment is that the IRS notify the putative responsible person of the proposed assessment by mail to the last known address or in-person delivery at least 60 days prior to the assessment.²⁴⁷⁰ As we discuss before, this assessment scheme forces litigation about the liability into forums other than the Tax Court, except for CDP proceedings. Finally, since the TFRP is viewed as a collection mechanism for tax properly due, it is not treated as a penalty for purposes of § 6751(b)(1)’s requirement that the proposing officer’s immediate superior approve in writing.²⁴⁷¹

c. Statute of Limitations.

The statute of limitations on assessment of the trust fund TFRP is established by the employer’s statute of limitations on assessment of the underlying trust fund taxes.²⁴⁷² The statute is thus 3 years if the employer filed a nonfraudulent return and forever if the employer did not file a return or filed a fraudulent return.²⁴⁷³ If, having filed a nonfraudulent return, the employer extends the statute of limitations on assessment or collection of the trust fund tax liability, the TFRP statute is not extended. In addition, if the employer obtains an installment agreement with respect to the trust fund taxes, the statute for assessing the TFRP or collecting from the person assessed is not extended.²⁴⁷⁴ Where the statute on the TFRP is in jeopardy, the IRS may request that the putative responsible person execute a consent to extend the statute of limitations on assessment of the TFRP.²⁴⁷⁵

²⁴⁷⁰ § 6672(b). Like the notice of deficiency, if the notice is by mail, the requirement is that the notice be mailed to the last known address, not that the taxpayer have received the notice. Hickey v. Commissioner, T.C. Memo. 2009-2.

²⁴⁷¹ United States v. Rozbruch, 2014 U.S. Dist. LEXIS 91789 (SDNY 2014). I have not chased this down, but I suspect that the internal processing of such proposals invariably require such approval.

²⁴⁷² The IRS earlier had taken the position that there was no statute of limitations for the TFRP, but the position had been rejected in Lauckner v. United States, 68 F.3d 69 (3d Cir. 1995). The IRS subsequently modified its position. A.O.D. 1996-06, 1996-2 C.B. 1.

²⁴⁷³ This is the IRS’s position. ILM 200532046 (6/30/05), reproduced at 2005 TNT 156-12. Accepting the logic of the position that an employer’s qualification for the normal three statute applies also to persons liable for the TFRP, it would follow that where the employer’s statute is extended or unlimited, the statute for persons liable for the TFRP would be extended or unlimited also.

²⁴⁷⁴ Indeed, an installment agreement with the employer does not prevent the IRS from collecting against the party otherwise liable for the TFRP. The IRS may voluntarily withhold collection, but that is a separate decision the IRS makes based on all the facts and circumstances.

²⁴⁷⁵ The consent form is Form 2750. Failure to execute the Form upon request may result in the prompt assessment of the TFRP with as complete an investigation and consideration of defenses as would otherwise be available. Contrary to normal income tax cases, it is generally in the person’s favor to execute a consent because, until assessment, the taxpayer is only liable for the

The statute of limitations is suspended upon the mailing of the notice required before assessment from the date of the notice through the later of (i) 90 days after the date of the notice or (ii) if the taxpayer makes timely protest, 30 days after the IRS makes its final administrative determination.²⁴⁷⁶ There is, of course, an exception for jeopardy.²⁴⁷⁷

4. IRS Policy to Collect Only Once.

The IRS's policy is to collect only once the underlying trust fund tax that should have been paid over.²⁴⁷⁸ In this sense, the TFRP is a collection mechanism for the unpaid underlying trust fund taxes rather than a true penalty imposed to the full extent on each responsible person.²⁴⁷⁹ Literally read, § 6672 could impose the delinquent trust fund tax upon each responsible person so that the IRS could theoretically collect the trust fund tax amount more than once. Obviously, to the extent that imposition of civil punishment has a deterrent effect, the imposition of the TFRP on each responsible person would have the maximum deterrent effect. But, as interpreted, the IRS only collects the trust fund tax delinquency once.

Hence, if the employer itself can and does pay the delinquent trust fund tax, the IRS will not proceed against those who were technically liable under § 6672 at the point that the tax became delinquent. Savvy persons potentially liable under § 6672 after using the trust fund tax for other cash flow needs will try to cause the employer, by hook or by crook, to pay the trust fund taxes before finally going under. Often, however, the employer will have nothing left to pay those trust fund taxes.

principal of the trust fund taxes and interest accrues as to him only after the TFRP is assessed. Postponing the assessment date thus works affirmatively in the person's favor.

²⁴⁷⁶ § 6672(b)(3).

²⁴⁷⁷ § 6672(b)(4).

²⁴⁷⁸ See Policy P-5-60, IRM 1.2.14.1.3 (Approved 06-09-2003). The policy is recognized in cases, and the courts appear willing in some cases to hold the IRS to the policy where it seems to be deviating from it or has through its own inattention impaired the proper functioning of the policy. For example, in Cheatle v. United States, 589 F.Supp.2d 694 (W.D. VA 2008), one of the responsible persons settled his liability by paying a portion of the TFRP and, after time during which that person could have sued for refund of the amount he paid, the IRS erroneously refunded the TFRP he paid. The IRS sued to recover the erroneous refund, but in its collection activity never gave Cheatle, another responsible person, credit for the TFRP the other person paid and the IRS erroneously refunded. The Court discussed the collect only once policy, and stated that, except for the IRS's screw-up in refunding the amount to the other person, Cheatle would be entitled to reduce his liability under this policy. The Court therefore ordered the IRS to abate the amount of the benefit Cheatle would have received except for its screw-up. In discussing the collect only once policy, the Court read a Fourth Circuit precedent as implicitly holding that, as a matter of law, the IRS is entitled to collect only once, citing United States v. Pomponio, 635 F.2d 293, 296 (4th Cir. 1980).

²⁴⁷⁹ United States v. Huckabee Auto. Co., 783 F.2d 1546, 1548 (11th Cir. 1986). Although courts frequently state that the liability is not a penalty, it does have certain penalty-like characteristics – e.g., it is not deductible and it is not dischargeable in bankruptcy.

Where the IRS is having difficulty collecting from the employer (which is, of course, the incentive to the IRS to assert the TFRP), a typical strategy adopted by a person against whom the IRS asserts the TFRP is to point the finger at other persons within the employer's organization so that the IRS (they hope) will collect from the pointees rather than the pointer. The pointer may even help the IRS locate assets of the pointees in the hope that the IRS will levy against them first. If this strategy is successful and the IRS succeeds in collecting the trust fund tax from one of the pointees, the pointer may successfully avoid his own liability to the IRS for the TFRP.²⁴⁸⁰ In order to properly assess this opportunity for a pointee, you must understand the further nuances discussed in the balance of this section.

The IRS's policy to collect only once requires that it pay careful attention to the administrative issues in the implementation of the policy, so that, if possible, it does collect at least once. For example, the IRS may work out an installment plan with the employer to pay the unpaid trust fund taxes over a period of time that extends beyond the expiration of the statute of limitations for assessment of the TFRP. The IRS's policy statement says that, "Absent statute considerations," normally it will not pursue the TFRP during the period the installment agreement is in effect with and being honored by the employer.²⁴⁸¹ But, if the installment period extends beyond the statute of limitations, the IRS may assert the TFRP protectively in order to guard against the possibility that the employer may default on the installment agreement.

The statute of limitations may require that the IRS take other protective actions. Consider this example: within the normally applicable 3 year limitations period for assessment, the IRS determines that A and B are liable for the TFRP. A has resources that may easily be tapped by the IRS to pay the full trust fund tax delinquency. B has some resources, but they are not easily tapped (e.g., more than adequate equity in an expensive home). Since the IRS can, if it chooses, proceed only against one of them even though both are "liable," can or will the IRS assert the TFRP only against A and collect from A? All other things being equal, that might be a good strategy for the IRS so as to limit the unnecessary expenditure of its resources to pursue B. But, think about it. A may bring a refund suit within the applicable refund period of limitations (2 years from the date of payment). If the assessment against A was made at the end of the 3 year statute of limitations and A instituted his refund remedy after the 3 year statute of limitations closed on assessment, the IRS would be at risk that A would prevail in the refund remedy and then be unable to assess against B. So the IRS will protectively assess against B, although it may – but need not – withhold collection until A's refund statute of limitations has expired or, if A pursues a refund, A's potential for recovery has been denied with finality.

What if the IRS assesses against both A and B and thereafter collects the entire amount from A or even collects from the employer under an installment plan? Under the collection only once policy, the unpaid assessments against B or against A and B, respectively, should be abated. If the employer paid, of course, the employer will be entitled to no refund or, if it were entitled to a refund, that would mean it was not liable for the tax and the responsible persons would not be liable for the tax. So, upon payment or even partial payments by the employer, the assessments against A and B

²⁴⁸⁰ The pointer may be subject to the right of contribution discussed below.

²⁴⁸¹ Policy P-5-60, paragraph (6), IRM 1.2.14.1.3 (Approved 06-09-2003).

could be abated as appropriate. But, if the IRS collects only from A, it will have to postpone any abatement of B's assessment until A cannot pursue refund or has failed in the pursuit of a refund.

What happens if the IRS collects from both A and B and the amount collected exceeds the amount of the delinquent trust fund tax? Clearly, under the collection only once policy, someone is entitled to a refund. First, because of the statute of limitations problems noted above, the IRS will not make any refund until it is clear that the statute of limitations on either A or B, respectively obtaining a refund or they have litigated and lost.²⁴⁸² Once it is clear that the IRS is entitled to retain the TFRP paid in the amount of the underlying trust fund tax, it is clear that any excess collected must be refunded. To whom should it be refunded? The IRS's policy is to refund the excess to the person whose payment created the excess.²⁴⁸³ Thus, for example, if the IRS collected in full first against A and then against B, once A may no longer claim a refund, the excess payment will be refunded to B because B's payment created the excess. Is this fair? We discuss below A's right of contribution if A disproportionately pays the trust fund tax, but it is clear that, in the administration of the tax laws, the IRS may adopt this methodology for determining to whom it pays the refund. We should note that the IRS interprets the IRM instructions to refund the excess to the person whose payment created the excess as permissive and not necessarily mandatory, so that presumably in appropriate cases, some other method of refund might be appropriate.²⁴⁸⁴

From the foregoing examples, you can see that the statute of limitations may force the IRS to proceed against a responsible person when it is possible that, with a little more time, the IRS may be able to collect against the employer or even against another putative responsible person. The person may want to attempt to negotiate with the IRS the use of an extension of the assessment limitations period against him in the hopes that the IRS's need to assess the tax against him will be mooted by payment by someone else.²⁴⁸⁵

Because of the policy to collect only once, a taxpayer against whom the TFRP has been asserted may request and receive from the IRS the following information despite the general rule that taxpayer return information may not be disclosed: (1) the name of any other person against whom the TFRP has been asserted; and (2) the general nature of the IRS's collection efforts, if any, against such other person(s) and the amount collected.²⁴⁸⁶ Obviously, a person who has been assessed the TFRP might find this information useful in assessing his economic exposure and taking certain strategic action. For example, let's assume that A and B have been assessed the TFRP, that both are clearly liable for the tax, and that, after making the assessments, the IRS has fully collected against A. Armed with the information that the IRS has collected from a clearly responsible person, B may be able to stave off collection attempts by the IRS, subject to any action the IRS feels it needs

²⁴⁸² FSA 199904032, 1999 TNT 20-64 (2/1/1999).

²⁴⁸³ IRM 5.7.7.3 (04-13-2006) ("Refund the excess overpayment to the Taxpayer whose payment created the excess.")

²⁴⁸⁴ See FSA 199904032, reprinted at 1999 TNT 20-64 (2/1/1999).

²⁴⁸⁵ The Form for extending the time to assess the TFRP is Form 2750, Waiver Extending Statutory Period for Assessment of the Trust Fund Recovery Penalty.

²⁴⁸⁶ § 6103(e)(9); see IRM 5.1.1.6.4 (08-21-2006).

to take to insure that A does not successfully pursue a refund claim. Even if the IRS were to feel that it must protectively collect against B, B might consider his ultimate exposure in light of the IRS's one collection policy which generally allows the IRS to refund to the person whose payment created the excess payment.

5. Collection Due Process.

When the employer (corporation or partnership) has invoked the CDP remedy, collection of the employer's liability for trust fund taxes will be suspended during the pendency of the proceeding. However, there is no prohibition against the IRS asserting or attempting to collect the TFRP from a responsible person while the employer's CDP remedy is pending.²⁴⁸⁷ Of course, the person against whom the IRS asserts the TFRP may have his or her own CDP remedies.

6. Litigating the TFRP.

a. The Traditional Procedure - The Refund Suit.

(1) Procedural Predicates.

The TFRP is generally litigated in refund suits in either the district court or Court of Federal Claims.²⁴⁸⁸ There is no "ticket to the Tax Court" (notice of deficiency) in TFRP cases. Denial of access to the Tax Court -- which is a prepayment forum for litigating liability -- can have a harsh effect. The Flora rule requires in tax refund suits that the tax must be fully paid before the taxpayer may file a refund suit. It is not unusual for trust fund penalties to be quite large and thus prohibitive if the Flora rule were to apply full bore. Fortunately, the due process issues -- and certainly general fairness issues -- that might otherwise inhere in the full bore application of the Flora rule are avoided by two procedural techniques -- one statutory and the other non-statutory -- that permit the putative responsible person to litigate the liability without payment of the entire amount.

The key to these techniques is the divisible tax concept which was discussed earlier beginning on p. 546. Recall that the Flora rule requires full prepayment of the tax liability. The concept for the TFRP is that it is the same as the underlying tax liability for withholding (both the income tax withholding and the employee's share of FICA withholding). These tax liabilities are, in tax concept, divisible taxes²⁴⁸⁹ -- individual liabilities for each employee for each quarter. They are not aggregated for all employees for the quarter. Accordingly, under this concept, Flora only requires that the putative responsible person prepay the tax liability for one person for the quarter in order to contest whether the putative responsible person was a responsible person for that quarter. In many cases, this amount will be less than \$100. Where the records are available to the putative responsible person, the actual minimum liability for the quarter can be determined precisely.

²⁴⁸⁷ IRM 5.1.9.3.5.4 (10-31-2001).

²⁴⁸⁸ As we noted earlier, refund suits have a predicate claim for refund requirement. The claim for refund of the TFRP is the Form 843, Request for Refund and Request for Abatement.

²⁴⁸⁹ § 6331(i)(2).

However, because it is often difficult for the putative responsible person to know precisely the amount for the lowest paid employee, an estimate will suffice but, since the prepayment of at least one minimal amount is jurisdictional the estimate should err on the side of caution (i.e., ramp up the amount to be certain that at least one employee's divisible tax will be covered).²⁴⁹⁰ It is important in making the payment to designate the payment as completely as possible (e.g., trust fund FICA for one named employee, if possible – unnamed employee if not possible – for the 1st quarter of 2005).²⁴⁹¹

As noted in discussing the divisible tax concept, this technique to use a partial payment is useful only if the IRS does not collect on the unpaid balance during the pendency of the refund suit. The first statutory technique in is in the TFRP Code section. Section 6672(c) provides, in part relevant to the fairness issue presented by the prepayment rule, that the taxpayer may pay the amount required for one person (“not less than the minimum amount required to commence a proceeding in court with respect to his liability for such penalty,” which as I noted above may be precisely calculated or is sometimes estimated), file a claim for refund (the predicate to a refund suit) and furnish a bond for the balance. Collection measures will then be suspended pending the resolution of the claim for refund and any suit for refund if the IRS does not act on the claim for refund in a way satisfactory to the putative responsible person. If a refund suit is filed, the IRS will counterclaim for the uncollected balance of the assessment so as to resolve in one proceeding the taxpayer's liability for all employees for all quarters involved.

The second – and more easily available – statutory technique applies for some (but not all) divisible taxes, including the TFRP. Section 6331(i) precludes a levy during any period that a proceeding contesting the liability for a divisible tax if the proceeding would be res judicata or collateral estoppel for the unpaid tax liability. The precise scope of res judicata and collateral estoppel levy relief provision may be uncertain, for example, where the taxpayer pays for one employee for one quarter and the Government has made assessments for other employees or for other quarters where the facts may be materially different. Technically, until and unless the Government counterclaims, the proceeding might not be res judicata or collateral estoppel as to the other quarters, although arguments could be made that, depending upon the facts, it might be. But,

²⁴⁹⁰ IRM 8.25.1.7.4.2 (12-07-2012 which states as a predicate to filing claim for refund that the taxpayer (i.e., the putative responsible person) pay the tax for one individual for each applicable period. The IRM further says (boldface added): “If the amount required cannot be accurately determined, the Service may accept a **representative amount.**” Historically, the presumption has been that a minimal amount such as \$100 or \$200 would do the trick, and the DOJ attorneys have not contested the amount. However, you should keep in mind that the DOJ attorneys will have access to the underlying records from which a precise determination can be made and might easily spot that the estimated amount paid does not cover the lowest paid employee. Anecdotal information I have received is that DOJ lawyers are becoming more diligent about insuring the minimum prepayment. But see Kaplan v. United States, 2014 U.S. Claims LEXIS 24 (2014) (which shows considerable leniency as to a low representative amount where the records are not available).

²⁴⁹¹ The IRS should post a voluntary payment as designated by the taxpayer. Rev. Proc. 2002-26, 2002-1 C. B. 746.

the Government usually does counterclaim, so the proceeding will be res judicata or collateral estoppel.²⁴⁹² Injunctions are available for violation of this prohibition, despite the general rule that injunctions are not available in tax matters.²⁴⁹³

There is still another technique, albeit non-statutory, for suspending collection activity while the case is pending, although its continuing need is probably pre-empted by § 6331(i). The putative responsible person first meets the Flora rule by paying for one employee for **one** of the quarters involved (this can be actual or a reasonable estimate). As in the statutory avenues, the Government will then counterclaim for the uncollected balance. The taxpayer through his counsel will ask (politely) the DOJ Tax attorney handling the case to request that the IRS not pursue collection measures while the putative responsible person's liability for the tax is being litigated. The IRS will honor the request so long as ultimate collection of the tax is not in jeopardy (a term of art that we have encountered above which does not mean that the IRS is risk free, but that means the taxpayer is not doing something affirmatively to prevent the IRS from collecting).²⁴⁹⁴

I caution readers that the Government has taken the position that, a person subject to multiple quarter TFRP assessments must pay the minimum amount for **each** quarter rather than just one quarter as discussed in the preceding paragraph.²⁴⁹⁵ In that case, the Court of Federal Claims declined to decide the issue because it could resolve the case on other issues. Because this issue is so important, I quote the entire argument on the subject from the Government's brief in which the Government acknowledges that the direct cases on point hold otherwise, but argues in the text that the structure of the refund jurisdiction provision and Flora require the holding. The argument is:

²⁴⁹² One way to invoke § 6331(i) with more certainty is to pay the minimum amount (say \$1000) for each quarter that the TFRP is asserted rather than just for one of the quarters. That way the Government will have to counterclaim rather than holding back to litigate the other quarters in some other case and perhaps some other court. See e.g., Beard v. United States, 99 Fed. Cl. 147 (2011).

²⁴⁹³ § 6331(i)(4)(A) & (B) (prohibiting a levy or collection proceeding and permitting an injunction for violation of the provision, but allowing the Government to counterclaim in the original proceeding). In Beard v. United States, 99 Fed. Cl. 147 (2011), the alleged responsible person paid \$100 for each quarter and sued for refund in the Court of Federal Claims. The U.S. counterclaimed for the balance but then sued that person and another in local district court seeking to resolve liability of both alleged responsible persons in a single proceeding which could not be done in the Court of Federal Claims. The Court of Federal Claims granted an injunction under this provision, holding that the suit by the United States in the district court was a “collection proceeding.”

²⁴⁹⁴ See Policy P-5-16(3), IRM 1.2.1.5.3, cited at IRM 5.7.7.6.2(3) (04-13-2006).; see USLife Title Insurance Co. v. United States, 784 F.2d 1238, 1243 (5th Cir. 1986); and Brown v. United States, 591 F.2d 1136, 1143 (5th Cir. 1979).

²⁴⁹⁵ Roseman v. United States, 2013 U.S. Claims LEXIS 2 at fn. 4 (2013) (“Defendant argues that payment must be made for one employee for each of the periods involved. Given the facts presented, this court need not address this argument.”)

Although there is non-binding authority holding otherwise, the general structure of federal tax litigation dictates that, to maintain a refund suit for section 6672 penalties for multiple quarters, the taxpayer must first pay the amount of the assessment attributable to one employee for each quarter in suit. In general, subject matter jurisdiction over tax refund suits is determined on a tax-period basis. See, e.g., Harris v. United States, 33 Fed. Cl. 470,473 (1995) (dismissing refund suit for lack of subject matter jurisdiction over some tax years because the plaintiff had not filed administrative refund claims, and over other tax years because the plaintiff had not fully paid the assessments), *aff'd*, 106 F.3d 426 (Fed. Cir. 1997) (Table); see also Comm'r v. Sunnen, 333 U.S. 591, 598 (1948) ("Income taxes are levied on an annual basis. Each year is the origin of a new liability and of a separate cause of action."). Thus, a taxpayer seeking a refund of income taxes for multiple tax years must pay the full amount of income tax assessed for each such year before filing suit. See, e.g., Tonasket, 218 Ct. Cl. at 709, 712; Snyder v. United States, 539 F.2d 706, 1976 WL 23945, at *1-2 (4th Cir. 1976) (*per curiam*) (Table); cf Magnone v. United States, 733 F. Supp. 613, 616 (S.D.N.Y. 1989) (explaining that "a taxpayer who owes back taxes for several years may pay interest on and sue with respect to only one of them"), *aff'd*, 902 F.2d 192 (2d Cir. 1990) (*per curiam*). There is no reason to treat section 6672 penalties, which are assessed based on a quarterly tax period, any differently. Accordingly, a taxpayer suing for a refund of section 6672 penalties for multiple quarters must pay the amount of the penalty attributable to one employee for each quarter in suit.

At least one district court has held, to the contrary, that a taxpayer assessed with § 6672 penalties need pay only the amount attributable to one employee for one quarter before filing suit for multiple quarters. See Todd v. United States, 2009 WL 3152863, *4 (S.D. Ga. 2009). In addition, obiter dicta in two circuit court cases seem to support the Todd holding. In re Queen, 16 F.3d 411, 1994 WL 12029, at *3 n.* (4th Cir. 1994) (*per curiam*) (Table) (noting that a taxpayer challenging an assessment of Section 6672 penalties "may not need to pay the entire amount of the assessed penalties ... ; rather, he may be able simply to pay the amount allegedly owed for one quarter for one employee"); USLIFE Title Ins. Co. v. Harbison, 784 F.2d 1238, 1243 n.6 (5th Cir. 1986) (noting that a "Section 6672 liability is a divisible liability" and therefore "a responsible person need only pay the tax attributable to one employee for one quarter in order to maintain a claim for refund"). Finally, two other district court decisions seem to have implicitly followed the Todd rule without explicitly analyzing the question. See Brammer v. United States, 897 F. Supp. 1022, 1023 (N.D. Oh. 1995); Spivak v. United States, 254 F. Supp. 517, 522 (D.C. N.Y. 1966), *aff'd* on other grounds, 370 F.2d 612 (2d Cir. 1967).²⁴⁹⁶

I further caution readers that the minimum payment must be made and the taxpayer must be prepared to prove it. In the past, practitioners have assumed that perhaps a payment of \$100 for a quarter would be deemed sufficient even if they did not have access to the records to show that it

²⁴⁹⁶ Memorandum on motion to dismiss, pp. 12-13.

covered the trust fund liability for one employee. The Government has indicated that it may put the taxpayer to proof on this issue. So, if the taxpayer is estimating in making the payment, estimate on the high side.²⁴⁹⁷

(2) The Litigation.

TFRP cases are fun – at least they are fun for litigators who like litigation (some claim the skill but really don't like litigation). The law is reasonably settled. The inquiry is into a range of facts and circumstances, in which litigating skills and advocacy are more likely to influence the outcome. In the district court, either party may demand a jury to resolve the fact questions of liability (responsibility and willfulness). The litigator is, of course, locked in by facts, but how he or she presents the facts – how he or she weaves the tapestry – can influence the outcome. Of course, the client may have a lot at stake in the litigation and may not view it with as much fun as the litigator.

In TFRP litigation in the district court, the person can usually have a real live jury, a judge who has little interest in tax cases (although the judge will probably prefer the facts and circumstances issues of TFRP liability to the more arcane issues of the tax law) and a much less genteel venue than found in the Tax Court. Contrary to litigation in the Tax Court, rules of procedure and evidence really do matter (or at least matter more). And you will get instant feedback from the jury – which is not so great when you lose (although, as your parents taught you, you learn even when you lose).

(3) Counterclaims and Other Parties.

If the refund litigation is pursued in the district court, the Government will not only counterclaim against the plaintiff in the case for any amounts unpaid on his or her TFRP assessment, but will also seek if possible to join all persons against whom it has assessed the TFRP in order to resolve the issue of those responsible in one proceeding. In some of these cases, the Government may assume the role of a stakeholder asserting that at least one of the persons in the case is liable for the TFRP and then let those persons duke it out with the traditional defense that someone other than me is liable for the TFRP. Usually, however, the Government will take a more active position in which it will seek to establish TFRP liability for all the persons it assessed (remember, the more persons that are liable, generally, the more likely the Government will collect). Depending upon the number of parties joined in the litigation, it can be somewhat of a free for all (at least as trials go), unless the judge keeps tight rein on counsel for the parties.

Further, although it is the Government who usually seeks to join other persons it alleges are subject to the penalty, the plaintiff in the refund litigation may. Whether it is the Government or the plaintiff seeking to join, however, the court involved must have personal jurisdiction over the party as to whom joinder is sought.²⁴⁹⁸

²⁴⁹⁷

²⁴⁹⁸ See Goldberg v. United States, 2014 U.S. Dist. LEXIS 77945 (S.D. FL 2014) (jurisdiction of third party that refund plaintiff sought to join not present).

Under these procedures the putative responsible person's liability will then be resolved in the refund/counterclaim/cross claim litigation. Upon completion of the litigation, the IRS will conform the assessment to the result of the litigation, and, if any tax is due, the IRS will proceed with collection measures (which we have discussed earlier in this chapter).

I have assumed in the foregoing discussion that the refund litigation is brought in the district court. A person assessed the TFRP is entitled to sue for refund in the United States Court of Federal Claims. I discuss the attributes of this alternative forum elsewhere in this book, but for now suffice it to say that this alternative is usually chosen because of some favorable precedent (usually subtle in the context of the TFRP). Many persons contesting the TFRP will want a jury which is only available in the district court.

But there is another wrinkle in litigating the TFRP in the Court of Federal Claims. In the past, if the IRS assessed the TFRP against multiple persons, one preferring to litigate in the Court of Federal Claims could do so under the less than full payment procedures noted above. The Government, preferring to litigate the matter in one proceeding but unable to join the other persons in the Court of Federal Claims proceeding, would often file a proceeding in the district court seeking to reduce to judgment the outstanding assessments against all parties, including the refund plaintiff in the Court of Federal Claims proceeding and then ask the Court of Federal Claims to stay action on the refund suit while they all duked it out in the district court. Previously, in the exercise of its discretion, the Court of Federal Claims granted the motion to stay in some cases. However, Congress has changed the law to now prohibit the Government's joining of the Court of Federal Claims claimant in the district court proceeding.²⁴⁹⁹

b. The CDP Alternative Procedure.

The CDP procedure offers a possible judicial remedy for at least some TFRP determinations.²⁵⁰⁰ The CDP procedure is not available until the assessment and further IRS action to either file a lien or levy on assets. Whether the Tax Court can consider the merits of the TFRP liability will turn upon whether the putative responsible person "did not otherwise have an

²⁴⁹⁹ § 6331(i)(4)(i). For discussion of the past practice, see Order in Rineer v. United States, 2007 U.S. Claims LEXIS 402 (12/21/ 2007), reproduced at 2007 TNT 250-62, a case involving tax assessments prior to the effective date of the statute, but declining to stay the Court of Federal Claims proceeding, thus permitting it to proceed and perhaps resolve the issue prior to an action on the district court proceeding.

²⁵⁰⁰ See Ginsberg v. Commissioner, 130 T.C. 88 (2008); and Livingston v. Commissioner, T.C. Memo. 2008-260. These two cases were dismissed because of lack of jurisdiction because they arose from IRS action prior to the effective date of transfer of jurisdiction over TFRP matters from the district court to the Tax Court. But, for IRS action after that effective date (October 16, 2006), the Tax Court has jurisdiction over TFRP assessments. For discussion of some procedural aspects related to TFRP CDP cases, see PMTA 2009-163 (12/18/09), reproduced at 2010 TNT 60-22.

opportunity to dispute such tax liability.”²⁵⁰¹ This limitation on the Tax Court’s jurisdiction is designed to incentivize the party to pursue earlier available remedies for contesting merits. The classic case where it is available is where a taxpayer receives a notice of deficiency and can petition the Tax Court; the taxpayer is not able to contest the merits of the underlying tax liability in such cases. The putative responsible person receives no notice of deficiency as a predicate to a TFRP assessment and has no judicial remedy prior to assessment. But once there is an assessment and the taxpayer pays the relatively minor amount to pursue a refund remedy, the taxpayer does have a judicial remedy. The question will be whether the availability of that post-assessment partial payment remedy will preclude Tax Court jurisdiction over the merits in a later CDP action. There has been no holding on it, but one could infer from the cases that have been decided that there would be jurisdiction.²⁵⁰² Moreover, opportunity to dispute may not even require a judicial remedy. The putative responsible person usually does receive some type of notice entitling him to an administrative review with Appeals and this alone, if received by the person, may be sufficient.²⁵⁰³

Assuming that the CDP remedy is available, the key downsides of using the CDP procedure to contest the merits will be (i) the lack of a jury or a generalist judge and (ii) the lack of robust discovery in the Tax Court. The key upside will be the Government’s inability to force the other putative responsible persons into the litigation, thus (i) holding down the costs from the presence of multiple parties, and (ii) avoiding having to deal with those missing persons’ claims that the party invoking the CDP remedy is the responsible person.²⁵⁰⁴

7. Bankruptcy and the TFRP.

The TFRP arises because the employer is in financial difficulty. If the employer paid the trust fund tax, there would be no TFRP. The employer becomes financially strapped and uses the trust fund taxes for float. Frequently, the employer will go into bankruptcy and propose a plan of reorganization that includes a deferred payout of the trust fund taxes. The IRS, however, is not required to exhaust its remedies against the employer before it proceeds against any responsible

²⁵⁰¹ § 6330(c)(2)(B).

²⁵⁰² In Ginsberg and Livingston, supra, the putative responsible persons were contesting the TFRP determination before the district court and, after remand to the IRS for supplemental determination, before the Tax Court. The Tax Court dismissed both because of the effective date jurisdiction barrier, and not because it would have otherwise not have had jurisdiction to consider the merits of the TFRP determination. See also Hickey v. Commissioner, T.C. Memo. 2009-2 (in which the taxpayer conceded liability and raised procedural issues).

²⁵⁰³ See Mason v. Commissioner, 132 T.C. No. 14 (2009) (holding that, even though the notice was mailed to the person, the person did not receive it and thus did not have the opportunity to pursue an administrative remedy; hence the CDP procedure is available).

²⁵⁰⁴ This may be a mixed blessing because having that missing person in the same room might offer the decision maker (judge or juror) the fall back comfort that someone will be liable if the particular putative responsible person is relieved of liability.

officer for the TFRP.²⁵⁰⁵ Accordingly, rather than accepting the deferred payout which will, of course, be dependent upon the success of the reorganization, the IRS can proceed to use the TFRP to collect the trust fund tax.²⁵⁰⁶

Also, the TFRP is not dischargeable in bankruptcy.²⁵⁰⁷

8. Planning for the TFRP.

The way to avoid the TFRP is, of course, to comply with the requirement that gross payroll be paid and the withholding amount be withheld and paid over. Don't pay net payroll which would leave the employer without cash to meet its obligation to pay over the withheld or deemed withheld trust fund taxes.

If, however, a client has failed to pay over the withholding taxes and has had the foresight to engage you as his attorney, you can give him the following advice. First, if your client expects the corporation (assuming a corporate or other limited liability employer) to survive the downturn in its business, then work with the IRS to have the corporation pay the taxes. We deal elsewhere in working with the IRS on collection matters. Keep in mind, of course, that the employer will have penalties for failing to pay over. But, if the employer can get an installment agreement, the employer may be able to work it out. Second, if the corporation has otherwise free assets, use them to pay the IRS the trust fund tax rather than paying third party creditors, being careful to designate in writing that all payments are to be applied to the principal only of the trust fund taxes.²⁵⁰⁸ The responsible person prefers this and benefits because it reduces the trust fund liability for which he or she can be held liable. Thus, if the corporation were to owe income taxes (it well may not owe current income taxes because of the current financial problems causing the failure to withhold and pay over, but perhaps it might owe past due taxes that can't be covered by NOL carrybacks), pay the trust fund taxes first. The limitation on the ability to designate payments to the trust fund portion

²⁵⁰⁵ In the Matter of: Prescription Home Health Care, Inc., 2002 U.S. App. LEXIS 27122 (5th Cir. 2002), citing Hornsby v. Internal Revenue Service, 588 F.2d 952, 954 (5th Cir. 1979).

²⁵⁰⁶ In the Matter of: Prescription Home Health Care, Inc., supra.

²⁵⁰⁷ United States v. Sotelo, 436 U.S. 268, 274 (1978).

²⁵⁰⁸ For examples, both arising in bankruptcy of the underlying employer, (i) where the taxpayer used otherwise unencumbered funds to get right on its trust fund taxes (Begier v. Internal Revenue Service, 496 U.S. 53 (1990)); and (ii) where the taxpayer used otherwise encumbered funds to do so (Zwosta v. J.P. Morgan Chase, 395 B.R. 378 (6th Cir. Bankr Panel 2008)). I won't here develop the bankruptcy consequences of the difference, but I suspect you can quickly discern them without elaboration.

The procedure for designating payment is laid out in Rev. Rul. 79-284, 1979-2 Cum. Bull. 83. Absent a specific designation, the IRS will apply the payment to the non-trust fund liability. IRM 1.2.1.5.14, subpart. (7), Policy Statement P-5-60 (Approved 06-09-2003). See Wood v. United States, 808 F.2d 411, 416 (5th Cir. 1987). Note, however, that if the payment is pursuant to an installment agreement, the IRS takes the position that the payment is not voluntary and that the IRS may apply the payments as it sees fit regardless of the taxpayer's designation.

is that the payment must be “voluntary” and not pursuant to enforced collection measures (including installment agreements); the IRS may apply “involuntary payments” as it deems fit, which means that they will be designated last to the trust fund portion of the tax.²⁵⁰⁹

9. Contribution Among Responsible Persons.

Responsible persons who pay disproportionately on the TFRP relative to other responsible persons may recover from the others “an amount equal to the excess of the amount paid by such person over such person's proportionate share of the penalty.”²⁵¹⁰ The suit must be brought independently of a case in which the United States is asserting the TFRP against one or more of the parties. As discussed above, in the tax refund suit where the Government not only counterclaims against the person bringing the suit but also joins others that it has determined to be responsible persons, the parties cannot determine their proportionate payment liabilities in that proceeding. The liability determined in the refund/collection suit is joint and several. Responsible persons having to pay that joint and several liability in disproportionate amounts can only seek contribution in a separate proceeding involving only the persons potentially liable for the TFRP.

