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Taxpayer Protections in the Proposed IRS Restructuring Act: Burden of Proof

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Summary

The Internal Revenue Service Restructuring and Reform Act of 1997 (H.R.2676, 105th Congress) contains a number of provisions designed to strengthen taxpayer rights in dealings with the Internal Revenue Service. The House passed its version of the bill on November 5, 1997, and the Senate passed its version on May 7, 1998. This is one of a series of CRS reports designed to discuss the taxpayer protection and rights provisions in that bill. This report discusses the proposal to shift the burden of proof in court proceedings relevant to ascertaining the income tax liability of a taxpayer. The provision can be found in section 301 of the House version and section 3001 of the Senate version.

The Internal Revenue Service Restructuring and Reform Act of 1997, H.R. 2676 (105th Congress), contains a number of provisions designed to strengthen taxpayer rights in dealings with the Internal Revenue Service. Both the House and Senate versions of the bill would amend the Internal Revenue Code to add a new section 7491, which is designed to shift the burden of proof from the taxpayer to the government in court proceedings relating to determinations of income tax liability. This report discusses section 301 of the House version of the bill and section 3001 of the Senate version.

Current Law

Under current law, in noncriminal tax cases, the burden of proof is generally on the taxpayer.[1] This is a common law provision, not a statutory edict. Assuming the case has reached the trial stage, the government presents the Internal Revenue Service determination or assessment. The IRS determination as to the amount of tax owing is presumed to be correct. If the taxpayer did not appear or did not defend, the government would win the case. In order to win, the taxpayer must prove by a preponderance of the

[1] Tax Court Rule 142 provides that the burden of proof is on the taxpayer except as otherwise provided by statute or determined by the court.

evidence that the IRS determination is incorrect, and if the taxpayer is suing for a refund, the correct amount of the tax. If the taxpayer has introduced sufficient evidence to allow a reasonable judge to decide in the taxpayer's favor, the presumption of correctness is rebutted. The winner of the case will be the side that establishes, by a preponderance of evidence, that its interpretation of the facts should prevail. Ties go to the government since the burden of proof is on the taxpayer. There are several situations in which the Internal Revenue Code or Tax Court rules place the burden of proof on the government.[2]

At common law there were a number of theories for assigning the burden of proof to a party. Among them were the party who has the affirmative issue should have the burden of proof; the plaintiff should have the burden of proof; the party who is alleging a disfavored contention should have the burden of proof; the party alleging the least likely scenario should have the burden of proof; the party with the knowledge about a particular issue should have the burden of proof; and the burden of proof could be allocated by statute.[3]

The general allocation of the burden of proof to the taxpayer has been justified by several of the common law principles. It is generally thought to be appropriate to place this burden on the taxpayer because the taxpayer usually has control of the evidence on the issues.[4] In suits for refunds, it is thought to be reasonable to require the plaintiff to explain why the taxpayer engaged in the seemingly inconsistent actions of voluntarily overpaying the taxes and then requesting the money back.[5] In collection suits brought by the government, it is thought to be appropriate to place the burden on the taxpayer for a number of reasons. One is that to do otherwise would place a taxpayer who failed to respond to the government's notice of deficiency in a better position than a taxpayer who paid the taxes and then sued for a refund. Another is that the taxpayer is alleging a disfavored scenario or a less likely situation, i.e., the most common scenario is that a citizen owes its government some taxes and the government is not in the best position to calculate the taxes due. If the citizen disagrees with the government's calculation, then the citizen should prove what the correct amount is. Finally, placing the burden of proof on the taxpayer advances the goal of making the tax collection system more efficient.[6]

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[2] Under Tax Court Rule 142, the government has the burden of proof when a case involves the issue of fraud with the intent to evade tax (IRC § 7454(a)), in cases involving certain taxes on foundation managers (IRC § 7454(b)), in cases involving transferee liability (IRC § 6902(a)), in cases involving fraudulent information returns under 6201(d), and in cases where the IRS asserts affirmative defenses, new matters, or increases in deficiencies.

[3] Martinez, *Tax Collection and Populist Rhetoric: Shifting the Burden of Proof in Tax Cases*, 39 HASTINGS L.J. 239, 249-254 (1988).

