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**STATE BAR OF CALIFORNIA
TAXATION SECTION¹**

**PROPOSALS FOR TAX COURT
IMPLEMENTATION OF
SHIFTING BURDEN OF PROOF TO IRS**

This proposal was prepared principally by Woodford G. Rowland, Esq. with comments from other members of the Taxation Section Executive Committee and the Tax Procedure and Litigation Committee. The author wishes to thank Charles Rettig, Dennis Perez, Mark Bernsley, Wendy Abkin, Tom Lamons and David Kirsch for their contributions to this paper.²

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¹ The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association.

² Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

EXECUTIVE SUMMARY

Pending legislation would change the general rule and shift the burden of proof to the Internal Revenue Service in most income tax cases. Currently, the taxpayer has the burden of proof. This paper proposes changes in Tax Court practice in light of those changes.

There are currently two pending bills. Under the Senate bill, the burden of proof does not shift unless the taxpayer introduces "credible evidence." The taxpayer retains the initial burden of going forward with evidence. At the close of the taxpayer's case, the court must determine whether credible evidence has been offered. If so, the burden shifts if the taxpayer demonstrates that it has satisfied certain "limitations" involving substantiation, records maintenance, cooperation with IRS requests, and net worth. It is proposed that the Court revise Rule 142 so that a taxpayer who desires to shift the burden of proof must file a skeletal motion to shift burden of proof at least 45 days before the calendar call. The Service, if it approves the motion, will file detailed opposition and the taxpayer will file a detailed response. At the trial, the judge will decide any issues as to the "limitations" on the motion papers.

The House bill purports generally to impose the burden of proof on the Service in income tax cases. This rule is subject to "limitations". The taxpayer must assert a "reasonable dispute" and must satisfy substantiation and cooperation requirements. The proposed statute and legislative history suggest a lesser procedural burden on taxpayers than the Senate's approach. A pretrial determination of burden of proof is possible and desirable. It is proposed that the House bill could be implemented by requiring the taxpayer to file, no later than 60 days before calendar call, a notice as to burden of proof. The notice would state that the burden of proof is on the Service and would aver that the taxpayer asserts a reasonable dispute and has satisfied the limitations. If the Service objects, it would file a detailed motion, to impose burden of proof and the taxpayer will respond. The court will ordinarily rule on the motion, based on the papers, before trial.

Suggested revisions to the Standing Pretrial Order are summaries of the finalized Section 7491 and the revised Rule 142, and a statement on the limited role generally played by burden of proof.

DISCUSSION

I. CURRENT LAW AND TAX COURT RULE

Under current law, the taxpayer generally has the burden of proof in a Tax Court case. In cases involving fraud and certain other issues, the burden of proof is imposed on the Service. Tax Court Rule 142, titled Burden of Proof, provides as follows:

(a) General: The burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in the answer, it shall be upon the respondent. As to affirmative defenses, see Rule 39.³

II. LEGISLATIVE PROPOSALS

Pending legislation would change the general rule and shift the burden of proof to the Service in certain income tax cases, subject to limitations. The House of Representatives⁴ and the Senate⁵ have passed different versions of the legislation.

This legislation could have far reaching effects. The Service will have the burden of proof in many cases, under the approach of either the House or Senate. Notably, the legislation would impose on the Service the "ultimate burden of proof or persuasion on the merits." That is, the thrust of the legislation is not limited to either of two lesser burdens, the rebuttable

³Presumably, the current legislation is not intended to change the current rule with respect to new matter, increases in deficiency and affirmative defenses. The balance of Rule 142 deals with fraud, Rule 142(b); foundation managers, trustees and organization managers, Rule 142(c); transferee liability, Rule 142(d); and accumulated earnings tax, Rule 142 (e).

⁴Section 301 of the Internal Revenue Service Restructuring and Reform Act of 1997 (H.R. 2676), adding Internal Revenue Code section 7491 ("House Bill § 7491"), attached as Exhibit 1. Exhibit 2 is an excerpt from the House Ways & Means Committee Report, H.R. Rep. No. 105-364, 105th Cong., 1st Sess. (1997), ("Ways and Means Committee Report").

⁵Section 3001 of the Internal Revenue Service Restructuring and Reform Act of 1998 (H.R. 2676), also adding Internal Revenue Code section 7491 ("Senate Bill § 7491"), attached as Exhibit 3. Exhibit 4 is an excerpt from the Senate Finance Committee Report, S. Rep. No. 105-174, 105th Cong., 2d Sess. (1998), ("Finance Committee Report").

presumption of correctness that attaches to the notice of deficiency, or the burden of going forward with evidence.⁶

The parties will conduct settlement negotiations with the new burden of proof rules in mind. The government will need to anticipate the burden of proof and may proceed more aggressively in seeking discovery and stipulations. Thus more motions to compel may be filed. There may be pervasive changes in taxpayer practices as taxpayers seek to satisfy new requirements for cooperation with IRS requests, recordkeeping and substantiation.