Statutory contribution is relatively new, so the warp and woof of the provision have not been fleshed out. One interesting aspect of the provision is that it does not on its face require that the IRS have asserted the TFRP against the person(s) from whom contribution is sought. Assume that A is president and B is CFO of a corporate employer that is delinquent in trust fund taxes to the tune of \$100,000. The IRS asserts a TFRP of \$100,000 against A, the President of the company, but does not assert the TFRP against B for some reason (such as it thinks B may not be liable, it thinks B is only marginally liable and knows that A was clearly liable and has the funds to pay the full amount,

²⁵⁰⁹ In In re Frank Meador Buick, Inc., 1991 U.S. App. LEXIS 24802 (4th Cir. 1991), the court explained the legal distinction between voluntary and involuntary payments in this context:

It is the policy of the IRS to allow an employer who voluntarily makes tax payments to designate that such payments should be applied first to its trust fund tax liability. United States v. Energy Resources Co., 495 U.S. 545, 548 (1990). Payments classified as being made involuntarily may not be designated. “An involuntary payment of Federal taxes means any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor.” Amos v. Comm'r, 47 T.C. 65, 69 (1966). The IRS generally applies involuntary payments to the nontrust fund portion of the tax liability and seeks to recover the trust fund portion from the responsible parties. In re Technical Knockout Graphics, Inc., 833 F.2d 797, 799 (9th Cir. 1987); cf Muntwyler v. United States, 703 F.2d 1030, 1032 (7th Cir. 1983) (citing IRS Policy Statement P-5-60 (“[w]hen a payment is involuntary, IRS policy is to allocate the payments as it sees fit.”)).

²⁵¹⁰ § 6672(d). Prior to § 6672(d)'s enactment, responsible persons were left to the vagaries of state law. For example, some states viewing the conduct penalized (failure to withhold and pay over trust fund taxes) as torts or tort-equivalents might apply a doctrine that joint tortfeasors cannot seek contribution. See e.g., Luce v. Luce, 119 F. Supp. 779, 784 n. 4 (E.D. Ohio 2000).

or thinks that B cannot pay and the IRS's resources are better focused elsewhere, etc.). A pays the minimal amount (\$100), files claim for refund and, upon denial of the claim, A sues for refund. The Government counterclaims for the balance of the assessment - \$99,900. Since the Government has not determined liability for any other person, the Government does not join any other party and, of course, does not join B. A loses the litigation, and the Government proceeds to collect the full \$100,000 from A. A then sues B under § 6672 urging that B was also a responsible person. B urges that Congress did not intend § 6672(d) to bless open-ended litigation over liability and thus should be construed to exclude from § 6672(d) liability those persons whom the IRS has not determined to be responsible persons.

In the only litigation of which I am aware on this issue, the Court held that § 6672(d) has no predicate requiring that the IRS have determined § 6672 liability and, thus, in this example, B can be sued for contribution.²⁵¹¹ The Court reasoned that, in determining who to assess and pursue collection for the TFRP, the IRS should be able to proceed in the most efficient manner for collection of the trust fund tax and not be sidetracked pursuing persons from whom collection may be more difficult. So, the Court reasoned, Congress enacted the contribution provision to permit the parties in an independent private action to seek contribution and felt that, given the fact that the statute does not require an IRS assessment, it would not be appropriate to limit such actions to persons upon whom the IRS assessed.

The statute quantifies the amount that may be recovered as “the excess of the amount paid by such person over such person's proportionate share of the TFRP.” It is not yet clear how the proportionate determination is made. Is it based upon some assessment of the relative contributions of the responsible persons to the failure to withhold and pay over? How is that assessment made?

10. Summary.

Some important facets of the TFRP are discussed in Judge Posner's opinion in Mortenson v. National Union Fire Insurance Co., 240 F.3d 677 (7th Cir. 2001). In that case, the plaintiff sought recovery of the TFRP under a directors and officers (“D&O”) liability insurance policy which insures directors and officers against liabilities arising from their conduct as directors and officers. As is usual in such policies, penalties were excluded. The question presented was whether the TFRP was a penalty. Judge Posner concludes that the TFRP is indeed a penalty at least for insurance purposes; his reasoning includes important analyses of the TFRP itself (some case citations omitted):

The insurance policy does not define “penalties,” and Mortenson argues that therefore it is ambiguous and we must interpret the term as favorably to Mortenson as reason allows. So interpreted, the term does not, he continues, encompass the penalty imposed by section 6672(a), because it is not “really” a penalty. He offers a number of reasons why it is not. One is that the aim is to collect taxes rather than to punish the willfully delinquent responsible person, as shown by the fact that it is the policy of the Internal Revenue Service not to use the statute to collect more than

²⁵¹¹ See Memorandum and Order dated 12/5/01 in Bromley v. Frey, et al. (S. D. Tex. - H-01-0182).

the total amount of unpaid tax. So if the unpaid tax were \$250,000, which would make each responsible person who had willfully failed in his duty to see to its payment liable for a \$250,000 penalty, the total penalties assessed against all those responsible persons would be capped at \$250,000. For example, if the IRS was able to collect \$100,000 of the \$250,000 in unpaid tax from the company itself, the penalties collected from the responsible persons would be capped at \$150,000.

* * * *

[P]enalties are frequently imposed for conduct well short of deliberate wrongdoing. Reckless and negligent homicide are crimes, fines are imposed for speeding even when the driver was unaware that he was exceeding the speed limit, and there are even strict liability crimes, where the defendant's state of mind is irrelevant and even the fact that he could not have prevented the criminal act from occurring is not a defense. Willfulness within the meaning of section 6672(a) "means that the person either knew the taxes were not being turned over to the government and nonetheless opted to pay other creditors, or recklessly disregarded a known risk that the taxes were not being paid over." We went further and held that gross negligence is sufficient to constitute willfulness under the statute.

Although it is true that the Internal Revenue Service caps the penalty at the amount of tax due, this is not a statutory limitation; it is simply an enforcement policy. The fact that the statute now allows contribution does not cap the penalty at the amount of taxes either, or for that matter impose any other ceiling. Contribution is not about total liability, but about its allocation among the wrongdoers. In a case in which the amount of tax due was \$250,000, and two responsible persons were each liable for the penalty, the government could if it wanted assess and collect \$250,000 from each. The two would be free to seek contribution from other responsible persons, perhaps even to rearrange the liability voluntarily between themselves by means of an indemnity agreement * * *; but their obtaining contribution whether from each other or from others would not change the fact that the government had collected penalties twice as great as the amount of taxes owed. And finally the fact that the IRS uses section 6672(a) as a collection device does not distinguish it from a number of unmistakably criminal penalties, such as those for minor thefts, vandalism, and other minor property crimes, where the police use the threat of prosecution to induce the wrongdoer to make restitution to his victim more often than they actually prosecute.

We conclude that section 6672(a) imposes the civil counterpart of a fine. Monetary penalties for wrongful conduct are civil fines, and are encompassed by the "fines or penalties" provision in the insurance policy. * * * *

We have yet to mention the most compelling argument against the interpretation for which Mortenson contends. For obvious reasons, insurance companies try to avoid insuring people against risks that having insurance makes far

more likely to occur. The temptation that insurance gives the insured to commit the very act insured against is called by students of insurance “moral hazard” and is the reason that fire insurance companies refuse to insure property for more than it is worth—they don't want to tempt the owner to burn it down. Consider the likely effects of insuring against the section 6672(a) penalty. When a firm gets into financial difficulties and creditors are pressing it for repayment, the firm tries -- Opelika tried -- to pay the most pressing creditors currently and hold off the others till later. * * *

* This tendency is one of the reasons for the rules against preferences in bankruptcy, * * *, preferences being the favoring, often, of the most exigent creditors to the prejudice of the others, as the firm struggles to stay afloat. (When it sinks, the rest of the creditors go down with it.) The temptation to put the IRS at the end of the line is great. The IRS is unlikely to be aware that the firm is in difficulty, and if the firm decides therefore not to remit payroll taxes as they come due, but to favor the creditors who are threatening to seize the firm's assets or petition it into bankruptcy, the IRS is unlikely even to notice for some time that it is being stiffed. By the time it wakes up, the firm will probably be unable to pay the taxes that it failed to remit. It is to prevent firms from yielding to the temptation to put the IRS at the end of the creditor queue that Congress has imposed liability for nonpayment of payroll taxes on the responsible officers of the firm. For those persons to be insured against this liability will tempt them to do just what Opelika did here and what the penalty provision of section 6672(a) is designed to prevent -- pay other creditors first, funding the preference by not paying the IRS at all. It would be ironic to use the IRS's policy of lenity in forgoing multiple collection of the statutory penalty to reduce the likelihood of its collecting the taxes for the nonpayment of which the penalty is imposed.

It is strongly arguable, indeed, that insurance against the section 6672(a) penalty, by encouraging the nonpayment of payroll taxes, is against public policy, so falling under the last clause of the policy exclusion and possibly under the rule in Illinois as elsewhere that forbids certain types of insurance as being against public policy because of the acute moral hazard that the insurance creates. [Discussion of this issue omitted.] We need not decide, however, whether insuring against the section 6672(a) penalty falls within this ban. For purposes of interpreting this insurance policy, a penalty is a penalty is a penalty.

Affirmed.

Can you articulate why the TFRP may be a penalty for insurance purposes but not for tax purposes? You will recall that, although the Code calls the TFRP a penalty, the cases discussing it usually say that it is remedial in nature and thus not like a penalty. What about Judge Posner's comment that the TFRP is indistinguishable restitution under threat of prosecution in a run-of-the-mill state criminal proceeding, which, he thinks, has penalty characteristics? Is restitution a penalty in any sense?

C. Section 3505 Liability.

A companion provision imposes liability upon lenders and sureties and others who make credit for a troubled company without providing for the withholding and payment to the IRS of the trust fund taxes. § 3505. This can occur where the third party makes net payments directly to the employees (i.e., net of the trust fund taxes) or where, with notice or reason to believe that the employer will not pay the withheld amounts to the IRS, the lender supplies net funds to the employer who then pays the employees and does not pay over to the IRS. The Government has the burden of proof (persuasion) with respect to the elements of § 3505 liability.

Sections 3505 and 6672 may overlap where the lender or an officer of the lender exercises practical control over which creditors will be paid and thus participates in the decision that the IRS will not be paid the trust fund taxes.

The Government does not assess a § 3505 claim as it does in other cases (most prominently, as it does in § 6672 cases), but rather brings a suit against the lender. The suit must be brought within ten years after the assessment against the employer.²⁵¹² There is a conflict as to whether the employer's extension or suspension of the period of limitations for the underlying liability also extends the lender's period under § 3505.²⁵¹³

Finally, although the Government must give the notice and demand required by § 6303(a) before it may pursue administrative remedies against the taxpayer, that notice and demand is not a prerequisite to bringing a judicial action for collection. Hence, the Government can make the § 3505 for assessed taxes whether or not it has made notice and demand on the taxpayer.²⁵¹⁴

D. Special Collection Mechanisms for Tax Liabilities of Estates And Donees.

1. The Problem.

The problem is the same as the basis for transferee liability with which we dealt earlier. Transfers may be made to third parties (other creditors, estate beneficiaries or donees) which render the party principally liable for the tax – the taxpayer or, if he is deceased, his estate – unable to pay. There are some special statutes that deal with these circumstances.

²⁵¹² Regs. § 31.3505-1(d)(3).

²⁵¹³ See United States v. GE HFS Holdings, Inc., 2011 U.S. Dist. LEXIS 131307 (MD FL 2011) (holding no extension or suspension and discussing United States v. Harvis Construction Co., 857 F.2d 1360 (9th Cir. 1988) (no extension or suspension) and United States v. Associates Commercial Corp., 721 F.2d 1094 (7th Cir. 1983) (extension and suspension).

²⁵¹⁴ See Jersey Shore State Bank v. United States, 479 U.S. 442 (1987).

2. Beneficiary and Donee Liability for Estate or Gift Tax Under § 6324.

a. Lien on Property Transferred.

The United States has a unified gift and estate transfer tax regime. Under that regime, lifetime and testamentary gifts are aggregated as the transfers are made and transfer tax computed based on the aggregate transfers. For larger gifts (in the aggregate), the transfer tax (a gift tax during life and an estate tax at death) can be substantial. The transfer tax is imposed upon the transferor – donor or decedent’s estate, respectively. What protection does the IRS have if the transferor does not pay the tax?

Section 6324(a) creates a lien for the estate tax on all of the deceased’s property as of the date of death, and **§ 6324(b)** creates a lien on property given subject to the gift tax as of the date of the gift.²⁵¹⁵ The effect of the respective liens is a bit complex, but I will try to navigate the rules as I understand them. Both of the liens are silent liens and are effective without recording,²⁵¹⁶ except as I note herein.

As to the estate tax lien, the effect of the lien depends upon whether the property is probate property includable under § 2033 (“Probate Property”) or non-probate property includable under §§ 2034-2042 (“Non-probate Property”). Probate property is subject to the lien in the beneficiary’s hands and in the hands of transferees of the beneficiary; there is no innocent purchaser or purchaser for value exception.²⁵¹⁷ Non-probate Property is subject to the lien in the beneficiary’s hands; upon transfer by the beneficiary, the property is “divested” of the lien and a “like lien” then attaches to the beneficiary’s other property that can be divested only by transfer by the beneficiary to a purchaser or holder of a security interest.²⁵¹⁸

As to the gift tax lien, the donated property in the donee’s hands is subject to the lien but is divested of the lien if the donee transfers it to a purchaser or holder of a security interest. If the

²⁵¹⁵ This means that the lien is created even before the amount of tax it secures is ascertained (which would be at the time the return is filed). Detroit Bank v. United States, 317 U.S. 329 (1943). § 6324(b) seems to create this lien only if a “return was filed.” If the donor did not file a gift tax return, does the lien arise? This possible limitation does not exist for the estate tax return and the regulations expressly state that it applies for deficiencies. Regs. § 301-6324-1(a)(1).

²⁵¹⁶ United States v. Vohland, 675 F.2d 1071, 1074-1076 (9th Cir. 1982); Beaty v. United States, 937 F.2d 288, 290 (6th Cir. 1991).

²⁵¹⁷ Beaty v. United States, 937 F.2d 288, 290 (6th Cir. 1991) (“Under 26 U.S.C. § 6323(a), the general tax lien is not good against bona fide purchasers or other interest-holders unless the government perfects its interest by filing in the manner prescribed by 26 U.S.C. § 6323(f). The estate tax lien, by contrast, attaches to the property by operation of law and does not require filing to be good against innocent third parties.”).

²⁵¹⁸ § 6324(a)(2); see Rev. Rul. 69-23, 1961-1 C.B. 302 (1969).

donee transfers the property, all of the donee's property is subject to the gift tax lien except that the donee's property may be transferred free of the lien to a purchaser or holder of a security interest.²⁵¹⁹

In addition to the lien, personal liability (not just lien-type liability) is imposed on the transferee for the tax "to the extent of the value" of the property at the time of the transfer.²⁵²⁰ I discuss this personal liability in the section immediately following discussion of the lien.

The lien applies to all transfers subject to the estate or tax if tax is not paid (i.e., transfers subject to the estate tax and transfers subject to the gift tax for the period involved).²⁵²¹ This lien and liability attach even if the particular transferees' gift or bequest did not actually contribute to the tax liability in question. For example, assume these facts: (1) individual A makes a gift of \$1,000,000 cash to individual B which A reports on a timely gift tax return and fully pays the gift tax; (2) A makes a simultaneous gift of property worth \$1,000,000 to individual C, which A does not report on the gift tax return; and (3) the IRS timely assesses the gift tax on the gift to C. Both B and C are subject to the transferee lien and personal liability provisions; B is thus liable even though his gift does not contribute to the tax liability in question.²⁵²² A similar example in the case of an estate tax return would show that both B and C would be subject to the lien and potential liability.

The IRS may levy with respect to property subject to this lien.²⁵²³

The lien applies for 10 years and cannot be extended.²⁵²⁴ The IRS must actually complete levy or foreclose within that period.²⁵²⁵ Note, however, that the rules requiring a suspension of the statute of limitations (e.g., for a Tax Court proceeding or an offer in compromise) could apply.

²⁵¹⁹ § 6324(b).

²⁵²⁰ §§ 6324(a)(2) and 6324(b). See Baptiste v. Commissioner, 29 F.3d 1533, 1541 (11th Cir. 1994) (as to personal liability).

²⁵²¹ § 6324(c)

²⁵²² *Id.*, at 1276.

²⁵²³ Regs. 301.6331-1(a)(1).

²⁵²⁴ Beaty v. United States, 937 F.2d 288, 290 (6th Cir. 1991). For this reason, if the estate elects the special deferred payout provision of § 6166 there will be a period of time that the estate tax is outstanding and not protected by this lien. See Notice 2007-90, 2007-46, IRB 1003 ("During the final four years and nine months, the government's interest is no longer secured by the general estate tax lien. In most cases, approximately one-half of the total deferred estate tax still remains to be paid during that final, unsecured portion of the deferral period.").

²⁵²⁵ United States v. Cleavenger, 517 F.2d 230 (7th Cir. 1975).

b. Personal Liability.

Section 6324 imposes personal liability upon the beneficiary (defined broadly)²⁵²⁶ as to estate tax or the donee as to gift tax. As to the estate tax, the beneficiary's personal liability applies to **Non-probate Property** the beneficiary receives "to the extent of the value, at the time of the decedent's death, of such property."²⁵²⁷ Importantly, Probate Property included in the gross estate under § 2033 received by a beneficiary is not subject to this special liability provision, although the beneficiary may be held liable as a transferee under § 6901 and the property received will be subject to the special lien noted immediately above. As to the gift tax, the donee's personal liability is "to the extent of the value of such gift."²⁵²⁸ This liability arises immediately upon death or gift, respectively, and does not require any assessment or filing or any other action by the IRS, and may be pursued independently.²⁵²⁹

This transferee liability can be a problem. Suppose a young father working with a high tech company during the high tech bubble has stock in the company worth \$30,000,000. That is his only asset other than his home which is worth \$500,000. He has only \$400,000 of debt, all of which is a purchase money mortgage on his home. On December 31 of Year 1, father gives his son \$20,000,000 of the stock. By April 1 of Year 2, the stock had declined 90% in value, leaving father with stock worth \$1,000,000 and son with stock worth \$2,000,000. Father is required to file a gift tax return by April 15 of Year 2. The gift tax – after credits for the lifetime exemption for he and his wife – would exceed \$4,000,000. What is father to do? By selling all of the stock, father and son can pay \$3,000,000, leaving a \$1,000,000+ shortfall. Father and son are both liable for the \$1,000,000 shortfall.²⁵³⁰ Bummer!²⁵³¹

²⁵²⁶ Just for flavor as to its breadth, the classes by the personal liability for estate tax include "the spouse, transferee, trustee * * * surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive." § 6324(a)(2).

²⁵²⁷ § 6324(a)(2).

²⁵²⁸ § 6324(b).

²⁵²⁹ The IRS can pursue an action under § 7402 or transferee liability under § 6901 (which is not a predicate to the personal liability. See United States v. MacIntyre, 2012 U.S. Dist. LEXIS 79193, 18-20 (SD Tex. 2012); see also United States v. Geniviva, 16 F.3d 522, 525 (3d Cir. 1994) ("we hold that an individual assessment under 26 U.S.C. § 6901 is not a prerequisite to an action to impose transferee liability under 26 U.S.C. § 6324(a)(2)"). The IRS, of course, may proceed under § 6901, and where it does so, the substantive liability under § 6324(a)(2) will make irrelevant reference to state law (usually required under § 6901). Magill v. Comm'r, T.C. Memo 1982-148 (T.C. 1982).

²⁵³⁰ Gifts can have certain features of a classic estate freeze which is designed to assure that future appreciation goes into the donee's estate rather than the donor's, thus generally skipping a generation for the transfer tax. This dramatic example shows what can happen when the property drops in value rather than increases. That which was intended to lower the transfer tax as compared to the ultimate transfer tax if the donor retained the property actually increases the transfer tax as

Moreover, from the above example, you can see that, because the son has been required to pay the tax that was the primary obligation of the father (the donor), the son has not really received a \$20,000,000 gift. The law is clear, for example, that if the father had given son the gift (worth \$20,000,000) with the contractual obligation between father and son that son pay the gift tax related to the gift (\$4,000,000 if the amount of the gift were \$20,000,000), then the amount of the gift would only be substantially less than \$20,000,000 because of the donee's contractual obligation to pay the tax.²⁵³² This is a so-called "net-gift." However, given the fact that the father, as donor, did not contractually pass the obligation to the son and the father thus remained liable, vis-a-vis both the IRS and the son, the "net gift" rule would not apply to reduce the amount of the gift and resulting gift tax even though in fact the son has to pay some or even all of the gift tax.²⁵³³

Another interesting facet of this liability is that it is joint and several. The IRS can proceed against any beneficiary or donee without being limited to the proportion of the tax in issue that is attributable to the proportion of the property he or she received. There is no federal right of contribution in that case, but state law may supply one.

One interesting question is whether, given the scope of the personal liability, the IRS could proceed while the IRS issues a notice of deficiency against the taxpayer (the estate or donor) or while the taxpayer (estate or donor) is pursuing a Tax Court proceeding. You will recall from our discussion above that the IRS is generally prohibited against proceeding against the taxpayer before issuing a notice of deficiency or while a Tax Court case is pending, but the liability under § 6324 does not require a notice of deficiency. May the IRS proceed against a beneficiary or donee directly under § 6324? The IRS takes the position that it can, but urges restraint in doing so particularly while the taxpayer is pursuing a Tax Court case on the matter.

Still another question is whether and to what extent the liability is subject to interest. Using the same example, the father must file a gift tax return on April 15 of Year 2 reporting \$4,000,000 of liability but paying only \$3,000,000. As we have previously discussed, the father's deficiency of \$1,000,000 will be subject to interest from the due date of the return. No problem there. But, what about the son – will he be liable for the interest on the father's deficiency or will the son be liable to pay interest on his separate liability to the Government? Good question.²⁵³⁴

compared to the ultimate transfer tax if the donor retained the property.

²⁵³¹ For a similar phenomenon potentially wiping out the entire inheritance in the estate area, see Geniviva v. United States, 16 F.3d 522 (3d Cir. 1994).

²⁵³² Diedrich v. Commissioner, 457 U.S. 191 (1982); the actual calculation requires a complex calculation. See Rev. Rul. 75-72, 1975-1 C.B. 310. See also Armstrong v. United States, 277 F.3d 490 (4th Cir. 2002).

²⁵³³ Armstrong v. United States, 277 F.3d 490 (4th Cir. 2002).

²⁵³⁴ See Gregory A. Byron, Transferee Liability Under Section 6324: Defining the Extent of a Transferee's Liability for Interest, 32 Idaho L. Rev. 383 (1996), discussing inter alia, Baptiste v. Commissioner, 29 F.3d 1533 (11th Cir. 1994), and Baptiste v. Commissioner, 29 F.3d 433 (8th Cir. 1994). The author makes the interesting observation that, if the IRS proceeds against a transferee under § 6901, it might get such interest but might not if it proceeds directly under its rights under

As a personal liability, the IRS may pursue personal liability independently of the liens. Although the authority is sparse, the limitations period for this personal liability appears to be the same as the limitations period against the original transferor.²⁵³⁵ This invokes the general limitations periods for (1) assessment against the original transferor and (2) if assessment is timely made, then the 10 year collection period.²⁵³⁶

c. Relationship to 6901.

The IRS may invoke the transferee liability provisions of § 6901 with respect to the beneficiary or donee liability under § 6324 but is not required to do so.²⁵³⁷

3. Executor under 31 U.S.C. § 3713.

Executors generally have a duty to “(1) to marshal the decedent's assets, (2) to pay the decedent's debts (including those of the estate), and (3) to fulfill the dispositive terms of the decedent's will.”²⁵³⁸ An assessed tax liability is, of course, a debt of the estate, gives rise to a lien, and is subject to the mechanisms otherwise discussed to assure the IRS prior right to collect from the property of an estate. After all, as noted, the executor's obligation is to pay the decedent's debts in priority to distributions to beneficiaries.²⁵³⁹ But what about unassessed federal tax liabilities? The IRS may be conducting an audit of the decedent's pre-death income tax liabilities but have not yet made an assessment. Alternatively, the executor may know of potential liability for pre-death income taxes but the IRS does not. Still alternatively, the decedent may have pre-death unassessed income tax liabilities that are unknown to the executor or the IRS. There are obviously many variations among these points in the spectrum.

Section 3713 of Title 31 gives priority to Government claims in certain cases, including when the assets of an estate are insufficient to pay all debts of the debtor and holds the executor

§ 6324. See also Wendy C. Gerzog, Saigh It Ain't So, 2005 TNT 64-38. But see United States v. Marshall, 771 F.3d 854 (5th Cir. Tex. 2014) (holding that interest on the donee's liability from the date his donee liability arose is unlimited and thus not capped by the donor's liability).

²⁵³⁵ United States v. Botefuhr, 309 F.3d 1263, 1277 (10th Cir. 2002); United States v. Degroft, 539 F.Supp. 42, 44 (D. Md. 1981); United States v. Mangiardi, 2013 U.S. Dist. LEXIS 102012 (SD FL 2013).

²⁵³⁶ Id.

²⁵³⁷ See Regs. § 301.6901-1(b); see Geniviva v. United States, 16 F.3d 522 (3d Cir. 1994).

²⁵³⁸ Jay A. Soled, Implications of Discovering Unreported Income, Improper Deductions, and Hidden Assets Upon a Taxpayer's Death, 44 Ga. L. Rev. 697, 706 (2010).

²⁵³⁹ For an example of where an executor preferred the beneficiaries – two beneficiaries, one of whom was himself – over the IRS as creditor for a pre-assessed liability, see United States v. Shriner, 2014 U.S. Dist. LEXIS 32449 (D MD 2014), where the executor unsuccessfully claimed a supposed good faith reliance on counsel defense. The court gave short shrift to the argument and imposed liability under § 3713.

liable for “paying any part of a debt of the person or estate before paying a claim of the Government.”²⁵⁴⁰ This statute may apply when “(a) executors are on notice that a potential tax liability exists and (b) the statute of limitations is open.”²⁵⁴¹ If the statute is open, therefore, the executor’s liability turns upon notice. The executor will have to prove his or her lack of knowledge or fair notice, and, while the law may limit the executor’s duty to inquire, the executor may not ignore “suspicious circumstances that would prompt a prudent person to undertake an investigation.”²⁵⁴²

Of course, beneficiaries receiving distributions from the estate in these circumstances will be subject to the potential collection mechanisms of transferee liability and the special estate tax lien.

E. Transfers By Disclaimer or Renunciation.

We have discussed above the Drye case where the Supreme Court held that property which a beneficiary disclaims is property to which a tax lien upon the disclaiming beneficiary applies. Upon disclaimer, however, has the disclaiming beneficiary made a transfer subject to the gift tax thus giving rise to the foregoing lien? No.

F. IRS Use of State Law.

The IRS may use state law concepts and remedies to impose liability. For example, as you know, the general rule in most states is the partners in a general partnership are joint and severally liable for the partnership's debts. Assume a partnership has employees and thus incurs both trust fund taxes (the employee's income tax and share of FICA withholding) and the employer's share of FICA. Under state partnership law, a general partner is jointly and severally liable for these taxes.²⁵⁴³ You should note that this state law liability goes beyond the trust fund liability which is all the IRS can reach under § 6672. You should compare this result for general partnerships with the result for LLC and other limited liability entities that are treated as partnerships for federal tax purposes; in such cases, the state law limited liability will protect the owners (partners for tax

²⁵⁴⁰ § 3713(b).

²⁵⁴¹ Jay A. Soled, Implications of Discovering Unreported Income, Improper Deductions, and Hidden Assets Upon a Taxpayer's Death, 44 Ga. L. Rev. 697, 708 (2010). See the subsequent discussion in the article for what constitutes notice subjecting the executor to liability.

²⁵⁴² Soled, *supra*, p. 709-10. Compare Little v. Commissioner, 113 T.C. 474 (1999) (executor relieved where, although has some notice, the lawyer advised that the estate had no income tax liabilities) with United States v. Shriner, 2014 U.S. Dist. LEXIS 32449 (D MD 2014) (where the attorney gave no advice about the validity of the tax claim but apparently only advised as to the extent of the claim against the executor). The reasoning in Little and Shriner somewhat echo the Supreme Court’s analysis for failure to file penalty relief in United States v. Boyle, 469 U.S. 241, 251 (1985), which I discuss under the failure to file penalty.

²⁵⁴³ E.g. Remington v. United States, 210 F.3d 281 (5th Cir. 2000).

purposes) from general liability but will not protect them from the trust fund tax liability.²⁵⁴⁴ State law, of course, totally controls the issue of liability and scope of liability.

We discussed above the IRS's use of state law transferee liability, with certain federal tax code special procedures to implement the state law liability. Where liability is imposed under state law and there are no special tax Code procedures, the IRS must take the state law and its limitations as it finds them.

G. Constitutional Protections.

Do constitutional protections apply to the IRS's use of the broad levy power against third persons? We have discussed above the general constitutional requirements for levies. Courts have held that those apply particularly when levying against the property of third persons.²⁵⁴⁵

XVII. International Aspect of Collection of U.S. Tax from NonResidents.

The U.S. tax system taxes its citizens and certain classes of citizens (such as green card holders) wherever they reside. Nonresidence in the U.S. means that traditional IRS tools such as interaction with U.S. resident taxpayers and liens and levies are not available, unless some equivalent tool is offered or facilitated by other countries. This means that a tax avoidance mechanism is available for such nonresidents by avoiding having assets within the U.S. And, of course, being outside the country, the IRS cannot "go to the source" to force out information about assets, particularly their location in some venue that the IRS might be able to enforce collection.

One tool that seems to be useful to the IRS in collecting from such taxpayers is the "Customs Hold" in the Treasury Enforcement Communications System (TECS).²⁵⁴⁶ The TECS is a Customs database used by law enforcement, including the IRS. The IRS notifies the Department of Homeland Security (DHS) of the names of some nonresident taxpayers with outstanding tax liabilities for input into the TECS database. Taxpayers are notified of this action via Letter 4106, Letter Advising Taxpayer of Department of Homeland Security Notification. DHS then can detain such taxpayers seeking to enter the U.S. to collect their contact information at the places they will stay in the U.S. Although IRS managers believe this is an effective collection tool, there are no empirical studies to support that belief.

²⁵⁴⁴ CCA 200235023. The CCA notes that, in contrast, the IRS may look to the single member owner of such a state law entity despite the limited liability under state law.

²⁵⁴⁵ See Oxford Capital Corp. v. United States, 211 F.3d 280 (5th Cir. 2000), concurring opinion of Judge Dennis discussing the cases.

²⁵⁴⁶ TIGTA Report No. 2014-30-054 (9/12/14), titled The Internal Revenue Service Needs to Enhance Its International Collection Efforts.

XVIII. International Aspects of Collection of Foreign Country Tax.

A. The Revenue Rule.

Historically, the “Revenue Rule,” has been a barrier to one country seeking to collect taxes in another country. The Revenue Rule “at its core * * * prohibited the collection of tax obligations of foreign nations.”²⁵⁴⁷ Although described as a common law rule (suggesting some affiliation with Anglo-American jurisprudence), the Revenue Rule in one form or another is the general rule among countries.

This means that taxpayers desiring to avoid U.S. tax can put their assets in a foreign jurisdiction and thereby avoid the U.S. being able to collect U.S. tax from those assets. Similarly, persons subject to foreign country tax (including U.S. persons whose operations are subject to tax in a foreign country) can put or keep their money in the U.S. and avoid the foreign country enforcing those tax liabilities in the U.S.²⁵⁴⁸

²⁵⁴⁷ See Pasquantino v. United States, 544 U.S. 349, 361 (2005); see also, Attorney General of Canada v. R.J. Reynolds Tobacco Holdings, Inc., 268 F.3d 103, 106 (2d Cir. 2001), cert. denied 123 S.Ct. 513 (2002) (“a long-standing common law doctrine providing that courts of one sovereign will not enforce final tax judgments or unadjudicated tax claims of other sovereigns.”). See generally Brenda Mallinak, The Revenue Rule: A Common Law Doctrine for the Twenty-First Century, 16 Duke J. Comp. & Int’l L. 79, 94 (2006). In Pasquantino, the Supreme Court said that the rule is an extension of the general rule that one sovereign will not enforce the penal laws of another sovereign. 544 U.S., at pp. 360-361 (citing Wisconsin v. Pelican Ins. Co., 127 U.S. 265, 290 (1888), and Leflar, Extrastate Enforcement of Penal and Governmental Claims, 46 Harv. L. Rev. 193, 219 (1932)). I guess we now have authority that taxes are penal in nature!

²⁵⁴⁸ Attorney General of Canada v. R.J. Reynolds Tobacco Holdings, Inc. presents a dramatic instance of the application of the Revenue Rule. There, American Tobacco companies allegedly participated in a scheme to avoid Canada’s high tobacco tax. Apparently because those companies had no assets in Canada from which Canada could collect the taxes in issue, Canada sued in the U.S. Since the Revenue Rule would prevent Canada from bringing a direct collection suit in the U.S., Canada brought the suit as a civil RICO action wherein the measure of damages was in principal part the lost tax revenue. The underlying acts by the tobacco companies occurred in the U.S. and thus provided a jurisdictional nexus for the civil RICO claim. The majority held, in effect, that the Revenue Rule prevented Canada from using civil RICO to achieve indirectly that which it could not achieve directly through a straight collection suit in the U.S. for the Canadian taxes. The case has an extensive discussion of the Revenue Rule and the policies behind the rule. There is a vigorous dissent in the case contesting the majority’s analysis.

B. Alternatives Consistent with the Revenue Rule.

1. Custodian Subject to U.S. Process.

If custodian of the assets is subject to U.S. jurisdiction, the IRS can bring compulsory process against that person. Thus, if the taxpayer has a Tax Haven bank account, the IRS can levy the account by levying on the taxpayer or other custodian to bring the assets to the United States so that they can be properly seized.