[4] Saltzman, IRS PRACTICE AND PROCEDURE, 2D ED. ¶1.05[2][c] (1991).

[5] Martinez, *supra*, at 262.

[6] Martinez, *supra*, at 262-263.

House Provision

The House version of proposed IRC § 7491 states:

> (a) GENERAL RULE--The Secretary shall have the burden of proof in any court proceeding with respect to any factual issue relevant to ascertaining the income tax liability of a taxpayer.
>
> (b) LIMITATIONS--Subsection (a) shall only apply with respect to an issue if--
>
> > (1) the taxpayer asserts a reasonable dispute with respect to such issue,
> >
> > (2) the taxpayer has fully cooperated with the Secretary with respect to such issue, including providing, within a reasonable period of time, access to an inspection of all witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the Secretary, and
> >
> > (3) in the case of a partnership, corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii).
>
> (c) SUBSTANTIATION--Nothing in this section shall be construed to override any requirement of this title to substantiate any item.

The bill would strike IRC § 6201(d), enacted as part of the Taxpayer Bill of Rights 2, P.L. 104-168, § 602(a). IRC § 6201(d) permits taxpayers who assert a reasonable dispute relating to an item of income reported on an information return and who fully cooperate with the IRS to shift the burden of proof to the IRS. It requires the IRS to come forward with probative evidence in addition to the information return. This paragraph was enacted as part of an effort to allow taxpayers to protect themselves against the filing of fraudulent information returns (Forms 1099 or W-2). Presumably this provision would be dropped because it would be subsumed by proposed IRC § 7491.

The amendments would apply to court proceedings arising in connection with examinations begun after the date of enactment.

Senate Provision

The Senate version of proposed IRC § 7491 states:

> (a) BURDEN SHIFTS WHERE TAXPAYER PRODUCES CREDIBLE EVIDENCE.
>
> > (1) GENERAL RULE.-If in any court proceeding, a taxpayer introduced credible evidence with respect to any factual issue relevant to ascertaining the income tax liability of the taxpayer, the Secretary shall have the burden of proof with respect to such issue.
> >
> > (2) LIMITATIONS.-Paragraph (1) shall apply with respect to an issue only if—

(A) the taxpayer has complied with the requirements under this title to substantiate any item,

(B) the taxpayer has maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews, and

(C) in the case of a partnership, corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii).

(3) COORDINATION.--Paragraph (1) shall not apply to any issue if any other provision of this title provides for a specific burden of proof with respect to such issue.

(4) EXPANSION TO TAX LIABILITIES OTHER THAN INCOME TAX.--In the case of court proceedings arising in connection with examinations commencing 6 months after the date of the enactment of this paragraph and before June 1, 2001, this subsection shall, in addition to income tax liability, apply to any other tax liability of the taxpayer.

(b) USE OF STATISTICAL INFORMATION ON UNRELATED TAXPAYERS.--In the case of an individual taxpayer, the Secretary shall have the burden of proof in any court proceeding with respect to any item of income which was reconstructed by the Secretary solely through the use of statistical information on unrelated taxpayers.

(c) PENALTIES.--Notwithstanding any other provision of this title, the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.

The amendments would apply to court proceedings arising in connection with examinations commencing after the date of enactment.

Effect of Bill

The House and Senate versions of the bill are quite similar. The House version would impose the burden of proof on the government in any court proceeding with respect to any factual issue relevant to determining the income tax liability of the taxpayer. The Senate version would impose the burden on the government for a particular factual issue relevant to determining the income tax liability of the taxpayer once a taxpayer introduced "credible evidence" with respect to that issue. Both versions require the taxpayers to keep records necessary to substantiate any item. Both versions require that the taxpayer cooperate with reasonable requests by the IRS for access to witnesses, information, and documents. The Senate version requires cooperation with respect to meetings and interviews. The House version requires full cooperation, the Senate version only requires cooperation. Both versions of the bill limit access to this provision to partnerships, corporations, or trusts with net worths of $7 million or less. (There is no limit on an individual's net worth.)

