

# ARE THERE PROCEDURAL DEFICIENCIES IN TAX FRAUD CASES?: A REPLY TO PROFESSOR SCHOENFELD

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## INTRODUCTION

Since the Senate hearings on alleged abuses by the Internal Revenue Service (IRS),<sup>1</sup> and the resulting IRS Reform Act, enacted in 1998,<sup>2</sup> scholarly attention to perceived inequities in the resolution of tax controversies has mushroomed.<sup>3</sup> For example, Professor Eric Posner has argued that the fact the IRS reform was widely supported despite the impediments it imposes to audits suggests that, in the absence of trust in the IRS, the public may not voluntarily comply with federal tax laws.<sup>4</sup>

Last year, the *Indiana Law Review* published an article entitled *A Critique of the Internal Revenue Service's Refusal to Disclose How It "Determined" a Tax Deficiency, and of the Tax Court's Acquiescence with This View* by Professor Marcus Schoenfeld (the "article").<sup>5</sup> The article argued that current law unfairly advantages the IRS in civil tax cases, particularly tax fraud cases. It reflects a particular concern that "the [IRS] combines with the Tax Court to keep the taxpayer from obtaining information about how the Service made its

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1. During three days of hearings before the Senate Finance Committee, taxpayers and IRS agents told "horror stories" about IRS treatment of taxpayers. See Wm. Brian Henning, *Reforming the IRS: The Effectiveness of the Internal Revenue Service Restructuring and Reform Act of 1998*, 82 MARQ. L. REV. 405, 405 (1999). The hearings were broadcast on television. See Ryan J. Donmoyer, *Three Days of Hearings Paint Picture of Troubled IRS*, 76 TAX NOTES 1655, 1655 (1997).

2. Internal Revenue Service Restructuring and Reform Act of 1998, 105 Pub. L. 206; 112 Stat. 685 § 1203 (1998).

3. See, e.g., Heather B. Conoboy, *A Wrong Step in the Right Direction: The National Taxpayer Advocate and the 1998 IRS Restructuring and Reform Act*, 41 WM. & MARY L. REV. 1401 (2000); Henning, *supra* note 1, at 405; Steve R. Johnson, *The Dangers of Symbolic Legislation: Perceptions and Realities of the New Burden-of-Proof Rules*, 84 IOWA L. REV. 413 (1999); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781 (2000); Amy S. Wei, *Can Mediation Be the Answer to Taxpayers' Woes?: An Examination of the Internal Revenue Service's Mediation Program*, 15 OHIO ST. J. ON DISP. RESOL. 549 (2000).

4. See Posner, *supra* note 3, at 1812.

5. Marcus Schoenfeld, *A Critique of the Internal Revenue Service's Refusal to Disclose How It "Determined" a Tax Deficiency, and of the Tax Court's Acquiescence with This View*, 33 IND. L. REV. 517 (2000).

determination of the taxpayer's deficiency."<sup>6</sup>

Professor Schoenfeld's article provides a helpful overview of tax cases involving civil fraud, and discusses a wide array of procedural issues that arise in many of those cases. There is all too little scholarship on tax procedure,<sup>7</sup> so it is particularly rewarding to discover an additional contribution. Although I agree with Professor Schoenfeld's concern that there should be appropriate controls on the power of the IRS,<sup>8</sup> I disagree both with his suggestions for change and with some of the premises underlying those suggestions.

Professor Schoenfeld's argument, briefly stated, is that a combination of factors conspire to hinder taxpayers' defense of civil tax cases, particularly cases involving allegations of fraud.<sup>9</sup> The factors he points to span a variety of aspects of tax procedure. First, a "presumption of correctness"<sup>10</sup> attaches to the statutory notice of deficiency,<sup>11</sup> the letter from the IRS that legally asserts an underpayment in tax and is required for the United States Tax Court ("Tax Court") to take jurisdiction over a resulting lawsuit.<sup>12</sup> Second, notices of deficiency do not always adequately explain the reasons for the asserted deficiency.<sup>13</sup> Third, the Tax Court generally will not "look behind"<sup>14</sup> a notice of deficiency to see what underlies it.<sup>15</sup> Fourth, techniques allowed by the Tax Court to reconstruct unreported illegal income may "yield harsh results,"<sup>16</sup> particularly with respect to co-conspirators only marginally involved in a criminal conspiracy.<sup>17</sup> Fifth, the IRS may assert "that all of its documents are privileged,"<sup>18</sup> and therefore not available in discovery.<sup>19</sup> Sixth, the Tax Court position that IRS errors will be remedied at trial ignores the substantive importance of the notice of deficiency.<sup>20</sup> Finally, collateral estoppel generally precludes a taxpayer criminally convicted from denying facts found in the criminal trial but does not preclude a civil tax trial of a taxpayer who was acquitted criminally.<sup>21</sup> In making these points, the article also discusses related issues such as the procedures for declaring notices of deficiency involving

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6. *Id.* at 569.

7. Steve Johnson, *A Residual Damages Right Against the IRS: A Cure Worse than the Disease*, 88 TAX NOTES 395, 395 (2000).

8. *See* Schoenfeld, *supra* note 5, at 568.

9. *Id.* at 517.

10. *Id.*

11. *Id.*

12. *See* I.R.C. §§ 6212(a), 6213(a) (Supp. 1999).

13. Schoenfeld, *supra* note 5, at 517.

14. *Id.* at 524.

15. *Id.* at 524-25.

16. *Id.* at 518.

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.* at 549.

unreported income “arbitrary and erroneous.”<sup>22</sup>

Tax controversy procedure, like civil litigation procedure generally, reflects a balancing of interests of plaintiff and defendant. In tax controversies, the parties are the IRS and the taxpayer. In general, the procedural rules seek to provide a level playing field, place the burden of producing information on the party in possession of that information, and encourage settlement. Professor Schoenfeld’s criticism of the IRS and the Tax Court should be considered in that context. That is, to what extent are the burdens he discusses unfairly targeted at taxpayers, and to what extent do they reflect only one side of an even-handed balancing act?

Professor Schoenfeld’s concerns, listed above, logically fall into two general categories: taxpayer access to IRS information and IRS techniques for proving tax fraud. Accordingly, this reply has two principal parts. Part I disputes Professor Schoenfeld’s contentions that the IRS’s approach, coupled with the Tax Court’s rules, hampers taxpayers’ abilities to obtain appropriate information to defend tax deficiency and tax fraud suits. Section A briefly outlines basic tax controversy procedure. Section B focuses on notices of deficiency. It discusses their importance and the multiple roles they play in tax controversies, and it specifically considers the “presumption of correctness” as well as uninformative, inaccurate, and arbitrary notices. Section C of Part I explores procedures for obtaining the report of the IRS revenue agent.

Part II of this reply analyzes the IRS’s methods of proving tax fraud, focusing on the areas Professor Schoenfeld finds particularly objectionable: collateral estoppel, the use of badges of fraud, and IRS-protective positions. Section A of this Part analyzes the use of collateral estoppel and badges of fraud in the context of the IRS’s burden of proving fraud by clear and convincing evidence. This section argues that these methods are appropriate means for the IRS to use to try to meet that burden. Section B of Part II focuses on IRS-protective positions, which address a materially different aspect of any fraud case: the amount of the deficiency. Once fraud is proven by the IRS, it is the *taxpayer* who bears the burden of proving the amount of the deficiency that is *not* attributable to fraud. Section B focuses on the problems that this procedural posture causes while refuting some of Professor Schoenfeld’s objections to IRS-protective positions.

## I. OBTAINING INFORMATION FROM THE IRS IN CIVIL TAX CONTROVERSIES

### A. *Basic Tax Controversy Procedure*

As Professor Schoenfeld explains, civil tax cases generally begin with a disagreement between the taxpayer and the IRS over the tax owed by the taxpayer.<sup>23</sup> If the disagreement began with a refund claim filed by the taxpayer, the IRS manifests its disagreement with a “notice of disallowance.” In other cases, an unresolved dispute generally results in IRS issuance of a “notice of

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22. *See id.* at 539-40.

23. *Id.* at 520.

deficiency," the letter mentioned previously that alerts the taxpayer to the amount of the alleged deficiency (underpayment of tax). The notice may also contain additions to tax for such things as late filing of the return, negligence, or fraud. It generally also provides an explanation of the deficiency and additions to tax.

Except where collection of the tax is in jeopardy,<sup>24</sup> the IRS generally is required by statute to mail the taxpayer a notice of deficiency prior to assessment.<sup>25</sup> "Assessment" is formal recording by the IRS of the taxpayer's tax liability.<sup>26</sup> Assessment is a legal prerequisite to the IRS's administrative collection procedures. The notice of deficiency therefore is central to tax controversies.

The notice of deficiency also provides the taxpayer with a "ticket to the Tax Court"; Tax Court subject-matter jurisdiction over tax deficiency cases requires both a notice of deficiency and a timely responsive petition (generally one that is filed within ninety days of the date the notice of deficiency was mailed).<sup>27</sup> The IRS is required to file an answer.<sup>28</sup> Those documents form the pleadings in Tax Court litigation; additional pleadings may be made in the form of amendments and a reply when required.<sup>29</sup> In civil fraud cases, the IRS bears the burden of persuasion by "clear and convincing evidence."<sup>30</sup>

### B. *The Notice of Deficiency*

Exchange of information between the IRS and the taxpayer typically begins with the audit. In most tax controversies, after the audit, the IRS will send the taxpayer a preliminary notice of deficiency, commonly known as a thirty-day letter. The thirty-day letter is the cover letter accompanying the IRS revenue agent's report. It provides an opportunity for the taxpayer to obtain an administrative appeal by responding within thirty days.<sup>31</sup> Informal communications, the revenue agent's report, the appeals conference, and other settlement efforts are all sources of information about the IRS's case.

If a tax controversy remains unresolved when the statute of limitations nears

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24. I.R.C. § 6861(a) (1994).

25. *Id.* § 6212(a) (Supp. V 1999) ("If the Secretary [of the Treasury] determines that there is a deficiency in respect of any tax imposed by [certain subtitles and chapters of the Code] he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail."). The authorization language apparently refers to the method of delivery; the notice itself is not optional. *See id.* § 6213(a) (subject to certain exceptions, "no assessment of a deficiency in respect of any tax imposed by [certain subtitles and chapters] and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer").

26. *See* LEANDRA LEDERMAN & STEPHEN W. MAZZA, *TAX CONTROVERSIES: PRACTICE AND PROCEDURE* 8 (2000).

27. I.R.C. § 6213(a) (1994).

28. *TAX CT. R. PRAC. & P.* 30; *see also id.* at 36.

29. *See id.* at 30, 37, 41.

30. *Id.* at 142(b); *see also* I.R.C. § 7454(a) (1994).

