

TAX ISSUES

INTRODUCTION

Internal Revenue Code section 7803(c)(2)(B)(ii)(X) not only requires the National Taxpayer Advocate to identify the tax issues most often litigated in the federal courts, but requires her to classify the issues by the type of taxpayer involved and to include recommendations, if appropriate, for mitigating disputes of this nature. We recognize that many issues are litigated because of legitimate interpretative and factual disputes of law. However, administrative or legislative change could eliminate or minimize some of the litigation discussed in this section.¹

The Taxpayer Advocate Service worked with the Office of Chief Counsel to identify the issues most frequently litigated. Our office researched a commercial database for decisions filed for each issue by the United States Tax Court, federal district courts, the United States Court of Federal Claims and the United States bankruptcy courts during the time period June 1, 2001 through May 31, 2002. For this analysis and report, the term “litigated” is defined as a case with a published decision by the court. This does not mean that the taxpayer has exhausted the appeals process. This year we report on 11 issues because the number of cases with a published decision for Joint and Several Liability and Barred Refunds fell within a very narrow range and we feel that both issues merit discussion.

This year’s analysis and reporting of the most litigated issues are more comprehensive and detailed than any previous Annual Report to Congress. Each issue includes a general discussion of the relevant law, an analysis of the cases litigated (including discussion of specific significant or representative cases), and a conclusion, which in some instances contains specific recommendations for legislative or administrative change. We have listed each of the cases litigated in tables and have categorized the cases by type of taxpayer. The case listings for each issue also include the taxpayer’s name, the specific citation of the case, the court in which it was tried, a brief synopsis of the issue, whether the taxpayer was represented at trial by counsel, and the decision of the court.

TAX LITIGATION IN GENERAL

Taxpayers generally have access to four different tribunals in which to litigate a tax matter – the United States Tax Court, the federal district courts, the United States Court of Federal Claims, and the U.S. bankruptcy courts. Each of these courts has specific jurisdiction over certain types of tax cases.

¹ See, e.g., “Unreported and Underreported Income,” and “Relief from Joint and Several Liability” *infra*.

² See IRC § 6214.

³ See, e.g., IRC §§ 7428(a), 7476, 7477, 7478, 7479.

⁴ IRC § 6330(d).

⁵ IRC § 7442.

The United States Tax Court is generally a “pre-payment” forum and has jurisdiction over deficiency cases,² declaratory judgments,³ lien and levy cases,⁴ and other matters that are authorized from time to time by statute.⁵ Both the federal district courts and the Court of Federal Claims are “refund fora.”⁶ They have jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,⁷ and (2) the taxpayer has filed an administrative claim for refund.⁸ The federal district courts are the only forum in which a taxpayer can receive a jury trial. Bankruptcy courts can adjudicate tax matters that involve a debtor’s open tax years and that were not previously adjudicated before the initiation of a bankruptcy case.⁹

Each of the courts has specific rules regarding procedure and evidence. The Tax Court and U.S. Court of Federal Claims are national courts; the Tax Court holds trial calendars in 62 cities.¹⁰ The federal district and bankruptcy courts, on the other hand, are local courts, sitting in judicial districts throughout the nation.

The taxpayer’s choice of judicial forum depends on many factors, including the court’s procedures, the burden of proof, and the controlling precedent. As noted above, if the Tax Court has subject matter jurisdiction over the taxpayer’s case, he or she can litigate without paying the tax in advance but must file a petition within the prescribed 90 days from the date of receiving a Notice of Deficiency.¹¹

Over 95 percent of all tax-related litigation is adjudicated in the Tax Court.¹² Table Intro-A shows the number of docketed cases in inventory in the Tax Court, the Court of Federal Claims, and the district courts as of the end of each of the fiscal years 1991 through 2001. Table Intro-B shows the dollars in dispute for the docketed case inventory in these courts over the same time period.

⁶ 28 U.S.C. § 1346(a)(1).

⁷ See *Flora v. United States*, 362 U.S. 145 (1960).

⁸ IRC § 7422(a).

⁹ See 11 U.S.C. §§ 505(a)(1) and (a)(2)(A).

¹⁰ The Tax Court holds trial sessions in 15 additional cities for cases involving up to \$50,000 in dispute per tax year.

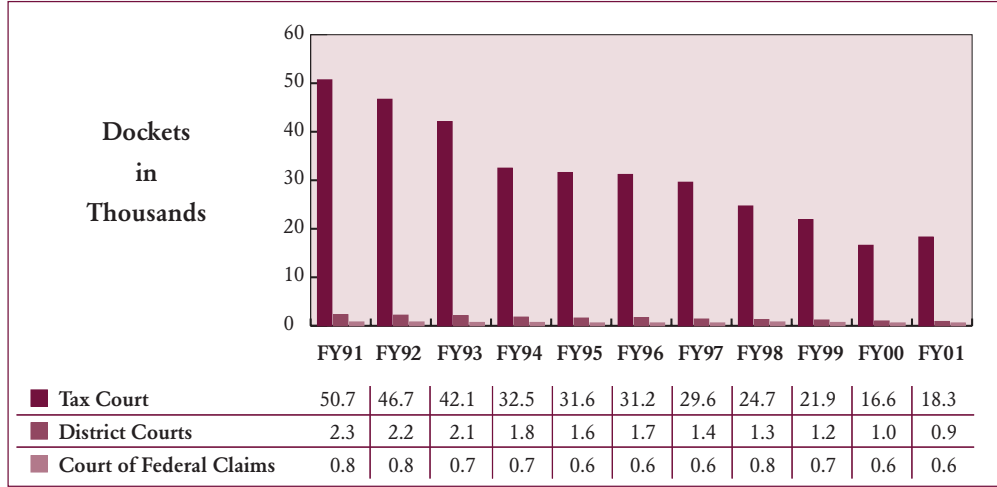
¹¹ IRC § 6213(a). A petitioner who is outside the United States at the time the Notice of Deficiency is mailed has 150 days within which to file a petition with the Tax Court.

¹² Judge David Laro, *The Evolution of the Tax Court As An Independent Tribunal*, 1995 U. Ill. L. Rev. 17.



**TABLE INTRO-A
DOCKETED INVENTORY - CASES IN DISPUTE**

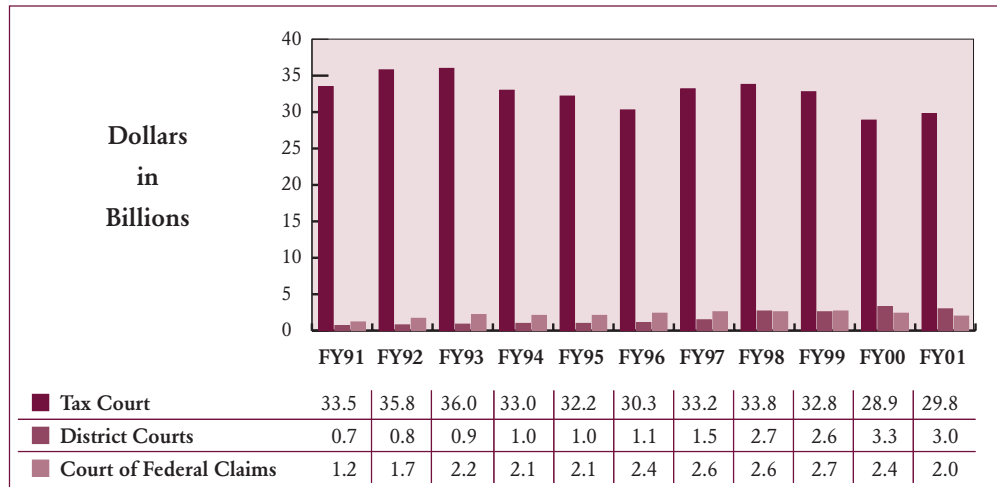
Pending Before Tax Court, District Courts, and Court of Federal Claims



Does not include cases on appeal and declaratory judgments.
Source: Counsel Automated Tracking System, TL-711 and TL-712

**TABLE INTRO-B
DOCKETED INVENTORY - DOLLARS IN DISPUTE**

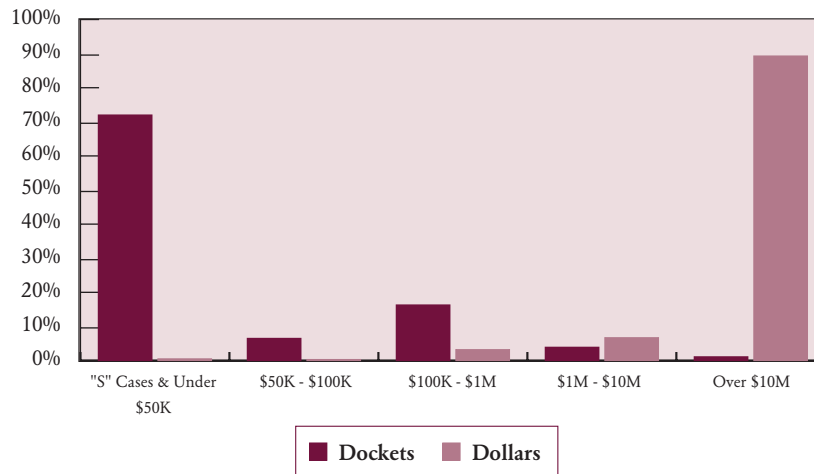
Pending Before Tax Court, District Courts, and Court of Federal Claims



Does not include cases on appeal and declaratory judgments.
Source: Counsel Automated Tracking System, TL-711 and TL-712

Table Intro-C shows the percentages of dollars in dispute and total dockets by dollar category in the Tax Court’s inventory as of September 30, 2001. It is interesting to note that while “S” cases and other cases involving amounts under \$50,000 accounted for only 0.5 percent of the dollars in controversy, they constituted 72 percent of the docketed cases. On the other hand, cases with over \$10 million in dispute made up only 1.1 percent of the case docket inventory yet these same cases accounted for 89.3 percent of the entire dollars in dispute.

TABLE INTRO-C
TAX COURT INVENTORY - PERCENTAGE OF DOLLARS IN DISPUTE AND
TOTAL DOCKETS BY DOLLAR CATEGORY, AS OF SEPTEMBER 30, 2001



Does not include cases on appeal and declaratory judgments.
 Source: Counsel Automated Tracking System, TL-711

Thus, the Tax Court regularly deals with a few cases in which a large tax liability is at issue and many cases in which the amount in controversy is relatively small. This dichotomy has been a constant fact of Tax Court litigation over the last eleven years.¹³

¹³ Counsel Automated Tracking System, TL-711.

MOST LITIGATED TAX ISSUES



PRO SE LITIGATION

Early in our analysis of issues, it became apparent that a significant number of taxpayers chose to represent themselves before the court (“*pro se*” representation¹⁴). All persons have a right to plead their own case before all courts of the United States or to retain counsel.¹⁵ The right to self-representation applies equally to taxpayers who find themselves engaged in disputes with the Internal Revenue Service (IRS).

The Tax Court Rules of Practice and Procedure provide that in the absence of appearance by counsel, an individual may appear on his or her own behalf. A corporation or unincorporated association may be represented by an authorized officer of the corporation or by an authorized member of the association. An estate or trust may be represented by the fiduciary.¹⁶

In federal courts such as the district courts or the Court of Federal Claims, the provisions of 28 U.S.C. § 1654 apply, with specific rules for each court. In federal district courts, local rules provide for *pro se* representation. In the Court of Federal Claims, Rule 83.1(c)(8) provides that an individual may represent him- or herself or a member of his or her immediate family as a party before the court.

Over the last decade, more than 70 percent of cases filed by taxpayers in the Tax Court were *pro se* cases.¹⁷ One reason for the predominance of *pro se* petitioners in the Tax Court is that a taxpayer does not have to pay the tax at issue in order to litigate. Further, the Tax Court has a simplified procedure for handling small dollar cases.¹⁸

Overall, it appears that persons who act *pro se* do so for a number of reasons. Some cite mistrust of lawyers or the cost of legal services. Some *pro se* litigants believe that their cases are not very complex. Prior experience with litigation can lead some persons to distrust the entire legal process. “They sometimes assume that their lawyers complicate issues purposefully in order to charge higher fees. They can also misconstrue the judge’s duty to remain objective as behavior that is impervious and unsympathetic.”¹⁹ Yet a 1991 American Bar Association study of *pro se* litigants found the following:²⁰

- ◆ Persons with annual incomes of less than \$50,000 are more likely to represent themselves.

¹⁴ “*Pro se*” means “for oneself; on one’s own behalf; without a lawyer.” *Black’s Law Dictionary* 1236-37 (7th ed. 1999).

¹⁵ Under the provisions of Title 28 U.S.C. § 1654, in all courts of the United States the parties may plead and conduct their own cases personally or by counsel as they are permitted by rules of such courts, to manage and conduct causes therein.

¹⁶ Tax Court Rule 24(b).

¹⁷ IRS Counsel Automated Tracking System, TL 708A, Prepared by: CC:FM:PM:O.

¹⁸ IRC § 7463(b) provides a simplified process for disputes involving \$50,000 or less.

¹⁹ Margaret Graham Tebo, *Self-Serve Legal Aid*, ABA Journal, August 2002, at 43.

²⁰ The *Pro se* Law Center, available at www.pro-selaw.org/pro-selaw/index.asp.

- ◆ Approximately 20 percent of self-represented litigants report that they can afford an attorney but do not want one.
- ◆ Self-represented persons are more likely to be satisfied with the judicial process than those who are represented by lawyers.
- ◆ Almost 75 percent of those who represented themselves in court said they would do so again.

Despite these survey results, Tax Court judges, Counsel field attorneys, and employees and volunteers of Low Income Taxpayer Clinics²¹ all report that taxpayers generally obtain better results when they are represented by a professional who is authorized to practice before the Court. These observations are borne out by the following discussion of the most litigated issues. Table Intro-D illustrates the number and percentage of cases where *pro se* and represented taxpayers prevailed in each of the issues considered.

TABLE INTRO-D
PRO SE CASES

MOST LITIGATED ISSUE	PRO SE TAXPAYERS			REPRESENTED TAXPAYERS		
	TOTAL CASES	TAXPAYER PREVAILED	PERCENT	TOTAL CASES	TAXPAYER PREVAILED	PERCENT
Abusive Trusts	24	0	0%	14	0	0%
Barred Refunds	8	0	0%	4	0	0%
Capital Gain/Loss	10	2	20%	21	11	52%
Collection Due Process	67	1	1%	29	2	7%
EITC	36	14	39%	16	7	44%
Fraud Penalty	15	3	20%	15	6	40%
Joint and Several Liability	6	3	50%	8	2	25%
Itemized Deductions	24	4	17%	11	1	9%
Trade & Business Expenses	65	13	20%	30	12	40%
Unreported/ Underreported Income	89	13	15%	47	18	38%
Valuation	5	3	50%	49	5	10%
Total	349	53	15%	244	64	26%

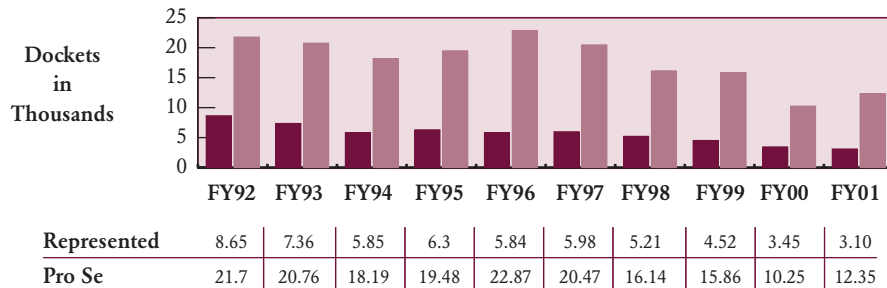
²¹ Low Income Taxpayer Clinics provide free or nominal fee representation to low income taxpayers in disputes with the IRS. See IRC § 7526.



TRENDS AND ANALYSIS

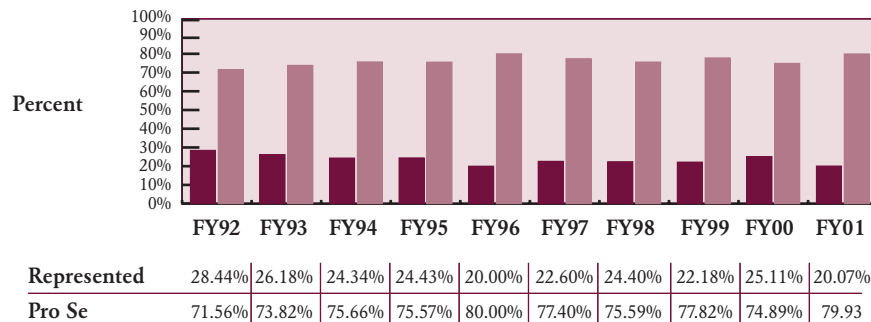
The following charts (Tables Intro-E and Intro-F) indicate the number and percentage of cases in which taxpayers either were represented by counsel or represented themselves over the last ten fiscal years.²² The increase in *pro se* cases in fiscal year 2001 may be explained by the IRS Reform and Restructuring Act of 1998 (RRA '98).²³ Taxpayers now have access to the courts for collection matters²⁴ and stand-alone proceedings for relief from joint and several liability.²⁵ These may be the types of issues that lend themselves to *pro se* representation, particularly where the cost of representation would be greater than the tax liability at issue.

**TABLE INTRO-E
CASES PETITIONED TO TAX COURT - PETITIONER: REPRESENTED OR *PRO SE***



Does not include cases on appeal and declaratory judgments.
Source: Counsel Automated Tracking System, TL-708A

**TABLE INTRO-F
CASES PETITIONED TO TAX COURT - PETITIONER: REPRESENTED OR *PRO SE***



Does not include cases on appeal and declaratory judgments.
Source: Counsel Automated Tracking System, TL-708A

²² The IRS fiscal year runs from October 1st through September 30th.

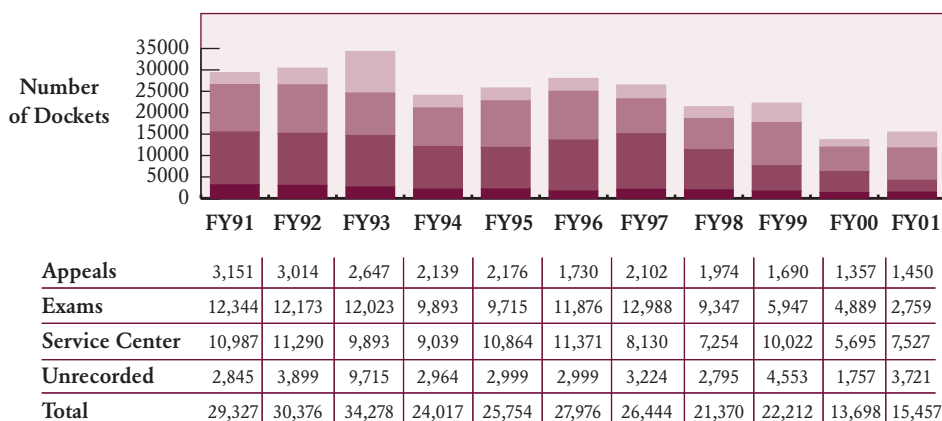
²³ Pub. L. No. 105-206.

²⁴ Collection Due Process hearings under IRC §§ 6320 and 6330.

²⁵ IRC § 6015.

Pro se representation occurs at all levels of practice before the Internal Revenue Service. For example, a 2001 IRS customer satisfaction survey report indicates that 77 percent of the Appeals cases heard by IRS are *pro se*.²⁶ Table Intro-G shows the source of cases petitioned to the Tax Court over an eleven-year period. In recent years, the largest number of Tax Court cases originated from IRS Service Center examinations or collection actions. Service Center (or “campus”) activity includes Earned Income Tax Credit examinations, automated underreporter and substitute-for-return programs, and the “innocent spouse” (i.e. joint and several liability) program. These programs involve relatively small amounts of tax in dispute. However, they are also the types of IRS activities in which a taxpayer would be inclined to represent himself or herself because representation is too costly either at the outset or in relation to the amount of tax in dispute.

TABLE INTRO-G
SOURCE OF CASES PETITIONED TO TAX COURT



Source: Counsel Automated Tracking System, TL-708B

ANALYSIS OF *PRO SE* LITIGATION

The following table (Table Intro-H) lists the most litigated tax issues for the period June 1, 2001 through May 31, 2002. The number of cases in which taxpayers represented themselves before the court is also noted.

²⁶ <http://www.irs.gov/pub/irs-utl/newappealsinternet.pdf>



TABLE INTRO-H

MOST LITIGATED ISSUE	TOTAL NUMBER OF LITIGATED CASES REVIEWED	PRO SE LITIGATION	PERCENTAGE OF PRO SE CASES
Abusive Trusts	38	24	63%
Barred Refunds	12	8	67%
Capital Gains	31	10	32%
Collection Due Process	96	67	70%
EITC	52	36	69%
Fraud Penalty	30	15	50%
Joint and Several Liability	14	6	43%
Itemized Deductions	35	24	69%
Trade & Business Expenses	95	64	68%
Under/Underreported Income	136	89	65%
Valuation	54	5	9%
Total	593	349	59% overall

Collection Due Process (CDP), Earned Income Tax Credit (EITC), Itemized Deductions, Trade & Business Expenses, Barred Refunds, Under and Unreported Income and Abusive Trusts all show high percentages of *pro se* litigants. Of the 348 *pro se* cases litigated, 83 percent (289 cases) were tried in United States Tax Court.

CONCLUSION

The number of people handling their own legal problems, of any type, has increased dramatically in recent years. Self-representation raises concerns about protecting the rights of those who represent themselves while ensuring that the courts are not excessively burdened by the need to inform and assist *pro se* litigants.²⁷

“Meeting the challenge of *pro se* litigation is a long-term effort that includes overcoming barriers, questioning the way of doing things, dealing with the complexities of collaborating with other stakeholders, testing innovative approaches, and working toward special procedures to assist with this increase in litigants.”²⁸

²⁷ American Bar Association, *Pro se or Self-representation*, available at <http://www.abanet.org>.

²⁸ Kathleen M. Sampson, *Meeting The Pro se Challenge (2002)*, available at <http://www.ajs.org>.

We must acknowledge that most civil tax litigation occurs without a lawyer representing the taxpayer, despite the fact that taxpayers routinely fare better in court when represented by counsel. Courts, the Internal Revenue Service, associations of lawyers, accountants, and enrolled agents, and Congress all have a stake in developing innovative approaches to *pro se* litigants, to make sure that their self-representation does not lead to incorrect results. In this Report, the National Taxpayer Advocate proposes several initiatives to address this issue. She and the Taxpayer Advocate Service encourage all participants in the tax system to rise to the challenge of *pro se* litigation.



**LITIGATED
ISSUE #1****NONFILER/UNREPORTED AND UNDERREPORTED INCOME**

PRESENT LAW

Current law defines gross income as “all income from whatever source derived.”²⁹ Gross income includes (but is not limited to) the following:

- (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
- (2) Gross income derived from business;
- (3) Gains derived from dealings in property;
- (4) Interest;
- (5) Rents;
- (6) Royalties;
- (7) Dividends;
- (8) Alimony and separate maintenance payments;
- (9) Annuities;
- (10) Income from life insurance and endowment contracts;
- (11) Pensions;
- (12) Income from discharge of indebtedness;
- (13) Distributive share of partnership gross income;
- (14) Income in respect of a decedent; and
- (15) Income from an interest in an estate or trust.

Internal Revenue Code (IRC) sections 71 through 90 address items specifically included in gross income, and IRC sections 101 through 140 address items that are specifically excluded.

If the Internal Revenue Service believes that a taxpayer has unreported or underreported income, the IRS notifies the taxpayer via the audit process or the Automated Underreporter program. Usually these items are easily identifiable amounts of income from taxable sources, including wages, nonemployee compensation, interest, dividends, rents, and pensions. Taxpayers are given the opportunity to agree to the adjustments to their tax, to disagree and appeal the adjustments to the Appeals function, or to resolve their differences with the IRS through the court system.

²⁹ IRC § 61(a).

ANALYSIS OF LITIGATED CASES

There were 136 cases with income and nonfiler issues litigated in the federal court system between June 1, 2001, and May 31, 2002. TAS analyzed these cases for trends or patterns in an effort to develop recommendations that could help resolve cases before litigation. Table 3.1.4 identifies the cases analyzed.

Of these litigated cases, 23 were strictly nonfiler cases. Another six cases involved taxpayers who filed returns in some years but not in others. In 15 of the 29 cases with nonfiler issues, the taxpayers used frivolous arguments in attempts to evade the payment of income taxes. Another three cases contained issues of fraud. The remaining 11 cases involved unreported or underreported income from nonemployee compensation, business gross receipts, rental income, wage income, capital gains, or constructive dividends. The cases contained a variety of issues, as noted above, with differing sets of facts and circumstances.

The income issues from all of the cases analyzed are categorized in Table 3.1.1 below:

TABLE 3.1.1
UNDERREPORTED INCOME ISSUES

INCOME ISSUES EMERGING FROM ANALYZED CASES	NUMBER OF CASES	PERCENT OF TOTAL
Frivolous Filers/Frivolous Nonfilers	21	15.5%
Indirect Methods of Determining Income by IRS	17	12.6%
Criminal Fraud and Civil Fraud Penalty	14	10.3%
IRA/Retirement Distributions/Social Security Income	9	6.6%
Lawsuit Settlements & Contingent Attorney Fees	8	5.9%
Wage Income	6	4.4%
Unreported/Underreported Gross Receipts	6	4.4%
Gambling Income	5	3.7%
Sham Trusts	5	3.7%
Cancellation of Debt Income	4	2.9%
Lawsuit Settlements (Attorney Fees Not an Issue)	4	2.9%
Constructive Dividend Income	4	2.9%
Capital Gain Income	3	2.2%
Interest Income	3	2.2%
Unemployment Compensation	3	2.2%
Other Miscellaneous Issues	24	17.6%
Total	136	100.0%

The cases cover a wide range of taxpayers, including individuals, businesses (corporations, partnerships and trusts), and estates. The above table identifies the various categories of income that were determined to be the most significant in each case. However, many cases involved two or more income issues as well as other issues.



Twenty-one of the 136 cases litigated involved frivolous filers and frivolous nonfilers. The cases categorized as “sham trusts” often contained frivolous arguments as well. Tax Court judges have shown little patience for such arguments and often penalize the plaintiffs under IRC section 6673(a)(1). The penalty under this section can be as high as \$25,000, in addition to any other penalties that apply in a given case. The court can assert the penalty if the taxpayer does one or more of the following:

- ◆ fails to exhaust the available administrative remedies
- ◆ raises constitutional issues
- ◆ institutes pretrial delays
- ◆ litigated the same issues previously
- ◆ uses delaying tactics
- ◆ takes particular actions that are frivolous or groundless.³⁰

The following table indicates the penalties applied under IRC § 6673(a)(1) in the cases litigated for frivolous issues. This illustrates the seriousness with which the Tax Court views what it determines to be frivolous arguments.

TABLE 3.1.2
SANCTIONS AGAINST FRIVOLOUS FILERS & NON-FILERS

TABLE OF SANCTIONS APPLIED		
NAME	CITATION	§6673(a)(1) PENALTY AMOUNT
Barnes	T.C. Memo. 2001-155	2,000
Bland-Barclay	T.C. Memo. 2002-20	1,500
Caralan Trust	T.C. Memo. 2001-241	12,500
Carpentier	T.C. Memo. 2002-43	15,000
Combs	T.C. Memo. 2001-264	25,000
Corcoran	T.C. Memo. 2002-18	2,000
Curtis	T.C. Memo. 2001-308	15,000
Funk	T.C. Memo. 2001-291	25,000
Hart	T.C. Memo. 2001-306	15,000
Heisey	T.C. Memo. 2002-41	2,000
Howard	T.C. Memo. 2002-85	7,500
Laidlaw	T.C. Summary Opinion 2001-179	25,000
Madge	T.C. Memo. 2000-370	25,000
Monaghan	T.C. Memo. 2002-16	1,500
Olsen	T.C. Memo. 2001-217	750
Ruocco	T.C. Memo. 2002-91	12,500
Scheckel	T.C. Summary Opinion 2001-84	500
Simanonok	T.C. Memo. 2002-66	5,000
Yacksyzn	T.C. Memo. 2002-99	1,000

³⁰ IRC § 6673.

In 17 of the 136 cases litigated, the IRS used indirect methods to accurately determine the taxpayer's income. These methods are principally employed when taxpayers keep inadequate books and records that do not clearly reflect their income.³¹

Indirect methods include bank account analysis, source and application of funds, net worth analysis, and cash transaction analysis. For example, in a bank account analysis, all deposits to a taxpayer's various accounts are totaled. The IRS subtracts nontaxable amounts, such as transfers, gifts, redeposits, and reimbursements, and then treats the remainder as the taxpayer's taxable gross income. Indirect methods of determining income are well established and accepted by the courts. In *Krist v. Commissioner*, a case involving unreported gross receipts, the Court wrote: "Section 6001 imposes a duty on all persons liable for any tax to maintain records. It is well established that where a taxpayer fails to maintain adequate records, the Commissioner may prove the existence and amount of unreported income by any method that will clearly reflect the taxpayer's income."³²

Fourteen of the cases litigated involved issues of civil or criminal fraud. When a taxpayer is found guilty of criminal fraud, intent to defraud the government by understating income or overstating expenses is typically present. When criminal fraud is tried and proven in the court system, prison sentences or other criminal penalties may be imposed as well as the civil fraud penalty. The burden of proof rests with IRS when asserting the civil fraud penalty. Therefore, the IRS takes a conservative approach when pursuing this penalty.

The remaining litigated cases represent situations in which the taxpayer disagreed with the IRS that the income in question was taxable. These cases involved numerous issues, such as IRA and other retirement distributions, social security income, lawsuit settlements, wage income, unreported or underreported business gross receipts, and other categories of income. See the first table in this section titled "Underreported Income Issues" for a more complete breakdown of the issues.

Pro se plaintiffs are those who forego the option to have counsel represent them in court, and choose to represent themselves. Table 3.1.3 shows the breakdown of *pro se* taxpayers in the cases litigated in this analysis and the outcomes of those cases. *Pro se* litigation is discussed in detail in the Introduction to this section of the report.

³¹ IRC § 446(b).

³² *Krist v. Comm'r*, T.C. Memo 2001-140, at *13 to *14.



TABLE 3.1.3
PRO SE CASES

MOST LITIGATED ISSUE	TOTAL CASES	PRO SE	NOT PRO SE	DECISION FOR TAXPAYER	DECISION FOR IRS	SPLIT DECISION
Individuals	75	52	23	4	65	6
Businesses	59	37	22	2	36	21
Estates	2	0	2	1	1	0
Total	136	89	47	7	102	27

One significant issue that emerged during this analysis concerns the taxability of attorney fees in cases of nonphysical personal injury. Nonphysical personal injury cases usually involve employment discrimination, race discrimination, sex discrimination, age discrimination, breach of contract, and wrongful termination. Even though only eight cases were litigated in this category, they reveal inconsistent treatment of taxpayers, depending upon where the taxpayer is located and the court in which the case is heard.

If a taxpayer lives in a state under the jurisdiction of the U.S. Court of Appeals for the Fifth, Sixth, or Eleventh Circuits, and wins a settlement in a nonphysical personal injury case, the attorney fee portion of the settlement may be excluded from gross income. However, if the same taxpayer receives a settlement from the same type of lawsuit in a state under the jurisdiction of the U.S. Court of Appeals for the First, Third, Fourth, Seventh, Ninth, Tenth, or Federal Circuits, the attorney fee portion of the settlement must be included in gross income. This means it is possible for the attorney fees and tax burden to consume the majority, or possibly all, of the damages received by the taxpayer.³³ See the legislative recommendation included in the Key Legislative Recommendations section of this report for a more complete analysis of this issue.

CONCLUSION

This analysis identified one issue, the taxability of attorney fees in nonphysical personal injury cases, in which a legislative change could significantly reduce taxpayer burden and promote equity for all taxpayers, regardless of their physical residence. The balance of the litigated cases did not present opportunities to propose legislative or systemic changes. The cases represent a variety of issues with very different sets of facts and circumstances. Many result from honest disagreements with the IRS regarding the taxability of certain kinds of income. Others are the result of taxpayers attempting to delay the inevitable payment of taxes for as long as possible, not necessarily due to frivolous arguments or actions, but because they do not understand the tax law, are not able to pay the taxes due, have not maintained adequate books and records, or because of other circumstances.

³³ Timothy R. Koski, *Should Clients Escape Tax on Lawsuit Proceeds Retained by Attorneys?*, Tax Notes Today, (2001) 126-42.