The purpose of this paper is to suggest general changes to the Tax Court Rules of Practice and Procedure ("Rules") and to Tax Court practice, in light of the pending legislation. Interpretative questions arising under both versions of the legislation are beyond the scope of this paper.

This paper will first discuss the Senate version, then the House version.⁷ The Senate bill is simpler to apply and it raises fewer procedural concerns. One might conclude that the Senate's changes to the House bill are indicative of the legislation's future course.

A. The Senate Bill

The Senate bill provides that the burden of proof will shift to the Service if the taxpayer introduces credible evidence with respect to any factual issue relevant to determining its income tax liability.⁸ This rule is subject to three "limitations". First, the taxpayer must have complied with applicable requirements to substantiate any item.⁹ Second, the taxpayer must have maintained all required records, and must have cooperated with reasonable Service requests for witnesses, information, documents, meetings, and interviews.¹⁰ Third, in the case of a partnership, corporation or trust, the taxpayer's net worth must not be more than \$7 million.¹¹

⁶ Ways and Means Committee Report, 54-57; Finance Committee Report, 43-46.

⁷ The House bill passed November 5, 1997 and the Senate bill passed on May 7, 1998.

⁸ Senate Bill § 7491(a) (1).

⁹ *Id.* at § 7491(a) (2) (A).

¹⁰ *Id.* at § 7491(c) (2) (B).

¹¹ *Id.* at § 7491(c) (2) (C).

In addition, the Senate bill contains two rules dealing with specific contexts. First, in the case of an individual taxpayer, the Service will have the burden of proof on any income item reconstructed by the Service solely through use of statistical information on unrelated taxpayers.¹² Second, the Service will have a “burden of production” regarding an individual’s liability for any penalty or addition to tax.¹³

B. The House Bill

The House bill declares that the Service “shall have the burden of proof in any court proceeding with respect to any factual issue relevant to ascertaining the income tax liability of a taxpayer.”¹⁴ This rule applies only if three “limitations” are satisfied. First, the taxpayer must assert a “reasonable dispute” with respect to the issue.¹⁵ Second, the taxpayer must have fully cooperated with the Service, including providing, within a reasonable time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the Service.¹⁶ Third, certain taxpayers must meet net worth limitations – corporations, trusts and partnerships whose net worth exceed \$7 million will retain the burden of proof.¹⁷

The most striking feature of the House approach is its general rule that the Service will have the burden of proof in income cases. However, this simplicity will be undercut in practice by the need to determine in specific cases whether the stated limitations apply.

III. COMMENTS AND SUGGESTIONS FOR IMPLEMENTATION

The Tax Court will have the responsibility to implement the legislation. The Court’s rules and procedures should assist the parties in

¹²*Id.* at § 7491(b).

¹³*Id.* at § 7491(c).

¹⁴ House Bill § 7491(a).

¹⁵ *Id.* at § 7491 (b) (1).

¹⁶*Id.* at § 7491 (b) (2).

¹⁷*Id.* at § 7491 (b) (3).

determining who has the burden of proof, and should specify procedures to be followed in cases where the Court must determine who has the burden. Also, considering the large proportion of Tax Court petitions filed by *pro se* taxpayers, it might be beneficial for the Court to provide information about the limited role that the burden of proof plays.

A. Comments on Senate Bill

General

Under the Senate bill, the burden of proof does not shift unless the taxpayer introduces “credible evidence.” The Committee Report defines the standard in weighty terms:

The burden will shift to the Secretary under this provision only if the taxpayer first introduces credible evidence with respect to a factual issue relevant to ascertaining the taxpayer’s income tax liability. Credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of Service correctness). A taxpayer has not produced credible evidence for these purposes if the taxpayer merely makes implausible factual assertions, frivolous claims, or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that it is worthy of belief. If after hearing evidence from both sides, the court believes that the evidence is equally balanced, the court shall find that the Secretary has not sustained his burden or proof.¹⁸

The Senate bill does not envision a major shift in how a Tax Court trial will proceed. The taxpayer must first produce its evidence. At the close of the taxpayer’s case, the judge can make the “credible evidence” determination. Only after that determination will the trial judge need to deal

¹⁸Finance Committee Report, 45-46.

with the three so-called limitations. If the credible evidence threshold is satisfied, a taxpayer who wants to shift the burden must show that the three limitations are satisfied.¹⁹

Leaving the burden of proof up in the air until the taxpayer rests its case is not ideal. Litigators would prefer to know from the outset if they have the burden. However, the Senate bill and the Finance Committee Report do not seem to envision a pretrial determination of burden of proof.