31. *See* LEDERMAN & MAZZA, *supra* note 26, at 9.

expiration, the IRS will send the taxpayer a notice of deficiency. The notice of deficiency is the first official, required notice to the taxpayer of the IRS's assertion of a tax underpayment. As discussed above, the taxpayer may be well-served in the IRS's case at the point he receives a notice of deficiency. Nonetheless, the notice of deficiency provides official notice of the deficiency amount and the IRS's reason for the adjustment.

Mailing of a notice of deficiency has multiple, important consequences. First, the notice of deficiency provides notice to the taxpayer of the asserted deficiency and of the IRS's intent to assess if the taxpayer does not respond by filing a timely Tax Court petition (a notification function). Second, the notice provides the taxpayer with the jurisdictional "ticket to the Tax Court," as discussed above. Third, assessment of tax is prohibited during the ninety-day period within which the taxpayer may petition the Tax Court, and if a Tax Court petition is filed, until the Tax Court decision is final. Fourth, as a corollary, the notice tolls the statute of limitations on assessment for the length of the prohibited period plus sixty days, providing the IRS with time to assess tax should the taxpayer lose the Tax Court case or fail to petition the Tax Court. Fifth, if the taxpayer does petition the Tax Court, the notice of deficiency becomes part of the pleadings, in effect forming the first statement of the IRS's case, analogous to a complaint. Finally, in Tax Court, the notice of deficiency plays an important role in allocating the burden of proof.<sup>32</sup>

A notice of deficiency that is defective such that it is invalid is void *ab initio* so that, generally speaking, it plays none of these functions.<sup>33</sup> The immediate effect of a Tax Court determination that a notice is invalid is that the Tax Court will dismiss the case for lack of subject-matter jurisdiction. A key collateral consequence is that an invalid notice does not toll the statute of limitations on assessment, so the period for assessment ordinarily will have expired.<sup>34</sup> Expiration of the statute of limitations precludes assessment and collection of tax by the IRS.

Professor Schoenfeld accurately points out that, in considering arguably defective notices of deficiency, the Tax Court has overemphasized the jurisdictional function of the notice of deficiency.<sup>35</sup> I have previously argued that not all defects in notices of deficiency are grounds for invalidation and

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32. The notice of deficiency therefore has three main functions and several lesser functions. The three main functions are the notice function, the pleading function in a Tax Court case, and the jurisdictional function in Tax Court. Confusing these functions may result in inappropriate remedies for defective notices, particularly inappropriate dismissals for lack of Tax Court subject-matter jurisdiction. See generally Leandra Lederman, "Civilizing Tax Procedure: Applying General Federal Learning to Statutory Notices of Deficiency," 30 U.C. DAVIS L. REV. 183 (1996).

33. Cf. *Roszkos v. Comm'r*, 850 F.2d 514, 517 (9th Cir. 1988) (stating that notices of deficiency sent to incorrect addresses were "null and void").

34. See, e.g., *Reddock v. Comm'r*, 72 T.C. 21, 26 (1979); *Atlas Oil & Ref. Corp. v. Comm'r*, 22 T.C. 552, 558-59 (1954), *overruled on other grounds by Woods v. Comm'r*, 92 T.C. 776, 778 (1989).

35. See Schoenfeld, *supra* note 5, at 534.

concomitant dismissal of the Tax Court case.<sup>36</sup> Instead, the Tax Court should consider whether a defect affects the notification or pleading function or is truly *jurisdictional*.<sup>37</sup> In fact, a notice of deficiency needs far fewer elements to allow the Tax Court to take jurisdiction over the case than it does to notify a taxpayer in enough detail to enable the taxpayer to rebut IRS allegations in his principal Tax Court pleading, the petition.<sup>38</sup>

1. *The "Presumption of Correctness."*—As Professor Schoenfeld points out, a "presumption of correctness" is afforded the notice of deficiency.<sup>39</sup> This term is somewhat misleading. Professor Schoenfeld argues that "the Notice [of deficiency] . . . carries substantive weight because it is presumed to be correct."<sup>40</sup> However, the presumption of correctness is not a true presumption; it carries no more evidentiary weight than does the "presumption of innocence" of a criminal defendant. The presumption of correctness merely serves to assign the burden of going forward.<sup>41</sup> That is, by affording the notice of deficiency initial credence, the taxpayer must come forward in any Tax Court case with evidence to counter it, rather than the IRS first submitting additional documents.<sup>42</sup>

There are two main rationales for the presumption of correctness. First, it is the taxpayer who has the evidence supporting the entries on his tax return.<sup>43</sup> Second, in the usual case, the IRS follows a businesslike routine that will be effective in the vast majority of cases. In fact, many audits end at the administrative level before a notice of deficiency is ever prepared. If the IRS has concluded its administrative process through issuance of the notice, the presumption of administrative regularity justifies placing the initial burden in litigation on the taxpayer.<sup>44</sup>

There are two important exceptions to the usual case in which the notice of deficiency provides a basis for placing the burden of going forward on the taxpayer, one of which, "arbitrary and erroneous" notices, was discussed by

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36. See Lederman, *supra* note 32, at 238.

37. See *id.*

38. Learned Hand famously stated that "the notice is only to advise the person who is to pay the deficiency that the Commissioner means to assess him; anything that does this unequivocally is good enough." *Olsen v. Helvering*, 88 F.2d 650, 651 (2d Cir. 1937).

39. Schoenfeld, *supra* note 5, at 517.

40. *Id.* at 518 (emphasis added).

41. See, e.g., *United States v. Janis*, 428 U.S. 433, 441 (1976); *Portillo v. Comm'r*, 932 F.2d 1128, 1133 (5th Cir. 1991); *Anastasato v. Comm'r*, 794 F.2d 884, 886 (3d Cir. 1986); cf. *DiMauro v. United States*, 706 F.2d 882, 884 (8th Cir. 1983) (in wagering excise tax case, government must come forward with evidence connecting taxpayer to wagering before presumption applies).

42. See *Anastasato*, 794 F.2d at 887. "The presumption of correctness establishes a *prima facie* case, but it arises only if supported by foundational evidence connecting the taxpayer with the tax-generating activity." *Id.* (emphasis added).

43. Sean M. Moran, *The Presumption of Correctness: Should the Commissioner Be Required to Carry the Initial Burden of Production*, 55 *FORDHAM L. REV.* 1087, 1100 (1987).

44. See Lederman, *supra* note 32, at 201 n.97.

Professor Schoenfeld. In *Janis v. United States*,<sup>45</sup> the United States Supreme Court termed an arbitrary assessment a “‘naked’ assessment without any foundation whatsoever.”<sup>46</sup> The line of cases addressing arbitrary and erroneous notices reflects the understanding that, in cases involving unreported income, the rationale that the taxpayer possesses the evidence breaks down. As many courts have noted, it is difficult, if not impossible, to prove a negative (that is, nonreceipt of income). Thus, in unreported income cases, particularly those involving income allegedly received from illegal or illicit sources,<sup>47</sup> if a taxpayer alleges that the notice was arbitrary and erroneous, the burden of going forward shifts back to the IRS to support the notice.<sup>48</sup>

In *Ryan v. Commissioner*,<sup>49</sup> a case that influenced Professor Schoenfeld’s article,<sup>50</sup> the Tax Court stated it this way:

As we review each of [the IRS’s] assertions concerning each respective search [by the police officer petitioners], we consider whether respondent has presented predicate evidence linking the specific petitioner to the tax-generating activity from which respondent asserts income has arisen for such petitioner. Where there is no such predicate evidence, we attribute no income to that petitioner.<sup>51</sup>

When the IRS is able to tie the taxpayer to the illegal or illicit income-generating activity, the IRS has met its burden, and the burden then shifts back to the taxpayer. Faced with the allegation of a source of the income, the taxpayer is then empowered to provide some defense to the allegation.

In several cases, taxpayers have been successful in shifting the burden to the IRS based on an allegation that the notice of deficiency was arbitrary and erroneous. Some of those cases were won on motion by the taxpayer because the IRS could not come up with evidence supporting the notice.<sup>52</sup> Admittedly, those cases suggest administrative failure that burdened the taxpayer. However, prevailing taxpayers are entitled to sue for administrative costs and litigation

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45. 428 U.S. 433 (1976).

46. *Id.* at 441.

47. “Most of the cases stating that the Commissioner is not entitled to the presumption [of correctness] based on a naked assessment without factual foundation have involved illegal income.” *Anastasato*, 794 F.2d at 887. *Anastasato* involved the receipt of illicit “override” commissions by a travel agent. *See id.* at 885. It is particularly hard to disprove the receipt of income that a recipient would generally have received secretly.

48. *Cf. Gerardo v. Comm’r*, 552 F.2d 549, 554 (3d Cir. 1977) (stating that in case of unreported illegal income, the IRS must present “some predicate evidence connecting the taxpayer to the charged activity.”).

49. 75 T.C.M. (CCH) 1778 (1998).

50. *See* Schoenfeld, *supra* note 5, at 517 n.\*. (“The opinions of the author are largely based [sic] and are augmented by . . . *Ryan*.”).

51. *Ryan*, 75 T.C.M. (CCH) at 1777-78.

52. *See, e.g., Portillo v. Comm’r*, 932 F.2d 1128, 1130 (5th Cir. 1991).

fees.<sup>53</sup> Those costs and fees may be awarded if the IRS pursued a frivolous position, the taxpayer exhausted any administrative remedies afforded by the IRS, and the taxpayer meets a net worth requirement.<sup>54</sup>

An exception to the usual burden of proof procedure was statutorily created in 1998. Code section 7491 provides the taxpayer with the opportunity to shift the burden of proof to the IRS, if he meets several requirements. Because, in order to do so, the taxpayer is required to make an initial presentation of "credible evidence" with respect to the factual issue,<sup>55</sup> it is most accurate to say that section 7491 places the burden of going forward on the taxpayer, though it allows a shift in the burden of persuasion. As noted by numerous commentators,<sup>56</sup> section 7491 is likely to be of little practical use. In addition, the IRS already bears the burden of proving fraud. However, it is important to note that the content of section 7491, with its "credible evidence" requirement,<sup>57</sup> suggests continuing cognizance of the practical reality that the taxpayer is the one with evidence supporting the entries on the tax return, just as the presumption of correctness does.

Thus, the so-called presumption of correctness, though unfortunately implying a degree of deference to the IRS, in fact serves the salutary purpose of allocating the burden of going forward to the party in possession of the evidence relating to the controversy. Even the workings of section 7491 reflect this notion. Where the presumption would allocate the burden of going forward to a party without evidence, because it alleges receipt of illicit income, case law

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53. See I.R.C. § 7430 (1994).

54. See *id.*

55. I.R.C. § 7491(a)(1) (Supp. V 1999).

56. See, e.g., Johnson, *supra* note 3, at 413 (Code section 7491 "is a pernicious exercise in symbolic legislation."); Anthony F. Newton, *The 'Stat' Notice in the New Millennium: Shouldn't the Notice Be User Friendly?*, 91 TAX NOTES 1139, 1157 (2001) ("Congress did make a feeble attempt to level the playing field with the addition of section 7491. However, its effect has not yet been realized and, due to its limitations, more likely than not, it never will be."); see also Higbee v. Comm'r, 116 T.C. 438 (2001).