TABLE 3.1.4
LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Taxpayers (Issues Other Than Business Issues)					
Acuncius	T.C. Memo. 2002-21	U.S. Tax Court	Cancellation of debt income	No	Taxpayer
Banaitis	T.C. Memo. 2002-5	U.S. Tax Court	Settlement proceeds, attorney fees	No	IRS
Biehl	118 T.C. 467	U.S. Tax Court	Attorney fee for lawsuit	No	IRS
Bland-Barclay	T.C. Memo. 2002-20	U.S. Tax Court	Wage income	Yes	IRS
Bokman	T.C. Summary Opinion 2001-137	U.S. Tax Court	Sale of residence	Yes	Taxpayer
Bonner	T.C. Summary Opinion 2001-170	U.S. Tax Court	Nonemployee compensation	Yes	IRS
Brickey	289 F.3d 1144	U.S. Court of Appeals 9th Cir.	Illegal income	No	IRS
Broedel	T.C. Memo 2001-135	U.S. Tax Court	Settlement proceeds, loan from retirement fund	Yes	IRS
Bynam	T.C. Memo 2001-142	U.S. Tax Court	Wage income	Yes	IRS
Carpentier	T.C. Memo. 2002-43	U.S. Tax Court	Interest, dividends, rental income	No	IRS
Carver	T.C. Summary Opinion 2001-94	U.S. Tax Court	Gambling winnings	Yes	IRS
Cipriano	T.C. Memo. 2001-157	U.S. Tax Court	Interest income	Yes	IRS
Clayborn	T.C. Summary Opinion 2001-152	U.S. Tax Court	Social Security disability benefits	Yes	IRS
Comey	T.C. Memo. 2001-275	U.S. Tax Court	Income from gain on sale of mutual fund shares, interest, dividends, and capital gains	Yes	IRS
Corcoran	T.C. Memo. 2002-18	U.S. Tax Court	Wage and interest income, unemployment compensation	Yes	IRS



TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Curtis	T.C. Memo. 2001-308	U.S. Tax Court	Wage and rental income	Yes	IRS
Dela Cruz	T.C. Summary Opinion 2001-154	U.S. Tax Court	Social Security disability benefits	Yes	IRS
Dimon	T.C. Memo. 2002-105	U.S. Tax Court	Nonemployee compensation	Yes	IRS
Dirkes	T.C. Memo. 2002-60	U.S. Tax Court	Wage income	Yes	IRS
Ervin	T.C. Memo. 2002-134	U.S. Tax Court	Settlement proceeds, attorney fees	No	Split
Farris	T.C. Summary Opinion 2001-132	U.S. Tax Court	Gambling winnings	Yes	IRS
Favero	T.C. Memo. 2001-219	U.S. Tax Court	Wage income	Yes	IRS
Ferreira	T.C. Summary Opinion 2001-167	U.S. Tax Court	Unemployment compensation	Yes	IRS
Francisco	267 F.3d 303	U.S. Court of Appeals 3d Cir.	Delay damages from settlement	No	IRS
Freeman	T.C. Memo. 2001-254	U.S. Tax Court	Settlement proceeds, attorney fees	No	IRS
Goodchild	T.C. Summary Opinion 2001-102	U.S. Tax Court	Disability benefits	No	IRS
Grace	T.C. Summary Opinion 2002-35	U.S. Tax Court	Workers' compensation benefits	Yes	IRS
Greene	12 Fed. Appx. 606	U.S. Court of Appeals 9th Cir.	Wages and compensation	Yes	IRS
Harris	T.C. Memo. 2001-281	U.S. Tax Court	Unemployment compensation	Yes	IRS
Hart	T.C. Memo. 2001-306	U.S. Tax Court	Wage and interest income, IRA distribution	Yes	IRS
Heisey	T.C. Memo. 2002-41	U.S. Tax Court	Wage income, nonemployee compensation, sale of residence	Yes	IRS
Hendricks	T.C. Memo. 2001-299	U.S. Tax Court	IRA distribution	Yes	IRS
Hernandez	T.C. Summary Opinion 2001-144	U.S. Tax Court	Interest income	Yes	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Howard	T.C. Memo. 2002-85	U.S. Tax Court	Wage income	Yes	IRS
Hukkanen-Campbell	274 F.3d 1312	U.S. Court of Appeals 10th Cir.	Settlement proceeds, attorney fees	No	IRS
Huynh	T.C. Summary Opinion 2001-131	U.S. Tax Court	Insurance payments on credit card debt	Yes	IRS
Kenseth	259 F.3d 881	U.S. Court of Appeals 7th Cir.	Settlement proceeds, attorney fees	No	IRS
LeBlanc	T.C. Summary Opinion 2001-92	U.S. Tax Court	Gambling winnings	Yes	IRS
Lehmuth	T.C. Summary Opinion 2001-190	U.S. Tax Court	Settlement proceeds, attorney fees	Yes	Split
Lutz	T.C. Memo. 2002-89	U.S. Tax Court	Gambling winnings	No	Split
Major	T.C. Summary Opinion 2002-36	U.S. Tax Court	Commission income	Yes	IRS
Mangels	T.C. Summary Opinion 2002-40	U.S. Tax Court	Nonemployee compensation, wage and interest income, cancellation of debt income	Yes	IRS
Monaghan	T.C. Memo. 2002-16	U.S. Tax Court	Wage and dividend income, capital gains	Yes	IRS
Norris	T.C. Memo. 2001-152	U.S. Tax Court	Federal Employees Retirement System payments	Yes	IRS
Olsen	T.C. Memo. 2001-217	U.S. Tax Court	Wages and Social Security benefits	Yes	IRS
Parker	13 Fed. Appx. 611	U.S. Court of Appeals 9th Cir.	Sale of residence	No	IRS
Penn	T.C. Memo. 2001-267	U.S. Tax Court	Interest income, social security benefits	Yes	IRS
Price	T.C. Memo. 2001-307	U.S. Tax Court	Wage and other income	Yes	IRS
Quintero	T.C. Summary Opinion 2002-47	U.S. Tax Court	Wage income	No	IRS



TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Ramey	T.C. Summary Opinion 2001-156	U.S. Tax Court	Settlement proceeds	No	IRS
Reytblatt	T.C. Memo. 2001-209	U.S. Tax Court	Nonemployee compensation, wages, dividend and interest income, income from an annuity	Yes	IRS
Rinehart	T.C. Memo. 2002-71	U.S. Tax Court	Cancellation of debt income	No	Split
Rosario	T.C. Memo. 2002-70	U.S. Tax Court	Guaranteed advance payments	No	Taxpayer
Satrang	T.C. Summary Opinion 2001-140	U.S. Tax Court	Gambling winnings	Yes	IRS
Scheckel	T.C. Summary Opinion 2001-84	U.S. Tax Court	Wages, interest income	Yes	IRS
Shelton	T.C. Summary Opinion 2002-9	U.S. Tax Court	Wage, interest, and rental income	Yes	Split
Simanonok	T.C. Memo. 2002-66	U.S. Tax Court	Military retirement pay, Social Security benefits	Yes	IRS
Smith	T.C. Summary Opinion 2002-33	U.S. Tax Court	Distributions from various employee retirement plans	Yes	IRS
Specking	117 T.C. No. 9	U.S. Tax Court	Wage income	No	IRS
Sykes	T.C. Memo. 2001-169	U.S. Tax Court	Illegal income, cash hoard	Yes	Split
Taken	T.C. Summary Opinion 2001-98	U.S. Tax Court	Wage income, interest income, gambling winnings	Yes	IRS
Tanner	117 T.C. No. 20	U.S. Tax Court	Nonstatutory employee stock option	No	IRS
Timmerman	T.C. Summary Opinion 2002-51	U.S. Tax Court	Distribution from a profit-sharing plan	Yes	IRS
Tinsman	12 Fed. Appx. 431	U.S. Court of Appeals 8th Cir.	IRA distribution, wage income	Yes	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Torre	T.C. Memo. 2001-218	U.S. Tax Court	Dividend income	Yes	IRS
Tritz	T.C. Summary Opinion 2001-76	U.S. Tax Court	Income from severance package	Yes	IRS
Tsakopoulos	T.C. Memo. 2002-8	U.S. Tax Court	Cancellation of debt income	No	Taxpayer
Vega	T.C. Summary Opinion 2002-14	U.S. Tax Court	Retirement plan distribution, interest income	Yes	IRS
Webster	T.C. Summary Opinion 2002-43	U.S. Tax Court	Nonemployee compensation, wages, prizes and awards, interest income, IRA distribution	Yes	IRS
Weir	T.C. Memo. 2001-184	U.S. Tax Court	Pension income	No	IRS
Whitehead	T.C. Memo. 2001-317	U.S. Tax Court	Constructive dividends, fringe benefits	No	IRS
Whittaker	T.C. Memo. 2001-224	U.S. Tax Court	Annuity payments from retirement plan	Yes	IRS
Wolgamott	T.C. Memo. 2001-188	U.S. Tax Court	Deferred compensation, unemployment compensation	Yes	IRS
Yacksyzn	T.C. Memo. 2002-99	U.S. Tax Court	Wage income and distributions from various employee retirement plans	Yes	IRS
Zidar	T.C. Memo. 2001-200	U.S. Tax Court	Capital gains from redemption of corporate stock	No	IRS



TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)					
Bacon	88 A.F.T.R. 2d 6396	U.S. Court of Appeals 3d Cir.	Unreported income from corporations	No	IRS
Barnes	T.C. Memo. 2001-155	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Barnard	T.C. Memo. 2001-242	U.S. Tax Court	Schedule C and corporate gross receipts	No	Split
Beck	T.C. Memo. 2001-270	U.S. Tax Court	Constructive dividends	Yes	Split
Bisceglia	T.C. Memo. 2002-22	U.S. Tax Court	Schedule C gross receipts	No	Split
Brodsky	T.C. Memo. 2001-240	U.S. Tax Court	Unreported income	No	Split
Cannon	T.C. Memo. 2001-292	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Caracci	118 T.C. No. 25	U.S. Tax Court	Corporate asset transfers	No	Split
Caralan Trust	T.C. Memo. 2001-241	U.S. Tax Court	Underreported gross income	No	Split
Chama	T.C. Memo. 2001-253	U.S. Tax Court	Distributive share of partnership income.	No	IRS
Chappel	T.C. Memo. 2001-146	U.S. Tax Court	Schedule C gross receipts	Yes	Split
Clark	T.C. Memo. 2001-205	U.S. Tax Court	Schedule C gross receipts, rental income	Yes	IRS
Cohen	T.C. Memo. 2001-249	U.S. Tax Court	Schedule C gross receipts, capital gains	Yes	IRS
Combs	T.C. Memo. 2001-264	U.S. Tax Court	Income diverted to trusts	Yes	IRS
Cordes	T.C. Memo. 2002-124	U.S. Tax Court	Constructive dividends, interest income	No	Split
Coyle/Regal Mobile Home Sales, Inc.	T.C. Summary Opinion 2002-42	U.S. Tax Court	Gross receipts from sales, commission income, rental/installment sale income	No	Split
Dang	T.C. Memo. 2002-117	U.S. Tax Court	Gross receipts from Schedule C and partnership	No	Taxpayer
DelVecchio	T.C. Memo. 2001-130	U.S. Tax Court	Schedule C gross receipts, capital gains	Yes	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Eddie Cordes, Inc.	T.C. Memo. 2002-125	U.S. Tax Court	Constructive dividends, interest income	No	Split
Framatome Connectors USA, Inc.	118 T.C. No. 3	U.S. Tax Court	Constructive dividends	No	IRS
Funk	T.C. Memo. 2001-291	U.S. Tax Court	Income diverted to trusts	Yes	IRS
Furniss	T.C. Memo. 2001-137	U.S. Tax Court	Commission, wage, and pension income, dividend and interest income, unemployment compensation	Yes	IRS
Gale	T.C. Memo. 2002-54	U.S. Tax Court	Settlement proceeds, attorney fees	Yes	IRS
Glenn	T.C. Summary Opinion 2001-83	U.S. Tax Court	Schedule C gross receipts	Yes	Split
Hadri	T.C. Memo. 2002-77	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Ihlenfeldt	T.C. Memo. 2001-259	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Ishler/20th Century Marketing, Inc.	T.C. Memo. 2002-79	U.S. Tax Court	Constructive dividends, distributive share of S corporation income, commission income	No	IRS
Jones	268 B.R. 865	U.S. Bankruptcy Court, Tampa	Settlement proceeds	No	IRS
Kang/Ngo	T.C. Summary Opinion 2001-97	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Kaufman	T.C. Memo. 2001-161	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Key	T.C. Memo. 2001-166	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Knelman	33 Fed. Appx. 346	U.S. Court of Appeals 9th Cir.	Schedule C gross receipts	Yes	IRS
Krist	T.C. Memo. 2001-140	U.S. Tax Court	Schedule C gross receipts	Yes	Split
Laidlaw	T.C. Summary Opinion 2001-179	U.S. Tax Court	Commission income	Yes	IRS



TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Lobe	T.C. Memo. 2001-204	U.S. Tax Court	Business gross receipts, wages, interest income, nonemployee compensation	Yes	IRS
Madge	23 Fed. Appx. 604	U.S. Court of Appeals 8th Cir.	Business gross receipts	Yes	IRS
Motaghayer	T.C. Summary Opinion 2001-109	U.S. Tax Court	Income from S corporation	Yes	Split
Mueller	T.C. Memo. 2001-178	U.S. Tax Court	Embezzlement income, liquidating dividend, capital gains	Yes	IRS
O'Connell	T.C. Memo. 2001-158	U.S. Tax Court	Corporate distributions	Yes	IRS
Owens	T.C. Memo. 2001-143	U.S. Tax Court	Schedule C gross receipts, insurance proceeds	Yes	IRS
Owens	T.C. Memo. 2001-314	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Pappas	T.C. Memo. 2002-127	U.S. Tax Court	Unreported income from various sources	Yes	Split
Park	T.C. Memo. 2002-50	U.S. Tax Court	Gift income, Schedule C gross receipts	No	Split
Pham	T.C. Memo. 2002-101	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Possas	T.C. Summary Opinion 2002-28	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Residential Management Services Trust/Carey	T.C. Memo. 2001-297	U.S. Tax Court	Income diverted to a trust, Schedule C gross receipts	Yes	IRS
Ruocco	T.C. Memo. 2002-91	U.S. Tax Court	Schedule C gross receipts	Yes	Split
Sams	T.C. Memo. 2001-293	U.S. Tax Court	Constructive dividends, rental income, corporate gross receipts	No	Split
Smarthealth, Inc.	T.C. Memo. 2001-145	U.S. Tax Court	Customer overpayments	No	Taxpayer
Swain	118 T.C. No. 22	U.S. Tax Court	Income diverted to a trust	Yes	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Textron, Inc.	117 T.C. No. 7	U.S. Tax Court	Subpart F income	No	Split
Tietig	T.C. Memo. 2001-190	U.S. Tax Court	Sale of lots, capital gains, interest income, partnership and S corporation income	Yes	Split
Velasco	T.C. Memo. 2001-252	U.S. Tax Court	Commission income	No	IRS
Wapnick	T.C. Memo. 2002-45	U.S. Tax Court	Unreported income from accounting fees, check cashing, capital gains, interest income	Yes	IRS
Welch	T.C. Memo. 2002-84	U.S. Tax Court	Schedule C gross receipts	No	IRS
Westpac Pacific Foods, Save Mart	T.C. Memo. 2001-175	U.S. Tax Court	Upfront payments received in consideration of entering various purchasing contracts	No	IRS
Wu	T.C. Memo. 2002-68	U.S. Tax Court	Unreported income from computer sales diverted from S corporation	Yes	Split
Zack	291 F.3d 407	U.S. Court of Appeals 6th Cir.	Constructive dividends	No	IRS
Zhadanov	T.C. Memo. 2002-104	U.S. Tax Court	Constructive dividends, Social Security benefits	Yes	Split

Estate/Gift Taxpayers

Estate of Burris	T.C. Memo. 2001-210	U.S. Tax Court	Life insurance proceeds	No	Taxpayer
Estate of Johnson	T.C. Memo. 2001-182	U.S. Tax Court	Schedule C gross receipts, asset transfers, capital gains, Social Security benefits, gambling income	No	IRS



**LITIGATED
ISSUE #2****COLLECTION DUE PROCESS (CDP)**

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of a lien³⁴ filed by the IRS or a proposed levy action.³⁵ The IRS Restructuring and Reform Act of 1998 established the Collection Due Process (CDP) hearing to ensure that lien and/or proposed levy actions are both warranted and procedurally correct.³⁶

The IRS mails a certified notice to the taxpayer, giving him or her the opportunity to request a CDP hearing.³⁷ The taxpayer must return a signed, written request for a hearing within 30 days of the date of notice.³⁸ Unless the IRS has reason to believe collection of the tax is in jeopardy, the Service will stop levy action during the 30-day period.³⁹ When a taxpayer requests CDP hearings with respect to both a lien and a proposed levy, the Appeals Officer will conduct one hearing.⁴⁰

If the taxpayer's appeal is filed on time, the IRS will suspend collection action throughout the process. Internal Revenue Code Section 6330(e)(1) requires the collection statute of limitations to be suspended until the date the appeals determination is final or the taxpayer withdraws the request for a hearing.⁴¹

The taxpayer may raise one or more of the following issues relating to the unpaid tax:

- ◆ Appropriateness of collection actions;
- ◆ Collection alternatives such as installment agreement, offer-in-compromise, posting a bond or substitution of other assets;
- ◆ Appropriate spousal defenses; and
- ◆ The existence or amount of the tax, but only if the taxpayer did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the tax liability.⁴²

³⁴ IRC § 6320.

³⁵ IRC § 6330.

³⁶ Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206, Section 3401.

³⁷ IRC § 6320(a)(2)(C) and IRC § 6330(a)(2)(C). The notice regarding a lien filing is sent after the lien is filed; it is required to be sent not more than five days after the day of the filing of the notice of lien. The notice regarding a levy is sent prior to the levy action; it is required to be sent not less than 30 days before the day of the first levy.

³⁸ Treas. Reg. § 301.6330-1(c)(2), Q&A-C1, C3.

³⁹ IRC § 6330(e)(1).

⁴⁰ IRC § 6320(b)(4).

⁴¹ IRC § 6330(e)(1).

⁴² IRC § 6330(c)(2).

The taxpayer may not reintroduce an issue that was raised and considered at a prior administrative or judicial hearing, if the individual participated meaningfully in the prior hearing or proceeding.⁴³

CDP hearings are informal and can be conducted face-to-face, by telephone or by correspondence.⁴⁴ The hearing is to be held by an impartial officer from the Appeals unit of the IRS.⁴⁵ Within 30 days of the Appeals determination, the taxpayer may petition the appropriate court.⁴⁶ The Notice of Determination, which sets forth Appeals' findings and decisions, provides instructions for litigation, including the court of jurisdiction.⁴⁷

The legislative history of the IRS Restructuring and Reform Act of 1998 addresses in detail the standard of review that the Court is to apply in reviewing the Commissioner's administrative determinations. Where the validity of the tax liability was properly at issue in the CDP hearing, the amount of the tax liability will in such cases be reviewed by the appropriate court on a *de novo* basis.^{48 49} Where the validity of the underlying tax liability is not properly at issue, the court will review the Commissioner's administrative determination for abuse of discretion.⁵⁰

ANALYSIS OF LITIGATED CASES

Ninety-six CDP cases were litigated in the federal court system from June 1, 2001 through May 31, 2002. Table 3.2.1 provides a detailed listing of litigated CDP cases. Seventy-seven taxpayers raised issues originating from individual returns, 18 taxpayers raised business tax issues, and one estate case was heard.

The outcomes of these CDP cases are as follows:

- ◆ Fifty-one decisions were rendered in favor of IRS,

⁴³ IRC § 6330(c)(4).

⁴⁴ Treas. Regs. 301.6330-1(d)(2), Q&A-D7

⁴⁵ IRC §§ 6330(b)(1) and 6330(b)(3).

⁴⁶ IRC § 6330(d)(1).

⁴⁷ IRM 8.72.3.9(5) states the Tax Court has jurisdiction of CDP cases where the underlying tax liability is the type of liability that is subject to the deficiency procedures (e.g., income, gift, and estate taxes). IRM 8.72.3.9(6) states the U.S. District Courts have jurisdiction over CDP cases not within the jurisdiction of the Tax Court, that is, those where the underlying tax liability is not the type of liability subject to the deficiency procedures (e.g., Trust Fund Recovery Penalty, employment taxes, and excise taxes other than those under IRC Chapters 41, 42, 43, and 44).

⁴⁸ Internal Revenue Service Restructuring and Reform Act of 1998, House Report 105-599, 105th Congress, 1998.

⁴⁹ "*De novo*" is defined as anew; afresh; a second time. Black's Law Dictionary (6th ed.1990).

⁵⁰ Abuse of discretion is synonymous with a failure to exercise a sound, reasonable, and legal discretion. It is a strict legal term indicating that appellate court is of opinion that there was commission of an error of law by the trial court. Black's Law Dictionary (6th ed. 1990).



- ◆ Thirty-five cases were dismissed,
- ◆ Three cases were decided in favor of the taxpayer,
- ◆ Three cases resulted in split decisions, and
- ◆ Four cases were sent back to IRS Appeals for a hearing.

In one fairly typical case where the IRS prevailed, a taxpayer argued that the IRS Appeals Officer failed to compromise or accept expenses claimed in arriving at a payment schedule. The court found that the Appeals Officer's calculations and disallowance of claimed expenses were reasonable, and that IRS could proceed with its proposed collection action.⁵¹

In 14 of the 35 cases that were dismissed, the courts found taxpayers failed to state a claim upon which relief could be granted:

- ◆ In one case, the taxpayer claimed IRS had "acted improperly in refusing to entertain a settlement...of its proposed tax levy," but provided no specific item of law or regulation in support of this position.⁵²
- ◆ In another case, the court ruled that the taxpayer failed to raise a spousal defense or challenge to the Commissioner's proposed levy by offering a less intrusive means of collecting the tax. Instead, the court held the taxpayer's complaint contained nothing but frivolous and groundless arguments relating to the Uniform Commercial Code. The taxpayer was deemed to have conceded all issues that were not raised during the CDP hearing or in the court petition.⁵³

Six dismissed cases involved late filing:

- ◆ One taxpayer claimed it was not clear whether the filing period was counted in calendar days or business days. The court concluded that a timely filed petition must be filed within 30 calendar days and dismissed the case because the taxpayer's petition was filed beyond the filing requirement.⁵⁴
- ◆ Another taxpayer claimed his notice of determination after a CDP hearing was delayed because of legal holidays and slow rural mail delivery in a foreign country. The court dismissed the case, noting that the law does not give additional time to file a petition even if the taxpayer is in another country.⁵⁵

⁵¹ Schulman v. Commissioner, T.C. Memo. 2002-129.

⁵² Asbury v. Internal Revenue Service, 2002-1 U.S.T.C. 50,117.

⁵³ Tipp v. Commissioner, T.C. Memo. 2001-272.

⁵⁴ Guerrier Jr. v. Commissioner, T.C. Memo. 2002-3.

⁵⁵ Sarrell v. Commissioner, 117 T.C. No. 11 (2001). Unlike the notice of deficiency under IRC § 6213(a), the taxpayer in a CDP hearing is not granted extra time to respond when he or she is out of the U.S. at the time of mailing the notice of determination.

The courts decided there was a lack of jurisdiction in thirteen cases:

- ◆ The United States Court of Appeals for the Tenth Circuit upheld the District Court's ruling in one particular case. The District Court dismissed this case for lack of jurisdiction because the Tax Court had jurisdiction over the underlying liability at issue, and therefore had exclusive jurisdiction over the appeal of the levy determination.⁵⁶

The courts dismissed two cases because the taxpayers did not comply with court orders:

- ◆ The court ordered the taxpayer in one case to obtain legal counsel within 30 days, then dismissed the case because the taxpayer failed to respond or comply with the order.⁵⁷

The courts decided in the taxpayer's favor in three cases:

- ◆ A taxpayer was notified that a telephonic hearing was scheduled for January 10, 2001. The Appeals Officer returned a message from the taxpayer (requesting a face-to-face hearing) on January 4, 2001, and informed the taxpayer that the January 4th call would constitute his CDP hearing. The court ruled that an unscheduled telephone call does not constitute a hearing.⁵⁸
- ◆ A taxpayer requested a CDP hearing because of the IRS' intent to levy. The IRS filed a motion to dismiss the taxpayer's petition seeking a review of determination to levy, claiming the court lacked jurisdiction because the lien was filed prior to the effective date of RRA '98, even though the notice of intent to levy was issued after this date. The court dismissed the IRS' motion and held that the taxpayer was entitled to a due process hearing because the lien and levy constitute two separate collection actions.⁵⁹

Split decisions occurred in three cases. In two of them, the IRS prevailed on the CDP issue, but the taxpayers prevailed when IRS requested they be penalized for bringing frivolous or groundless actions. The courts concluded the penalties were not appropriate.⁶⁰

Four cases were sent back to Appeals for a CDP hearing. In one case, IRS could not prove the taxpayer had received a notice of proposed liability. Thus, the court gave the taxpayer an opportunity to challenge the merits of the underlying tax liability.⁶¹

⁵⁶ Glass v. Internal Revenue Service, 21 Fed. Appx. 870 (2001).

⁵⁷ Safe-Watch 24 Security Inc. v. Internal Revenue Service, 2002 U.S. Dist LEXIS 2981.

⁵⁸ Montijo v. United States, 2002 US Dist. LEXIS 9602.

⁵⁹ Parker v. Commissioner, 117 T.C. 63 (2001).

⁶⁰ Service Engineering Trust v. Commissioner, T.C. Memo. 2001-181, McMahan v. Commissioner, T.C. Memo. 2001-191.

⁶¹ Herycyk v. United States, 89 A.F.T.R. 2d 1584 (2001).



Analysis of the litigated cases identified several procedural issues:

- ◆ A taxpayer was denied a hearing due to a heavy workload at the IRS. The court remanded the case back to Appeals for a hearing.⁶²
- ◆ IRS filed a motion for a summary judgment for improper service. The court ruled that improper service does not require that the case be dismissed.⁶³
- ◆ The court ruled Form 12153 (Request for a Collection Due Process Hearing) is not necessary for the IRS to provide a CDP hearing and the request may be submitted on any document.⁶⁴
- ◆ Although in one case, the majority of the court ruled in favor of IRS, six judges dissented regarding the issue of “what constitutes a hearing.” The taxpayers contended they were not afforded a face-to-face hearing and their hearing was conducted by correspondence. The dissenting judges felt that the court should have addressed this issue and stated that it was the intent of Congress that a face-to-face hearing would occur.⁶⁵
- ◆ The taxpayer claimed that he was not provided verification of the validity of the assessments. The Appeals Officer did not provide the taxpayer with a copy of the transcript prior to the hearing. The majority of the court ruled in favor of the IRS and determined that the requirements under IRC § 6330(c)(1) were met. Two judges dissented and found the IRS failed to provide the taxpayer with proof of assessments and did not allow the taxpayer to discuss the validity of the assessments.⁶⁶
- ◆ A revenue agent instead of an Appeals Officer held a CDP hearing, contrary to the requirements of the regulations. Despite the error, the taxpayer did not raise this issue in his petition. As a result, the court declined to consider this issue on the grounds that any allegations of error must be set forth in the petition.⁶⁷

Seventy percent of the litigated CDP cases were *pro se*. Of the ten taxpayers who won their cases, received split decisions, or had their cases sent back to Appeals for a CDP hearing, counsel represented seven.

⁶² Ahee v. United States, 89 A.F.T.R. 2d 1247 (2001).

⁶³ Brantley v. District Director, 2002-1 U.S.T.C. 50,251.

⁶⁴ Brantley v. District Director, 2002-1 U.S.T.C. 50,251.

⁶⁵ Lunsford v. Commissioner, 117 T.C. 183 (2001).

⁶⁶ Nestor v. Commissioner, 118 T.C. 162 (2002).

⁶⁷ Strickland v. Commissioner, T.C. Memo. 2001-312.

CONCLUSION

The CDP provisions of the IRS Restructuring and Reform Act of 1998 have had a major impact on taxpayers, their representatives, the IRS, and the federal courts. As all the participants continue to chart their way through this process, problems will arise which may require administrative or legislative modifications.

One such problem frequently raised by the IRS is abuse of the CDP process by taxpayers who submit frivolous arguments and documents. This analysis of litigated cases did uncover evidence of such abuse, as noted in cases where the courts identified the arguments as frivolous, upheld the assertion of frivolous return penalties, and/or imposed sanctions. To address this problem, pending legislation proposes to increase the frivolous submission penalty from \$500 to \$5,000, and allow the IRS to return those submissions without further consideration.⁶⁸

While there is a need to remedy the problem, this solution raises some concerns:

- ◆ Who will be empowered to determine whether submissions are frivolous?
- ◆ Will there be an independent review of these determinations?
- ◆ Will submissions that raise both significant procedural issues as well as frivolous grounds survive this process?
- ◆ Will the IRS be diligent in correcting a “frivolous” designation erroneously placed on the database?

The examination of litigated cases revealed that the courts have ruled on significant procedural issues, even in cases where the taxpayer has raised frivolous arguments.⁶⁹ Two significant examples of these rulings are (1) that a CDP request can be submitted on any document,⁷⁰ and (2) an unscheduled telephone call does not constitute a hearing.⁷¹

The court also ruled in another case that filing a notice of tax lien constitutes a collection action.⁷² This raises the question of whether the IRS should modify its current practice of filing liens when collection actions are prohibited (e.g., filing a Notice of Federal Tax Lien after an offer-in-compromise has been submitted).

⁶⁸ Tax Relief Guarantee Act of 2002, H.R. 586, Section 217.

⁶⁹ Fifty-one of the litigated cases raised frivolous arguments; four of these cases resulted in the courts ruling on procedural issues.

⁷⁰ *Brantley v. District Director*, 2002-1 U.S.T.C. 50,251.

⁷¹ *Montijo v. United States*, 2002 U.S. Dist. LEXIS 9602.

⁷² *Parker v. Commissioner*, 117 T.C. 63 (2001).



The issue of *pro se* representation illustrates the benefit of taxpayers having counsel. Those who hire outside representation succeed more often than those who do not. Increased participation by *pro bono* counsel and Low Income Taxpayer Clinics should raise the level of representation in court, thereby improving the taxpayer's position.

The Office of the Taxpayer Advocate will continue to study CDP issues as an on-going advocacy project. We will continue to review litigated cases to identify trends, and to assist in improving this vital arena for taxpayer rights. Our focus and concerns are:

- ◆ What should constitute a CDP hearing?
- ◆ Is the CDP process being abused? If so, is IRS overcorrecting for that abuse?
- ◆ When taxpayers need a hearing, can they obtain one? Or are they sometimes persuaded to settle prematurely, without complete resolution of the case?

TABLE 3.2.1
LITIGATED CASES: COLLECTION DUE PROCESS

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Taxpayers (Issues Other Than Business Issues) <i>Note: If sufficient information to identify the issue was not available in the court case, it was placed in this category.</i>					
Strickland	T.C. Memo. 2001-312	Tax Court	Levy	Yes	IRS
Smith	T.C. Memo. 2002-59	Tax Court	Levy	Yes	IRS
Mann	T.C. Memo. 2002-48	Tax Court	Levy	No	IRS
Kuglin	T.C. Memo. 2002-51	Tax Court	Lien and Levy	No	IRS
Duffield	T.C. Memo. 2002-53	Tax Court	Levy	No	IRS
Guerrier Jr.	T.C. Memo. 2002-3	Tax Court	Levy	Yes	Dismissed
Gunderson	T.C. Memo. 2002-26	Tax Court	Lien and Levy	Yes	IRS
Aguirre	117 T.C. 324 (2001)	Tax Court	Lien and Levy	Yes	IRS
Ahee	89 A.F.T.R. 2d 1247 (2001)	District Court for Nev.	Levy	Yes	Sent back to Appeals
Asbury	2002-1 U.S.T.C. 50,117	Western District of Pa.	Lien	No	Dismissed
Bartschi	2001-2 U.S.T.C. 50,672	District Court for Az.	Levy	Yes	Dismissed
Brantley	2002-1 U.S.T.C. 50,251	Middle District of Fla.	Lien	Yes	Dismissed
Coleman	T.C. Memo. 2002-132	Tax Court for Nev.	Levy	Yes	IRS

TABLE 3.2.1 — LITIGATED CASES: COLLECTION DUE PROCESS (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Danner	208 F. Supp. 2d. 1166 (2002)	Eastern District of Wash.	Levy	Yes	Dismissed
Frain	2002-2 U.S.T.C. 50,553	District Court for NJ	Levy	No	IRS
Geller	2001-2 U.S.T.C. 50,703	Southern District of Ohio	Levy	Yes	Dismissed
Glass	21 Fed. Appx. 870 (2001)	10th Circuit	Levy	Yes	Dismissed
Hoffman	209 F. Supp. 2d. 1089 (2002)	Western District of Wash.	Levy	Yes	Dismissed
Holliday	T.C. Memo. 2002-67	Tax Court	Lien and Levy	Yes	IRS
Johnson	89 A.F.T.R. 2d. 2018 (2001)	Northern District of Utah	Levy	Yes	Dismissed
Kelly	209 F. Supp. 2d. 981 (2002)	Eastern District of Mo.	Levy	Yes	IRS
Kintzler	2001-2 U.S.T.C. 50,696	District Court	Levy	Yes	Dismissed
Klawonn	T.C. Memo. 2002-27	Tax Court	Levy	Yes	IRS
MacLeod	2001-2 U.S.T.C. 50,699	Southern District of Ca.	Levy	Yes	Dismissed
Magana	118 T.C. No. 30	Tax Court	Lien and Levy	No	IRS
Newman	T.C. Memo. 2002-135	Tax Court	Lien and Levy	Yes	IRS
Reinhart	2002 U.S. Dist. Lexis 13741	Eastern District of Ca.	Levy	Yes	IRS
Remole	2002-1 U.S.T.C. 50,224	Central District of Illinois	Levy	No	IRS
Rennie	2001 U.S. Dist. LEXIS 18954	Eastern District of Ca.	Levy	Yes	Sent back to Appeals
Sarrell	117 T.C. No. 11 (2001)	Tax Court	Lien and Levy	Yes	Dismissed
Schulman	T.C. Memo. 2002-129	Tax Court	Levy	Yes	IRS
Roberts	118 T.C. 365 (2002)	Tax Court	Levy	Yes	IRS
Hurford	T.C. Memo. 2002-94	Tax Court	Lien and Levy	Yes	IRS
Nicklaus	117 T.C. No. 10 (2001)	Tax Court	Lien	Yes	IRS
Tolotti	T.C. Memo. 2002-86	Tax Court	Lien	Yes	IRS
Boyd	117 T.C. No. 12 (2001)	Tax Court	Levy	Yes	IRS
Chase	T.C. Memo. 2002-93	Tax Court	Levy	Yes	IRS



TABLE 3.2.1 — LITIGATED CASES: COLLECTION DUE PROCESS (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Downing	118 T.C. 22 (2002)	Tax Court	Levy	Yes	IRS
Harris	T.C. Memo. 2002-75	Tax Court	Levy	Yes	IRS
Hart	2001-2 U.S.T.C. 50,641	3RD Cir.	Levy	Yes	Dismissed
Howard	T.C. Memo. 2002-81	Tax Court	Levy	Yes	IRS
Jackson	T.C. Memo. 2002-100	Tax Court	Levy	No	Dismissed
Johnson	117 T.C. 202 (2001)	Tax Court	Levy	Yes	Dismissed
Joye	T.C. Memo. 2002-14	Tax Court	Levy	Yes	IRS
Kaeckell	T.C. Memo. 2002-114	Tax Court	Levy	Yes	IRS
Lindsey	T.C. Memo. 2002-87	Tax Court	Levy	Yes	IRS
Lunsford	117 T.C. 159 (2001)	Tax Court	Levy	No	IRS
Lunsford	117 T.C. 183 (2001)	Tax Court	Levy	No	IRS
Nestor	118 T.C. 162 (2002)	Tax Court	Levy	Yes	IRS
Ogden	T.C. Memo. 2002-15	Tax Court	Levy	Yes	Dismissed
Vossbrinck	T.C. Memo. 2002-96	Tax Court	Levy	Yes	IRS
Weishan	T.C. Memo. 2002-88	Tax Court	Levy	Yes	IRS
Whitfield	T.C. Summary Opinion 2002-38	Tax Court	Levy	Yes	IRS
Williams	T.C. Memo. 2002-111	Tax Court	Levy	Yes	IRS
Yacksyzn	T.C. Memo. 2002-99	Tax Court	Levy	Yes	IRS
Barker	T.C. Memo. 2002-13	Tax Court	Levy	Yes	IRS
Parker	117 T.C. 63 (2001)	Tax Court	Lien and Levy	No	Taxpayer
Adams	2002-1 U.S.T.C. 50,295	District Court for Nev.	Lien and Levy	Yes	Dismissed
McNeil	2002-1 U.S.T.C. 50,415	Western District of Mich.	Levy	Yes	Dismissed
Tornichio	2002-1 U.S.T.C. 50,411	Northern District of Ohio	Levy	Yes	Dismissed
McIntosh	2002-1 U.S.T.C. 50,204	Southern District of Ohio	Levy	Yes	Dismissed
Stanifird	2001-2 U.S.T.C. 50,492	District Court for Az.	Levy	Yes	IRS
Hickey	2002-1 U.S.T.C. 50,294	District Court for Nev.	Levy	Yes	Dismissed
Montijo	2002 US Dist. Lexis 9602	District Court for Nev.	Lien	Yes	Taxpayer

TABLE 3.2.1 — LITIGATED CASES: COLLECTION DUE PROCESS (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Van Gaasbeck	2002-1 U.S.T.C. 50,309	District Court for Nev.	Levy	Yes	Dismissed
Walz	2002-1 U.S.T.C. 50,377	District Court for Minn.	Levy	Yes	Dismissed
Hart	2002-1 U.S.T.C. 50,460	Northern District of Ohio	Levy	Yes	Dismissed
Baxter	T.C. Memo. 2001-300	Tax Court	Lien and Levy	Yes	Dismissed
Lindsay	T.C. Memo. 2001-285	Tax Court	Lien	Yes	IRS
Lopez	T.C. Memo. 2001-228	Tax Court	Lien and Levy	Yes	Dismissed
McMahan	T.C. Memo. 2001-191	Tax Court	Levy	No	Split
Obersteller	T.C. Memo. 2002-106	Tax Court	Lien and Levy	Yes	IRS
Tipp	T.C. Memo. 2001-272	Tax Court	Lien and Levy	Yes	Dismissed
Tkac	T.C. Summary Opinion 2001-175	Tax Court	Lien and Levy	Yes	Dismissed
Watson	T.C. Memo. 2001-213	Tax Court	Lien and Levy	Yes	IRS
Moore	T.C. Memo. 2001-305	Tax Court	Lien and Levy	No	IRS

Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)

Dogwood Forest Rest Home Inc.	181 F. Supp. 2d. 554 (2001)	Middle District of N.C.	Levy	No	IRS
Evergreen Resources Inc.	2002-1 U.S.T.C. 50,422	Eastern District of Ca.	Lien and Levy	No	Dismissed
Jon H. Berkey,	PC 2001-2 U.S.T.C. 50,708	Eastern District of Mich.	Levy	No	IRS
Barnhill	T.C. Memo. 2002-116	Tax Court	Levy	Yes	IRS
Herycyk	89 A.F.T.R. 2d 1584 (2001)	Northern District of Ohio	Lien and Levy	No	Sent back to Appeals
Pikover	2001-2 U.S.T.C. 50,702	Central District of Ca.	Lien	No	IRS
Bonfante	2002-1 U.S.T.C. 50,266	Southern District of Ohio	Levy	No	Dismissed
Thomson	2001-2 U.S.T.C. 50,614	Southern District of Fla.	Lien	No	Dismissed
The Inner Office Inc.	89 A.F.T.R. 2d 1311 (2002)	Northern District of Tx.	Levy	No	Dismissed



TABLE 3.2.1 — LITIGATED CASES: COLLECTION DUE PROCESS (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
CPS Elect. Ltd	200 F. Supp. 2d 120 (2002)	Northern District of N.Y.	Lien and Levy	No	IRS
Driver Logistics Service	197 F. Supp. 2d 1346 (2002)	Middle District of Fla.	Levy	No	Split
Lee	2002-1 U.S.T.C. 50,365	Middle District of Tenn.	Lien and Levy	Yes	Dismissed
Compucl Service Corporation	2002-1 U.S.T.C. 50,284	District Court for Md.	Levy	No	IRS
Dami	2002-1 U.S.T.C. 50,433	Western District of Pa.	Lien and Levy	No	IRS
Logical Marketing Inc	2002 US Dist. LEXIS 7516	Northern District of Ca.	Levy	No	Sent back to Appeals
Safe-Watch 24 Security Inc	2002 US Dist. LEXIS 2981	Northern District of Ga.	Lien and Levy	Yes	Dismissed
Sillavan	2002-1 U.S.T.C. 50,236	Northern District of Ala.	Levy	No	Dismissed
Wald	2002-1 U.S.T.C. 50,278	Southern District of Fla.	Levy	Yes	Dismissed
Service Engineering Trust	T.C. Memo. 2001-181	Tax Court	Lien and Levy	No	Split
Estate/Gift Taxpayers					
Estate of Doster	T.C.Memo. 2002-2	Tax Court	Lien and Levy	No	IRS

**LITIGATED
ISSUE #3**
TRADE OR BUSINESS EXPENSES
PRESENT LAW

Internal Revenue Code section 162(a) permits a taxpayer to deduct ordinary and necessary trade or business expenses paid or incurred during the taxable year.⁷³

These expenses include:

- ◆ Reasonable allowance for salaries or other compensation for personal services actually rendered;
- ◆ Travel expenses while away from home in the pursuit of a trade or business; and
- ◆ Rentals or other payments for use of property in a trade or business.⁷⁴

In addition to the general allowable expenses described above, IRC § 162 addresses deductible and non-deductible expenses incurred in carrying on a trade or business (e.g. fines and penalties; state legislators' travel expenses away from home; and special rules for health insurance costs of self-employed individuals).⁷⁵

Deductions for ordinary and necessary expenses incurred in carrying on a trade or business are closely related to a larger group of statutory provisions⁷⁶ that allow taxpayers to deduct business and profit-oriented expenditures at some time during the life of the enterprise – when the cost is paid or incurred, over an asset's useful life, when it is sold, or when the business venture is terminated.⁷⁷ Internal Revenue Code section 162 is one of the Code's most basic provisions, but it becomes considerably more complex when applied in conjunction with other sections. In effect, some code sections specifically limit or disallow deductions permitted under section 162's broad grant.

