Don't Let Burden of Proof Shift to the Taxpayer

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Introduction

Since 1998, the tax law has provided that the burden of proof in tax court cases will be on the government, not the taxpayer. However, it also provides that this can be shifted back to the taxpayer in a number of circumstances, mostly involving lack of taxpayer cooperation with examinations. The issue of who bears the burden of proof is important, even if your case, like most, never goes as far as the tax court. This is because the burden will operate as a background issue that will tend to help to affect the settlement posture of both the taxpayer and the IRS. Many factual issues are not susceptible to a clear resolution and are disputed by both parties. In those cases, the party having the burden of proof will feel at a disadvantage, and will feel greater pressure to concede in negotiations.

The expression "burden of proof" is a legal term that can be broadly defined as the obligation of a party in a dispute to provide sufficient evidence and warrant for their position.[i] Historically, taxpayers had the burden of proof and therefore were deemed "guilty until proven innocent," meaning that the tax system required the taxpayer to face the formidable task to try and prove their innocence. This was seen largely as an unpopular and unfair burden for taxpayers, who had only limited resources to battle with the IRS.

The Internal Revenue Service defines the burden of proof as:

"The responsibility to prove entries, deductions, and statements made on your tax returns... You must be able to prove (substantiate) certain elements of expenses to deduct them. Generally, taxpayers meet their burden of proof by having the information and receipts (where needed) for the expenses. You should keep adequate records to prove your expenses or have sufficient evidence that will support your own statement. You generally must have documentary evidence, such as receipts, canceled checks, or bills, to support your expenses. Additional evidence is required for travel, entertainment, gifts, and auto expenses."[ii]

The burden of proof, therefore, is to provide documentation to prove one's factual tax position. In transferring the burden of proof to the government, and thereby the obligation to prove the disputed facts, taxpayers benefited by having a more level playing field when up against the IRS. The 1998 shift in the burden of proof from the taxpayer to the IRS provides taxpayers a welcome respite from having to prove their innocence.[iii]

Unfortunately, this shift in the burden of proof is not automatic and does not come without some effort and responsibility from the taxpayer.[iv] The taxpayer must work within strict guidelines in order to keep the burden of proof with the government. Therefore, many see the shift in the burden of proof as a paradox that requires taxpayers to keep better records, a consequence to a benefit that provides the taxpayer with less need to do so much to try to prove innocence.

Burden of Proof

In civil tax matters, the applicable burden of proof is the preponderance of the evidence.[v] Therefore, having the burden of proof means that the party must prove their claim/production against the other party. The party must present evidence supporting their case, and the party must show the merits of his or her claim.[vi]

For cases where the IRS is accusing the taxpayer of fraudulent activities, the applicable standard is clear and convincing evidence.[vii] Finally, in criminal tax cases the burden of proof is raised to the higher beyond a reasonable doubt level, which is the standard for all criminal proceedings in United States courts.

Burden of Production

The burden of production, also known as the burden of going forward, is the burden of providing sufficient evidence on an issue in order to prevail in the dispute. In Tax Court cases initiated by the IRS, the government bears the burden of production. The Internal Revenue Commissioner must make a *prima facie* case that the additional taxes or penalties sought are appropriate under applicable law. In other words, the government must set forth a sufficient amount of evidence to support its position. Once the government satisfies its burden of production, the burden of providing additional evidence then shifts to the taxpayer.

Burden of Persuasion vs. Burden of Production

The burden of proof engulfs both the burden of persuasion and the burden of production.[viii] As noted above, the burden of production entails providing sufficient evidence to support one's position. The burden of persuasion, on the other hand, is the burden of convincing the court that your position is in fact correct. The party that bears the burden of persuasion is required to persuade the court by the applicable standard, whether it be preponderance of the evidence, clear and convincing evidence, or beyond a reasonable doubt. The ultimate burden of persuasion remains will always stay with party to which it was initially assigned.[ix]

Burden of Proof – Prior to the shift

Prior to the IRS Restructuring and Reform Act of 1998, the tax courts applied common law rules for burden of proof. The burden of proof lay with the taxpayer subject to an IRS audit prior to the change in law. As such, the taxpayer had the burden of demonstrating that the taxes were filed correctly. The taxpayer had to provide evidence showing that the deductions, credits, refunds and stated amounts on the filed tax forms were true and correct.