Of course, the smart U.S. tax evader will simply put his assets in an institution (bank, brokerage, etc.) that has no sufficient U.S. presence to be subject to compulsory process in the U.S.

2. Compulsory Process Against the U.S. Taxpayer.

If the taxpayer himself or herself is subject to U.S. jurisdiction, the IRS can levy on the taxpayer – a levy which will at least in theory reach the assets the taxpayer has in other countries. The Government then can have a court hold the taxpayer in contempt if he or she does not deliver the assets subject to the levy.²⁵⁴⁹

How will the IRS know and be able to prove in a contempt proceeding that the taxpayer has assets overseas? We have discussed some of the IRS's investigative techniques that can be brought to bear (pp. 387 ff.). At the collection phase, the IRS can and will request the taxpayer to complete a financial statement. The taxpayer is not required, however, to complete the financial statement, but if the taxpayer fails to do so, the IRS can issue a summons to ask questions, including the nature of the taxpayer's assets and their location.

Assume, however, that the existence of a foreign account would tend to incriminate the taxpayer (i.e., unreported income or lying on Form 1040 about the foreign account). Can the taxpayer assert a privilege to having to disclose the existence of the foreign account? The answer is that he can – **generally**. Is the IRS stymied? Note the word generally. The general rule is certainly that a U.S. individual can assert a Fifth Amendment privilege and, under the Act of Production doctrine, can assert the Fifth Amendment to prevent compulsion to produce documents regarding the foreign account. But, the Government has two work-arounds. First, the Government can issue compulsory process – IRS summons or grand jury subpoena – that avoids the Fifth Amendment privilege under the “required records” doctrine. I covered that earlier in the discussion of privileges. Second, the Government may issue compulsory process – IRS summons or grand jury subpoena – to force the taxpayer to sign a “consent directive” which is a document authorizing foreign parties, such as banks, to divulge information about the assets. I covered that also under the discussion of privileges.

²⁵⁴⁹ See FTC v. Affordablemedia, LLC, 179 F.2d 1228 (9th Cir. 1999) (a nontax case holding the U.S. person in contempt for failing to honor an order to have assets in a Cook Island Trust delivered to the court).

So, assuming the taxpayer is given sufficient incentive to sign the consent directive, what happens if the Tax Haven bank doesn't comply (typically asserting that its laws prohibit such disclosures). The reasoning of Affordablemedia easily could support a contempt order if the court had the slightest inkling that the taxpayer could cause the information to be forthcoming despite such alleged laws. And, of course, once the information is disgorged, the IRS could seek and a court would order the taxpayer to demand return to the U.S. of the monies in the account and, failing their return, impose civil contempt against the taxpayer.

Of course, at the information gathering stage prior to collection, the IRS has sources other than the taxpayer as to the existence of a foreign account. Often jilted spouses or lovers who took trips with the taxpayer to the Tax Haven are more than pleased to turn the taxpayers in, former business partners, etc. And, we discussed above the IRS's initiative to subpoena the credit card records from U.S. persons (to wit, American Express and MasterCard) who have information that might tie a U.S. taxpayer to a foreign bank account.

Still, all in all, although the IRS has these various techniques, placing assets in foreign jurisdictions is a time-honored and, I suspect, usually successful method of evading assessment or collection. The issue for taxpayers considering that gambit really is whether the costs, if detected (even if the risk of detection is slight), are so high that the taxpayer's personal cost/benefit assessment cautions against it.

C. Cracks in the Revenue Rule.

1. Treaties.

As noted above, U.S. tax treaties now have exchange of information requirements which obligate one treaty party, upon a proper request from the other, to use their internal processes to obtain information and share it with the other party.²⁵⁵⁰

Some U.S. treaties go beyond merely the exchange of information and provide for use of each other's legal systems for tax collections. E.g., the Third Protocol (1995) of the U.S.-Canada Treaty of 1980 provides for reciprocal enforcement of some tax debts of the treaty parties. The majority decision in Attorney General of Canada indicated that there are only 5 U.S. treaties providing for general assistance in collecting some tax debts of the other treaty partner.²⁵⁵¹ The

²⁵⁵⁰ See e.g., United States v. Stuart, 489 U.S. 353 (1989), involving use of the IRS summons at the request of Canadian tax authority under the U.S. Canadian double tax treaty.

²⁵⁵¹ See Keith Fogg, International Efforts by the IRS - Expanding the Number of Treaties in Which We Have Collection Language (Procedurally Taxing Blog 11/191/4), identifying the five treaty countries as Canada, France, Holland, Denmark and Sweden. I think the treaties referred to here are the double-tax treaties.

standard treaty provision requires such assistance in collecting only amounts necessary to protect on the Limitations of Benefits clause.²⁵⁵²

Of course, the reason Tax Haven jurisdictions have no such treaty provisions (they wouldn't be Tax Haven jurisdictions if they did) is to avoid such treaty information sharing provisions and tax debt collection provisions. Tax Havens typically do not have such treaties with the U.S. But Tax Havens are under heavy attack to change their ways. Thus, in response to economic incentives, some of these traditional Tax Haven countries have entered into Tax Information Exchange Agreement (also referred to as a "TIEA"). How effectively they work is another issue. But the point here is that a taxpayer may get caught in this ever-expanding net as the developed countries continue their assault on Tax Havens and offer them sufficient incentives to move closer to the global mainstream. At some point, this could mean not only tax information sharing agreements, but also reciprocal tax debt collection as in the U.S.-Canada Treaty.²⁵⁵³

2. Pasquantino and Extensions.

In Pasquantino v. United States, 544 U.S. 349 (2005), the Supreme Court held that the U.S. wire fraud statute (and mail fraud statute) could apply to use of U.S. media to effect evasion of a foreign country's taxes. In doing so, the Supreme Court resolved a conflict among the circuits as to whether the common law revenue rule and similar prudential considerations (including presumption against extraterritoriality and the rule of lenity) required the wire fraud statute to be interpreted so exclude foreign tax violations as an object of the offense. The conduct being penalized (use of the U.S. media) occurs within the U.S. and the U.S. has a sufficient interest in regulating that conduct that it can penalize it. There was nothing in the statute or its interpretation that would suggest that Congress intended or would have intended it not to apply when the object of the conduct was a foreign fraud as opposed to a U.S. fraud.

In deciding Pasquantino, the majority noted:

We express no view on the related question whether a foreign government, based on wire or mail fraud predicate offenses, may bring a civil action under the Racketeer Influenced and Corrupt Organizations Act for a scheme to defraud it of taxes. See Attorney General of Canada v. R. J. Reynolds Tobacco Holdings, Inc., 268 F.3d 103, 106 (CA2 2001) (holding that the Government of Canada cannot bring a civil RICO suit to recover for a scheme to defraud it of taxes); Republic of Honduras v. Philip Morris Cos., 341 F.3d 1253, 1255 (CA11 2003) (same with respect to other foreign governments).²⁵⁵⁴

²⁵⁵² See e.g., U.S. Treasury 1996 Model Convention Technical Explanation, discussing Article 26.

²⁵⁵³ See Keith Fogg, International Efforts by the IRS - Expanding the Number of Treaties in Which We Have Collection Language (Procedurally Taxing Blog 11/19/14).

²⁵⁵⁴ Pasquantino, p. 1771, n. 1.

Ch. 15. Partnerships and S Corporations.

I. Introduction.

The preceding materials deal principally with a taxpayer who owes a tax liability and how the system interfaces with that taxpayer in reporting tax liability, determining additional tax liability through audits, appeals and litigation, and assessing and collecting any additional liability or refunding any overpayment. In other words, we have dealt with liabilities between a **tax payer** and the IRS.

The Code requires certain tax-related reporting by persons and entities that, with respect to the reporting, are not **tax payers**. We have covered above certain information reports such as the various Forms 1099 with respect to which the reporters are not tax payers. Within this category of reporting but not tax paying persons are certain entities that report the results of their operations (income, deduction and credits) and allocate those results to and among other persons who then report their shares so allocated and pay any tax due. The principal such entities you will encounter are partnerships (including limited liability companies that are treated as partnerships) and S Corporations. The entities in the past were called “flow-through” entities, because their component income, deductions and credits flowed through and were taxed to the partners or shareholders respectively. In today's world, particularly in the international context, they are referred to as “transparent entities.”

The **Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”)**²⁵⁵⁵ amended the Code to provide unified audit and litigation procedures for such entities. (I give you the name of the statute because tax practitioners use the acronym TEFRA to identify partnerships and procedures originally enacted by this statute; the Code sections thus added are in Chapter 63, Subchapter C, titled Tax Treatment of Partnership Items, §§ 6221-6234.) The core TEFRA concept is that, with respect to the results of the operations of the partnership, the partnership itself will be the audit and litigating **unit** as to entity level items. When those issues are resolved at the entity level, the results are then allocated out to the owners (partners or shareholders) in their proper shares without further ado.

To fully understand these provisions, you need a brief introduction to the system pre-TEFRA.²⁵⁵⁶ Prior to TEFRA, for example, a partnership with 1,000 or more partners might still be audited as an entity since the partnership did file a partnership return that hit the IRS's radar screen. However, while the partnership level audit was proceeding and at its conclusion, the IRS would have to coordinate the results with the 1,000 partners, who might be scattered throughout the country or overseas. Even relatively simple procedural steps – such as assuring that all partners’

²⁵⁵⁵ 96 Stat. 648, Title IV, which has the short name “Tax Treatment of Partnership Items Act of 1982.”

²⁵⁵⁶ Good introductions and background are found in United States v. Woods, ___ U.S. ___, 134 S. Ct. 557, 562-563 (2013); Callaway v. Commissioner, 231 F.3d 106 (2d Cir. 2000) and in Randell v. United States, 64 F.3d 101 (2d Cir. 1995).

statutes of limitations were extended if that became necessary – could be an administrative nightmare, since each of the partners needed to be contacted and could make independent decisions as to whether to extend the statute. Although there are not that many 1,000 partner partnerships, there are any number of 20 - 999 partner partnerships, which created the same administrative problems although lesser in scope.

The system became stressed, particularly during the partnership tax shelter heyday in the late 1970s and early 1980s where any number of promoters wanting money and taxpayers wanting to avoid taxes were quite willing to exploit the administrative problems. Moreover, each partner could separately litigate his or her liability arising from the partnership's activities. Not only could this lead to inconsistent results, but it also became an administrative and judicial nightmare.

I give an example of this administrative complexity from a case involving a tax shelter partnership in a pre-TEFRA year. In that case, a group of 20 partnerships were involved in the so-called “Elektra-Hemisphere” tax shelter. The IRS audited the partnerships and determined that the partnerships had claimed erroneous tax benefits which it had allocated to and among the partners. The IRS sent notices of deficiency to the partners accordingly. The general partners hired a law firm to represent those partners who desired it to do so. Over 4,000 of the limited partners elected to let the law firm represent them, and the law firm (and its successor) then filed over 17,000 petitions in the Tax Court on behalf of those partners (the larger number being because multiple years were involved and thus multiple notices of deficiency were sent). In all of these multiple proceedings the principal issue was the proper tax results for the partnerships’ operations.

The law firm would receive correspondence from the partner including the notice of deficiency and would then file a form petition, changing only the variable information (the name(s) of the petitioner(s), the IRS office issuing the notice of deficiency, the amount of deficiency and penalties asserted against the partner(s), and any other adjustments not arising from the partnerships). The Tax Court then set trials for test cases, and deferred decision on the other cases. Many partners in the deferred cases agreed to be bound by the test case; others did not. The taxpayers lost in the test cases. That resolved the nontest cases wherein the taxpayers had agreed to be bound. The Court then held show cause hearings for the nontest cases wherein the taxpayers had not agreed to be bound, directing them to show cause why the result in their cases would be different than the results of the test cases. These procedures made the best of a bad situation and did bring some degree of order to chaos. But, there were inevitable cracks in the process.

Thus, in the case, the taxpayer's accountant without the authority of the taxpayer had routinely sent the notice of deficiency to the law firm which had then routinely filed a petition in the Tax Court on the assumption that it had authority to do so. In fact, the taxpayer had not authorized the filing of a petition. Some 10 years later it surfaced that the taxpayer had never authorized the filing of the petition. The Tax Court held that the petition was invalid. What does that mean? You will recall that, under § 6213(a), the IRS may not assess a tax liability until the Tax Court proceeding has concluded and under § 6503(a)(1) the statute of limitations on assessment is suspended “if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, until the decision of the Tax Court becomes final.” During this entire period, the IRS operated on the assumption that a Tax Court proceeding had suspended that partner’s statute of limitations. The

taxpayer asked the Tax Court to hold, contemporaneously with its holding that a valid petition had not been filed, that the statute of limitations on assessment had not been suspended and thus prevented any assessment for that pre-TEFRA year. The Tax Court declined to so hold, saying that the issue was not before it.²⁵⁵⁷ I hope this discussion gives you some idea of the complexities of the system prior to the TEFRA partnership changes.

TEFRA dealt with these administrative problems by enacting the basis for the current unified procedures for partnerships. The core principle is that the IRS will audit or otherwise deal with the partnership entity through an authorized representative of the partnership in unified proceedings (audits and litigation) that will determine for all partners the tax results of partnership operations. The tax results so determined will then be administratively allocated to and among the partners in their respective partnership distributive shares. Significant administrative issues were addressed such as who represents the partnership, whether other partners can participate in the proceedings, how to keep the partners' statutes of limitations from expiring while the entity level unified proceedings are in process, etc. The provisions are quite complex in how they resolve the host of issues involved, but for present purposes I want you to keep the focus on the overarching principle to resolve partnership audits and litigation in unified proceedings at the entity level. With that focus you will understand the basis for Congress's choices of procedures to implement the system.

Because of the complexity of the TEFRA provisions, I shall deal only with the key administrative themes.²⁵⁵⁸

II. Partnerships.

A. Entities Subject to Procedures.

Partnerships, other than qualifying “small partnerships,” required to file a partnership return are subject to the TEFRA partnership procedures.²⁵⁵⁹ Partnerships are defined to include “a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of

²⁵⁵⁷ I hope you will see that the IRS will argue that the language of the statute authorizes the suspension solely based upon the docketing of the case regardless of lawyer’s actual authority to file. See Eversole v. Commissioner, 46 T.C. 56 (1966); and Martin v. Commissioner, T. C. Memo. 2003-288.

²⁵⁵⁸ The IRS has identified the general TEFRA procedures and a number of issues in CC-2009-027, published in 2009 TNT 164-5 (8/21/09). This is a worthwhile read.

²⁵⁵⁹ § 6231(a)(1)(A). A partnership that is required to file a return but does not is subject to the TEFRA procedures. By contrast, if a partnership return is filed but it is later determined that there was no partnership entity, the TEFRA rules will nevertheless apply. § 6233(a) and Regs. § 301.6233-1(b). Also, some associations – such as joint operating agreements – that might otherwise be treated as partnerships are excluded from the requirement of filing partnership returns and thus are not subject to the TEFRA procedures. See e.g., § 761(a) and Regs. § 1.761-2(a) & (b).

which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.²⁵⁶⁰

Small partnerships are exempted from the TEFRA procedures and thus continue to be treated under the prior individual partner audit and litigation rules described in the introduction. A small partnership qualifying for this treatment is a partnership with “10 or fewer partners each of whom is an individual (other than a nonresident alien), a C Corporation, or an estate of a deceased partner.”²⁵⁶¹ Husbands and wives (and their estates) are treated as one partner for this purpose.²⁵⁶² Otherwise qualifying small partnerships may elect to be subject to the TEFRA procedures.²⁵⁶³

B. Partners Subject to the Procedures.

Persons subject to the TEFRA procedures include any partner in a partnership and any other person whose income tax liability is determined “in whole or in part, by taking [partnership items] into account directly or indirectly.”²⁵⁶⁴ Thus, so-called pass-through partners are bound by the unified audit and litigation results. To illustrate, if A, an individual, is a partner in partnership X and partnership X is a partner in partnership Y, A will be affected by determinations made as to partnership Y. In the terminology of the Code, partnership X is a pass-through partner, and A is an indirect partner of partnership Y.²⁵⁶⁵

C. Rule of Consistency in Partner Return Reporting.

A partner is required to treat the “flow-through” item on the partner's return consistent with its treatment on the partnership return.²⁵⁶⁶ The Partnership notifies each Partner of his or her share of partnership items via a Schedule K-1, titled “Partner’s Share of Income, Deductions and Credits,”

²⁵⁶⁰ § 761(a); see also § 7701(a)(1) and also Regs. § 1.761-1(a) (cross-referencing Regs. § 301.7701-1, 2 and 3 which includes the definition of partnership under the check-the-box procedures which permit some corporate entities to qualify as partnerships for tax purposes). The statutory definition is not a litmus test of what types of common activity constitute a partnership. In Commissioner v. Tower, 327 U.S. 280, 286 (1946), the Court held that a partnership for tax purposes exists when persons “join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses.” The test is factual and an issue of intent (not intent as to the label but intent as to the common activities that together add up to partnership). See Commissioner v. Culbertson, 337 U.S. 733 (1949).

²⁵⁶¹ § 6231(a)(1)(B).

²⁵⁶² Id.

²⁵⁶³ § 6231(a)(1)(B)(ii).

²⁵⁶⁴ § 6231(a)(2).

²⁵⁶⁵ § 6231(a)(9) & (10).

²⁵⁶⁶ § 6222(a).

that the partnership must send annually to each partner. The partner is required to report the items consistently with the Schedule K-1.

If a partner disagrees with the partnership's treatment reflected on the Schedule K-1 and desires to report differently, the partner may either notify the IRS of his or her election to treat a partnership item inconsistently with its treatment on the partnership return,²⁵⁶⁷ or file an administrative adjustment request (“AAR”).²⁵⁶⁸ In either event, the notification or request is filed on the Form 8082, titled “Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR).” Otherwise, if a partner treats items inconsistently with the partnership's treatment of those items, the IRS may assess a deficiency against the partner without any notice, as a “computational adjustment” without issuance of a notice of deficiency and may impose penalties, including the fraud penalty.²⁵⁶⁹ And, if the partner so notifies the IRS, the IRS may not adjust the notifying partner’s return reporting the inconsistent treatment unless the IRS conducts a partnership level audit or notifies the partner that that partner’s partnership items will be treated as nonpartnership items subject to audit with respect to that partner’s return alone.²⁵⁷⁰

D. Unified Partnership Level Proceedings for Partnership Items.

The key administrative concept is the unified proceeding with respect to partnership items. Section 6221 thus states broadly:

Except as otherwise provided in this subchapter, the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level.

Similarly, Section 6226(f) provides:

A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, and the applicability

²⁵⁶⁷ § 6222(b). Form 8082 is used to report the inconsistency.

²⁵⁶⁸ § 6227(a). The IRS then has the authority to conduct a partnership proceeding or treat the items for which an AAR is filed as nonpartnership items and calculate the tax liability of the partner requesting the AAR accordingly. See § 6227(a). As noted by the Tax Court, the IRS generally opts to conduct a partnership proceeding. Samueli v. Commissioner, 132 T.C. No. 16 (2009) (citing 2 Audit, Internal Revenue Manual (IRM) (CCH), pt. 4.31.4.2.3.1(4), at 10,864 (Sept. 1, 2006)).

²⁵⁶⁹ §§ 6222(c) &(d) & 6230(a)(1). See Samueli v. Commissioner, 132 T.C. No. 16 (2009).

²⁵⁷⁰ Regs. § 301.6222(b)-2(a).

of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

A “**partnership item**” is a tax item that is “more appropriately determined at the partnership level than at the partner level.”²⁵⁷¹ Obviously, the partnership’s income, deductions and credits are partnership items. And, whether a partnership is in a trade or business or whether the “partnership lacks economic substance is an adjustment to a partnership item.”²⁵⁷² A partnership item is determined at the partnership level.

A “**nonpartnership item**” is one that is “not a partnership item.”²⁵⁷³ Nonpartnership items are determined at the individual partner level and raised by notice of deficiency to the partner. Sometimes this dividing line between items that are to be determined at the partnership level and items that are to be determined at the individual partner level is not so clear and, in such cases, the IRS may protectively proceed both at the partner level via the TEFRA procedures and at the individual level via the notice of deficiency.²⁵⁷⁴

The regulations contain a laundry list of the types of items that are “partnership items” subject to these procedures.²⁵⁷⁵ Most of these you will easily recognize simply by keeping in mind Congress’ purpose to have a unified proceeding at the partnership level as to items related to the partnership that can reasonably be determined at the partnership level in a single proceeding. Common sense²⁵⁷⁶ and focus on the purpose of the TEFRA unified proceedings will generate the right result as to what is a partnership item more appropriately determined at the partnership level. Nevertheless, the IRS and the courts continue to struggle with the concept of what is a partnership item.

There is a third category of items – “affected items” – which are determined at the partner level but which may be automatic adjustments as a result of the treatment of partnership items. The unified partnership level proceeding will not determine the affected items for each partner specifically, but the determinations of the partnership items will necessarily also determine the resolution of affected items on the partners’ returns unless they require individualized partnership facts. Thus, there are two types of affected items: (i) those that do not require individualized partnership determinations (sometimes called computational affected items) and (ii) those that do

²⁵⁷¹ § 6231(a)(3).

²⁵⁷² United States v. Woods, ___ U.S. ___, 134 S. Ct. 557, 563 (2013).

²⁵⁷³ § 6231(a)(4).

²⁵⁷⁴ See Bausch & Lomb Inc. v. Commissioner, T.C. Memo 2009-112 (where the IRS took the protective dual positions and, in the Tax Court proceeding regarding the taxpayer’s petition to have the notice of deficiency redetermined, successfully urged that the notice of deficiency was invalid because the matter in dispute between the taxpayer and the IRS was properly to be determined at the partnership level via the TEFRA procedures).

²⁵⁷⁵ Regs. § 1.301.6231(a)(3)-1.

²⁵⁷⁶ Common sense is an attribute that gets sorely tested in the tax shelter partnerships where even the most outrageous arguments are made to avoid an adjustment.

require such determinations (sometimes called noncomputational affected items).²⁵⁷⁷ Examples of affected items that would not require further partner level determinations are the automatic adjustments that flow from changes in income resulting from the partnership item adjustments (such as allowable medical deductions, etc.). The adjustments for affected items, as well as for the partnership items themselves, are subject to the special statute of limitations for the TEFRA procedures.²⁵⁷⁸

There is a key exception to the requirement for a notice of deficiency as to penalties where the partner may have partner level defenses. Penalties such as the accuracy related penalties (§ 6662) and the fraud penalty (§ 6663) were originally nonpartnership items requiring a notice of deficiency to the individual partner after the partnership level proceedings were concluded.²⁵⁷⁹ This allowed each partner to contest the penalties separately from the unified partnership proceeding. This has some logic to it. For example, you will recall that there is a reasonable cause exception (§ 6664(c)) that relates to the partner's individual level attributes. Some partners may qualify under this exception, while others may not. Another example is the substantial understatement penalty that requires certain threshold dollar amounts that may be applied only at the partner level and, as to tax shelters, only applies if the partner did not reasonably believe that he or she would not prevail.

In 1997, however, Congress determined that many of the issues related to liability for penalties could be resolved, at least initially, at the partnership level in a unified proceeding. Congress amended the TEFRA procedures to provide that penalties related to partnership item adjustments are determined in the unified partnership level proceeding and that, therefore, no notice

²⁵⁷⁷ See Duffie v. United States, 600 F.3d 362, 366 (5th Cir. 2010) (adopting opinion of district court attached as an appendix). See CC-2009-11 (3/11/09), published at 2009 TNT 54-19.

²⁵⁷⁸ The affected item concept does create some uncertainty as to whether the IRS must make the adjustment under the TEFRA statute of limitations or the partner's individual statute of limitations. As noted elsewhere, the statute of limitations for partnership related adjustments is the greater of the TEFRA partnership statute of limitations or the partner's individual statute of limitations. But, if an adjustment is an affected item, it in some circumstances may not be subject to the TEFRA provisions and the partner's statute of limitations controls even if shorter than the TEFRA statute of limitations. Because of this nuance, the IRS has procedures that require a protective partner level statutory notice of deficiency under the following circumstances (CC-2009-11, reproduced at 2009 TNT 54-19):

If a partner has reported a loss (or reduced gain) on the partner's individual return as a result of having sold the TEFRA partnership interest or an asset distributed by the TEFRA partnership, the IRS should make certain protective assessments to ensure that the assessments are made before the period of limitations on assessment expires. Given the different types of affected items -- those that can be directly assessed and those requiring determinations at the partner level -- the IRS may not know with certainty how a court will classify the affected item.

²⁵⁷⁹ United States v. Woods, ___ U.S. ___, 134 S. Ct. 557, 563 (2013).

of deficiency need be issued to the partner.²⁵⁸⁰ The individual partner is not permitted to raise his or her individual partner-level defenses to the penalty in the partnership proceeding, but may then contest the penalty after assessment by paying the tax, filing a claim for refund and, if the claim is denied, suing for refund.²⁵⁸¹ The Regulations assert that, although the accuracy related penalty itself is determined at the partnership level, the reasonable cause and good faith exception must be asserted at the partner level in a post-TEFRA proceeding refund suit based on factors unique to the partner.²⁵⁸² (In Code-speak, this means that liability under § 6662 is determined at the partnership level,²⁵⁸³ but any partner have a § 6664 good faith and reasonable cause defense may assert them at the partnership level in a refund suit.) Some courts, however, have held that the partner's reasonable cause and good faith defense can be asserted at the partnership level in the TEFRA proceeding, at least in cases where the partner is also an actor in the partnership proceeding whose actions and good faith can be asserted by the partnership.²⁵⁸⁴

Again common sense and clear focus on the reasons for this penalty regime is required to get the right result. Thus, for example, the Tax Court held that, because it had jurisdiction to determine that the partnership must be disregarded and meaning, necessarily, that the partners had no outside partnership basis, the Tax Court in the unified partnership proceeding could consider and sustain a partner-level penalty asserted in the FPAA.²⁵⁸⁵ This penalty regime can present potential

²⁵⁸⁰ §§ 6221 and 6230(a)(2)(A)(i); see also § 6226(f). This procedure is explained and applied in United States v. Woods, ___ U.S. ___, 134 S. Ct. 557 (2013); see also Fears v. Commissioner, 129 T.C. 8, 10 (2007), Domulewicz v. Commissioner, 129 T.C. 11, 23, and Bedrosian v. Commissioner, T.C. Memo. 2007-376.

²⁵⁸¹ § 6230(c)(1)(C), (c)(3) & (c)(4); Fears v. Commissioner, 129 T.C. No. 2 (2007); Regs. § 301.6221-1(c) & (d); This procedure is explained and applied in United States v. Woods, ___ U.S. ___, 134 S. Ct. 557 (2013). See also Klamath Strategic Inv. Fund v. United States, 568 F.3d 537, 547 (5th Cir. 2009); and Santa Monica Pictures, LLC v. Commissioner, T.C. Memo. 2005-104, at n. 195, determining at the partnership level whether there was substantial authority and a reasonable belief that the tax shelter item would more likely than not prevail for purposes of the substantial understatement penalty but noting that matters uniquely determined at the partner level (e.g., whether the understatement is substantial) can be presented in a subsequent refund suit. (Note that this test to avoid a substantial understatement penalty for a tax shelter is no longer the law.)

²⁵⁸² Regs. § 301.6221-1(d).

²⁵⁸³ This includes negligence, substantial understatement, and the various mis-valuation penalties. United States v. Woods, ___ U.S. ___, 134 S. Ct. 557 (2013),

²⁵⁸⁴ Klamath Strategic Investment Fund v. United States, 568 F.3d 537, 548 (5th Cir. 2009) (citing Santa Monica Pictures v. Commissioner, 2005-104; and Stobie Creek Investments, LLC v. United States, 82 Fed. Cl. 636, 703-04, 717-21 (2008)). For a good concise summary of the problem, see a post on Miller & Chevalier's Tax Appellate Blog titled "Schizophrenic Application of Tax Penalties (Part II)" at:

<http://appellatetax.com/2010/08/12/schizophrenic-application-of-tax-penalties-part-ii/>

²⁵⁸⁵ Petaluma FX Partners v. Commissioner, 131 T.C. 84 (2008), affirmed in part and reversed in part, 591 F.3d 649 (D.C. Cir. 2010).

anomalies. In a Tax Court partnership level proceeding,²⁵⁸⁶ the determination of the partner's outside partnership basis was required but could not be determined in the unified partnership proceeding.²⁵⁸⁷ So, a notice of deficiency is required to determine the tax deficiency.²⁵⁸⁸ However, the penalty which, after all, is a percentage of the tax due could be determined in the unified proceeding but could not be put in the notice of deficiency under this penalty regime.

Any other item that requires determinations to be made at the partner level, however, requires a notice of deficiency to the partner.²⁵⁸⁹ In addition, a spouse claiming innocent spouse treatment as to the item may invoke administrative and Tax Court consideration of the claim.²⁵⁹⁰

In certain circumstances a partnership item or items may be converted into a nonpartnership item or items.²⁵⁹¹ The conversion excepts the items from the unified audit proceedings and subjects it instead to partner level audit, including the notice of deficiency procedures we covered above.²⁵⁹² Such a conversion can occur, for example, as to a partner subject to a criminal tax investigation, in which case the conversion occurs on the date the partner is first notified that he or she is subject to the criminal tax investigation.²⁵⁹³ Similarly a termination or jeopardy assessment against the partner or a bankruptcy proceeding involving the partner would make a partnership level proceeding inappropriate.²⁵⁹⁴

E. Statutes of Limitation.

TEFRA provides a special minimum statute of limitations rule for assessing tax to the partners for partnership items and affected items. The partner's assessment periods of limitations are determined under § 6501, and TEFRA does not change that rule. TEFRA does, however, provide a rule that may extend the partner's statute of limitations for partnership and affected items beyond the statute of limitations provided in § 6501. TEFRA provides that each partner's § 6501 assessment period for tax attributable to partnership and affected items will not expire before the date that is three years after the later of: (i) the date on which the partnership return for the taxable year was filed or (ii) the last day for filing the return for that year (determined without regard to

²⁵⁸⁶ Domulewicz v. Commissioner, 129 T.C. 11 (2007).

²⁵⁸⁷ Note that the Tax Court in Petaluma FX Partners v. Commissioner, 131 T.C. 84 (2008), affirmed in part and reversed in part, 591 F.3d 649 (D.C. Cir. 2010), avoided this anomaly by determining that the penalties asserted there (substantial understatement and valuation misstatement) were more appropriately determined at the partnership level because the partnership was to be disregarded.

²⁵⁸⁸ Thompson v. Commissioner, 729 F.3d 869 (8th Cir. 2013).

²⁵⁸⁹ § 6230(a)(2).

²⁵⁹⁰ § 6230(a)(3).

²⁵⁹¹ See § 6231(a)(4) and 6231(b)(1).

²⁵⁹² See § 6230(a)(2)(A)(ii).

²⁵⁹³ Regs. § 301.6231(c)-5.

²⁵⁹⁴ § 6231(c)(1)(A); Regs. § 6231(c)(7).

extensions).²⁵⁹⁵ The net effect of this rule is that the partner's statute of limitations as to the partnership and affected items may be extended under TEFRA but will not be shortened. This has practical effect in those cases where the special TEFRA extension period has expired but the partner's statute of limitations is still open (e.g., (i) by partner-level consent the partner's statute of limitations (including by special Form 872-1, Consent to Extend the Time to Assess Tax As Well As Tax Attributable to Items of a Partnership,²⁵⁹⁶ (ii) by the partner-level 6 year statute for 25% omission, or (iii) at the partner level, "In the case of a false or fraudulent return with the intent to evade tax,"²⁵⁹⁷ which would keep the partner's statute open forever under § 6501(c)(1).²⁵⁹⁸

This minimum – “not later than” – period may be extended as to all partners by agreement with the person acting for the partnership (see Tax Matters Partner below).²⁵⁹⁹ Similarly, there are special rules paralleling the general § 6501 rules for longer statutes in case of: (i) false or fraudulent

²⁵⁹⁵ § 6229(a). Thus, early filed returns have the statute determined from the due date for the return. This rule is comparable to a similar rule for income tax returns. § 6501(b)(1) and § 6513(a).

One nuance of this rule is that, as to any partner (including an indirect partner) who is not disclosed on the partnership return, the statute of limitations is open until 1 year after the date the previously undisclosed partner is identified to the IRS. § 6229(e). This exception is often called the unidentified partner exception. For an application of this rule as to an indirect partner, see Gaugh Properties v. Commissioner, 738 F.3d 415 (DC Cir. 2013).

²⁵⁹⁶ The language of the consent is quite sweeping:

Without otherwise limiting the applicability of this agreement, this agreement also extends the period of limitations for assessing any tax (including additions to tax and interest) attributable to any partnership items (see section 6231 (a)(3)), affected items (see section 6231 (a)(5)), computational adjustments (see section 6231(a)(6)), and partnership items converted to nonpartnership items (see section 6231 (b)).

For a case discussing the scope and effect of Form 872-I, see WHO515 Investment Partners v. Commissioner, T.C. Memo. 2012-316.

²⁵⁹⁷ There is a significant interpretive issue of whether the language of § 6501(c)(1) requires the taxpayer's (in this case, the partner's) personal fraud or can include the fraud of another person (such as a partnership) without the taxpayer's (here partner's) personal fraud. Allen v. Commissioner, 128 T.C. 37 (2007) (taxpayer's personal fraud not required); and BASR Partnership v. United States, ___ F.3d ___, 2015 U.S. App. LEXIS ___ (Fed. Cir. 2015) (taxpayer's personal fraud required).

²⁵⁹⁸ Curr-Spec Partners, LP v. Commissioner, 579 F.3d 391, 399 (5th Cir. 2009); Andantech L.L.C. v. Commissioner, 331 F.3d 972 (D.C. Cir. 2003); GD Global Fund LLC v. United States, 481 F.3d 1351 (Fed. Cir. 2007); Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner, 114 T.C. 533 (2000) (reviewed), rev'd on other grounds 249 F.3d 175 (3d Cir. 2001). This consistent holding is controversial, although it appears a fairly straightforward interpretation of the statute. Can you articulate an argument against the holding based on what you know about the unified partnership audit rules?

²⁵⁹⁹ § 6229(a) & (b). The consent to extend the statute of limitations is on Form 872-P (you will recall that the consents in nonpartnership cases are Forms 872 and 872-A).

partnership returns (6 years except “in the case of partners so signing or participating in the preparation of the return, any tax imposed by subtitle A which is attributable to any partnership item (or affected item) for the partnership taxable year to which the return relates may be assessed at any time),”²⁶⁰⁰ (ii) substantial omissions (6 years for 25% gross income),²⁶⁰¹ (iii) no return,²⁶⁰² and (iv) Service prepared returns.²⁶⁰³ Finally, the period may be extended by failure to file the necessary information about listed transactions.²⁶⁰⁴

If the IRS issues an FPAA to the partnership, the statute for partnership items and affected items at the partner level is suspended during the period that the partnership or any partner may file a judicial proceeding contesting the FPAA, during the period any resulting judicial proceeding is pending, and for one year thereafter.²⁶⁰⁵ Within that one year period, the IRS may assess with respect to the partnership items and the affected items even if the partner’s statute of limitations had otherwise closed.