The prospect of a mid-trial burden of proof determination has interesting implications. The trial judge may be inclined to take the motion to shift under advisement, although the parties could find it helpful for the court to make a determination. On the other hand, a determination that the taxpayer has not offered credible evidence means, perhaps, not only that the burden does not shift to the Service, but also that a bench decision should be rendered against the taxpayer. Should the court allow a taxpayer to offer what it believes will constitute credible evidence, then seek a determination on burden of proof, before deciding whether to put on the balance of its case-in-chief or to wait and rebut the government's case?

Taxpayer's Showing on "Limitations"

The three limitations actually involve four different subjects: substantiation, records maintenance, cooperation, and net worth. It is neither essential nor desirable that evidence on these four subjects be offered as part of the taxpayer's case-in-chief or, indeed, that evidence be formally introduced at any time with respect to these matters, except in the unusual case where factual issues cannot be resolved any other way. Considerations in this regard follow:

1. Frequently, substantiation and records maintenance are not in dispute and it is not essential that the court receive evidence on these subjects for the sole purpose of determining burden of proof.

¹⁹"The taxpayer has the burden of proving that it meets each of these conditions, because they are necessary prerequisites to establishing that the burden of proof is on the Secretary." Finance Committee Report, 45.

2. The taxpayer's cooperation is seldom, if ever, relevant to the issues in the case. Hearing evidence on the cooperation limitation would clash with the Tax Court's usual unwillingness to look behind a notice of deficiency. A Tax Court trial is a trial de novo and the details of the administrative proceeding are not relevant. *Greenberg's Express, Inc. v. Commissioner*, 62 T.C. 324, 327-328 (1974). Evidence on this subject could be very detailed, and in many cases the Court could devote more time to a review of pretrial cooperation than to the merits of the case.

3. There will seldom be factual issues as to a taxpayer's compliance with the net worth requirements.

4. Factual issues relating to the limitations can be resolved as "preliminary issues" through motion-type procedures rather than through formal evidentiary presentations. (Motions are typically resolved on the papers. Tax Court Rule 50. See Rule 43(e), Fed.R.Civ.P., motions may be heard on affidavits. Also see Rule 104(a), Fed.R.Evid., preliminary questions concerning admissibility of evidence shall be determined by the court, not bound by rules of evidence.)

Proposal for Implementation

An appropriate way for the Court to implement the burden of proof rules is through a new motion procedure that can be set forth in a revised Rule 142, and a revision of the Standing Pretrial Order.²⁰ A revised Rule 142 could involve the following elements:

1. A paraphrase of Section 7491.

2. A taxpayer who desires to shift the burden of proof under Section 7491 must file and serve a motion to shift burden of proof within 45 days before the calendar call. The motion must contain a statement that the petitioner has satisfied each of the limitations. (This statement will be subject to the certification provision of Rule 33(b).²¹ At this point, there is no need for the petitioner to provide detailed information as to its substantiation, records maintenance, cooperation, and net worth.)

²⁰In the revised Rule 142 and in the Standing Pretrial Order, the parties should be encouraged to reach stipulations on the "limitations."

²¹Under Rule 33(b) the signature of counsel or a party constitutes a certificate that the signer has read the pleading and that it is well grounded in fact.

3. If the Service agrees that the taxpayer has complied with the limitations, then it must file and serve a statement of non-opposition no later than 30 days before the calendar call. If the Service denies that the taxpayer has complied, it must file and serve an objection to the taxpayer's motion, specifying the basis for its denial, with sufficient factual detail for the taxpayer to respond, and for the court to determine the issues. (The parties should be attempting to reach stipulations at this time.)

4. If the Service has objected, then no later than 15 days before the calendar call, the taxpayer shall file and serve a reply to the Service objection. The reply shall be detailed and factually oriented; it must address the substance of the Service's objections. (The court might require this submission to be in affidavit form. At this point, the court has before it a set of detailed motion papers. The trial judge need not consult these papers until the beginning of the trial and need not make any decisions until the close of the taxpayer's case. Ordinarily, these papers will be sufficient for the court to make a determination. Even when serious factual issues preclude a determination on the papers, the motion process should serve to narrow the issues so the court can require further submissions or can hear oral testimony on the actual issue(s) in dispute.)

Some minor questions about order of proof are raised by the proposed rules. The Service will have the burden of proof in cases involving income reconstructions based on statistical information – does the Service have the burden of going forward as well as the ultimate burden of proof? The simplicity of the statutory provision suggests so. Imposing a burden of production on the Service as to penalties and additions to tax also raises a question. Ordinarily, the taxpayer would proceed with its case, and the Service must satisfy its burden either on cross-examination of the taxpayer's witnesses, or by offering a case of its own. If the only issue is a penalty issue, it seems that the government should go first.