Rules regarding the practical application of IRC § 162 have evolved largely from the vast body of case law and administrative guidance (e.g., rulings and revenue procedures) that have developed over the years. The IRS, Congress and courts continue to pose questions and provide legal guidelines about whether a taxpayer is entitled to certain trade or business deductions. The litigated cases analyzed for this report reveal this process is ongoing. When a taxpayer seeks a redetermination of tax liability because the IRS has disallowed trade or business expenses, the courts must often address a series of questions before issuing decisions, including those discussed below.

⁷³ IRC § 446. The taxable year in which a business expense may be deducted depends on whether the taxpayer uses the cash or accrual method of accounting.

⁷⁴ IRC § 162 (a)(1), (2), and (3).

⁷⁵ IRC § 162(f), (h), and (l).

⁷⁶ Itemized Deductions for Individuals and Corporations (e.g., IRC § 165 losses, IRC § 167 depreciation, and IRC § 183 activities not engaged in for profit) and inventories (IRC § 471, cost of goods sold).

⁷⁷ Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates And Gifts* ¶ 20.1.1 (3rd ed. 1999)



What constitutes a trade or business as referenced in IRC § 162?

“Trade or Business” is one of the most widely used terms in the Internal Revenue Code, but no definition appears in the Code or in any Treasury Regulation.⁷⁸ In *Commissioner v. Groetzinger*, Justice Blackmun wrote “...the Code has never contained a definition of the words ‘trade or business’ for general application, and no regulation has been issued expounding its meaning for all purposes. Neither has a broadly applicable authoritative judicial definition emerged.”⁷⁹ The definition of “trade or business” comes from the so-called common law of federal income tax, concepts developed or defined by court decisions.⁸⁰

In 1987, the IRS challenged the decision of the United States Courts of Appeals for the Seventh Circuit, which affirmed the Tax Court’s ruling that the taxpayer, a full-time gambler, was engaged in a trade or business as defined by IRC § 162(a) and § 62(1).⁸¹ In the case at issue, *Commissioner v. Groetzinger*, the Supreme Court held “...that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer’s primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.” In the end, the Supreme Court admitted adherence to the general position of the Court’s holding in *Higgins v. Commissioner*, that whether a taxpayer is engaged in a trade or business depends on the fact of each case.⁸²

In reaching its decision in *Groetzinger*, the Supreme Court examined a number of significant cases and noted the cases produced results but no clear guidance in deciding what is a trade or business.⁸³ Justice Blackmun wrote, “The issue in this case has ‘been around’ for a long time and, as indicated above, has not met with consistent treatment in the Tax Court itself or in the Federal Courts of Appeals.”⁸⁴

What is an ordinary and necessary expense?

Ordinary and necessary business expenses are current business expenses that are paid or incurred during the taxable year and are fully deductible, as opposed to unreasonable expenses and capital expenditures. A current business expense must be both ordinary and

⁷⁸ F. Ladson Boyle, *What is a Trade or Business*, 39 Tax Law. 737 (1986). The term “trade or business” appeared in at least 492 subsections of the Code and 664 provisions of the regulations.

⁷⁹ 480 U.S. 23, 27 (1987).

⁸⁰ Carol Duane Olson, *Toward A Neutral Definition of “Trade or Business” In The Internal Revenue Code*, 54 U. Cin. L. Rev. 1199 (1986).

⁸¹ As defined by the Internal Revenue Code of 1954 as it existed in 1987, the tax year at issue.

⁸² 312 U.S. 212 (1941).

⁸³ E.g., *Flint v. Stone Tracy Co.* 220 U.S. 107 (1911); *Deputy v. DuPont*, 308 U.S. 488 (1940); *Higgins v. Commissioner*, 312 U.S. 212 (1941).

⁸⁴ 480 U.S. 23, 32-33 (1987).

necessary in relation to the taxpayer's trade or business.⁸⁵ In *Welch v. Helvering*,⁸⁶ Justice Cardozo emphasized the difference between "ordinary" and "necessary" and the need to satisfy both in order to achieve the deduction. In *Deputy v. du Pont*, the Supreme Court held that an expense is considered ordinary if it is customary or usual and is of common occurrence in the taxpayer's business.⁸⁷ An expense is considered necessary if it is appropriate and helpful for the development of taxpayer's business.

In addition to being ordinary and necessary, the courts have held that the amount of the expense must be reasonable. In *Commissioner v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held "...the element of reasonableness is inherent in the phrase 'ordinary and necessary.' Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount."⁸⁸ Specific statutory language provides that salaries or other compensation for personal services actually rendered must be reasonable, and travel expenses incurred while away from home in pursuit of trade or business must not be lavish or extravagant.⁸⁹

Is the expense a currently deductible expense or capital expenditure?

A currently deductible expense is an ordinary and necessary expense that is paid or incurred during the taxable year in carrying on a trade or business.⁹⁰ Examples of currently deductible expenses are management expenses, labor, supplies, incidental repairs, operating expenses of automobiles used in trade or business and traveling expenses while away from home solely in pursuit of trade or business.⁹¹

A capital expenditure is the amount paid for a new building or for permanent improvements that increase value or lengthen useful life, subject to certain exceptions.⁹² As such, no deductions are allowed for cost of acquisition, construction, improvement, or restoration of an asset that is expected to last more than one year.⁹³ Instead, capital expenditures may be subject to amortization, depletion, or depreciation over the useful life of the property. Determining whether expenditures are deductible under IRC § 162(a) or must be capitalized under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach in applying principles of capitalization and deductibility.

⁸⁵ IRC § 162 (a).

⁸⁶ 290 U.S. 111 (1933); *see also* *Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345 (1971).

⁸⁷ 308 U.S. 488, 495 (1940); *see also* *Commissioner v. Tellier*, 383 U.S. 687, 698 (1966).

⁸⁸ 176 F.2d 815, 817 (6th Cir. 1949).

⁸⁹ IRC § 162(a)(1) and (2).

⁹⁰ IRC § 162(a).

⁹¹ *See* Treas. Reg. § 1.162-1 for a more complete list.

⁹² IRC § 263.

⁹³ IRC § 263(a); Treas. Reg. § 1.263 (a)-2.



In *Commissioner v. Lincoln Savings and Loan Association*, the IRS sought review of a decision of the United States Court of Appeals for the Ninth Circuit holding that the taxpayer's statutorily mandated payment to the Federal Savings and Loan Insurance Corporation (FSLIC) was a deductible capital expenditure and ordinary and necessary business expense under section 162(a) of the Internal Revenue Code of 1954. The Supreme Court held the payment served to create a separate and distinct additional asset for the taxpayer. Thus, the payment was capital in nature and not an ordinary and necessary expense.⁹⁴

In *INDOPCO Inc., v. Commissioner*, the taxpayer sought review of a decision of the United States Court of Appeals for the Third Circuit, which affirmed the United States Tax Court's holding that certain legal and professional expenses incurred by the taxpayer as part of a friendly takeover by another corporation were capital expenditures and not currently deductible business expenses under IRC § 162(a). The Supreme Court affirmed the lower courts' decision that the takeover resulted in long-term, future benefits for the taxpayer. It rejected the taxpayer's argument that because the expenses did not create a separate and distinct additional asset they could not be capitalized under section 263 of the Code.⁹⁵ In response to the taxpayer's argument, the Court clarified its holding in *Lincoln*, "*Lincoln Savings* stands for the simple proposition that a taxpayer's expenditure that 'serves to create or enhance...a separate and distinct' asset should be capitalized under § 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under IRC § 263."⁹⁶

Can the taxpayer substantiate that the expense was paid or incurred during the taxable year?

Present law requires a taxpayer to maintain books and records that substantiate income, deductions and credits.⁹⁷ A taxpayer must keep adequate records to substantiate deductions claimed as trade or business expenses.⁹⁸ If a taxpayer is unable to substantiate deductions by documentary evidence (e.g. invoice, paid bill, or canceled check) but can establish that he had some deductible business expenditures, the *Cohan Rule* may apply.

The *Cohan* rule is a rule of "indulgence" that was established by the United States Court of Appeals for the Second Circuit in its decision in *Cohan v. Commissioner*.⁹⁹ The Court of Appeals held "...the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to

⁹⁴ 403 U.S. 345 (1971).

⁹⁵ 503 U.S. 79 (1992).

⁹⁶ 503 U.S. 79, 86-87 (1992).

⁹⁷ IRC § 6001; Treas. Reg. § 1.446-1(a)(4).

⁹⁸ IRC § 6001; Treas. Reg. § 1.6001-1(a), (e).

⁹⁹ 11 BTA 743 (1928), aff'd and rev'd, 39 F.2d 540, 543-544 (2d Cir. 1930).

allow nothing at all appears to us inconsistent with saying that something was spent.”¹⁰⁰ A taxpayer can argue entitlement to deduct business expenses under the *Cohan* rule but if he is unable to establish a reasonable basis for the expense, the Court is not compelled to follow the rule.

In *Williams v. Commissioner*, the United States Court of Appeals for the Fifth Circuit held “For the basic requirement is that there be sufficient evidence to satisfy the trier that at least the amount allowed in the estimate was in fact spent or incurred for the stated purpose. Until the trier has that assurance from the record, relief to the taxpayer would be unguided largesse.”¹⁰¹

In the event that the IRS has applied the *Cohan* rule in determining a deficiency amount, the taxpayer bears the burden of proving entitlement to a larger deduction. The courts have stated on numerous occasions that trade and business deductions are a matter of legislative grace and a taxpayer bears the burden of proving entitlement to any deduction claimed.¹⁰²

In certain instances, Congress has required specific and exact substantiation of expenses. For example, IRC § 274(d) requires strict substantiation of expenses for travel, meals and entertainment, and gifts, with respect to any listed property as defined in IRC § 280F(d)(4). Listed property includes any passenger automobile or other means of transportation.¹⁰³ A taxpayer is required to substantiate a claimed IRC § 274(d) expense by adequate records or sufficient evidence corroborating the taxpayer’s statement establishing the amount, time, and place and business purpose of the expense. Even if such an expense would otherwise be deductible, the deduction may still be denied if there is insufficient substantiation to support it.¹⁰⁴

Who has the burden of proof in a substantiation case?

When the Commissioner of Internal Revenue issues a notice of proposed deficiency to a taxpayer, it is presumed to be correct, and the burden is on the taxpayer to show that the proposed determination is incorrect. However, under certain circumstances, the burden of proof shifts to the Commissioner.¹⁰⁵

Internal Revenue Code section 7491, Burden of Proof, was enacted as part of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 1998).¹⁰⁶ Under the provi-

¹⁰⁰ 39 F. 2d 540, 544 (2d Cir. 1930).

¹⁰¹ 245 F.2d 559 (5th Cir. 1957).

¹⁰² *INDOPCO, Inc. v. Commissioner*, 503 U.S.79, 84 (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

¹⁰³ IRC § 280F(d)(4)(A)(i) & (ii).

¹⁰⁴ Treas. Reg. § 1.274-5T.

¹⁰⁵ IRC § 6663, Civil fraud is an exception to the Commissioner’s presumed correctness. The burden of proof has to be carried by clear and convincing evidence. See IRC § 7454 and United States Tax Court Rule 142(a).

¹⁰⁶ Pub. L. No. 105-206, § 3001(a) & (c)(1) (1998), 112 Stat. 685, 726, 727.



sions of IRC § 7491(a)(1), if, in any court proceeding, a taxpayer introduces credible evidence with respect to his tax liability the burden may shift to the Commissioner of Internal Revenue.¹⁰⁷ To shift the burden to the Commissioner, a taxpayer must meet these three requirements:¹⁰⁸

1. Taxpayer must comply with all substantiation and record keeping requirements in accordance with the applicable Internal Revenue Code section.
2. Taxpayer must cooperate with requests for witnesses, documents, meetings and interviews.
3. Finally, if the taxpayer is a partnership, corporation or trust, that taxpayer must meet the net worth requirements (less than \$7 million) of IRC § 7430(c)(4)(A)(ii).

ANALYSIS OF LITIGATED CASES

Trade or Business Expenses is listed as one of the top ten issues identified by the IRS in audits¹⁰⁹ for the fiscal years 1998, 1999 and 2000, and one of the top ten Appeals issues in Coordinated Examination Program (CEP) audits by dollar amounts and number of cases.¹¹⁰ Prior editions of the National Taxpayer Advocate's Annual Report to Congress have identified Trade or Business Expenses as one of the issues most litigated by taxpayers.

Ninety-five cases involving trade or business expense issues were identified and selected for review for this year's report.¹¹¹ Deduction of allowable expenses under IRC § 162(a) and subject to the strict substantiation of IRC § 274(d) is the top litigated issue for individual taxpayers, especially *pro se* taxpayers.¹¹² The top litigated issues for business taxpayers are deduction of current expenses under IRC § 162(a) versus capitalizing expenditures under IRC § 263(a) and deduction of expenses for reasonable allowance for salaries or other compensation for personal services actually rendered (IRC § 162(a)(1)).

¹⁰⁷ IRC § 7491(a)(1) applies to court proceedings in which the examination started after July 22, 1998, and if there is no examination, to the taxable period or events which started or occurred after July 22, 1998.

¹⁰⁸ IRC § 7491(a)(2)(A) & (a)(2)(B), & (a)(2)(C).

¹⁰⁹ Joint Committee Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986; GAO-01 301R Information on Federal Tax System C-115 (April 2001). Identifies audit sources as Coordinated Examination Program (CEP) audits, non-CEP audits, district office audits and service center audits for individuals, corporate, fiduciary, estate, and other returns.

¹¹⁰ Joint Committee Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986; GAO-01 301R Information on Federal Tax System C-115 TO C-125 (April 2001).

¹¹¹ Individual taxpayers include sole proprietor and the self-employed. Business taxpayers include corporations, trust and partnerships.

¹¹² Parties who represent themselves in a court proceeding without the assistance of a lawyer are called *Pro se*. The right to self-representation comes from the Latin words: "Pro se" which means "For oneself; on one's own behalf; without a lawyer." Black's Law Dictionary (7th ed. 1999), at 1236-1237.

TABLE 3.3.1
TRADE OR BUSINESS EXPENSE ISSUES LITIGATED

ISSUE AND NUMBER OF CASES	TAXPAYER		
	INDIVIDUAL	BUSINESS	ESTATE
Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d) (30 cases)	30		
Carrying on a trade or business and entitled to deductions (12 cases)	11	1	
Current expenses ordinary and necessary in trade or business (10 cases)	10		
Deduction of expense and Substantiation and application of the <i>Cohan</i> Rule (10 cases)	9		1
IRC § 162(a) and other applicable IRC sections (9 cases)	8	1	
Deduction and substantiation of Traveling expenses while away from home in pursuit of trade or business (3 cases)	3		
Current Deductible Business Expense v. Capital Expenditure IRC § 162(a) v. § 263(a) (8 cases)	2	6	
Deduction of punitive fine or penalties disallowed per IRC § 162(f) (2 cases)	1	1	
Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1) (6 cases)		6	
Deduction of expense treated as compensation per IRC § 162(a)(1) and limitations of IRC § 274(a) (3 cases)		3	
Refund Suit for employment taxes related to Claimed Business Expenses (1 case)		1	
Deduction of rent or other payments for property in use of trade or business IRC § 162(a)(3) (1 case)		1	
Total	74	20	1

Eighty-seven percent of the cases were filed in United States Tax Court. The courts ruled in favor of the IRS in 70 of the 95 cases, with the appeals courts deciding in favor of the IRS in seven out of nine cases. Individual taxpayers were not successful as a category of litigants. The courts decided in favor of two individual taxpayers and issued split decisions in 13 cases.



TABLE 3.3.2
COURT DECISIONS

TYPE OF TAXPAYER	IRS	TAXPAYER	SPLIT
Individual	59	2	13
Business	10	9	1
Estate	1	0	0
Total	70	11	14

Individual Taxpayers

This group of individual taxpayers presented little or no evidence to support their claimed deductions, did not give credible testimony, and often lacked knowledge of tax law. In most cases, the taxpayer appeared ignorant of the strict substantiation requirements for business and trade expenses, and that without substantial proof, the courts could not overcome the strictures of IRC § 274(d).

In *Xuncax v. Commissioner*, the Tax Court wrote:

“First, the record is entirely devoid of anything which could corroborate the self-serving averments that cash payments were in fact made during the year at issue. Second, even if we were willing to accept that cash had been remitted, the record provides no basis for a reasonable estimate of the deductible amount. The oral testimony contains no numerical information whatsoever, as to either the number or the amount of payments, and the written statement is both ambiguous and so blatantly conjectural as to be almost useless for estimation purposes.”¹¹³

The number of adverse decisions in individual taxpayer cases raised the following questions:

- ◆ Why is deduction of trade or business expenses one of the ten most litigated tax issues in federal court?
- ◆ More specifically, why is the trade or business expense deduction in accordance with IRC § 162 and § 274(d) one of the ten most litigated issues by *pro se* taxpayers, despite the strict substantiation requirements set forth by law?

¹¹³ *Xuncax v. Commissioner*, T.C. Memo 2001-226, * 15-16.

A detailed analysis of 30 of the original 95 cases was conducted to identify factors, if not answers, to these questions. *Pro se* taxpayers filed 28 of the 30 petitions in the Tax Court cases. The court ruled in favor of one *pro se* taxpayer, issued split decisions in eight cases and ruled against twenty-one *pro se* taxpayers. Fourteen cases were filed under regular procedures and sixteen were filed under the small tax case procedures.¹¹⁴ Overall, the Tax Court accommodated *pro se* taxpayers, especially those who filed their cases under small tax case procedure. The small tax case procedures are heard and decided by special trial judges, do not require briefs or oral arguments, and operate informally. However, a major drawback, especially for *pro se* taxpayers, is that the court's decision in small tax cases cannot be appealed.

Individual taxpayers routinely claimed expenses for cars and transportation without possessing understanding or knowledge of the substantiation requirements under IRC § 274(d). Many of these litigants, *pro se* taxpayers, could not meet that burden.¹¹⁵

In *Newhouse v. Commissioner*, the Court noted: "When petitioner was questioned about the existence of substantiation for his business expenses, specifically the automobile expenses, he replied: 'I have found it to be not financially worthwhile to complete detailed logs of things.' He added that 'I don't have any detailed records with me at this time.'"¹¹⁶

In some cases, the Tax Court did not allow *pro se* taxpayers trade or business deductions in excess of those allowed by the Commissioner, absent documentation. In *Franklin v. Commissioner*, the Tax Court wrote:

At trial petitioner presented no documentary evidence to support his claims for deductions in excess of the amounts allowed by respondent. Petitioner argued that he had records to substantiate amounts that would exceed those allowed by respondent; however, his records were 'scattered' in several places, and, with sufficient time he could produce the records that would establish his entitlement to additional deductions.¹¹⁷

In cases where taxpayers provided the IRS with a factual basis to estimate eligible expenses under the *Cohan* rule after the Tax Court petition was filed, the court allowed a reasonable estimation.

¹¹⁴ See Tax Court Rule 170, Small Tax Case Procedures.

¹¹⁵ In *Arhontes v. Commissioner*, T.C. Summary Opinion 2002-10, the Tax Court in finding for IRS noted that "Evidence fell short."

¹¹⁶ *Newhouse v. Commissioner*, T.C. Summary Opinion 2002-18, * 10-11.

¹¹⁷ T.C. Summary Opinion 2002-13, * 5.



In *Furnish v. Commissioner*, a favorable ruling for the individual taxpayer, the Tax Court wrote: "...the record establishes that the petitioner fully cooperated with the IRS from the audit level through the trial stage. Furthermore, having observed petitioner's appearance and demeanor at trial, we find him honest, forthright and credible."¹¹⁸ The Court found the taxpayer's testimony credible and estimated his deductible expense for labor cost, office expense, utilities and car and truck expenses for the three years at issue.¹¹⁹

In another case with a favorable ruling for the taxpayer, the burden of proof shifted to the IRS on the issue of deduction of business expense for advertising. The Tax Court allowed the taxpayers the full amount of the deduction claimed on their income tax return.¹²¹

In cases where the taxpayers came to court prepared, brought adequate information and documentation to support their deductions, and offered credible testimony the Tax Court allowed deductions to the extent possible.¹²¹

An individual taxpayer representing him or herself in federal tax matters is not a new trend. In the last ten years, *pro se* taxpayers filed 75 percent of the petitions filed in the United States Tax Court.¹²² *Pro se* taxpayers represent a growing customer base of the IRS Office of Appeals. The IRS Office of Appeals' mission is to resolve tax controversies, without litigation, on a fair and impartial basis for both the government and the taxpayer.¹²³ During a presentation at an IRS Nationwide Tax Forum in 2002, Appeals acknowledged that 77 percent of its customer base now consists of *pro se* taxpayers.¹²⁴ "IRS as a whole and Appeals specifically, need to do a better job of explaining the Appeals process and taxpayer rights. IRS will need to tailor our communications with taxpayers to ensure that the needs of individual taxpayers will be met."¹²⁵

¹¹⁸ T.C. Memo 2001-286, * 10-11.

¹¹⁹ T.C. Memo 2001-286, * 12.

¹²⁰ *Possas v. Commissioner*, T.C. Summary Opinion, 2002-28.

¹²¹ See, e.g., *Krist v. Commissioner*; T.C. Summary Opinion 2001-140; *Lemos v. Commissioner*, T.C. Summary Opinion 2002-29; *Webb v. Commissioner*, T.C. Summary Opinion 2001-172.

¹²² IRS Chief Counsel Automated Tracking System, TL 708A, Prepared by CC:FM:PM:O.

¹²³ IRM 8.1.3.2 Appeals Mission (May 19, 1998).

¹²⁴ The 2002 Nationwide Tax Forums are the Service's major outreach activity to the tax practitioner community. Appeals participated, and in response to the requests from the participants provided copies of their presentations, available at <http://www.irs.gov/pub/irs-utl/newappealsinternet.pdf>.

¹²⁵ 2001 TNT 27-9; *IRS Releases Strategic Plan for Fiscal Years 2000-2005*. (IRS Strategic Plan fiscal year 2000-2005 (February 7, 2001) (doc 2001-3873).

Business taxpayers were more successful than individuals when litigating trade or business expense issues.¹²⁶ Two significant decisions were issued:

- ◆ In *Sutherland Lumber-Southwest, Inc. v. Commissioner*,¹²⁷ the IRS disallowed all deductions claimed by a corporation for expenses incurred in allowing its officers to use corporate aircraft for vacations. The Tax Court rejected the IRS' argument that the corporation's deduction, under IRC § 162, was limited to the amount claimed as compensation by the officers rather than the actual cost of providing vacation flights. The Eighth Circuit Court of Appeals affirmed the Tax Court decision. The Tax Court followed the eighth circuit court's ruling in two subsequent cases.¹²⁸ On February 11, 2002, IRS Chief Counsel issued an Action on Decision (AOD) recommending acquiescence in cases with the same set of facts.¹²⁹
- ◆ In *U.S. Freightways Corp v. Commissioner*, the IRS determined that the corporate taxpayer improperly deducted its vehicle fleet operating expenses. The Tax Court agreed with the IRS and ruled that the corporation was required to capitalize these expenses. The Court of Appeals for the Seventh Circuit reversed the Tax Court's findings. The Seventh Circuit weighed all of the arguments and determined that the fleet operating expenses at issue were fixed one-year items and the benefits expired within that set year.¹³⁰ The Court of Appeals for the Seventh Circuit recognized a "one-year rule" for purposes of allowing a deduction for prepaid license fees and insurance premiums. The expenses were allowed as ordinary and necessary expenses deductible under IRC § 162 (a).¹³¹

In January 2002, the IRS issued an advance notice of proposed rulemaking seeking public comments on rules that would clarify the application of Internal Revenue Code section 263(a) for expenditures incurred in acquiring, creating, or enhancing certain intangible assets or benefits.¹³² "The IRS and the Treasury Department are concerned that the current level of uncertainty and confusion is neither fair to taxpayers nor consistent with sound and efficient tax administration."¹³³

¹²⁶ Twenty cases filed by business taxpayers were reviewed as part of the larger group of 95 cases. The court ruled in favor of the IRS in ten cases, in favor of the taxpayer in nine cases and issued a split decision in one case.

¹²⁷ 255 F.3d 495 (8th Cir. 2001).

¹²⁸ *Midland Fin. Co. v. Commissioner*, T.C. Memo 2001-203; *Nat'l Bancorp of Alaska, Inc. v. Commissioner*, T.C. Memo 2001-202.

¹²⁹ 2002 AOD LEXIS 1, CC-2002-02 (Chief Counsel Action on Decision).

¹³⁰ 270 F.3d 1137 (7th Cir. 2001).

¹³¹ "The case was remanded to the Tax Court for the limited purpose of considering the Commissioner's argument that the taxpayer's method of accounting did not clearly reflect income. 270 F.3d 1137,1147 (7th Cir. 2001).

¹³² 67 Fed. Reg. 3461 (Jan. 24, 2002).

¹³³ 67 Fed. Reg. 3461-3462 (Jan. 24, 2002).



Tax litigation filed by business taxpayers crossed industry lines¹³⁴ and attracted attention and in some cases support from stakeholders.¹³⁵ Deduction of trade or business expense issues litigated by businesses included:

- ◆ Reasonable compensation,¹³⁶
- ◆ Trade or business expense versus capital expenditures,¹³⁷
- ◆ Expenses deducted for amounts treated as compensation and/or fringe benefits to employees,¹³⁸ and
- ◆ Deduction of amounts paid to redeem common stock held in the employee stock ownership trust (ESOT) underlying the Employee Stock Ownership Plan (ESOP).¹³⁹

¹³⁴ Businesses litigating trade or business expense deduction issues between June 1, 2001 and May 31, 2002 included major airlines, financial institutions, automobile makers, trucking companies and service companies.

¹³⁵ In the case of *U.S. Freightways v. Commissioner*, 270 F. 3d 1137 (2001), the National Federation of Independent Business (NFIB) Legal Foundation joined the American Trucking Association Inc., in filing an amicus brief.

¹³⁶ IRC § 162(a)(1); *International Capital Holding Corp. v. Commissioner*, T.C. Memo 2001-262.

¹³⁷ IRC § 162 and IRC § 263; See *Wilson v. CIR*, T.C. Memo 2002-61.

¹³⁸ IRC § 162 (a); IRC § 274 (a)(1); IRC § 274 (e)(2); Treas. Reg. § 1.61-21; *Midland Financial Corp. v. Commissioner*, T.C. Memo 2001-203.

¹³⁹ IRC § 311(a); IRC § 317 (b); *Chrysler Corporation v. Commissioner*, T.C. Memo 2001-244.

CONCLUSION

Advocating legislative changes to substantiation requirements for trade or business expense deductions does not appear to be the most effective method of reducing litigation over trade or business expenses.

A look at the legislative history of IRC §§ 162 and 274(d) reveals the efforts by past presidents, Congress and the Treasury to curb abuse relating to improper deductions for meals and entertainment.¹⁴⁰ The most controversial effort occurred in 1984, when Congress changed the record keeping requirements for expenditures subject to section 274(d), and established tax preparer and negligence penalties.¹⁴¹

The laws regarding substantiation of business expenses, particularly under IRC § 274(d) with respect to entertainment and transportation, are well established. This case analysis indicates that individuals, especially *pro se* taxpayers, with trade or business expenses will benefit from the IRS taking a proactive approach through education, outreach, and partnering with stakeholders.

¹⁴⁰ In 1961, Treasury reported to Congress that widespread abuse was developing in the use of expense accounts. President Kennedy recommended disallowing business entertainment deductions, curtailing deductions for business travels and business gifts and limiting the amount of deduction for business meals. See Revenue Act of 1962, S. Rep. No. 87-1881 (1962) reprinted at 1962-3 C.B. 707. These proposals were intended to prevent personal and extravagant expenses from being borne by the federal government (i.e. by other taxpayers). Instead, Congress enacted legislation that included strict substantiation requirements. In 1978, President Carter proposed a similar plan, calling for disallowance of all business entertainment deductions and restricting deductions of business meal expenses. Congress rejected this plan, deciding instead to limit deductions of expenses for entertainment facilities. In 1984, Treasury released its plan, proposing a complete denial of all deductions for entertainment expenses. See Wendy Gerzog Shaller, *Limit Deductions for Mixed Personal/Business Expenses: Curb Current Abuse and Restore Some Progressivity Into The Tax Code*, 41 Cath. U.L. Rev. 581 (1992).

¹⁴¹ The Tax Reform Act of 1984, (Pub. L. No. 98-369, Sec. 179(b)(2)) made three distinct changes to IRC § 274(d). It required taxpayers to keep contemporaneous records; it eliminated the ability of taxpayers to offer written and oral testimony in lieu of records, and it added other forms of transportation to the list of property subject to the requirements of IRC § 274(d). In an attempt to improve compliance, Congress enacted two controversial retroactive changes to prior law. First, it made paid income tax preparers responsible for advising taxpayers of the substantiation requirements of IRC § 274(d) and to get written confirmation from the taxpayers that they met the requirements. The second change related to the negligence penalty; it would now be applied to any portion of an underpayment attributable to failure to comply with the record keeping requirements.