Prior to the shift, certain exceptions to the common law were in place that could shift the burden of proof to the IRS. These exceptions were not affected by the Restructuring and Reform Act of 1998, and are still effective today. IRC section 7427 and section 162(c) represent two of the major exceptions. Section 7427 of the IRC states that the burden of proof shifts to the commissioner when the preparer is involved in the understatement of taxes.[x] Section 162(c) states that the burden of proof shifts when circumstances such as bribes and illegal payments are raised[xi]. Other such sections of the IRC that were unaffected by the Reform Act of 1998 are:

- Sections 7454(a) and 7422(e) dealing with fraud[xii];
- Section 6201(d) shifting the burden of proof to the IRS for the verification of amounts shown on information returns[xiii];
- Section 534 shifting the burden of proof to the commissioner when earnings and profits have been permitted to accumulate beyond the reasonable needs of the business[xiv];
- Section 6902(a) shifting the burden of proof to the commissioner when the issue of whether one is liable for a tax as a transferee of property belonging to a taxpayer[xv];
- And section 7429(g) jeopardy levy or assessment procedures.[xvi]

Internal Revenue Services Restructuring and Reform Act of 1998

President Clinton signed the IRS Reform Act of 1998 into law after Congress passed the act by overwhelming majorities in both the House and the Senate.[xvii] This act included several provisions that were implemented to provide tax relief for issues such as earned income credit expansions, new IRAs, principal residence gain exclusions, included education incentives, and reduction of long term capital gain holding periods. The IRS Restructuring and Reform Act also created several new provisions for estate and gift taxes. An oversight board was created to oversee certain IRS plans and practices, reorganize the IRS operating structure, and initiate new disciplinary actions for employee misconduct. Taxpayers' rights and privileges were also expanded for areas such as audit criteria, new due process requirements, a more inclusive innocent spouse provision, and interest calculations.[xviii]

Despite all of these new provisions under the umbrella of the IRS Restructuring and Reform Act, the most important change affected by the legislation is still considered to be the potential shift in the burden of proof for tax court cases. The IRS Restructuring and Reform Act allows taxpayers to shift the burden of proof to the IRS in certain circumstances where the taxpayer meets required specifications set by the IRC. However, the burden shifts to the IRS only if the taxpayer:

- Keeps records as required in the Codes and Regulations;
- Abides by the substantiation requirements of the Codes and Regulations;
- Introduces credible evidence relevant to the factual issue; and
- Cooperates with the IRS and its agents' requests.[xix]

Other significant provisions implemented as part of the IRS Restructuring and Reform Act were:

- Extending attorney-client provision to accountants and enrolled agents - The Act extends the attorney-client privilege to clients of CPAs and tax advisors authorized to practice before the IRS. (The privilege, if applied during the course of tax discussions, consultations, and representations before the IRS, can be applied to communications. However, the privilege can only be invoked the against the IRS, and cannot be used to protect tax crime communications.);
- Tax relief in certain specified circumstances; and
- Expansion of privileges and rights in the following areas:
    - Audit criteria;
    - Tip reporting;
    - Levies, seizures, and liens;
    - Interest calculations for taxes and refunds;
    - New due process requirements;
    - Offers in compromise and installment agreements;
    - Third party summonses; and
    - More inclusive innocent spouse provisions.

The changes in policy made as part of the 1998 Reform Act were primarily intended to expand taxpayers' rights while also improving the level of customer service afforded to United States taxpayers.

The Shift of the Burden of Proof

By possibly shifting the burden of proof to the IRS, taxpayers are greatly benefited by now being in the position of innocent until proven guilty, thus lessening their disadvantage against the IRS. However, whether the shift occurs depends on the record keeping, substantiation, cooperation, and circumstances of the taxpayer. IRC section 7491 is effective for tax cases based on IRS examinations initiated after July 22, 1998,[xx] and has the following three subdivisions:

1. Section 7491(a) shifts the burden of proof to the IRS in disputes concerning income taxes, estate taxes, generation-skipping taxes, and gift taxes, provided that the taxpayers satisfy the requirements and present credible evidence. Taxpayers must meet the following requirements:
    a. Maintain all records required by the Code and regulations;
    b. Meet all substantiation requirements of the Code and regulations;
    c. Cooperate with any reasonable request for documentation, information, and witnesses by the IRS;
    d. Meet certain net worth qualifications (only if taxpayer is a partnership, corporation, or trust); and
    e. Exhaust all its administrative remedies, including appeal rights.
2. Section 7491(b) deals with items of income generated from statistical information from unrelated taxpayers. Under this provision, the burden of proof is transferred to the Internal Revenue Service for any court proceeding "when the IRS reconstructs any item of the taxpayer's income using solely statistical information on unrelated taxpayers. This is true whether the taxpayer does or does not cooperate and provides evidence or otherwise meets the requirements of IRC 7491(a)."[xxi]

3. Section 7491(c) only applies to individuals. It shifts the burden of proof when there is a penalty, addition to tax, or additional amount involved.[xxii] In cases where the IRS seeks to impose a penalty against an individual, the IRS must first find and provide some evidence that demonstrates that the taxpayer took a position that was illegal. Once the IRS has puts forth the sufficient evidence, the burden of proof will then shift back to the taxpayer, who must refute the penalty by showing reasonable cause or good faith reliance on a tax advisor.