Notwithstanding the foregoing, there are some affected items that may not be subject to the TEFRA statute of limitations provisions, in which case the IRS must make the assessment within

²⁶⁰⁰ § 6229(c)(1) (paralleling § 6501(c)(1) and (2)’s unlimited statute, except that, as to an innocent partner, the statute is 6 years rather than an unlimited statute of limitations).

²⁶⁰¹ § 6229(c)(2) (incorporating § 6501(e)(1)(A), the 25% omission rule). Note that § 6501(e) contains provisions not included by incorporation in § 6229(c)(2) (such as the gross revenue spin on gross income in § 6501(e)(1)(A)(i) and the adequate disclosure provision in § 6501(e)(1)(A)(ii)). See CC&F Western Operations Ltd. Partnership v. Commissioner, 273 F.3d 402, 407 (1st Cir. 2001).

Section 6229(c)(2) should be interpreted consistently with § 6501(e) as to the incorporated provisions. Cf. United States v. Home Concrete, ___ U.S. ___ n. 1, 132 S.Ct. 1836, 1846 (2012) (applying the interpretation of § 6501(e)(1)(A) in Colony, Inc. v. Commissioner, 357 U.S. 28, 37 (1958) that an overstatement of basis resulting in an understatement of gross income is not an omission of gross income for this purpose).

²⁶⁰² § 6229(c)(3).

²⁶⁰³ § 6229(c)(4).

²⁶⁰⁴ § 6501(c)(10). See Blak Investments v. Commissioner, 133 T.C. 431 (2009), Blak was a partnership level proceeding, but the partners’ statute of limitations was still open at the effective date for the obligation to make the disclosure and hence the partners’ failure to provide the notice extended their statutes of limitation. As noted above, this has the effect that the partnership level proceeding is still within the statute as to them.

²⁶⁰⁵ § 6229(d). This rule parallels the extension upon issuance of a notice of deficiency in § 6503(a)(1). Even a defective TMP petition contesting the FPAA will toll the statute under this section. O’Neill v. United States, 44 F.3d 803 (9th Cir. 1995). This parallels the same rule for notices of deficiency and Tax Court proceedings under § 6501(a)(1). See Shockley v. Commissioner, 686 F.3d 1228 (11th Cir. 2012); see also Robert W. Wood and Dashiell C. Shapiro, For Whom the Statute Tolls, 140 Tax Notes 1035 (Sept. 2, 2013) (noting that “[T]he key fact in O’Neill was the Service’s lack of knowledge of the TMP’s bankruptcy;” and suggesting that the IRS’s knowledge of the defect by the time of issuing the FPAA may defeat application of this rule).

the partner's statute of limitations or lose the ability to do so. For this reasons, in those cases, the IRS has procedures to issue protective notices of deficiency, with resulting protective assessments, if the agents are unsure as to the possibility of the statute running at the partner level.²⁶⁰⁶

If a partnership or affected item is converted into a nonpartnership item so that determinations are made at the partner level, the statute of limitations is the partner's statute of limitations, but not less than 1 year after the conversion event.²⁶⁰⁷

F. Tax Matters Partner.

The partnership is represented in the unified proceedings by the partnership's "Tax Matters Partner," often acronymed to "TMP."²⁶⁰⁸ The TMP can sign a consent to extend the statute of limitations for the partnership and otherwise enter agreements with the IRS respecting the proceedings or litigation.²⁶⁰⁹ The TMP is required to keep the partners informed during the proceedings.²⁶¹⁰ This is in addition to a requirement that the IRS notify the partners of the commencement of the audit and the conclusion of the audit.²⁶¹¹ The TMP is usually designated in the partnership agreement, but fall back rules are provided for determining the TMP in the event the partnership agreement does not designate or the partner designated does not serve.²⁶¹²

There has been some controversy as to whether a person who is designated as the TMP may continue to serve as TMP after a conflict of interest develops. In Transpac Drilling Venture 1982-12 v. Commissioner,²⁶¹³ the Second Circuit held that the IRS could not continue to deal with a TMP to obtain a valid consent to extend the statute of limitations where the TMP was under criminal investigation, and thus had an incentive to ingratiate himself with the IRS at the expense of the partners to whom the TMP owed a fiduciary duty, and the limited partners had declined to extend

²⁶⁰⁶ See CC-2009-11 (3/11/09), reproduced at 2009 TNT 54-19) requiring partner level protective notices and assessments in the following circumstances:

If a partner has reported a loss (or reduced gain) on the partner's individual return as a result of having sold the TEFRA partnership interest or an asset distributed by the TEFRA partnership, the IRS should make certain protective assessments to ensure that the assessments are made before the period of limitations on assessment expires. Given the different types of affected items -- those that can be directly assessed and those requiring determinations at the partner level -- the IRS may not know with certainty how a court will classify the affected item.

²⁶⁰⁷ § 6229(f)(1); see Gingerich v. United States, 77 Fed. Cl. 231 (2007) (determining event that starts the 1 year period).

²⁶⁰⁸ § 6231(a)(7).

²⁶⁰⁹ § 6229(b).

²⁶¹⁰ § 6223(g).

²⁶¹¹ § 6223(a).

²⁶¹² See Regs. § 1.6231(a)(7)-1 for the rules for designating the TMP.

²⁶¹³ 147 F.3d 221 (2d Cir. 1998).

the statute of limitations. Subsequently, the Second Circuit clarified that its decision in Transpac Drilling was based upon a clear and actual conflict.²⁶¹⁴ Even with this clarification, Transpac appears to be a limited holding.²⁶¹⁵

G. Notice to Partners.

The partners are notified by the IRS or by the TMP as to the key events in the proceedings.²⁶¹⁶ In larger partnerships, the partner must be at least a 1% partner to be entitled to notice.²⁶¹⁷ However, the TMP is required to notify all partners of significant developments in the audit.

H. Partner Participation in Proceedings.

Partners other than the TMP may participate in the audit and litigation.²⁶¹⁸ It is still, however, just one proceeding at the audit and litigation stages.

I. Settlements.

An elaborate system for reaching settlements during the audit is provided.²⁶¹⁹ Generally, the IRS may settle with one or more partners.²⁶²⁰ If the IRS enters such an agreement with less than all the partners, the other partners have the right to the same treatment.²⁶²¹ The TMP may enter such

²⁶¹⁴ Madison Recycling Assocs. v. Commissioner, 295 F.3d 280, 288 (2d Cir. 2002).

²⁶¹⁵ See Phillips v. Commissioner, 272 F.3d 1172 (9th Cir. 2001); United States v. Martinez, 564 F.3d 719 (5th Cir. 2009) (distinguishing Transpac Drilling on basis that (i), unlike the facts in Transpac Drilling, the IRS had not sought consents from the partners and been denied the consents, (ii) the IRS did not have a pending criminal investigation against the tax matters partner, (iii) the tax matters partner's request for a quid pro quo via relief from the preparer penalties was not disabling because the IRS had already determined not to seek the penalty, and (iv), although the IRS believed the tax matters partner was dishonest, that alone did not create a per se conflict between his interests and the limited partners' interests sufficient to put the IRS' reliance unreasonable under the circumstances.). But the Second Circuit is determined to continue its holding in the same fact pattern. See Leatherstocking 1983 Partnership v. Commissioner (2d Cir. 10/20/2008), unpublished opinion, summarily reversing the Tax Court on the basis of Transpac.

²⁶¹⁶ §§ 6223(a) (notice IRS must give) and 6223(g) (TMP's obligation to keep partners informed).

²⁶¹⁷ § 6223(b)(1).

²⁶¹⁸ §§ 6224 & 6226(d).

²⁶¹⁹ § 6224(c).

²⁶²⁰ § 6224(c)(1).

²⁶²¹ § 6224(c)(2). A covered settlement must be a settlement of only the partnership item and not a combined settlement of partnership and nonpartnership items. Regs. § 301.6224(c)-3(b)(1); See Cinema '84, et al. v. Commissioner, 294 F.3d 432 (2d Cir. 2002) (approving the

an agreement for a nonnotice partner (i.e., one whose interest is so small that the IRS is not required to give notice under these procedures).²⁶²²

J. Conclusion of Audit - 60-Day Letter & Appeal.

At the conclusion of the audit, if sufficient time remains on the statute of limitations (the IRM requires one-year), the IRS will issue a “60-day letter” which permits the partnership or any partner to appeal to the IRS.²⁶²³ The “60-day letter” is the TEFRA analog to the 30-day letter we discussed for Examinations of non-TEFRA taxpayers. As in the general context, the appeal is taken by filing a protest. The appeal then takes place essentially as it does in the general context discussed earlier in the text.

K. Conclusion of Audit (or Appeal, If Taken) - FPAA.

At the conclusion of the partnership audit and the appeal, if taken, the IRS issues a Final Partnership Administrative Adjustment, commonly acronymed to "FPAA." The FPAA is analogous to a notice of deficiency.²⁶²⁴ You will recall that the notice of deficiency advises the taxpayer that the IRS has determined net additional tax liability.²⁶²⁵ That does not happen in the FPAA because the partnership is not a tax payer. Rather the FPAA notifies the partnership and the partners of the adjustments the IRS has determined at the partnership level.²⁶²⁶ The tax effect when and if those determinations are “flowed-through” to the partners is not calculated at this time. Like the notice of deficiency, the FPAA is the key item that concludes the administrative proceedings and offers the opportunity to litigate. Thus, as I shall note, just as the notice of deficiency is the “ticket to the Tax Court,” so the FPAA is the “ticket to the Tax Court.”

requirement as a Temporary Regulation, but perhaps leaving open the question of whether the rule would apply if the settlement of the partnership item and the nonpartnership item were independent of each other, which may be a very difficult showing in most cases). Thus, for example, a settlement that covers the abatement of interest on the partner level tax under § 6404 does not trigger this consistency rule. Jaffe v. Commissioner, TCM 2004-122 (citing Cinema ‘84).

²⁶²² § 6224(c)(3).

²⁶²³ The Code does not provide for this appeals process. It is discussed in the in the Flow-Through Entity Handbook in the IRM. See e.g., IRM 4.31.1.2 (08-01-2006).

²⁶²⁴ Sealy Power, Ltd. v. Commissioner, 46 F.3d 382, 385-86 (5th Cir. 1995).

²⁶²⁵ For a good discussion of the determination and notice purposes of both the notice of deficiency and FPAA, see Natalie Holdings Inc., et al. v. United States, 2003 U.S. Dist. LEXIS 1978 (WD Tex. 2003).

²⁶²⁶ The IRS may sent the FPAA to persons it believes to be partners even if they subsequently are determined not to be partners, without violating § 6103. Abelein v. United States, 323 F.3d 1210 (9th Cir. 2003).

The issuance of the FPAA suspends the special TEFRA statutes of limitations during the period the partnership may file a judicial proceeding and for one year thereafter.²⁶²⁷

L. Judicial Remedies.

You will recall that a key feature of the general nonpartnership system discussed earlier is that taxpayers have a right to a prepayment remedy via the notice of deficiency. The partnership audit provisions similarly allow a prepayment remedy. During the partnership audit, the IRS may not assess the partners for the partnership items.²⁶²⁸ Upon completion of the partnership level audit (including appeals if taken), the IRS issues the FPAA. The TMP then has 90 days to petition for readjustment in the Tax Court, the Court of Federal Claims or an appropriate district court.²⁶²⁹ If the TMP does not file a petition within this period, then any notice partner may file a petition for readjustment within the next 60 days.²⁶³⁰ Regardless of who institutes the proceeding, all partners are treated as parties to the suit and may participate therein. Because it is possible that one partner might file in the Tax Court and another in the district court, the Tax Court case will take priority as the single unified litigation of the partnership items.²⁶³¹ If more than one case is filed in the Tax Court, the first in time takes precedence and the others are dismissed.²⁶³² If there is no Tax Court case filed but multiple cases filed in the other forums, the first to be filed is the one that proceeds to finality and all partners may participate in that litigation.²⁶³³ If a case proceeds in a district court, the case will be tried to a judge rather than a jury because this proceeding does not fit within the narrow classes of cases where juries are permitted in suits against the United States.²⁶³⁴

The filing of the case suspends the statute of limitations.²⁶³⁵ Indeed, even if the tax matters partner filing the proceeding is serving his or her own interests rather than the interests of the partners, the filing of the case will suspend the statute of limitations.²⁶³⁶

²⁶²⁷ § 6229(d).

²⁶²⁸ § 6225(a); this is the partnership analogue to the restriction on assessment in § 6213(a).

²⁶²⁹ § 6226.

²⁶³⁰ See § 6226(b)(1).

²⁶³¹ § 6226(b)(2).

²⁶³² PCMG Trading Partners v. Commissioner, 131 T.C. 206 (2008).

²⁶³³ § 6226(b)(3) & (4).

²⁶³⁴ See Eastwood Mall v. United States, 1994 U.S. App. LEXIS 33713 (6th Cir. Ohio 1994) (citing Thomas v. United States, 695 F. Supp. 1021, 1022 (E.D. Mo. 1988)); and RCL Properties, Inc. v. United States, 2009 U.S. Dist. LEXIS 37816 (D. Colo. 2009). In Eastwood Mall, the court noted that FRCP 39(c) permits an advisory jury in which case the jury's decision is advisory and, even if the judge acts on it, must still enter findings and conclusions are required by FRCP 52.

²⁶³⁵ §§ 6229(d) & 6226.

²⁶³⁶ United States v. Martinez, 564 F.3d 719, 727-8 (5th Cir. 2009), citing O'Neill v. United States, 44 F.3d 803, 805-806 (9th Cir. 1995).

Finally, for any partner level litigation, the matters that were or should have been litigated at the partnership level cannot be litigated. As noted elsewhere, those matters are resolved summarily without a notice of deficiency as a computational adjustment. Hence, the taxpayer will not receive a notice of deficiency ticket to the Tax Court. And, the taxpayer cannot bring a refund suit attributable to partnership items.²⁶³⁷

M. Conclusion of Unified Proceedings.

1. Partnership Items.

At the conclusion of the unified proceedings, the IRS distributes the determinations of partnership items finally made (either the determinations in the FPAA if there is no unified litigation or the determinations in the litigation) to the partners in their distributive shares as computational adjustments which do not require a notice of deficiency be issued to the partners.²⁶³⁸ The opportunity for judicial review has already been provided at the partnership level, so there is no further need for partner judicial review, which is the sole purpose of the notice of deficiency.²⁶³⁹

2. Affected Items.

Adjustment at the partner level may also be made for items that are not “partnership items” but are instead “affected items.” Affected items are items that are affected by the partnership items. For any affected item which is a computational or automatic adjustment requiring no further determinations at the partner level, the IRS may assess immediately as a computational adjustment.²⁶⁴⁰ An example of an affected item that could be made by computational adjustment is a medical deduction which is automatically affected by percentages of adjusted gross income, so that if all that is at issue is the partnership item adjustment and the automatic affected item adjustment (here the medical deduction), the IRS could assess immediately without a notice of deficiency. For

²⁶³⁷ § 7422(h).

²⁶³⁸ § 6230. The Court of Federal Claims held that notices of computational adjustments are not subject to the holding of Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987) that a notice of deficiency stating a facially invalid basis for the deficiency is invalid. Bush v. United States, 2012 U.S. Claims LEXIS 1083 (2012). Even as to notices of deficiency, Scar is subject to limited application. But, according to the Court of Federal Claims it does not apply at all to notices of computational adjustment. Bush did not really involve a facially invalid computational adjustment – just a notice that the adjustment had been based on the best information available rather than the very old year return (1983) which had been misplaced. Perhaps if the notice of computational adjustment had misidentified the tax shelter involved, the Court of Federal Claims might have been more receptive to a Scar type argument.

²⁶³⁹ Callaway v. Commissioner, supra, p. 109.

²⁶⁴⁰ § 6230(a)(1).

affected items that may require further partner level determinations, a partner level notice of deficiency may be required.²⁶⁴¹

3. Penalties.

Finally, as we noted above (pp. 754 ff.), certain penalties that formerly were not partnership items are now partnership items even if there are partner level defenses that must be asserted only at the partner level. This means that they can be summarily assessed without a notice of deficiency and the partner can only contest by refund suit.

N. The Oversheltered Partner Return.

The individual partner with material partnership losses may have also made aggressive claims on his return as to nonpartnership items. For example, assume that a partner has the following items of income and loss on a return (assume no other items in the calculation of taxable income):

Partnership Loss	(\$100,000)
Other Income	\$ -0-
Taxable Income	\$ -0-

This illustrates a phenomenon called an “oversheltered return” (which is defined as a return showing a partnership loss and no taxable income).²⁶⁴² The IRS audits and determines that, instead of \$0 other income, the taxpayer had \$50,000 other income. The taxpayer still has no taxable income and no deficiency because of the partnership loss, so the IRS can’t issue a notice of deficiency. The partnership has not yet been audited with respect to that loss. The IRS may issue a “notice of adjustment” which, assumes solely for purposes of the notice, that the partnership loss is correctly reported.²⁶⁴³ The notice of adjustment is a substitute for a notice of deficiency; a deficiency does not exist, of course, because of the partnership loss that may or may not be proper. The taxpayer may then file a petition in the Tax Court to contest the proposed adjustment, and failure to file the petition will mean that the adjustments are deemed correct (specifically, if the partnership loss is disallowed in whole or in part, the IRS may make the partner level adjustment and send a notice of deficiency based upon the adjustments in the notice of adjustment). In some cases where the partnership loss is disallowed under the TEFRA procedures, which would then turn the effect of the adjustments into a deficiency, the notice of adjustment will be treated as a notice of deficiency and any petition filed will be a petition for redetermination of the deficiency.²⁶⁴⁴

²⁶⁴¹ § 6230(a)(2)(A). Petaluma FX Partners v. Commissioner, 591 F.3d 649 (D.C. Cir. 2010). for a good crisp discussion of affected items requiring partner level determinations required by notice of deficiency.

²⁶⁴² § 6234(b).

²⁶⁴³ § 6234.

²⁶⁴⁴ § 6324(g)(3).

Without this special procedure, a subsequent disallowance of the partnership loss under the TEFRA procedures could result in the statute of limitations being closed with respect to the adjustments from the nonpartnership item(s).

O. A Reprise.

The partnership unified audit and litigation rules attempt to apply a fairly simple concept in a context where there is generally a good fit, but sometimes there are serious glitches where the rules simply do not offer the answer. See, e.g., **Callaway v. Commissioner**, 231 F.3d 106 (2d Cir. 2000) (for a good court summary of the overview of the partnership tax rules).

III. Large Partnerships.

In 1997, Congress enacted special provisions for large partnerships dealing with certain potential glitches inherent in the normal TEFRA partnership rules. In summary, partnerships with more than 100 partners may elect more simple procedures in which, for example, the partners are not notified of the commencement of the TEFRA audit procedures and the partnership representative can bind the partnership and all of its partners.²⁶⁴⁵ Large service partnerships (such as accounting firms and law firms) are excluded from the rule.²⁶⁴⁶ Adjustments to electing large partnerships are made either (i) by flowing through the results to the partner in the year of adjustment or (ii) having the partnership itself pay a deemed tax with respect to the adjustment. These provisions are found at §§ 771 ff., with the audit procedures in §§ 6240 ff. The election for large partnership audit treatment is made under § 6255(a). If the partnership does not make the election, the TEFRA rules apply. I shall not cover these rules in any more detail here, but they generally address problems with having a large number of partners and create unified and less cumbersome solutions for that problem.

There is some concern that large partnerships, particularly those whose operations are on the scale of large corporations, not electing under this simplified procedure and thus remaining subject to the TEFRA rules are not audited as frequently as they should because of the difficulty of implementing the TEFRA rules.²⁶⁴⁷ An author noted:

Hampered by the 1982 Tax Equity and Fiscal Responsibility Act, the law governing large partnership audits, and its aging information technology systems, the IRS lacks the capacity to audit more than a few large, widely held partnerships each year.

That capacity constraint -- a numerical figure known to only a select few at the IRS -- concerns the number of partner-level tax bills that the IRS can send out

²⁶⁴⁵ See H. R. Rep. No. 105-148, at 218-28, 1997-4 C.B. 319, 540-550.

²⁶⁴⁶ See § 755 (b)(2), incorporated by § 6255(a)(1).

²⁶⁴⁷ Amy S. Elliott, Audit Proof? How Hedge Funds, PE Funds, and PTPs Escape the IRS, 136 Tax Notes 351 (July 23, 2012).

each year. Because partnerships are passthrough entities, IRS agents can't determine the resulting net tax revenue from any partnership-level adjustments until they've calculated their impact on a partner-by-partner basis (as some partners may be tax-exempt foreigners, pension funds, or taxpayers with net losses). If the IRS doesn't audit the partnership itself, it generally can't challenge the partnership profits and losses reported on an individual partner's return.

The problem is severe enough that the Obama administration has proposed treating some very large partnerships as corporations for audit purposes.²⁶⁴⁸

IV. S Corporations.

Prior to 1996, S Corporations were subject to TEFRA tax treatment paralleling partnerships in that, generally, the tax attributes flow through to be taxed at the shareholder level rather than the entity level. Like partnerships, S Corporations file an entity level return which is generally just an information return (like partnerships), although there is a potential for entity level tax for C Corporations that have converted to S Corporations (the so-called built-in gains tax²⁶⁴⁹). Because of the similarity of the two types of entities, S Corporations were formerly subject to TEFRA unified audit procedures that apply to partnerships (see above). For years after 1996, however, the entity level audit procedures for S Corporations were repealed.²⁶⁵⁰

The shareholders are still required to report consistently with the treatment on the corporate return or notify the IRS of any inconsistent treatment.²⁶⁵¹ Any shareholder failing to notify the IRS of inconsistent treatment is subject to audit adjustment consistent with the return as filed without the benefit of the notice of deficiency.²⁶⁵²

The IRS audits the S Corporation by auditing a shareholder return. In this regard, the shareholder level audit can be limited to the S Corporation flow-through items which then requires an audit at the entity level.

²⁶⁴⁸ Id.

²⁶⁴⁹ § 1374.

²⁶⁵⁰ Small Business Job Protection Act of 1996, Pub L No 104-737, 104th Cong, 2d Sess, § 1307(c)(1) (Aug 20, 1996).

²⁶⁵¹ § 6037(c).

²⁶⁵² § 6037(c)(3). See Small Business Job Protection Act of 1996, Pub. L. 104-188, sec. 1307(c)(1), 110 Stat. 1781 (repealing unified audit procedures for S corporations).

Ch. 16. Overpayments.

I. Introduction.

The bulk of this book has been concerned with underpayments of tax and the processes and procedures that apply to underpayments. We now focus on overpayments and begin with a review of earlier materials which you might want to review at this point.

II. Overpayment Issues Previously Addressed.

A. Role of the Claim for Refund.

We discussed above the nature of the claim for refund, the statute of limitations and the doctrine of variance. (See pp. 221 ff.)

B. Interest.

We discussed above the concept that overpayments are monies due to the taxpayer which bear interest. (See pp. 281 ff.)

C. Statutes of Limitation.

We discussed above the statute of limitations for filing the claim for refund and, if it is denied wholly or partially, the statute of limitations on filing suit for refund. (See pp. 222 ff.)

D. Who May Seek Return of the Overpayment?

The IRS may refund a tax payment to the taxpayer involved. Most tax professionals would say, perhaps instinctively, that the taxpayer is the only one to whom a tax may be refunded.²⁶⁵³ This would mean, of course, that only the taxpayer may file the claim for refund and the suit for refund.

However, the Supreme Court recognized in United States v. Williams, 514 U.S. 527 (1995) (which we read earlier) that there may be situations where a nontaxpayer can sue. How broad is the relief provided in Williams? As we earlier discussed, the IRS takes the position that amendments to the Code that specifically give relief to a person in Mrs. Williams' situation effectively eviscerate any continuing precedential value of Williams for a refund suit by a nontaxpayer.²⁶⁵⁴ But is the IRS reading Williams too narrowly? Consider the following: In advising that the victim of an

²⁶⁵³ Pershing Div. of Donaldson, Lufkin & Jenrette v. United States, 22 F.3d 741 (7th Cir. 1994), citing citations included its own precedent in Busse v. United States, 542 F.2d 421, 425 (7th Cir. 1976) and Snodgrass v. United States, 834 F.2d 537, 540 (5th Cir. 1987).

²⁶⁵⁴ Rev Rul 2005-50, citing §§ 6325(b)(4) and 7426(a)(4), enacted as part of the 1998 Restructuring Act.

embezzlement could not file a claim for refund and receive a refund of the embezzler's overpaid tax funded with embezzled funds, the IRS reasoned as follows:

In our view, Williams should be read narrowly, limited to the facts presented in that case. The present case does not involve a payment made under protest to remove a federal tax lien and, therefore, Williams is distinguishable. Additionally, the employer did not make a payment to the Service in this case, and so would not qualify as a taxpayer even under a broad reading of Williams. Moreover, even if a court were to disagree with our reading of Williams and decide that Pershing [a case prior to Williams that denied refunding to an embezzlement victim] has no life after Williams, such a decision would not give the victim in the subject case standing to obtain a refund. Unlike Pershing, where the sham entity that pays the tax has no tax liability to be assessed and the victim can be deemed to be the person who paid the tax, in the subject case where the embezzler directs the funds into his own tax account, the money at issue was actually paid by the person with a tax liability to be assessed and that person has the standing to obtain a refund of any money overpaid.

We recognize that these are sympathetic facts because the embezzled funds can be traced to the wrongdoer's tax account; however, the Service has no authority to put the government in a worse position than other creditors of the wrongdoer who have no knowledge or notice of an embezzlement. That is, if the wrongdoer paid a third party for services or goods with embezzled funds, the victim could not obtain the funds from the third party; instead, the victim's cause of action is against the wrongdoer. Accordingly, to the extent that Employee would have been entitled to a refund, Employer may be entitled to obtain that amount from Estate. We do not recommend paying any such refund to Employer as state law controls the disbursement of Estate's assets to Employee's creditors.²⁶⁵⁵

Do you think the IRS's position is correct? Consider the position from the perspective of an tax administrator. Does that change your view? Consider the position from the perspective of a court.²⁶⁵⁶ Does that change your view?

III. Tentative Refunds on Carrybacks and Claim of Right.

Section 6411 permits taxpayers who have certain carrybacks from one tax year to an earlier tax year to apply for quick, tentative refunds of the earlier years' tax(es). For example, a corporate taxpayer may generate a net operating loss in Year 3 and carryback that net operating loss to Year 01 to generate a Year 01 refund. In this example, the taxpayer's entitlement to the refund depends upon whether it has a Year 03 net operating loss. When the taxpayer files its tax return and application to carry the loss back, the IRS will not have had an opportunity to audit the Year 03 net operating loss claim. Section 6411 requires the IRS to perform a "limited examination," subject to later detailed review if the IRS chooses, and to make a refund within 90 days from the date the

²⁶⁵⁵ ILM 200519081, unofficially reproduced at 2005 TNT 93-51.

²⁶⁵⁶ Cf. Begner v. United States, 428 F.3d 998 (11th Cir. 2005).

application for tentative refund was filed or from the date the return for the loss year was due (Year 03 in the example), whichever is later.²⁶⁵⁷ Congress' policy for the quick refund after only limited examination was:

the Commissioner, confronted by millions of returns and an economy which repeatedly must be nourished by quick refunds, must first pay and then look.²⁶⁵⁸

The limited review consists of checking for material omissions and computational errors. If the application for tentative refund passes that limited review, the IRS will make the refund. Thereafter, the IRS may audit the Year 03 return to determine the proper amount of the net operating loss, if any, that can be carried to Year 1 and make adjustments accordingly. If, upon the more thorough audit, the IRS determines that the tentative refund was excessive because the NOL claimed is too great, the IRS may immediately assess the resulting amount due from the taxpayer to the IRS without first issuing a notice of deficiency.²⁶⁵⁹

Except for the calculation of interest, the application for tentative refund is not considered a claim for refund.²⁶⁶⁰ Thus, there is no way to litigate the issue of whether the IRS properly failed

²⁶⁵⁷ § 6411(b). These limited review is designed to create a presumption in favor of refund provided the request is facially regular even if there is a risk that a subsequent deficiency upon closer review may not be collectible. See FSA 200149014, reproduced at 2001 TNT 237-25.

²⁶⁵⁸ Warner v. Commissioner, 526 F.2d 1, 2 (9th Cir. 1975); see also H.R. Rep. No. 79-849, at 2 (1945), reprinted in 1945 C.B. 566, 566-67. Because of the exigent need to which this quick refund procedure applies, there is no requirement for Joint Committee Staff review (discussed in the next section of the text above) prior to issuing the tentative refund, but the IRS must later submit a report when and if it finally determines the refund is appropriate. § 6405(b). The civil statute of limitations should remain open for any corrective action depending upon the comments of the JCT Staff, and the IRS may not enter a closing agreement pending JCT Staff review that would foreclose making the adjustment.

²⁶⁵⁹ § 6213(b)(3) (treating the “the amount of the excess as a deficiency as if it were due to a mathematical or clerical error appearing on the return”). You will recall that § 6213(b)(1) permits the immediate assessment of mathematical or clerical errors. One issue presented by this summary assessment procedure is whether an intervening Tax Court decision for the year to which the loss was taken (Year 1 in the example above) would be res judicata preventing the IRS from taking the summary assessment remedy provided by § 6213(b)(1). The Eighth Circuit answered that question in Jefferson Smurfit Corp. v. United States, 439 F.3d 448 (8th Cir. 2006), where it held that, by virtue of the express treatment in the statute, claim preclusion did not apply. See also Ron Lykins, Inc. v. Commissioner, 133 T.C. 87 (2009) (holding consistently with Jefferson Smurfit that principles of res judicata did not apply, but basing its holding on narrower grounds than Jefferson Smurfit: “we decide this case on the narrower basis of the statutory scheme in sections 6411, 6212(c)(1), 6213(b)(3), and 6511(d)(2)(B) that is applicable only to tentative refunds and that excepts the operation of res judicata in that specific circumstance.” Ron Lykins, Inc. p. __ n. 25.

²⁶⁶⁰ § 6411(a) (flush language).

to grant the application for tentative refund.²⁶⁶¹ Rather, if the taxpayer desires to contest the denial of the application, the taxpayer must invoke the regular refund procedures by filing a claim for year 01 and sue after the claim is denied or the or the six-month period expires.²⁶⁶²

This tentative refund procedure also applies to refunds under the claim of right provisions in § 1341.²⁶⁶³

IV. Joint Committee Review of Large Refunds.

Section 6405(a) prohibits refund of income or estate and gift taxes and most other refunds in excess of \$2,000,000 until 30 days after the IRS has submitted a report to the Joint Committee on Taxation (“JCT”),²⁶⁶⁴ where it is reviewed by the staff of the JCT.²⁶⁶⁵ The \$2,000,000 threshold is determined based on net over-assessments for the audit cycle in a multi-year review. The IRS report details the IRS's findings and conclusions with respect to the refund it proposes to make. This gives the Joint Committee Staff an opportunity to review the proposed refund and comment thereon.²⁶⁶⁶

²⁶⁶¹ Regs. § 1.6411-1(b)(1) & (2).

²⁶⁶² Coca Cola Co. v. United States, 2009 U.S. Claims LEXIS 199 (Ct. Fed. Cl. 2009). Taxpayers attempts to somehow convert the application, Form 1139, or communications with the IRS about the application into an informal claim for refund have generally been unsuccessful. See e.g., Kirsh v. United States, 131 F. Supp. 2d 389, 391 (S.D.N.Y. 2000), aff'd, 258 F.3d 131 (2d Cir. 2001).

²⁶⁶³ § 6411(d).

²⁶⁶⁴ The complete list from § 6405(a) is: “any income, war profits, excess profits, estate, or gift tax, or any tax imposed with respect to public charities, private foundations, operators' trust funds, pension plans, or real estate investment trusts under chapter 41, 42, 43, or 44.” Thus, for example, excise taxes are excluded from this requirement.

For a fuller discussion than offered in the text, see Diana Lisa Erbsen, The Joint Committee Refund Review Function: Is It “Worth a Damn,” 96 TNT 131-19.

²⁶⁶⁵ The history of the JCT review of refunds is recounted in George K. Yin, James Couzens, Andrew Mellon, the “Greatest Tax Suit in the History of the World,” and the Creation of the Joint Committee on Taxation and its Staff, 66 Tax L. Rev. 787, 866-873 (2013). A lighter but very informative summary of the current refund review is in Eric Kroh, JCT Will Review a Refund if It's Big Enough, 143 Tax Notes 160 (Apr. 14, 2014).

²⁶⁶⁶ The process is reviewed in IRM 4.36.1 (“Joint Committee Process Overview). Note that, as the statute is written, it gives the JTC staff 30 days to make its comments on the IRS report and the statute does not give JTC veto authority over the proposed refund. As a practical matter, JTC staff review often takes more than 30 days. Can the IRS issue refund at the end of the 30-day period if JTC staff has not provided its comments? And, if the JTC staff comments negatively on the refund, can the IRS refund anyway? From a strict legal perspective, the answer to both questions is yes. From a practical perspective, the answer is no (Congress is, after all, the hand that feeds the IRS). In agreeing to such a refund, the IRS usually advises that the refund is contingent upon favorable JTC staff review (whenever it comes, even outside the 30 day period).

Technically, § 6405(a) does not give the Joint Committee a veto power over the refund.²⁶⁶⁷ Moreover, the statute does not prohibit the refund if the Joint Committee Staff fails to do anything in the 30 day period nor, even, does it prohibit the refund if the Joint Committee staff disapproves.²⁶⁶⁸ Practically speaking, however, the IRS and the DOJ will almost invariably condition settlements requiring a refund over the threshold upon favorable review by the Staff of the Joint Committee.²⁶⁶⁹

²⁶⁶⁷ See CC-2003-023 (7/3/03), unofficially reported at 2003 TNT 134-54 (7/14/03), which contains a good summary of the Joint Committee review requirement. The JCT website says: Although the statute does not require that the IRS comply with Joint Committee Staff requests for adjustments, both the Joint Committee Staff and the IRS view the review process as a way of improving tax administration. Thus, the IRS will not pay any part of a refund while the Joint Committee Staff has a continuing objection * * * *. <http://www.jct.gov/about-us/refund-review.html> (visited 7/14/10). This may seem inconsistent, but I think the sense is not that JCT Staff have a veto power but that the IRS, knowing where its bread is buttered, makes the prudential decision to reach agreement with JCT staff. If that means that the IRS back off its original proposal, then so be it. I have no proof of this, but I strongly suspect that the JCT staff are reasonable in the process – are not rogue players. Further, for whatever it is worth, I would imagine that the practical dynamics of a JCT Staff review is the throttle back on the amount of the refund rather than insist that the IRS increase the amount of the refund.