TABLE 3.3.3
LITIGATED CASES: TRADE OR BUSINESS EXPENSES

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Taxpayers <i>Note: If sufficient information to identify the issue was not available in the court case, it was placed in this category.</i>					
Allison	T.C. Summary Opinion 2001-161	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Arhontes	T.C. Summary Opinion 2002-10	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Awadallah	T.C. Summary Opinion 2001-93	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Beck	T.C. Memo. 2001-198	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	IRS
Bedoy	T.C. Summary Opinion 2001-120	Tax Court	Current expenses ordinary and necessary to trade or business	No	IRS
Beecroft	T.C. Summary Opinion 2001-166	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Bjornstad	T.C. Memo. 2002-47	Tax Court	Deduction and substantiation of travel expenses while away from home in pursuit of trade or business	Yes	Split
Bland-Barclay	T.C. Memo. 2002-20	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	IRS
Blodgett	T.C. Memo. 2001-147	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Boyd	T.C. Memo. 2002-46	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	No	Split
Brayshaw	T.C. Summary Opinion 2002-22	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Bright	T.C. Summary Opinion 2001-164	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS

TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Burton	T.C. Summary Opinion 2002-19	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Bush	T.C. Memo. 2002-33	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Calimer	T.C. Summary Opinion 2001-75	Tax Court	Deduction and substantiation of travel expenses while away from home in pursuit of trade or business	Yes	IRS
Campbell	28 Fed. Appx. 613 (2002)	8th Circuit	Current expenses ordinary and necessary to trade or business	No	IRS
Chapell	T.C. Memo. 2001-146	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Clark	T.C. Memo. 2002-32	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Cotta	T.C. Summary Opinion 2001-133	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
De Bane	T.C. Summary Opinion (CCH) 2002-5	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Ecker	T.C. Summary Opinion 2002-44	Tax Court	Current expenses ordinary and necessary to trade or business	No	Split
Emmit	T.C. Memo. 2001-179	Tax Court	Carrying on a trade or business and entitled to deductions	No	IRS
Erbs	T.C. Summary Opinion 2001-85	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Favero	T.C. Memo. 2001-219	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Franklin	T.C. Summary Opinion 2002-13	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Friedmann	T.C. Memo. 2001-207	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	IRS
Furnish	T.C. Memo. 2001-286	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Taxpayer



TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Gage	T.C. Memo. 2002-72	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
Gale	T.C. Memo. 2002-54	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	IRS
Garrett	T.C. Summary Opinion 2001-126	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Glenn	T.C. Summary Opinion 2001-83	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Griffin	T.C. Memo. 2002-6	Tax Court	IRC § 162(a) and other application IRC sections	No	IRS
Hamdan	12 Fed. Appx. 590 (2001)	9th Circuit	Current expenses ordinary and necessary to trade or business	Yes	IRS
Ihlenfeldt	T.C. Memo. 2001-259	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	Split
Kang	T.C. Summary Opinion 2001-97	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	Split
Kringen	T.C. Summary Opinion 2001-169	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Krist	T.C. Summary Opinion 2001-140	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Kwan	T.C. Memo. 2002-16	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Land	T.C. Summary Opinion 2001-111	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Lemos	T.C. Summary Opinion 2002-29	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Levitt	T.C. Summary Opinion 2001-147	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Levy	T.C. Memo. 2001-136	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	IRS

TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Lewis	T.C. Summary Opinion 2002-49	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	IRS
Llewellyn-Rose	T.C. Summary Opinion 2002-8	Tax Court	Deduction and substantiation of travel expenses while away from home in pursuit of trade or business	Yes	IRS
Lobato	2002-1 U.S.T.C. 50,332 (2002)	Northern District of Oklahoma	IRC § 162(a) and other application IRC sections	No	IRS
Mayo	T.C. Summary Opinion 2001-146	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
McKelvey	T.C. Memo. 2002-63	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
McMullen	T.C. Summary Opinion 2001-87	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Mejanartowicz	T.C. Summary Opinion 2001-150	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	IRS
Mosier	T.C. Summary Opinion 2001-104	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Newhouse	T.C. Summary Opinion 2002-18	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Olsen	T.C. Memo. 2002-42	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Osborne	T.C. Memo. 2002-11	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
Owens	T.C. Memo. 2001-143	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Pappas	T.C. Memo. 2002-127	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
Possas	T.C. Summary Opinion 2002-28	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	Taxpayer



TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Poyda	T.C. Summary Opinion 2001-91	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	IRS
Richards	T.C. Summary Opinion 2002-3	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Romer	T.C. Memo. 2001-168	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Seawright	117 T.C. 294 (2001)	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	Split
Simpson	23 Fed. Appx. 425 (2001)	6th Circuit	Deduction of expense, substantiation, and application of Cohan Rule	Yes	IRS
Sullivan	T.C. Memo 2002-131	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Sweet	2001 T. C. Summary LEXIS 293	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	No	IRS
Tokh	25 Fed. Appx. 440 (2001)	7th Circuit	Deduction of expense, substantiation and application of Cohan Rule	Yes	IRS
Triplett	T.C. Memo. 2001-230	Tax Court	Deduction of punitive fine or penalties disallowed under IRC § 162(f)	Yes	IRS
Trudel	T.C. Summary Opinion 2002-39	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
Tsakopoulos	T.C. Memo. 2002-8	Tax Court	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS
Vaksman	T.C. Memo. 2001-165	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Verma	T.C. Memo. 2001-132	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS

TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Webb	T.C. Summary Opinion 2001-172	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Wilson	T.C. Memo. 2001-301 Opinion 2001-172	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	No	IRS
Wilson	T.C. Memo. 2002-61	Tax Court	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	Yes	IRS
Xuncax	T.C. Memo. 2001-226	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Zanath	T.C. Summary Opinion 2001-118	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	IRS

Business Taxpayers (Corporation, Partnership, Trust Issues)

B&D Foundations, Inc	T.C. Memo. 2001-262	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	IRS
Beech Trucking Co., Inc.	118 T.C. 428 (2002)	Tax Court	IRC § 162(a) and other application IRC sections	No	IRS
Caralan Trust	T.C. Memo. 2001-241	Tax Court	Carrying on a trade or business and entitled to deductions	No	IRS
Chrysler Corporation	T.C. Memo. 2001-244	Tax Court	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS
Damron Auto Parts, Inc.	T.C. Memo. 2001-197	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	Taxpayer
Florida Progressive Corporation	264 F.3d 1313 (2001)	11th Circuit	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS



TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Haffner's Service Stations Inc.	T.C. Memo. 2002-38	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	IRS
Hunt & Sons Inc.	T.C. Memo. 2002-65	Tax Court	IRC § 162(a)(3) Deduction of rent or other payment for use of property in trade or business	No	Split
Illinois Tool Works Inc.	117 T.C. No. 4 (2001)	Tax Court	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS
International Capital Holding Corp.	T.C. Memo. 2002-109	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	Taxpayer
Midland Financial Co.	T.C. Memo. 2001-203	Tax Court	Deduction of expense treated as compensation per IRC § 162(a)(1) and IRC § 274 (a)(1) and (e)(2)	No	Taxpayer
National Bancorp of Alaska, Inc.	T.C. Memo. 2001-202	Tax Court	Deduction of expense treated as compensation per IRC § 162(a)(1) and IRC § 274 (a)(1) and (e)(2)	No	Taxpayer
Plastic Engineering & Technical Services	T.C. Memo. 2001-324	Tax Court	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS
Sutherland Lumber-Southwest Inc.	255 F.3d 495 (2001)	8th Circuit	Deduction of expense treated as compensation per IRC § 162(a)(1) and IRC § 274 (a)(1) and (e)(2)	No	Taxpayer
Talley Industries Inc.	18 Fed. Appx. 661 (2001)	9th Circuit	Deduction of punitive fine or penalties disallowed under IRC § 162(f)	No	IRS

TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
UAL Corporation	117 T.C. No. 2 (2001)	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	Taxpayer
United Airlines Inc.	51 Fed. Cl. 722 (2001)	Ct. Fed. Claims	Refund of Employment taxes related to payment of employee travel expenses	No	Taxpayer
United Dairy Farmers Inc.	267 F. 3d 510 (2001)	6th Circuit	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS
U.S. Freightways Corp.	270 F. 3d 1137 (2001)	7th Circuit	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	Taxpayer
Wagner Construction Inc.	T.C. Memo. 2001-160	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	Taxpayer

Estate/Gift Taxpayers

Estate of Gaffner	T.C. Memo. 2001-239	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	No	IRS
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MOST LITIGATED TAX ISSUES



PRESENT LAW

The Internal Revenue Code of 1986 includes more than 200 provisions that require valuation of property or rights to property in order to assess the correct tax liability. A few of these sections and related rulings are:

- ◆ **Internal Revenue Code section 2031(a):** The fair market value (FMV) of a decedent's gross estate shall be determined by including, to the extent provided, the value at the time of death of all property, real or personal, tangible or intangible, wherever situated.
- ◆ **Internal Revenue Code section 2512(a):** The fair market value (FMV) of the property at the date of a gift shall be considered the amount of the gift.
- ◆ **Internal Revenue Code section 2701:** Special valuation rules and restrictions apply in the case of transfers of interests in corporations or partnerships.
- ◆ **Revenue Ruling 81-253:** No minority shareholder discount is allowed with respect to transfers of shares of stock between family members based upon a composite of the family members' interest at the time of the transfer.
- ◆ **Revenue Ruling 59-60 as modified by Revenue Ruling 65-193:** Specific methods are provided for valuing shares of capital stock of closely held corporations for estate tax purposes. These methods may also be applied to corporate stocks on which market quotations are unavailable or scarce.

The IRS has outlined its approach, methods and factors for valuing shares of stock for closely held corporations as well as corporate stocks.¹⁴² Corporate stocks are defined as the capital or principal funds raised by a corporation through subscribers' contributions or the sale of shares.¹⁴³ A closely held corporation is defined as a business of which 20 percent or more shares are owned by one individual or as a corporation with 45 or fewer shareholders.¹⁴⁴ Issues regarding both stock valuation and closely held partnerships are regularly litigated in the federal court system.

Determining fair market value has long been essential in administering both the income tax and estate tax laws. The IRS established the Engineering and Valuation Program to meet this need. The concepts of cost basis, fair market value and depreciation of assets created an immediate need for specialists in the natural resources and utilities fields. By the end of the 1920s, the IRS employed 45 Engineer Specialists. As demand for their services grew, more Engineers and Valuation Specialists joined the IRS workforce. The Engineering and Valuation Program is today part of the Field Specialist Group under the

¹⁴² Rev. Rul. 59-60, 1959-1 C.B. 237 as modified by Rev. Rul. 65-193, 1965-2 C.B. 370.

¹⁴³ Black's Law Dictionary 1428 (7th ed. 1999).

¹⁴⁴ IRC § 6166(b)(1).

Large and Mid-Size Business (LMSB) Operating Division. The primary function of this program is to provide specialized services to the IRS Examination, Collection, Criminal Investigation, Appeals, and Counsel employees.

Valuation specialists receive referrals from the IRS operating divisions to assist with the valuation of property, corporate stocks, closely held corporations, art, intangibles, and other items. In many cases, the amount of tax liability depends on technical considerations, engineering issues, or asset valuations.

ANALYSIS OF LITIGATED CASES

Valuation represents approximately one percent of IRS Chief Counsel's open tax cases for litigation. Between June 1, 2001 and May 31, 2002, 54 valuation cases were litigated within the federal court system. A detailed listing of the cases can be found on Table 3.4.2. The cases tried are categorized as follows:

TABLE 3.4.1
TYPES OF VALUATION CASES

TYPE OF VALUATION	TOTAL CASES	ESTATE AND GIFT TAX	INDIVIDUAL INCOME	CORPORATE INCOME
Stock valuation (mostly closely held)	10	8	1	1
Value of partnership/real estate interests	13	13		
Sales/leaseback/leases/rentals	4		1	3
Worthless stocks/bad debts/losses	5		1	4
Excessive compensation	3			3
Sham transactions	6		4	2
Charitable contributions	4		4	
Lottery winnings/annuity tables	2	2		
Other cases	7		3	3
Total	54	23	14	17

Twenty-three of the 54 delegated cases involved estate and gift tax returns. The two most common issues for this category of cases were closely held stock and partnership/real estate interests. Of these 23 cases, 10 were rulings by the United States Court of Appeals, 12 were Tax Court decisions, and one was a United States Court of Federal Claims case.

The applicability and determination of the value of minority discounts and lack of marketability discounts were prevalent issues in these cases. These discounts are associated with determination of the fair market value of property for federal estate and gift tax purposes. The outcome of the litigated cases generally favors taxpayers in that the proposed notice of deficiency is usually adjusted.



The cases reviewed involved closely held corporations or partnership interests where market quotations were not available and where in-depth analysis was necessary to determine whether the value should be adjusted for marketability, minority interest or other factors. The analysis of the litigated cases for business taxpayers in Table 3.4.2 indicates that many of the cases contained the following factors that led to litigation:

- ◆ Inconsistencies in statistical data.
- ◆ Lack of supporting documents to collaborate or substantiate the analysis and conclusion that discounts are applicable, and the amount of the discount to be applied.
- ◆ Expert witnesses for both the taxpayer and the IRS who did not address or provide proper support for analysis relating to discount factors.

According to an IRS Counsel report dated April 18, 2002, 29 valuation cases were settled prior to litigation. These included 18 cases settled by Appeals, seven by Counsel, and four that were dismissed for lack of jurisdiction. All settled cases in this category dealt with stock or real property valuation. IRS Counsel litigated 14 valuation cases from June 1, 2001 through May 31, 2002. Most of the valuation issues in these cases also involved closely held stock and valuation of property or real estate.

Of the 54 sample cases litigated, only four contained issues of charitable contributions. Since this is such a small part of the sample, it would appear that most issues regarding gifts of assets are resolved during the audit or appeals process.

CONCLUSION

There are many different methodologies for determining the fair market value (FMV) of property. The United States Tax Court has observed:

Disputes over valuation fill our dockets, and for good reason. We approximate that 243 sections of the Code require fair market value estimates in order to assess tax liability, and that 15 million tax returns are filed each year on which taxpayers report an event involving a valuation-related issue. It is no mystery, therefore, why valuation cases are ubiquitous.

Today, valuation is a highly sophisticated process. We cannot realistically expect that litigants will, will be able to, or will want to, settle, rather than litigate, their valuation controversies if the law relating to valuation is vague or unclear.

We must provide guidance on the manner in which we resolve valuation issues so as to provide a road map by which the Commissioner, taxpayers, and valuation practitioners can comprehend the rules applicable thereto and use these rules to

resolve their differences. Clearly articulated rules will also assist appellate courts in their review of our decisions in the event of an appeal.¹⁴⁵

The LMSB Operating Division has recognized the need for additional guidance in this area. LMSB has begun to address the inconsistencies and vagueness by creating the Valuation Policy Council, which is reviewing policies and procedures regarding the valuation and engineering program. The Council has developed a charter, held meetings and established a review team to study the internal workings of valuation. The team made several recommendations to improve the valuation process and developed guidelines that are required for business valuation as of October 2002. The team's recommendations are explained in Publication 3579 and are listed below:

- ◆ Establish an IRS Valuation Policy Council;
- ◆ Establish an Issue/Industry Specialist position for valuation issues;
- ◆ Develop guidelines for valuing real property interests;
- ◆ Update Revenue Ruling 59-60;
- ◆ Develop guidelines for valuing personal property;
- ◆ Require taxpayers to substantiate their valuation opinions;
- ◆ Produce a vehicle to provide guidance to taxpayers on valuations for all federal tax purposes; and
- ◆ Recommend that Counsel consider revising the estate and gift regulations to update and remove obsolete material.

The Valuation Policy Council will partner with other operating divisions to implement more clearly defined business valuation standards for all examiners and valuation specialists within IRS. Training to help define these new standards began in October 2002. The IRS is also developing guidelines concerning real and personal property valuations.

LMSB is working with the Small Business/Self-Employed Operating Division (SB/SE) to revise Form 8283 (Non-cash Charitable Contributions). The IRS is considering whether to establish an appraisal program so that Appeals settlements will benefit from valuation expertise. This will allow valuation specialists to put their knowledge toward a uniform, consistent approach.

LMSB has taken a leadership role in responding to recurring litigation in the valuation area. Its work includes developing a strategy for pre-filing activities, providing guidance and education to taxpayers, and establishing policy with the input of our external and internal stakeholders.¹⁴⁶ These initiatives could help to reduce the number of valuation cases litigated.

¹⁴⁵ Estate of Aufer v. Commissioner, TC Memo. 1998-185.

¹⁴⁶ Internal Revenue Service Publication 3579 (02-2000), *Valuation Policy & Procedures*.



TABLE 3.4.2
LITIGATED CASES: VALUATION

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Income Tax (Issues Other Than Business Issues)					
Arbini	T.C. Memo 2001-141	Tax Court	Charitable contribution/ FMV	No	IRS
Berry	T.C. Memo 2001-311	Tax Court	Sham transactions/ valuation overstatement	No	IRS
Cameron	2002 Tax Ct Summary Lexis 4	Tax Court	Value of charitable contributions	Yes	Split
Caracci	T.C. Memo 2002-25	Tax Court	TP participation in asset transfer	No	IRS
Carroll	22 Fed. Appx. 52 (2001)	2nd Cir.	Sham transaction/ valuation overstatement	No	IRS
Espinosa	24 Fed. Appx. 825 (2001)	9th Cir.	Transferee liability / TP insolvent or solvent at time of transfer	No	IRS
Gow	19 Fed. Appx. 90 (2001)	4th Cir.	Sham transactions / Valuation of stock	No	IRS
Yeager	T.C. Memo 2002-9	Tax Court	Section 183 Horse Breeding Expectation assets may appreciate in value	No	Taxpayer
Schmidt	T.C. Summary Opinion 2002-23	Tax Court	Casualty loss Earthquake repairs	Yes	IRS
Seawright	117 T.C. 294	Tax Court	Inventory valuation	Yes	Split
Thornsjo	T.C. Memo 2001-129	Tax Court	Sham transaction/ valuation overstatement	No	IRS
Tate	118 T.C. 354	Tax Court	Charitable contribution and stock	No	IRS
Wetizman	T.C. Memo 2001-215	Tax Court	Sham transaction / Valuation overstatement	Yes	IRS
Whitehead	T.C. Memo 2001-317	Tax Court	FMV employee leased vehicles	No	IRS
Landrum	T.C. Summary Opinion 2001-112	Tax Court	Charitable contributions /FMV	No	IRS

TABLE 3.4.2 — LITIGATED CASES: VALUATION (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Business Income (Schedule C, Corporation, Partnership, Trust Issues)					
Andantech L.L.C.	T.C. Memo 2002-97	Tax Court	Sale/Leaseback of computer equipment	No	IRS
B & D Foundations Inc.	T.C. Memo 2001-262	Tax Court	Excessive compensation sole shareholder	No	IRS
Bemidji Distributing Co, Inc.	T.C. Memo 2001-260	Tax Court	Value of covenant not to compete	No	Split
Boca Investering Partnership	167 F. Supp. 2d 298 (2001)	District Court for DC	Sham transactions	No	Taxpayer
DHL Corp	285 F.3d 1210 (2002)	9th Cir.	Valuation misstatements and sale of international trademark	No	Split
Eddie Cordes, Inc.	T.C. Memo 2001-265	Tax Court	Valuation of transferred assets	No	IRS
Flint Industries	T.C. Memo 2001-276	Tax Court	Worthless stock / Bad debt deduction	No	Split
FMC Corp	T.C. Memo 2001-298	Tax Court	Theft losses/stock redemption valuation	No	IRS
Haffner's Service Station Inc	T.C. Memo 2002-38	Tax Court	Excessive compensation in reference officers bonuses	No	Split
Hunt & Sons, Inc.	T.C. Memo 2002-65	Tax Court	Excessive FMV Rental of Land/Sales leaseback issues	No	Split
Minnesota Lawyers Mutual Ins.	285 F.3d 1086 (2002)	8th Cir.	Insurance company unpaid losses /Estimates unreasonable	No	IRS
Nicole Rose Corp.	117 T.C. 328	Tax Court	Interest in business leases	No	IRS
Physicians Ins Co.	T.C. Memo 2001-304	Tax Court	Insurance company unpaid losses/Actuary Estimates	No	Split
Saba Partnership	273 F.3d 1135 (2001)	DC Cir	Sham transactions/ Installment sales lacked substance	No	Taxpayer



TABLE 3.4.2 — LITIGATED CASES: VALUATION (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
South Tulsa Pathology Lab	118 T.C. 84	Tax Court	Stock valuation/ reorganization/spin-off	No	IRS
Wagner Construction Co	T.C. Memo 2001-160	Tax Court	Excessive compensation/ sole shareholder	No	Split

Estate and Gift Tax

Adams	88 A.F.T.R. 2d 6057 (2001)	Northern District of Texas	Valuation of assignee partnership interest	No	Taxpayer
Adams	T.C. Memo 2002-80	Tax Court	Reduction of FMV stock interests	Yes	Split
Armstrong	277 F.3d 490 (2002)	4th Cir.	Under valuation of stock when gift tax paid	No	IRS
Baird	T.C. Memo 2001-258	Tax Court	Estates interests in timberland	No	Split
Cook	T.C. Memo 2001-170	Tax Court	Lottery winning value based on annuity tables	No	IRS
Costanza	T.C. Memo 2001-128	Tax Court	Transfer of real property where taxable gifts no sale	No	IRS
Edwards	T.C. Memo 2001-229	Tax Court	Interest in ranch land includible in gross estate/ oral options restrict sale of use	No	IRS
Fontana	118 T.C. 318	Tax Court	Stock aggregated increasing valuation	No	IRS
Godley	286 F.3d. 210 (2002)	4th Cir	Valuation of partnership Interests	No	IRS
Barlett	186 F. Supp. 2d 875 (2002)	Central District of Illinois	Transferee gift tax	No	IRS
Harper	T.C. Memo 2002-121	Tax Court	Limited partnership Interests	No	Split
Heck	T.C. Memo 2002-34	Tax Court	Valuation stocks closely held companies	No	Split
Helis	52 Fed. Cl. 745 (2002)	Court of Federal Claims	Partnership interests overvalued	No	Split

TABLE 3.4.2 — LITIGATED CASES: VALUATION (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Jameson	267 F.3d 366 (2001)	5th Cir.	Valuing the assets of the estate	No	Vacated and remanded
Rogers	281 F.3d 1108 (2002)	10th Cir.	Bad debt deductions/ loans to shareholders/ stock redemption	No	IRS
Dailey	T.C. Memo 2002-263	Tax Court	Valuation of family ltd. Partnership interests retained and gifted	No	Taxpayer
Mitchell	T.C. Memo 2002-98	Tax Court	Valuation of stock. burden of proof	No	Remand of valuation
Schwan	T.C Memo 2001-174	Tax Court	Stock closely held	No	Split
Shackleford	262 F.3d 1028 (2001)	9th Cir.	Lottery winnings/ annuity valuation	No	IRS
Trompeter	279 F.3d 767 (2001)	9th Cir.	Under reported value of estate / valuation of stock	No	Vacated and remanded
Trotter	T.C. Memo 2001-250	Tax Court	Value of real estate	No	IRS
True	T.C. Memo 2001-167	Tax Court	Closely held business interest buy sell agreements	No	IRS
Shepherd	283 F.3d 1258 (2002)	11th Cir.	Leased timberland gifted to family partnership/ minority shares	No	IRS



LITIGATED
ISSUE #5

EARNED INCOME TAX CREDIT (EITC)

PRESENT LAW

In 2002, the federal Earned Income Tax Credit (EITC) is expected to provide more than \$30 billion in refundable credits to low income working families.¹⁴⁷ The credit represents one of the nation's largest anti-poverty programs, moving an average of five million Americans above the poverty line each year.¹⁴⁸

Congress enacted the EITC in 1975¹⁴⁹ with the goal of relieving the working poor from Social Security taxes¹⁵⁰ and creating a greater work incentive for low income families.¹⁵¹ Working taxpayers with "earned income"¹⁵² can qualify for the credit in one of two ways, either with a "qualifying child"¹⁵³ or by "income-only."¹⁵⁴ For tax year 2001, the amount of EITC that could be claimed with a qualifying child or children ranged from \$9 to \$4008. The refundable credit ranged from \$2 to \$364 for taxpayers qualifying under the "income-only" rules.¹⁵⁵

¹⁴⁷ W&I Earned Income Tax Credit Program Office, EITC Reports – Submission Processing, August 2002.

¹⁴⁸ Center on Urban & Metropolitan Policy, The Brookings Institution and The Progressive Policy Institute, *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of EITC*, May 2002, p. 1.

¹⁴⁹ Tax Reduction Act of 1975; Public Law 94-12; (H.R. 2166); Title II Sec 204, Reductions in Individual Income Taxes, March 29, 1975. During this period in history, the United States economy experienced its sharpest decline since the 1930's. As the economic situation deteriorated, unemployment rates rose – from 5.2 percent in January 1974 to 8.2 percent in February 1975, which was the highest rate since 1941. S. Rep. No. 94-36 (1975)

¹⁵⁰ S. Rep. No. 94-36 (1975). The Earned Income Tax Credit was to provide relief to workers with dependent children who pay little or no income taxes but were subject to the social security payroll tax on their earnings. Because it would increase their after-tax earnings, the credit, in effect, was anticipated to provide an added bonus or incentive for low income people to work, and therefore, of importance in inducing individuals with families receiving Federal assistance to support themselves. It was also expected to be effective in stimulating the economy because the low-income people were expected to spend a large fraction of their increased disposable incomes. *Id.*, at *9-10.

¹⁵¹ H.R. Rep. No. 94-19 (1975). "The Tax Reduction Act of 1975 takes prompt and effective action to check the drastic downward slide in our economy and to restore economic growth and move us closer to full employment," at *2-3.

¹⁵² IRC § 32(c)(2).

¹⁵³ IRC § 32(c)(3).

¹⁵⁴ IRC § 32(c)(1)(A)(ii).

¹⁵⁵ IRS Publication 596, *Earned Income Credit (EIC) 2001*, Earned Income Credit Table.

General EITC Eligibility

For a taxpayer to claim the EITC, the following requirements must be met:

- ◆ The taxpayer must provide his or her taxpayer identification number (TIN)¹⁵⁶; if married, the TIN of the spouse is also required.¹⁵⁷ If qualifying children¹⁵⁸ are involved, the taxpayer must provide the name, age and TIN of each child.¹⁵⁹
- ◆ If married (as determined under IRC § 7703), the taxpayer must file a joint return for the taxable year.¹⁶⁰
- ◆ The taxpayer must be a U.S. citizen or resident alien.¹⁶¹ The term “eligible individual” does not include any nonresident alien, unless that person is treated as a resident of the United States for the taxable year¹⁶² and does not include any individual claiming benefits of IRC § 911 (citizens or residents living abroad) for the taxable year.¹⁶³
- ◆ The taxpayer must have earned income.¹⁶⁴ Taxable earned income includes wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income for the taxable year, plus net earnings from self-employment.¹⁶⁵
- ◆ The taxpayer must meet income thresholds, which vary according to how the credit is claimed.¹⁶⁶ For tax year 2001, the earned income could not exceed:
 - ◆ \$ 32,121 if the taxpayer claimed more than one qualifying child,
 - ◆ \$ 28,281 if the taxpayer claimed one qualifying child, or
 - ◆ \$ 10,710 if the taxpayer met “income only” qualifications.

¹⁵⁶ IRC § 32(c)(1)(F)(i). There are several types of taxpayer identification numbers including Social Security Numbers (SSN), IRS Individual Taxpayer Identification Numbers (ITIN), IRS Adoption Taxpayer Numbers (ATIN) and Employer Identification Numbers (EIN). Treas. Reg. § 301.6109-1.

¹⁵⁷ IRC § 32(c)(1)(F)(ii).

¹⁵⁸ IRC § 32(c)(3)(D).

¹⁵⁹ IRC § 32(m). For purposes of the EITC, a TIN means a SSN issued to an individual by the Social Security Administration.

¹⁶⁰ IRC § 32(d).

¹⁶¹ IRC § 32(c)(1)(E).

¹⁶² IRC § 6013(g) & (h).

¹⁶³ IRC § 32(c)(1)(D).

¹⁶⁴ IRC § 32(c)(2)(A).

¹⁶⁵ The Economic Growth and Tax Relief Reconciliation Act of 2001; Pub. L. No. 107-16, Title III, § 303 changed the definition of earned income to include wages, salaries, tips and other employee compensation, but only if such amounts are includible in gross income for the taxable year. Previous rules required taxpayers to include taxable and non-taxable earned income in determining EITC eligibility. Non-taxable earned income included such things as salary deferrals, salary reductions, and excludable employer-provided benefits. It also replaced modified adjusted gross income with adjusted gross income. These rules are effective beginning in 2002. Prior rules still apply to cases from previous years.

¹⁶⁶ IRC § 32(a)(2).



- ◆ The taxpayer's investment income must not exceed a specified amount.¹⁶⁷ For tax year 2001, investment income was capped at \$2,450. Investment income for most taxpayers is the total of taxable interest, tax-exempt interest, dividend income, and capital gain net income.
- ◆ The taxpayer claiming the credit must not be the qualifying child of another taxpayer.¹⁶⁸

Additional Requirements for Taxpayers with Qualifying Child or Children

Additional requirements apply to taxpayers claiming the EITC with one or more qualifying children:

- ◆ Qualifying children must meet a relationship test.¹⁶⁹ In general, an individual meets the relationship test if the qualifying child or children are:
 - ◆ a son or daughter, stepson or stepdaughter, or a descendent of any such individual, or
 - ◆ a brother or sister, stepbrother or stepsister, or a descendant of any such individual whom the taxpayer cares for as his or her own child, or
 - ◆ an eligible foster child (i.e., an individual not described above who is placed with the taxpayer by an authorized placement agency and whom the taxpayer cares for as his or her own child).
- ◆ Qualifying children must meet a "residency requirement."¹⁷⁰ A qualifying child or children must have the same principal place of abode as the taxpayer for more than one half of the taxable year. Beginning in tax year 2002, the residency test for a foster child or children has become more than one half of such taxable year instead of the entire year.¹⁷¹
- ◆ Qualifying children must meet certain age requirements.¹⁷² A qualifying child must be under the age of 19 at the end of the tax year, a student who has not reached the age of 24 at the end of the tax year,¹⁷³ or a child who is permanently and totally disabled¹⁷⁴ at any time during the tax year regardless of age.

¹⁶⁷ IRC § 32(i).

¹⁶⁸ IRC § 32(c)(1)(B).

¹⁶⁹ IRC § 32(c)(3)(B).

¹⁷⁰ IRC § 32(c)(3)(A)(ii).

¹⁷¹ In prior years, the residency requirement for foster children was for the entire year, which still applies to older cases. This change was enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, Title III, § 303.

¹⁷² IRC § 32(c)(3)(C).

¹⁷³ IRC § 151(c)(4).

¹⁷⁴ IRC § 22(e)(3).

- ◆ If an individual (or individuals) may be claimed and is claimed as a qualifying child by two or more taxpayers, the individual (or individuals) shall be treated as the qualifying child of the taxpayer who is:
 - ◆ a parent of the individual, or if the parents do not apply, the taxpayer with the highest adjusted gross income.
 - ◆ If the parents claiming the credit with respect to the qualifying child do not file a joint return, the child will be treated as the qualifying child of the parent with whom the child resided for the longest period of time, or the parent with the highest adjusted gross income if the child resides with both parents for the same amount of time.¹⁷⁵

Additional Requirements for Taxpayers Claiming EITC on “Income Only” Basis

The following are additional requirements for taxpayers claiming “income-only” EITC:

- ◆ The taxpayer must meet a residency test that requires the taxpayer’s principal place of abode to be in the United States for more than one-half of the taxable year.¹⁷⁶
- ◆ The taxpayer must meet an age requirement. The taxpayer, or if married, either the taxpayer or the spouse must be at least 25 years of age but less than 65 years of age before the close of the tax year.¹⁷⁷
- ◆ The taxpayer cannot be a dependent (under IRC § 151) of another taxpayer in the same calendar year.¹⁷⁸

ANALYSIS OF LITIGATED CASES

Fifty-two cases involving EITC issues were litigated in the federal court system during the period June 1, 2001 through May 31, 2002. A detailed listing of these cases is found in Table 3.5.6. The table categorizes the cases by the type of taxpayer.

The 52 EITC cases are broken down into the following six categories: legislative, procedural and substantive, minor or computational, new evidence, correspondence, or systemic.

¹⁷⁵ IRC § 32(c)(1)(C). Starting in 2002, if an individual may be claimed, and is claimed, as a qualifying child by two or more taxpayers for the same year, the taxpayer who is the parent of the qualifying child trumps all other individuals for eligibility. If both individuals are parents, the parent with whom the child resided for the longest period of time is the eligible individual. If the child resided with both parents for the same amount of time, then the parent with the highest adjusted gross income becomes the eligible individual. Previously, the individual with the highest modified adjusted gross income for the taxable year was the eligible individual with respect to claiming the EITC. The prior year rules apply to older cases.

¹⁷⁶ IRC § 32(c)(1)(A)(ii)(I).

¹⁷⁷ IRC § 32(c)(1)(A)(ii)(II).

¹⁷⁸ IRC § 32(c)(1)(A)(ii)(III).



TABLE 3.5.1
CATEGORIES OF EITC CASES

LEGISLATIVE	PROCEDURAL AND SUBSTANTIVE	MINOR OR COMPUTATION	NEW EVIDENCE	CORRESPONDENCE	SYSTEMIC
3	24	22	2	1	0
6%	46%	42%	4%	2%	0

The categories are defined as follows:

Legislative-based issues

- ◆ Unresolved problems that require legislation to resolve and were previously addressed in the National Taxpayer Advocate’s Annual Report to Congress.
- ◆ Unresolved problems that require other legislation to resolve.
- ◆ Resolved problems addressed by legislation enacted after the case was litigated.

Procedural and substantive-based issues

- ◆ IRS failed to administer existing tax laws, procedures or requirements correctly; or
- ◆ Taxpayers failed to correctly comply with existing tax laws, procedures or requirements.

Minor or computation-based issues

- ◆ EITC is affected as a result of adjustments to income, deductions or expenses.
- ◆ EITC is a secondary issue and not the primary reason litigation was initiated and may or may not be affected by the decision of the court.

New evidence-based issues

- ◆ The taxpayer or a third party provided new or additional information not previously considered by or provided to the IRS.

Correspondence-based issues

- ◆ IRS generated unclear correspondence to a taxpayer, and the taxpayer is unable to determine what is required to verify the claim.
- ◆ A taxpayer’s correspondence to the IRS failed to substantiate the taxpayer’s claim to the satisfaction of the IRS.
- ◆ The taxpayer failed to respond to the IRS.
- ◆ IRS failed to consider correspondence provided by the taxpayer during the examination or audit process.

Systemic-based issues

- ◆ An IRS system failed to perform correctly or an IRS process failed to achieve the expected results.¹⁷⁹

¹⁷⁹ None of the 52 cases involved systemic-based litigation.

ANALYSIS OF ISSUES

Legislative Based Issues

Congress has passed legislation or the National Taxpayer Advocate has made recommendations for all three of the litigated cases in the legislative category.

- ◆ There were two cases litigated that involved adjusted gross income (AGI) issues with other individuals living in the home.¹⁸⁰ The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) clarified the tiebreaker rule in situations where two or more individuals may claim the same qualifying child.¹⁸¹
- ◆ The remaining case involved a taxpayer who claimed his daughter for all tax purposes, including EITC.¹⁸² He based his decision on a divorce decree that granted him the right to claim a dependency exemption deduction for his daughter. This case, and many others, illustrates the confusion surrounding the differing definitions of who qualifies as a child for purposes of the dependency exemption, child care credit, filing status and EITC. It serves as an example of the need for a uniform definition of a qualifying child as proposed by the National Taxpayer Advocate, the Joint Committee on Taxation,¹⁸³ Congress,¹⁸⁴ and the Department of the Treasury.¹⁸⁵

Procedural and Substantive Based Issues

The 24 cases within the procedural and substantive category account for the largest number of cases tried. The procedural and substantive issues break down as follows:

- ◆ Thirteen cases involved taxpayers who did not or were not able to provide proof of relationship, residency, and/or meeting foster child guidelines (e.g., “cared for as the taxpayer’s own child”).¹⁸⁶

¹⁸⁰ *Obriot v. Commissioner*, T.C. Summary Opinion 2001-86 and *Obriot v. Commissioner*, T.C. Summary Opinion 2001-162.