Public interest in the burden of proof in civil tax matters is a significant part of the overall push towards tax reform. One vehicle for educating parties before the court as to matters involving burden of proof is the Standing Pretrial Order authorized under Rule 132(b). The Standing Pretrial Order might be revised to include detailed references to revised Rule 142 and Section 7491 as well as the following statement:

Cases are generally resolved on the basis of the controlling facts, as the court finds them, rather than according to who has the burden or proof. A party is encouraged to offer evidence of its factual position regardless of whether that party has the burden of proof.

B. Comments on House Proposal

General

The House took a different approach than the Senate. The Senate's approach can be described as a conditional shift in the burden of proof, subject to limitations. That is, the burden shifts to the Service if the taxpayer offers "credible evidence" and also satisfies the limitations. The House bill, as a norm, imposes the burden of proof on the Service, subject to limitations. The proposed language proclaims: "The Secretary shall have the burden of proof... ." The House and Senate bills share key concepts such as "substantiation" and "cooperation" although the specifics differ somewhat.

The House approach leaves open when the burden of proof determination takes place, but seems to call for a pretrial determination. Litigators might want that determination as early as possible. But a taxpayer may be unable to satisfy the cooperation requirement until after some discovery (perhaps informal, perhaps formal) has taken place, and until administrative remedies have been exhausted.²²

Moreover, if it is determined that the Service has the burden of proof, then the Service would also have the burden of going forward with evidence. (There is no reason in the proposed statutory language or the Ways and Means Committee Report to conclude otherwise.)

An important concept unique to the House bill is that the shift applies only if "the taxpayer asserts a reasonable dispute with respect to such issue." The Ways and Means Committee Report does not explicate the term "reasonable dispute", nor does it prescribe the time frame in which the taxpayer must assert a "reasonable dispute." It would not seem fruitful for

²² Significant interpretative issues exist here. Does "cooperation" refer to before and after the case is docketed, or just before? Do "administrative remedies" refer to an Appeals Office conference after the case is docketed?

the Tax Court or the parties to devote significant time and resources to a pretrial determination of whether the dispute is reasonable.

Implementation

Neither the House bill nor the Ways and Means Committee Report make clear how the parties and the Court will determine who has the burden of proof in a specific case. However, there are two significant indicators of an appropriate course. One is the statutory language, purporting to effect a general shift in the burden of proof. This legislation is of reform character. The bill will be more helpful to taxpayers, especially unsophisticated taxpayers if they need not undertake a significant procedural burden to show that none of the three limitations apply. The second indicator is the following statement in the Ways and Means Committee Report: "The taxpayer has the burden of proving that it meets each of [the three] conditions, because they are necessary prerequisites to establishing that the burden of proof is on the Secretary."²³

Attempting to follow the direction of these indicators, the following procedure is suggested (to be incorporated in revised Rule 142 and the Standing Pretrial Order):²⁴

1. No later than 60 days before the calendar call, the taxpayer must file and serve a Notice as to Burden of Proof stating the taxpayer's position that the burden of proof is on the Service. The statement must aver that the taxpayer asserts a reasonable dispute and has satisfied each of the "limitations". (The statement, which need not contain detail, is subject to the certification provision of Rule 33(b). This timing allows the possibility of a determination well in advance of trial. A taxpayer can file and serve the Notice at the earliest time it believes that the statute is satisfied.)

2. If the Service has no objection it need not take any action. If the Service objects, it must file and serve a Motion to Impose Burden of Proof within 15 days. (The motion must be supported by sufficient factual detail for the taxpayer to respond and for the court to determine the issues. The parties should be attempting to reach stipulations.)

²³Ways and Means Committee Report, 57.

²⁴ Another approach would be to re-design the standard petition and answer in a way that the components of the burden of proof determination are resolved through the pleading process.

3. 15 days after the Service files its motion, the taxpayer must file an objection if it opposes the motion. (The objection should be detailed and factually oriented, perhaps in affidavit form. To accommodate the parties' trial preparation and presentation, the court will ordinarily rule on the motion before the trial, perhaps after a telephonic hearing. If the judge cannot rule before the trial, he or she might facilitate the trial by making a ruling on order of proof.)

Modified procedures might be applied in Small Tax Cases under Section 7463. The "first step" (i.e., the motion under the Senate bill or the notice under the House bill) might be dispensed with. Or, the notice or motion could be reduced to a form that can be included in the Standing Pretrial Order.

EXHIBIT 1

Section 301 of the Internal Revenue Service Restructuring and Reform Act of 1997 (H.R. 2676), adding Internal Revenue Code section 7491

SEC. 301. BURDEN OF PROOF.

(a) IN GENERAL- Chapter 76 (relating to judicial proceedings) is amended by adding at the end the following new subchapter:

Subchapter E--Burden of Proof

Sec. 7491. Burden of proof.