²⁶⁶⁸ In an interview, George K. Yin, the former tax counsel to the Senate Finance Committee, said that JCT has no authority beyond the review function. “That is to say, the Joint Committee must have an opportunity to review such proposed refunds, but has no ability, for example, to stop any refund with which it may disagree.” Interview with George K. Yin, 25 ABA Tax Section News Quarterly 14, 17 (Winter 2006).

As to the time to process refunds, it is reported that “[a]bout 75 percent of reports are processed in 30 days, while 90 percent are processed within 45 days.” Eric Kroh, JCT Will Review a Refund if It's Big Enough, 143 Tax Notes 160 (Apr. 14, 2014). The same article quotes a practitioner as saying that the review typically is finished in 30 days and has never known one to take in excess of 50 days.

²⁶⁶⁹ Eric Kroh, JCT Will Review a Refund if It's Big Enough, 143 Tax Notes 160 (Apr. 14, 2014) (“Although the IRS is not statutorily required to wait more than 30 days for the JCT to finish reviewing a case before releasing a refund, in practice the agency will not issue one until the committee has weighed in.”). See also e.g., DOJ Settlement Reference Manual, ¶ II.C. At the May Meeting 2002 of the ABA Tax Section, the long-time chief of DOJ’s Review Section orally reported that DOJ had once settled without JCT approval, but that it was “a terrible mistake.” Minutes of the Meeting.

See United States v. United States District Court for the Northern Mariana Islands, 694 F.3d 1051, 1055 n4 (9th Cir. 2012), discussing the interplay of this provision with the DOJ delegations of authority to settle cases).

In a case pending in a court, the report must be made with respect to any full or partial settlement or concession which would result in refunds or credits exceeding \$2,000,000.²⁶⁷⁰ For cases handled by the DOJ, DOJ will prepare and submit the report.²⁶⁷¹

A return to the taxpayer of an amount held as a cash bond rather than as a payment of tax is not a refund and need not be reported to the Joint Committee.²⁶⁷²

Consider the following about the process:

First, why does Congress require such a review if there is a refund of \$2,000,000 but does not require the review if the IRS foregoes a proposed deficiency of \$2,000,000? Isn't the effect on the fisc the same in either event?²⁶⁷³ Although the statute does not contain an analogous requirement in a deficiency context, IRS Appeals does periodically submit reports to JCT on the largest deficiency cases. On the same theme, what if the IRS spots a large tax issue on audit and does not pursue the adjustment. Isn't the effect on the fisc the same? Yet there is not JCT review in either of these cases.²⁶⁷⁴

Second, if you are representing a large taxpayer in an audit where the IRS is noising about a deficiency exceeding \$2,000,000 and you think the taxpayer may have a good defense in litigation, how would the potential for Joint Committee review affect your decision as to whether to prepay or deposit (both in order to stop the running of interest which would include the hot interest penalty for large underpayments)?

Third, what is the correlation between the required Joint Committee review and the tentative refund procedure discussed above (pp. 768 ff.)? A tentative refund for a large taxpayer may well

²⁶⁷⁰ IRM 35.4 ("Settlement of Joint Committee Cases")

²⁶⁷¹ Id.

²⁶⁷² IRM 35.5.4.3(5) (08-11-2004_

²⁶⁷³ See George K. Yin, Let's Get the Facts of the Couzens Investigation Right!, 2013 TNT 165-12 (8/26/13) (a former tax counsel to the JCT who recounts the history of this provision as being based on congressional concerns about favoritism for large taxpayers, but pointing out that the favoritism can be effected by simply not requiring the payment of the tax in the first place; Professor Yin concludes: "Thus, if Congress was seriously concerned with possible, corrupt favoritism by the agency (rather than mere posturing to gain political advantage), it badly missed the mark.").

²⁶⁷⁴ For more on this seeming anomaly, see George K. Yin, James Couzens, Andrew Mellon, the "Greatest Tax Suit in the History of the World," and the Creation of the Joint Committee on Taxation and its Staff, 66 Tax L. Rev. 787, 866-873 (2013). Professor Yin, uniquely situated by experience to write this history, calls the omission "an important oversight" because it ignores an important possibility for corruption in the IRS, which was the reason for JCT review of refunds. Moreover, since the JCT is involved in other systemic aspects of the tax system, the absence of review of these other ways of achieving an equivalent effect to a large refund deprives the JCT and its staff of unique perspective within its area of responsibility.

exceed the \$2,000,000 amount. If the IRS must act on the application for refund before it has performed an audit, it will not be in a position to provide a meaningful report to the Joint Committee. In that event, the refund is made within the 90 day period required by § 6411(b), and a report is made to JCT after the IRS has performed such audit as it chooses to make.²⁶⁷⁵

²⁶⁷⁵ § 6405(b).

Ch. 17. Miscellaneous.

I. Nonfiler Initiatives.

Systemically, one of the biggest problems facing the IRS is how to encourage taxpayers to file tax returns. IRS data indicate that there are 55 million potential nonfilers. It is difficult to project the amount of the revenue loss with respect to nonfilers. The IRS believes that most of these nonfilers (well over 85%) would owe little or no tax; many might be entitled to refunds that, for some reason, they choose not to claim by filing a return. Nevertheless, nonfilers undermine the voluntary compliance system which is premised upon the notion that if I report and pay tax, if any, that I owe, others will do so also. Of course, there cannot be a perfect system in which all taxpayers will have the encouragement to file. The IRS's mission requires that it take initiatives to encourage the system to work as perfectly as possible.

Many taxpayers that might otherwise be nonfilers are forced or encouraged by built-in systems to file. The system of employee withholding and information returns both for employees (Form W-2) and for other payees (the series of Forms 1099, for payments to independent contractors, payments of interest and dividends, etc.) all force or encourage a taxpayer to file returns. But there is a vast part of our economy where these pressures do not exist or taxpayers choose not to respond to them.

The IRS has certain policies, programs and initiatives that may be described as nonfiler initiatives. These include:

(1) The Voluntary Disclosure Policy. Perhaps the most prominent such policy is the Voluntary Disclosure policy noted above (pp. 306 ff.).

(2) Computer Matching Program. The IRS has a computer matching program based upon the various information returns it receives. If, for example, it receives a computer file database of Forms 1099-Int from a bank identifying the taxpayers to whom it paid interest, including taxpayer X, the IRS computers will do a computer search to match the payment to the return. It will quickly pick up if no return was filed for the social security number of Taxpayer X. Principally using this information, the IRS then has a Taxpayer Delinquency Initiative and Substitute for Return Initiative. Under these initiatives, the IRS will gather information from available sources (principally information returns) and write the taxpayer to encourage the filing of a return. If the taxpayer cannot be located or fails to file the returns, the IRS will then use the authority under § 6020(b) to prepare a return and assess the tax. The IRS can then employ the collection measures noted above.

(3) Stop Filer Program. The IRS has a “stop filer” program that attempts to identify taxpayers who previously filed but who stopped filing.²⁶⁷⁶ This can be substantially supported by computers. There are legitimate reasons that a person does not file after filing for previous years

²⁶⁷⁶ IRM 5.19.2.2.1 (09-11-2012), IMF Delinquency Case Creation; see also GAO Report GAO-09-238, titled “Tax Gap” (1/28/2009), noting some deficiencies in the scope of the stop filer program.

-- the person dies, for example. But barring some indication of a reason to stop filing, the IRS may attempt at least by correspondence to confirm whether the taxpayer should be filing and then take such additional measures as appropriate.

Of course, the IRS must make a cost/benefit determination in its nonfiler efforts. By looking at the profile of a particular taxpayer or class of taxpayers that appears to be a nonfiler(s), the IRS may determine that it is not cost effective to pursue obtaining returns from the taxpayer(s).²⁶⁷⁷ In the past, this policy might permit the IRS to ignore the taxpayer(s) where the known indications are the he or she (they) would not owe a material tax or even might be entitled to a refund. But, there is a factor to consider other than the immediate tax liability or refund -- that is getting the taxpayer back into the system for future years when there might be significant net tax revenue at stake (at least in the aggregate) and keeping faith with compliant taxpayers.

II. Tax Protestor and Tax Defier Initiatives.

I have mentioned the term “tax protestor” at several points in the text. The term tax protestor has become a mainstream term although its precise meaning may not be clear. Tax protestors run the gamut from those with some type of sincerely held legal objections (including constitutional objections) at one extreme to those who simply masquerade their attempt to evade tax in the guise of such objections at the other extreme. Historically, the term tax protestors could apply to taxpayers over the entire spectrum. The Department of Justice now is using the term “tax protestor” to describe those with a sincerely held belief end of the spectrum and the term “tax defier” for those who evade in the guise of tax protest.²⁶⁷⁸

A former AAG of the Tax Division, Nathan Hochman, describes the difference as follows:

Ever since the Sixteenth Amendment was ratified over ninety-five years ago and then upheld by the Supreme Court three years later, the central debate over income taxation has focused on what will be taxed, how much it will be taxed, and for how long it will be taxed. Over those many years, Americans have legitimately protested the “what,” the “how much,” and the “how long.” These “tax protestors” have sought change by working within the system, advocating tax legislation before Congress, commenting on proposed IRS regulations interpreting the tax laws, and arguing before the Tax Court and other federal courts about the meaning and application of particular tax laws. These “tax protestors” do not question the underlying legitimacy of the United States' tax system but channel their protest to the details of the taxes themselves.

²⁶⁷⁷ See IRS Policy Statement P-5-133.

²⁶⁷⁸ Nathan J. Hochman, Stopping “Frivolous Squared” Before It Spreads, 20 Stan. L. & Pol'y Rev. 69 (2009). Wikipedia even has an entry on tax protestor which tends to emphasize the sincerely held belief type of taxpayer, thus justifying the DOJ's attempt to distinguish the two types of taxpayer by adopting different terminology. See http://en.wikipedia.org/wiki/Tax_protestor.

Over the last fifty years, the term “tax protestor” has devolved from describing those individuals engaged in legally valid and protected conduct to those individuals engaged in illegitimate tax defiance, who deny the legal underpinnings of the tax system itself. This “tax defier” conduct has taken many forms, including filing frivolous returns or no returns at all, flooding the IRS and courts with meritless arguments and positions that courts have uniformly rejected for decades, and trying to pay off their tax debts with fictitious financial instruments, such as comptroller warrants, sight drafts and bills of exchange. The tax defiers have evolved their distribution network for their positions over the years, from initially peddling their products to a relatively small audience in books, then audiotapes, videotapes, and DVDs, to reaching out to mass audiences through websites and blogs on the Internet that can be accessed with the click of a mouse.²⁶⁷⁹

Since the constitutionality of the income tax (and federal taxes generally) have long since been recognized by the courts, there is little room for the “tax protestor” to maneuver in avoiding tax obligations, but there will undoubtedly be taxpayers who, for one reason or another, will maintain a sincerely held belief that they cannot legally or constitutionally be taxed. Most taxpayers engaging in tax defiance conduct do not have a sincerely held belief, but merely seek to mask their tax evasion in the guise of legitimate protest. There are a great number of these taxpayers and this obviously creates a major compliance problem for the IRS. This requires that the IRS employ major enforcement resources against tax defiers and even tax protestors because even sincerely held but wrong beliefs can undermine the tax system. As the AAG concluded in his discussion:

As President John F. Kennedy once said, “For voluntary self-assessment to be both meaningful and productive of revenues, the citizens must not only have confidence in the fairness of the tax laws, but also in the uniform and vigorous enforcement of these laws.” The American multi-trillion dollar, voluntary self-assessment tax system is unique in the world, if not human history. Its laws emanate from a constitutional amendment almost 100 years old and have been intricately developed over time through hundreds of thousands of hours of effort and analysis from all three branches of government - legislative, executive and judicial. Tax defiers scoff at this system and have tried to undermine it with constitutional and statutory arguments that the courts have labeled ridiculous, absurd, frivolous, and “frivolous squared.” If not responded to forcefully and effectively, tax defier attacks threaten to significantly increase the current Tax Gap, because they would result in taxpayers no longer trusting the fairness of the system, which, in turn, may substantially affect their voluntary compliance in filing accurate returns and paying taxes due and owed. To combat this small, vocal, but potentially large problem, the Tax Division's National Tax Defier Initiative has harnessed the civil and criminal prosecutorial tools of the national government to strategically shut down, deter and prosecute tax defier conduct throughout the nation. Uniformly and vigorously enforcing America's tax laws is particularly crucial at this time to maintain the

²⁶⁷⁹ Hochman, *supra*, pp. 69-80.

confidence and trust that citizens have in the fairness of the country's tax system - the linchpin to all efforts to lower the Tax Gap.²⁶⁸⁰

III. Lower Hanging Fruit - Global High-Wealth Returns; Foreign Accounts.

I noted earlier the Global High Wealth initiative. (See beginning p. 378.) This is contemporaneous with the brouhaha with UBS and the resulting enforcement initiative that resulted in a high drama facedown between the U.S. and Swiss Governments, a dramatic crack in the wall of Swiss banking secrecy that we discussed above. I discussed that initiative beginning on p. 378

IV. Alternative Dispute Resolution and Other Nontraditional Resolution Techniques.

A. Traditional ADR.

One of the hot topics in IRS practice has been for some time the use of ADR to resolve disputes with the IRS. I mentioned above that mediation is now being used in Appeals and test programs for binding arbitration are now required. ADR has been very successful in civil non-tax litigation, and the notion is that it can be used in appropriate cases to resolve disputes between the practitioner and the IRS.

The IRS has tried ADR in transfer pricing cases. In a landmark case, Apple Computer submitted transfer pricing to arbitration under the baseball arbitration procedure (i.e., the arbitrators must accept the most reasonable position of the parties rather than coming in between the parties' positions). I won't get into the details, but the perception – perhaps not the reality – is that the IRS won the arbitration,²⁶⁸¹ so taxpayers have apparently been less willing to use ADR for such big ticket matters. Nevertheless, there does appear to be significant mediation and arbitration activity both in Appeals and in litigation in the Tax Court, for which there is rarely public notice of the details.²⁶⁸²

Not only is ADR available for disputes with the IRS, but it is also available where the disputes involve other countries. This usually arises in transfer pricing disputes where the issue is whether the U.S. company has properly priced the goods and services it provides a related entity in

²⁶⁸⁰ Hochman, *supra*, pp. 82-83.

²⁶⁸¹ The perception may not be the reality because, although the arbitrators accepted the IRS position, the IRS had backed off substantially from the position in the notice of deficiency before finalizing its position with the arbitrators. If the taxpayer was taking an extremely aggressive position to counterbalance the IRS's initial position in the notice of deficiency but did not thereafter moderate the position as aggressively as the IRS did, the taxpayer would lose. But the IRS may have had to give up a large part of the dollars originally at issue in order to prevail, so that the taxpayer really did prevail as to the dollars originally at issue.

²⁶⁸² One Tax Court case that does provide a caution to practitioners considering ADR, particularly arbitration. In Duncan v. Commissioner, 121 T.C. 293 (2003), the Tax Court held that arbitration is a contractual arrangement and the parties will be held to their contract.

a foreign country. As noted earlier in text, that pricing, if respected, can determine where income is taxed and can thus erode the fisc of countries where the income is really earned. The U.S. income tax treaties usually contain a Mutual Agreement Procedure requiring the competent authorities of the respective countries to resolve disputes to avoid double taxation; in a transfer pricing dispute, this would mean determining appropriate transfer prices for goods and services and calculating taxes accordingly. This exercise has traditionally been done through country to country negotiations by their respective “competent authorities,” which are the offices related to their tax administrations that implement the treaties. The process entails attempting in good faith to reach agreement; the competent authorities usually reach agreement, but not always. ADR can be used to break deadlock between the competent authorities. Some treaties thus now provide for arbitration, but any type of ADR – including arbitration – can be used by the competent authorities if they agree to do so. It is reported that arbitration is being used with a number of competent authorities to resolve transfer pricing disputes.²⁶⁸³ For example, the U.S. and Canada have used baseball arbitration in transfer pricing disputes subject to the Mutual Agreement Procedure in our tax treaties.²⁶⁸⁴

I believe we will see more use of ADR in the disputes between taxpayers and the IRS. I do not have prescience enough to be able to predict the precise shape of the ADR initiatives that will finally come into the regular bag of tricks the practitioner can invoke to meet his or her client's needs. But I do know that this will increasingly be an opportunity that is and will be available.

B. Other Quasi-ADR.

I would like to mention in this context certain other IRS initiatives that, while not ADR, do represent nontraditional techniques for resolving disputes as early as possible.

1. Advance Pricing Agreements (“APAs”).

Perhaps the most prominent nontraditional dispute resolution technique is the Advance Pricing Agreement. Section 482 of the Code permits the IRS to allocate income, deductions, etc. between taxpayers under common control where the pricing on transactions between the taxpayers is not at arm's length. The pricing on the transactions is referred to as transfer pricing. The U.S. fisc generally has no overall interest on transfer pricing between U.S. related parties in the same tax bracket, but does have a major interest on such pricing on transactions between a U.S. taxpayer and a related foreign taxpayer.²⁶⁸⁵ By manipulating the transfer pricing, the commonly controlled

²⁶⁸³ Patrick Temple-West, International arbitration for tax disputes, "baseball" style (Reuters 11/15/12).

²⁶⁸⁴ Id. The article reports that the IRS has succeeded in early rounds of baseball arbitration with Canada. As with the Apple arbitration noted above, the perception of success in baseball arbitration simply as a result of the arbitrator picking one side's number can be deceiving if that side gave up too much in presenting its number.

²⁶⁸⁵ The IRS would also have an interest in transfer pricing between solely U.S. related parties to the extent that one of the parties may be subject to a materially lower effective tax rate,

taxpayers can effectively push taxable income from the U.S. taxpayer to the related foreign taxpayer, thus causing a revenue loss to the U.S. fisc. For some time now, the IRS's largest audit adjustments and the largest and most contentious tax litigation has been over transfer pricing. The cases are fact intensive, expensive to litigate and fraught with uncertainty in final resolution.

Recognizing that litigation was time consuming, expensive and distracting for the IRS and for the taxpayer, the IRS developed its APA program to permit the IRS and the taxpayer to agree upon transfer pricing methodologies in advance (up to a 5 year advance period). Those methodologies are based upon taxpayer representations (including economic studies) and certain critical economic assumptions that must continue to exist during the period. Taxpayers must report annually to the IRS on the critical factual assumptions. The net result of an APA is that the IRS and taxpayer do not have to worry about major transfer pricing controversy over the period of the agreement. APAs are major – usually time consuming and expensive – agreements to negotiate,²⁶⁸⁶ but many taxpayers feel it is in their advantage to do so. In addition, in many cases, the IRS will use the APA as a basis for settling past years. Thus, for example, in one case I was handling involving major transfer pricing adjustments, we considered going for an APA that could settle five future years and would likely also be used to settle seven open years for which adjustments had been proposed by the IRS. In short, if a satisfactory agreement could be reached, the taxpayer would have certainty for twelve years. We decided for other reasons not to do that, but nevertheless the opportunity was quite tempting.

Not surprisingly, the IRS reserves the right to cancel APAs if the taxpayer does not comply with the terms and conditions of the APA.²⁶⁸⁷

The user fee for APAs is from \$22,500 to \$50,000.²⁶⁸⁸ The user fee is only the tip of the iceberg in terms of cost to the taxpayer. An expert report will be required, and competent expert reports in this area are expensive. Also, there will likely be significant outside lawyer fees required, although sophisticated corporate tax and legal departments could probably handle it themselves at,

because the incentive would be to use transfer pricing to push profit to the party subject to the lower effective rate. Despite this, most of the observable action in this area is where a U.S. taxpayer deals with a foreign related party subject to a lower effective tax rate where the incentive would be to push profits offshore, thereby escaping the U.S. tax net (either altogether or via a deferral which can, if extended, be the equivalent of exemption).

²⁶⁸⁶ The IRS periodically publishes guidance for the procedure to request APAs. The current guidance is found in Rev. Proc. 2006-9, 2006 IRB 1.

²⁶⁸⁷ See Rev. Proc. 2006-9, 2006 IRB 1. The APA “contract” is made subject to the then applicable Rev. Proc. which gives the IRS the right to cancel. In Eaton v. Commissioner, 140 T.C. 410 (2013), the taxpayer sought to enforce the APA as a contract with the Commissioner having the right to cancel only if the Commissioner established noncompliance. The IRS urged that, since its right to cancel was subject to the terms of the Rev. Proc., the IRS’s cancellation was subject to an abuse of discretion standard. The Court held for the IRS.

²⁶⁸⁸ IR-2005-144 (12/19/05), updated in Rev Proc 2007-17, 2007-4 IRB.

of course, significant internal costs. Finally, of course, whether the legal work is done out-house or in-house, there will be a significant internal cost for the input from the business and accounting functions in preparing the expert report and in dealing with the IRS's requests for information.

2. Pre-Filing Agreements.

IRS's LB&I Division adopted a Pre-filing Agreement ("PFA") process on a permanent basis.²⁶⁸⁹ The goal of the PFA is to provide the qualifying LB&I Division taxpayers a process to request examination and resolution of specific issues relating to completed transactions or events²⁶⁹⁰ to be reported on tax returns not yet filed, thereby potentially achieving reductions in allocations of resources in post-filing examinations.²⁶⁹¹ The PFA is a closing agreement under § 7121 and is thus binding on the parties.

The PFA may involve up to 4 years beyond the current year. The PFA covers only unfiled returns for the period indicated. As with the APA (also a forward looking agreement), the question arises whether the basis of the agreement can be rolled back to earlier years where the return is already filed and the issue may have been raised in audit. There is no set answer, but the IRS in the management of its audits is likely to apply the basis of the agreement if the circumstances have not changed in a material way to make the agreement irrelevant to the earlier year(s).

The user fee for PFAs is \$50,000.²⁶⁹²

3. Compliance Assurance Process ("CAP").

The IRS has adopted a program called Compliance Assurance Process for large case taxpayers.²⁶⁹³ The program seeks through active collaboration between the IRS and the taxpayer to resolve issues as to completed transactions before the return is filed. The following is a description of the CAP program:

CAP functions as follows: LB&I taxpayers that are either publicly held or agree to submit audited financial statements to the Service on a quarterly basis can apply to be in CAP. The Service decides whether to accept a taxpayer into CAP. Upon entering into CAP, the taxpayer signs a Memorandum of Understanding (MOU), which specifies the parameters for the taxpayer's disclosure of information,

²⁶⁸⁹ IRM 4.30.1 Pre-Filing Agreement Program; and Rev. Proc. 2001-22, 2001-9 I.R.B. 745.

²⁶⁹⁰ Future transactions are not considered, but may be addressed under the letter ruling procedure discussed elsewhere in the text.

²⁶⁹¹ 4.30.1.1.1 (01-09-2002) Background.

²⁶⁹² Rev. Proc. 2009-13

²⁶⁹³ The program was originally announced as a pilot program in 2005 in Ann. 2005-87, 2005-50 IRB 1144. The program was made permanent in 2011. IR 2011-32 (March 31, 2011).

establishes disclosure procedures, and indicates the taxpayer's good faith participation. In CAP, taxpayers have to reveal to the Service in real time all material business transactions and other tax issues that arise, as well as the taxpayer's proposed tax positions. The goal is to resolve all tax issues prior to return filing. If the taxpayer and the Service cannot reach agreement on all tax issues prior to return filing, then the taxpayer will undergo normal, post-filing examination on the unresolved issues. If the taxpayer meets IRS expectations in CAP, the taxpayer can enter into the compliance maintenance phase, which involves a lower level of IRS review. In this phase, taxpayers must continue making disclosures of material completed business transactions and tax issues. Taxpayers can move in and out of the compliance maintenance phase based on a number of factors, including the complexity of the taxpayer's tax situation. Taxpayers can terminate their involvement in CAP by written request, and the Service can terminate a taxpayer's involvement as a result of failure to abide by the CAP requirements.

CAP's popularity has been steadily increasing. Tax administrators have argued that CAP is the "most significant example of re-engineering the audit process" and a "win-win program" for taxpayers and the IRS. The Service has indicated both that taxpayer satisfaction with CAP is "overwhelmingly high" and that CAP will improve voluntary compliance while cutting audit cycle time. Tax practitioners have repeatedly seconded the IRS claims about CAP's tax administration benefits. The tax press has noted that CAP has been heralded as "one of the most successful corporate tax enforcement innovations" since the creation of the large business division in 2000. The academic literature has also provided consistent support for CAP. With the program's finalization in 2011 and its shift, at that point, from a program by invitation only to a program open to all LB&I taxpayers, it is poised to expand in the large business taxpayer base. Indeed, the Service's announcement that it had finalized and opened the program to application was acclaimed by taxpayers for meeting the "pent-up demand to get into the program." The Service has indicated both that it "expects to see a growth spurt" in the program, and that it hopes to "expand [on CAP's] success systemwide."²⁶⁹⁴

V. Tax Shelters.

A. Introduction - The Compliance Problem.

Marketed tax shelters have been a compliance problem for many years. During the late 1970s and early 1980s, many individuals subject to then very high maximum individual income tax rates (going up to 70%) invested in tax shelters to reduce their tax liabilities. In response, Congress enacted various changes to the Code (the at risk rules, basis limitations, increased penalties, etc.) and

²⁶⁹⁴ Leigh Osofsky, Some Realism About Responsive Tax Administration, 66 *Tax L. Rev.* 121, 134-136 (2012) (footnotes omitted) (critiquing some features of CAP that may make its implementation not as productive as conceptualized and offering some solutions to the problems).

significant individual income tax rate reductions designed to take away the incentive to play the tax shelter game (at least, so it was thought until the excess of the late 1990s). Corporations were, however, not burdened by these disincentives because tax sheltering at the corporate level was not then perceived as a major compliance problem.

In the 1990s, corporate tax sheltering began to proliferate or at least become more visible to the IRS and the public. And, with significantly increasing individual income (at least in the upper reaches of the income spectrum) and resulting high individual taxes for those lucky individuals (even with the reduced rates), creative and aggressive tax and financial professionals began again to design complex tax shelters for individuals. This is simply a tax iteration of the adage that where there is demand, supply will surface. As a result, individual tax sheltering again became a problem by the mid-1990s.

The line between shelters that simply achieve benefits intended by Congress and those that are abusive is often very hard to draw. But the perception is that some shelters crossed the line (as amorphous as the line was or at least was imagined) and created two systemic problems: (1) abusive tax shelters artificially reduce federal revenue at a time when deficits are a major problem; and (2) by permitting some taxpayers to pay less than they owe, they create a major unfairness issue -- taxpayers who don't play the game are subsidizing the cost of Government for those who do.

The visible players in the game in the 1990s and continuing into the 2000s were (i) large corporations and very wealthy taxpayers who artificially reduced their tax liabilities and (ii) their professional “enablers” (major accounting and law firms and major financial firms whose moral compass was thrown off balance by the substantial fees they could “earn”).

[G]iven how few tax returns our cash-strapped IRS now audits, the reward-to-risk ratio for playing the audit lottery with extremely shady tax shelter schemes is very high. In fact, an illustration of Gresham's Law seems to have occurred in the tax field. Just as bad money drives out good in an unregulated market, bad tax advisors can drive out good ones. Accounting firms that don't market tax shelters fear they'll lose customers to their competitors. Tax lawyers who honorably refuse to write letters blessing dubious shelters -- an essential insurance policy for tax avoiders against being criminally charged if a scheme is detected and rejected by the IRS -- find their clients shifting to less principled attorneys.

In fact, all of the major accounting firms, including Ernst & Young, Deloitte Touche, PricewaterhouseCoopers and KPMG, have been involved in marketing clearly abusive tax shelters. So have many supposedly-respectable law firms. Numerous large banks and investment firms, such as Citigroup, Bank of America, Wachovia and Merrill Lynch, have also been implicated in tax evasion and/or aggressive sheltering activities.

The more dubious the scheme, the more the lawyers and accountants charge their clients: “My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling

squarely within the tax shelter orbit,” a KPMG tax advisor told the firm in May of 1999 (as a Senate investigation revealed this February).

Far too many investors and business owners are tempted to understate their gross business receipts and/or overstate their expenses, move their investments offshore, fail to report their capital gains accurately, and so forth. Not all succumb, of course. Even for those who do, the actual alchemy of making income disappear for tax purposes is probably often a mystery. That doesn't in any way absolve the tax cheats and aggressive avoiders from blame: they're the demand side of the equation. But without the supply side, the lawyers, accountants and banks that set up the shelters, the demand would go unrequited.

The ethically-challenged tax advisers who are willing to help would-be tax evaders are well aware that the chances of their clients being audited by the IRS are extremely low, so long as a tax return doesn't raise obvious red flags. Their chief weapons to win this “audit lottery” are complexity and subterfuge.²⁶⁹⁵

Tax shelters are very difficult to define in a way that does not throw out at least some babies with the bath water or, on the other hand, is so narrow that too many loopholes remain. Even for abusive shelters, the ethical taxpayer or practitioner may have to rely upon the gut instinct that it is too good to be true (or, like pornography, they know it when they see it even when they are definition-challenged). We have already encountered the Code's attempt to define tax shelters in terms of the accuracy related penalty. The accuracy related penalty has a definition in § **6662(d)(2)(C)(iii)** that includes any arrangement “if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.” This is a very broad and sweeping definition. Virtually anything where the significant motivation to enter the transaction is tax advantage and very little business purpose is a tax shelter. The Compaq case discussed above in the penalty section is a classic example of a tax shelter, this time of the corporate variety. Yet, although the tax shelter was clearly viewed as abusive and thus failed at the trial level with the imposition of penalties, it was blessed by the appellate court. It was a tax shelter; it was just a tax shelter that, at least the appellate court, believed was legal and not abusive. Both the Tax Court and the Fifth Circuit are good courts, with good judges having radically different views of what is an abusive tax shelter and where to draw the line.

Another example of a highly structured transaction is presented in **Long Term Capital Holdings, L.P. v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd in unreported decision at 150 F. App'x 40 (2d Cir. 2005)**, a case that achieved considerable notoriety because of the tax amounts and personalities involved (including prominent tax lawyers as advisors and testifiers – a mock Bushism for witnesses – and a Nobel Prize winner as a principal business decision maker). The facts are dizzyingly complex, perhaps requiring the genius of a Nobel Prize winner even to understand. And that ultimately was the downfall of the shelter, for the district court plainly recognized that all parties involved (including the lawyers) were smart enough to know that

²⁶⁹⁵ Robert S. McIntyre, Tax Cheats and Their Enablers, 2005 TNT 70-20.

they had a tax shelter house of cards that would ultimately fail or was at high risk of failing and were hiding the defects in the complexity and hidden reporting. Basically, they were playing the audit lottery and lost.²⁶⁹⁶

Abusive tax shelters are many and varied. Some are outright fraudulent, usually wrapped in a shroud of paper work and cascade of words designed to present the shelter as a real deal. The more sophisticated are often without substance but do have some at least attenuated, if superficial, claim to legality. Some of the characteristics that I have observed for tax shelters that the Government might perceive as abusive are that (i) the transaction is outside the mainstream activity of the taxpayer, (ii) the transaction is incredibly complex in its structure and steps so that not many (including their intended audience, IRS auditors) will have the ability, tenacity, time and resources to trace it out to its illogical conclusion (this feature is often included to increase the taxpayer's odds of winning the audit lottery); (iii) the transaction costs of the arrangement and risks involved, even where large relative to the deal, offer a favorable cost benefit/ratio only because of the tax benefits to be offered by the audit lottery, (iv) the promoters of the adventure make a lot more than even an hourly rate even at the high end for professionals (the so-called value added fee, which is often insurance type compensation to mediate potential penalty risks by shifting them to the tax professional or the netherworld between the taxpayer and the tax professional) and (v) the objective indications as to the taxpayer's purpose for entering the transaction are a tax savings motive rather than any type of purposive business or investment motive.²⁶⁹⁷ More succinctly, Michael Graetz, a Yale Law Professor, has described an abusive tax shelter as “[a] deal done by very smart people that, absent tax considerations, would be very stupid.”²⁶⁹⁸ Other thoughtful observers vary the theme, e.g. a tax shelter “is a deal done by very smart people who are pretending to be rather stupid themselves for financial gain.”²⁶⁹⁹

²⁶⁹⁶ See also Santa Monica Pictures LLC v. Commissioner, T.C. Memo. 2005-104.

²⁶⁹⁷ For a similar multi-factor definition, see Joseph Bankman, The Tax Shelter Problem, 57 Nat'l Tax J. 925, 925 (2004) (“a (1) tax motivated; (2) transaction unrelated to a taxpayer's normal business operations; that (3) under a literal reading of some relevant legal authority; (4) produces a loss for tax purposes in excess of any economic loss; (5) in a manner inconsistent with legislative intent or purpose.”).

²⁶⁹⁸ Quoted in Erik M. Jensen, Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating the Alternatives, 56 St. Louis L.J. 1,3 (2012). Professor Jensen offers his own succinct version: “a transaction with claimed tax benefits that are questionable in light of congressional intentions and basic good sense, but that have sufficient authority so that fraud is not involved.”.

²⁶⁹⁹ *Id.*, quoting David Hariton. The definitions will necessarily vary from observer to observer. Consider for example (Kyle D. Logue, The Problem of Tax Law Uncertainty and the Role of Tax Insurance, Va. Tax Rev. 339 , 346 n. 6 (Fall 2005)):

The term “tax shelter” is notoriously difficult to define. Unless otherwise specified, I use the term loosely to mean transactions that are primarily tax-motivated and that rely for their tax advantages on a reading of the tax laws that is (a) technically legal (that is, not obviously illegal) but (b) more likely than not be rejected by a court if examined on the merits. Many other definitions of tax shelters have been offered,

For example, an economically motivated taxpayer would be willing to invest \$100 in an exotic arrangement X if the taxpayer has no further economic benefit, risk or costs and can achieve a tax benefit of \$1,000. In this example (a highly simplified one), the taxpayer would have a net \$100 economic loss on the transaction -- i.e., his \$100 cost with no economic return. Yet the tax savings alone would give him a \$900 profit (\$1,000 in pocket tax savings less \$100 of economic cost). The question in tax shelters is whether Congress intended tax benefits for such nonpurposive activity. The trial level opinion in Compaq answers the question in the negative; the appellate decision answers the question in the positive, so long as the technical tax structure adheres to the Code. The Compaq appellate decision was music to tax shelter promoters' ears, appearing to justify very aggressive exploitation of tax loopholes.