Because [the taxpayers] have failed to provide credible evidence of a casualty loss, the burden of proof as to this issue is not placed on [the IRS]. Further, for similar reasons regarding our discussion of [the taxpayers'] evidence for purposes of section 7491, we conclude that [the taxpayers] have not met their burden of proof.

*Id.* at 443; cf. Nathan E. Clukey, *Examining the Limited Benefits of Shifting the Burden of Proof to the IRS*, 82 TAX NOTES 683 (1999).

This article . . . posits that . . . an expansive reading of credible evidence must be rejected, and that once that is done, the statute will have a noticeable effect in regard to evidence not governed by heightened substantiation requirements—by giving the taxpayer a strategic advantage compared to prior law. However, it acknowledges that where the heightened substantiation requirements are applicable, this strategic advantage will be eviscerated.

*Id.* at 685.

57. *Id.* at 688.

provides a mechanism for shifting that burden to the IRS.

2. *Inaccurate, Arbitrary, and Uninformative Notices of Deficiency*.—One of Professor Schoenfeld's major complaints is the rule of *Greenberg's Express, Inc. v. Commissioner*.<sup>58</sup> In *Greenberg's Express*, the Tax Court held that it would not "look behind a deficiency notice to examine the evidence used or the propriety of [the IRS's] motives or of the administrative policy or procedure involved in making [the] determinations."<sup>59</sup> The court reasoned that the Tax Court trial is a *de novo* proceeding in which the administrative record is irrelevant.<sup>60</sup> In effect, the court seemed to be stating that it would not invalidate the notice because of the process that generated it, even if that process might be defective. Professor Schoenfeld makes the excellent point that the facts of *Greenberg's Express* involved the issue of whether the IRS had chosen to audit certain taxpayers for an impermissible reason, not if the audit process itself was careless or otherwise defective. He argues that "*Greenberg's Express* is of little pertinence to an inquiry into *how* (not *why*) a revenue agent may have committed errors in preparing his determination of the assertions set out in the Statutory Notice."<sup>61</sup>

Although this analysis might imply that the holding of *Greenberg's Express* should be limited to cases involving IRS selection of which returns to audit, there is still value in treating the notice of deficiency as a pleading that the Tax Court does not look behind. Essentially, the notice makes allegations of fact that the taxpayer has the option to dispute in court.<sup>62</sup> If there are mistakes in the notice of deficiency, the taxpayer should have the evidence necessary to correct them unless they arrive out of an arbitrary and erroneous notice, which the taxpayer is empowered to counter procedurally, as discussed above. Analyzing the process used to generate the notice would distract from analysis of the substantive issues in the case.

Professor Schoenfeld posits that "[a]pplying *Greenberg's Express* as the Service argues would shield almost all information that might tend to show that an employee of the Service acted improperly or carelessly."<sup>63</sup> However, the *Greenberg's Express* court did state that it would shift the burden of going

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58. 62 T.C. 324 (1974).

59. *Id.* at 327.

60. *Id.* at 328.

61. Schoenfeld, *supra* note 5, at 528 (emphasis in original).

62. If the taxpayer never receives the notice or fails to petition the Tax Court in a timely manner, he will still have an opportunity to litigate, post-assessment. Two fora will be available to the taxpayer: the United States District Courts and the United States Court of Federal Claims. *See* 28 U.S.C. §§ 1346(a)(1), 1491(a)(1) (1994). Following assessment, the taxpayer will be required to pay the tax. Following payment, a taxpayer who wishes to contest the tax liability must file a refund claim as a prerequisite to suit. I.R.C. § 7422(a) (1994). Upon disallowance of the claim, waiver of disallowance by the taxpayer, or passage of six months, the taxpayer may file suit in either of the refund fora listed above. *See id.* § 6532(a)(1). Unfortunately, the "full payment" rule does provide a barrier to accessing those fora. *See* *Flora v. United States*, 362 U.S. 145 (1960).

63. Schoenfeld, *supra* note 5, at 529.

forward to the IRS if a taxpayer presented substantial evidence of unconstitutional conduct by the IRS.<sup>64</sup> Professor Schoenfeld makes this point quite clearly: “[T]he Tax Court did not say that it would *never* look behind the Statutory Notice. On the contrary, the court said it would do so, particularly when there was substantial evidence of unconstitutional behavior on the part of the Service’s employees in preparing the Statutory Notice.”<sup>65</sup> He points out that, in that instance, “the Statutory Notice would no longer carry the presumption of correctness that is normally conferred upon it.”<sup>66</sup> In other words, the Tax Court would shift the burden of going forward to the IRS.

*a. Inaccurate notices.*—Professor Schoenfeld used *Scar v. Commissioner*<sup>67</sup> as “[a]n extreme example of the Tax Court’s persistent refusal to look behind a Statutory Notice.”<sup>68</sup> *Scar* is extreme; its facts are highly unusual and unrepresentative of the overwhelming majority of statutory notices. However, *Scar* has little relevance to Tax Court reluctance to examine the pre-notice of deficiency administrative process at the IRS. Instead, *Scar* is a case about the proper remedy for an inaccurate notice of deficiency.

As Professor Schoenfeld relates in his article, the notice of deficiency in *Scar* asserted a deficiency of \$96,600 based on the disallowance of deductions attributable to the “Nevada Mining Project,”<sup>69</sup> a tax shelter in which the Scars had never invested. The notice calculated the deficiency by applying the maximum marginal rate of seventy percent to \$138,000 of disallowed deductions. An attachment explained, “In order to protect the government’s interest and since your original income tax return is unavailable at this time, the income tax is being assessed at the maximum tax rate of 70%.”<sup>70</sup>

The Scars’ Tax Court petition denied that they had ever had any interest in the Nevada Mining Project. The IRS’s answer denied the allegations of the petition in full. The Scars moved to dismiss for lack of jurisdiction. In response, the IRS conceded that the Scars had never had any interest in Nevada Mining, and moved for leave to amend its answer, to state a decreased deficiency attributable to Executive Productions, Inc., a videotape tax shelter.<sup>71</sup>

In court, the IRS explained that the error in the notice had occurred because one of its agents had transposed numbers when entering the code assigned to the videotape tax shelter.<sup>72</sup> The *Scar* case reflects a degree of sloppiness rarely seen. As is evident from the case, the tax shelter era of the 1980s produced a

64. 62 T.C. at 328.

65. Schoenfeld, *supra* note 5, at 527-28 (emphasis in original) (footnotes omitted).

66. *Id.* at 528.

67. 81 T.C. 855 (1983), *rev’d*, 814 F.2d 1363 (9th Cir. 1987).

68. Schoenfeld, *supra* note 5, at 531.

69. *Scar v. Comm’r*, 814 F.2d 1363, 1365 (9th Cir. 1987), *rev’g* 81 T.C. 855 (1983).

70. *Id.* This aspect of the case is discussed below. See *infra* notes 81-83 and accompanying text.

71. 814 F.2d at 1365-66.

72. *Id.* at 1365.

voluminous caseload for the IRS.<sup>73</sup>

The main issue decided in *Scar*, which went up to the Court of Appeals for the Ninth Circuit, was whether the faulty notice of deficiency was “invalid” and therefore required dismissal for lack of Tax Court subject-matter jurisdiction.<sup>74</sup> The Ninth Circuit reversed the Tax Court’s ruling that the notice was valid, holding that the notice had failed to make the “determination” required by section 6212(a).<sup>75</sup> Professor Schoenfeld praises the outcome in *Scar*, stating:

The view of the Ninth Circuit in *Scar* seems correct. There really should be a “determination” as prescribed in the statute and the Service’s published internal procedures, and then those determinations of fact and law should be spelled out in the Notice. This is necessary to permit fairness in litigation. The Statutory Notice not only confers jurisdiction on the Tax Court, in practical effect it is really also the initial pleading in the case.<sup>76</sup>

Although Professor Schoenfeld is correct that the notice of deficiency serves a pleading function once a taxpayer invokes the Tax Court’s jurisdiction by filing a petition, and although notices of deficiency should specify their determinations, as the Code requires,<sup>77</sup> that does not mean *Scar* was correctly decided. In fact, what *Scar* did was turn a defect in a pleading function (framing the litigation) into a *jurisdictional* objection. As discussed previously, much less is required to get a case before a court than to make one’s case to the court. In *Scar*, the notice of deficiency met minimum jurisdictional standards: it contained the Scars’ names and address, the correct tax year, a deficiency amount, and a statement explaining how the deficiency was calculated.<sup>78</sup>

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73. That volume is evidenced in part by the inventory of the Tax Court. IRS data reflects that in 1981, the Tax Court had about 38,000 docketed cases, with about seventeen percent of those tax shelter cases, while in 1984, the Tax Court had about 43,000 docketed cases, thirty-three percent of which were tax shelter cases. See U.S. TAX COURT JUDICIAL CONFERENCE, CHIEF COUNSEL FOR THE INTERNAL REVENUE SERVICE, OCTOBER 1986, at 1. According to the Tax Court, in fiscal year 1984, 42,024 cases were filed and 63,598 were pending. See UNITED STATES TAX COURT, 1990 FISCAL YEAR STATISTICAL INFORMATION (1991). By contrast, in fiscal year 2000, only 16,572 cases were pending in the Tax Court, and fewer than eleven percent of those were tax shelter cases. See OFFICE OF CHIEF COUNSEL, INTERNAL REVENUE SERVICE, AMERICAN BAR ASSOCIATION TAX SECTION COURT PROCEDURE COMMITTEE 11 (2001). *Scar* was decided in 1983, during a spurt in tax shelter litigation.

74. 814 F.2d at 1365.

75. See *id.* at 1370.

76. Schoenfeld, *supra* note 5, at 534.

77. See I.R.C. § 7522 (1994). Section 7522 is discussed in more detail later. See *infra* text accompanying notes 100-11.

78. Cf. *Scar*, 814 F.2d at 1370 n.11 (“In the case before us the Commissioner argues that, because the notice contained the Taxpayers’ names, social security number, the tax year in question, and ‘the’ amount of deficiency, it was ‘clearly sufficient.’”); *Olsen v. Helvering*, 88 F.2d 650, 651 (2d Cir. 1937) (holding that anything that communicates IRS’s intent to assess suffices); *Donohue*

The *Scar* notice nevertheless is highly problematic. Judge Hall, the former Tax Court judge who dissented in *Scar*, stated that a notice of deficiency is “nothing more than ‘a jurisdictional prerequisite to a taxpayer’s suit seeking the Tax Court’s redetermination of [the IRS’s] determination of the tax liability.’”<sup>79</sup> That is an overstatement; it does not account for the pleading function of the notice. As I have previously argued, “The egregious content errors in the Scars’ statutory notice are troublesome but are not jurisdictional. The content errors in the *Scar* notice should instead have been corrected during the litigation.”<sup>80</sup> Once the *Scar* answer was amended, it would have asserted “new matter” not raised in the notice of deficiency, which would place the burden of proof on those issues on the IRS.<sup>81</sup> In fact, even if the IRS had not moved to amend its answer, the Scars could have moved to have the burden shifted to the IRS under Tax Court Rule 142(a) on the issues relating to the videotape tax shelter.