¹⁸¹ IRC § 32(c)(1)(C).

¹⁸² *Rabold v. Commissioner*, T.C. Summary Opinion 2001-119.

¹⁸³ Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986; Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System, JSC-3-01, April 2001, p. 35.

¹⁸⁴ Tax Simplification Act of 2002, H.R. 5166, 107th Cong. (2002).

¹⁸⁵ Department of the Treasury, *Proposal for Uniform Definition of a Qualifying Child*, April 2002.

¹⁸⁶ *Argomaniz v. Commissioner*, T.C. Summary Opinion 2001-117; *Barajas v. Commissioner*, T.C. Summary Opinion 2002-59; *Briggsdaniels v. Commissioner*, T.C. Memo. 2001-321; *Carlisle v. Commissioner*, T.C. Summary Opinion 2002-11; *Jeter v. Commissioner*, T.C. Memo. 2001-223; *Mares v. Commissioner*, T.C. Memo. 2001-216; *Mayeux v. Commissioner*, T.C. Summary Opinion 2001-121; *Paramore v. Commissioner*, T.C. Summary Opinion 2001-113; *Poole v. Commissioner*, T.C. Summary Opinion 2001-163; *Reed v. Commissioner*, T.C. Summary Opinion 2001-89; *Rivera v. Commissioner*, T.C. Summary Opinion 2001-124; *Taylor v. Commissioner*, T.C. Summary Opinion 2002-25 and *Wilkerson v. Commissioner*, T.C. Summary Opinion 2002-37.



- ◆ One taxpayer's case was dismissed for failure to comply with court orders to produce documentation in support of her claim.¹⁸⁷
- ◆ Several taxpayers filed returns claiming Head of Household Filing Status, and courts found that they were ineligible (i.e., married or single filing status).¹⁸⁸
- ◆ One case was dismissed for failure to state a claim because the taxpayer was a prison inmate who as a statutory matter did not have earned income and therefore did not qualify for the EITC.¹⁸⁹
- ◆ One taxpayer's unearned rental income exceeded the allowable maximum for disqualified income.¹⁹⁰
- ◆ A taxpayer's claim for reimbursement of administrative and litigation costs was denied after family status issues were conceded.¹⁹¹
- ◆ A court ruled that an IRA withdrawal was includible in Modified Adjusted Gross income.¹⁹² (Applies under the former and current AGI for EITC purposes.)

Minor or Computation Based Issues

Of the 22 cases in this category, 10 dealt with business deductions and expenses.¹⁹³ These cases generally do not involve any substantive determination or holding by the court with regard to the Earned Income Tax Credit. The disposition of the cases and any resulting adjustments to the taxpayer's income may also result in an adjustment to or a denial of any earned income tax credit claimed by the taxpayer. These EITC issues are treated largely as computational matters by the parties and the courts and are not further addressed in the courts' opinions.

Six cases were bankruptcy based, either as initial litigation or as the appeal of a bankruptcy case.¹⁹⁴ These cases did not involve the IRS, and eligibility for or applicability of

¹⁸⁷ *Brown v. Internal Revenue Service*, 88 A.F.T.R. 2d 7331 (M.D. Ala. 2001).

¹⁸⁸ *Allen v. Commissioner*, T.C. Summary Opinion 2001-116; *Benitez v. Commissioner*, T.C. Summary Opinion 2002-12; *Chappell v. Commissioner*, T.C. Memo. 2001-146; *Kang v. Commissioner*, T.C. Summary Opinion 2001-97; *Ramirez-Ota v. Commissioner*, T.C. Summary Opinion 2002-27 and *Washington v. Commissioner*, T.C. Summary Opinion 2002-31.

¹⁸⁹ *Wilson v. Commissioner*, T.C. Memo. 2001-139; IRC § 32(c)(2)(B)(iv).

¹⁹⁰ *Holbrook v. Commissioner*, T.C. Summary Opinion 2001-135.

¹⁹¹ *Huynh v. Commissioner*, T.C. Memo. 2002-110.

¹⁹² *Phillips v. Commissioner*, T.C. Summary Opinion 2002-2; 2002 T.C. Summary LEXIS 3.

¹⁹³ *Allison v. Commissioner*, T.C. Summary Opinion 2001-161; *Residential Management Services Trust v. Commissioner*, T.C. Memo. 2001-297; *Coyle v. Commissioner*, T.C. Summary Opinion 2002-42; *Esposito v. Commissioner*, T.C. Memo. 2001-131; *Furnish v. Commissioner*, T.C. Memo. 2001-286; *Glenn v. Commissioner*, T.C. Summary Opinion 2001-83; *Land v. Commissioner*, T.C. Summary Opinion 2001-111; *Poyda v. Commissioner*, T.C. Summary Opinion 2001-91; *Sweet v. Commissioner*, 2001 T.C. Summary Lexis 293 and *Xuncax v. Commissioner*, T.C. Memo. 2001-226.

¹⁹⁴ *In re Allen*, 266 BR 713 (Bankr. N.D. Iowa 2001); *In re Ekenasi*, 271 BR 256 (S.D. W.V. 2002); *In re Hammermeister*, 270 BR 863 (Bankr. S.D. Ohio 2001); *In re Ivory*, 269 BR 890 (Bankr. N.D. Ala. 2001); *In re Jackson*, 2001 Bankr. LEXIS 1125 (Bankr. M.D. Ga. 2001); *In re Wessels*, 271 BR 313 (W.D. Wis. 2002).

the EITC was not being litigated. In some cases, the debtor's income was at issue in dischargeability or exempt property claimed. Thus, the court often noted deductions and credits including the EITC identified on the debtor's federal tax return.

- ◆ Three cases involved the discharge of student loans. They were identified for the review because the taxpayer's income tax return was part of the court case and contained an EITC claim.
- ◆ Two cases involved exempt property claims related to federal tax refunds, including EITC amounts.
- ◆ The remaining case involved discharge of a mortgage obligation. The tax return, which included EITC, was an incidental part of the case.

There were three Court of Appeals cases. In two instances, taxpayers appealed sentences after being convicted of making and/or aiding and assisting in the filing of false income tax returns claiming EITC.¹⁹⁵ The other Court of Appeals case¹⁹⁶ involved a class action lawsuit dealing with refund anticipation loans in which a member of the class claimed EITC.¹⁹⁷

In one of the remaining three cases, the taxpayer did not claim the EITC but did pay his mother a wage from his business in order to allow her to have earned income and thus be eligible to claim the EITC.¹⁹⁸ In another case, an increase in income cut the EITC.¹⁹⁹ The final case involved income-only EITC eligibility and the taxability of gross income annuity payments received from the retirement plan of a deceased spouse.²⁰⁰

New Evidence Based Issues

In the first of two cases where new evidence was presented to the court, the taxpayer and a former spouse were issued statutory notices of deficiency because they both claimed their children for EITC purposes.²⁰¹ The former spouse failed to challenge the parallel deficiency notices by filing a timely action in United States Tax Court. The IRS considered his default as evidence in favor of the taxpayer. The Commissioner conceded that the taxpayer was entitled to the EITC. The litigation related to the taxpayer's right to recover attorney fees and costs under IRC § 7430.

¹⁹⁵ *United States v. Leonard* 289 F.3d 984 (7th Cir. 2002); *United States v. Price*, 89 A.F.T.R. 2d 2544 (10th Cir. 2002).

¹⁹⁶ *Reynolds v. Beneficial National Bank*, 288 F.2d 277 (7th Cir. 2002).

¹⁹⁷ A refund anticipation loan is a loan made to a taxpayer based upon an expected refund. This loan is a contract between a taxpayer and lender. The IRS is not involved in this contract.

¹⁹⁸ *Awadallah v. Commissioner*, T.C. Summary Opinion 2001-93.

¹⁹⁹ *Quintero v. Commissioner*, T.C. Summary Opinion 2002-47.

²⁰⁰ *Whittaker v. Commissioner*, T.C. Memo. 2001-224.

²⁰¹ *Sherbo v. Commissioner*, 255 F.3d 650 (8th Cir. 2001).



The second case involved the 1997 and 1998 tax years of a taxpayer and wife who separated in 1995. Based on the wife's testimony, the taxpayer was allowed EITC and the head-of-household filing status on his 1997 income tax return.²⁰²

Correspondence Based Issues

The sole correspondence-based case dealt with possible errors identified by the IRS on the taxpayer's income tax return.²⁰³ The taxpayer contended that he and his wife made several attempts to correct certain discrepancies by visiting an IRS office, writing correspondence, and conducting telephone conversations. The court stated that "the essence of the petitioner's difficulties appear to stem from his perceived inability to obtain accurate and relevant information from the IRS. Petitioner now turns to the court for assistance, although it is unclear what specific relief he seeks."²⁰⁴ In his original complaint, the taxpayer asked for a more favorable determination regarding his indebtedness. However, he failed to identify specific determinations of the IRS that he challenged or to clarify the relief he was seeking. The court dismissed the case for lack of jurisdiction and failure to state a claim.

Court Decisions and Representation

The analysis of the 52 litigated cases identified the decision rendered by the court in each case as well as the type of taxpayer representation.

Table 3.5.2 below outlines the decisions of the court.

TABLE 3.5.2
COURT DECISIONS

COURT DECISION SUMMARY ²⁰⁵				
LITIGATION BASED CATEGORY	FOR IRS/U.S.	FOR TAXPAYER	SPLIT DECISION	DISMISSED
Legislative (3)	1		2	
Procedural and Substantive (24)	15	3	5	1 ²⁰⁶
Minor or Computational (22)	11	4	7	
New Evidence (2)			2	
Correspondence (1)	1			
Total Review (52)	28²⁰⁷ (54%)	7 (13%)	16 (31%)	1 (2%)

²⁰² *Corona v. Commissioner*, T.C. Summary Opinion 2001-181. EITC and the head-of-household filing status were disallowed for 1998.

²⁰³ *Stubblefield v. Commissioner*, 2002-1 USTC ¶ 50,382 (S.D. Texas 2002).

²⁰⁴ *Stubblefield v. Commissioner*, 2002-1 USTC ¶ 50,382 (S.S. Texas 2002), at 2.

²⁰⁵ The determinations in this table reflect the entirety of the courts' decisions – not just the EITC issue.

²⁰⁶ *Brown v. Internal Revenue Service*, 88 A.F.T.R. 2d 7331 (M.D. Ala. 2001). In the dismissed case, the court stated that the taxpayer engaged in a clear pattern of willful contempt, evidenced by her repeated failure to comply with the orders of the court. The court dismissed the case without prejudice as the least severe sanction that will remedy plaintiff's inaction in the case. The taxpayer failed to provide any evidence to support her claim to either the IRS or the Court.

²⁰⁷ In five of the cases, the respondent was other than the IRS.

In 69 percent or 36 of the cases tried, the taxpayers represented themselves. The remaining 31 percent or 16 cases were litigated by attorneys. The court decisions by representation were as follows:

TABLE 3.5.3
COURT DECISIONS BY REPRESENTATION

COURT DECISIONS BY REPRESENTATION					
PRO SE - 36			ATTORNEY REPRESENTATION - 16		
For IRS/ Government	21	58%	For IRS/Government	7	44%
For TP	2	6%	For TP	5	31%
Split Decision	12	33%	Split Decision	4	25%
Dismissed	1	3%	Dismissed	0	0
Totals	36	100%		16	100%

The majority of cases involved non-business or individual taxpayers, who represented themselves (*pro se*) in 65 percent of cases tried. The remaining Schedule C (Profit or Loss From Business (Sole Proprietorship)) taxpayers elected to represent themselves 80 percent of the time. See Table 3.5.6 for a detailed listing of the cases by type of taxpayer, individual or business.

ANALYSIS OF SETTLED CASES

During the period April 19, 2001 through April 18, 2002, either the Office of Chief Counsel or Office of Appeals settled 635 cases with EITC issues after the cases were docketed but before they were litigated.²⁰⁸ Of the 635 cases identified, 139 case summaries were selected for review.²⁰⁹ The findings are:

- ◆ Ninety-two percent (128) had the potential to be resolved earlier in the process.²¹⁰
- ◆ Eighty-six percent (119) included dependency-exemption issues.
- ◆ Eighty-one percent (113) involved lack of documentation as the basis of disagreement.
- ◆ Eleven percent, or 12 of the 113 lack of documentation cases, included foster child issues.

²⁰⁸ Case Cross Reference By Unique Issue Listing Report 04/19/2001 to 04/18/2002. The Office of Chief Counsel developed its Unique Issue Listing (UIL) system to track the types of cases where taxpayers petitioned the Tax Court.

²⁰⁹ A random sample of cases from the UIL was selected for review. Originally, there were 159 settled cases selected. Sixteen files could not be located and four did not involve the EITC as an issue. Case summaries were provided instead of the actual case files to avoid disclosure concerns.

²¹⁰ One hundred and four of the case summaries received from the Office of Appeals included a category identified as “maybe” as an answer to “could the case have been resolved earlier in the process?” The “maybe” and “yes” answers were combined as having the potential for earlier resolution.



- ◆ Seventy-one percent (98) dealt with filing status issues. Ninety-three percent or 91 of the 98 cases, involved Head of Household (HOH) filing status.
- ◆ Four percent (6) dealt with Schedule C (Profit or Loss From a Business [Sole Proprietorship]) issues.

Table 3.5.4 below identifies the outcome of the settled cases.

TABLE 3.5.4
SETTLED CASES

SETTLED CASE RESOLUTION SUMMARY		
FOR IRS	FOR TAXPAYER	SPLIT DECISION
19 (14%)	81 (58%)	39 (28%)

OBSERVATIONS

Every individual taxpayer must determine his or her filing status when filing a federal income tax return (i.e., single, head-of-household, married filing jointly, or married filing separately) and the number of personal and dependency exemptions to which they are entitled. Additionally, millions of taxpayers must determine EITC eligibility to take advantage of the refundable credit available to low income working families.²¹¹

The complexity of the tax law, with its multiple definitions of a child and numerous rules and exceptions, causes taxpayers and IRS employees alike to make errors while trying to navigate the process of determining eligibility. In tax year 2000, the IRS held 416,000 taxpayer refunds due to EITC issues.²¹² As outlined in the present law section of this report, taxpayers claiming the EITC with a qualifying child must meet 11 requirements to qualify for the credit, while those claiming income-only EITC must meet ten requirements.

²¹¹ In tax year 2001, 19,777,601 taxpayers filed returns claiming the EITC. (EITC Coverage Rate Report, June 24, 2002, W&I EITC Reports and Reference Data: Earned Income Tax Credit Coverage Rate (FY 1996 – 2002)).

²¹² Report 1 – Exam Section Service Center Inventory – dated 05-25-01. The total number projected was 470,160. The May report was the last in which W&I and SBSE combined available data.

Often, the errors made while attempting to determine eligibility result in the IRS withholding refunds, generating error notices, and issuing statutory notices of deficiency to taxpayers. These disputes may take months or in some cases more than a year to resolve. As a result, many taxpayers petition the Tax Court to resolve the EITC issue. Approximately 22 percent of the docketed cases for the period from October 1, 2001 through July 31, 2002, consist of EITC, dependency exemption and filing status issues, which represent approximately 12 percent of IRS Counsel's time.²¹³

Litigated vs. Settled

Fifty-two cases litigated between June 1, 2001 and May 31, 2002 identified EITC as an issue. From April 19, 2001 to April 18, 2002, the IRS Counsel and Appeals functions settled 635 cases with EITC issues after being docketed and prior to litigation.²¹⁴ The number of cases docketed or litigated before being resolved clearly illustrates the burden placed on low income taxpayers trying to qualify for EITC. Eighty-six percent of settled cases resulted in a full or partial settlement for the taxpayer. This raises a concern about why settlements were not reached earlier in the process.

Litigated and settled cases were reviewed for commonalities and variances. The following is a comparison of the findings between the two types of cases reviewed.

- ◆ Cases dealing with multiple issues (such as EITC, dependency exemptions and filing status)
 - Litigated cases – 90 percent (47 cases out of 52 reviewed)*
 - Settled Cases – 96 percent (134 cases out of 139 reviewed)*
- ◆ Cases dealing with documentary issues (such as residency, relationship and foster child guidelines)
 - Litigated cases – 25 percent (13 cases out of 52 reviewed)*
 - Settled cases – 81 percent (113 cases out of 139 reviewed)*

There was a significant difference in the outcome of litigated cases and settled cases. Table 3.5.5 below gives a comparison.

²¹³ IRS Counsel tracking information from October 1, 2001 to July 31, 2002.

²¹⁴ Case Cross Reference By Unique Issue Listing Report, 04/19/2001 to 04/18/2002.



TABLE 3.5.5
LITIGATED VS. SETTLED DECISIONS

LITIGATED VERSUS SETTLED DECISION – OUTCOME COMPARISON		
	LITIGATED	SETTLED
For IRS/Government	28 (54%)	19 (14%)
For Taxpayer	7 (13%)	81 (58%)
Split Decision	16 (31%)	39 (28%)
Dismissed	1 (2%)	-
Total Reviewed	52	139

Our review of the 52 Tax Court cases involving the EITC indicates a variety of reasons why taxpayers petition the court. Fifty-six percent of the litigated cases reviewed contained EITC, Dependency Exemptions, head-of-household filing status or a combination of these factors as a key issue in the case. Twenty-four percent of those cases resulted in a split decision where the taxpayer prevailed on at least one of the family status issues litigated.

Many of these issues have been or will be addressed by recent legislation²¹⁵ or through legislative recommendations made in the National Taxpayer Advocate's FY 2001 Annual Report To Congress.²¹⁶ Proposed legislation would reduce taxpayer burden, lessen complexity and move toward simplification and fair administration of this intricate portion of the tax code.²¹⁷

Procedural and substantive issues accounted for a large number of disputes. These issues include such items as lack of documentation concerning relationship, including eligible foster child, residency and filing status. The analysis of cases indicates a considerable lack of understanding regarding eligibility issues and presents the IRS with an opportunity to administratively improve the EITC program.

²¹⁵ *Economic Growth and Tax Relief Reconciliation Act of 2001*; Pub. L. No. 107-16, Title III, § 303.

²¹⁶ In FY 2001, the National Taxpayer Advocate recommended five legislative changes to reduce taxpayer burden and simplify the tax code in the area of family status. The recommendations are: Create a Uniform Definition of a Qualifying Child, Remove Means-Tested Public Assistance and Other Government Benefits in the Computation of Support, Require a "Voluntary" Release of Exemptions by Custodial Parents, Eliminate the Age Restrictions for Taxpayers Claiming Earned Income Tax Credit with No Qualifying Child, and Expand the Definition of Head of Household Filing Status. *National Taxpayer Advocate FY 2001 Annual Report To Congress*, December 31, 2001, p. 76.

²¹⁷ Tax Simplification Act of 2002, H.R. 5166, 107th Cong. (2002).

Documentary Evidence

A cross-functional team within the IRS is identifying items and information that would qualify as documentary evidence to support relationship and residency requirements. The National Taxpayer Advocate is represented on this team. Administrative changes to documentary evidence requirements to prove relationship and residency and foster care guidelines should improve the taxpayers' ability to substantiate their claims and resolve issues without petitioning the Tax Court.

Foster Child Guidelines

In 1997, 1.8 million children lived with relatives, with neither of their parents present in the home, according to the analyses of the 1997 National Survey of America's Families (NSAF). The majority (1.3 million) of these children lived with kin privately without involvement of the child welfare system, while half a million children were removed from their parents by a public agency because of abuse or neglect and placed with kin.²¹⁸

The National Survey of America's Families is evidence of the increase in the number of non-traditional families. In 1999, 1,710,828 million returns claimed foster children as dependents.²¹⁹ Understandable guidelines for taxpayers in non-traditional family roles are necessary. There is an opportunity for improvement by providing an understandable definition and clear guidelines for the term "cared for as the taxpayer's own child."

Today, taxpayers arrive at one interpretation of caring for a foster child as one's own child, while the IRS arrives at another. Judges of the Tax Court have also grappled with this issue. None of the litigated cases reviewed can be cited as precedent, but there are clear indications of factors considered by the courts. Some of the factors considered by the Tax Court in determining a parental role include:

- ◆ Providing financial assistance. (On its own, the mere fact of contributing financially does not rise to the level of caring for an individual as one's own child).
- ◆ Assisting with homework.
- ◆ Enforcing discipline.
- ◆ Teaching personal hygiene.
- ◆ Educating about social issues.

²¹⁸ Jennifer Ehrie, Rob Green & Rebecca Clark, *Children Cared for by Relatives: Who Are They and How Are They Faring?* Urban Institute, February 2001, p. 1.

²¹⁹ Tax Year 1999, Information Returns Transaction File (IRTF).



For those non-traditional families where the child lives without either parent present, the current restrictive requirement the child be placed by an “authorized placement agency” can yield counter-intuitive and undesirable results. For example, a court order awarding an unrelated person custody of the child may not be considered placement by an authorized placement agency.

The National Taxpayer Advocate supports administrative procedures that will provide clear guidance for EITC eligibility, including the types of factors used in court case determinations. This guidance will assist employees and taxpayers in making accurate determinations about their eligibility for the EITC. These administrative procedures may require changes to regulations, Internal Revenue Manuals, and other published materials.

CONCLUSION

This review demonstrates how complicated it is for taxpayers and IRS employees to determine EITC eligibility. Many findings from the review confirm the problems that the National Taxpayer Advocate’s previous recommendations, TAS systemic advocacy initiatives, and pending legislation have attempted to address. There are of course EITC cases that are litigated because of legitimate interpretive and factual disputes. However, this analysis makes clear that all too many low income taxpayers struggle to determine EITC eligibility. Even when their determinations are correct, they may not be able to make their cases under current processes unless they seek judicial intervention.

TABLE 3.5.6
LITIGATED CASES: EARNED INCOME TAX CREDIT

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Taxpayers (Other Than Business)					
Allen	266 BR 713 (Bankr. N.D. Iowa 2001)	Bankruptcy Court Northern District of Iowa	Exempting tax refund and EITC from bankruptcy proceedings	NO	Split
Allen	T.C. Summary Opinion 2001-116	Tax Court	Head-of-Household filing status and EITC for three children	YES	Split
Argomaniz	T.C. Summary Opinion 2001-117	Tax Court	Dependency exemption deductions, Head-of-Household filing status, child care credit, child tax credit and EITC for niece and nephew	YES	IRS
Barajas	T.C. Summary Opinion 2002-59	Tax Court	Petitioner's siblings qualifying under eligible foster child requirement	YES	Taxpayer
Benitez	T.C. Summary Opinion 2002-12	Tax Court	Married taxpayer used Head-of-Household filing status, claiming dependency exemption deductions and EITC	YES	IRS
Briggsdaniels	T.C. Memo. 2001-321	Tax Court	Dependency exemption deduction, head-of household filing status and EITC claimed for taxpayer's children living in state foster care	YES	IRS
Brown	88 A.F.T.R. 2d 7331 (M.D. Ala. 2001)	US District Court for the Middle District of Alabama	IRS violated constitutional rights by denying EITC	YES	Dismissed
Carlisle	T.C. Summary Opinion 2002-11	Tax Court	Guardianship of child for dependency exemption deduction and EITC	YES	IRS



TABLE 3.5.6 — LITIGATED CASES: EARNED INCOME TAX CREDIT (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Corona	T.C. Summary Opinion 2001-181	Tax Court	Dependency exemption deductions, Head-of-Household filing status, child tax credit and EITC claimed by both parents	YES	Split
Ekenasi	271 BR 256 (S.D.W.V. 2002)	Bankruptcy Court Southern District of W.V.	Appeal decision of U.S. Bankruptcy discharge for student loan	NO	Upheld discharge of student loan.
Esposito	T.C. Memo. 2001-131	Tax Court	Federal income tax deficiencies and accuracy-related penalties	YES	IRS
Hammermeister	270 BR 863 (Bankr. S.D. Ohio 2001)	Bankruptcy Court Southern District of Ohio	Dischargeability of a mortgage obligation (imposed by state court divorce decree) under bankruptcy. (Hammermeister v Hammermeister)	NO	Taxpayer (Wife/Plaintiff)
Huynh	T.C. Memo. 2002-110	Tax Court	Claims for dependency exemption, filing status and EITC. Claims for court costs.	NO	Split
Ivory	269 BR 890 (Bankr. N.D. Ala. 2001)	Bankruptcy Court for the Northern District of Alabama	Discharge of Student Loan	NO	Taxpayer
Jackson	2001 Bankr. LEXIS 1125 (Bankr. M.D. Ga. 2001)	Bankruptcy Court for Middle District of Georgia.	Exempting tax refund and EITC from bankruptcy proceedings	NO	Taxpayer
Jeter	T.C. Memo. 2001-223	Tax Court	Dependency exemption deductions for 2 children and relative, claiming EITC	YES	IRS

TABLE 3.5.6 — LITIGATED CASES: EARNED INCOME TAX CREDIT (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Leonard	289 I. 3d 984 (7th Cir. 2002)	7th Circuit US Appeals	Sentence for guilty plea one count tax fraud	NO	Affirmed sentence
Mares	T.C. Memo. 2001-216	Tax Court	Dependency exemption deductions for siblings and mother, Head-of- household filing status, and EITC	YES	IRS
Mayeux	T.C. Summary Opinion 2001-121	Tax Court	Dependency exemption deduction and qualifying children for EITC	NO	Taxpayer
Obriot	T.C. Summary Opinion 2001-86	Tax Court	EITC with a qualifying child and Head-of- Household filing status	YES	Split
Obriot	T.C. Summary Opinion 2001-162	Tax Court	Dependency exemption deduction for daughter, Head-of-Household filing status, childcare credits and EITC	YES	Split
Paramore	T.C. Summary Opinion 2001-113	Tax Court	Dependency exemption deduction, Head-of- Household filing status, and EITC for son	YES	Split
Phillips	T.C. Summary Opinion 2002-2; 2002 T.C. Summary LEXIS 3	Tax Court	IRA proceeds included in modified adjusted gross income	NO	IRS
Poole	T.C. Summary Opinion 2001-163	Tax Court	Dependency exemption deductions, Head-of- Household filing status, child care credit and EITC for two children	YES	IRS
Quintero	T.C. Summary Opinion 2002-47	Tax Court	Determination of employee vs. self- employed. Income exceeding threshold for claiming EITC	NO	Split



TABLE 3.5.6 — LITIGATED CASES: EARNED INCOME TAX CREDIT (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Rabold	T.C. Summary Opinion 2001-119	Tax Court	Divorce decree provides taxpayer entitled to dependent exemption deduction, also claimed Head-of-Household filing status and EITC	YES	IRS
Ramirez-Ota	T.C. Summary Opinion 2002-27	Tax Court	Head-of-Household filing status and claiming EITC	YES	IRS
Reed	T.C. Summary Opinion 2001-89	Tax Court	Dependency exemption deduction, Head-of-Household filing status and EITC	YES	IRS
Reynolds	288 F. 2d 277 (7th Cir. 2002)	7th Circuit US Appeals	Class action lawsuit concerning Refund Anticipation Loans	NO	Judgement reversed. Case remanded to district court
Rivera	T.C. Summary Opinion 2001-124	Tax Court	Dependency exemption deductions for nephews, Head-of-Household filing status, EITC and addition to tax	YES	IRS
Sherbo	255 F. 3d 650 (8th Cir. 2001)	8th Circuit US Appeals	Discretionary award of litigation cost and attorney's fees	NO	Affirmed for IRS
Taylor	T.C. Summary Opinion 2002-25	Tax Court	Custody of children for dependency exemption deductions, head-of-household filing status and EITC	YES	Taxpayer
Washington	T.C. Summary Opinion 2002-31	Tax Court	Married taxpayer used Head-of-Household filing status, claiming EITC	YES	IRS

TABLE 3.5.6 — LITIGATED CASES: EARNED INCOME TAX CREDIT (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Wessels	271 BR 313 (W.D. Wis. 2002)	US District Court for Western District of Wisconsin	Appeal decision of U.S. Bankruptcy discharge for student loan	NO	Reversed bankruptcy discharge
Whittaker	T.C. Memo. 2001-224	Tax Court	Income annuity payments from deceased spouse's retirement plan included in gross income	YES	IRS
Wilkerson	T.C. Summary Opinion 2002-37	Tax Court	Dependency exemption deduction, head-of-household filing status, childcare credit and EITC for someone else's child	YES	IRS
Wilson	T.C. Memo. 2001-139	Tax Court	EITC	YES	IRS

Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)

Allison	T.C. Summary Opinion 2001-161	Tax Court	Schedule C expenses	YES	Split
Awadallah	T.C. Summary Opinion 2001-93	Tax Court	Schedule C income and expenses	YES	IRS
Chappell	T.C. Memo. 2001-146	Tax Court	Schedule C income and expenses and Head-of-Household filing status for 1994 and 1995, EITC for 1995	YES	Split
Coyle	T.C. Summary Opinion 2002-42	Tax Court	Liability for deficiency, addition to tax and penalty assessment	NO	Split
Furnish	T.C. Memo. 2001-286	Tax Court	Schedule C deductions, addition to tax and penalties.	YES	Split
Glenn	T.C. Summary Opinion 2001-83	Tax Court	Schedule C income and expenses net operating loss deductions and accuracy-related penalties	YES	Split



TABLE 3.5.6 — LITIGATED CASES: EARNED INCOME TAX CREDIT (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Holbrook	T.C. Summary Opinion 2001-135	Tax Court	Disqualified income and EITC eligibility	YES	IRS
Kang	T.C. Summary Opinion 2001-97	Tax Court	Relationship between petitioners and business expenses	YES	Split
Land	T.C. Summary Opinion 2001-111	Tax Court	Schedule C deductions and expenses	YES	IRS
Poyda	T.C. Summary Opinion 2001-91	Tax Court	Medical and business expenses	YES	Split
Price	89 A.F.T.R. 2d 2544 (10th Cir. 2002)	10th Cir. US Court of Appeals	Sentence for aiding and assisting in filing false tax returns and of making and subscribing a false tax return	NO	Affirmed for USA
Stubblefield	2002 – 1 USTC ¶150,382 (S.D. Texas 2002)	District Court	Taxpayer did not challenge specific determinations of the IRS or clarify the relief being sought	YES	IRS
Sweet	2001 T.C. Summary LEXIS 293	Tax Court	Schedule C income and expenses and EITC eligibility	NO	IRS
Xuncax	T.C. Memo. 2001-226	Tax Court	Schedule C offset gross profits and expense deductions	YES	Split

LITIGATED
ISSUE #6

ABUSIVE TRUSTS

PRESENT LAW

Definition

A trust is an entity created to hold assets for the benefit of certain persons or entities, with a trustee managing the trust.²²⁰ A trustee is a person or entity who holds the assets of a trust for the benefit of the beneficiaries and manages the trust and its assets under the terms of the trust stated in the declaration of trust.²²¹ A beneficiary is a person or entity (such as a charity) that is to receive assets or income from a trust.²²²

A trust is created and governed by state law. In establishing a trust, the grantor (owner of assets) places personal property, real estate, cash, investments, or other assets into the trust to be administered by a trustee (trust company, bank, or individual). The trustee then administers the assets for the beneficiary (the person named in the deed of trust who will receive income or corpus from, or use of the assets).

Federal Taxation of Trusts

For federal income tax purposes, a trust is considered a separate taxable entity. The gross income of a trust is determined in much the same way as that of an individual. A trust must file a federal income tax return, Form 1041 (U.S. Income Tax Return for Estates & Trusts), each year using a separate tax rate schedule.²²³ The deductions and credits allowed to individuals are also allowed to trusts. However, special rules govern the computation of certain deductions and the allocation of certain credits and deductions between the trust and the beneficiaries.²²⁴

The principle of taxing trusts is that all income from whatever source derived (other than exempt income, such as tax-free interest on municipal obligations, etc.) is taxable to the trust entity or to the beneficiary. Regardless of who is taxed, the income retains its character and the taxpayer is allowed the credits, exclusions, capital gains benefits, or other privileges attached to the income.²²⁵ Where no valid trust exists, the income is taxable to the grantor.

²²⁰ Black's Law Dictionary 1513 (7th ed. 1999).

²²¹ Black's Law Dictionary 1519 (7th ed. 1999).

²²² Black's Law Dictionary 149 (7th ed. 1999).

²²³ Treas. Reg. § 1.641(a) - 2.

²²⁴ Treas. Reg. § 1.641(b) - 1.

²²⁵ IRC §§ 643 and 652.



Economic Substance

In cases where the IRS has argued that a trust is abusive and should be disregarded for federal tax purposes, the courts have generally ruled for the IRS if the trust lacks economic substance. In such cases, courts consider the following factors in making this determination:

- (1) whether the taxpayer's relationship as grantor to property purportedly transferred into trust differed materially before and after the trust formation;
- (2) whether the trust had a bona fide independent trustee;
- (3) whether an economic interest in the trust passed to trust beneficiaries other than the grantor; and
- (4) whether the taxpayer honored restrictions imposed by the trust or by the law of trusts.²²⁶

Analysis of Litigated Cases

Thirty-eight trust cases were litigated in the federal court system between June 1, 2001 and May 31, 2002. The cases can be summarized as follows:

TABLE 3.6.1
LITIGATED TRUST CASES

ORIGIN OF LITIGATED CASE	NUMBER OF CASES
Income Tax Examination	23
Collection Action	8
Criminal Investigation	5
Injunction	1
Sanctions Against Attorney	1
Total Cases Litigated	38

A more detailed listing of the cases can be found in Table 3.6.3.

In 24 of the litigated cases, taxpayers represented themselves before the court. Twelve taxpayers were represented by attorneys or were lawyers themselves, and in two cases neither the taxpayer nor a representative was present for the proceeding.

Three of the cases that originated with a criminal investigation involved promoters of what the IRS considered an abusive trust scheme or tax shelter. In another case, the court issued an injunction against the promoter of such a scheme.²²⁷

²²⁶ *Markosian v. Commissioner*, 73 T.C. 1235 (1980); see also *Cim Trust v. Commissioner*, T.C. Memo. 2001-172.

²²⁷ *United States v. Sweet*, 89 A.F.T.R.2d, 2189 (2002).

Defining an abusive trust

An abusive trust, also known as a “sham trust,” is created for the purpose of avoiding taxes and lacks economic substance. Trusts are considered abusive if they are established to conceal the true ownership of assets and income or disguise the substance of a financial transaction. In a sham or an abusive trust, the same person often is the grantor, trustee, and beneficiary.²²⁸

An abusive trust can be classified as either a domestic or a foreign scheme trust. Domestic schemes involve a series of trusts that are formed in the United States, while foreign trust schemes are formed offshore, outside U.S. jurisdiction. Both types may involve multiple layers of trusts, with each trust distributing income to the next layer. These schemes give the appearance of separating responsibility and control from the benefits of ownership, but in reality both are controlled and directed by the same taxpayer, thereby reducing taxable income to nominal amounts.²²⁹ The IRS in Publication 2193 (Too Good to be True Trust) enumerated elements commonly found in abusive trust promotions:

- ◆ A promise to reduce or eliminate income and self-employment tax;
- ◆ Deductions for personal expenses paid by the trust;
- ◆ Depreciation deductions on an owner’s personal residence and furnishings;
- ◆ High fees for trust packages, to be offset by promised tax benefits;
- ◆ Use of backdated documents;
- ◆ Unjustified replacement of trustee;
- ◆ Lack of an independent trustee;
- ◆ Use of post office boxes for trust addresses;
- ◆ Use of terms such as *pure trust*, *constitutional trust*, *sovereign trust*;
- ◆ Use of unincorporated business organizations such as, Common Law Trust Organizations (COLATOS) and Foreign Common Law Trust Organizations (FORCOLATOS).