Forste v. Commissioner

In *Forste v. Commissioner of Internal Revenue*,[xxiii] the burden of proof was successfully transferred from the taxpayer to the IRS for the first time following the implementation of the IRS Restructuring and Reform Act of 1998. In 1996, Forste received $45,615 from Deloitte, Haskins & Sells (DHS), Forste's former employer, as part of a settlement agreement for his unlawful termination. Forste had excluded that amount from gross income pursuant to Section 104(a)(2), but the IRS claimed that $25,130 should have been included as taxable income. When the case went to tax court, Forste was able to demonstrate that the amount in question was compensation from the settlement, thus he provided the required credible evidence. Under Section 7491, the burden of proof then shifted to the IRS. Since the IRS failed to meet its burden of proof, the tax court held that Forste was allowed to exclude $25,130 form gross income. This was a seminal case in that it showed taxpayers could now actually shift the burden of proof to the IRS. It also provided an excellent example of what is required by the taxpayer to satisfy the record-keeping and expense substantiation requirements.

The Tax Court Process

Taxpayers have the right to appeal notices of deficiency (90-day letters) sent out by the IRS during an audit. As part of the notice of deficiency, the IRS informs the taxpayer of the items that need to be adjusted or that are disallowed, as well as any additional interest and penalties due.

To appeal the notice of deficiency, the taxpayer may:

- File a letter of protest in direct appeal to the appeals office within 30 days;
- File a petition to be heard in tax court within 90 days; or
- File a petition in federal district court rather than tax court. The taxpayer may find this route advantageous since the district court judges often have less expertise in tax law than do the tax court judges. However, the taxpayer must first pay any amounts assessed against them prior to the initiation of the case. This represents a significant drawback when determining where to file the petition.

The civil tax courts determine whether or not there can be a shift in the burden of proof, based on Section 7491.[xxiv]

Court cases where shift in the burden of proof occurred

A common reason why taxpayers fail to shift the burden of proof to the IRS is their inability to provide credible evidence as required by Section 7491. In *Higbee v. Commisioner*,[xxv] Higbee claimed new deductions and expenses (additional deductions on a casualty loss, charitable contributions, unreimbursed employee expenses, and Schedule C and E deductions) after the IRS did not allow the Schedule C deductions originally reported on the Higbees' 1996 tax return. Higbee presented non-governmental documents to support his casualty loss claim and charitable contributions deductions, but the tax court ruled that Higbee failed to introduce credible evidence that met the standards in Section 7491. As such, the burden of proof was not shifted to the IRS.

The presentment of credible evidence alone is not sufficient to shift the burden of proof. Taxpayers must also substantiate their claims. In. *Baker v. Commissioner*,[xxvi] the Bakers reported medical expenses that included lifetime residence, an emergency pull-cord system, 24-hour licensed nursing response, and nursing services on their tax return. The Bakers additionally reported the use of a pool, spa, and exercise facilities as medical expenses. The IRS questioned the necessity of these items. The Bakers were able to provide credible evidence through the testimony of a medical professional who stated under oath that the Bakers' use of the pool, spa, and exercise facilities was medically necessary. However, the court could not substantiate what percentage of those facilities was for medical rather than general use. Therefore, the substantiation requirement was unfulfilled, and the burden of proof was not shifted to the IRS.

Finally, non-cooperation with the IRS will prevent the burden of proof from shifting to the government. In *Swanson v. Commissioner*,[xxvii] the IRS accused the Swansons of creating a sham trust, resulting in additional tax being due, and penalties being assessed against them. During their interview with the IRS agent assigned to their case, the Swansons refused to answer any questions. The Swansons then filed a lawsuit against the agent personally, and refused to answer his questions in a subsequent interview due to the ongoing litigation. A new IRS agent was assigned to their case for a third interview, but the Swansons continued to avoid questions, citing the Fifth Amendment right against self-incrimination. Because of their blatant lack of cooperation with the IRS, the Swansons were unable to shift the burden of proof to the government.

Keeping the burden of proof on the IRS

Shifting the burden of proof to the IRS is dependent upon the taxpayers' compliance with record-keeping and substantiation requirements set forth in the IRC and regulations. Taxpayers forgo the opportunity to shift the burden of proof when they fail to comply with these requirements. Therefore, taxpayers must keep adequate records and meticulously follow substantiation requirements.