SEC. 7491. BURDEN OF PROOF.

(a) GENERAL RULE- The Secretary shall have the burden of proof in any court proceeding with respect to any factual issue relevant to ascertaining the income tax liability of a taxpayer.

(b) LIMITATIONS- Subsection (a) shall only apply with respect to an issue if--

(1) the taxpayer asserts a reasonable dispute with respect to such issue,

(2) the taxpayer has fully cooperated with the Secretary with respect to such issue, including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the Secretary, and

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

(c) SUBSTANTIATION- Nothing in this section shall be construed to override any requirement of this title to substantiate any item.

(b) CONFORMING AMENDMENTS-

(1) Section 6201 is amended by striking subsection (d) and redesignating subsection (e) as subsection (d).

(2) The table of subchapters for chapter 76 is amended by adding at the end the following new item:

Subchapter E. Burden of proof.

(c) EFFECTIVE DATE- The amendments made by this section shall apply to court proceedings arising in connection with examinations commencing after the date of the enactment of this Act.

EXHIBIT 2

Excerpt of House Ways & Means Committee Report,
H.R. Rep. No. 105-364, 105th Cong., 1st Sess. (1997)

TITLE III. TAXPAYER BILL OF RIGHTS 3

A. BURDEN OF PROOF

(SEC. 301 OF THE BILL AND NEW SEC. 7491 OF THE CODE)

PRESENT LAW

Under present law, a rebuttable presumption exists that the Commissioner's determination of tax liability is correct.²⁵

This presumption in favor of the Commissioner is a procedural device that requires the plaintiff to go forward with prima facie evidence to support a finding contrary to the Commissioner's determination. Once this procedural burden is satisfied, the taxpayer must still carry the ultimate burden of proof or persuasion on the merits. Thus, the plaintiff not only has the burden of proof of establishing that the Commissioner's determination was incorrect, but also of establishing the merit of its claims by a preponderance of the evidence'.²⁶

The general rebuttable presumption that the Commissioner's determination of tax liability is correct is a fundamental element of the structure of the Internal Revenue Code. Although this presumption is judicially based, rather than legislatively based, there is considerable evidence that the presumption has been repeatedly considered and approved by the Congress. This is the case because the Internal Revenue Code contains a number of civil provisions that explicitly place the burden of proof on the Commissioner in specifically designated circumstances. The Congress would have enacted these provisions only if it recognized and approved of the general rule of presumptive correctness of the Commissioner's determination. A list of these civil provisions follows.

(1) *Fraud*.--Any proceeding involving the issue of whether the taxpayer has been guilty of fraud with intent to evade tax (secs. 7454 (a) and 7422 (e)).

(2) *Required reasonable verification of information returns*.--In any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an

²⁵*Welch v. Helvering*, 290 U.S. 111, 115 (1933).

²⁶*Danville Plywood Corp. v. U.S.*, U.S. Cl. Ct., 63 AFTR 2d 89-1036, 1043 (1989); citations omitted.

information returned filed with the Secretary by a third party and the taxpayer has fully cooperated with the Secretary (including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer as reasonably requested by the Secretary), the Secretary has the burden of producing reasonable and probative information concerning such deficiency in addition to such information return (sec. 6201(d)).

(3) *Foundation managers*- Any proceeding involving the issue of whether a foundation manager has knowingly participated in prohibited transactions (sec. 7454(b)).

(4) *Transferee liability*- Any proceeding in the Tax Court to show that a petitioner is liable as a transferee of property of a taxpayer (sec. 6902(a)).

(5) *Review of jeopardy levy or assessment procedures*- Any proceeding to review the reasonableness of a jeopardy levy or jeopardy assessment (sec. 7429(g) (1)).

(6) *Property transferred in connection with performance of services*- In the case of property subject to a restriction that by its terms will never lapse and that allows the transferee to sell only at a price determined under a formula, the price is deemed to be fair market value unless established to the contrary by the Secretary (sec. 83 (d) (1)).

(7) *Illegal bribes, kickbacks, and other payments*- As to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment (sec. 162 (c) (1) and (2)).

(8) *Golden parachute payments*- As to whether a payment is a parachute payment on account of a violation of any generally enforced securities laws or regulations (sec. 280G (b) (2) (B)).

(9) *Unreasonable accumulation of earnings and profits*- In any Tax Court proceeding as to whether earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, provided that the Commissioner has not fulfilled specified procedural requirements (sec. 534).

(10) *Expatriation*- As to whether it is reasonable to believe that an individual's loss of citizenship would result in a substantial reduction in the individual's income taxes or transfer taxes (secs. 877 (e), 2107 (e), 2501 (a) (4)).