To be contrasted are the areas where Congress has chosen to give tax incentives even if there is no realistic expectation of economic profit apart from the tax benefits. Congress has thus provided tax incentives to low-income housing that might not otherwise offer the appropriate economic incentive. In these areas, the benefits were intended by Congress and thus are not abusive even apart from realistic expectations of economic profit.

I now turn to the various Government initiatives to combat the abusive tax shelter problem. As of the date of writing this edition, the IRS has a web site titled "Abusive Tax Shelters and Transactions" (Page Last Reviewed or Updated: 22-Jun-2015) listing a number of the abusive tax shelter initiatives. I cover some of them in more detail here. The initiatives often involve increased and more focused use of tools the IRS already has (such as regular and John Doe summonses) and the development of new legislative, administrative and judicial initiatives to more effectively address the problem.

B. Congressional Initiatives.

1. Introduction.

Congress has addressed tax shelters in other ways. First, Congress from time to time will enact targeted legislation to deal with the perceived abuse in the substantive provision exploited by the industry.²⁷⁰⁰ For example, in response to a contingent liability tax shelter that the Court's ultimately rejected on substance over form and related grounds, Congress enacted § 358(h) to require that basis be reduced for contingent liabilities transferred in tax-free reorganizations. Congress, however, rarely has the appetite to play whack-a-mole with creative and aggressive tax planners and taxpayers. So, this legislative substantive solution is often episodic and an incomplete solution. Further, from time-to-time, Congress will enact more general substantive legislation such as the passive activity loss rules, basis rules and such similar rules designed to take the incentive out

some broader and some narrower than the one just stated. Some of these other definitions are mentioned below.

²⁷⁰⁰ Erik M. Jensen, Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating the Alternatives, 56 St. Louis L.J. 1, 12-17 (2012) (discussing also the limits of targeted substantive legislation).

of abusive tax sheltering.²⁷⁰¹ The most recent of these congressional initiatives is the codification of the economic substance doctrine,²⁷⁰² along with an automatic penalty.²⁷⁰³ These too are episodic, but in classic whack-a-mole style do generally tend to address the abuses for which they are crafted.

In addition to such substantive legislation, Congress enacted legislation that falls more easily in the procedure category designed to make abusive tax shelters more visible to the IRS and to punish abusive tax shelter behavior. In the balance of this section, I focus on that legislation which many practitioners believe is more effective at rooting out tax shelter abuse.²⁷⁰⁴ I do include a discussion of the codification of the economic substance doctrine because of the penalty imposed for violating the codification.

2. Increasing the Promoter Penalty – Upping the Ante.

Congress' early attempt to stem the tax shelter abuse tide was to penalize the promoter.

Section 6700 imposes a penalty on any person who (1) organizes (or assists in the organization of) any plan or arrangement, or participates (directly or indirectly) in the sale of any interest in an entity or plan or arrangement, and (2) in connection with such organization or sale, makes or furnishes a statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement (3) which the person knows or has reason to know is false or fraudulent (4) as to any material matter. 26 U.S.C. § 6700(a).²⁷⁰⁵

²⁷⁰¹ See Jensen, *supra*, pp. 17-21.

²⁷⁰² § 7701(o). See Jensen, *supra*, pp. 21-43.

²⁷⁰³ The § 6662(a) 20% accuracy related penalty is imposed for understatements attributable to "any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law". § 6662(b)(6). The 20% penalty is increased to 40% for any "non-disclosed non-economic substance transactions" - i.e., "transactions described in subsection (b)(6) with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return").

²⁷⁰⁴ E.g., Jensen, *supra*, p. 45, quotes a noted practitioner, Peter Canellos, "The key to deterrence for all classes of tax shelters is reporting and penalties. To fight what amounts to audit lottery and to nip schemes in the bud, airtight, focused, prompt, and efficient disclosure rules are required." This is just to say that abusive tax shelters are all about the audit lottery, so that effective deterrence is targeted at insuring detection and punishing behavior that hides the ball.

²⁷⁰⁵ United States v. Benson, 561 F.3d 718, 721-722 (7th Cir. 2009). This case involved an injunction rather than the penalty, but the injunction requires a finding that the person has engaged in conduct subject to the § 6700 penalty. § 7408(b). Hence, the court was required to find as a predicate that Benson was subject to the § 6700 penalty.

You will see in the elements of the penalty one specific element that is easy to identify – a false or fraudulent statement. As often proclaimed in criminal cases, it is all about lying, cheating or stealing. But the statute has broader concepts – e.g., “organizes” and “plan” – that are not narrowly confined, but instead intended to sweep in all sorts of conduct consistent with the congressional intent to punish organized tax misbehavior. By illustration from a case,²⁷⁰⁶ a promoter wrote a book titled the Law That Never Was claiming that the Sixteenth Amendment was unconstitutional and also promoted a Package that would assist taxpayers in avoiding payment of tax. The promoter further claimed that taxpayer’s could exploit the so-called Cheek defense by claiming that they did not know the tax was lawful and thus could not be convicted of a tax crime because they did not act willfully. The promoter’s claims have been consistently rejected by the courts in cases involving other persons. Amazingly, the promoter had been criminally prosecuted and convicted of tax crimes and still promoted his arrangement. The court easily found the “plan” element as follows:

First, the definition of a plan for purposes of § 6700 is broad. Raymond, 228 F.3d at 811 (“any ‘plan or arrangement’ having some connection to taxes” (citing Kaun, 827 F.2d at 1147)). Courts have not been hesitant in finding tax protesters' activities to qualify as plans. Kaun, 827 F.2d at 1148 (“words ‘any other plan or arrangement’ are clearly broad enough to include a tax protester group”); Raymond, 228 F.3d at 811-12 (sale of program that told customers they could legally refuse to pay federal income tax was sale of an interest in a plan under § 6700); United States v. Schulz, 529 F. Supp. 2d 341, 348 (N.D.N.Y. 2007) (instruction guide on stopping employer withholdings was plan or arrangement), *aff'd*, 517 F.3d 606, 607 (2d Cir. 2008). Benson's plan was simpler than some prior tax protester schemes, but its purpose was the same -- to evade tax liability. Instead of filing false tax returns, Benson's plan encouraged customers not to file a tax return at all. Such a don't-do-it-yourself kit does not require forms or filings. Here, the devil is not in the details. Like every other tax protester, Benson was selling an illegal method by which to avoid paying taxes; the details of that method are immaterial.²⁷⁰⁷

The Court also handily found the other elements of § 6700 present.

The § 6700 penalty is (i) \$1,000 or (ii) if the person establishes that it is lesser, 100% of the gross income “derived or to be derived” from the activity.²⁷⁰⁸ However, for false or fraudulent misstatements, the penalty is 50% of the **gross** income derived from the property without the \$1,000

²⁷⁰⁶ Id.

²⁷⁰⁷ P. 722.

²⁷⁰⁸ § 6700(a)(2).

ceiling.²⁷⁰⁹ The activity is each sale or promotion and may apply separately to each person involved in the sale or promotion.²⁷¹⁰

The penalty requires some level of conscious participation or scienter. The false or fraudulent standard, of course, requires the same level of proof as fraud elsewhere in the Code, and since this is a civil context the Government bears the burden by clear and convincing evidence. In determining scienter, the courts consider such factors as (i) the person's reasonable reliance on knowledgeable professionals; (ii) the person's level of sophistication and education; and (iii) the person's familiarity with tax matters.²⁷¹¹ But, the penalty may be based on “imputation of knowledge” where “commensurate with the level of comprehension required by the [person's] role in the transaction.”²⁷¹² Thus, the greater the person's involvement in the transaction and level of education and experience, the more likely it is that the person knew or had reason to know that the statements he made, or caused others to make, were false or fraudulent.²⁷¹³

The IRS may assess this penalty without any predicate action such as the income tax notice of deficiency that confers a prepayment remedy by filing a Tax Court petition. This means that the taxpayer is relegated to a refund remedy. The refund remedy, you will recall, is subject to Flora's full payment rule, which could be daunting given the size of some § 6700 penalty assessments. The full payment rule is, however, mitigated by the divisible nature of the § 6700 penalty assessments (i.e., per sale) and is further mitigated by a special refund proceeding with only 15% payment.²⁷¹⁴

3. Tightening the Registration and Reporting Requirements.

a. “Reportable Transactions.”

Many of the tax shelters – certainly most or all abusive ones – rely upon the audit lottery. They may be abusive, they may be complex, they may stink, but ultimately, if the IRS does not discover them or can't understand them, they work! (What I mean is that the taxpayer gets the tax benefits as if they legally worked.) So, Congress addressed the issue of the IRS's ability to discover

²⁷⁰⁹ See § 6700(a)(2) (last sentence as added by the American Jobs Creation Act of 2004).

²⁷¹⁰ Whether a partnership is a person separate from its partners has been decided differently in two separate cases. Compare In re Tax Refund Litigation v. United States, 766 F. Supp. 1248, 1257 (E.D.N.Y. 1991), aff'd in part and rev'd in part, 989 F.2d 1290 (2d Cir. 1993) (not separate persons hence, once penalty applied to partnership, cannot apply to partners) with Bailey Vaught Robertson & Co. v United States, 828 F. Supp 442 (N.D. Tex. 1993) (partners separate from partnership and can be separately assessed the penalty, thus rejecting In re Tax Refund Litigation).

²⁷¹¹ E.g., United States v. Estate Preservation Services, 202 F.3d 1093, 1103 (9th Cir. 2000).

²⁷¹² United States v. Campbell, 897 F.2d 1317, 1321-22 (5th Cir. 1990).

²⁷¹³ H.R. Rep. 101-247 at 1397 (1989).

²⁷¹⁴ For both mitigation rules, see Humphrey v. United States, 2011 U.S. Dist. LEXIS (ND GA 2011). The 15% payment opportunity is in § 6703(c).

abusive tax shelters by creating the concept of “reportable transaction” which taxpayers and material advisors must report. A reportable transaction is a transaction “of a type which the Secretary determines as having a potential for tax avoidance or evasion.”²⁷¹⁵ Currently, reportable transactions include: (i) “Listed transactions” described in IRS Notices, regulations or other guidance;²⁷¹⁶ (ii) “confidential transactions;”²⁷¹⁷ (iii) transactions with “contractual protection” requiring return of a fee if the tax benefit is not obtained;²⁷¹⁸ (iv) “loss transactions” in which a taxpayer claims a tax benefit exceeding a certain amount (\$10,000,000 for corporations);²⁷¹⁹ and (v) “transactions of interest” which the IRS has identified by notice, regulation or other guidance.²⁷²⁰

b. Registration

Each material advisor for a reportable transaction is required to register and disclose the principal tax benefits of the transaction.²⁷²¹ Failure to register or filing false or incomplete information is subject to a \$50,000 penalty, except that, for failure to register listed transactions, the penalty is the greater of \$200,000 or 50% of the gross income derived by the person with respect to the transaction.²⁷²² The 50% amount is increased to 75% if the failure to register is intentional.

c. Taxpayer Reporting.

Taxpayers must report on their income tax returns reportable transactions.²⁷²³ All transactions that are “substantially similar” – a broad concept to prevent avoidance – must be reported. A taxpayer participating in a reportable transaction is required to disclose on its tax return the key tax shelter features – including the (i) “expected tax treatment and all potential tax benefits,” (ii) “any tax result protection” and (iii) “sufficient detail for the [IRS] to be able to understand the tax structure of the reportable transaction and the identity of all parties involved.”²⁷²⁴

²⁷¹⁵ § 6707(a)(c)(1).

²⁷¹⁶ Regs. § 1.6011-(b)(2). The current iteration is IRS Notice 2009-59, 2009-31 I.R.B. 170.

²⁷¹⁷ Regs. § 1.6011-4(b)(3).

²⁷¹⁸ Regs. § 1.6011-4(b)(4).

²⁷¹⁹ Regs. § 1.6011-4(b)(5).

²⁷²⁰ Regs. § 1.6011-4(b)(6).

²⁷²¹ § 6111(a). See § 6111(b) for definition of material advisor.

²⁷²² § 6707(b)(2).

²⁷²³ Regs. § 1.6011-4.

²⁷²⁴ Reg. § 1.6011-4(d). I have seen no statistics for the audit coverage that results from reportable transactions disclosures, but I know anecdotally historically that return disclosures often do not substantially increase the likelihood of audit. I suppose that the latter is a bit of an overstatement, but taxpayers often believe that disclosures guarantee audits. And, I do suspect the audit coverage for reportable transactions is far greater than for return disclosures generally, although not as great as perhaps most taxpayers fear. E.g., Jensen, *supra*, p. 47 (“if taxpayers have

d. Penalties.

(i) Failure to Disclose Reportable Transaction. In 2004, Congress added a new penalty for failing to disclose information with respect to a reportable transaction.²⁷²⁵ The penalty, as amended in 2010, is “75 percent of the decrease in tax shown on the return” as a result of the reportable transaction but the amount thus derived is subject to a minimum penalty and a maximum penalty. The minimum penalty for both listed and non-listed reportable transactions is \$5,000 for a natural person and \$10,000 for all other taxpayers. The maximum penalty is (i) “in the case of a listed transaction, \$200,000 (\$100,000 in the case of a natural person)” and (ii) “in the case of any other reportable transaction, \$50,000 (\$10,000 in the case of a natural person).” The minimum and maximum penalties apply even if there ultimately is no understatement with respect to the transaction required to be reported, because the conduct penalized is the failure to disclose the reportable transaction rather than the tax savings.²⁷²⁶ The penalty may not be waived except that the IRS has sole, unreviewable discretion to rescind the penalty if (i) a listed transaction is not involved and (ii) waiver would promote tax administration.²⁷²⁷ Corporations required to file SEC reports must report the payment of this and related penalties on their SEC reports.²⁷²⁸

(ii) Accuracy Related Penalty for Understatements Attributable to Reportable Transactions. In 2004, Congress enacted § 6662A to impose a 20% penalty to understatements attributable to a listed transaction or a reportable transaction with a significant purpose of tax avoidance.²⁷²⁹ A reportable transaction is one that the IRS determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.²⁷³⁰ A listed transaction is a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the IRS as a tax avoidance transaction for purposes of the reporting disclosure

to disclose questionable return positions, they are less likely to participate in reportable transactions at all. Disclosure is not an admission that a taxpayer's reporting of a transaction is wrong, but it is like tattooing ‘audit me’ on one's forehead or corporate logo (or so a participant might fear).”).

²⁷²⁵ § 6707A(a), added by the American Jobs Creation Act of 2004.

²⁷²⁶ Yari v. Commissioner, 143 T.C. No. 7 (2014).

²⁷²⁷ § 6707A(d). In Temporary Regulations (Reg. § 301.6707A-1T), the IRS advises that, in exercising its discretion to rescind, it will consider relevant facts and circumstances bearing upon whether the assessment of the penalty is contrary to equity and good conscience. Factors include (1) whether the taxpayer has a history of complying with the tax laws; (2) whether the violation results from an unintentional mistake of fact; and (3) whether the penalty is disproportionately large compared to the tax benefit claimed. Other factors may be considered. Rescission is only appropriate if the penalty applies in the first case; a rescission request is not to be used to contest the threshold liability. See Rev Proc 2007-21, 2007-9 IRB 613 for the procedures to request rescission.

²⁷²⁸ § 6707A(e).

²⁷²⁹ § 6662A(a). The IRS has provided guidance on the interpretation and application of the penalty in Notice 2005-12, 2005-7 C.B. 494.

²⁷³⁰ § 6707A(c)(1).

requirements.²⁷³¹ The penalty is increased to 30% if adequate disclosure is not made.²⁷³² The only exception is if the taxpayer satisfies a more stringent reasonable cause and good faith exception added to § 6664(d), which for listed transactions requires adequate disclosure.

e. Extended Statute of Limitations.

If the taxpayer fails to include on the return the information required to be included with respect to a listed transaction, the time for assessment does not expire before 1 year after the earlier of (A) the date on which the Secretary is furnished the information required under § 6011, or (B) the date that a material advisor meets the requirements of § 6112 with respect to a request by the Secretary under § 6112 relating to the undisclosed listed transaction.²⁷³³

f. List Maintenance Requirement.

Each material advisor (defined broadly) is required to maintain a list of investors with related information as required by the Regulations and make the list available for inspection by the IRS.²⁷³⁴ If the person otherwise subject to this requirement fails to make the list available within 20 days of a request from the IRS, the penalty is \$10,000 per day after the 20th day.²⁷³⁵

g. Injunctions.

Section 7408 authorizes the IRS to seek and courts to grant injunctive relief for promotion or sale of abusive tax shelters.²⁷³⁶

h. FATP Privilege Denied.

The federally authorized tax practitioner privilege is not available for communications regarding tax shelters.²⁷³⁷ Note that the attorney-client privilege may still apply where it is otherwise applicable.

²⁷³¹ § 6707A(c)(2).
²⁷³² § 6662A(c). See Notice 2005-12, 2005-7 C.B. 494 regarding the required disclosure.
²⁷³³ § 6501(c)(10), as added by § 814 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).
²⁷³⁴ § 6112, as amended by the American Jobs Creation Act of 2004.
²⁷³⁵ § 6708, as amended by the American Jobs Creation Act of 2004.
²⁷³⁶ See U.S. v. Ernst & Whinney, 735 F.2d 1296 (11th Cir. 1984), cert. denied, 470 U.S. 1050 (1985).
²⁷³⁷ § 7525(b) (as amended by the American Jobs Creation Act of 2004).

4. Denying Interest Deductions.

No deduction for interest is allowed for interest paid or accrued on any underpayment of tax which is attributable to the portion of any reportable transaction understatement with respect to which the relevant facts were not adequately disclosed.²⁷³⁸

5. Codifying Economic Substance with A Strict Liability Penalty.

The 2010 health care legislation included the codification of the economic substance doctrine.²⁷³⁹ The economic substance doctrine is a judicial doctrine, initially conceived as a tool of statutory construction to limit certain tax benefits to Congress' intent for enacting them. The general concept sounds OK, but the doctrine proved to be troubling in its application to many of the abusive tax shelters that proliferated in the late 1990s and early 2000s. At least a significant part of the trouble arose from the Supreme Court's mishandling of Frank Lyon Co. v. United States, 435 U.S. 561 (1978).²⁷⁴⁰ Over time in the 2000s, the courts seemed to be reaching some consensus over the application of the doctrine, still there were substantial differences that resulted in conflicts – at least perceived conflicts – among the circuits. Given the Supreme Court's screw-up Frank Lyon, it appeared unlikely that the Supreme Court would want to wade into that muck again to clarify and resolve any conflicts, and, of course, the Supreme Court could easily mess it up again.²⁷⁴¹ Congress determined that codification of the doctrine with Congress' particular desired spin on the doctrine was appropriate. Section 7701(o), titled Clarification of Economic Substance Doctrine, now provides that a transaction

shall be treated as having economic substance only if–

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

²⁷³⁸ § 162(m).

²⁷³⁹ Section 7701(o), as added by the Health Care and Education Reconciliation Act of 2010 (H.R. 4872). For an excellent discussion, see Erik M. Jensen, Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating the Alternatives, 56 St. Louis L.J. 1, 21-43 (2012).

²⁷⁴⁰ Frank Lyon is the poster child for the saying that tax cases are too important to turn loose on the Supreme Court. See Bernard Wolfman, The Supreme Court in the Lyon's Den: A Failure of Judicial Process, 66 Cornell L. Rev. 1075, 1098 (1981). It has thus been noted by a thoughtful observer that that “few [tax] shelters are shoddier than those approved by the Court in Lyon and Brown.” Charles I. Kingson, How Tax Thinks, 27 Suffolk U. L. Rev. 1031, 1034-35 (2004). Brown is the earlier decision in Commissioner v. Clay B. Brown, 380 U.S. 563 (1965).

²⁷⁴¹ See, for a more recent, Supreme Court opinion oblivious to the imperatives of the tax law, Gitlitz v. Commissioner, 531 U.S. 206 (2001), a case that, fortunately, has not created near the mischief that Frank Lyon has because, I think, courts may more easily distinguish and thus ignore it.

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

The clarification also makes certain clarifications in how the tests are applied.

The warp and the woof of the economic substance doctrine and its codification are beyond the scope of this book, but suffice it to say that, although it avoided a direct slap on the hands to the Supreme Court for the confusion, Congress did clarify some of the inconsistent treatments in the lower courts that were generated by Frank Lyon.

With the codification, Congress enacted strict a strict liability 20% penalty for transactions without economic substance or “failing to meet any similar rule of law.”²⁷⁴² (It is not clear what the latter language means, so that the IRS will have considerable leeway under Chevron and its progeny to define the scope of the language.)²⁷⁴³ The penalty is 20% but increases to 40% if the transaction is not disclosed on the return or an amended return filed before an audit starts.²⁷⁴⁴ The reasonable cause exception applicable to other penalties is denied for this penalty.²⁷⁴⁵ This means that “no opinion of counsel, regular church attendance or anything else is going to protect a taxpayer against the penalty if the transaction is deemed to lack objective economic substance.”²⁷⁴⁶ Finally, an amended return filed after the taxpayer is contacted for audit cannot meet the disclosure requirements to avoid this penalty.²⁷⁴⁷

Because of the broad language and potential broad reach of the codification practitioners were hoping for some for of regulatory “angel list” whereby the IRS would pronounce some types or categories of transactions to not be subject to economic substance attack, but it appears unlikely that such a list will be forthcoming.

6. Congressional Investigations.

Congress periodically becomes more active in investigating the scope of the problem with a view toward further legislative solutions. In November 2003, Senate Permanent Subcommittee on Investigations Committee on Homeland Security and Governmental Affairs conducted a hearing on the role of tax professionals in the U.S. tax shelter industry and issued a scathing majority and

²⁷⁴² § 6662(b)(6).

²⁷⁴³ However, the codification does resolve a disagreement among the courts by requiring that the transaction must **both (conjunctive)** “‘meaningfully’ change a taxpayer's economic position (an objective test), **and** the taxpayer must have a ‘substantial’ non-tax purpose for the transaction (a subjective test).” § 7701(o)(1).

²⁷⁴⁴ § 6662(i).

²⁷⁴⁵ § 6664(c)(2) and (d)(2).

²⁷⁴⁶ Jensen, *supra*, p. 29-30.

²⁷⁴⁷ § 6662(i)(3).

minority reports criticizing certain major firm players in the tax shelter industry.²⁷⁴⁸ The Committee focused its fire on prominent law firms, accounting firms and financial institutions who enabled the supposed transactions underlying the tax superstructure.

Finally, a spin off from the current financial crisis of false and misleading financial statements, of which Houston's own Enron Corporation is the poster-child, that has rocked the financial markets and substantially eroded the financial base of much of Congress' constituency may be more legislation on the tax shelter problem.²⁷⁴⁹ Philosophically, the aggressiveness in the corporate tax shelters may be a reflection of the same aggressiveness that gave rise to financial statement manipulation. If it is OK to manipulate results reported to shareholders, why is it not OK also to manipulate tax results? Many firms reporting increasingly growing profits (whether or not they really earned the profits) were not content with paying the taxes that normally accompany large profits and took aggressive tax positions, often in the form of promoted tax shelters, to avoid having to pay tax.²⁷⁵⁰ It is reported that Enron used abusive tax shelters to report higher financial earnings than it should have. For other reasons, Enron did not owe significant current taxes for the years but was able to anticipate for financial statement purposes alleged future tax benefits from the shelters. Enron was assisted in this effort by some of the most prestigious financial, accounting and law firms who were willing to stretch the tax rules for the client. A similar phenomenon of assistance has since been observed in the individual tax shelter arena. Congress will almost certainly have more to say on the tax shelter issue.²⁷⁵¹

²⁷⁴⁸ Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, The Role of Professional Firms in the U.S. Tax Shelter Industry (2/8/05). The Committee report followed and is generally in line with an earlier Minority Staff Report of the same committee titled U.S. Tax Shelter Industry: the Role of Accountants, Lawyers, and Financial Professionals: Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2.

²⁷⁴⁹ See e.g., the Staff of the Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, JCS-3-03 (February 2003).

²⁷⁵⁰ I had a professor in law school who was fond of saying that he liked to pay tax, for that meant he was making money. In the environment of the late 1990s and early 2000s, an attitude arose that you should not have to pay tax even when you were making (or at least reporting to investors) large profits.

²⁷⁵¹ For example, the report of the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs into the U.S. Tax Shelter Industry: the Role of Accountants, Lawyers, and Financial Professionals is expected soon and is expected to be a legislative "indictment" of the assisters of abusive tax shelters, along with recommendations for legislative remedies. In addition, Congress has just begun a round of hearings dealing with tax issues for tax exempt entities. The identified problems for tax-exempt entities include allegations that they have facilitated abusive tax shelter transactions.

C. Administrative Initiatives.

1. Strategic Study Initiatives.

a. Office of Tax Shelter Analysis.

The IRS is also undertaking certain administrative initiatives to identify and address tax shelters as early as possible. In February 2000, the IRS established the Office of Tax Shelter Analysis (“OTSA”) which is under the LB&I Division. The OTSA reviews the tax shelter disclosures filed under the foregoing rules in order to identify abusive shelters and taxpayers who have invested in them. The OTSA also coordinates with field examination personnel who have sighted potentially abusive shelters. The OTSA works with Chief Counsel and Treasury’s Office of Tax Policy.²⁷⁵²

b. Abusive Shelters Initiative.

The IRS has classified tax shelters as a priority and has established a lead development center to centralize the receipt and development of leads on abusive tax transactions used by promoters and preparers (“ATAT”).²⁷⁵³

2. Abusive Shelters and the States.

The IRS has entered “Abusive Tax Avoidance Transaction Memorandums of Understanding” with a number of state tax agencies to share information about abusive tax shelters.²⁷⁵⁴

States have become very aggressive to recapture tax dollars lost to abusive tax sheltering. California has been most aggressive, enacting retroactive legislation, increasing and creating new penalties, increasing the statute of limitations for assessment, enacting the economic substance doctrine, etc. California adopted a voluntary compliance initiative encouraging taxpayers to get right and offering some incentives to do so.

²⁷⁵² For a good discussion of OTSA, see Sheryl Stratton, News Analysis -- Inside OTSA: a Bird's-eye View of Shelter Central at the IRS, 100 Tax Notes 1246 (Sept. 8, 2003).

²⁷⁵³ See TIGTA report titled The Lead Development Center Effectively Researched Abusive Tax Scheme Leads but Could Be More Proactive in Identifying Promoters (2/16/04), reproduced at 2004 TNT 78-14 (4/16/04).

²⁷⁵⁴ See IR-2004-19 (2/10/04), reproduced at 2004 TNT 28-7 (2/10/04). An example of the Memorandum is reproduced at 2003 TNT 180-27.

3. Audits and Summonses.

The IRS has stepped up its audit activity with respect to the shelters and is devoting substantial resources to the audits.²⁷⁵⁵ The audits are both of the taxpayers (which requires that they first be identified, sometimes a difficult task as will be noted) and the promoters with respect to the responsibilities and penalties imposed upon them by the Code.

As we discussed above (pp. 444 ff), in the audit arena, the IRS has taken the gloves off with respect to its genteel approach to tax accrual workpapers when corporate taxpayers have invested in shelters that are listed transactions. The new rules for tax shelter items are:

1. The IRS will routinely request the audit workpapers relating only to the Listed Transactions where the taxpayer timely and properly reported a Listed Transaction.²⁷⁵⁶
2. The IRS will “routinely request all tax accrual workpapers” for years under examination and may request them for years not under examination where the taxpayer has invested in a Listed Transaction that are not timely and properly reported.²⁷⁵⁷
3. The IRS may “as a discretionary matter” request all tax accrual workpapers if (i) the taxpayer entered multiple Listed Transactions or (ii) entered a single Listed Transaction and has financial irregularities.²⁷⁵⁸
4. An IDR will first be used, followed by the summons if the taxpayer’s response is not adequate.²⁷⁵⁹

The IRS Chief Counsel has described these rules as “one of the smartest things the IRS did in [combating] tax shelters,” because the threat of opening up tax accrual workpapers “completely changes the cost-benefit analysis for companies engaging in squirrely transactions.”²⁷⁶⁰

Also, as we discussed above, the IRS’s principal investigative tool is the IRS summons. The summons is being used with great effect in the quest to identify the taxpayers involved and in investigating the promoters themselves. In order to identify the taxpayers, the IRS has two summons

²⁷⁵⁵ For example, the IRS released a comprehensive Audit Technique Guide for tax shelters informing agents of various techniques to consider. The Guide is reproduced at 2005 TNT 102-14. The IRS earlier had issued a comprehensive Audit Technique Guide for penalties applying to abusive tax shelters. This Guide is reproduced at 2005 TNT 64-21.

²⁷⁵⁶ IRM 4.10.20.3.2.3(1) (07-12-2004).

²⁷⁵⁷ IRM 4.10.20.3.2.3(2) (07-12-2004).

²⁷⁵⁸ IRM 4.10.20.3.2.3(3) (07-12-2004).

²⁷⁵⁹ IRM 4.10.20.4. (07-12-2004).

²⁷⁶⁰ Christopher M. Netram, Korb Says Tax Accrual Workpaper Privilege Issues Will Be Resolved Soon, 2005 TNT 93-1

approaches. First, using the Tiffany Fine Arts approach, the IRS can summons promoters with respect to their Code responsibilities – specifically the lists required in the list maintenance requirements.²⁷⁶¹ Second, the IRS can use the John Doe summons procedure, the procedure specifically designed to obtain the identities of unknown taxpayers.

With great fanfare, the IRS has summoned the records of major accounting firms and other shelter promoters and then, upon noncompliance, brought either summons enforcement proceedings in the case of the regular summons or contempt proceedings in the case of the John Doe summons to obtain information about the shelters and the taxpayers who bought into them. The promoters often resist those summonses because they want to avoid identifying the investors. The IRS has been uniformly successful, at least ultimately in the judicial proceedings involving compliance, in obtaining the names of the investors.²⁷⁶²

4. Designation for Litigation.

The IRS has a designation for litigation procedure whereby it picks one or more issues in a specific case that it desires to litigate in order to develop the law.²⁷⁶³ Cases designated for litigation will not be settled – meaning that the taxpayer must either litigate or concede in full. The designation for litigation procedure has received much press in the tax shelter arena, but is not limited to tax shelters. It can apply in any area where the IRS believes it is more important that the law be developed than a particular case settled. Obviously, the IRS will pick the cases that it believes offer the best chance of prevailing on its view of the law. The process of designating for litigation takes time and consideration at several levels within the IRS. The taxpayer will have an opportunity to present arguments as to why the particular case is not an appropriate vehicle for designation for litigation. The taxpayer will certainly want to take that opportunity because designation for litigation will limit the option of settling the case and will almost certainly significantly increase the costs of litigation.

²⁷⁶¹ You will recall that, under Tiffany Fine Arts, the IRS can issue a regular summons to a shelter promoter to obtain information regarding the shelter promoter's Code responsibilities and, if the information or documents obtained in that inquiry identify the taxpayer, so be it. The IRS is empowered to investigate the shelter promoter's list maintenance and disclosure compliance.

²⁷⁶² The judicial proceedings – summons enforcement proceedings and the John Doe summons proceedings – are discussed below and in the previous text discussing privileges.

²⁷⁶³ See Notice 2004-017; and IRM 33.3.6 (“Designating a Case for Litigation”). For a good discussion of the process for designating cases for litigation, see B. John Williams, IRS Chief Counsel Explains Designation Procedure for Case Litigation, 2003 TNT 82-27 (4/29/03). In summary, the goal of the program is to provide more efficient tax administration by litigating important recurring issues to obtain precedential resolution that will then affect future cases.

5. Mandatory IDRs about Listed Transactions.

In LB&I audits, the IRS will issue IDRs regarding listed transactions.²⁷⁶⁴

6. Disclosure Initiatives.

The IRS sometimes has special disclosure initiatives for widely used tax abuses, such as the offshore voluntary disclosure program for offshore and related bank account income tax and FBAR noncompliance. It has, in the past, used such programs for tax shelters.²⁷⁶⁵

7. Penalties.

The IRS will aggressively pursue penalties in tax shelters.²⁷⁶⁶ These penalties are civil and criminal penalties.

a. Civil Penalties.

The IRS is pursuing penalty investigations against the promoters. As we discussed above, there are promoter penalties potentially applicable for shelters that are false or have valuation misstatements and for failure to register tax shelters. Indeed, the potential application of these penalties are the linchpin for regular summonses to the promoters when the IRS is trying to identify the taxpayers investing in the summonses.

The IRS will also pursue penalties against the investors. The penalties will be the accuracy related penalties (see the settlement initiatives below) and may include civil penalties.

b. Criminal Penalties.

The IRS and its companion in tax law enforcement, DOJ, may pursue criminal investigations and prosecutions. Indeed, DOJ and the IRS are currently conducting prominent criminal investigations and prosecutions of tax shelter abusers – both taxpayers and their enablers (tax professionals rendering opinions or otherwise assisting and other enablers) necessary to effect the abusive schemes. I discuss this in more detail below.

8. Circular 230 and OPR Initiatives.

Tax practitioners are often enablers in the abusive tax shelter game. Not surprisingly, the IRS is rattling its sabers to threaten the risk of disbarment of practitioners who play the tax shelter

²⁷⁶⁴ IRM 4.46.3.3.4 (07-26-2011), Abusive Tax Shelter Mandatory Information Document Request (IDR).

²⁷⁶⁵ Announcement 2002-2, 2002-2 I.R.B. 304.

²⁷⁶⁶ See the Audit Technique Guide for penalties applying to abusive tax shelters. This Guide is reproduced at 2005 TNT 64-21.

game too aggressively. As we noted above, the Office of Professional Responsibility (“OPR”) has the right to disbar practitioners from practice before the IRS.

Circular 230 addresses issues related to abusive tax shelters, giving OPR more enforcement hammers to discourage abuse in the tax shelter opinion context. Suffice it to say that they are aimed at those who enable abusive tax shelters, although the bar is concerned that they approach the target with a shotgun rather than a rifle.

One of the principal areas of interest in OPR was to issue standards for opinions issued by practitioners in abusive tax shelters.²⁷⁶⁷ The sad history of tax shelters illustrates that practitioners were all too willing to lend their positions and prestige to the promotion of abusive tax shelters. The tax opinion letter was a key marketing component of hokey tax shelters where taxpayers believed, rightly or wrongly, that their claimed reliance on the tax shelter opinion would give them risk-free access to the audit lottery for a transaction that they really knew did not work. Often the practitioners issued such opinions out of sheer greed (the fees were outsized for the kind and quality of work underlying the opinions), but sometimes they did it out of sheer incompetence. Either way, they violated ethical rules for lawyers and CPAs not to violate the law and to bring a level of competence to their practices. In response, the IRS issued new Circular 230 regulations for tax opinions. The general scope of the regulations is: (i) to create “best practices” which are aspirational to give practitioners a good ethical goal and (ii) create mandatory, and thus punishable, standards for “covered opinions” and “other written advice.” Particularly in the area of tax shelter opinions, the regulations require the practitioner to exercise a greater duty of inquiry without relying upon unverified information.²⁷⁶⁸

D. Judicial Initiatives.

1. Judicial Enforcement of Summonses.

As noted, the IRS has used both the regular summons and the John Doe summons to obtain the identities of taxpayers (as well as documents related thereto). The judicial proceedings related to this initiative are (i) the summons enforcement proceeding for the regular summons and (ii) the ex parte judicial procedure provided for the John Doe summons. The Government regularly achieves a successful result in these case, although the resistance is often fierce resulting in delays.