The Senate version contains several provisions not in the House bill. First, it would put the burden of proof on the government any time the IRS attempts to reconstruct an individual taxpayer's income through the use of statistical information derived from unrelated taxpayers. Second, it would place the burden of production on the government in cases where the individual is liable for any penalty, addition to tax, or additional amount. Third, for a limited time dating from 6 months after enactment until May 31, 2001, the burden shift would apply to any tax liability, not just income tax liability. Fourth, the Senate bill clarifies that proposed section 7491 would not apply if another section of the Internal Revenue Code deals with the burden of proof on a specific issue.

It is difficult to determine what might actually happen in courts operating under either version of this provision. Since the bill would require taxpayers to maintain any records required to substantiate any item and to cooperate with the IRS, including providing access to witnesses and records in a timely fashion, it is possible that this provision might not have a great impact on the conduct of tax trials.[7] Many tax disputes do not make it to trial. Presumably, those disputes will continue to be resolved as they are now; however, one cannot foresee if the shifting of the burden of proof might induce more taxpayers to risk the hazards of litigation because the balance of proof would be tilted in their favor. One cannot know whether shifting of the burden of proof might induce the IRS to try to settle more cases administratively because of the hazards of litigation might be tipped against them.

Both versions of the bill would require the IRS to do careful trial preparation. With the government bearing the burden of proof, the IRS would have to produce more, and more credible, evidence than the taxpayer. The House bill is limited to income tax proceedings. The Senate bill would apply not only to income tax proceedings, but also, for a limited period, to all tax proceedings. Estate, gift, and generation-skipping taxes, employment taxes, and excise taxes are a few of the additional taxes that come to mind. Under the Senate bill, the IRS cannot rely on statistics alone to make its case. Also under the Senate bill, if neither the taxpayer nor the IRS introduces evidence about penalties, then the IRS should not be sustained on the penalty issue. Under current law, many of the penalties are automatically calculated and imposed based on amount owed and length of time the tax was owed.

Because the bills require taxpayer cooperation as a condition of shifting the burden of proof, taxpayers will probably continue to cooperate with the IRS at the administrative level, at least to the extent that they do now. It is possible the first part of any court proceeding would involve a determination as to whether the taxpayer had cooperated with the IRS and which party should bear the burden of proof. This could add to the length and complexity of trials and, presumably, create a new ground for appealing an adverse decision. If the burden is not shifted to the government because of lack of taxpayer cooperation, taxpayers would continue to litigate under the same conditions as under present law.

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[7] E.g., Tax Court Rule 91 requires parties to stipulate to all matters on which complete or partial agreement can be reached which are relevant to the pending case, regardless of whether the matters involve fact, opinion, or the application of law to fact. Rules 120-124 describe various procedures for decisions without trial, including judgment on the pleadings and summary judgment.

If the burden is shifted to the government, there may or may not be a change in the trial outcomes. Since it is possible that courts would continue to operate much as they do now, retaining a presumption of correctness for IRS determinations and the requirement that taxpayers produce the evidence over which they have control, the shift in the burden of proof may simply mean that ties go to the taxpayer. On the other hand, a shift of the burden of proof may cause the government to become more intrusive in its search for evidence and in its demands for cooperation in order to build its case. Congress may be asked to impose more onerous reporting requirements, so that taxpayers could be required to generate and keep information that the IRS might need should litigation arise. Failure to keep such records could give rise to unfavorable presumptions against the taxpayer. Increased intrusiveness and increased record keeping burdens would be likely to affect all taxpayers, not just those with tax disputes they are litigating against the government.

Proponents of the bill believe it is designed to create fairer conditions when taxpayers must litigate income tax issues with the IRS. Proponents analogize tax collection to criminal cases and argue that taxpayers should be presumed innocent until proven guilty. They believe that taxpayers should win when both sides' evidence is equally persuasive. Critics of the bills point out that tax disputes are civil matters, and historically it has been deemed appropriate to place the burden of proof on the taxpayer. Critics of the bills worry that a shift in burden of proof may encourage fewer taxpayers to settle their disputes, lengthen the dispute resolution process, or encourage more taxpayers to resist challenges by the IRS. Critics fear that the tax collection process could be slowed, and the amount of uncollected taxes could rise.