(11) *Public inspection of written determinations*- In any proceeding seeking additional disclosure of information (sec. 6110 (f) (4) (A)).

(12) *Penalties for promoting abusive tax shelters, aiding and abetting the understatement of tax liability, and filing a frivolous income return*- As to whether the person is liable for the penalty (sec. 6703 (a)).

(13) *Income tax return preparers' penalty*- As to whether a preparer has willfully attempted to understate tax liability (sec. 7427).

(14) *Status as employees*- As to whether individuals are employees for purposes of employment taxes (pursuant to the safe harbor provisions of section 530 of the Revenue Act of 1978).²⁷

REASONS FOR CHANGE

The Committee is concerned that individual and small business taxpayers frequently are at a disadvantage when forced to litigate with the Internal Revenue Service. The Committee believes that the present burden of proof rules contribute to that disadvantage. The Committee believes that, all other things being equal, facts asserted by individual and small business taxpayers who fully cooperate with the Service and satisfy all relevant substantiation requirements should be accepted. The Committee believes that shifting the burden of proof to the Secretary in such circumstances will create a better balance between the Service and such taxpayers, without encouraging tax avoidance.

EXPLANATION OF PROVISION

The bill provides that the Secretary shall have the burden of proof in any court proceeding with respect to a factual issue if the taxpayer asserts a reasonable dispute with respect to any such issue relevant to ascertaining the taxpayer's income tax liability. Two conditions apply. First, the taxpayer must fully cooperate at all times with the Secretary (including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the Secretary).²⁸

Full cooperation also includes providing reasonable assistance to the Secretary in obtaining access to and inspection of witnesses, information, or documents not within the control of the taxpayer (including any witnesses, information, or documents located in foreign countries).²⁹

A necessary element of fully cooperating with the Secretary is that the taxpayer must exhaust his or her administrative remedies (including any appeal rights provided by the Service). The taxpayer is not required to agree to extend the statute of limitations to be considered to have fully cooperated with the Secretary. Second, certain taxpayers must meet the net worth limitations that apply for awarding attorney's fees. In general, corporations, trusts, and partnerships whose net worth exceeds \$7 million are not eligible for the benefits of the provision. The taxpayer has the burden of proving that it meets each of these conditions, because they are necessary prerequisites to establishing that the burden of proof is on the Secretary.

²⁷Public Law 95-600 (November 6, 1978), as amended by section 1122 of the Small Business Job Protection Act of 1996 (Public Law 104-188; August 20, 1996).

²⁸This requirement parallels the present-law provision relating to reasonable verification of information returns (sec. 6201 (d)).

²⁹Full cooperation also includes providing English translations, as reasonably requested by the Secretary.

The provision explicitly states that nothing in the provision shall be construed to override any requirement under the Code or regulations to substantiate any item. Accordingly, taxpayers must meet all applicable substantiation requirements, whether generally imposed³⁰ or imposed with respect to specific items, such as charitable contributions³¹ or meals, entertainment, travel, and certain other expenses.³² Substantiation requirements include any requirement of the Code or regulations that the taxpayer establish an item to the satisfaction of the Secretary.³³ Taxpayers who fail to substantiate any item in accordance with the legal requirement of substantiation will not have satisfied all of the legal conditions that are prerequisite to claiming the item on the taxpayer's tax return and will accordingly be unable to avail themselves of this provision regarding the burden of proof. Thus, if a taxpayer required to substantiate an item fails to do so in the manner required (or destroys the substantiation), this burden of proof provision is inapplicable.³⁴

EFFECTIVE DATE

The provision applies to court proceedings arising in connection with examinations commencing after the date of enactment.

³⁰See e.g., Sec. 6001 and Treas. Reg. sec. 1.6001-1 requiring every person liable for any tax imposed by this Title to keep such records as the Secretary may from time to time prescribe, and secs. 6038 and 6038A requiring United States persons to furnish certain information the Secretary may prescribe with respect to foreign businesses controlled by the U.S. person.

³¹Sec. 170 (a) (1) and (f) (8) and Treas. Reg. sec. 1.170A-13.

³²Sec. 274 (d) and Treas. Reg. sec. 1.274 (d)-1, 1.274-5T, and 1.274-5A.

³³For example, sec. 905 (b) of the Code provides that foreign tax credits shall be allowed only if the taxpayer establishes to the satisfaction of the Secretary all information necessary for the verification and computation of the credit. Instructions for meeting that requirement are set forth in Treas. Reg. sec. 1.905-2.

³⁴If, however, the taxpayer can demonstrate that he had maintained the required substantiation but that it was destroyed or lost through no fault of the taxpayer, such as by fire or flood, existing tax rules regarding reconstruction of those records would continue to apply.