²⁷⁶⁷ See Erik M. Jensen, Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating the Alternatives, 56 St. Louis L.J. 1, 51-57 (2012).

²⁷⁶⁸ See 31 C.F.R. 10.35. One of the most prevalent results of these OPR rules regarding covered opinions and other written advice is the ubiquitous disclaimer on emails that claims that the substantive portion of the email is not intended to be tax advice. The disclaimer is usually required by law firms and, usually, it appears in emails having subject matter that no one could reasonably believe contained tax advice (e.g., jokes being forwarded, etc.). The IRS has issued proposed Regulations that will substantially modify these requirements. See REG-138367-00, 77 FR 57055 (9/17/12).

2. Statute of Limitations Issues.

a. Introduction - the 3-Year and 6-Year Statutes.

An abusive tax shelter “works” – at least for the taxpayers and promoters – to the extent that the statute of limitations on assessment runs out. Accordingly, taxpayers and promoters pursued delay tactics to the Government’s summonses seeking taxpayer identities, hoping that by doing so, the statute of limitations would run at least for one more year. Most of the abusive shelters as designed avoid the 6 year statute of limitations either by not involving an omission of gross income or by adequately (perhaps) disclosing.²⁷⁶⁹ Hence, all the taxpayers need to do is outrun the 3 year statute of limitations or, if applicable the 6-year statute of limitations. But, depending upon how long it takes the Government to initiate summons procedures, delay may achieve a taxpayer benefit under the 6-year statute also.

b. Unlimited Statute for Fraudulent Tax Shelters.

It is commonplace with practitioners that there is an unlimited statute of limitations for fraud. § 6501(c)(1) (“false or fraudulent return with the intent to evade tax”). Many of the abusive tax shelters go beyond exploiting real uncertainties in the tax law and are fraudulent. It is accepted, for example, that promoters of these fraudulent abusive tax shelters can be convicted of tax evasion with respect to a taxpayer’s return. Therefore, the returns are fraudulent, thus certainly mandating an unlimited statute of limitations if the taxpayer committed the fraud reported on the return. An issue not yet finally resolved is whether the fraud of someone other than the taxpayer (such as a fraudulent preparer or a promoter of a fraudulent tax shelter reported on the return) invokes this unlimited statute of limitations. See Allen v. Commissioner, 128 T.C. 37 (2007) (preparer’s fraud alone is sufficient for unlimited statute); BASR Partnership v. United States, ___ F.3d ___, 2015 U.S. App. LEXIS ___ (tax shelter promoter’s fraud alone not sufficient; actual taxpayer’s fraud required; cite incomplete because decided print date of this text); see discussion p. 188). Not only that, if the language of § 6501(c)(1) includes fraud on the return without the taxpayer’s fraud, it would appear that such fraud would avoid principles of res judicata or collateral estoppel and the preclusive language of settlements with the IRS would not prevent the IRS from opening up the years involved and imposing the tax and penalties (except perhaps the civil fraud penalty unless the taxpayer’s fraud is involved).²⁷⁷⁰

²⁷⁶⁹ See § 6501(e)(1)(A). Note that for variations of a so-called basis enhancing strategy that created phony basis as the fulcrum for sheltering capital gain, the Supreme Court held that the 6-year statute does not apply. United States v. Home Concrete, ___ U.S. ___, 132 S.Ct. 1836 (2012). That issue is covered in the Chapter on the statute of limitations.

²⁷⁷⁰ See § 6212(c)(1) (further deficiency notice allowed after Tax Court decision is final “in the case of fraud;” and closing agreements under § 7122 or by Form 870-AD, both have exceptions for “fraud or malfeasance, or misrepresentation of a material fact.”

c. Statute Extension for Summons Noncompliance.

The Code provides that, if compliance with a third party summons (both a regular summons for which the taxpayer is entitled to notice and a John Doe summons) is not resolved within six months after the issuance of the summons, the taxpayer's statute of limitations is suspended from six months after the summons is issued through the final resolution of the response.²⁷⁷¹ This suspension does not apply to a regular summons issued to the taxpayer to investigate its own liability under the Tiffany Fine Arts gambit, thereby permitting the coincidental discovery of the shelter investors' identities.²⁷⁷²

Hence, when the IRS proceeds by regular summons under Tiffany Fine Arts against the promoter or other participant in the sales process, the IRS would often be stonewalled with assertions of the identity privilege often on the basis that assertion of the privilege was required by their contractual and ethical responsibilities to the unnamed taxpayers. In order to test the assertion of the identity privilege, the IRS brought summons enforcement proceedings. The summons enforcement proceeding is a fairly summary proceeding and thus, alone, probably would not achieve substantial delays except where the documents involved are voluminous and some are subject to perhaps colorable claims of privilege, which will slow down a court that has to weed through the claims and separate the wheat from the chaff. One court having to do that at the expenditure of great judicial resources and time dealing with marginal or frivolous claims of privilege, created its own suspension of the statute of limitations by holding (probably a dicta holding) that, if the statute of limitations on assessment for the underlying taxpayers would expire within 60 days of the entry of the order, that period was extended for 60 days after the entry of the order.²⁷⁷³

Most of the potentially affected taxpayers in regular summonses to the promoters under Tiffany Fine Arts thus just let the promoter fight the delay battle. Others, however, pursued a separate strategy by bringing a regular civil injunction suit – again in the name of John Doe to protect the privilege – against the person to whom the regular summons was issued to enjoin that person from giving the information and/or documents to the Government. Such a separate proceeding could gum up the works, at least by introducing sufficient uncertainty that delays would

²⁷⁷¹ § 7609(e)(2); see Regs. § 301.7609-5(1). A John Doe summonsee is required to notify the ultimate taxpayer(s) – the “John Doe(s)” – of the statute suspension. § 7609(i)(4). Note that the taxpayers are not entitled to intervene of right in a regular summons to a promoter with respect to the promoter's responsibilities (as opposed to a regular third party summons under § 7609). See § 7609(b). They might have been able to intervene under the Federal Rules of Civil Procedure, but if they had done so, presumably, the suspension of the statute under § 7609(e)(1) would not apply because the intervention would not be under § 7609.

²⁷⁷² The provision is contained in § 7609 which deals with procedures for third party summonses. The only third party summons related to unknown taxpayers is the John Doe summons. Hence, a summons issued to investigate compliance with the taxpayer's Code responsibilities (list maintenance) is not a third party summons subject to this statute suspension.

²⁷⁷³ United States v. KPMG LLP, 316 F. Supp.2d 30 (D. D.C. 2004).

be involved. There is no provision for suspension of the statute of limitations in such a civil suit between private parties.²⁷⁷⁴

Where the IRS pursued the John Doe summons procedure and was met with delays, the statute provides for an extension beginning 6 months after the service of the summons and ending with resolution of the summons.²⁷⁷⁵ However, for taxpayers whose statute of limitations expired in the threshold 6 month period, they won by the summonsee's noncompliance! (Assuming, of course, that a court does not find some basis for an equitable suspension; e.g., if the taxpayer were found to be complicit in the promoter's delay in responding to the John Doe summons.)

3. Grand Jury Investigations.

An even more dramatic development is the increased use of grand jury investigations targeting allegedly abusive tax shelter promotions. Grand jury investigations are far superior to the IRS criminal investigation for complex shelter investigations.²⁷⁷⁶ The Government thus used the grand jury to investigate tax shelter promotion activities by at least two large accounting firms (KPMG and Ernst & Young) and one large law firm (Jenkins & Gilchrist) that failed as a result of its tax shelter activity. These investigations produced a flurry of indictments against KPMG related defendants, Ernst & Young defendants, and Jenkins & Gilchrist defendants. Several guilty pleas and convictions have been obtained.

The Government encountered difficulty in its KPMG defendant prosecution, which was the first and most prominent case in its current criminal initiative against allegedly abusive tax shelters. In that case, involving 19 original defendants, the trial judge dismissed 13 defendants because of unconstitutional pressure by the grand jury prosecutors during the grand jury investigation that caused KPMG to withdraw attorneys fees for those persons fingered by the prosecutors, and the court of appeals affirmed the dismissal.²⁷⁷⁷ While this was a major set back for the Government's tactics, the subsequent guilty pleas and convictions have put some of the wind back in the sail of the Government's criminal enforcement initiatives against tax shelters.

The guts of the Government's criminal case in complex shelter cases is to present dastardly deeds that the jury can understand. Juries rarely understand tax and accounting arcania, so in criminal cases, such arcania are merely the setting, they are not the smoking gun for conviction.

²⁷⁷⁴ John Doe I v. United States, 398 F.3d 686 (5th Cir. 2005).

²⁷⁷⁵ § 7609(e)(2).

²⁷⁷⁶ See Paul S. Diamond, Federal Grand Jury Practice and Procedure 1 (4th ed. 2001) ("the federal grand jury investigation is certainly the greatest legal engine ever invented for the discovery of evidence."). Perhaps the major tool of the grand jury is the grand jury subpoena. Ronald G. White and Michael Gerard, Grand Jury Subpoenas and the Fifth Amendment Privilege, A-1 (ABA White Collar Criminal Conference 3/5/2008).

²⁷⁷⁷ United States v. Stein, 495 F. Supp. 2d 390 (S.D.N.Y. 2007), aff'd United States v. Stein, 541 F.3d 130 (2d Cir. 2008); see also earlier district court opinion at United States v. Stein, 435 F. Supp. 2d 330 (S.D.N.Y. 2006).

Rather, in order for the Government to convict, the Government has to show the lie or equivalent – that the defendant(s) lied, cheated or stole. Thus, for example, in the Enron prosecution where accounting arcania (fully the equal of tax arcania) was the setting, the prosecution’s theme was: “This is a simple case. It is not about accounting. It is about lies and choices.”²⁷⁷⁸ Many of the complex shelters and certainly all of them that created too good to believe magic had embedded in them several and often a plethora of lies that are fertile ground for prosecution and conviction.²⁷⁷⁹

4. Conclusion.

These various judicial, administrative and legislative initiatives (and more to come) are a veritable juggernaut to stem the tide of losses arising from tax shelters. It remains to be seen whether they will have a major effect, but I suspect that they will have such an effect, although, given the nature of the Code, there will always be players who will try to skirt any new lines that may be drawn.

VI. Transfer Pricing.

Transfer pricing is the tax issue involving overwhelmingly the most tax dollars in audits and litigation. By manipulating prices in related party transactions, taxpayers can put profits in the related party that is best tax advantaged. As to the U.S. fisc, transfer pricing manipulations generally have maximum revenue impact in cross-border transactions in which profits that would otherwise be taxed in the U.S. are moved offshore to a related party. If the organization is a foreign multinational enterprise shifting profits from a U.S. subsidiary to one of its foreign affiliates, the profit will escape U.S. tax altogether. If the organization is a U.S. multinational enterprise, shifting profits from a U.S. entity to one of its foreign subsidiaries will achieve deferral of U.S. tax until the profits are repatriated to the U.S., which can be indefinitely postponed in many cases thus achieving the economic effect of exemption from current taxation.

Example 1: US Parent Company (USP) sells widgets to its foreign subsidiary (FSub) which is incorporated and does business in foreign country (“F”) that imposes 5% effective tax rate on FSub's profits. USP's cost of manufacturing is \$50 per unit, and FSub, a sales company, sells the product to unrelated F country purchasers for \$100 per unit. FSub incurs \$5 cost per unit to make the sales. The total economic profit is thus \$45 (\$100 sales price less manufacturing costs of \$50 and sales costs of \$5). Assume that, if FSub were not related to USP, USP would sell the product to FSub for \$75 which would mean that the \$25 profit would be taxed by the U.S. and \$20 profit would be taxed by F Country. USP, however, has an incentive to lower the sale's price to FSub, a

²⁷⁷⁸ John C. Hueston, Behind the Scenes of the Enron Trial: Creating Decisive Moments, 44 AM. CRIM. L. REV. 197, 207 (2007).

²⁷⁷⁹ See my discussion of this genre of claim in John A. Townsend, Tax Obstruction Crimes: Is Making the IRS’s Job Harder Enough?, 9 Hous. Bus. & Tax L.J. 260 (2009). See also Professor Green’s article at the same symposium, Stuart P. Green, What Is Wrong with Tax Evasion? 9 Hous. Bus. & Tax L.J. 221 (2009); and Professor Green’s seminal work in white collar crime, Stuart P. Green, Lying, Cheating and Stealing: a Moral Theory of White Collar Crime (2007).

related party, in order to push profits into FSub whose profits are subject to a lower F Country tax rate. Let's say then that USP sells to FSub for \$55, with the result that, upon FSub's sale to unrelated parties for \$100 per unit, thus leaving USP with \$5 profit and shifting \$20 profit to FSub. The U.S. tax base has been eroded by \$20 per unit. Section 482 permits the IRS to adjust the price to \$75 per unit -- the "arm's length price" -- and apply the U.S. tax results accordingly. That adjustment -- referred to as a primary adjustment -- can have a collateral consequence to account for the fact that F Sub then has \$20 more cash than it should have, and additional U.S. tax consequences -- referred to as correlative adjustments -- can result from the primary adjustment.

Example 2: Let's reverse Example 1. Foreign Parent Company ("FP") sells widgets to its U.S. subsidiary ("USSub"). In this example, FP will be motivated to shift profits out of the U.S. by increasing the sales price of its widgets. Thus, let's assume that FP sells the widgets for USSub for \$90 per unit, thus leaving the USSub with a \$5 profit (i.e., \$100 sales price per unit, less \$90 cost of goods sold per unit and \$5 cost of sales per unit). However, if FP sold for the "arm's length price," USSub would purchase for \$75 per unit and would thereby report to the U.S. profit and taxable income per unit of \$20 (\$100 sales price less \$75 cost of goods sold and \$5 sales costs). The U.S. tax base would be eroded \$15 by FP selling for \$90 rather than \$75, the arm's length price. Section 482 permits the IRS to adjust the sales price to \$75 per unit -- the "arm's length price" -- and apply the U.S. tax results accordingly. Collateral adjustments can attend that primary adjustment also.

Transfer pricing manipulations are very difficult for the IRS to detect or address, so long as the taxpayer is not a real hog (remember the old adage regarding the bull, the bear and the hog; you make money being a bull or a bear but not a hog). And then when the IRS does spot or think it has spotted abuse, the IRS has a great deal of difficulty in sustaining its position as to pricing. For example, you will remember our old friend the Compaq case in which the Tax Court rejected an exotic corporate tax shelter but the Fifth Circuit sustained the shelter. In an earlier opinion involving Compaq, the Tax Court resoundingly rejected the IRS transfer pricing adjustments which involved far more tax dollars. Accordingly, the tax shelter of preference for many corporate taxpayers is transfer pricing.

The Code contains several procedural provisions addressed at giving the taxpayer the incentive to avoid being a hog on its transfer pricing adjustments and give the IRS better tools to identify potential transfer pricing adjustments. They are:

(1) The Substantial Net § 482 Transfer Price Adjustment Penalty. Section 6662(e)(3) provides a substantial accuracy related penalty for substantial net § 482 transfer pricing adjustments. I have addressed this penalty problem above. Excluded from the penalty base are adjustments that meet certain requirements including record keeping requirements.²⁷⁸⁰

²⁷⁸⁰ § 6662(e)(3)(B).

(2) Record Keeping Requirements. The Code has special reporting rules designed to identify related party transactions, particularly cross-border transactions, with penalties designed to encourage compliance with the reporting rules.²⁷⁸¹

One consequence of transfer pricing adjustments that have the effect of increasing the U.S. tax base in an international transaction is that the tax base in the foreign leg (or legs) of the related parties transaction will, if made consistent, be eroded. Go back to the examples I posited. The taxpayers in each example will have reported the transaction according to the transfer price it initially set. That is, in example 1, the U.S. taxpayer (“USP”) would have reported and paid tax on \$5 profit per unit to the U.S. and the foreign taxpayer would have reported and paid tax on \$40 profit per unit to F Country. In example 2, the U.S. taxpayer (“USSub”) would also have reported and paid tax on \$5 profit to the U.S., and the foreign taxpayer would have reported and paid tax on \$40 profit per unit to F Country. When the U.S. subsequently adjusts the intercompany sales price to \$75, the U.S. fisc will have been made whole, but consistency would require that the foreign tax be reduced and taxes refund to the foreign related party (FSub and FP, respectively in the examples). If the adjustments are not made consistent between the U.S. and the foreign country, there will in effect be double taxation of the same quantum of income.

Consistency will require the cooperation of the foreign government to adjust the foreign corporation's profits downward and issue a refund accordingly. Normally, neither a taxpayer nor the U.S. can require such cooperation unless the foreign government has surrendered that part of its sovereignty (never). The mechanism whereby foreign governments are encouraged to make consistent adjustments is referred to as the competent authority mechanism or, referring to its general name under the treaty, the mutual agreement procedure which obligates the competent authorities of each treaty state to attempt to reach agreement upon the request of one of the treaty states. The U.S. has tax treaties with a number of foreign governments, including almost all of the developed countries in which U.S. taxpayers may be doing business either directly through branches or through related entities. Those tax treaties are designed to avoid double taxation, among other things. The tax treaties are administered in each country through an official referred to as “the competent authority.” The competent authority in the U.S. has been the Assistant Commissioner (International), who delegates the day to day functioning to the Tax Treaty Division within the IRS. Under U.S. treaties, when the U.S. proposes to make a primary § 482 adjustment which would mean that, on a consistent basis, foreign tax will have been overpaid, the U.S. taxpayer can request competent authority assistance for the U.S. competent authority to negotiate with the foreign government to make a consistent adjustment. The treaties do not require the competent authorities of the two countries (the U.S. and the foreign country) to reach a consistent agreement. The treaties do, however, require the competent authorities to negotiate in good faith to try to reach a consistent agreement to avoid double taxation. Competent authority assistance usually works because most countries do negotiate in good faith.

The problem is that “arm's length pricing” is not a fixed, finite number, but is a range. Each country in the negotiating process may, in good faith, take a position in that range (which can be

²⁷⁸¹ See §§ 6038 - 6038C.

quite a large range depending upon how one views the economics) that best advantages the country. In the above example, I have assumed an arm's length price of \$75, but the range of potential arm's length prices might be from \$70 to \$80. In the first example, where a U.S. taxpayer (USP) is selling to a foreign taxpayer, the U.S. might want the \$80 point in that range, whereas F Country dealing in good faith might quickly agree that the original price \$55 was too low but would want to adjust only to \$70. Both points would be in a range that each country could reasonably take a position in good faith. But, if the countries stuck there, the U.S. would or could impose tax based on an arm's length price of \$80 and F Country could impose a tax based on an arm's length price of \$70, with a smaller refund issued, or perhaps even stick the F Country taxpayer with its reported \$55 price, with no refund issued. There would be \$10 double taxation in the first alternative and \$25 double taxation in the second.

Usually, the competent authorities are able to resolve their differences to reach a mutually acceptable point within the range so that the parties are not subject to double taxation. In this example, the competent authorities would agree to some point in the range -- say \$75 -- and impose tax results in each jurisdiction accordingly. However, the competent authorities are not always able to reach agreement even when they are dealing in good faith. And, sometimes, one or even both of the competent authorities may be merely going through the motions and not really dealing in good faith. The loser, in such standoffs, is the taxpayer whose costs of doing business across national borders is increased by double taxation. In a broader economic sense, that cost is really borne by the two countries because trade will be impeded by economic double taxation or the risk of such double taxation. Accordingly, in order to encourage trade, both countries' competent authorities will have a significant incentive not to take petty and unreasonable positions in the competent authority process and to strive to reach a consistent agreement. That does not always happen, but it happens enough that on balance in most of our trading partner countries economic double taxation can usually be avoided.²⁷⁸²

One initiative in this area is the Advanced Pricing Agreements discussed above whereby, if successful, the IRS and the taxpayer agrees upon a pricing methodology for up to five years.

²⁷⁸² In the example, when the competent authority negotiations work there will be no double taxation. But, if the non-U.S. treaty partner is unreasonable and insist on the price originally reported to it (a larger share of the economic base than it is entitled), the U.S. competent authority has considerable latitude to give the U.S. taxpayer relief from the resulting double taxation by adopting a position that is not consistent with U.S. law. See Lee A. Sheppard, Don't Pay that Tax, Danilack Warns 2011 TNT 67-3 (4/7/11) (paraphrasing and quoting the U.S. competent authority as follows: "The competent authority is not constrained by U.S. law in the positions it can take, so it can reduce or eliminate U.S. tax. Danilack warned his audience not to get ideas. 'We don't rewrite the tax code,' he said, adding that the lack of a domestic-law constraint means that the competent authority has 'flexibility to negotiate on a principled basis.'")

VII. Industry Issue Resolution (“IIR”) Program.

The IRS has initiated a so-called Industry Issue Resolution (“IIR”) Program.²⁷⁸³ The goal of the program is to identify industry-wide issues that might require significant intensive work in individual audits and to work with industry to develop acceptable resolution that can then be applied in audits without the individual issue intensive work that would otherwise be required.

The IRS believes that the issues most appropriate for the program will have two or more of the following characteristics:

- the proper tax treatment of a common factual situation is uncertain.
- the uncertainty results in frequent, and often repetitive, examinations of the same issue.
- the uncertainty results in taxpayer burden.
- the issue is significant and impacts a large number of taxpayers, either within an industry or across industry lines.
- the issue requires extensive factual development, and an understanding of industry practices and views concerning the issue would assist IRS in determining the proper tax treatment.²⁷⁸⁴

The IRS believes that the following are not appropriate for consideration under the IIR program:

- issues that are unique to one or a small number of taxpayers.
- issues that are primarily under the jurisdiction of IRS Operating Divisions other than the LB&I and SB/SE Divisions.
- issues that involve transactions that lack a bona fide business purpose, or transactions with a significant purpose of improperly reducing or avoiding federal taxes.
- issues that involve transfer pricing or international tax treaties.²⁷⁸⁵

When the IRS determines the industry-wide resolution it believes is appropriate in consultation with industry groups, it will issue guidance in the form of a regulation, a revenue ruling, a revenue procedure or a notice, as appropriate.

²⁷⁸³ See the description of the program at Rev Proc 2003-36, 2003-18 I.R.B. 859; and Notice 2005-59. See IRS web page titled “Industry Issue Resolution Program” (Page Last Reviewed or Updated: 06-Jan-2015).

²⁷⁸⁴ Id., § 3.01.

²⁷⁸⁵ Id §. 3.02.

VIII. Remedies for IRS Employee Misconduct.

A. Introduction.

The IRS is a large organization with many employees. It is inevitable that there will be some rotten apples in the barrel who will misbehave. The issue addressed here is what are the consequences of their misbehavior and specifically whether a taxpayer has remedies for misbehavior.

We discussed above (pp. 63 ff.), the so-called Caceres doctrine which holds that, generally, a taxpayer has no remedy for damage imposed by an IRS employee's violation of the IRM. What about violation of the Code or of constitutional rights?

There are certain implicit remedies in the Code rules we have discussed above. If the IRS makes an assessment outside the statute of limitations (even knowingly so), the taxpayer's remedy is to have the assessment abated, judicially if necessary. Some of the Code's rules do not necessarily prescribe a remedy, in which case it is up to the courts to determine what remedy, if any, may be appropriate for the violation. For example, we discussed above the requirement that the notice of deficiency advise the taxpayer of the final date for filing a petition for redetermination in the Tax Court. If the notice does not state that date, is it invalid and therefore cannot support a subsequent assessment? The statute does not say, and the few cases to date seem to state that the notice of deficiency is not thereby invalidated so long as it is otherwise regular on its face.

What about tort and tort-like remedies for an IRS employee's negligent or intentional actions that result in damage to taxpayers that are not remedied simply by correcting the improper action (e.g., reversing the improper assessment or returning property wrongfully levied upon)? Under general tort law, there are two potential targets for tort-like action – the employer and the employed (i.e., the IRS employee committing the malfeasance). Generally, in torts, it is best to nail the employer – here the Government – because the employer generally has deeper pockets than the employee.

This presents the first problem here. The general rule is that the Government is the employer and the general rule of Anglo-American jurisprudence is that the sovereign cannot be sued unless it has expressly consented to be sued. We shall first look at the areas in which the Government has consented to be sued for actions of IRS employees.

We then consider actions directly against the IRS employee.

This is a complex area of the law and the following will only introduce you to the subject.²⁷⁸⁶

²⁷⁸⁶ A good article is Michael G. Tanner, IRS Misconduct in an Audit: Is There A Civil Remedy?, 55 Tax Lawyer 107 (2001). I have relied significantly on this article in preparing this summary.

B. Remedies Against the United States.

1. Federal Tort Claims Act (“FTCA”).²⁷⁸⁷

The FTCA waives the general rule of sovereign immunity prohibiting suit against the United States, thus allowing some seeking tort recoveries against the United States. Under the FTCA, aggrieved citizens may recover for wrongful acts or omissions of United States employees acting within the scope of their responsibility. Where the FTCA applies, it is the only remedy available (meaning that there is no separate remedy against the employee). The remedy is for negligence, but generally not for most intentional torts.²⁷⁸⁸ Liability is determined by the law of the state in which the act or omission occurred; the United States is liable to the same extent as a private citizen would be, but not for prejudgment interest or punitive damages.²⁷⁸⁹ The FTCA, however, requires the exhaustion of certain administrative remedies available whereby the claims must first be presented to the Government agency and denied.²⁷⁹⁰

The FTCA remedy is, however, not available “in respect of the assessment or collection of any tax.”²⁷⁹¹ The exception thus virtually eliminates FTCA remedies in tax matters. The courts interpret the exception liberally to avoid FTCA liability but will draw a line in particularly egregious cases when the agent’s conduct is sufficiently remote from his IRS responsibilities.

Assuming a citizen aggrieved by putative IRS employee misconduct can clear that not insubstantial hurdle, there is still one other potential limitation under FTCA. The FTCA does not apply if the employee’s putative misconduct was “based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty.”²⁷⁹² This discretionary function limitation to FTCA is an affirmative defense that must be raised and proved by the Government. The exception applies only to acts that are discretionary in nature.

²⁷⁸⁷ 28 U.S.C. §§ 2671-80 (2001).

²⁷⁸⁸ § 2680(h) exempts “assault, battery, false imprisonment, false arrest, malicious prosecution, abuse of process, libel, slander, misrepresentation, deceit or interference with contract rights.”

²⁷⁸⁹ § 2674.

²⁷⁹⁰ The time periods on presenting the claim and pursuing judicial action are somewhat reminiscent of the claim for refund procedure – i.e., the claim must be presented within two years of the date it accrues and then the suit must await denial of the claim or lapse of six months from the date the claim was presented. Unlike the suit for refund, however, the FTCA claim must be filed within six months from the date of denial. § 2401(b); 2665(a).

²⁷⁹¹ § 2680(c).

²⁷⁹² § 2680(a).

2. Remedies for Wrongful Return Information Disclosures.

I discussed above the general statutory prohibition against the IRS disclosing taxpayer return information. In that discussion, we also included the statutory remedy under § 7431. I do not repeat that discussion here.

3. Reckless, Intentional or Negligent Disregard of Code and Regulations.

Section 7433 of the Code allows taxpayers to sue and recover:

[i]f, 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 * * * *

The provision, added in 1998, permits a remedy for many of the activities excluded by the tax exception to the FTCA.

The limitations of § 7433 are significant. First, the liability requires that the IRS or agent have disregarded a provision of the Code or a tax regulation. Violations of internal operating procedures, including the IRM, are not covered. Second, a taxpayer may only recover “actual direct economic damages,”²⁷⁹³ which means pecuniary out of pocket damages.²⁷⁹⁴ Third, the statute allows recovery only for collection activities. Are assessment activities – which perforce must precede collection activities – within the ambit of the term “collection activities?” The answer appears to be no.²⁷⁹⁵ Fourth, the taxpayer is required to mitigate his or her damages.²⁷⁹⁶

As with other claims against the Government, the taxpayer is required to exhaust his or her administrative remedies and pursue the claim within the time limits allowed under the FTCA.²⁷⁹⁷

4. Recovery of Attorneys Fees.

I covered above the provisions for recovering fees and costs (including attorneys fees) against the Government in administrative and judicial proceedings. I do not repeat that discussion

²⁷⁹³ § 7433(b)(1).

²⁷⁹⁴ Damages to reputation not demonstrably pecuniary in nature are not recoverable.

²⁷⁹⁵ Shaw v. United States, 20 F.3d 182, 184 (5th Cir. 1994); the holding of which was re-affirmed in Gandy Nursery, Inc. v. United States, 412 F.3d 602 (5th Cir. 2005); see generally, Michael G. Tanner, IRS Misconduct in an Audit: Is There a Civil Remedy, 55 Tax Lawyer 107, 116-117 (2001).

²⁷⁹⁶ § 7433(d)(2).

²⁷⁹⁷ § 7433(d)(1); see Regs. § 301.7433-1(e).

here, but obviously the taxpayer may recover such fees when the Government employee misconduct has led to or protracted the administrative or judicial proceedings.

C. Remedies Against Government Employees (Bivens).

Normally, for actions within the scope of the Government employee's employment, the action against the agent is deemed to be an action against the Government, which means that the Government may be substituted as the party defendant in any suit and the case dismissed if the case does not meet the requirements noted above for suits against the United States.

However, all actions are not within the scope of an employee's liability. Does that mean that all a taxpayer need do is to plead and prove action outside the scope of the employee's employment? No, even if outside the scope, so long as related to the employment (just outside the scope), the agent may not be sued.

There is one key exception, however, commonly referred to as a Bivens remedy.²⁷⁹⁸ If the conduct rises to the level of a constitutional violation, Bivens allows a tort remedy against the Government employee, despite the absence of any statute conferring the right. This remedy has parameters, of course. First, the conduct complained of must rise to the level of a constitutional violation. Second, the remedy is governed by the statute of limitations of the state in which the injury occurred. Third, the remedy is not available in areas in which Congress has provided remedies. Fourth, the remedy may not be available in certain areas where special caution is required. Fifth, the Government employee must not have absolute or qualified immunity for the conduct in question, although this may be an affirmative defense rather than its absence being an element of the claim. An example of the latter is that a Government employee committing perjury in a judicial proceeding has immunity based on common-law witness immunity even if it results in a wrongful judgment in the judicial proceedings, thereby violating the citizens' constitutionally protected rights.²⁷⁹⁹

²⁷⁹⁸ Bivens refers to the case of Bivens v. Six Unknown Named Agents of Federal Bureau of Narcotics, 403 U.S. 388 (1971).

²⁷⁹⁹ See Briscoe v. LaHue, 460 U.S. 325 (1983). It is perhaps an open question as to whether the immunity defense can be avoided if the complaining citizen pleads and proves a conspiracy to give the perjured testimony. See Dory v. Ryan, 25 F.3d 81, 84 (2d Cir. 1994); and San Filippo v. United States Trust Co., 737 F.2d 246, 255 (2d Cir. 1984), cert. denied, 470 U.S. 1035 (1985).

Ch. 18. Trends in Enforcement Efforts

I. General.

Mark Twain mused that “there are lies, damned lies, and statistics.”²⁸⁰⁰ The statistics on the IRS’s enforcement efforts do, however, tell a story. So, I offer the more nuanced aphorism: “It is easy to lie with statistics, but easier to lie without them,” attributed to Fred Mosteller, one of the most eminent statisticians of the 20th Century.

II. Sources.

I commend to you the following sources for compilations and analyses of trends in IRS enforcement of the tax laws as follows:

First, the IRS Data Book, published annually is a rich source for data from which trends can be derived. The web site for annual versions of the data book is:

<http://www.irs.gov/uac/SOI-Tax-Stats-IRS-Data-Book>

Second, Syracuse University has gathered a great deal of data through FOIA requests and has compiled tables and graphs reporting trends in IRS enforcement efforts. These may be reviewed at Syracuse University’s TRAC IRS web site maintained by Syracuse University. The web site is: <http://trac.syr.edu/tracirs/>.

Third, the Treasury Inspector General for Tax Administration (“TIGTA”) issues many reports during each year. Many of these reports deal with some phase of tax enforcement. The TIGTA web site is: <http://www.treasury.gov/tigta/>

III. Trends.

Audit and enforcement are down because resources are down as Congress squeezes the IRS.

²⁸⁰⁰ Per the Wikipedia entry on “[Lies, damned lies and statistics](#),” Mark Twain popularized the saying which he attributed it to Benjamin Disraeli, 19th Century British Prime Minister, but there is no evidence that Disraeli actually said it. There is, as usual, a more nuanced aphorism: “It is easy to lie with statistics, but easier to lie without them,” attributed to Fred Mosteller, one of the most eminent statisticians of the 20th Century.

Ch. 19. Ethics, Malpractice and Tax Procedure.

I. Introduction.

Many ethical issues confront the tax practitioner. This book is designed for the law student of tax procedure, so I deal with examples of the types of ethical issues that confront the tax attorney in a tax procedure practice. However, since tax procedure and its implications cover virtually the entire gamut of tax practice, the following discussion may be used fruitfully by all tax practitioners. I do not attempt to provide an exhaustive discussion, but do provide some examples in order to help you frame the analysis when you are confronted with variations of the issues in your practice.

Ethical issues obviously overlap with the civil and criminal penalty issues that we covered above. An attorney acts unethically if, in his or her practice, he or she commits a tax crime or assists a taxpayer or other person in the commission of a tax crime (itself a crime under, you will recall, § 7206(2) or 18 U.S.C. §§ 2 or 371). But, an attorney's ethical responsibilities are not confined by the criminal statutes. Does an attorney act unethically if the attorney knows or believes that the client's position will subject the client or the practitioner himself to a civil penalty?

This is not a course in ethics. I shall therefore not attempt to be encyclopedic in the applications of the ethical rules to the tax practice. I will, however, illustrate through example the types of issues that arise. I don't have easy answers and in some cases will simply pose the issue without the answers. As in all law school courses and in law practice, if you spot the issue, you can then yourself -- with research and thought, working from the known to the unknown with principled analysis -- come up with as good an answer as anyone can.

II. Ethical Issues in Planning.

Read the following articles that are in the materials for this course: Richardson, Audit Avoidance via Intent Modification -- Is Fred Corneel onto Something ... or Not, 2001 TNT 131-93; and Corneel, Audit Avoidance: A Response to David Richardson, 2001 TNT 131-91.