Thus, *Scar* involved an erroneous notice of deficiency. The Ninth Circuit’s decision to invalidate the notice did not require “looking behind” it to evidence regarding the IRS’s administrative process. Instead the court found that information on the face of the notice warranted the court’s concern. Unfortunately, the court chose the wrong remedy: it simply should have shifted the burden of going forward to the IRS, rather than invalidating the notice and therefore dismissing the case.

*b. Arbitrary notices.*—One issue in *Scar* was the apparent arbitrariness of the IRS’s “determination,” because the Scars’ original return was unavailable. At first blush, it may appear impossible for the IRS to make a determination of tax liability without the taxpayer’s return. However, the IRS codes data from each tax return.<sup>82</sup> The IRS’s position, supported by case law,<sup>83</sup> is that the IRS

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v. Comm’r, 37 T.C.M. (CCH) 954, 954-56 (1978) (holding that mutilated notice containing no date, address, year or deficiency amount was sufficient for Tax Court subject-matter jurisdiction).

79. 814 F.2d at 1372 (Hall, J., dissenting) (quoting *Stamm Int’l Corp. v. Comm’r*, 84 T.C. 248, 252 (1985)). Subsequent decisions, even in the Ninth Circuit, have limited *Scar* to its facts. See, e.g., *Clapp v. Comm’r*, 875 F.2d 1396, 1402 (9th Cir. 1989) (“Only where the notice of deficiency reveals on its face that the Commissioner failed to make a determination is the Commissioner required to prove that he did in fact make a determination.”); *Campbell v. Comm’r*, 90 T.C. 110 (1988).

Where the alleged notice of deficiency reveals on its face that [the IRS] failed to make a determination, then the Ninth Circuit would require respondent to prove that he did make a determination. Here the 9-page document does not reveal on its face that [the IRS] failed to make a determination.

*Id.* at 114.

80. Lederman, *supra* note 32, at 238.

81. See TAX CT. R. PRAC. & P. 142(a).

82. See *Scar*, 814 F.2d at 1374 n.4, stating:

Although the “unavailability” of the Scars’ return may indicate that the Scars’ original paper return was not before the Commissioner, it does not show that specific data on that return or relation to the video-tape tax shelter was not considered. Due to the computerization of the IRS, the Commissioner no longer operates from original paper

“may rely on taxpayer return information duly recorded in the Service’s official records and data bases”<sup>84</sup> because a requirement that the IRS rely only on the original paper return would inhibit the IRS’s efforts to computerize.<sup>85</sup> Computerization generally makes the IRS’s processes both quicker and less costly.<sup>86</sup>

Another concern expressed in *Scar* is the hypothetical of an IRS run amok, sending out notices of deficiency willy-nilly. The Ninth Circuit reproduced from Judge Sterrett’s dissent in the Tax Court an invented, tongue-in-cheek notice that reflects this fear. In part, it states:

Dear Taxpayer: There is a rumor afoot that you were a participant in the Amalgamated Hairpin Partnership during the year 1980. Due to the press of work we have been unable to investigate the accuracy of the rumor or to determine whether you filed a tax return for that year.<sup>87</sup>

It seems unlikely that the IRS would send out notices based on mere rumor or worse, invidious discrimination against certain taxpayers.<sup>88</sup> In fact,

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returns.

*Id.* (Hall, J., dissenting); *Whittington v. Comm’r*, 78 T.C.M. (CCH) 339 (1999) (IRS used Returns Transaction Data System (RTVUE), a line-by-line transcript of taxpayer’s return, in arriving at its deficiency determination).

83. *See, e.g.*, *Griner v. Comm’r*, 1991 U.S. App. LEXIS 30021 (9th Cir. 1991) (“Griner’s argument that the determination was invalid because the Commissioner may not have used the original papers filed by the Griners is without merit. Whether the Commissioner used the originals, copies, or computer reports of the returns is not important.”); *Whittington v. Comm’r*, 78 T.C.M. (CCH) 339 (1999) (upholding IRS use of RTVUE transcript of taxpayer’s return to arrive at deficiency determination).

84. IRS FSA 200004017, 1999 FSA LEXIS 291, \*9.

85. *Id.* However, in a Tax Court case, appealable to the Ninth Circuit, in which the IRS did not actually use the transcript of the return that was in its files, and simply computed the tax at the top marginal rate, the IRS found the notice of deficiency invalid under the reasoning of *Scar*. *See Kong v. Comm’r*, 60 T.C.M. (CCH) 696 (1990); *see also Toll v. Comm’r*, 1991 U.S. App. LEXIS 17529 (9th Cir. 1991) (similar holding by the Ninth Circuit, on similar facts); *Carnahan v. Comm’r*, 61 T.C.M. (CCH) 2406, 2407-08 (1991) (prior docket in the case was dismissed because it was based on notice of deficiency that stated “[i]n order to protect the government’s interest and since your original income tax return is unavailable at this time, the income tax is being assessed at the maximum tax rate of 70%.”).

86. For example, in 1993, the IRS estimated that its use of the RTVUE system would save \$1.2 million dollars, and would enable the IRS to provide taxpayers with transcripts of their accounts within twenty-four to forty-eight hours of a request, as opposed to the six to eight weeks required to obtain a copy of a tax return. *See Fact Sheet FS-93-3*, 1993 IRB LEXIS 394.

87. *Scar*, 814 F.2d 1363, 1370 n.12 (9th Cir. 1987) (quoting *Scar v. Comm’r*, 81 T.C. 855, 869 (1983) (Sterrett, J., dissenting)).

88. In a Litigation Guideline Memorandum issued by the IRS to its personnel shortly after *Scar* was decided, and released in 2000 under the Freedom of Information Act, the IRS stated, in part:

investigation of the “abuses” alleged at the IRS hearings—most of which were concentrated in the collections area<sup>89</sup>—suggests that many of them were unfounded.<sup>90</sup> In addition, the Code provides criminal penalties for unauthorized inspection of return information by IRS employees.<sup>91</sup> Furthermore, the Internal Revenue Service Restructuring and Reform Act of 1998 included a provision known as the “Ten Deadly Sins,” commission of which requires termination of the IRS employee.<sup>92</sup> The “sins” include “violations of the Internal Revenue Code of 1986, Department of Treasury regulations, or policies of the Internal Revenue Service (including the Internal Revenue Manual) for the purpose of retaliating against, or harassing, a taxpayer, [or] taxpayer representative,”<sup>93</sup> as well as “threatening to audit a taxpayer for the purpose of extracting personal gain or benefit.”<sup>94</sup>

Taxpayers also have tools to contest arbitrary or unfounded notices of deficiency. First, the Tax Court provides a forum for taxpayers to contest notices of deficiency without first paying the deficiency asserted. In addition, an undocumented notice alleging unreported income would be arbitrary and erroneous, which, on the taxpayer’s motion, would result in a shift to the IRS of the burden of going forward, unless the IRS were able to tie the taxpayer to the tax-generating activity. In the case of an arbitrary notice denying a deduction, credit, or exclusion, the taxpayer should have the evidence to rebut the IRS’s contention. Furthermore, as discussed above, Code section 7430 allows a court to award a prevailing taxpayer reasonable litigation and administrative costs if the IRS’s position was not substantially justified and the taxpayer “has exhausted the administrative remedies available”<sup>95</sup> to him within the IRS.<sup>96</sup>

Section 7430, which requires that the taxpayer substantially prevail, will not protect a taxpayer who loses on the merits after a successful “fishing expedition”

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Notwithstanding our legal view that the Ninth Circuit panel majority was incorrect in its legal analysis of the jurisdiction of the Tax Court and our commitment to defend the jurisdiction as noted above, the process the Service used in *Scar* is rightly condemned. The Office of Chief Counsel has expressed to the Examination Division its strong objections to the procedure of issuing inadequate notices to “protect the government’s interest.” Steps are being taken to prevent a repeat of the situation exemplified by *Scar*. All attorneys in the Office of Chief Counsel should be aware of this and take necessary steps to forestall further *Scar* situations.

LGM TL-3 (Jan. 15, 1988), 2000 TNT 121-89.

89. See George Guttman, *Public Relations: The IRS Could Do a Lot More to Help Its Image*, 87 TAX NOTES 479, 480 (2000).

90. Ryan J. Donmoyer, *Horror Story Heard by Senate Panel Was Half-Told Tale*, 79 TAX NOTES 518, 520 (1998).

91. See I.R.C. § 7213A (Supp. V 1999).

92. H.R. 2676, 105th Cong. § 1203 (1998).

93. *Id.* at § 1203(b)(6)-(10).

94. *Id.*

95. I.R.C. § 7430(b)(1) (1994).

96. *Id.* § 7430.

by the IRS. However, Tax Court rules require parties or their attorneys to sign their pleadings,<sup>97</sup> and they contain sanctions similar to Rule 11 of the Federal Rules of Civil Procedure for pleadings filed for improper purposes:

The signature of counsel or a party constitutes a certificate by the signer that . . . to the best of the signer's knowledge, information, and belief formed after reasonable inquiry, it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and *that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation*. . . . If a pleading is signed in violation of this Rule, the Court, upon motion or upon its own initiative, may impose upon the person who signed it, a represented party, or both, an appropriate sanction, which may include an order to pay to the other party or parties the amount of the reasonable expenses incurred because of the filing of the pleading, including reasonable counsel's fees.<sup>98</sup>

This provision provides a sanction for the hypothetical circumstance in which IRS pleadings were made in order to perpetuate a case premised on harassing the taxpayer.

*c. Uninformative notices.*—Professor Schoenfeld also expresses concern about specificity in notices of deficiency, arguing that

[a]pplying *Greenberg's Express* as the Service argues would shield almost all information that might tend to show that an employee of the Service acted improperly or carelessly. Except for the most blatant and erroneous situations, such as an obvious and substantial mathematical error on the face of the Statutory Notice, or a Notice which clearly does not refer to the petitioner's income or deductions, a petitioner must know how the specific dollar assertions in the Statutory Notice were computed in order to begin to bear his burden of refuting the assertions.<sup>99</sup>

It is certainly true that the taxpayer must know how the dollar amounts in the notice were determined in order to produce appropriate evidence to contradict the determination. However, *Greenberg's Express* does not prevent specificity in notices of deficiency. On the contrary, Code section 7522, enacted subsequent to the decision in *Greenberg's Express*, requires specificity in IRS notices, including notices of deficiency. In part, it provides: "Any notice to which this section applies shall describe the basis for, and identify the amounts (if any) of,

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97. See TAX CT. R. PRAC. & P. 23(a)(3) ("The original signature, either of the party or the party's counsel, shall be subscribed in writing to the original of every paper filed by or for that party with the Court, except as otherwise provided by these Rules."); *id.* at 33(b) ("If a pleading is not signed, it shall be stricken, unless it is signed promptly after the omission is called to the attention of the pleader.").