Outcome of Litigated Cases

The IRS prevailed in whole or part in all 38 cases litigated.²³⁰ In a significant number of cases, the courts examined the economic substance of the trusts and held that the entities were not bona fide trusts.

²²⁸ See, e.g., *Fox v. Commissioner*, T.C. Memo. 2001-208.

²²⁹ See, e.g., *Caralan Trust v. Commissioner*, T.C. Memo. 2001-241.

²³⁰ See, *Audio Invs. v. Robertson*, 203 F. Supp. 2d 555 (DSC 2002), a quiet title action in which the IRS was a third party defendant because it had seized and sold the plaintiff’s property to the defendant in order to satisfy plaintiff’s outstanding tax obligation.



In one case, for example, the proposed deficiency resulted from the IRS' assertion that certain trust arrangements were shams and merely an attempt to avoid or evade income tax.²³¹ The taxpayer did not attack the correctness of the IRS determination, but instead used a variety of frivolous and immaterial arguments that challenged the IRS' authority to make such a determination. The United States Tax Court granted the IRS' motion for summary judgment with respect to both the deficiency and penalties.

The litigated cases originating from criminal investigations involved appeals of criminal offenses. In *United States v. Trupin*, the taxpayer had been found guilty of tax evasion and filing a false document with the IRS.²³² The government alleged that the taxpayer transferred assets to numerous corporations, which were in fact owned by the taxpayer's family trusts, solely to evade tax. The prosecution also asserted that the taxpayer filed a false statement of assets, omitting the property transferred. The court held that the jury was entitled to rely upon the economic realities of ownership and title and that the complex mechanisms used by the taxpayer to possess and transfer the assets permitted the inference that the concealment of assets was willful. Accordingly, the court denied the taxpayer's motion for a judgment of acquittal or a new trial.

In a case litigated due to collection action, taxpayers with a tax deficiency transferred their personal and real property to a trust.²³³ The court recommended that a judgment be entered against the taxpayers for unpaid taxes, foreclosed on the taxpayers' home and business property, and set aside the proceeds to pay the taxes owed after payment of senior lienholders.

Cases Settled Prior to Litigation

Although some cases reach the courts, a large number are settled prior to litigation. These cases are resolved in the IRS Examination, Appeals, Counsel or Criminal Investigation units. Cases that were not litigated are categorized as follows:

- 1) Cases settled in IRS Appeals or the Office of Chief Counsel prior to litigation; and
- 2) Cases resolved by IRS Criminal Investigation or the United States Department of Justice prior to litigation.

Cases Settled in IRS Appeals and the Office of Chief Counsel

Between September 7, 2001 and May 29, 2002, approximately 148 cases involving abusive trusts settled in IRS Appeals and Counsel before litigation, with Appeals settling 114 cases and Counsel handling the remaining 34. The cases included the following issues:

²³¹ *Swain v. Commissioner*, 118 T.C. 358 (2002).

²³² U.S. Dist. LEXIS 8041 (S.D.N.Y. June 18, 2001).

²³³ *United States v. Wight*, 2002-1 U.S.T.C. 50,287 (E.D. Cal. 2002).

- ◆ Assignment of income
- ◆ Grantor trust
- ◆ Sham trust
- ◆ Trust income attributable to grantors
- ◆ Sham assignments of income
- ◆ Fiduciary and distributions deductions for abusive trusts
- ◆ Abusive trust

Cases Settled by IRS Criminal Investigation and the United States Department of Justice

When IRS Office of Chief Counsel refers a case to the United States Department of Justice (DOJ), the department can either reject the case or accept it and refer it to the United States Attorney’s office, which will review the matter and contact the taxpayer. The taxpayer may then concede the case by entering into a plea agreement or contest the issues. If the taxpayer does not enter into a plea agreement, the case will be scheduled for trial.

As of November 20, 2002, IRS Criminal Investigation reported the following:²³⁴

**TABLE 3.6.2
CRIMINAL CASES**

FISCAL YEAR 2002 (OCTOBER 1, 2001 THROUGH SEPTEMBER 30, 2002)	NUMBER OF CASES
Criminal Investigations Initiated	108
Prosecution Recommendations	55
Indictments/Informations	44
Convictions	26
Incarceration* Rate	88.2%
Average Months to serve (w/prison)	32
Average Months to serve (all Sent)	28

*Incarceration may include prison time, home confinement, electronic monitoring, or a combination thereof. Fiscal year 2002 runs October 1 2001 through September 30, 2002

All of the above cases were directly related to abusive trusts. Most were not litigated in the traditional sense: they never came to trial or were resolved before trial. A substantial number of the taxpayers entered plea agreements and were subsequently sentenced and fined.

²³⁴ *Summary of Abusive Trust Schemes*, available at <http://www.irs.gov>.

MOST LITIGATED TAX ISSUES



Trusts have been used as a vehicle to evade taxes for decades.²³⁵ With the advent of the internet, abusive trust promoters can now market schemes to a broader audience. With the exception of the individual income tax return, there are more trust returns filed than any other type.

From 1997 through 2001, Form 1041 filings increased at a rate of 16.85 percent, and the number of estate and trust filings was second only to filings of Form 1040, Individual Income Tax Return.²³⁶

The IRS estimates that in tax year 2000 alone, there were 570,000 abusive domestic trust returns and offshore schemes. Sixty-five thousand were domestic abusive trust returns.²³⁷ The estimated tax revenue loss is between \$20 billion and \$40 billion.²³⁸ With the increase of IRS resources targeting abusive trusts, it is certain that more of these cases will reach the courts in the coming years.

While the loss of revenue to the Treasury is substantial, there are also economic and social effects on the taxpayers who become involved in these types of trust schemes. Once a court determines a trust is abusive, the taxpayer faces not only an income tax deficiency, but also interest, penalties and possible criminal sanctions. While many of those involved in trust schemes simply oppose taxes, the group also includes vulnerable individuals who have been duped by skilled promoters. The promoters are also subject to appropriate sanctions and penalties, including criminal prosecution.

The majority of cases involving abusive trust issues are usually settled in the IRS audit or appeals process after the taxpayer obtains help from a tax professional. Taxpayers who pursue litigation often make frivolous and groundless arguments in court.²³⁹ For example, one taxpayer refused to participate in administrative proceedings and failed to comply with court orders on the ground that Federal Income taxes are unconstitutional.²⁴⁰ As a result, courts will frequently impose sanctions under IRC § 6673 on these litigants.²⁴¹

²³⁵ Tax Issue Director, Michael Brostek, U.S. General Accounting Office, *Enhanced Efforts to Combat Abusive Tax Schemes – Challenges Remain*, Testimony Before the Committee on Finance, U.S. Senate, GAO-02-618T (2002).

²³⁶ *Small Business Self Employed: Trusts and Estates*, available at <http://www.irs.gov>.

²³⁷ Tax Issue Director, Michael Brostek, U.S. General Accounting Office, *Enhanced Efforts to Combat Abusive Tax Schemes – Challenges Remain*, Testimony Before the Committee on Finance, U.S. Senate, GAO-02-618T (2002).

²³⁸ *Id.*

²³⁹ *Johnson v. Commissioner*, 289 F. 3d 452 (2002); *Barnes v. Commissioner*, T.C. Memo. 2001-155; *Deserio v. Commissioner*, T.C. Memo. 2001-154; *Matrixinfosys Trust v. Commissioner*, T.C. Memo. 2001-133; *Sigerseth v. Commissioner*, T.C. Memo. 2001-148.

²⁴⁰ *Combs v. Commissioner*, T.C. Memo. 2001-264.

²⁴¹ IRC § 6673(a)(1) provides that there will be sanctions and costs awarded by the courts. For Tax Court proceedings, there are sanctions and costs up to \$25,000 awarded for proceedings instituted primarily for delays, or for frivolous or groundless positions. For proceedings in other courts, where the taxpayer's position is frivolous or groundless the penalty can be imposed up to \$10,000; collection of sanctions as well as sanctions and costs awarded by a court of appeals can be assessed and collected in the same manner as a tax.

In *Funk v. Commissioner*, the taxpayer filed a petition alleging that the Commissioner made errors in determining the assessment and deficiency in his case.²⁴² The taxpayer failed to report over \$1,000,000 of income from two trusts, which were found to be shams, thereby making the income taxable under the assignment of income doctrine. The taxpayer alleged that the Commissioner lacked authority to make a ‘determination’, that the deficiency asserted did not conform with the tax laws, and that the statute of limitations had not been extended. The court rejected the taxpayer’s claims, finding that the case was “frivolous and was brought by petitioner primarily for delay.” In addition to granting the Commissioner’s motion to dismiss the case, the court exercised its discretion to impose and require the taxpayer to pay a \$25,000 penalty to the United States.²⁴³

Expansion of Abusive Tax Schemes

Abusive trusts and other tax schemes are promoted through seminars, advertisements, publications and the internet. The IRS has been fighting such abusive tax schemes for years, but historically the agency reacts only after an upsurge. While the internet has fueled the growth of many new and old schemes, they also spread by word of mouth. As one taxpayer succeeds in avoiding tax by using an abusive trust, the scheme takes hold and grows exponentially.

Abusive trusts are just one of many abusive tax scams promoted to the public. The recent slavery reparations credit scheme illustrates the force with which a scam can take hold. The IRS has periodically seen slavery reparations claims in previous years; the latest resurgence began in late 2000 and false filings accelerated in 2001.

In 2001, the IRS received approximately 80,000 tax returns claiming slavery reparations credits that exceeded \$2.7 billion.²⁴⁴ The largest influx of claims began in 1998 on the heels of an announced settlement of a \$1.25 billion case from Swiss banks accused of hoarding cash deposited by Holocaust victims. This settlement prompted discussions in the African American community about what reparations might be due to blacks in America as a result of slavery.²⁴⁵

Once this issue came to the forefront, the topic gained recognition in magazine and newspaper articles, talk shows, radio, and discussions in the Congressional Black Caucus. A

²⁴² *Funk v. Commissioner*, T.C. Memo. 2001-291.

²⁴³ The courts have determined that resources are wasted when taxpayers’ arguments are frivolous and without merit. *Norton v. Commissioner*, T.C. Memo. 2002-137. Norton also demonstrated that the court will exercise its discretion under IRC § 6673(a)(1) and require taxpayers to pay penalties of not more than \$25,000 per case.

²⁴⁴ IRS News Release No. IR-2001-08, “Slavery Reparation scams surge, IRS urges taxpayers not to file false claims,” January 24, 2001.

²⁴⁵ “Swiss Banks to Make First Payment to Holocaust Survivors,” November 20, 1998, available at <http://www.cnn.com>.



book entitled *The Debt: What America Owes to Blacks* by Randall Robinson helped galvanize the issue.²⁴⁶ In that book, Mr. Robinson argues that the United States must be prepared to make restitution to African-Americans for 246 years of slavery.

Certain promoters seized the moment and began marketing a sales pitch to African Americans, stating that they could receive up to \$500,000 in a reparations credit or refund from the Internal Revenue Service. However, no provision of tax law allows African-Americans to obtain credits or refunds related to slavery reparations.²⁴⁷

The slavery reparations scam demonstrates the need for the IRS to consider the following questions in order to identify and minimize future “epidemics” of this nature:

- 1) What event or environment acted as a catalyst for the emergence or resurgence of the tax avoidance scheme?
- 2) How was information about this scheme publicized and disseminated?
- 3) At what point were the tax avoidance schemes first identified as a matter for concern by the press, by tax agencies, or by private organizations?
- 4) At what point in the promotion of the scheme did it become *acceptable* for taxpayers to participate in the scheme?
- 5) What proactive initiatives can be taken to address a scheme before it becomes an epidemic?
- 6) What is the IRS currently doing to recognize and combat future schemes?
- 7) Is the most appropriate medium being used to educate taxpayers?
- 8) How does the IRS measure the effectiveness of its outreach efforts and other deterrent strategies?

Recommendations

Like the slavery reparations scam, many abusive trust schemes involve heavily promoted products. The reparations scam demonstrates that these promotions can appear persuasive and attractive to taxpayers who otherwise comply with their tax obligations. The National Taxpayer Advocate is concerned about this trend.

The National Taxpayer Advocate endorses an approach that identifies schemes in their infancy and takes appropriate educational and deterrent actions before the schemes reach epidemic proportions. Recognizing and preventing the next tax scheme from proliferating is an efficient use of limited resources. Criminal convictions of and injunctions against

²⁴⁶ Randall N. Robinson, *The Debt: What America owes to Blacks*, Dutton/Plume, New York, 2000.

²⁴⁷ U.S. Department of Justice News Release, “Justice Department Sues to Enjoin Return Preparers Implicated in Slavery Reparations Tax Scam,” March 6, 2002.

promoters of tax schemes are essential deterrents, but often occur years after the schemes have taken root.

IRS educational programs should not only inform the public generally but also should identify those taxpayers most likely to be affected and adopt a fresh approach to reaching that audience. The traditional education, outreach and communication methods alone, including publications, news releases and contacts with practitioner groups, are not necessarily the most effective. The IRS needs not only to consider a new message but also to partner with messengers who possess the social power to effect a change in perception. Using the slavery reparation scheme as an example, national and local leaders in the African-American community could have been informed and consulted during the *infancy* of the scheme. Their influence could have prevented the scam from reaching the epidemic stage. As a supplement to its traditional compliance initiatives, the IRS should consult marketing experts with knowledge of psychology and sociology to assist in understanding and tracking the development and acceptance of ideas.

Finally, the National Taxpayer Advocate supports IRS's efforts to reenergize its compliance program. IRS has identified and publicized key areas of non-compliance, including abusive trusts, and will focus enforcement resources on these key areas during the coming year. While a comprehensive approach is needed to reduce the number of tax avoidance schemes such as abusive trusts, concentrating resources in a few key areas could have a significant impact.



TABLE 3.6.3
LITIGATED CASES: ABUSIVE TRUST

BUSINESS TAXPAYERS (SCHEDULE C, CORPORATION, PARTNERSHIP, TRUST ISSUES)					
NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Andantech, L.L.C. Audio	T.C. Memo. 2002-97	Tax Court	Sale & leaseback	No	IRS
Investments Trust	203 F. Supp. 2d 555 (2002)	District Court for South Carolina	Sale was legal	Yes	IRS (third party)
Barnes	T.C. Memo. 2001-155	Tax Court	Assessment/ Sanctions upheld	Yes	IRS
Caralan Trust	T.C. Memo. 2001-241	Tax Court	Assessment sustained	No	IRS
Cim Trust	T.C. Memo. 2001-172	Tax Court	Assessment sustained	Yes	IRS
Combs	T.C. Memo. 2001-264	Tax Court	Assessment sustained	Yes	IRS
Comey	T.C. Memo. 2001-275	Tax Court	Assessment sustained	Yes	IRS
Criss	T.C. Memo. 2002-62	Tax Court	Assessment sustained	Yes	IRS
Deserio	T.C. Memo. 2001-154	Tax Court	Assessment sustained	Yes	IRS
Fennel Trust	T.C. Memo. 2001-316	Tax Court	Assessment sustained	Yes	IRS
Fox	T.C. Memo. 2001-208	Tax Court	Assessment sustained	Yes	IRS
Funk	T.C. Memo. 2001-291	Tax Court	Assessment sustained	Yes	IRS
Herbst Asset Mgmt. Trust	T.C. Memo. 2002-73	Tax Court	Assessment sustained, lack of jurisdiction	No (no show)	IRS
Johnson	289 F. 3d 452 (2002)	7th Circuit	Sanctions on attorney	No	IRS
Matrixinfosys Trust	T.C. Memo. 2001-133	Tax Court	Assessment sustained	Yes	IRS
Norton	T.C. Memo. 2002-137	Tax Court	Assessment sustained	No	IRS
Pelham	T.C. Memo. 2001-173	Tax Court	Assessment sustained	Yes	IRS
Residential Mgmt. Servs. Trust	T.C. Memo. 2001-297	Tax Court	Assessment sustained	No	IRS
Richards Asset Mgmt. Trust	T.C. Memo. 2002-74	Tax Court	Assessment sustained	No (No show)	IRS
Ruocco	T.C. Memo. 2002-91	Tax Court	Assessment sustained	Yes	IRS

MOST LITIGATED TAX ISSUES

MOST LITIGATED

TABLE 3.6.3 — LITIGATED CASES: ABUSIVE TRUST (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Service Engineering Trust	T.C. Memo. 2001-181	Tax Court	Assessment sustained	No	IRS
Sigerseth	T.C. Memo. 2001-148	Tax Court	Assessment sustained	Yes	IRS
Snyder	T.C. Memo. 2001-255	Tax Court	Assessment sustained	Yes	IRS
Swain	118 T.C. No. 22 (2002)	Tax Court	Assessment sustained	Yes	IRS
Tarragon Trust	T.C. Memo. 2001-315	Tax Court	Assessment sustained	No	IRS
Bell	89 A.F.T.R. 2d 1486 (2002)	Eastern District of California	Tax Sale	Yes	IRS
Bollin	264 F. 3d 391 (2001)	4th Circuit	Conviction upheld	No	IRS
Brock	88 A.F.T.R. 2d 7068 (2001)	Eastern District of California	Tax lien enforcement	Yes	IRS
Chappell	15 Fed. Appx. 484 (2001)	9th Circuit	Conviction upheld	No	IRS
Engels	2001-2 U.S.T.C. 50,723 (2001)	District Court of Iowa	Liens valid	No	IRS
Evseroff	2001-2 U.S.T.C. 50,783 (2001)	Eastern District of New York	Foreclosure	No	IRS
Rempel	202 F. Supp. 2d 1051 (2001)	District Court for Alaska	Foreclosure	Yes	IRS
Stewart	19 Fed. Appx. 46 (2001)	4th Circuit	Bail	Yes	IRS
Sweet	89 A.F.T.R. 2d 2189 (2002)	Middle District of Florida	Injunction	Yes	IRS
Trupin	2001 U.S. Dist. Lexis 8041 (2001)	Southern District of New York	Tax Evasion	No	IRS
Wight	2002-1 U.S.T.C. 50,287 (2002)	Eastern District of California	Foreclosure	Yes	IRS
Lundberg	32 Fed. Appx. 795 (2001)	9th Circuit	Conviction upheld	Yes	IRS
Powell	31 Fed. Appx. 424 (2002)	9th Circuit	Collection	Yes	IRS



LITIGATED
ISSUE #7

ITEMIZED DEDUCTIONS

PRESENT LAW

The amount of individual federal income tax due is determined by first computing taxable income as defined by Internal Revenue Code section 63.²⁴⁸ Taxpayers may subtract either a standard deduction or certain itemized deductions from gross income to arrive at taxable income. The basic deduction amount depends on the taxpayer's filing status.²⁴⁹ An additional standard deduction amount is available to taxpayers who are age 65 or older, blind or both.²⁵⁰ Standard deductions are adjusted annually for inflation using the Consumer Price Index.²⁵¹

Itemized deductions are specified "personal" and "other" expenses allowed as deductions in arriving at taxable income. Personal expenses include interest payments, such as mortgage interest and points;²⁵² nonfederal taxes, including state and local income taxes, and real estate and personal property taxes;²⁵³ gifts to charity;²⁵⁴ medical expenses;²⁵⁵ and casualty and theft losses.²⁵⁶ Other deductible expenses include certain payments related to production or collection of income, including expenses related to the management of property held for the production of income.²⁵⁷

ANALYSIS OF LITIGATED CASES

In recent years, approximately 30 percent of individual taxpayers have itemized their deductions while the rest claimed the standard deduction.²⁵⁸ Thirty-five cases involving itemized deductions were litigated in the federal court system from June 1, 2001 through May 31, 2002. A detailed listing of the cases is found on Table 3.7.2. The listing categorizes each case tried according to the type of taxpayer involved. The table also identifies the specific itemized deduction; tells whether an attorney represented the taxpayer or the taxpayer represented him or herself before the court *pro se*; and gives the decision of the court.

²⁴⁸ IRC § 63, Taxable Income Defined.

²⁴⁹ IRC § 63(c)(2).

²⁵⁰ IRC § 63(c)(3).

²⁵¹ IRC § 63(c)(4).

²⁵² IRC § 163.

²⁵³ IRC § 164.

²⁵⁴ IRC § 170.

²⁵⁵ IRC § 213.

²⁵⁶ IRC §§ 165(f) & 165(h).

²⁵⁷ IRC § 162.

²⁵⁸ U.S. General Accounting Office, *Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing*, GAO-02-509, Washington, D.C. March 2002.

The specific itemized deductions that were litigated most often are:

TABLE 3.7.1
ITEMIZED DEDUCTION CASES

ITEMIZED DEDUCTIONS	NUMBER OF CASES	PERCENTAGE OF CASES
Employee Business Expenses	15	42.9
Charitable Contributions	6	17.1
Taxes and/or Interest	5	14.3
Miscellaneous Deductions	4	11.4
All Others	5	14.3
Total	35	100

All 35 cases were litigated in the United States Tax Court. The Court ruled in favor of the IRS in 30 of the cases tried. Nearly 50 percent of the cases reviewed were tried in just three states: 21.6 percent in California; 13.5 percent in Florida; and 10.8 percent in Texas. Each of these states has four or more locations where a trial can be held. Four cases were appealed and upheld; in two of these cases, the taxpayer had legal representation. Taxpayers represented themselves (*pro se*) in 69 percent of the 35 cases litigated, but the courts ruled in favor of *pro se* taxpayers in only four cases.

A common factor in many cases was the court's finding that taxpayers failed to substantiate the deductions taken and their records did not demonstrate ordinary business care and prudence.²⁵⁹ The court ruled in 20 cases (57 percent) that the taxpayer failed to substantiate the itemized deductions claimed.

The itemized deductions most frequently litigated involved unreimbursed employee business expenses. Fifteen of the 35 cases litigated were due to employee business expense issues. Twelve of these cases were *pro se*. Two cases, one of which was *pro se*, were decided in favor of the taxpayer. This particular *pro se* taxpayer was allowed to deduct the expense of printed flyers as an employee business expense.²⁶⁰ The respondent did not question this expense until the morning of the trial, even though the examiner had allowed the expense as an itemized deduction during the audit. The court held the expense was allowable absent the respondent's ability to prove otherwise.

²⁵⁹ Ihlenfeldt v. Commissioner; T. C. Memo, 2001-259; Landrum v. Commissioner; T.C. Summary Opinion 2001-112; and Tokh v. Commissioner 25 Fed. Appx. 440 (7th Cir 2001).

²⁶⁰ Possas v. Commissioner, T.C. Summary Opinion, 2002-28.



The following are two examples of taxpayer claims that the court disallowed:

- ◆ A deduction for work expenses claimed by a common law employee on a Schedule C business return.²⁶¹
- ◆ Travel expenses were disallowed and the court held that the taxpayer failed to prove that he incurred claimed travel expenses “away from home”, and that he had failed to substantiate the expenses.²⁶²

In each case, the claim was denied due to lack of substantiation, or because the expenses were not considered ordinary and necessary business expenses. It could not be determined if the taxpayers simply did not keep sufficient records of their expenses or were unaware of what expenses are not reimbursed by employers and are deductible for employees.

CONCLUSION

The IRS produces the following educational material for small businesses, which includes publications and CD-ROMs:

- ◆ Publication 3693 (Introduction to Federal Taxes for Small Business/Self/Employed)
- ◆ Publication 3207 (Small Business Resource Guide)
- ◆ Publication 3700 (A Virtual Small Business Workshop CD ROM)

The products contain information that is marketed specifically to taxpayers with employee business expenses. The publications cover vehicle expenses, business use of the home and record keeping. Similar products or specific education/outreach programs for employees with unreimbursed business expenses would provide additional resources to assist in preparing their tax returns.

Charitable contributions are an itemized deduction issue that is frequently litigated. Substantiation of these contributions depends on record keeping by the taxpayer as well as the charitable organization. The IRS is addressing the issue of substantiation of charitable contributions. The report of the latest public meeting by the IRS Advisory Committee on Tax Exempt and Government Entities (ACT) outlines an extensive outreach plan for this program.²⁶³ ACT plans to improve the IRS website and publications that address record keeping requirements for the individuals and reporting requirements for organizations. Publication 1771 (Charitable Contributions – Substantiation and

²⁶¹ Nicholas v. Commissioner, T.C. Summary Opinion, 2001-106.

²⁶² Wilson v. Commissioner, T.C. Memo, 2001-301.

²⁶³ Advisory Committee on Tax Exempt and Government Entities Public Meeting, Washington, DC, June 21, 2002.

Disclosure Requirements), published in March 2002, is an excellent example of ACT's efforts.²⁶⁴

A recent General Accounting Office (GAO) report estimates that 70 percent (86 million) of returns filed claimed the standard deduction in tax year 1998.²⁶⁵ Of those taxpayers, 948,000 could have reduced their taxes by itemizing their mortgage interest, mortgage points, and state and local income tax payments that exceeded the standard deduction. The GAO further estimates that if charitable contributions, real estate taxes, and personal property taxes are included, as many as 2.2 million people could have lowered their taxes by itemizing. The report did not attempt to determine the reasons why taxpayers claimed the standard deduction when they might have paid less tax by itemizing.

Of the 35 cases reviewed, only five taxpayers provided the necessary documentation to support their claims in court. The case histories identify lack of documentation and preparation as reasons the courts ruled against the taxpayers. Better tax preparation can be achieved through contemporaneous record keeping and community resources. The IRS has various outreach programs, such as Tax Counseling for the Elderly (TCE) and Volunteer Income Assistance (VITA) available to help taxpayers during the filing season. By following the detailed record keeping process suggested in Publication 1771, taxpayers may be able to avoid litigation and resolve controversies with the IRS during the Appeals process. Low income taxpayers who seek judicial resolution of their dispute may receive assistance from the Low Income Taxpayer Clinics, which may provide *pro bono* representation to those who are eligible.

²⁶⁴ IRS Publication 1771, (Rev. March 2002).

²⁶⁵ U. S. General Accounting Office, *Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing*, Report to House Majority Leader, House of Representatives (March 2002).



TABLE 3.7.2
LITIGATED CASES: ITEMIZED DEDUCTIONS

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Arthur	T. C. Summary Opinion 2001-166	Tax Court	Charitable contributions, Employee business expenses	Yes	IRS
Barclay	T. C. Memo 2002-20	Tax Court	All itemized deductions	Yes	IRS
Blodgett	T. C. Memo 2001-147	Tax Court	Employee business expenses	Yes	IRS
Burton	T. C. Summary Opinion 2001-155	Tax Court	Not for profit	Yes	TP
Cameron	T. C. Summary Opinion 2002-4	Tax Court	Charitable contributions	Yes	IRS
Carver	T. C. Summary Opinion 2001-94	Tax Court	Losses	Yes	IRS
Cruz	T. C. Summary Opinion 2001-154	Tax Court	Attorney fees	Yes	TP
Dixon	15 Fed. Appx. 469 (2001)	9th Cir.	Employee business expenses	Yes	IRS
Ecker	T. C. Summary Opinion 2002-44	Tax Court	Employee business expenses	No	TP
Elliott	T. C. Memo 2001-164	Tax Court	Employee business expenses	No	IRS
Emerson	T. C. Memo 2001-186	Tax Court	Employee business expenses	Yes	IRS
Griffin	T. C. Memo 2002-6	Tax Court	Taxes paid Employee business expenses	No	IRS
Hackley	T. C. Summary Opinion 2002-19	Tax Court	Interest expenses Taxes paid	Yes	IRS
Harrell	T. C. Summary Opinion 2001-80	Tax Court	Charitable contributions Medical expenses Taxes paid	Yes	IRS
Higbee	116 T.C. No. 28	Tax Court	Charitable contribution	Yes	IRS
Ihlenfeldt	T. C. Memo 2001-259	Tax Court	Employee business expenses	Yes	TP
Landrum	T. C. Summary Opinion 2001-112	Tax Court	Not for profit	No	IRS

TABLE 3.7.2 — LITIGATED CASES: ITEMIZED DEDUCTIONS (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Lemos	T. C. Summary Opinion 2002-29	Tax Court	Employee business expenses	Yes	IRS
Levitt	T. C. Summary Opinion 2001-147	Tax Court	Employee business expenses	Yes	IRS
Mayo	T. C. Summary Opinion 2001-146	Tax Court	Medical expenses	Yes	IRS
Mellon Bank	265 F.3d 1275 (2001)	Federal Cir.	Miscellaneous deductions – advice	No	IRS
Minneman	T. C. Summary Opinion 2001-122	Tax Court	Losses	Yes	IRS
Morcos	T. C. Summary Opinion 2001-114	Tax Court	Employee business expenses Business use of the home	No	IRS
Mosier	T. C. Summary Opinion 2001-104	Tax Court	Employee business expenses	Yes	IRS
Newhouse	T. C. Summary Opinion 2002-18	Tax Court	Employee business expenses	Yes	IRS
Nicholas	T. C. Summary Opinion 2001-106	Tax Court	Employee business expenses	No	IRS
Nordbrock	T. C. Memo 2002-112	Tax Court	Interest expenses	Yes	IRS
O’Connell	T. C. Memo 2001-158	Tax Court	Bad debts Not for profit	Yes	IRS
Possas	T. C. Summary Opinion 2002-28	Tax Court	Employee business expenses	Yes	TP
Strange	270 F.3d 786 (2001)	9th Cir.	Taxes paid	No	IRS
Todd	118 T.C. No. 19	Tax Court	Charitable contributions	No	IRS
Tokh	25 Fed. Appx. 440 (2002)	7th Cir	Charitable contributions Employee business expenses	Yes	IRS
Weil	T. C. Memo 2001-212	Tax Court	Interest expenses	No	IRS
Wilson	T. C. Memo 2001-301	Tax Court	Employee business expenses	No	IRS
Zanath	T. C. Summary Opinion 2001-118	Tax Court	Employee business expenses	Yes	IRS



LITIGATED
ISSUE #8

CAPITAL GAIN AND LOSS

PRESENT LAW

Gains and losses from the sale or exchange of property are generally recognized for income tax purposes.²⁶⁶ Such gains or losses are classified as either “ordinary” or “capital” in nature. They must further be categorized as either short term or long term.²⁶⁷ Generally, the sale or exchange of a “capital” asset results in a capital gain or loss²⁶⁸ and the sale of a “noncapital” asset results in an ordinary gain or loss.²⁶⁹

For the most part, all property owned and used for personal or investment purposes is a “capital” asset. The following assets are noncapital in nature: property held for sale to customers; depreciable property used in a trade or business; real property used in a trade or business; copyrights, literary, musical or artistic compositions; a letter or memorandum; accounts or notes receivable; U.S. Government publications; certain commodities derivative financial instruments; hedging transactions; and supplies used in a trade or business.²⁷⁰

Historically, the tax rate imposed on capital gains has varied considerably. The Taxpayer Relief Act of 1997 (TRA 97) created a reduction in the capital gains tax rate for individuals.²⁷¹ Long-term capital gains on the sale of assets held for eighteen months or longer were taxed at a top rate of 28 percent.

The IRS Restructuring and Reform Act of 1998²⁷² impacted “long-term” assets and “long-term” gains by:

- ◆ Shortening the holding period of a long-term capital asset from eighteen to twelve months²⁷³ and taxing the gain from the sale of a “long-term” capital asset at a maximum rate of 20 percent.²⁷⁴
- ◆ Reducing the tax rate on long-term gains realized by taxpayers in the lowest tax bracket from a 15 percent rate to a 10 percent rate when the asset was held from one to four years²⁷⁵ and an 8 percent rate if the asset was held for five or more years.²⁷⁶

²⁶⁶ IRC § 61.

²⁶⁷ IRC § 1222.

²⁶⁸ IRC § 1201 and IRC § 1211.

²⁶⁹ IRC § 64 and IRC § 65.

²⁷⁰ IRC § 1221.

²⁷¹ The Taxpayer Relief Act of 1997, Public Law 99-514, Section 311.

²⁷² Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206, Section 5001.

²⁷³ IRC § 1223.

²⁷⁴ IRC § 1(h)(1)(C).

²⁷⁵ IRC § 1(h)(B).

²⁷⁶ IRC § 1(h)(2)(A).

- ◆ Creating a special reduced rate of 18 percent for assets sold after December 31, 2000 if the assets were held for more than five years.²⁷⁷

The IRS Restructuring and Reform Act of 1998 also altered the taxation of “short-term” gains.²⁷⁸ Gains on assets held one year or less are considered “short-term” and are taxed at the same rates as ordinary income.²⁷⁹

There are numerous special tax provisions related to capital gains. Many of these provisions are intended to prevent the conversion of ordinary income into capital gains and to limit arbitrage²⁸⁰ transactions that would take advantage of the difference between tax rates on ordinary income and capital gains.²⁸¹

Because of the complexity in characterizing capital assets, determining the basis of assets and construing the special treatment of certain assets classified as “exceptions,” capital gain and loss issues can result in litigation.

ANALYSIS OF LITIGATED CASES

Thirty-one cases with capital gain and loss as a primary issue were tried in the federal courts between June 1, 2001 and May 31, 2002. Table 3.8.1 lists the cases.

The litigated cases primarily involved the following sub-issues:

- ◆ Determination of Asset Basis
- ◆ Treatment of Bad Debts
- ◆ Characterization as Capital or Ordinary
- ◆ Miscellaneous “Other”

Eighteen of the cases involved individual taxpayers, 11 cases involved businesses, and two involved estates. Generally, taxpayers chose to use legal representation in federal court proceedings. However, 10 individuals chose to represent themselves *pro se*. The courts ruled for the IRS in 17 cases and for the taxpayer in six cases. Split decisions occurred in eight of the cases tried.

²⁷⁷ IRC § 1(h)(2)(A).

²⁷⁸ Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Section 5001.

²⁷⁹ IRC § 1222.

²⁸⁰ Arbitrage is defined as “[t]he simultaneous buying and selling of identical securities in different markets, with the hope of profiting from the price difference in those markets.” *Black’s Law Dictionary* 99 (7th ed. 1999).

²⁸¹ Leonard E. Burman, *The Labyrinth of Capital Gains Tax Policy, A Guide for the Perplexed*, Washington D.C., Brookings Institution Press, 1999 p. 9-32.



Determination of Asset Basis

Ten of the 31 capital gain and loss cases analyzed involved the issue of asset basis. Generally, a taxpayer's basis in an asset is the amount paid for or invested in the asset.²⁸² The basis of property is critical for purposes of computing the taxpayer's gain or loss on the sale, exchange, or disposition of the property. Taxpayers are required to maintain accurate records of all items that affect the basis of property so that accurate computations can be made for tax purposes.²⁸³

In certain cases, the law requires taxpayers to make adjustments (increases or decreases) to the amount paid for or invested in an asset to compute an "adjusted basis." If a taxpayer pays \$200,000 for a house and then makes \$50,000 worth of capital improvements, for example, the taxpayer's adjusted basis is likely to be \$250,000.²⁸⁴ Special rules apply when the basis of an asset is an amount other than the original cost, requiring the fair market value of an asset to be used for income tax calculations.²⁸⁵ Because of these complexities of tax law, the correct determination of basis is a frequently litigated capital gain and loss issue.