III. Ethical Issues in Return Preparation.

Normally, the attorney is not the return preparer. But, an attorney can be a return preparer if he or she advises the client as to how the item or transaction is to be reported on the return. What are the attorney's ethical responsibilities in this case?

The attorney historically serves two key roles – that of advisor and that of advocate. Which role best fits the attorney's role in advising as to reporting positions on the return? Is the tax return like a pleading in a civil case, where, at least in Federal courts, FRCP Rule 11 polices abuses and perhaps sets normative standards of attorney conduct? Is the Government an adversary of the taxpayer in the return filing process, so that the attorney representing the taxpayer is acting in his role as advocate? Does the attorney owe a responsibility to the Government that, while perhaps not trumping his or her responsibility to the client, might limit that responsibility?

The historical approach is that, vis-a-vis the responsibilities to the Government and the tax system, the attorney is acting as advocate for the client and may recommend any position that is not frivolous, just as he or she may do in litigation, at least so long as there is reasonable basis or a realistic possibility of success.²⁸⁰¹ Of course, the attorney is required in all events to advise the client as to the risks to the client from reporting the transaction in the manner contemplated. The attorney remains the attorney for the client owing a duty of loyalty and objectivity. Thus, even if the attorney avoids ethical impropriety, the attorney must still advise the client as to the risks of the client being subject to penalties. As noted, above, the accuracy related penalties – particularly the substantial understatement penalty – may apply in certain circumstances as to positions that meet the minimum ethical threshold, however it may be formulated. Thus, as you will recall, absent a disclosure, a return position may be penalized if it does not have substantial authority, a threshold that is higher than the threshold as to the propriety of the lawyer’s advice. The lawyer must advise the client realistically about the chances of attracting penalties. Even if the attorney can ethically advise the taxpayer as to the propriety of the position, he cannot do so if the taxpayer is also not aware of the penalties the position may attract.

Let's think now about the audit lottery discussed in the articles I asked you to read. The audit lottery is a lottery the taxpayer wins by not getting audited. The lottery so formulated has two aspects. First, being subjected to an audit is distracting and can be expensive even the positions are sustained as reported after the audit or litigation after the audit. Rational people thus want to avoid audit even where they think correctly they owe no additional tax. Second, being subjected to an audit can be both distracting and expensive where the taxpayer does owe additional tax. In either of these two situations, the taxpayer will almost certainly want to do what is necessary to lower his or her audit exposure. But, the audit lottery is perceived as most objectionable when played by taxpayers who owe additional tax. Here, the IRS’s low audit rates appear to give real incentive to taxpayers to play the lottery.

²⁸⁰¹ See generally, Frank J. Gould, Giving Tax Advice - Some Ethical, Professional and Legal Considerations, 97 Tax Notes 523 (2002). As the author notes, the historical analysis was on the basis of the advocate role of the lawyer which has carried forward. The ABA’s initial attempt to address some perceived uncertainty was in ABA Opinion 314 which opined that the law should have a reasonable basis for the return position. While, in terms of the words used, the reasonable basis formula appeared more strict than the not frivolous formula, in practice it is not at all clear what, if any, the difference was. In the subsequently issued Opinion 85-532, the reasonable basis standard was abandoned in favor of “some realistic possibility of success.” Even so, while the change in language for the standard might suggest that the ABA intended to raise the ethical bar, there is no guidance that indicates that it really did so. In all of these reformulations, the ABA continued to adhere to the position that the attorney was acting as advocate and was simply playing with different formulations as to when the line had been crossed. The differences between the formulations just were not clear. A subsequent ABA Tax Section Task Force with unclear authority to speak authoritatively did attempt to differentiate the two standards, but in ways that also injected some uncertainty. In any event, these proposals were never adopted, so the issue remains somewhat muddled.

The taxpayer plays the audit lottery on the notion that the benefits to be derived (taxes underpaid) are greater than the risks undertaken. What are the risks? They are, roughly, (1) whether you will be audited at all (we now have a very low audit rate), (2) whether, if audited, the agent will recognize or understand the risky transaction, (3) whether, if the agent understands the position reported, he or she will disagree with it, (4) whether, if you litigate with the IRS over its disagreement, the taxpayer will lose, and (5) whether, if you lose, you will be subject to a civil or criminal penalty. Many taxpayers choose to play the audit lottery, because they conclude that the risks presented by the answers to these questions are very low.

The question that has bedeviled the tax bar for some time is whether it is appropriate to advise clients as to the audit lottery. This can play out in several ways. For example, the taxpayer may advise that he has \$100,000 income that he received in cash from a party who will not report it to the IRS. He advises that he would prefer not to pay tax on it, and seeks advice from you as to whether, in his circumstances, the IRS would find out about it if he did not report it and pay tax on it. Can you advise him that the audit rate is very low and, in those circumstances, he is not likely to be audited?

Some attorneys take the position that the audit lottery and its various permutations should not be part of the attorney's advice; others take the position that an attorney may -- indeed has the obligation to -- discuss the possible consequences of conduct. These latter attorneys say that advising as to consequences is not the same as advising the client to take inappropriate or illegal action. Thus, for example, if a client asks his attorney what the punishment for assassinating the president is, the attorney can certainly advise him that it includes the death penalty without anyone considering the attorney to have counseled the client to do the act. Similarly, if a client were to ask his attorney, what the speed limit is in a given stretch of road and what the chances are of him being stopped if he goes just 5 miles above the speed limit, an attorney with both knowledge of the law and that particular stretch and police practices in that particular stretch might well answer that the speed limit is 65 mph and that it is unlikely that the client will be ticketed if he goes no more than 70 mph. Indeed, if the attorney knows the turf well enough, the attorney might even be able to say that he knows the cop on this beat and knows that he does not stop unless the cars are going at least 75. Yet, no one would view that as counseling the client to speed.

What if you suspect that the client will take the information you provide about the audit lottery and then act on it in a way that you believe is inappropriate -- i.e., you yourself would not be willing to take the return reporting position on your return? Do you owe a client a lesser duty or no duty at all simply because your client, without your encouragement, would do something you would not do? Is merely giving a client your best advice about the elements of the audit lottery based upon your vast experience encouraging your client to act inappropriately?

A related question is whether you as a professional may assist a client in taking action that is otherwise legal but which is intended to make the reporting or nonreporting of a transaction less likely to be audited. For example, we studied the rules that provide a six year statute of limitations in the case of an omission of 25% of gross income unless the transaction is disclosed on the return. The general thinking is that the disclosure may increase the audit risk for a return. Can you as a professional discuss with the taxpayer the audit risks if there is no disclosure as compared to the

audit risks if there is a disclosure? Even more subtly, if the client wants to foreclose the six year statute by making a disclosure, can you assist him in making a disclosure that, while meeting in your judgment the requirements for a disclosure, is still worded in such a way as also in your judgment to lower the audit profile for the return? A similar question is presented where a client wants to consider a disclosure to avoid the substantial understatement penalty. Most practitioners, I believe, feel that, so long as the disclosure is fair and accurate, it does not have to wave a red-flag begging the IRS to audit the transaction.

Finally, can the tax professional advise or assist a client in reporting a transaction in one of two (or more) permissible manners based upon a belief that the manner chosen will be less likely to be audited than the other? Of course, if the taxpayer does really have two (or more) alternative ways to report a transaction, I am not aware of any that condition the choice upon the taxpayer's mental perceptions as to likelihood of audit, so the taxpayer's motivation in making the choice should be irrelevant. At least, that's what I think most tax professionals would say. And, they would then conclude that the taxpayer can make his or her choice for any reason, including perceptions as to likelihood of audit, and the professional likewise can advise or assist for any reason.

IV. Ethical Issues with Amended Returns.

Example: A new client advises you that he or she significantly underreported the taxes on the return he or she filed 6 months ago. Upon questioning the client about it, you determine that the facts suggest the possibility -- perhaps even the probability -- that the new client could have criminal tax problems if the IRS were to discover the matter. A threshold question is a purely legal one -- is a taxpayer required to file an amended return to correct an error on a previously filed original return? The answer to that is no. The law does not impose that duty. May the attorney insist that the client file an amended return? No, the client is a free agent, and, in any event, the attorney should not insist that the client do something that the law does not command. May the attorney counsel the client that it might be in his or her best interest to file an amended return even though that action is not commanded by law? Yes, of course. Because, just as the audit lottery phenomenon is within a tax attorney's competence to advise, so is the practical consequences of failing to file an amended return within a tax attorney's competence to advise. I discussed above the "voluntary disclosure" policy (pp 306 ff) under which a taxpayer can obtain some assurance that he or she will not be prosecuted for tax and tax-related crimes by filing an amended return. This may be a very practical incentive for the attorney to counsel filing an amended return.

So far, we have focused on ethical issues with respect to an amended return that corrects underpayment of tax on a previously filed return. What about an amended return that claims an overpayment? We noted above that such a return is a claim for refund. Certainly, a taxpayer will be self-motivated to file a claim for refund, although the taxpayer is not legally required to file one. But there are significant issues lurking here as the tax attorney rummages through his or her bag of tricks for the client. You will recall that, by careful attention to the statutes of limitations, the statute of limitations on additional assessments can expire while the statute of limitations on claiming a refund is still open. This will in effect create a one-way opportunity for the taxpayer.

Let me illustrate in an example. Let's say that the taxpayer is audited and the IRS sets up a single issue that results in a deficiency of \$100,000. You counsel the taxpayer that, in your best judgment as a seasoned tax litigator, you can win that issue in whichever court the taxpayer chooses to litigate it. However, since you handled that audit, you also know that the auditing agent did not spot an even larger issue that, in your judgment, the taxpayer would lose in any court that the taxpayer chooses to litigate it. That issue would create a tax liability larger than the dollars that would be saved on the issue that you believe the taxpayer could win. One of the traditional gambits is to preserve the refund statute of limitations, let the assessment statute expire, and then file the claim for refund. For example, assume that the Year 01 return was filed on April 15 of Year 02, the audit deficiency was proposed on September 1 of Year 04, your client signs a Form 870 waiver of the restrictions on assessment for Year 01 on September 5 of Year 04, the IRS assesses the tax on February 1 of Year 5, the taxpayer pays on February 10 of Year 05, and the statute of limitations on further assessment expires on April 15 of Year 5. You will recall that, although the statute of limitations on further assessment has expired, the taxpayer still has 2 years from the date of the February 10 payment to claim a refund. So, on June 1 of Year 05, the taxpayer files a claim for refund alleging that the IRS erred on the one audit issue (the only issue the IRS knows about). In that claim for refund, the taxpayer does not mention the issue the IRS did not audit and is not otherwise aware of, despite the fact that, in his attorney's judgment, he would lose that issue and his taxes for the year are therefore not overpaid. Can the taxpayer lawfully sign the amended return (the claim for refund) with the jurat? Can the attorney counsel or otherwise assist the taxpayer in filing the return?

On a separate issue, do you think that the nature of proper return disclosure is different on the original return than it is on an amended return?

V. Ethical Issues in the Audit.

A. Closing the Statute Gambit.

Attorneys, of course, can't mislead. An attorney cannot mislead a revenue agent auditing his client's tax returns. As we noted above, there are criminal penalties for lying to an agent (§ 7212(a) and 18 U.S.C. § 1001). Certainly the attorney cannot commit a crime. Short of lying, where is the ethical line drawn?

Let's go back to the example noted above with respect to the claim for refund. In representing the taxpayer at the audit stage, the attorney knows that there are two potential issues -- the one raised by the agent as to which the attorney believes the taxpayer has a slam dunk winner and the one not spotted by the agent as to which the attorney believes the taxpayer has a slam dunk loser. Must the attorney tell the agent about the losing issue? May the attorney tell the agent about the losing issue? Must the attorney consult with the taxpayer and follow the taxpayer's instructions as to whether the attorney tells the agent? If the taxpayer refuses to allow the attorney to tell the agent about the issue, must the attorney resign, should the attorney resign, and may the attorney resign?

Most attorneys take the position that the attorney is not required to advise the agent as to the unspotted issue, so long as the attorney does not do anything affirmative to misrepresent. When the agent closes out the case, the attorney may then have to face the issue of whether he or she will assist with the claim for refund, but I have discussed that above. Let's return to the audit, however, and ask the question regarding the attorney's predicament where he knows he or she must not do anything to mislead the agent. What if the agent directly asks the attorney whether he or she is aware of any potential issues not addressed in the audit? Certainly, the attorney cannot directly answer that question no. Can or should the attorney respond by just saying that it is the agent's audit and the agent can do as he or she sees fit, but it is not the attorney's job to give the agent leads? What if the agent prepares a Notice of Changes (Form 4549) or a Waiver of the Restrictions on Assessment (Form 870) calculating the additional tax liability based on the one issue the agent addressed and asks the attorney to agree to the numbers thus calculated? May the taxpayer sign and may the attorney counsel the taxpayer to sign? Most attorneys do not view either of those forms as a representation by the taxpayer or his attorney that the amount of tax due indicated is the correct amount of tax due; rather, the amount of tax is simply the agent's determination as to the amount of tax due.

Of course, one of the dangers of knowing about an unspotted issue and playing it close to the line in avoiding a misrepresentation while gently nudging the agent away from the unspotted issue is that, if the IRS learns of the issue later, it may have a reconstructionist view of the attorney's activities during the audit and bring criminal or IRS disbarment proceedings.

B. Statement 1999-1.

Let's use another example. What if there is one issue raised by the agent and there are no unspotted issues of which the attorney is aware? The attorney has determined that the IRS will surely prevail on that issue if it is litigated and has advised the taxpayer that litigation would be fruitless. The agent then sends the attorney a calculation of the tax liability resulting from that issue and presents the Form 4549 or Form 870 with the incorrect calculation on it, making a major error so that the amount of tax indicated due is just a fraction of the proper amount. The attorney quickly spots that a major calculation error has been made in the taxpayer's favor. Can the attorney or the client execute it, in the hopes that it will then sail through the IRS without correction of the error and the statute will thereafter close on additional assessments?

There is some authority on this subject in Statement of Standards of Tax Practice 1999-1 ("Statement 1999-1), issued by the ABA Tax Section which is not an authoritative body for the issuance of ethical standards but is nevertheless a thoughtful body. In that Statement, one of the scenarios considered is an erroneous calculation by the appeals office, but the material facts are otherwise basically the same. Standard 1999-1 takes the position that the attorney's knowledge of the error is a client confidence which would normally not be disclosable without the client's consent, but further takes the position that the client has impliedly consented so as to permit and even require the attorney to disclose without discussing the matter with the client. The implied consent arises because, in authorizing the attorney to settle with the appeals officer before the number was calculated, the taxpayer already knew what bottom-line tax liability he or she was agreeing to; the authority to effectuate the settlement encompassed the correct calculation. But, what if, in

authorizing the settlement, the taxpayer stated to the attorney his expectation that the tax liability would be \$100,000, the IRS calculates it to be \$125,000 and the attorney then calculates it to be \$150,000? Statement 1999-1 takes the position that there is no implied authority because the client's stated expectation to the attorney is inconsistent with such implied authority, and therefore the attorney cannot disclose.

Statement 1999-1 takes a different approach for so-called “conceptual” errors that inhere in the IRS's calculations. The example given is that the attorney and the appeals officer agree that the taxpayer is entitled to a \$100,000 deduction that was originally reflected on Schedule C. The attorney, however, believes that the deduction is attributable to a passive activity requiring that the deduction be deferred. That issue was not addressed at appeals (remember the “unspotted issue”), and the IRS calculation treats the deduction as nonpassive giving the taxpayer a current tax savings to which the taxpayer is probably not entitled. Statement 1999-1 treats the error as “conceptual” rather than “calculational,” thus requiring that the attorney not disclose the error without the express consent of the taxpayer.

Even if you were comfortable that there is no legal requirement that the client authorize you to advise the agent of the error, should you insist to the client that he or she authorize you to do so?

I should caution that Statement 1999-1 is by no means the last word on this subject. As noted, it was not even promulgated by any body officially or unofficially having authority over ethical issues.

C. Conflicts of Interest in Audits.

Normally, the attorney is not faced with a conflict of interest in tax procedure practice. The attorney represents the taxpayer and the only other party in interest is the Government whom the attorney does not represent. No need for a conflict search there. But, that does not mean that conflicts of interest do not abound in a tax procedure practice and in audits in particular.

We have already discussed one example above where, during the course of an audit in which the attorney represents the taxpayer, the IRS desires to interview the accountant. The accountant may then want the taxpayer's attorney to represent the accountant at the interview. Alternatively, the taxpayer's interest might be best served if the attorney were to guide the accountant through the process and the best way to accomplish that might be for the attorney to undertake the representation of the accountant. Can the attorney undertake that representation? Should the attorney undertake the representation? (See the discussion above, pp. 407 ff.)

Another example that is not necessarily unique to tax law is where you represent a corporation, partnership or other juridical entity. You are hired and continue being hired based on the good graces of the president, CEO or other managing individual. What do you do if the legal services the managing individual asks of you, at the corporation's cost, is in his interest but not necessarily in the corporation's interest? We saw in the Richardson/Corneel dialog a situation where the attorney would bill the corporation for the legal services really performed on behalf of the corporation's owners. In that example, the persons receiving the individual legal services were the

owners of the corporation, so there is no employee/shareholder conflict. But, misdescribing the services rendered or even rendering the statement without description to the corporation is wrong, because it lends itself to tax fraud by giving the corporation the tools and incentive to claim a deduction for what is really a disguised dividend.

Would it make any difference if you found that the corporation paid the lawyer's firm \$2,000,000 in legal fees for work that clearly was on the corporation's behalf and then the law firm, as a matter of good client development or retention, did his personal work for free? Would it matter in the same case if the CEO controlling the relationship were not the sole shareholder of the corporation? Would it matter if the corporation were a publicly held company?

Another common example is representing husband and wife who filed a joint return in either the audit or in the litigation of a tax issue. Because of joint and several liability, both spouses have a common interest in getting the number down as low as possible. But, what about the innocent spouse relief issue? To the extent that one spouse qualifies for innocent spouse relief the burden of the tax is shifted to the other spouse. Consider the attorney's obligations in a typical situation: Husband as the family breadwinner comes to you with a notice of deficiency issued to husband and wife with respect to their joint return. Husband asks for advice on whether to litigate liability and to represent him and her if he decides to litigate. Can you represent both? Under what conditions? Does either or both of them need separate counsel as to the potential innocent spouse defense? Can they engage you only to represent them in getting the number down, but not addressing the innocent spouse issue? These questions are at the forefront of every tax litigator's practice, and the litigator must have developed some method for fully recognizing the parameters of the issue and resolving them in a way that does not result in malpractice.

VI. Ethical Issues in Litigation.

There are a host of ethical rules that apply to litigation, and tax litigation is not just a form of litigation subject to these rules. I shall not deal with them here.

I would like to return to the example posited above -- the calculation error in the client's favor. At the end of tax litigation, calculations are usually required. What if the IRS makes a calculation error in the taxpayer's favor either in the Tax Court as to the amount of the deficiency or overpayment or in a refund court (District Court or Court of Federal Claims) as to the amount of overpayment? We noted above the conclusion of Statement 1999-1 that, in IRS administrative setting, the attorney usually has implied consent to disclose the error to the IRS. Is the answer different in litigation?

Standard 1999-1 states that the answer is different. The attorney must disclose the error to the opposing Government attorney.

VII. Ethical Issues in Collections.

The same genre of issues arise in collections issues. You should have the flavor for these issues in this setting from the foregoing materials.

VIII. A Reminder on IRS Disbarment.

I remind you that, in addition to state bars and courts to which an attorney is admitted to practice, the IRS which allows practitioners to practice before it also has the ability to disbar a practitioner for unethical or criminal practices. You may want to review at this point the discussion above of the Office of Professional Responsibility (pp. 31 ff.).

IX. A Brief Note on Malpractice.

Needless to say, in any area of the law malpractice is a risk. From an ethical standpoint, all attorneys are required to bring a certain level of competence to the representation of their clients. If they do not, they may face disbarment and liability for malpractice and, under some states' law, deceptive trade practices or some such claim. We cannot here discuss the full ramifications of such potential claims. I do, however, want you to read one case -- **Streber v. Hunter**²⁸⁰² which arose from the representation of the taxpayers in **Streber v. Commissioner**, a case we read earlier (pp. 344 ff.) in discussing a taxpayer's ability to avoid the substantial understatement penalty based on the existence of substantial authority. Some of the points I want you to note about the malpractice case are:

1. Tax specialists will be held to a higher standard than attorneys who do not specialize. Thus, theoretically, clients suffering the same kind and quantum of damage can recover if they engage a tax specialist but not if they engage an attorney who is not a tax specialist. This obviously raises the risk for being a specialist and that higher risk, just as the basic malpractice risk itself must be factored into the fees a lawyer must charge.

2. Other good tax lawyers will indeed testify against their peers. Mike Cook, the testifying expert for the plaintiffs is a very good lawyer. Attorneys who do testify make good money for their efforts -- they are, after all, specialists. Query: can a testifying tax specialist who botches his or her testimony be held liable for malpractice? Or, if not malpractice since they are not appearing as an attorney for the client but rather a specialist, can they be held liable for negligence?

3. Note that the Texas Deceptive Trade Practices Act has changed in a way beneficial to lawyers so as to make lawyers less likely to become guarantors for a good result.

4. This case illustrates several sound maxims -- do not depend upon any particular client too much, for your judgment may become clouded; do your homework in advance rather than after you and the client have been committed to the cause; be reasonable.

I wish all of you the best in your practice.

²⁸⁰² 221 F.3d 701 (5th Cir. 2000).

APPENDIX A - RESOURCES

I offer here some resources which I have found useful in my practice.

Internal Revenue Code

I recommend Cornell University's LII site:

<https://www.law.cornell.edu/uscode/text/26>

That link is for the top level for the entire Code. To go to a specific Code section, just a slash mark and the section number. This, for IRC § 6213, the URL is:

<https://www.law.cornell.edu/uscode/text/26/6213>

Similarly, other Codes can be viewed by substituting the Code (e.g. Title 18) in the above convention with the Code section after the hash. For example, the URL for 18 U.S.C. § 1001 is:

<https://www.law.cornell.edu/uscode/text/18/1001>

IRS Internal Revenue Manual

The IRS web site for the top level Table of Contents is:

<http://www.irs.gov/irm/>

IRS Organizational Chart

http://www.irs.gov/pub/irs-news/irs_org_chart_2012.pdf

Texts and Casebooks.

Michael Saltzman and Leslie Book, IRS Practice and Procedure (Thomson Reuters). This is the standard practitioner text in this area. It is frequently cited by the courts, including the United States Supreme Court (e.g., Hibbs v. Winn, 542 U.S. 88, 100 (U.S. 2004)).

Leandra Lederman and Stephen Mazza, Tax Controversies: Practice and Procedure (LEXIS-NEXIS). This is a narrower (but not much narrower focus) and is quite good.

Camilla Watson and Brookes Billman, Jr., Federal Tax Practice and Procedure (2d ed.). I have not used this book, but have a copy and it seems quite comprehensive.

Periodicals.

Tax Analysts' Tax Practice Magazine is a good source for current developments and articles related to tax procedure. These procedure-related materials are selected from Tax Analysts' larger

services, including Tax Notes Today (accessible through LEXIS), Daily Tax Notes (a print service), Tax Notes (a weekly print service, also available through LEXIS).

Blogs (with References to Other Sources)

For Tax Procedure Generally

Procedurally Taxing, published by Professors Leslie Book and Keith Fogg and practitioner Stephen J. Olsen.

The URL is here: <http://www.procedurallytaxing.com/>

This is an excellent blog. The blog also has helpful links to resources.

For the UH Tax Procedure Class (and Others Using this Book)

Federal Tax Procedure Blog, published by Jack Townsend (the author of this book).

The URL is here: <http://federaltaxprocedure.blogspot.com/>

I post matters on this blog from time to time to supplement this book. I previously used it as a general tax procedure blog, but the Procedurally Taxing Blog is so much better, so I scaled it back to just serving the needs of readers of my book.

Other Resources

Federal Tax Crimes Blog, published by Jack Townsend

The URL is here: <http://www.federaltaxcrimes.blogspot.com/>

We cover some tax crimes topics in this book, but I do not recommend as related reading for this class unless a student has a particular interest in the subject.

APPENDIX B - INTEREST AND PENALTY EXAMPLES

The following table will provide an example on how interest and penalties can affect the bottom-line amount owing. I make the following assumptions: \$10,000 of tax deficiency is owing for the Year 2008. The tax return was due 4/15/09 and interest on the principal and on any accuracy related penalty starts running from that date. Assume that the payment date is 8/30/12. I have rounded out the bottom-line amounts to the nearest \$100 since the precise dollar amount is not important to the general point I want to make. Where more precise calculations are important, Time Value's Tax Interest Program does a good job.

	2006 Tax Due as of 4/15/07	\$10,000.00			
Payment Date			8/30/12		
	Tax + Deficiency Interest Only (No Penalty)	Tax + Accuracy Penalty (20%) + Interest on Tax and Penalty	Tax + Fraud Penalty (75%) + Interest on Tax and Penalty	Tax + Delinquency Penalty + Interest on Tax	
Penalty Section		6662	6663	6651(a)(1)	6651(a)(2)
Total Due	\$11,314	\$13,576	\$19,799	\$14,142	\$13,364

Calculations made with Time Value's Tax Interest Calculation Program
<http://www.timevalue.com/>

APPENDIX C - ACRONYMS, INITIALISMS & SHORT-HANDISMS²⁸⁰³

AAG —Assistant Attorney General, Usually here referring to the AAG for the Tax Division.
ACS —Automated Collection System
ADR —Alternative Dispute Resolution
ALJ —Administrative Law Judge
AOD —Action on Decision
APA —Advance Pricing Agreement
AUSA —Assistant U.S. Attorney
BSA —Bank Secrecy Act
B.T.A —Board of Tax Appeals
CAF —Computer Authorization File
CAP —Collection Appeals Program
C.B. —Cumulative Bulletin
CBI —Caribbean Basin Initiative
CDP —Collection Due Process
CES —Criminal Enforcement Section of DOJ Tax Division
CFR —Code of Federal Regulations
CIC —Coordinated Issue Case
CI —Criminal Investigation Division (also referred to as “CID”)
COD —Cancellation of Indebtedness
CTM —DOJ Tax Division Criminal Enforcement Section Criminal Tax Manual.
CTR —Currency Transaction Report
DCC —Detroit Computing Center
DIF —Discriminate Index Function
DISC —Domestic International Sales Corporation
DOJ —Department of Justice
FATP —Federally Authorized Tax Practitioner Privilege
FBAR —Report of Foreign Bank and Financial Accounts, Form TD F 90-22.1
FDCPA—Federal Debt Collection Practices Act
FICA —Federal Insurance Contributions Act
FinCEN—Financial Crimes Enforcement Network
FISC —Foreign International Sales Company
FOIA —Freedom of Information Act
FPAA —Final Partnership Administrative Adjustment
F.R. —Federal Register
FRAP —Federal Rules of Appellate Procedure
FRCP —Federal Rules of Criminal Procedure
FRCrP —Federal Rules of Criminal Procedure
FTCA —Federal Tort Claims Act
FUTA —Federal Unemployment Tax Act
GAO —Government Accounting Office

²⁸⁰³ See p. 2, fn. 1 of the text.

GPO —Government Printing Office
 HITS —High Income Taxpayer Strategy
 IDR —Information Document Request
 IIR —Industry Issue Resolution Program
 IRB —Internal Revenue Bulletin
 IRM —Internal Revenue Manual
 IRS —Internal Revenue Service
 JCT —Joint Committee on Taxation, U.S. Congress
 LTA —Local Taxpayer Advocate
 MLAT —Mutual Legal Assistance Treaty
 MSSP —Market Segment Specialization Program
 NDWC—Notice of Determination of Worker Classification
 NOL —Net Operating Loss
 Nonacq—Nonacquiescence
 NOPA —Notice of Proposed Adjustment
 NPRM —Notice of Proposed Rulemaking
 NRP —National Research Program
 NTA —National Taxpayer Advocate
 OECD —Organization for Economic Cooperation and Development
 OIC —Offer in Compromise
 OPA —Office of Penalty Administration
 OPR —Office of Professional Responsibility
 OTSA —Office of Tax Shelter Analysis
 OVCI —Offshore Voluntary Compliance Initiative
 OVDI —Offshore Voluntary Disclosure Initiative
 OVDP —Offshore Voluntary Disclosure Program
 PFA —Pre-Filing Agreement
 PLR —Private Letter Ruling
 QO —Qualified Offer
 RAR —Revenue Agents Report
 Rev Proc—Revenue Procedure
 Rev Rul —Revenue Ruling
 SAC —Special Agent in Charge of an Office of IRS CI
 SB/SE —Small Business/Self-Employed
 SECA —Self Employment Contributions Act
 SFC —Senate Finance Committee
 SFR —Substitute for Return
 SG —Solicitor General of the United States (DOJ Office)
 SOP —Settlement Option Procedure
 STJ —Special Trial Judge, a magistrate like judge
 TAM —Technical Advice Memorandum
 TAO —Taxpayer Assistance Order
 TAS —Taxpayer Advocate Service
 T.C. —Tax Court
 TCMP —Taxpayer Compliance Measurement Program

T.D. —Treasury Decision
TEAM —Technical Expedited Advice Memorandum
TEFRA—Tax Equity and Fiscal Responsibility Act of 1982
TFRP —Trust Fund Recovery Penalty (also called Responsible Person Penalty)
TIEA —Tax Information Exchange Agreements
TIGTA—Treasury Inspector General for Tax Administration
TMP —Tax Matters Partner
USAO —United States Attorneys Office - e.g., USAO for SDNY (Southern Dist. of N.Y.)
U.S.C. —United States Code
USP —US Parent Company

APPENDIX D - ON FOOTNOTES

In earlier versions, I included the contents of this Appendix as a footnote in the text. As the reader can quickly (even just visually) discern, the footnote got out of control. Accordingly, since I was really enamored of the footnote's contents and did not want to either include the canteens in the text or delete them, I offer them in this Appendix at the end of the entire text, a destination not to be reached by many readers of the text.

In an earlier article, John A. Townsend, Judge Posner's Opinion in Kikalos, 108 Tax Notes 593 (Aug. 1, 2005), I had the following footnote which may or may not discourage readers from reading any more of my footnotes (and since it is my own work, I don't bother to indent it to show that I am quoting):

It was reported in 1999 that Judge Posner had never used a footnote in a judicial opinion. Lawrence Lessig, "The Prolific Iconoclast," *The American Lawyer* (December 1999). I have not attempted empirical research, but I don't recall having seen a footnote in his opinions. I surmise that Judge Posner thinks that, if the point is worthy of the distraction of a footnote, the point can be concisely made with less distraction in the text. The debate over the use of footnotes in judicial opinions raged for a while but now seems to be in a state of relative quiescence; I suspect that all that could be said was said and said often. (I would have footnoted some representative articles from the debate, but I am already in a footnote limiting me to the string cite, which is just a convention, also used by Judge Posner in his opinions, when footnotes are not available (as in this footnote) or when a footnote might violate some norm, self-imposed or not.) I cite but one article that will lead you where you want to go to pursue the matter further. Edward R. Becker, In Praise of Footnotes, 74 Wash. L. Q. 1 (1996). And, I should at least mention that tax lawyers should like judicial opinion footnotes for they occupy a large part of our time and mental resources such as they are (e.g., Crane v. Commissioner, 331 U.S. 1, 14 n.37 (1947)), for which we can bill clients and often collect. Judge Posner's preference for the footnoteless opinion may be aesthetically pleasing (at least, provided that the string cites in the text are not too distracting), but, if widely emulated, threatens a not-insubstantial part of our livelihood.

I did have occasion to confront this footnote issue in my teaching. For some years, I have prepared my own tax procedure and tax crimes texts. For all the reasons Judge Posner cites, my early versions of the tax procedure text had no footnotes. My concept, I think like Judge Posner's, was to avoid the distractions of footnotes. I have since fully populated the text with footnotes – many footnotes – but I provide my students a footnoteless version of the text so that they are not distracted. The footnoted version is geared to practitioners who need authority or discussion than appropriate for a student text. (Also, I give myself some license to frolic and detour in footnotes, but usually not in the text.)

Now for the frolic and detour (an oft-cited abuse of footnotes), I offer the following from others:

"Encountering [a footnote], is like going downstairs to answer the doorbell while making love." Attributed to Noel Coward in Arthur A. Austin, Footnotes as Product Differentiation, 40 Vand. L. Rev. 1131, 1152 (1987); NPR Weekend Edition Transcript, "The Possible Demise of the Footnote" (Sept. 7, 1996). The attribution to Coward may be imperfect, as Prof. Austin develops in a subsequent, appropriately long, footnote. See Arthur A. Austin, Footnote*, Skulduggery** and

Other Bad Habits***, 44 U. Miami L. Rev. 1009, 1012 n.20 (1990). Still, regardless of who said or should have said it, the point is well made.

** Over the years the footnote has regularly provided a safe refuge for untenable hypotheses. Writers are inclined to behave as if they will be held less accountable for indiscretions committed below the text than in it. . . . Lunacy in small print is lunacy nonetheless, and it is particularly reprehensible when it is not even amusing.

Arthur A. Austin, Footnote*, Skulduggery** and Other Bad Habits***, 44 U. Miami L. Rev. 1009 (1990) (as an article title footnote, with the other article title footnotes omitted), quoting Bowersock, The Art of the Footnote, 53 Am. Scholar 54, 61 (1983/1984). To the extent that I have lunacy here, I hope it is at least amusing.

“Sometimes, he wrote, the only places to find any individuality or whimsy in the pages of Supreme Court decisions is on their bottoms.” David Margolick, The Footnote Fetish in Judicial Opinions: A Weather Vane of High Court Philosophy, The New York Times, Jan. 4, 1991 (attributing statement to Tony Mauro).

“Happiness is a long footnote. Happiness for whom? For him who writes it?” Arthur A. Austin, Footnote*, Skulduggery** and Other Bad Habits***, 44 U. Miami L. Rev. 1009, 1016 (1990).

Finally, I just picked up this little diversion in the footnote of a Ninth Circuit opinion (Estate of Saunders v. Commissioner, 745 F.3d 953, 962 n. 8 (9th Cir. 2014)):

n8 In a footnote in its opening brief, and again on reply, the Estate contends that the tax court contravened the Tax Court Rules of Practice and Procedure. Arguments raised only in footnotes, or only on reply, are generally deemed waived. City of Emeryville v. Robinson, 621 F.3d 1251, 1262 n.10 (9th Cir. 2010); Graves v. Arpaio, 623 F.3d 1043, 1048 (9th Cir. 2010) (per curiam). We therefore decline to address this argument.

Which, I suppose, is a good rule if judges like Justice Scalia don’t usually read footnotes anyway.