98. *Id.* (emphasis added).

99. Schoenfeld, *supra* note 5, at 529 (footnote omitted).

the tax due, interest, additional amounts, additions to the tax, and assessable penalties included in such notice."<sup>100</sup>

Enforcement of section 7522 should address Professor Schoenfeld's concerns about unspecific and uninformative notices. Unfortunately, Tax Court jurisprudence interpreting this provision has not been ideal. Section 7522 also provides that "[a]n inadequate description . . . shall not invalidate [the] notice."<sup>101</sup> That has the positive effect of avoiding a taxpayer win based on a jurisdictional ruling when the nature of the error actually affects the pleading function of the notice. However, the quoted sentence has the unfortunate effect of precluding one remedy without specifying another.

Over time, the Tax Court has developed the remedy of shifting the burden of proof to the IRS as a remedy for violation of section 7522.<sup>102</sup> This remedy in effect requires the IRS to come up with the explanation it did not afford in the notice of deficiency. It relieves the taxpayer from having to counter an unknown allegation. It is an excellent remedy for a vague notice. Unfortunately, in *Shea v. Commissioner*,<sup>103</sup> the Tax Court applied the same standard as it does to determine if the IRS has raised "new matter," which requires shifting the burden of proof to the IRS.<sup>104</sup> The "new matter" jurisprudence encourages the IRS to draft broadly worded notices of deficiency so that little raised subsequently will be found inconsistent with the determination in the notice of deficiency.<sup>105</sup> That test for new matter is not appropriate for determining whether the notice is adequately specific and descriptive.<sup>106</sup>

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100. I.R.C. § 7522(a) (1994). The section applies to notices of deficiency. *See id.* § 7522(b).

101. *Id.* § 7522(a).

102. *See Shea v. Comm'r*, 112 T.C. 183 (1999).

We, therefore, hold that where a notice of deficiency fails to describe the basis on which the Commissioner relies to support a deficiency determination and that basis requires the presentation of evidence that is different than that which would be necessary to resolve the determinations that were described in the notice of deficiency, the Commissioner will bear the burden of proof regarding the new basis. To hold otherwise would ignore the mandate of section 7522 and Rule 142(a).

*Id.* at 197; *Straight v. Comm'r*, 74 T.C.M. (CCH) 1457 (1997) (IRS conceded that shifting the burden of proof would be appropriate remedy for section 7522 violation); *Ludwig v. Comm'r*, 68 T.C.M. (CCH) 961, 963 (1994) ("What then remains of the responsibility of the IRS when the Commissioner fails to obey the command of section 7522(a)? Perhaps this Court could fashion some sort of remedy for the taxpayer, such as imposing the burden of proof, or at least the burden of going forward, on the Government.").

103. 112 T.C. 183 (1999).

104. *See id.* at 193-94; TAX CT. R. PRAC. & P. 142(a); *see also Elliott v. Comm'r*, 82 T.C.M. (CCH) 13, \*21 (2001) ("In a recent case, we considered whether the Commissioner's position was new matter in the context of section 7522." *Citing Shea v. Comm'r*, 112 T.C. 183 (1999)).

105. *See Leandra Lederman Gassenheimer, The Dilemma of Deficient Deficiency Notices*, 73 TAXES 83 (1995) (containing a detailed discussion).

106. *See Leandra Lederman, Deficient Statutory Notices and the Burden of Proof: A Reply to*

For example, in *Sellers v. Commissioner*,<sup>107</sup> the notice of deficiency stated that the IRS had disallowed the taxpayers' bad debt deduction "because it has not been established that any amount of bad debts existed in fact and in law."<sup>108</sup> Similarly, the IRS stated that it disallowed a net operating loss carryover "because it has been determined that a net operating loss did not exist in the year that caused the carryforward."<sup>109</sup> The Tax Court stated, with respect to section 7522, "At trial, [the IRS] has taken no position that would require [the taxpayers] to present evidence different from that necessary to resolve the determinations that were described in the notice of deficiency, so as to justify placing the burden of proof on [the IRS]."<sup>110</sup> In fact, the broader the statement in the notice of deficiency, the less likely different evidence would be needed to prove post-notice positions adopted by the IRS. Fortunately, the Tax Court does recognize the purpose of section 7522.<sup>111</sup> Additional reform in this area would solve the problem; *Greenberg's Express* need not be overruled.

### C. Obtaining the Revenue Agent's Report

Professor Schoenfeld argues that, because of *Greenberg's Express* and assertions of privilege, the IRS "consistently argues that all documents supporting its computations of a deficiency are . . . not discoverable."<sup>112</sup> He focuses on the revenue agent's report.<sup>113</sup> Yet, many, if not most, taxpayers receive the revenue agent's report *before* ever receiving a notice of deficiency; it generally arrives with the thirty-day letter. In fact, in order to demonstrate the function of the revenue agent's report, Professor Schoenfeld quotes *Block-Southland Sportswear Co. v. United States*<sup>114</sup> as saying, "The purpose of such letter and report is to inform the taxpayer of the results of an income tax audit for a particular year and to extend to him an opportunity to request a conference for a further discussion of a proposed adjustment in his tax liability."<sup>115</sup> The prior sentence of that opinion states, "On June 23, 1971, under Section 6532(a)(1) of the Internal Revenue Code of 1954, the District Director of Internal Revenue of the State of North Carolina issued to plaintiff his Form L191 (Rev. 3-69) commonly known as a 'thirty-day letter' to which was attached a Revenue

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Mr. Newton, 92 TAX NOTES 117, 122-23 (2001) (criticizing *Shea's* approach to § 7522).

107. 80 T.C.M. (CCH) 135 (2000).

108. *Id.* at 138.

109. *Id.*

110. *Id.* at 139 (citation omitted).

111. See *Elliott v. Comm'r*, 82 T.C.M. (CCH) 13, \*22 (2001) ("[The *Shea*] holding was predicated on our understanding that the purpose of section 7522 is to give taxpayers notice of the basis for a deficiency determination.").

112. Schoenfeld, *supra* note 5, at 536.

113. See *id.* at 536-37.

114. 73-1 USTC ¶ 9230, *aff'd*, 480 F.2d 921 (4th Cir. 1973).

115. Schoenfeld, *supra* note 5, at 537 n.122 (quoting *Block-Southland Sportswear Co.*, 73-1 USTC ¶ 9230).

*Agent's Report.*<sup>116</sup>

If the taxpayer does not receive a copy of the revenue agent's report with the thirty-day letter, many practitioners request it (and in fact, often request the entire administrative file) as soon as the notice of deficiency arrives.<sup>117</sup> If an informal request is unsuccessful, a Freedom of Information Act request is in order. That may or may not result in obtaining the file in time for use in Tax Court litigation. If it does not, use of the Tax Court's discovery procedures is the remaining option.

Professor Schoenfeld states that,

[i]n effect, the Service is asserting that *everything* its employees do at *any time* is potentially part of some future litigation and, thus, not discoverable. This position reinforces the Service's position in *Greenberg's Express*, sharply decreasing the likelihood that a petitioner will find a basis for any error in a Statutory Notice.<sup>118</sup>

Yet, *Peterson v. United States*,<sup>119</sup> the case that Professor Schoenfeld discusses immediately following the quoted language, contradicts the assertion that the taxpayer will be hampered. In that case, although the government argued that documents were privileged as prepared in anticipation of litigation or for trial, the court did not so find:

The only indication before the court that the documents were so prepared are conclusory statements by counsel for the Government. The Government has neither shown nor offered to show that such documents are trial preparation material. *Generally, it is this court's belief that IRS appellate conferee reports and IRS field agent reports are not prepared in anticipation of litigation or for trial.* Presumably they are prepared in the assessment and review process and, if they be held to be in anticipation of litigation, it is hard to see what would not be. Litigation cannot be anticipated in every such case when relatively few result in litigation. Since no showing to the contrary has been made or offered, it is this court's finding that the contents of the documents sought to be discovered by the plaintiffs through Interrogatories Nos. 6 and 8 are not trial preparation material and are not protected from discovery by rule 26(b)(3).<sup>120</sup>

*Peterson* was not the only case in which the taxpayer was able to obtain

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116. *Block-Southland Sportswear Co.*, 73-1 USTC ¶ 9230.

117. *Cf. Swanson v. Comm'r*, 106 T.C. 76, 81 (1996) ("Because the notice of deficiency failed to adequately explain respondent's bases for determining deficiencies and additions to tax with respect to the years at issue, petitioners requested and received the revenue agent's report in their case.").

118. Schoenfeld, *supra* note 5, at 537 (emphasis in original).

119. 52 F.R.D. 317 (S.D. Ill. 1971).

120. *Id.* at 320-21 (emphasis added).

revenue agent reports. In *Hernley v. United States*,<sup>121</sup> a case in which the taxpayer sought disclosure of grand jury materials, the Court of Appeals for the Seventh Circuit stated: “In support of their claim of right to depose Agent Johnson, the *Hernly* defendants asserted that in discovery they had obtained a copy of Agent Johnson’s Revenue Agent’s Report.”<sup>122</sup> The court also described contents of that report, including contents relating to civil fraud.<sup>123</sup>

Professor Schoenfeld’s concern may be that *Peterson* and other favorable cases were not decided by the Tax Court. He states:

[T]he [Internal Revenue] Service . . . often refuses to disclose exactly how it calculated the dollar amounts of the taxpayer’s asserted tax deficiencies, based upon its overly broad interpretation of case law. This refusal to disclose details seems to be contrary to the discovery rules of the Tax Court; however, the court usually agrees with the Service’s position because it does not wish to look into the inner administrative workings of the agency.<sup>124</sup>

Tax Court discovery rules seem to allow taxpayers to obtain revenue agents’ reports. Tax Court Rule 70(b)(1) states in part, “The information or response sought through discovery may concern any matter not privileged and which is relevant to the subject matter involved in the pending case.”<sup>125</sup> In *Haag v. Commissioner*,<sup>126</sup> the Tax Court admitted a thirty-day letter and revenue agent’s report into evidence “for the limited purpose of showing the basis for the deficiency determination, and not as proof of the facts contained therein.”<sup>127</sup> The Tax Court does not always admit revenue agents’ reports into evidence, but inadmissibility of evidence does not preclude its availability through discovery. “It is not ground for objection [to discovery] that the information or response sought will be inadmissible at the trial, if that information or response appears reasonably calculated to lead to discovery of admissible evidence, regardless of the burden of proof involved.”<sup>128</sup>

In *Rountree Cotton Co. v. Commissioner*,<sup>129</sup> a case submitted to the court fully stipulated, the Tax Court refused to admit into evidence a revenue agent’s report that the taxpayer had received “before issuance of the notice of deficiency.”<sup>130</sup> The court sustained the IRS’s relevance objection, finding that the IRS’s pre-notice administrative record was irrelevant given the absence of

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121. 832 F.2d 980 (7th Cir. 1987).