The ten cases that included basis issues fall into three categories: substantiation, allocation, and computation. The following are two examples of litigated cases involving a basis issue in which **substantiation** was a factor:

- ◆ The taxpayer challenged a determination by the IRS that he underreported capital gains from the redemption of corporate stock. The taxpayer owned, with his brother, a concrete repair business. After a dispute with his brother, the taxpayer received cash and forgiveness of a non-business debt to the corporation in return for relinquishing his stock in the business. The court held that the entire amount realized from the exchange of stock was a capital gain because the taxpayer failed to establish any basis in the stock.²⁸⁶
- ◆ The taxpayers failed to substantiate the costs of improvements to a condominium. Moreover, IRC § 1016(a)(2) required a decrease in their condominium basis to reflect depreciation for two tax years. The court found for the IRS due to the fact that the taxpayers failed to show that they had not understated their long-term capital gain on the sale of the property.²⁸⁷

²⁸² IRC § 1012.

²⁸³ IRC §§ 1001 and 6001.

²⁸⁴ IRC § 1016.

²⁸⁵ IRC § 1014.

²⁸⁶ *Zidar v. Commissioner*, T.C. Memo. 2001-200.

²⁸⁷ *Stoddard v. Commissioner*, T.C. Memo. 2002-31.

The following examples indicate the type of basis **allocation** issues that were litigated:

- ◆ The taxpayer bought and resold American Depository Receipts (ADR), which are essentially shares of a foreign corporation. The transaction resulted in gross dividend income, a foreign tax credit, and capital losses that the taxpayer claimed on his income tax return.

The Tax Court upheld the IRS determination that the ADR transaction was a sham and should be disregarded for income tax purposes.²⁸⁸ On appeal, the Ninth Circuit reversed the Tax Court decision. It held that the Tax Court had erred as a matter of law in disallowing the taxpayer's identification of the income, tax credit, and losses associated with the transaction. The appeals court held that (1) the transaction could not be treated as a sham because it had economic substance independent of generating tax benefits and a business purpose involving a reasonable possibility of profit; and (2) because the transaction affected the taxpayer's economic and nontax business interests, it would not be disregarded because it was motivated by tax considerations.

- ◆ The controlling issue in another case was whether any of the cost basis in the land purchased by the landowners' partnership could be allocated to water rights that were not legally vested at the time of the land purchase. The Tax Court held that the landowners acquired the water rights in a "separate transaction" that occurred after the original land purchase, and that the cost basis of the rights was therefore zero. The Ninth Circuit held that while the water rights were not vested at the time the partnership purchased the land, the purchase was made with a realistic expectation that water rights would eventually attach to the land. Thus, the landowners could apportion some of their cost basis in the land to the later sale of water rights appurtenant to that land.²⁸⁹

The following is an example of a litigated case involving **computation** of basis issues:

- ◆ The IRS assessed an income tax deficiency against a taxpayer after determining that the taxpayer had a capital gain rather than a loss on a sale of rental property, among other issues. The taxpayer did not provide a calculation of basis in the property or records showing depreciation. The taxpayer submitted a schedule of purported capital improvements but admitted that the total amount listed on the schedule erroneously doubled the amount of the items. A decision was entered in favor of IRS.²⁹⁰

²⁸⁸ *Compaq v. Commissioner*, 277 F.3d 778 (9th Cir. 2001), rev'g 113 T.C. 214 (1999). *Compaq* was a significant case also involving other prominent tax issues.

²⁸⁹ *Gladden v. Commissioner*: 112 T.C. 209 (1999), rev'd, 262 F.3d 851 (9th Cir 2001). Because the Tax Court ruled against the landowners on summary judgment, the record was undeveloped as to what portion of the cost of the land may have been a premium paid for the water rights later acquired by the partnership, or whether it was impracticable or impossible to determine what that premium may have been. Therefore, the Tax Court's decision was reversed and the case was remanded for further proceedings.

²⁹⁰ *Lewis v. Commissioner*: T.C. Summary Opinion 2001-142.



Treatment of Bad Debts

Tax law provisions relating to the treatment of non-business bad debts as short-term capital losses, and the interpretations of “bona-fide” and “wholly worthless” debts are very complex and can be factually difficult. Thus, taxpayers end up in litigation over these issues.

Eight of the 31 capital gain and loss cases reviewed contained disputes involving bad debts. Bad debt obligations are allowable under IRC § 166. This section of the Code describes two distinct categories of bad debts – business and non-business.

Internal Revenue Code section 166 states that a debt must be genuine to be deductible. A debt is genuine, or bona-fide, if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed sum of money. A business bad debt is generally a debt that was created or acquired in connection with a taxpayer’s trade or business.²⁹¹ Business bad debts generally received the most favorable tax treatment because they are deductible from income as ordinary losses without limitations when they become “partially” or “wholly” worthless.

Non-business bad debts are debts that were not received in the ordinary course of operating a trade or business. To be deductible, a non-business bad debt must be proven to be “wholly” worthless. There must be evidence of the non-business debt’s worthlessness, including the value of collateral and the financial condition of the debtor.²⁹² Non-business bad debts are deductible as “short-term” capital losses and are subject to the loss limitations under IRC § 1211.

To deduct non-business bad debts, taxpayers must be able to provide substantiation that clearly states basis in the loss, total worthlessness of the loss, and their method of accounting. Cash basis taxpayers can generally deduct a bad debt only when there has been an actual cash loss or the amount deducted was included in income.²⁹³ Taxpayers using the accrual method of accounting generally use a specific charge-off method to deduct business bad debt.

The following case summaries provide a flavor of the issues that arose in the seven bad debt cases that we reviewed:

- ◆ A taxpayer advanced money to a corporation of which he was general manager and a shareholder. The taxpayer took business bad debt losses (ordinary losses) that he said resulted from the money advances (loans) he had made to the corporation. The taxpayer stated he made these loans so he could collect a salary and the company could continue to operate. The court ruled that the “debts” for which

²⁹¹ IRC § 166.

²⁹² Id.

²⁹³ IRC § 166(d).

the taxpayer claimed a business bad debt deduction were not bona fide debts. The court deemed the payments as contributions of capital.²⁹⁴

- ◆ A taxpayer contended that he should be allowed to claim a non-business bad debt deduction on a personal loan. The taxpayer did not pursue payment of debt for nine years, at which time he claimed a bad debt loss. The court sustained the IRS's disallowance of the deduction because the taxpayer failed to establish that the loan was a bona fide debt or that the debt had become worthless in the year claimed.²⁹⁵
- ◆ A taxpayer advanced funds to three sister companies over a period of years. The advances continued, even though the likelihood of repayment was diminishing. When the sister companies went out of business, the taxpayer took a business bad debt and treated it as an ordinary loss. The court found that the payments to the sister corporations were contributions to capital rather than loans. A decision was entered for the IRS.²⁹⁶
- ◆ A taxpayer who had guaranteed a corporate loan claimed a bad debt deduction for amounts seized by a bank. The taxpayer argued that he was entitled to a business bad debt deduction for the amounts seized as the guarantee was to protect his salary as a corporate officer. The court ruled for the IRS, concluding that the bad debt deduction was a non-business bad debt, which allowed the taxpayer only a short-term capital loss.²⁹⁷

Characterization as Capital or Ordinary

Three of the 31 cases litigated included the issue of characterization, which was raised in conjunction with other capital gain and loss issues. Characterization is the identification and classification of an asset for tax purposes. Assets can be classified as capital assets subject to the capital gains and tax provisions of IRC § 1221 or as non-capital assets subject to the ordinary gains and loss provisions of IRC § 61 and IRC § 64.

The characterization of income or losses as either capital or ordinary and the further characterization of capital gains or losses as either short-term or long-term are essentially for income tax reporting purposes. The law further requires the additional identification of long-term capital gains and losses into long-term gains and losses that qualify for the 28 percent rate.²⁹⁸ Net capital gains must also be subclassified as those that qualify for five-year gains.

²⁹⁴ *Warning v. United States*, 2001-2 U.S.T.C. 50,729 (N.D. Okla. 2001).

²⁹⁵ *Webb v. Commissioner*, T.C. Summary Opinion 2001-172.

²⁹⁶ *Cerand & Company, Inc. v. Commissioner*, T.C. Memo. 2001-271.

²⁹⁷ *O'Connell v. Commissioner*, T.C. Memo. 2001-158.

²⁹⁸ IRC § 1(h).



There are additional “special tax provisions” for certain assets.²⁹⁹ These provisions add to the complexity of determining the correct tax treatment on the sale or exchange of an asset as either a capital gain or loss or an ordinary gain or loss.

An example of one of the cases litigated due to a characterization issue is as follows:

- ◆ The taxpayer, a farming business, claimed ordinary losses on transactions in hog futures related to hedging transactions. The Tax Court upheld the IRS position that the losses were capital and not ordinary because the taxpayer was not engaged in the hog business.³⁰⁰

Miscellaneous “Other”

Ten of the 31 cases analyzed were categorized as involving other issues that could not be primarily classified as relating to basis, characterization, or bad debt. These issues were raised in conjunction with other capital gain and loss issues. Below are some of the courts’ holdings regarding the cases that included other issues.³⁰¹

- ◆ The taxpayer reported a long-term capital loss from the sale of real property on his 1996 tax return. In 1993, the taxpayer conveyed the property to another person as a repayment of debt. The taxpayer contended that, in 1993, he received an option to repurchase the property that he conveyed. In 1996, the taxpayer relinquished his option to repurchase the property. An option contract or agreement was never prepared, but the taxpayer did execute a promissory note to the new owner. The taxpayer produced no evidence to show any payments of principal or interest to the new owner as required by the note. The Tax Court concluded that there was no sale or exchange of the property in 1996.
- ◆ The taxpayers were general partners in a partnership that owned shares in a fisheries corporation and was in the process of selling its stock in the corporation. During this time, the corporation had settled an insurance claim and distributed proceeds directly to the taxpayers. The disputed issue was whether the settlement distributions received by the taxpayers as partners were ordinary income as opposed to capital gain. The Tax Court concluded that the distributions were not proceeds from the sale of corporate shares. The form of the transaction was a distribution of the insurance proceeds from the corporation to the taxpayers, followed by a sale of the corporation’s stock. The court upheld the IRS finding that these distributions were ordinary income to the taxpayers.

²⁹⁹ IRC § 1(h)(2)(A).

³⁰⁰ Pine Creek Farms, Ltd. v. Commissioner, T.C. Memo. 2001-176.

³⁰¹ Hale v. Commissioner, T.C. Summary Opinion 2001-99, *see also* Steel v Commissioner, T.C. Memo 2002-113.

CONCLUSION

As discussed in the analysis section, the complexity of the tax law and its many provisions regarding capital gains and losses has created interpretation differences between the IRS and taxpayers. These differences can result in litigation.

Ten of the cases tried, or 32 percent, involved basis issues. The majority of the basis issues were fact specific and dealt with the interpretation of technical and complex matters of tax law. The IRS is currently exploring the use of publicly available software that will help determine the cost basis for securities transactions.³⁰² Such technology can reduce taxpayer burden by streamlining documentation of cost basis calculations during audits and can create a reliable standard for taxpayers, preparers, and the IRS.

The analysis of each case litigated did not identify underlying trends or similarities that would allow for specific recommendations. However, additional taxpayer education would be beneficial to provide a better understanding regarding capital gains and losses. The IRS currently utilizes revenue agents and estate and gift attorneys each filing season for a program in which they answer specific technical tax law questions of taxpayers and preparers. This program, known as R-Mail, includes the issue of capital gain and loss and has been successful in answering questions on a timely basis.³⁰³ IRS Chief Counsel currently uses private letter ruling procedures for highly technical issues.

The National Taxpayer Advocate encourages the IRS to continue its efforts to reduce taxpayer burden regarding capital gain and loss issues, and supports all education and assistance efforts that are currently in place. Our office is particularly interested in the computer software that the IRS is testing regarding the computation of basis. It appears this initiative would not only significantly reduce taxpayer burden in preparing tax returns, but would also impact the number of audits, administrative appeals, and litigated cases that result in a disagreement between taxpayers and the IRS regarding basis issues.

³⁰² National Customer Research Study, Internal Revenue Service, Research Analysis and Statistics, Washington, D.C. (Sept. 3, 2002).

³⁰³ IRS R-Mail Report for Filing Season 2002.



TABLE 3.8.1
LITIGATED CASES: CAPITAL GAINS AND LOSSES

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Taxpayers (Issues Other Than Business Issues)					
Yankwich	T.C. Memo. 2002-37	Tax Court	Other	No	Split
Stoddard	T.C. Memo. 2002-31	Tax Court	Basis (computation)	No	IRS
Webb	T.C. Summary Opinion 2001-172	Tax Court	Bad Debt	Yes	IRS Rule 155
Flint	T.C. Memo. 2001-276	Tax Court	Bad Debt	No	Split
Cohen	T.C. Memo. 2001-249	Tax Court	Basis (substantiation)	Yes	IRS Rule 155
Barnard	T.C. Memo. 2001-242	Tax Court	Basis (computation)	No	Split
Brodsky	T.C. Memo. 2001-240	Tax Court	Basis (substantiation)	No	IRS Rule 155
Lewis	T.C. Summary Opinion 2001-142	Tax Court	Basis (computation)	Yes	IRS Rule 155
Torre	T.C. Memo. 2001-218	Tax Court	Other	Yes	IRS
Zidar	T.C. Memo. 2001-200	Tax Court	Basis (substantiation)	No	IRS
Tietig	T.C. Memo. 2001-190	Tax Court	Basis (substantiation, computation)	Yes	IRS
O'Connell	T.C. Memo. 2001-158	Tax Court	Bad Debt	Yes	IRS Rule 155
Hale	T.C. Summary Opinion 2001-99	Tax Court	Other	Yes	IRS Rule 155
Pappas	T.C. Memo. 2002-127	Tax Court	Other	Yes	Split
Levy	T.C. Memo. 2001-136	Tax Court	Bad Debt	Yes	Split
Esposito	T.C. Memo. 2001-131	Tax Court	Other	Yes	IRS

TABLE 3.8.1 — LITIGATED CASES: CAPITAL GAINS AND LOSSES (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Lobato	2002-1 U.S.T.C ¶ 50, 332 (N.D. Okla. 2002)	USDC	Bad Debt	No	Taxpayer
Baker	118 T.C. No. 28(2002)	Tax Court	Characterization	No	IRS
Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)					
Bemidji	T.C. Memo. 2001-260	Tax Court	Characterization	No	Split
Brazoria Co Stewart Food	T.C. Memo. 2001-220	Tax Court	Bad Debt	No	IRS
Pine Creek Farms	T.C. Memo. 2001-176	Tax Court	Characterization	No	IRS
Alarecare Home Health	T.C. Memo. 2001-149	Tax Court	Other	No	Split
Compaq	277 F.3d 778(9th Cir. 2001)	Court of Appeals	Basis (allocation)	No	Petitioner
Warning	2001-2 U.S.T.C. ¶ 50, 729 (N.D. Okla 2001)	USDC	Bad Debt	No	Granted for D/IRS
Gladden	262 F.3d 851 (9th Cir. 2001)	Court of Appeals	Basis(allocation)	No	Reversed and Remanded/ TP
Cerand	254 F.3d 258 (D.C. Circuit 2001)	Court of Appeals	Bad Debt	No	Granted and Remanded/ TP
IES Industries	253 F.3d 350 (8th Cir. 2001)	Court of Appeals	Basis(allocation)	No	Affirmed/ TP
Steel	T.C. Memo. 2002-113	Tax Court	Other	No	IRS
Illinois Tool	117 T.C. No.4 (2001)	Tax court	Other	No	IRS Rule 155
Estate/Gift Taxpayers					
Estate of Keith Gurr	T.C. Summary Opinion 2002-7	Tax Court	Other	No	IRS
Estate of Branson	264 F.3d 904 (9th Cir 2001)	Court of Appeals	Other	No	Affirmed/ TP



LITIGATED
ISSUE #9

CIVIL FRAUD PENALTY

PRESENT LAW

In general, penalties support the Internal Revenue Service mission by enhancing voluntary compliance. Penalties enhance compliance by (1) helping taxpayers understand that compliant conduct is appropriate and noncompliant conduct is not; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the noncompliant taxpayer.³⁰⁴

Under Internal Revenue Code section 6663, a civil fraud penalty may be imposed on taxpayers who engage in intentional wrongdoing for the specific purpose of evading tax believed to be owed.³⁰⁵ The civil fraud penalty is distinct from criminal fraud sanctions. Whereas the criminal penalty is largely intended to be punitive, the civil fraud penalty is remedial in nature, designed primarily to safeguard revenue and reimburse the IRS for the heavy expense of investigations and for losses resulting from fraud.³⁰⁶

The civil penalty is an addition to tax that formerly was set forth in Internal Revenue Code section 6653(b). The Tax Reform Act of 1986 modified IRC § 6653(b) by increasing the fraud penalty rate from 50 percent to 75 percent, effective for tax returns due (determined without regard to extensions) after December 31, 1986.³⁰⁷ The law narrowed the scope of the fraud penalty so that it applies only to the amount of the underpayment attributable to fraud.³⁰⁸ The Omnibus Budget Reconciliation Act of 1989 (OBRA 89) redesignated IRC § 6653(b) as IRC § 6663 (effective for returns due after December 31, 1989).³⁰⁹

Internal Revenue Code section 6663 is imposed when any part of an underpayment of tax is due to fraud. The law provides for the 75 percent penalty on the portion of the underpayment attributable to fraud.³¹⁰ As an initial matter, the entire underpayment is considered attributable to fraud. However, if the taxpayer establishes (by a preponderance of evidence) that a portion of the underpayment is not due to fraud, that portion will not be subject to the 75 percent penalty.³¹¹ A special rule applies to joint returns, where the civil fraud penalty does not apply to a spouse unless part of the underpayment is the result of fraud perpetrated by that spouse.³¹²

³⁰⁴ IRS Policy Statement P-1-18 (4/27/92).

³⁰⁵ *Mitchell v. Commissioner*, 118 F.2d 308, 310 (5th Cir. 1941).

³⁰⁶ *Helvering v. Mitchell*, 303 U.S. 391, 401, 82 L.Ed. 917, 58 S. Ct. 630 (1938).

³⁰⁷ Tax Reform Act of 1986, Public Law 99-514, Section 1503(a).

³⁰⁸ S. Rep. No. 99-313, at 64 (1986).

³⁰⁹ The Omnibus Budget Reconciliation Act, Public Law 101-239, Section 7721(c)(1).

³¹⁰ IRC § 6663(a).

³¹¹ IRC § 6663(b).

³¹² IRC § 6663(c).

OBRA 89 modified the failure to file penalty in cases where a tax return is not filed because of fraud.³¹³ This penalty is an addition to tax of 15 percent for each month or fraction of month, with the total not to exceed 75 percent.³¹⁴

A finding of fraud rests upon the taxpayer's intent. The IRS must show by clear and convincing evidence that the taxpayer knew that his or her conduct was in bad faith or was believed to be in bad faith.³¹⁵ Fraud may be established by drawing reasonable inferences from the taxpayer's entire course of conduct.³¹⁶ The courts have developed several nonexclusive indicators of fraudulent behavior, which are sometimes referred to as "badges of fraud."³¹⁷ These are indirect evidence of fraud, considered in the context of all surrounding circumstances.³¹⁸

Courts have held that the badges of fraud include the following elements:

- ◆ Understatement of income
- ◆ Keeping inadequate records
- ◆ Failure to file tax returns
- ◆ Implausible or inconsistent explanations of behavior
- ◆ Concealment of income or assets
- ◆ Failure to cooperate with tax authorities
- ◆ Filing false documents
- ◆ Dealing in cash
- ◆ Engaging in illegal activity
- ◆ Failing to make estimated payments³¹⁹

The IRS procedures for asserting the civil fraud penalty are described in the Internal Revenue Manual (IRM).³²⁰ Auditors are trained to identify the badges of fraud and to develop civil and criminal referrals. The referrals are reviewed to ensure quality and are approved by management and the Fraud Referral Specialist of the Small Business and Self-Employed Division (SB/SE). The Criminal Investigation Division (CI) may receive referrals to determine whether a criminal inquiry is warranted. If CI declines to pursue a case, the auditor may still develop the civil fraud elements.

³¹³ The Omnibus Budget Reconciliation Act, Public Law 101-239, § 7741(a).

³¹⁴ IRC § 6651(f).

³¹⁵ IRC § 7454(a); U.S. Tax Ct. Rule 142(b).

³¹⁶ *Korecky v. Commissioner*, 781 F.2d 1566 (11th Cir. 1986).

³¹⁷ *Bradford v. Commissioner*, 796 F.2d 303, 307 (9th Cir. 1986).

³¹⁸ *King's Court Mobile Home Park, Inc. v. Commissioner*, 98 T.C. 511, 516 (1992).

³¹⁹ *Yang-Wu v. Commissioner*, T.C. Memo. 2002-68; see also *Bradford v. Commissioner*, supra note 317.

³²⁰ IRM 20.1.5.12.



ANALYSIS OF LITIGATED CASES

Civil fraud was at issue in 30 decisions litigated in the federal courts between June 1, 2001 and May 31, 2002. A detailed listing of the cases is found in table 3.9.1.

Taxpayers represented themselves before the court in 15 of the 30 cases, while attorneys represented the remaining 15. One of these *pro se* taxpayers prevailed when litigating the civil fraud penalty and split decisions were entered in two other *pro se* cases. The courts decided in favor of three taxpayers who were represented by counsel and issued split decisions in four other cases.

The fraud penalty was the primary issue in nine cases and was a collateral issue in the 21 others. Unreported income was the underlying issue in 17 of those 21 cases. Business deductions, net operating loss, the diesel fuel credit and valuation of an estate were the primary issues in the other four cases.

Of the nine cases where the fraud penalty was the primary issue, the courts sustained the IRS position in five cases and the taxpayers prevailed in three. The remaining two cases resulted in split decisions. Taxpayers offered several reasons for contesting the civil fraud penalty. The positions of the three taxpayers who prevailed were as follows:

- ◆ The taxpayer was grieving over the death of his spouse and was unable to focus on keeping adequate books and records.³²¹
- ◆ The taxpayers made honest mistakes and did not realize that their activities could be construed as fraudulent.³²²
- ◆ The taxpayer had no knowledge of fraudulent activity on the part of a company in which the taxpayer was a shareholder.³²³

The taxpayers' positions in the split decisions were:

- ◆ The taxpayer claimed reliance on her accountant's advice, which the court accepted for two out of three years before the court.³²⁴
- ◆ The taxpayer claimed that funds in his possession were not his income, but were corporate assets. As a result, there was no understatement to which the fraud penalty would attach. The taxpayer prevailed on his individual return, but the IRS was upheld on the corporate return.³²⁵

³²¹ Beck v. Commissioner, T.C. Memo. 2001-270.

³²² Terrell Equip. Co., Inc. v. Commissioner, T.C. Memo. 2002-58.

³²³ Estate of Feinsmith v. Commissioner, T.C. Memo. 2001-194.

³²⁴ Estate of Campana v. Commissioner, T.C. Summary Opinion 2001-159.

³²⁵ Zhadanov v. Commissioner, T.C. Memo. 2002-104.

Taxpayers made various arguments in four of the nine cases where the civil fraud penalty was sustained.

- ◆ One case was based on frivolous arguments where the taxpayer was contending his income from his business was not “gross income” under the tax code, that he was denied due process, and the sanction was inappropriate.³²⁶
- ◆ Another taxpayer relied on the “Cheek” defense, asserting that his failure to file was caused by a good-faith misunderstanding of the tax code.³²⁷
- ◆ The taxpayer in another case argued that the IRS did not prove fraud by clear and convincing evidence and that the Tax Court was “biased and prejudiced against him.”³²⁸
- ◆ The taxpayer claimed that income reported on Forms 1099 was overstated but did not specifically identify which forms reflected an overstatement and did not indicate any specific amounts of alleged overstatements.³²⁹

Of the 21 cases where the civil fraud penalty was the secondary issue, 17 taxpayers contested the penalty by challenging the underlying understatement of income or the method of determining the income. Overall, the courts sustained the penalty in 17 of the 21 cases.

CONCLUSION

We do not recommend any changes in legislation or IRS administrative procedures for asserting the civil fraud penalty. In the cases under review, the IRS’ decision to assess the penalty was based on circumstantial evidence or admission of guilt. The circumstantial evidence was established by associating the badges of fraud with the underlying issue that resulted in an understatement of tax. The reasons taxpayers litigated this issue were based on several contentions that challenged the badges of fraud, the issue causing the understatement of tax, or the legislative intent of applying the penalty. The IRS was usually sustained where taxpayers made frivolous arguments, provided implausible or inconsistent explanations of their behavior, engaged in illegal activities, failed to cooperate with taxing authorities, or kept inadequate books or records. Overall, the civil fraud penalty is asserted through the exercise of judgment and discretion. Because the burden of proof rests with the IRS, the IRS has appropriately taken a conservative posture when seeking to impose this penalty.

³²⁶ *Madge v. Commissioner*, T.C. Memo. 2000-370, *aff’d*, 23 Fed. Appx. 604 (8th Cir. 2001), *cert. denied*, 154 L. Ed. 2d 36, 123 S.Ct. 113 (2002).

³²⁷ *Lopez v. Commissioner*, T.C. Memo. 2001-211. *See Cheek v. United States*, 498 U.S. 192 (1991).

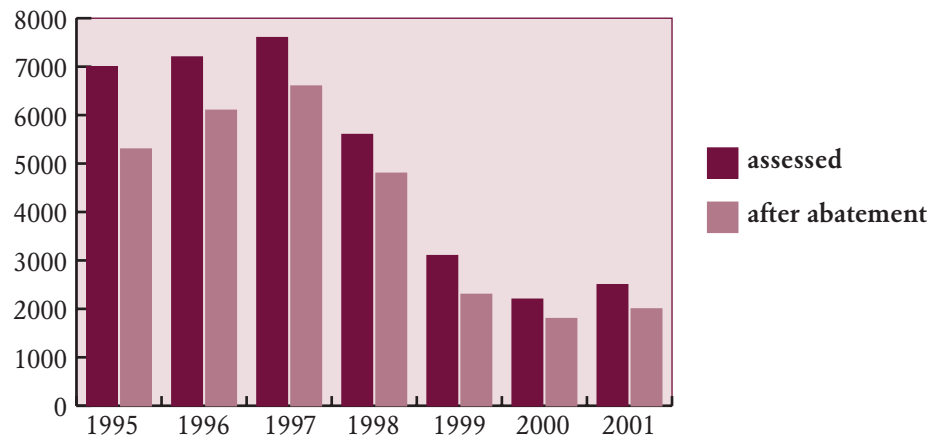
³²⁸ *House v. Commissioner*, T.C. Memo. 2000-22, *aff’d*, 24 Fed. Appx. 608 (7th Cir. 2001), *cert. denied*, 153 L.Ed.2d 840, 122 S.Ct. 2666 (2002).

³²⁹ *Levine v. Commissioner*, T.C. Memo. 2002-12.



The number and amount of civil fraud penalties assessed before and after abatement is recorded in the IRS Data Book, Publication 55b. The following graph demonstrates a decline in the number of penalties assessed after 1997:

THE NUMBER OF CIVIL FRAUD PENALTIES (CFP) ASSESSED BEFORE AND AFTER ABATEMENT FROM FISCAL YEARS 1995 TO 2001.³³⁰



The graph represents the number of civil fraud penalties assessed for all types of tax returns. The number of CFPs assessed rose until 1998, then began to decline. The reasons for this trend have not been analyzed. However, during this period the IRS has taken steps to strengthen the Fraud Penalty Program and improve the quality of fraud referrals.

It has not been determined whether the reduction in civil fraud penalties assessed is directly related to RRA98, which changed the enforcement of civil tax laws. However, after the law took effect, IRS resources shifted to customer service functions and fewer audits were conducted. The IRS has taken steps to reinvigorate the fraud program. The administrative process is established to ensure that the IRS effectively adheres to its policy and applies the civil fraud penalty in accordance with legislative intent.

³³⁰ IRS Data Book, Publication 55b, (1995, Table 15)(1996, Table 15)(1997, Table 15)(1998, Table 28)(1999, Table 29)(2000, Table 26)(2001, Table 26).

TABLE 3.9.1
LITIGATED CASES: FRAUD PENALTY

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Taxpayers (Issues Other Than Business Issues)					
Lopez	T.C. Memo. 2001-211	U.S. Tax Court	Fraud Penalty	No	IRS
Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)					
Bacon	88 A.F.T.R. 2d 6396 (3rd Cir. 2001)	U.S. Court of Appeals	Unreported income/ Fraud Penalty	No	IRS
Barnard	T.C. Memo. 2001-242	U.S. Tax Court	Unreported income/ Fraud Penalty	No	Split
Beck, E	T.C. Memo. 2001-270	U.S. Tax Court	Fraud Penalty	Yes	Taxpayer
Bisceglia	T.C. Memo. 2002-22	U.S. Tax Court	Unreported income/ Fraud Penalty	No	Split
Brodsky	T.C. Memo. 2001-240	U.S. Tax Court	Unreported income/ Fraud Penalty	No	Split
Clark	T.C. Memo. 2001-205	U.S. Tax Court	Unreported income/ Fraud Penalty	Yes	IRS
Console	T.C. Memo. 2001-232	U.S. Tax Court	Unreported income/ Fraud Penalty	Yes	IRS
Cordes	T.C. Memo. 2001-125	U.S. Tax Court	Unreported Income/ Fraud Penalty	No	IRS
Coyle	T.C. Summary Opinion 2002-42	U.S. Tax Court	Unreported Income/ Fraud Penalty	No	Split
Delvecchio	T.C. Memo. 2001-130	U.S. Tax Court	Net Operating Loss/ Fraud Penalty	No	IRS
Fagan	T.C. Memo. 2001-222	U.S. Tax Court	Unreported income/ Fraud Penalty	No	IRS
Hadri	T.C. Memo. 2002-77	U.S. Tax Court	Unreported income/ Fraud Penalty	Yes	IRS
House	2001 U.S. App. 26887 (7th Cir. 2001)	U.S. Court of Appeals	Fraud Penalty	Yes	IRS
Ishler	T.C. Memo. 2002-79	U.S. Tax Court	Unreported income/ Fraud Penalty	No	IRS
Levine	T.C. Memo. 2002-12	U.S. Tax Court	Fraud Penalty	No	IRS
Madge	88 A.F.T.R. 2d 6804 (8th Cir. 2001)	U.S. Court of Appeals	Fraud Penalty	Yes	IRS



TABLE 3.9.1 — LITIGATED CASES: FRAUD PENALTY (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Marsh	89 A.F.T.R. 2d 725 (9th Cir. 2002)	U.S. Court of Appeals	Unreported Income/ Fraud Penalty	Yes	IRS
Owens	T.C. Memo. 2001-314	U.S. Tax Court	Unreported Income/ Fraud Penalty	Yes	IRS
Pappas	T.C. Memo. 2002-127	U.S. Tax Court	Unreported income/ Fraud Penalty	Yes	IRS
Romer	T.C. Memo. 2001-168	U.S. Tax Court	Business Deductions/ Fraud Penalty	Yes	IRS
Terrell Equipment Co	T.C. Memo. 2002-58	U.S. Tax Court	Fraud Penalty	No	Taxpayer
Western Company of North America	52 Fed. Cl. 51	Federal Claims Court	Diesel Fuel Credit/ Fraud Penalty	No	IRS
Yang-Wu	T.C. Memo. 2002-68	U.S. Tax Court	Unreported Income/ Fraud Penalty	Yes	IRS
Zamzam	89 A.F.T.R. 2d 512 (4th Cir 2002)	U.S. Court of Appeals	Unreported Income/ Fraud Penalty	Yes	IRS
Zhadoavov, et al	T.C. Memo. 2002-104	U.S. Tax Court	Fraud Penalty	Yes	Split

Estate/Gift Taxpayers

Estate of Campana	T.C. Summary Opinion 2001-159	U.S. Tax Court	Fraud Penalty	Yes	Split
Estate of Feinsmith	T.C. Memo. 2001-194	U.S. Tax Court	Fraud Penalty	No	Taxpayer
Estate of Johnson	T.C. Memo. 2001-182	U.S. Tax Court	Unreported income/ Fraud Penalty	Yes	IRS
Estate of Trompeter	279 F.3d 767 (9th Cir. 2002)	U.S. Court of Appeals	Underreported taxable estate/Fraud Penalty	No	Taxpayer

**LITIGATED
ISSUE #10**
JOINT AND SEVERAL LIABILITY
PRESENT LAW

Taxpayers who are married at the end of the tax year can file their returns either jointly or separately. Many married taxpayers choose to file jointly because of the tax benefits that result from this status.

When couples file a joint return, they are jointly and severally liable for the tax and any interest or penalty due on that return even if they later divorce. This is true even if a divorce decree states that only one spouse will be responsible for any balances due on previously filed joint returns. Joint and several liabilities can result in one spouse paying the entire tax liability, even if the other spouse earned all the income.

The Internal Revenue Service Restructuring and Reform Act of 1998³³¹ (RRA '98) repealed the prior law that provided relief from joint and several liabilities.³³² The new law created three alternatives for taxpayers who have filed a joint return and are seeking relief from all or a portion of joint liability. The types of relief from joint and several liabilities are:

- ◆ “Traditional” relief,³³³
- ◆ Separation of liability,³³⁴ and
- ◆ Equitable relief.³³⁵

The new law regarding joint and several liability relief is effective for unpaid balances as of July 22, 1998, and for liabilities arising after that date. Taxpayers must request relief no later than two years after the first IRS collection activity.³³⁶

“Traditional” Relief

A taxpayer can be relieved of liability for tax, interest and penalties if his or her spouse omitted income, or overstated deductions, exemptions, credits or basis on the couple’s tax return. If relief is granted, the tax, interest and penalties that qualify for relief can be collected only from the other spouse. However, the electing spouse remains jointly and individually responsible for any tax, interest and penalties that do not qualify for relief, and the IRS can collect these amounts from either spouse. The taxpayer must meet all of the following conditions to qualify for “traditional innocent spouse” relief:

³³¹ The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685.

³³² RRA '98 repealed IRC § 6013(e) and replaced it with IRC § 6015.

³³³ IRC § 6015(b).

³³⁴ IRC § 6015(c).

³³⁵ IRC § 6015(f).

³³⁶ IRC § 6015(b)(1)(E); IRC § 6015(c)(3)(B); Rev. Proc. 2000-15, 2000-5 I.R.B. 447.



- ◆ File a joint return that understates tax due to erroneous items of the other spouse;³³⁷
- ◆ Establish that at the time both taxpayers signed the joint return the electing spouse did not know, and had no reason to know, that there was an understatement of tax; and
- ◆ Demonstrate that, after taking into account all the facts and circumstances, it would be unfair to hold the electing spouse liable for the understatement.