EXHIBIT 3

Section 3001 of the Internal Revenue Service
Restructuring and Reform Act of 1998 (H.R. 2676)
adding Internal Revenue Code section 7491

Subtitle A--Burden of Proof

SEC. 3001. BURDEN OF PROOF.

(a) IN GENERAL- Chapter 76 (relating to judicial proceedings) is amended by adding at the end the following new subchapter:

Subchapter E--Burden of Proof

Sec. 7491. Burden of proof.

SEC. 7491. BURDEN OF PROOF.

(a) BURDEN SHIFTS WHERE TAXPAYER PRODUCES CREDIBLE EVIDENCE-

(1) GENERAL RULE- If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the income tax liability of the taxpayer, the Secretary shall have the burden of proof with respect to such issue.

(2) LIMITATIONS- Paragraph (1) shall apply with respect to an issue only if-

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

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

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

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

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

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

(b) CONFORMING AMENDMENT- The table of subchapters for chapter 76 is amended by adding at the end the following new item:

SUBCHAPTER E. Burden of proof.

(c) EFFECTIVE DATE- The amendments made by this section shall apply to court proceedings arising in connection with examinations commencing after the date of the enactment of this Act.

EXHIBIT 4

Excerpt of Senate Finance Committee Report,
S. Rep. No. 105-174,
105th Cong., 2d Sess. (1998)

TITLE III. TAXPAYER PROTECTION AND RIGHTS

A. Burden of Proof (sec. 3001 of the bill and new sec. 7491 of the Code)

Present Law

Under present law, a rebuttable presumption exists that the Commissioner's determination of tax liability is correct. "This presumption in favor of the Commissioner is a procedural device that requires the plaintiff to go forward with prima facie evidence to support a finding contrary to the Commissioner's determination. Once this procedural burden is satisfied, the taxpayer must still carry the ultimate burden of proof or persuasion on the merits. Thus, the plaintiff not only has the burden of proof of establishing that the Commissioner's determination was incorrect, but also of establishing the merit of its claims by a preponderance of the evidence".

The general rebuttable presumption that the Commissioner's determination of tax liability is correct is a fundamental element of the structure of the Internal Revenue Code. Although this presumption is judicially based, rather than legislatively based, there is considerable evidence that the presumption has been repeatedly considered and approved by the Congress. This is the case because the Internal Revenue Code contains a number of civil provisions that explicitly place the burden of proof on the Commissioner in specifically designated circumstances. The Congress would have enacted these provisions only if it recognized and approved of the general rule of presumptive correctness of the Commissioner's determination. A list of these civil provisions follows.

- (1) Fraud.--Any proceeding involving the issue of whether the taxpayer has been guilty of fraud with intent to evade tax (secs. 7454(a) and 7422(e)).
- (2) Required reasonable verification of information returns.--In any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return filed with the Secretary by a third party and the taxpayer has fully cooperated with the Secretary (including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer as reasonably requested by the Secretary), the Secretary has the burden of producing reasonable and probative information concerning such deficiency in addition to such information return (sec. 6201(d)).
- (3) Foundation managers.--Any proceeding involving the issue of whether a foundation manager has knowingly participated in prohibited transactions (sec. 7454(b)).
- (4) Transferee liability.--Any proceeding in the Tax Court to show that a petitioner is liable as a transferee of property of a taxpayer (sec. 6902(a)).

- (5) Review of jeopardy levy or assessment procedures.--Any proceeding to review the reasonableness of a jeopardy levy or jeopardy assessment (sec. 7429(g)(1)).
- (6) Property transferred in connection with performance of services.--In the case of property subject to a restriction that by its terms will never lapse and that allows the transferee to sell only at a price determined under a formula, the price is deemed to be fair market value unless established to the contrary by the Secretary (sec. 83(d)(1)).
- (7) Illegal bribes, kickbacks, and other payments.--As to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment (sec. 162(c)(1) and (2)).
- (8) Golden parachute payments.--As to whether a payment is a parachute payment on account of a violation of any generally enforced securities laws or regulations (sec. 280G(b)(2)(B)).
- (9) Unreasonable accumulation of earnings and profits.--In any Tax Court proceeding as to whether earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, provided that the Commissioner has not fulfilled specified procedural requirements (sec. 534).
- (10) Expatriation.--As to whether it is reasonable to believe that an individual's loss of citizenship would result in a substantial reduction in the individual's income taxes or transfer taxes (secs. 877(e), 2107(e), 2501(a)(4)).
- (11) Public inspection of written determinations.--In any proceeding seeking additional disclosure of information (sec. 6110(f)(4)(A)).
- (12) Penalties for promoting abusive tax shelters, aiding and abetting the understatement of tax liability, and filing a frivolous income return.--As to whether the person is liable for the penalty (sec. 6703(a)).
- (13) Income tax return preparers' penalty.--As to whether a preparer has willfully attempted to understate tax liability (sec. 7427).
- (14) Status as employees.--As to whether individuals are employees for purposes of employment taxes (pursuant to the safe harbor provisions of section 530 of the Revenue Act of 1978).