122. *Id.* at 982 (emphasis added).

123. *See id.* at 982-83.

124. Schoenfeld, *supra* note 5, at 518.

125. TAX CT. R. PRAC. & P. 70(b)(1).

126. 88 T.C. 604 (1987), *aff’d*, 855 F.2d 855 (8th Cir. 1988).

127. *Id.* at 622 n.14.

128. TAX CT. R. PRAC. & P. 70(b)(1).

129. 113 T.C. 422 (1999), *aff’d*, 2001 U.S. App. Lexis 5258 (10th Cir. 2001).

130. *Id.* at 426.

allegations of unconstitutional IRS conduct.<sup>131</sup> However, Professor Schoenfeld's objection seems to be that the revenue agent's report may be *unavailable* to the taxpayer, not that it will be *inadmissible* as evidence supporting the taxpayer. In *Rountree Cotton*, as in most other cases, the taxpayer will already have obtained the report.<sup>132</sup>

## II. PROOF IN TAX FRAUD CASES

Although Professor Schoenfeld's primary concern seems to be with obtaining information from the IRS, he also expresses concern about the IRS's methods for proving tax fraud, particularly the use of collateral estoppel, badges of fraud, and allocation of the proceeds of a criminal conspiracy. Each of these is discussed below.

Code section 6663(a) contains the fraud penalty. It provides: "If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud."<sup>133</sup> Therefore, a civil fraud case requires proof of both underpayment of tax and fraud. The IRS has the burden of proving fraud, and it must do so by clear and convincing evidence.<sup>134</sup> In fact, the IRS must establish *each element* of fraud with that level of proof. Collateral estoppel and so-called "badges of fraud" are techniques the IRS uses to meet its burden of proving the fraud element. The underpayment element generally requires additional evidence.

An underpayment of tax in a fraud case generally stems either from disallowed deductions or unreported income. Professor Schoenfeld's article focuses on cases involving unreported income, particularly cases involving illegal income. Because of the difficulties of proving the negative of nonreceipt, an IRS determination of receipt of profits from an illegal enterprise requires some predicate evidence connecting the taxpayer to the activity.<sup>135</sup> The importance of this element of the proof is discussed below.

### A. Methods of Proving Fraud

1. *Collateral Estoppel*.—Professor Schoenfeld states that "[c]ollateral estoppel is . . . a no-win situation for the taxpayer: heads the Service wins, tails the taxpayer loses."<sup>136</sup> He is referring to the reality that in addition to the fact that a *conviction* of criminal tax evasion<sup>137</sup> estops the taxpayer from denying the

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131. *Id.*

132. *See supra* notes 113-28 and accompanying text.

133. I.R.C. § 6663(a) (1994).

134. *See id.* § 7454(a); TAX CT. R. PRAC. & P. 142(b).

135. *Anastasato v. Comm'r*, 794 F.2d 884, 887 (3d Cir. 1986); *Gerardo v. Comm'r*, 552 F.2d 554, 556 (3d Cir. 1977).

136. Schoenfeld, *supra* note 5, at 549 n.189.

137. For purposes of applying collateral estoppel, a plea of guilty is treated the same as a conviction. *See, e.g., McCulley v. Comm'r*, 73 T.C.M. (CCH) 3163, 3165 n.5 (1997); *see also*

elements of the crime, *acquittal* of a tax crime does not preclude a subsequent civil trial because the burden of proof is lower in a civil fraud trial (“clear and convincing evidence,” as opposed to “beyond a reasonable doubt”). This is not unique to tax cases; it is well known that when O.J. Simpson was acquitted of the murders of Nicole Brown and Ronald Goldman,<sup>138</sup> collateral estoppel did not preclude successful wrongful death suits by the families of the victims.<sup>139</sup> In fact, it is logical that although conviction under a higher standard of proof precludes contesting the predicate findings under a lower standard of proof, acquittal under a higher standard of proof does not preclude a subsequent suit under a lower standard of proof.

The doctrine of collateral estoppel allows a court to preclude relitigation of an issue that was decided in a previous case that involved the party against whom estoppel is sought. “Collateral estoppel, like the related doctrine of *res judicata*, has the dual purpose of protecting litigants from the burden of relitigating an identical issue with the same party or his privy and of promoting judicial economy by preventing needless litigation.”<sup>140</sup> The issue with respect to which estoppel is sought must have been necessary in reaching the original decision,<sup>141</sup> as well as part of a “valid and final judgment.”<sup>142</sup> In addition, courts consider whether the party sought to be estopped had a “full and fair opportunity to litigate”<sup>143</sup> the issue in the first suit.<sup>144</sup>

As previously indicated, burden of proof is also considered when a party seeks estoppel. Acquittal of a criminal charge is “an adjudication that the proof was *not sufficient to overcome all reasonable doubt* of the guilt of the accused.”<sup>145</sup> Accordingly, acquittal does not preclude a subsequent civil trial on the same issues;<sup>146</sup> the standard of proof is lower in a civil proceeding.<sup>147</sup> In

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Johnson v. Sawyer, 47 F.3d 716, 722 n.13 (5th Cir. 1995). However, there are good arguments that a plea should be analyzed differently. See Kathleen H. Musslewhite, *The Application of Collateral Estoppel in the Tax Fraud Context: Does It Meet the Requirement of Fairness and Equity?*, 33 AM. U. L. REV. 643 (1984).

138. See Julian A. Cook, Jr. & Mark S. Kende, *Color-blindness in the Rehnquist Court: Comparing the Court's Treatment of Discrimination Claims by a Black Death Row Inmate and White Voting Rights Plaintiffs*, 13 T.M. COOLEY L. REV. 815, 852 n. 193 (1996) (referring to *State of California v. Orenthal James Simpson*, B.A. 097211 (Cal. Super. Ct., Oct. 1, 1995)).

139. See Complaint for Damages for Wrongful Death Goldman v. Simpson, No. SC03640 (Cal. Super. Ct., L.A. County May 4, 1995), <http://www.court tv.com/casefiles/simpson/documents/goldcomp.html>; Complaint for Damages—Survival Action Brown v. Simpson, No. SC036876 (Cal. Super. Ct., L.A. County June 12, 1995), <http://www.court tv.com/casefiles/simpson/documents/browncomp.html>.

140. *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 326 (1979) (footnote omitted).

141. *Id.* at 326 n.5.

142. *Ashe v. Swenson*, 397 U.S. 436, 443 (1970).

143. *Montana v. United States*, 440 U.S. 147, 154 (1979).

144. See, e.g., *id.*

145. *Lewis v. Frick*, 233 U.S. 291, 302 (1914) (emphasis added).

146. E.g., *Helvering v. Mitchell*, 303 U.S. 391, 397 (1938) (“That acquittal on a criminal

addition, criminal conviction precludes relitigation in a civil case of the elements of the offense:

Because of the higher standard of proof and the numerous safeguards surrounding a criminal trial, a conviction in a criminal action is conclusive in a subsequent civil litigation between the same parties as to issues that were actually litigated and adjudicated in the prior criminal proceeding.<sup>148</sup>

The rationale behind applying collateral estoppel makes as much sense in tax cases as it does in other cases. Tax *fraud* cases are no exception. Thus, as Professor Schoenfeld notes, a taxpayer convicted of criminal tax fraud under Code section 7201 will likely be estopped from denying tax fraud in a subsequent civil suit.<sup>149</sup>

Under section 7201, the government must prove, beyond a reasonable doubt, that the taxpayer "willfully attempt[ed] in any manner to evade or defeat any tax . . . ." <sup>150</sup> In *Amos v. Commissioner*,<sup>151</sup> the Tax Court held that the *willfulness* element of section 7201 encompasses all of the elements of the fraud provision that is now Code section 6663.<sup>152</sup> Given the identity of issue combined with the

charge is not a bar to a civil action by the Government, remedial in its nature, arising out of the same facts on which the criminal proceeding was based has long been settled." )

147. See Commander Roger D. Scott, *Kimmel, Short, Mcvay: Case Studies in Executive Authority, Law and the Individual Rights of Military Commanders*, 156 MIL. L. REV. 52, 109 n.212 (1998) ("The same evidence that might not meet the higher standard of proof applicable in a criminal context ('beyond a reasonable doubt') might satisfy the standard of proof for liability in a civil context ('a preponderance of evidence')."). Civil fraud proceedings have an intermediate standard of proof, "clear and convincing evidence." *E.g.*, *Considine v. United States*, 683 F.2d 1285, 1286 n.1 (9th Cir. 1982); *Powell v. Granquist*, 252 F.2d 56, 61 (9th Cir. 1958).

148. *Sec. & Exch. Comm'n v. Everest Mgmt. Corp.*, 466 F. Supp. 167, 172 (S.D.N.Y. 1979) (footnote omitted); see also *Emich Motors Corp. v. Gen. Motors Corp.*, 340 U.S. 558, 568 (1951) (stating that "[i]t is well established that a prior criminal conviction may work an estoppel in favor of the Government in a subsequent civil proceeding.").

149. See Schoenfeld, *supra* note 5, at 547.

150. I.R.C. § 7201 (1994). The section provides, in full:

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

*Id.*

151. 43 T.C. 50 (1964), *aff'd*, 360 F.2d 358 (4th Cir. 1965), *overruled in part on other grounds* by *Meier v. Comm'r*, 91 T.C. 273 (1988).

152. *Id.* at 55; see also I.R.C. § 6663(a) (1994) ("If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud."). *Amos* was applying the fraud provision that used to be contained in Code section 6653(b). See *Amos*, 43 T.C. at 52.

higher burden of proof required in the criminal case, estoppel can apply to preclude the taxpayer to deny tax fraud if he was convicted of a willful attempt to evade or defeat tax.<sup>153</sup>

In addition, there is an array of tax crimes that do *not* estop the taxpayer from denying civil tax fraud.<sup>154</sup> Many of these other crimes are more easily proven by the IRS because they do not require proof of a tax deficiency, and Code section 7201 does.<sup>155</sup> Thus, not every taxpayer convicted of a tax crime will face collateral estoppel in a subsequent civil case.