Taxpayers who can prove that their records were destroyed or lost can reconstruct those records under most circumstances under the Cohan doctrine. The Cohan doctrine, however, only applies in instances where the loss and/or destruction of the records was caused by circumstances beyond the taxpayers' control or carelessness.[xxviii] Therefore, taxpayers are advised to have copies of their tax returns and supporting documents and to maintain them for a reasonable period of time.

In addition to the record-keeping and substantiation provisions, the taxpayer is also required to cooperate with all "reasonable" requests made by the IRS. A subjective standard comes in to play when the tax court determines which IRS requests were in fact "reasonable." Therefore, taxpayers should be as cooperative as they can so as to not lose the shift in the burden of proof on these grounds.

Avoiding shift-back in the burden of proof

In order to avoid a shift-back in the burden of proof, the taxpayer must meet his burden of production. That is, the taxpayer must meet his record-keeping, substantiation, and cooperation requirements.

A "new matter" exception also exists. If a new matter is presented in a case, the burden automatically shifts to the IRS. In the case of. *Chambers v. Commissioner*,[xxix] the taxpayer was the owner of a church and excluded some of its income pursuant to Section 501(c)(3). The IRS determined that the church did not qualify as an exempt, non-profit organization and calculated deficiencies and associated penalties. Following the initial notice of deficiency, the IRS sent a notice stating that the deficiencies and penalties were originally miscalculated and provided the taxpayer with the corrected amounts. At trial, the taxpayer argued that the corrected amounts constituted "new matters." Unfortunately, for the taxpayer, the court ruled that the difference was simply due to a miscalculation and did not represent a "new matter." Therefore, the burden of proof remained with the taxpayer.

Conclusion

The Restructuring and Reform Act of 1998 allows for the shift of the burden of proof from taxpayers to the government, and generally serves to protect the interests of taxpayers who are being audited by the IRS. This policy change benefits taxpayers, who previously had been saddled with the burden of proof in almost all civil tax matters. While the possibility for the shift in burden exists, taxpayers must satisfy the requirements set forth in Section 7491. Taxpayers must provide substantial and credible evidence, meet record-keeping and substantiation requirements, and cooperate with the IRS. The burden of proof oftentimes does not shift to the IRS because the taxpayer feels to meet one of these important provisions. For this reason, the IRS Restructuring and Reform Act of 1998 does not always provide taxpayers much relief from the previous system. From a practical standpoint, meticulous and accurate record-keeping is of the most important so that the taxpayer may be able to shift the burden of proof to the IRS.

Notes

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[iv] Lederman, L. Unforeseen Consequences of the Burden of Proof Shift*, 80 TAX NOTES 379 (1998).*
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[x] *I.R.C. § 7427*
[xi] *I.R.C. § 162(c)*
[xii] *I.R.C. § 7454(a); I.R.C. § 7422(e)*
[xiii] *I.R.C. § 6201(d)*
[xiv] *I.R.C. § 534*
[xv] *I.R.C. § 6902(a)*
[xvi] I.R.C. § 7429(g)
[xvii] "William J. Clinton: Statement of Administration Policy: H.R. 2676- Internal Revenue Service Restructuring and Reform Act." The American Presidency Project. The American Presidency Project. Eb. 15 Nov 2011 <http://www.presidency/ucsb.edu/ws/index.php?pid=74396>.
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[xx] Marcum, Tanya M. "Shifting the Burden-of-Proof Rules in Federal Tax Cases" The CPA Journal (2005)
[xxi] "Internal Revenue Manual- 13.1.2 Internal Revenue Service Restructuring and Reform Act of 1998 (RRA98)." Internal Revenue Service. Web. 15 Nov 2011.< http://www.irs.gov/irm/part 13/irm_13-001-002.html>
[xxii] *I.R.C. § 7491(c)*
[xxiii] *Norman L and Catherine J. Forste v. Commissioner of Internal Revenue. TC. Memo 2003-103.*
[xxiv] SOURCE.
[xxv] *Earl G. Hibee and Lesley A. Higbee v. Commissioner of Internal Revenue: 116 T.C. 438*
[xxvi] *Delbert L. and Margaret J. Baker v. Commissioner of Internal Revenue: 122 T.C. 143.*
[xxvii] *David W. and Connie L. Swanson v. Commissioner of Internal Revenue: T.C. Memo 2008-265*
[xxviii] Knight RA and Knight LG. "Shifting the Burden of Proof: Taxpayers will benefit only if they meet certain recordkeeping and substantiation requirements."
[xxix] Thomas F. and Kathryn H. Chambers v. Commissioner of Internal Reveune: T.C. Memo 2011-114