A taxpayer granted traditional relief from joint and several liabilities may receive a refund of an overpayment. Although the normal statutory limitation period applies to this refund,³³⁸ the IRS requires that the amount of tax be paid on or after July 22, 1998.³³⁹

Separation of Liability

A taxpayer may seek a separate liability election for deficiencies arising from a joint return. To qualify, the taxpayer must have filed a joint return and meet either of the following requirements:

- ◆ Be no longer married to, or be legally separated from the spouse with whom he or she filed the joint return for which he or she is requesting relief (widows and widowers are considered to be no longer married); or
- ◆ Not be a member of the same household as the spouse with whom he or she filed the joint return at any time during the 12-month period ending on the date relief is requested.

Even if the taxpayer meets the above requirements, separation of liability will not be granted if:

- ◆ The IRS proves that the taxpayer and spouse transferred assets as part of a fraudulent scheme;
- ◆ The IRS proves that at the time the taxpayer signed the joint return, the taxpayer had actual knowledge of items giving rise to the deficiency that were allocable to the spouse;
- ◆ The spouse (or former spouse) transferred property to the taxpayer to avoid tax or the payment of tax.

³³⁷ Generally, an understatement of tax is the difference between the total amount of tax that should have been shown on the return and the amount of tax that was actually shown on the return. Erroneous items include unreported income received by the other spouse, or an incorrect deduction, credit, or basis claimed by the other spouse.

³³⁸ IRC §§ 6511(a) and (b).

³³⁹ Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Sec. 3201(g)(1), 112 Stat. 685, 740 (1998).

Taxpayers cannot receive a refund of an overpayment if separate liability relief is granted.³⁴⁰

Equitable Relief

Taxpayers who do not qualify for traditional or separate liability relief may still be relieved of liability for paying tax, interest, and penalties under the equitable relief provision.

Taxpayers must meet all of the following conditions to qualify for equitable relief:

- ◆ The taxpayer does not qualify for traditional or separate liability relief;
- ◆ The taxpayer and spouse did not transfer assets to one another as a part of a fraudulent scheme;
- ◆ The spouse did not transfer assets to the taxpayer to avoid tax or the payment of tax;
- ◆ The taxpayer did not file the return with intent to commit fraud; and
- ◆ The taxpayer establishes that, taking into account all the facts and circumstances, it would be inequitable to hold him or her liable for the understatement or underpayment.³⁴¹

The IRS will consider all facts and circumstances to determine whether it is inequitable to hold the taxpayer responsible for understatement or underpayment of tax.³⁴²

The IRS' position is that a taxpayer is eligible to receive a refund under IRC § 6015(f) for the following payments:

- ◆ Amounts paid on or after July 22, 1998 and on or before April 15, 1999, and
- ◆ Installment payments made after July 22, 1998 pursuant to an installment agreement with the Service, where the individual is not in default, and where the payments are made after relief is requested.³⁴³

Community Property Laws

Community property laws of the state where the taxpayer lives determine what is community versus separate income and property. This determination affects the income that a married individual is required to report on his or her separate return. If a husband and wife live in a community property state and file separately, each is required to report his or her share of the community property income and all of his or her separate income.

Community property laws usually require couples to allocate community property income and expenses equally. Community property is all property acquired during a

³⁴⁰ IRC § 6015(g)(3) specifically excludes the issuance of a refund under the "separate liability."

³⁴¹ An underpayment is the amount of tax properly reported on the return but not paid.

³⁴² Rev. Proc. 2000-15 provides guidance on how to apply the equitable relief provision.

³⁴³ Rev. Proc. 2000-15, 2000-5 I.R.B. 447.



marriage while the spouses live in a community property state. It includes salaries, wages, pay for services, and income from real estate that is treated as community property under the laws of the state where the property is located.

In the event there are items that create an understatement of tax, married taxpayers who file separate returns in community property states may seek and be granted relief of liability under IRC § 66(c). Under regulations prescribed by the Secretary, an item of community income shall be included in the gross income of the other spouse if an individual:

- ◆ Filed a separate return for the tax year,
- ◆ Did not include an item of community income in gross income on the separate return,
- ◆ Establishes that he or she did not know of, and had no reason to know of, such item of community income; and
- ◆ Under all facts and circumstances, demonstrates that it would be inequitable to include the item of community property income in his or her gross income.³⁴⁴

If an individual does not qualify for relief under IRC§ 66(c), relief under IRC § 6015(f) may be considered.

Tax Court Review

If a request for relief is partially or fully disallowed, the taxpayer may petition the Tax Court within 90 days of the mailing date of the determination letter denying relief. The requesting spouse may also petition the court if the IRS does not make a determination within six months of the time the request is filed.³⁴⁵

ANALYSIS OF LITIGATED CASES

There were 14 joint and several liability relief cases litigated between June 1, 2001 and May 31, 2002. Of the 14 cases, 11 were litigated in Tax Court, one in the U.S. Court of Appeals (5th Circuit), one in the United States Court of Federal Claims and one in the Bankruptcy Court for the Northern District of West Virginia. Six of the 14 cases were litigated *pro se*, or without benefit of legal counsel. A detailed listing of the cases litigated is found on Table 3.10.2 of this report.

³⁴⁴ IRC § 66(c), Spouses relieved of liability in certain other cases.

³⁴⁵ IRC § 6015(e).

The cases we reviewed break down as follows:

TABLE 3.10.1
JOINT AND SEVERAL LIABILITY LITIGATED CASES

DECIDED IN FAVOR OF		TYPE OF TAXPAYER		TYPE OF CASE		TYPE OF UNDERSTATEMENT	
IRS	8	Individual	3	Understatement	11	Omitted Income	4
Taxpayer	5	Schedule C, Partnership or Trust	9	Underpayment	2	Erroneous Deductions	5
Pending	1	Estate and Gifts	2	Understatement and Underpayment	1	Both Income and Deductions	2
	14		14		14		11

The following is an analysis of some of the significant court decisions:

Cheshire v. Commissioner

The United States Tax Court, in a divided opinion, held in *Cheshire v. Commissioner*³⁴⁶ that the knowledge requirement of IRC § 6015(c)(3)(C) is met if the IRS proves the requesting spouse had knowledge of the underlying transaction that produced the omitted income and created the deficiency. A dissenting opinion argued that the term “item giving rise to a deficiency” in IRC § 6015(c)(3)(c) is ambiguous, so the statute could mean knowledge of the transaction or activity or it could mean knowledge that an entry on a tax return was incorrect. The court found that the wife had “an actual and clear awareness of the omitted income,” which in this case was a retirement distribution. The court found that the wife was aware of the distribution and the fact that it was deposited in a joint account. Thus, the election to allocate liability under IRC § 6015(c) was denied.

The United States Court of Appeals for the Fifth Circuit upheld the Tax Court’s decision.³⁴⁷ The requesting spouse did not qualify for relief under IRC § 6015(b) because she was aware of all of the facts regarding the underlying transaction that resulted in the understatement of tax on the return. This awareness was sufficient in this case regardless of the case’s classification as involving an omission of income or an erroneous deduction. The requesting spouse was similarly not entitled to relief under IRC § 6015(c). In making its decision, the Court of Appeals defined “item” to mean an item of income, deduction

³⁴⁶ 115 T.C.183 (2000), *aff’d*, 282 F.3d 326 (5th Cir. 2002).

³⁴⁷ *Cheshire v. Commissioner*, (5th Cir.) 282 F.3d 326 (2002).



or credit, rather than the *incorrect tax reporting* of an item of income, deduction or credit. The Court of Appeals also determined that the Tax Court did not abuse its discretion in denying relief under IRC § 6015(f).

Rowe v. Commissioner

Prior to litigation in the *Rowe*³⁴⁸ case, the Commissioner granted complete relief to the requesting spouse under IRC § 6015(c) for IRA distributions and farming activity losses attributable to the non-requesting spouse. The IRS also granted partial relief under IRC § 6015(c) for half of the unreported capital gains from jointly held property, an overstated mortgage interest deduction, and overstated charitable contributions that were found to be allocable to the non-requesting spouse. The only items remaining were half of the capital gains, mortgage interest, and charitable contributions and several minor items of income attributable to the requesting spouse. The IRS denied the taxpayer relief for these items under IRC § 6015(b) and under IRC § 6015(f). The Commissioner argued that, considering all facts and circumstances, the determination that petitioner was not entitled to equitable relief was consistent with published guidance.

The Tax Court found that the Commissioner abused his discretion in denying the taxpayer's claim for relief under IRC § 6015(f) for the allocated half of the capital gains, mortgage interest and charitable contributions. The court held that on the basis of all the facts and circumstances, compelling reasons existed for the respondent to grant the petitioner equitable relief. Liability was not eliminated for other minor items of income attributable to the requesting spouse.³⁴⁹

Mora v. Commissioner

Estate of Jonson v. Commissioner

Both cases were understatement cases arising from erroneous deductions. In each case, the return showed significant losses as the result of flow-through losses from partnerships.

In *Mora v. Commissioner*,³⁵⁰ the requesting spouse filed a petition in response to the denial letter received from the IRS. The taxpayer represented herself *pro se*; the non-requesting spouse intervened in this case.³⁵¹ The court determined the requesting spouse did not qualify for relief under IRC § 6015(b). Applying the standard enunciated by the U.S. Court of Appeals for the Ninth Circuit in *Price v. Commissioner*,³⁵² the Tax Court held that the requesting spouse had reason to know of the understatement because the losses

³⁴⁸ *Rowe v. Commissioner*, T.C. Memo. 2001-325.

³⁴⁹ The decision has not been entered and the appeal period is still open.

³⁵⁰ 117 T.C. 279 (2001).

³⁵¹ Tax Court Rule 325 sets forth the procedures for intervention by non-requesting spouses.

³⁵² 887 F.2d 959, 962 (9th Cir. 1989).

claimed were too large relative to the couple's income for a person of the requesting spouse's education level to ignore.

However, the court considered and granted relief under IRC § 6015(c). It found that the requesting spouse proved she had no involvement in the decision to invest in the partnership or have the partnership group prepare the couple's tax returns. The requesting spouse also signed no partnership documents. The Court cited *King v. Commissioner*³⁵³ in deciding that the requesting spouse did not have actual knowledge. Specifically, the requesting spouse did not know of the factual basis for the denial of the deductions claimed on the return. The court acknowledged that, while in many limited partnership cases neither spouse would have knowledge of the factual basis for denial of deductions, relief under IRC § 6015(c) would not be available to the spouse to whom the deductions are allocated, regardless of knowledge. Although the court ruled for the requesting spouse on this issue, the amount of relief was limited because of the provisions of IRC § 6015(d)(3)(B) (the tax benefit rule). The requesting spouse had the benefit of a reduced liability on the joint return because of the partnership loss.

In *Estate of Jonson v. Commissioner*,³⁵⁴ the Tax Court was presented with facts similar to those in *Mora*. The wife died while still married to and living with her husband, the petitioner. The husband, as personal representative, filed a claim for relief under IRC § 6015. The court considered relief under IRC § 6015(b), but found that the taxpayer had "reason to know." The deceased wife was educated and involved in the family finances, was aware of the investment and knew of the tax savings and risks. The court then considered relief under IRC § 6015(c), determining that the requesting spouse did not qualify because she was still married to the non-requesting spouse at the time of her death. Finally, the court determined the government did not abuse its discretion in denying equitable relief under IRC § 6015(f), citing several negative factors from IRS published guidance,³⁵⁵ including consideration of knowledge, significant benefit, and lack of economic hardship.

The key difference in the two cases is the ability to consider relief under IRC § 6015(c). The taxpayer in *Mora* qualified but the petitioner in *Jonson* did not. Marital status was determined at the time of death.³⁵⁶

³⁵³ 116 T.C. 198, 203 (2001).

³⁵⁴ 118 T.C. 106 (2002).

³⁵⁵ Rev. Proc. 2000-15, 2000-5 I.R.B. 447.

³⁵⁶ The personal representative on behalf of the estate has appealed this decision.



**MORRIS V. COMMISSIONER
BECK V. COMMISSIONER**

There were two cases litigated under IRC § 66(c), involving community property jurisdictions. Both of the requesting spouses contended they were entitled to relief because they had not filed joint returns. In *Morris v. Commissioner*³⁵⁷ the petitioner failed to include any portion of her husband's IRA withdrawals on her separate return. In *Beck v. Commissioner*,³⁵⁸ the petitioner did not file returns for the periods in question and her spouse included the income on his separate return. Both taxpayers represented themselves *pro se*.

In *Morris*, the Tax Court held that no part of the IRA withdrawal was community income and therefore no portion needed to be reported on the requesting spouse's return. After application of this holding, there remained a small deficiency for the 1996 year. The Court held that the IRS did not abuse its discretion in denying relief under IRC § 66(c) as to this deficiency. In *Beck*, the Court denied relief on the grounds that the requesting spouse had knowledge of the community income, and it would not be inequitable to hold her liable because she benefited from the untaxed income.

The IRS initially contended in *Beck* that the denial of equitable relief under IRC § 66(c) was not subject to judicial review. The Tax Court disagreed. The Court concluded that because IRC § 66(c) was enacted in the same section of legislation as IRC § 6015(f), and the Court had previously decided it had jurisdiction to review the Commissioner's determination for an abuse of discretion under that section, the Court similarly had jurisdiction to review the Commissioner's determination under IRC § 66(c) for an abuse of discretion.³⁵⁹

In *Morris*, the taxpayer had filed separate tax returns for the years at issue because she harbored doubts about her spouse's honesty in reporting his tax liability. The IRS determined that he had received several pension distributions and business income that had not been reported. The IRS applied community property principles to determine the parties' share of income, additional tax and deductions. The court, following *Bunney v. Commissioner*,³⁶⁰ held that the distributee or payee of an IRA distribution is the participant or beneficiary who is entitled to receive the distribution under the plan. The court further concluded that Louisiana community property law did not require a different result. The main erroneous items, the IRA distributions, were not community income and did not need to be included on the separate return.

³⁵⁷ T.C. Memo. 2002-17.

³⁵⁸ T.C. Memo. 2001-198.

³⁵⁹ See *Butler v. Commissioner*, 114 T.C. 276, 287-292. (2000); see also *Fernandez v. Commissioner*, 114 T.C. 324, 328-332 (2000) (Tax Court has authority in "stand alone" petition filed pursuant to IRC § 6015(e)(1)(A) to review denial of relief under section 6015(f).)

³⁶⁰ 114 T.C. 259 (2000).

The remaining adjustments related to the business income of the petitioner's husband and it was the petitioner's share of that community income that gave rise to a deficiency. The Court found that the taxpayer knew her husband was engaged in business and did not keep reliable records; it appeared she benefited from that income; the remaining deficiency was estimated to be only \$200 and the petitioner did not demonstrate that paying that tax would not create an economic hardship. The Court concluded that the Commissioner did not abuse his discretion in denying relief under IRC § 66(c).

FLORES V. UNITED STATES

In *Flores v. United States*,³⁶¹ the 1988 joint return reflected a balance due that was not fully paid when the return was filed. The IRS seized the Flores' community property, including their home, sold it and applied the proceeds to the joint liability. The taxpayer filed a timely claim for refund, requesting relief from joint and several liability. The IRS denied the claim and the taxpayer filed a complaint in the United States Court of Federal Claims.

The Court of Federal Claims held the taxpayer was entitled to relief under IRC § 6015(f) for the entire 1988 liability even though only a portion of it was unpaid as of July 22, 1998, the date of enactment of IRC § 6015.

In *Flores*, the Court decided that the phrase "remained unpaid" meant that if any amount of the liability for a year was unpaid, the entire liability for that year "remained unpaid" and was available to be refunded. The amounts to be refunded in this case were the proceeds from the seizure and sale of the petitioner's home. The government is not appealing the decision, but is not acquiescing in the decision. The Tax Court has not yet addressed this issue.

EWING V. COMMISSIONER

In *Ewing v. Commissioner*,³⁶² the decision of the Tax Court related to the IRS' motion to dismiss the case for lack of jurisdiction. The motion argued that the petition was not timely filed because it was filed 99 days after the IRS mailed the notice of determination, which was beyond the 90-day limit set forth in IRC § 6015(e)(1)(A)(ii). However, the court found the notice of determination was not mailed to the taxpayer's last known address; thus the petition was not filed later than the close of the 90th day after the date the Commissioner mailed the notice of determination to the last known address. The delay caused by the improperly addressed notice was prejudicial to the taxpayer's ability to timely file her petition. The court denied the motion to dismiss.

³⁶¹ 51 Fed. Cl. 49 (2001).

³⁶² 118 T.C. 31 (2002).



During the hearing on the motion, the court raised the issue of whether it lacked jurisdiction under IRC § 6015(e) to review the denial of equitable relief where no deficiency had been assessed. The court, in agreement with both parties' position, held that the absence of a deficiency does not deprive the Tax Court of jurisdiction over a petitioner's claim for equitable relief pursuant to IRC § 6015(f). This opinion basically holds that the Tax Court has jurisdiction over all IRC § 6015 cases, assuming a petition has been timely filed.

The court has not yet addressed the taxpayer's request for relief under IRC § 6015(f). The taxpayer and her husband filed a joint tax return for 1995 and reported tax due but did not pay the full amount. A trial on this issue is scheduled for early in 2003.

CONCLUSION

Our analysis of litigated cases brings into focus several issues that require additional guidance or legislative clarification.

Refunds Available When Taxpayers are Granted Equitable Relief Under IRC § 6015(f)

The provisions of IRC § 6015(g) specifically authorize refunds. The IRS has interpreted the phrase "unpaid tax or any deficiency" in IRC § 6015(f) to mean that refunds were not intended under this subsection. However, the language of IRC § 6015(g) and the allowance of equitable relief under IRC § 6015(f) appear to be sufficiently broad to permit the IRS to grant refunds to taxpayers warranting equitable relief. The IRS' published guidance provides that a requesting spouse is eligible to receive refunds under IRC § 6015(f) for:

- 1) Amounts paid on or after July 22, 1998, and on or before April 15, 1999; and
- 2) Installment payments, made after July 22, 1998, pursuant to an installment agreement entered into with the IRS and with respect to which an individual is not in default, that are made after the claim for relief is requested.³⁶³

This IRS guidance can prevent taxpayers who qualify for equitable relief from joint and several liabilities from receiving such relief. Particularly in those cases where the tax was not paid with the original return, a taxpayer may first learn of the liability when the IRS tries to collect it. To deny a refund of that collected amount to a taxpayer who otherwise qualifies for equitable relief can be in itself inequitable.

For married individuals in community property states, IRC § 66 provides for the allocation of income to the individual earning that income. This section also provides for relief from the effect of community property state laws on the federal tax liability of a spouse when, under the facts and circumstances, it would be inequitable to include the item of

³⁶³ Rev. Proc. 2000-15, 2000-5 I.R.B. 447.

community income in the individual's gross income. Therefore, credits and refunds are also restricted in applying IRC § 66(c) equitable relief.

The National Taxpayer Advocate's 2001 Annual Report to Congress discusses this subject in greater detail.³⁶⁴ The report recommends that the language of IRC § 6015(g) be modified to expand the scope of refunds under IRC § 6015(f) to include those refunds available to the taxpayer under the refund limitation rules described in IRC §§ 6511(a) and (b). Thus, a taxpayer qualifying for equitable relief under IRC § 6015(f) should be entitled to the same refunds as a taxpayer qualifying for "traditional" relief under IRC § 6015(b).

The rights of non-requesting spouses

Currently, the non-requesting spouse (NRS) has two opportunities to participate in the determination of whether the NRS is entitled to relief under IRC § 6015. The IRS notifies the NRS of the requesting spouse's claim for relief and provides the NRS with the opportunity to take part in the administrative review process.³⁶⁵ IRS includes a questionnaire with its letter to the NRS.³⁶⁶ The NRS is not required to respond to the questionnaire. However, if the spouse does respond, the examiner will consider the answers in making a decision to grant or deny relief. If the requesting spouse petitions the Tax Court, the NRS is given an opportunity to intervene.³⁶⁷

The final regulation under IRC § 6015 provides that the Secretary must notify the NRS of the preliminary and final determination.³⁶⁸ The regulations do not prohibit the NRS from appealing the IRC § 6015 determinations. Therefore, the NRS will now have a third opportunity to participate. IRS will now notify the NRS of its preliminary decision at the same time that it notifies the requesting spouse. The NRS will have the right to request an Appeals hearing to protest the determination to grant partial or full relief within 30 days of the notification letter. If the determination is a full denial, IRS will inform the NRS that he or she will be contacted if the requesting spouse protests the decision.

IRS is currently developing guidance and administrative procedures to implement these appeal rights. An explanation will be incorporated in letters sent to the requesting and non-requesting spouses. A Taxpayer Advocate Service employee is participating in this initiative.

³⁶⁴ National Taxpayer Advocate's FY 2001 Annual Report to Congress, Publication 2104 (Revision 12-2001), pages 155 – 158.

³⁶⁵ IRC § 6015(h)(2).

³⁶⁶ Form 12508, Innocent Spouse Information Request.

³⁶⁷ Tax Court Rule 325.

³⁶⁸ Treasury Regulation § 6015-1, Joint and Several Liability (effective July 18, 2002).



Equitable Relief Factors

The National Taxpayer Advocate's 2001 Annual Report to Congress recommended that Internal Revenue Code § 6015(f) be revised to describe the factors to be used in making the determination to grant equitable relief.³⁶⁹ Our recommendation that no one factor alone should be sufficient to warrant IRC § 6015(f) relief, and that knowledge, actual or constructive, should not automatically be given more weight than other factors is still applicable.

³⁶⁹ *National Taxpayer Advocate's FY 2001 Annual Report to Congress*, Publication 2104 (Revision 12-2001) pages 147 – 150.

TABLE 3.10.2
LITIGATED CASES, JOINT & SEVERAL LIABILITY

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Taxpayers (Issues Other Than Business Issues)					
Cheshire	282 F.3d 326 (2002)	5th Circuit	Retirement Distributions	No	IRS
Flores	51 Fed. Cl. 49 (2001)	Court of Federal Claims	Claim for refund	No	Taxpayer
Ewing	118 T.C. 31	Tax Court	Underpayment of Tax	No	Case still pending
Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)					
Morris	T.C. Memo. 2002-17	Tax Court	Community Property income	Yes	IRS
Smith	T.C. Memo. 2001-313	Tax Court	Unknown – Returns and Deficiency Notice were not available at time of trial	No	IRS
Beck	T.C. Memo. 2001-198	Tax Court	Community Property Income	Yes	IRS
Mueller	T.C. Memo. 2001-178	Tax Court	Items omitted from gross income	Yes	IRS
Mora	117 T.C. 279	Tax Court	Partnership losses	Yes	Taxpayer
Ishizaki	T.C. Memo. 2001-318	Tax Court	Unreported Income	No	IRS
Shafman	267 B.R. 709 (2001)	Bankruptcy Court for the Northern District of W. VA.	Understatement of Income	No	Taxpayer
Gillispie	T.C. Summary Opinion 2002-34	Tax Court	Income from business	Yes	Taxpayer
Rowe	T.C. Memo. 2001-325	Tax Court	Unreported Income/ Disallowance of Deductions	Yes	Taxpayer
Estate/Gift Taxpayers					
Estate of Gurr	T.C. Summary Opinion 2002-7	Tax Court	Capital Gains and Losses	No	IRS
Estate of Johnson	118 T.C. 106	Tax Court	Disallowance of losses related to a limited partnership	No	IRS



LITIGATED
ISSUE #11

BARRED REFUNDS

PRESENT LAW

Currently, a claim for refund or credit for an overpayment of tax must be filed within the later of two periods: three years after the filing date of the return to which the overpayment relates, or two years after the tax was paid.³⁷⁰ If a taxpayer does not file a return, any claim must be filed within two years after the tax is paid.³⁷¹ If the taxpayer and the Internal Revenue Service (IRS) agree to extend the time for assessment, the period for filing a refund claim is extended for the same period, plus six months.³⁷²

If no claim is filed within the prescribed period, the IRS is barred from issuing a refund or credit to the taxpayer, regardless of the merits of the claim.³⁷³ The United States Supreme Court has ruled that the statute of limitations cannot be suspended for equitable reasons.³⁷⁴

The two-year and three-year periods for filing claims do not run during any period in which the individual is financially disabled.³⁷⁵ This situation occurs when the individual is unable to manage his or her financial affairs because of a medically determinable, physical or mental impairment that is expected to result in death, or has lasted or can be expected to last for a continuous period of not less than 12 months. The IRS may require proof of the impairment.³⁷⁶ An individual is not considered financially disabled during any period when his or her spouse or any other person is authorized to act on behalf of the individual in financial matters.³⁷⁷ This subsection of the Internal Revenue Code was enacted in 1998.

ANALYSIS OF LITIGATED CASES

A sample of 12 cases, involving claims for refund of an overpayment of tax, which were litigated in the federal court system between June 1, 2001, and May 31, 2002, was analyzed for this section of the report. Table 3.11.1 lists the specific case citations. Eight of the twelve cases were litigated *pro se*, that is, the taxpayers represented themselves before the court. Only four taxpayers had attorneys or other representation.

³⁷⁰ IRC § 6511(a).

³⁷¹ *Id.*

³⁷² IRC § 6511(c)(1).

³⁷³ IRC § 6511(b)(1). *Long v. United States*, 130 Ct. Cl. 806 (1955); *Oropallo v. United States*, 994 F.2d 25 (1st Cir. 1993), cert. denied, 510 U.S. 1050 (1994); *Rinaldi v. Commissioner*, 30 Fed. Cl. 164 (1993).

³⁷⁴ *United States v. Brockamp*, 519 U.S. 347 (1997), but see discussion re IRC § 6511(h)(1) following.

³⁷⁵ IRC § 6511(h)(1), enacted after the Supreme Court's decision in *Brockamp* (footnote 374).

³⁷⁶ IRC § 6511(h)(2)(A). See Rev. Proc. 99-21 for the specific information required for an individual to request that the limitations period for claiming a tax credit or refund be suspended due to financial disability.

³⁷⁷ IRC § 6511(h)(2)(B).

The following categories of issues were found within the cases litigated due to barred refunds:

- ◆ Deposit vs. Payment of Tax
- ◆ Formal vs. Informal Claim
- ◆ Equitable Relief
- ◆ Miscellaneous Issues

Deposit v. Payment of Tax

A taxpayer can make a “deposit” with the IRS before a deficiency has been assessed or while challenging a deficiency in Tax Court. The deposit will prevent interest and penalties from accruing on any deficiency that is ultimately found. Unlike a payment, a deposit is not subject to a claim for credit or refund as an overpayment. The taxpayer may request return of all or part of the deposit at any time before the IRS is entitled to assess the tax. That amount will be returned to the taxpayer without interest, unless the IRS determines that assessment or collection of the tax due would be in jeopardy, or that the amount should be applied against any other liability.³⁷⁸

Upon completion of an examination, if a taxpayer who has made a deposit waives restrictions on assessment and collection of the deficiency or otherwise agrees to the full amount of the deficiency, an assessment will be made and any deposit will be applied against the assessed liability as a payment of tax. No notice of deficiency will be mailed in such a case. Thus, the taxpayer will not have the right to petition the Tax Court for re-determination of the deficiency.³⁷⁹

The United States Supreme Court has addressed the issue of deposits versus payments, ruling that the individual circumstances of each case must be evaluated.³⁸⁰ The circumstances include the timing of the remittance, the intent of the taxpayer when making it, and how the IRS treated the remittance upon receipt.³⁸¹

In one of the cases analyzed, the taxpayer argued that his remittances constituted deposits and not payments of tax.³⁸² However, after reviewing all the facts and circumstances in the case, the court determined that the remittances were payments of tax and not deposits.

³⁷⁸ Rev. Proc. 84-58.

³⁷⁹ *Id.*

³⁸⁰ *Rosenman v. United States*, 323 U.S. 658 (1945).

³⁸¹ *Fier v. United States*, 89 A.F.T.R.2d 1649 (2002), at *15; *Dantzler v. United States*, 183 F.3d 1247, at **7.

³⁸² *Fier v. United States*, 89 A.F.T.R.2d 1649 (2002), at *13.



FORMAL V. INFORMAL CLAIM

An individual must file a *formal claim* for refund or credit on Form 1040X, Amended U.S. Individual Income Tax Return, or on Form 843, Claim for Refund and Request for Abatement, within the prescribed statute of limitations.³⁸³ A separate claim must be filed for each year for which the taxpayer is requesting a refund.

An *informal claim* is not filed on Form 1040X and may be a letter or other document, but must contain enough information to be recognized and treated by the IRS as a valid claim.³⁸⁴ In all three litigated cases involving informal claims that were analyzed for this section, the taxpayers failed to meet the requirements for a valid informal claim.

In one case, the court summarized the law concerning informal claims as follows:

It has long been recognized that a writing which does not qualify as a formal refund claim nevertheless may toll the period of limitations applicable to refunds if;

- (1) the writing is delivered to the IRS before the expiration of the applicable period of limitations,
- (2) the writing in conjunction with its surrounding circumstances adequately notifies the IRS that the taxpayer is claiming a refund and the basis therefore, and
- (3) either the IRS waives the defect by considering the refund claim on its merits or the taxpayer subsequently perfects the informal refund claim by filing a formal claim before the IRS rejects the informal refund claim.³⁸⁵

Equitable Relief

One of the cases litigated in the “equitable relief” category involves a taxpayer who sought a refund of self-employment taxes she paid for the years 1986 to 1995 because her employer led her to believe that she was an independent contractor, making her responsible for paying her employment taxes directly to the IRS.³⁸⁶ On May 3, 1999, the IRS issued a determination letter ruling that she was an employee for federal tax purposes and that her employer was responsible for paying the employer’s share of her social security taxes. Prior to receiving this letter on January 22, 1999, the taxpayer filed a protective claim for refund of the taxes she had erroneously paid. The IRS subsequently refunded the 1995 taxes but disallowed her claims for the years 1986 through 1994 because the claims were not filed within the prescribed period.³⁸⁷

³⁸³ IRC § 6511(a).

³⁸⁴ Jackson v. Commissioner, T.C. Memo. 2002-44, at *11 to *12.

³⁸⁵ Id.

³⁸⁶ Knis v. United States, 86 A.F.T.R.2d 7157 (2000), *aff’d* 10 Fed. Appx. 942 (2001).

³⁸⁷ IRC § 6511(a).

The taxpayer appealed the disallowance to the United States Court of Federal Claims.³⁸⁸ Her appeal was based on the argument that the statute of limitations should not bar her claim because she was unaware until 1999 that her employer was responsible for paying her social security taxes. In essence, her claim was that the statute of limitations should be suspended for equitable reasons. In denying her claim, the Court cited the United States Supreme Court holding that IRC § 6511 contains no equitable exceptions that would permit a suspension.³⁸⁹ The taxpayer then appealed to the Court of Appeals for the Federal Circuit, which affirmed the lower court's ruling.³⁹⁰

Miscellaneous

Seven barred refund cases fell into the miscellaneous category. They contained a variety of facts and circumstances put forth by taxpayers for their failure to file timely claims.³⁹¹ No detailed analysis of these cases was conducted due to the varying issues.

CONCLUSION

The barred refund cases litigated between June 1, 2001, and May 31, 2002, do not present a principal underlying issue. In most instances, the issues appear to be factual in nature and do not suggest that legislation is required to address the perceived problems. In one instance, however, a legislative change may be warranted.

In *Knis v. United States*, the taxpayer erroneously paid self-employment taxes because her employer treated her as an independent contractor.³⁹² She was denied refunds of one-half of her social security taxes, even though she was unaware that she had been harmed until she received the IRS determination letter. This inequitable result can be alleviated by an amendment to IRC § 6511 to suspend the running of the final determination of employment classification, either in an administrative proceeding, or in a Tax Court proceeding involving determinations of employee status under Section 530 of the Revenue Act of 1978.

³⁸⁸ *Knis v. United States*, 86 A.F.T.R.2d 7157 (2000).

³⁸⁹ *United States v. Brockamp*, 519 U. S. 347 (1997), at *348.

³⁹⁰ *Knis v. United States*, 10 Fed. Appx. 942 (2001).

³⁹¹ *Burr v. Commissioner*, T.C. Memo. 2002-69; *Demes v. United States*, 52 Fed. Cl. 365; *Elder v. I.R.S.*, 2002-1 U.S.T.C. 50,357; *McBride v. United States*, 146 F. Supp. 2d 1105; *Van Sant v. United States*, 2002-1 U.S.T.C. 50,175; *Chrysler Corp. v. Commissioner*, 116 T.C. 465; *R.S. Good Trucking, Inc. v. United States*, 2002-1 U.S.T.C. 50,101.

³⁹² *Knis v. United States*, 86 A.F.T.R.2d 7157 (2000); 10 Fed. Appx. 942 (2001). See detailed discussion of cases in the Equitable Relief section above.



**TABLE 3.11.1
LITIGATED CASES: BARRED REFUND**

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Taxpayers (Issues Other Than Business Issues)					
Burr	T. C. Memo. 2002-69	U.S. Tax Court	Whether overpayment shown on 1994 delinquent return was barred as a credit against 1995 and 1996 tax liabilities	Yes	IRS
Demes	52 Fed. Cl. 365	U.S. Court of Federal Claims	Claim for refund of 1989 tax filed in 1998. Refund claim based on bad debt loss carryback	Yes	IRS
Elder	2002-1 U.S.T.C. 50,357	U. S. District Court for the Western District of Virginia, Lynchburg	Claim for refund filed in 2000 of 1985 tax paid in 1987	Yes	IRS
Fier	2002-1 U.S.T.C. 50,355	U. S. District Court for the Southern District of New York	Whether funds remitted to IRS in 1988 and 1989 for the 1981 tax year constituted deposits rather than payments		IRS
Jackson	T.C. Memo. 2002-44	U. S. Tax Court	Whether refund of overpayments made in 1993 and 1994 was barred and whether taxpayer's letter to IRS constituted an informal claim	Yes	IRS
Knis	10 Fed. Appx. 942	U.S. Court of Appeals for the Federal Circuit	Claim for refund of self-employment taxes erroneously paid	Yes	IRS

TABLE 3.11.1 — LITIGATED CASES: BARRED REFUND (cont.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
McBride	146 F. Supp. 2d 1105	U.S. District Court for the Northern District of California	Claim for refund filed in 1998 seeking a refund of taxes, penalties, and interest paid in 1984 and 1988 for tax years 1979 and 1981	No	IRS
Miller	15 Fed. Appx. 875	U.S. Court of Appeals for the Federal Circuit	Informal demand for refund filed in 1997 for refund of taxes withheld from wages for tax years 1977 through 1987 and 1989. Suit based on constitutional arguments	Yes	IRS
Van Sant	2002-1 U.S.T.C. 50,175	U. S. District Court for the District of Columbia	Claim for refund filed in 1993 for tax withheld from retroactive compensation received in 1986	Yes	IRS
Wertz	51 Fed. Cl. 443	U. S. Court of Federal Claims	Informal claim for refund filed in 1998 for tax withheld in 1993	Yes	IRS

Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)

Chrysler Corporation	116 T.C. 465	U. S. Tax Court	Claim for refund filed in 1995 of 1985 tax arising from application of carryover of foreign tax credits from 1980, 1981, and 1982	No	IRS
R.S. Good Trucking, Inc.	2002-1 U.S.T.C. 50,101	U. S. Court of Federal Claims	Claim for refund of employment taxes paid on truck drivers based on the safe harbor provisions of Section 530 of the Revenue Act of 1978	No	IRS

MOST LITIGATED TAX ISSUES