Reasons for Change

The Committee is concerned that individual and small business taxpayers frequently are at a disadvantage when forced to litigate with the Internal Revenue Service. The Committee believes that the present burden of proof rules contribute to that disadvantage. The Committee believes that, all other things being equal, facts asserted by individual and small business taxpayers who cooperate with the Service and satisfy relevant recordkeeping and substantiation requirements should be accepted. The Committee

believes that shifting the burden of proof to the Secretary in such circumstances will create a better balance between the Service and such taxpayers, without encouraging tax avoidance.

The Committee believes that it is inappropriate for the Service to rely solely on statistical information on unrelated taxpayers to reconstruct unreported income of an individual taxpayer. The Committee also believes that, in a court proceeding, the Service should not be able to rest on its presumption of correctness if it does not provide any evidence whatsoever relating to penalties.

Explanation of Provision

The provision provides that the Secretary shall have the burden of proof in any court proceeding with respect to a factual issue if the taxpayer introduces credible evidence with respect to the factual issue relevant to ascertaining the taxpayer's income tax liability. Four conditions apply. First, the taxpayer must comply with the requirements of the Internal Revenue Code and the regulations issued thereunder to substantiate any item (as under present law). Second, the taxpayer must maintain records required by the Code and regulations (as under present law). Third, the taxpayer must cooperate with reasonable requests by the Secretary for meetings, interviews, witnesses, information, and documents (including providing, within a reasonable period of time, access to and inspection of witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the Secretary). Cooperation also includes providing reasonable assistance to the Secretary in obtaining access to and inspection of witnesses, information, or documents not within the control of the taxpayer (including any witnesses, information, or documents located in foreign countries). A necessary element of cooperating with the Secretary is that the taxpayer must exhaust his or her administrative remedies (including any appeal rights provided by the Service). The taxpayer is not required to agree to extend the statute of limitations to be considered to have cooperated with the Secretary. Cooperating also means that the taxpayer must establish the applicability of any privilege. Fourth, taxpayers other than individuals must meet the net worth limitations that apply for awarding attorney's fees (accordingly, no net worth limitation would be applicable to individuals). Corporations, trusts, and partnerships whose net worth exceeds \$7 million are not eligible for the benefits of the provision. The taxpayer has the burden of proving that it meets each of these conditions, because they are necessary prerequisites to establishing that the burden of proof is on the Secretary.

The burden will shift to the Secretary under this provision only if the taxpayer first introduces credible evidence with respect to a factual issue relevant to ascertaining the taxpayer's income tax liability. Credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of Service correctness). A taxpayer has not produced credible evidence for these purposes if the taxpayer merely makes implausible factual assertions, frivolous claims, or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that it is worthy of belief. If after evidence from both sides, the

court believes that the evidence is equally balanced, the court shall find that the Secretary has not sustained his burden of proof.

Nothing in the provision shall be construed to override any requirement under the Code or regulations to substantiate any item. Accordingly, taxpayers must meet applicable substantiation requirements, whether generally imposed or imposed with respect to specific items, such as charitable contributions or meals, entertainment, travel, and certain other expenses. Substantiation requirements include any requirement of the Code or regulations that the taxpayer establish an item to the satisfaction of the Secretary. Taxpayers who fail to substantiate any item in accordance with the legal requirement of substantiation will not have satisfied the legal conditions that are prerequisite to claiming the item on the taxpayer's tax return and will accordingly be unable to avail themselves of this provision regarding the burden of proof. Thus, if a taxpayer required to substantiate an item fails to do so in the manner required (or destroys the substantiation), this burden of proof provision is inapplicable.

The provision also provides that in any instance in which the Secretary uses statistical information from unrelated taxpayers solely to reconstruct an individual taxpayer's income (such as average income for taxpayers in the area in which the taxpayer lives), the burden of proof is on the Secretary with respect to the item of income that was reconstructed by the Secretary.

Further, the provision provides that, in any court proceeding, the Secretary must initially come forward with evidence that it is appropriate to apply a particular penalty to the taxpayer before the court can impose the penalty. This provision is not intended to require the Secretary to introduce evidence of elements such as reasonable cause or substantial authority. Rather, the Secretary must come forward initially with evidence regarding the appropriateness of applying a particular penalty to the taxpayer; if the taxpayer believes that, because of reasonable cause, substantial authority, or a similar provision, it is inappropriate to impose the penalty, it is the taxpayer's responsibility (and not the Secretary's obligation) to raise those issues.

Effective Date

The provision applies to court proceedings arising in connection with examinations commencing after the date of enactment.