2. *Badges of Fraud*.—Commission of fraud requires scienter. That is, negligent or even grossly negligent activity does not constitute fraud because fraud has an intent element. It is rarely possible for the IRS to prove to a court the taxpayer's intent to violate the law through direct evidence (such as a confession). Accordingly, the IRS uses circumstantial evidence known as "badges of fraud" to try to meet its burden. Professor Schoenfeld lists ten of the badges fraud frequently used in civil tax cases:

- A. A Pattern of Understatement.
- B. Concealment of Assets or Sources of Income.
- C. Dealings in Cash.
- D. Failure to Maintain Books and Records.
- E. Engaging in Illegal Activities.
- F. Attempting to Conceal Illegal Activities.
- G. Failure to Cooperate with Tax Authorities.
- H. Showing a Willingness to Defraud Business Associates or Others.
- I. Taxpayer's Sophistication, Education, and Knowledge of Duty to Report Income.
- J. Giving Implausible Explanations.<sup>156</sup>

Most of the items on the above list—other than item I., which is not focused on acts—comport with intuition about the likely behavior of an individual engaged in tax fraud. With respect to the first item on his list, a pattern of understatement, Professor Schoenfeld states:

In any year for which the taxpayer has been convicted of filing a false return, under I.R.C. § 7206(1) (1999) [sic], the Service will treat that year as part of a pattern of understatement, thereby helping prove the intent to evade. However, this reasoning is circular and illogical. In *Wright*, the Tax Court decided that a conviction for filing a false return

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153. See, e.g., *Blohm v. Comm'r*, 994 F.2d 1542, 1554 (11th Cir. 1993); *Klein v. Comm'r*, 880 F.2d 260, 262 (10th Cir. 1989); *Gray v. Comm'r*, 708 F.2d 243 (6th Cir. 1983), *cert. denied*, 466 U.S. 927 (1984); *Fontneau v. United States*, 654 F.2d 8, 10 (1st Cir. 1981) (per curiam); *Amos v. Comm'r*, 43 T.C. 50, 56 (1964), *aff'd*, 360 F.2d 358 (4th Cir. 1965).

154. See, e.g., I.R.C. §§ 7203, 7206, 7207 (1994 & Supp. V 1999).

155. See *Sansone v. United States*, 380 U.S. 343, 351 (1965); *Lawn v. United States*, 355 U.S. 339, 361 (1958).

156. Schoenfeld, *supra* note 5, at 556.

under I.R.C. § 7206(1) (1999) does not equal fraud, because the required intent to evade tax is not an element of I.R.C. § 7206(1) (1999). It is quite illogical to say that § 7206(1) requires an additional factor to show fraud, and then attempt to prove that additional factor by invoking § 7206(1) itself.<sup>157</sup>

Certainly conviction of a section 7206(1) offense does not in and of itself establish fraud. If it did, it could be used to estop the taxpayer from rebutting a civil fraud claim for the same year.<sup>158</sup> That is, unlike Code section 7201, section 7206(1)<sup>159</sup> does not contain an element of intent to evade taxes,<sup>160</sup> nor does it require proof of an understatement of tax. The civil fraud penalty requires proof of both.<sup>161</sup> Nonetheless, conviction of a section 7206(1) violation is highly relevant. It demonstrates intent to file a false return, an illegal activity. If the return in fact understated tax, that is an instance of understatement of tax.<sup>162</sup> If there are other such instances, they may form a pattern. A pattern of understatement is an indicium of fraudulent intent.<sup>163</sup>

In *Investment Research Associates v. Commissioner*,<sup>164</sup> a fairly recent tax fraud case, the Tax Court compiled a longer list of indicia of fraud that included the following:

- 1) failure to produce records during discovery;
- 2) destruction of records;
- 3) misleading statements or actions;
- 4) commingling of personal assets with those of the taxpayer's corporation in an attempt to avoid tax;
- 5) diversion of income to third parties;

157. *Id.* at 557-58 (footnotes omitted).

158. *See supra* notes 153-55 and accompanying text.

159. Code section 7206 provides, in relevant part:

Any person who—

- (1) . . . Willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter . . . shall be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

I.R.C. § 7206 (1994).

160. *See United States v. Bishop*, 412 U.S. 346, 359-60 & n.8 (1973).

161. *See I.R.C. § 6663(a)* (1994).

162. *See, e.g., Considine v. United States*, 645 F.2d 925, 928-31 (Ct. Cl. 1981) (holding that prior conviction under section 7206(1) estopped taxpayer from contesting that the return was willfully false and resulted in an underpayment of tax, as indictment had charged that return was false because items of income were omitted).

163. "The existence of *several* indicia is persuasive circumstantial evidence of fraud." *Inv. Research Assocs. v. Comm'r*, 78 T.C.M. (CCH) 951, 1081 (1999) (emphasis added).

164. *Id.*

- 6) reporting income from property beneficially owned by the taxpayer on the returns of family members;
- 7) structuring of a business and use of cash management techniques which made difficult the tracing of income;
- 8) banking devices used to conceal earnings;
- 9) concealing income under the names of other persons who reported such income;
- 10) omission of income from the taxpayer's property, title to which was held in names of others who reported the income therefrom.<sup>165</sup>

Of course, as Professor Schoenfeld states, a taxpayer could have reasons other than tax evasion for engaging in any of these acts.<sup>166</sup> Thus, these items are merely indicia of fraud, not proof of fraud. Professor Schoenfeld expresses concern that “[t]he Service can assert, as an indicia [sic] of fraud, every badge of fraud against a taxpayer that could possibly be true. Of course, the Service will not assert any countervailing factors.”<sup>167</sup> He is probably right. However, in an adversary system, assertion of countervailing factors and evidence is the job of the taxpayer and his counsel, not of the IRS. In addition, the question of fraud is a factual one that courts resolve by considering the entire record.<sup>168</sup>

### B. Reconstruction of Income

Professor Schoenfeld understandably expresses great concern with respect to proper allocation of gross income in a tax fraud case involving co-conspirators.<sup>169</sup> There are inherent difficulties in reconstructing unreported income, and those difficulties are compounded if proceeds from an enterprise were divided among the participants. That is, conspiracy fraud cases may raise more risk of an excessive deficiency determination with respect to a particular taxpayer than do fraud cases involving a single individual.<sup>170</sup>

The IRS makes the initial determination of the amount of gross income

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165. *Id.* (citations omitted). *Investment Research Associates* cites the following cases: *United States v. Walton*, 909 F.2d 915 (6th Cir. 1990); *Scallen v. Commissioner*, 877 F.2d 1364, 1370-71 (8th Cir. 1989); *Furnish v. Commissioner*, 262 F.2d 727 (9th Cir. 1958); *Maddas v. Commissioner*, 114 F.2d 548 (3d Cir. 1940); *Lewis v. Commissioner*, 46 T.C.M. (CCH) 1311 (1983), *aff'd*, 762 F.2d 1009 (6th Cir. 1985); *McManus v. Commissioner*, 31 T.C.M. (CCH) 999 (1972), *aff'd*, 486 F.2d 1399 (4th Cir. 1973); *Estate of Beck v. Commissioner*, 56 T.C. 297 (1971); *Lang v. Commissioner*, 20 T.C.M. (CCH) 666 (1961); *Hecht v. Commissioner*, 16 T.C. 981 (1951).

166. Schoenfeld, *supra* note 5, at 567.

167. *Id.*

168. *See, e.g.*, *Gajewski v. Comm'r*, 67 T.C. 181, 199 (1976), *aff'd*, 578 F.2d 1383 (8th Cir. 1978).

169. *See* Schoenfeld, *supra* note 5, at 541.

170. *See, e.g.*, *Jones v. Comm'r*, 903 F.2d 1301, 1302-03 (10th Cir. 1990) (upholding deficiency based on \$33 million of unreported income from drug sales in a particular location, where taxpayer denied involvement but did not explain who might be receiving the drug proceeds instead).

allocable to a taxpayer. Its determination is reflected in the notice of deficiency. As discussed previously, even in civil cases not involving fraud, a determination of unreported income must have some support if the taxpayer denies receipt of income.<sup>171</sup> A determination without foundation is "arbitrary and erroneous."<sup>172</sup> If the taxpayer alleges such a "naked assessment," the burden of going forward shifts to the IRS. If the IRS cannot support its determination, generally by linking the taxpayer to an illegal tax-generating activity, the IRS loses.<sup>173</sup>

In civil cases involving an allegation of unreported income, if the taxpayer denies receiving the income, the IRS may use a variety of techniques to "reconstruct" that income. Court-approved techniques include the net-worth method, which "is particularly well-suited to ferreting out hidden income, especially income from illegal sources;"<sup>174</sup> the cash transaction method; the bank deposits method; the specific items method; the source and application of funds method; and the T-account method.<sup>175</sup> Each one seeks to establish the amount of income earned by the taxpayer and to compare it to the taxpayer's return to determine the amount of unreported income, if any.

In a case involving a fraud penalty, the IRS bears the burden of proving both fraud and an underpayment of tax by clear and convincing evidence. Use of these methods of reconstructing income assists the IRS in proving that there was an underpayment of tax; absent an underpayment, the fraud penalty does not apply.<sup>176</sup> However, once the IRS proves fraud, the burden shifts to the taxpayer to establish the amount of the deficiency *not* attributable to fraud.<sup>177</sup> A denial of the underlying activities will not help the taxpayer at this stage, because the court will not reach this stage unless it is convinced that the taxpayer committed fraud.<sup>178</sup>

171. See *supra* text accompanying notes 35-42.

172. *Id.*

173. *Id.*

174. Linda S. Eads, *From Capone to Boesky: Tax Evasion, Insider Trading, and Problems of Proof*, 79 CAL. L. REV. 1421, 1426 (1991). In *Holland v. United States*, 348 U.S. 121 (1954), the United States Supreme Court approved the use of the "net worth" method but required proof of a "likely source" of the unreported income. *Id.* at 132, 137-38.

175. See LEDERMAN & MAZZA, *supra* note 26, at 80.

176. See I.R.C. § 6663(a) (1994).

177. See *id.* § 6663(b).

178. *Cf. Jones v. Comm'r*, 903 F.2d 1301, 1303 (10th Cir. 1990) (upholding IRS assertion of \$33 million of unreported income). The court stated:

Jones offered almost no real evidence to prove that the Commissioner's assessment was erroneous except his weak attempts to distance himself from all drug sales. He made no attempt to suggest a more appropriate or more accurate estimate of his drug related income, nor did he suggest who, if not he, was receiving the majority of income arising from drug trafficking at Hanover Place in 1985.

*Id.* at 373. See also *Mandina v. Comm'r*, 43 T.C.M. (CCH) 359 (1982), *aff'd*, 758 F.2d 1399 (11th Cir. 1984 (per curiam), and *aff'd as modified sub nom. Schaffer v. Comm'r*, 779 F.2d 849 (2d Cir. 1985). In *Mandina*, the court stated:

In conspiracy cases, the IRS faces another level of complication in determining the taxpayer's deficiency, and the taxpayer faces a corresponding complication in rebutting that determination. Once the IRS has reconstructed income from the conspiracy, it must allocate the income among the participants. Professor Schoenfeld refers to allocation of aggregate conspiracy profits as the "slice of the pie" approach.<sup>179</sup> The IRS may alternatively use what Professor Schoenfeld terms the "act-by-act approach,"<sup>180</sup> under which the IRS allocates among co-conspirators profits from each of the conspiracy's acts rather than on an aggregate basis.<sup>181</sup> Under either method of allocation, the IRS may protectively redundantly allocate the total amount (of the pie or of profits from each act).<sup>182</sup>

Professor Schoenfeld expresses concern about the IRS's protective allocation of the same dollar amounts to multiple co-conspirators.<sup>183</sup> This is an important issue because of the taxpayer's burden of proving the amount of the deficiency that is not attributable to fraud.<sup>184</sup> It may be difficult for the taxpayer to prove that too much of the conspiracy's income was assigned to him rather than to co-conspirators, particularly in the likely absence of books and records. Yet, as Professor Schoenfeld notes, if the IRS does not take a protective position, it increases its risk of whipsaw.<sup>185</sup>

Professor Schoenfeld also points out that some co-conspirators may not have received notices of deficiency, perhaps because they were not convicted of

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Since we have concluded that respondent has shown with respect to each petitioner an underpayment of tax in the year 1969, a part of which was due to fraud, it is incumbent on petitioners to show that the amounts of the deficiencies as determined by respondent are in error. Because of the position taken by each petitioner, that he had received no unreported income, it is very difficult to determine exactly how much of the money extracted from DMI by the four petitioners was taken by each.

*Id.* (citation omitted).

179. Schoenfeld, *supra* note 5, at 544.

180. *Id.*

181. *Id.*

182. *See id.* at 543-44. The IRS does not always use redundant allocation. *See, e.g., Barber v. Comm'r*, 39 T.C.M. (CCH) 1026, 1029 (1980) (upholding IRS determination that one-seventh of bank robbery proceeds would be allocated to taxpayer, one of seven participants), *aff'd*, 679 F.2d 896 (9th Cir. 1982).

183. *See* Schoenfeld, *supra* note 5, at 544-47.

184. *See* I.R.C. § 6663(b) (1994).

185. Schoenfeld, *supra* note 5, at 543.

A whipsaw situation occurs in the tax field when two taxpayers take positions with respect to a particular transaction which are so inconsistent with each other that only one should logically succeed—and yet, because of jurisdictional or procedural reasons, first one and then the other prevails against the government.

*Remarks by Phillip R. Miller at Court of Claims Judicial Conference, October 14, 1971, on Whipsaw Problems in Tax Cases*, 25 TAX LAWYER 193 (1972).

underlying crimes<sup>186</sup> (and thus fraud would be harder to prove). If one taxpayer successfully argues that part of his “share” was actually received by others, the IRS would be faced with either increasing the deficiency of the others (procedurally disadvantageous), or being whipsawed if those others were either not before the court or had already successfully argued that those amounts were not received by them. Thus, he agrees that “the protective position makes sense”<sup>187</sup> under a “slice of the pie” approach.<sup>188</sup> He nonetheless questions the “logic behind the protective position . . . in act-by-act cases[,] [b]ecause there is no ‘pie.’”<sup>189</sup>

Actually, the difference between slice-of-the-pie and act-by-act case is the number of pies and size of those pies. That is, a particular case analyzed as a slice-of-the-pie case would have one large pie for allocation, while that case analyzed on an act-by-act basis would have multiple, smaller pies to allocate. *Mandina v. Commissioner*,<sup>190</sup> quoted below, illustrates this principle.<sup>191</sup>

Redundant allocation of slices of the pie or pies involved protects the IRS, but at the expense of taxpayer difficulties of proof. As Professor Schoenfeld points out, the taxpayer may not know until after trial how much the IRS really plans to attribute to him, hampering his defense.<sup>192</sup> Yet all is not lost. “The Commissioner has the right to make inconsistent determinations to protect the public fisc, as long as none of the deficiencies has been collected and the Commissioner acknowledges only one tax liability is due.”<sup>193</sup> That is, the IRS may collect only one tax on any given deficiency.<sup>194</sup> In fact, the IRS generally will drop its protective position before entry of decision. For example,<sup>195</sup> in *Ryan v. Commissioner*, an act-by-act case<sup>196</sup> that is an important focus of Professor

186. Schoenfeld, *supra* note 5, at 543.

187. *Id.* at 544.

188. *Id.*

189. *Id.* at 545.

190. 43 T.C.M. (CCH) 359 (1982), *aff'd*, 758 F.2d 1399 (11th Cir. 1984) (per curiam), and *aff'd as modified sub nom.* Schaffer v. Comm’r, 779 F.2d 849 (2d Cir. 1985).

191. See *infra* text accompanying note 200.

192. See Schoenfeld, *supra* note 5, at 546-47.

193. *Ryan v. Comm’r*, 75 T.C.M. (CCH) 1778, 1787 (1998) (emphasis added).

194. See, e.g., *Schaffer*, 779 F.2d at 852; *Gerardo v. Comm’r*, 552 F.2d 549, 556 (3d Cir. 1977).

195. Another example used by Professor Schoenfeld is *Arouth v. Commissioner*, 64 T.C.M. (CCH) 1390 (1992). See Schoenfeld, *supra* note 5, at 543 n.162. In that case, “[t]he court permitted the protective position until further information was uncovered; when no records or reliable testimony were uncovered regarding the conspirators’ division of income, the court determined that it was ‘appropriate to approximate the respective percentages of the sales proceeds that each petitioner received.’” *Id.* (quoting *Arouth*, 64 T.C.M. at 1395). In other cases, the IRS abandoned its protective position on brief, arguing instead for pro rata allocations. See, e.g., *Puppe v. Comm’r*, 55 T.C.M. (CCH) 1297, 1300 (1998).

196. Schoenfeld, *supra* note 5, at 544 n.167.

Schoenfeld's article,<sup>197</sup> the court noted, "At trial, [IRS's] counsel stated [IRS's] intention to ask the Court to decide the amounts of income each petitioner received individually. Accordingly, on brief [the IRS] no longer attributes the same dollar of income to more than one [taxpayer]. . . ."<sup>198</sup>

In addition, from the perspective of a particular co-conspirator, consolidating the cases of all parties to the conspiracy may be best because the Tax Court generally will avoid redundant deficiency determinations.<sup>199</sup> For example, in one case, the Tax Court stated:

Because of the lack of evidence and *our belief that it would be totally unfair to tax the same amount to each of these petitioners merely because of their failure to prove the division of the amount*, we conclude that one-third of the \$300,000 obtained from the June 20, 1969, check is taxable to each of petitioners Mandina, O'Nan and Schaffer, and none of this amount is taxable to petitioner Mitchell. Because of this same lack of evidence, we conclude that one-fourth of [the amounts from each of five transactions] is taxable to each of the four petitioners.<sup>200</sup>

Given this approach, consolidating the cases of all parties to the conspiracy may be better for taxpayers in multi-party fraud cases.<sup>201</sup>

Finally, on an act-by-act approach to the conspiracy, if the IRS does not connect a particular taxpayer with a tax-generating act, the court probably will not assign *any* income to the taxpayer from that act. In *Ryan*, the court stated:

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197. See, e.g., *id.* at 517 n.\* ("The opinions of the author are largely based and are augmented by . . . *Ryan*"); *id.* at 535-36 (describing facts surrounding testimony of revenue agent in *Ryan*); *id.* at 545-46 (describing complication in *Ryan* that arose from IRS use of protective positions); *id.* at 553-54 (using *Ryan* as an example of a case in which an element missing after application of partial collateral estoppel may be proven by other means).

198. *Ryan*, 75 T.C.M. at 1787.

199. See, e.g., *Ash v. Comm'r*, 33 T.C.M. (CCH) 974, 976-77 (1974) ("Respondent admits an inconsistent position and acts as a stakeholder. It would, therefore, seem inappropriate to tax both Ash and Cannon on the entire \$64,680. Accordingly we hold that Ash and Cannon each earned one-half of the total sent from Hodges to Ash, or \$32,340."), *aff'd sub nom. Cannon v. Comm'r*, 533 F.2d 959 (5th Cir. 1976).

200. *Mandina v. Comm'r*, 43 T.C.M. (CCH) 359, 373 (1982), *aff'd*, 758 F.2d 1399 (11th Cir. 1984) (*per curiam*), and *aff'd as modified sub nom. Schaffer v. Comm'r*, 779 F.2d 849 (2d Cir. 1985) (emphasis added).

On appeal, the Court of Appeals for the Second Circuit held that Schaffer should not have been attributed any income from certain transactions. *Schaffer*, 779 F.2d at 860. The Court of Appeals for the Eleventh Circuit affirmed the Tax Court's holding with respect to Mandina. Thus, in this case, appeals to different circuits resulted in a partial whipsaw for the IRS.

201. In a sense, once the aggregate deficiency is determined in a multi-party case, the case reflects a sort of reverse interpleader situation, with the IRS as a stakeholder. That is, interpleader serves to determine how to allocate a sum of money among multiple claimants, while in a multi-party tax fraud case, the issue is how to allocate the obligation to pay a sum of money. *Cf. Ash*, 33 T.C.M. (CCH) at 976 ("Respondent admits an inconsistent position and acts as a stakeholder.").

As we review each of respondent's assertions concerning each respective search, we consider whether respondent has presented predicate evidence linking the specific petitioner to the tax-generating activity from which respondent asserts income has arisen for such petitioner. Where there is no such predicate evidence, we attribute no income to that petitioner.<sup>202</sup>

#### CONCLUSION

Those accused of civil tax fraud, particularly following a related criminal conviction, will likely face a tough fight with the IRS. Is that fair? It is important to note that the IRS will encounter major obstacles, as well. The taxpayer generally benefits from his superior information about his activities. In addition, in attempting to reconstruct a taxpayer's transactions, the IRS will inevitably face difficulties resulting from the likelihood that a guilty taxpayer will have taken steps to conceal his activities.

Contrary to the impression given by Professor Schoenfeld's article, the taxpayer will not be precluded from receiving information about the IRS's case. Nonetheless, a taxpayer who denies any and all participation in the underlying activity is unlikely to win a tax fraud case if there is proof of his involvement in that activity. The taxpayer will not be able to rebut the amount of conspiracy profits allocated to him if he simply denies any participation in the conspiracy. A complete denial therefore may not be the best strategy, particularly in a case involving a related criminal conviction or substantial evidence of the taxpayer's participation in the conspiracy. Instead, the taxpayer may be able to present evidence indicating that someone else actually received amounts attributed to him.

A taxpayer facing the IRS in a civil fraud case also benefits from certain procedural protections. First, it is the IRS that bears the burden of proving both an underpayment of tax and the element of fraud. Second, its proof must rise to the level of clear and convincing evidence. A criminal conviction of the taxpayer will help the IRS meet that burden. That may seem unfair, but a criminal conviction means that the taxpayer, most likely represented by counsel, was found guilty of a crime beyond a reasonable doubt. Our justice system generally allows both a civil suit following a criminal conviction and use of collateral estoppel in the subsequent civil suit, if its elements are met.

In sum, Professor Schoenfeld's article is a valuable contribution to the limited literature on federal tax controversies. His article reflects serious concerns about the checks on the power of the IRS. This reply has indicated areas in which existing checks are sufficient, as well as areas in which improvements would make the tax controversy process more balanced and procedurally fair.

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202. *Ryan*, 75 T.C.M. (CCH) at 1787-88.