TAX NEWS

NEWSLETTER OF THE TAX SECTION OF THE STATE BAR OF ARIZONA

VOL. 7, #2, MAY 2002

INSIDE...

The New Tax Law Burden of Proof and Production

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On July 22, 1998, President Clinton signed into law the Internal Revenue Service Restructuring and Reform Act of 1998 (the "Act"). The Act, which was the product of many highly publicized hearings, provides for the burden of proof, which the taxpayer generally bears, to shift to the Internal Revenue Service ("IRS") if certain conditions are satisfied. Internal Revenue Code § 7491, which is the new burden of proof statute, applies to income (including self-employment), estate, gift and generation-skipping transfer taxes.

First and foremost, I.R.C. § 7491 will shift the burden of proof only if the applicable court proceeding arises in connection with an examination commencing after July 22, 1998. If there is no examination, I.R.C. § 7491 applies to court proceedings arising in connection with taxable periods or events beginning or occurring after July 22, 1998. Most equate an examination with an audit. However, an audit is not the only event that would be considered an examination for purposes of I.R.C. § 7491. According to the Conference Report to the Act, the shift of the burden will apply where the IRS performs a matching of an information return against amounts reported on a tax return or a review of a claim for refund prior to issuing the refund.

Second, the taxpayer must comply with each of the following requirements set forth in I.R.C. § 7491(a)(2) in order for the burden of proof to shift:

a. the taxpayer must substantiate any item required under Title 26;
b. the taxpayer must maintain all records required under

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Title 26 and cooperate with reasonable requests by the IRS for witnesses, information, documents, meetings and interviews; and

c. in the case of a partnership, corporation, or trust, the taxpayer's net worth cannot exceed $7 million.

The purpose of the limitations set forth in I.R.C. § 7491(a)(2) is explained in the Senate Finance Committee Report as follows:

> 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 Senate Finance Committee Report indicates that the above limitations do not require the taxpayer agree to an extension of the limitations period in order to fulfill the cooperation component. However, cooperation is defined as providing reasonable assistance to the IRS in accessing witnesses, information and documents not within the taxpayer's control, including providing English translations for witnesses or documents located in foreign countries. A necessary element of fully cooperating with the IRS is that the taxpayer must exhaust his administrative remedies (including any appeal rights provided by the IRS).

Third and finally, the taxpayer must produce credible evidence at trial with respect to any factual issues relevant to ascertaining the liability of the taxpayer under subtitle A or B of the Code. Internal Revenue Code § 7491 does not apply to legal issues. In the seminal case of Higbee v. Commissioner, 116 T.C. No. 28 (2001), the Tax Court found that I.R.C. § 7491 did not establish what constitutes credible evidence.

The Senate Finance Committee Report states that:

> [c]redible evidence 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 presumptions of IRS 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.

Although the Tax Court in Higbee did not find that the taxpayer satisfied the limitations under I.R.C. § 7491(a)(2), and therefore, did not interpret the "credible evidence" leg of the statute, the Court gave some indication of what constitutes credible evidence. Cases following Higbee have focused upon whether the taxpayer satisfied the limitations under I.R.C. § 7491(a)(2), rather than whether the taxpayer introduced credible evidence. With a plethora of decisions discussing I.R.C. § 7491, it is only a matter of time before the Court discusses a factual scenario in which the taxpayer meets the limitations under I.R.C. § 7491(a)(2).

In addition to shifting the burden of proof to the IRS, I.R.C. § 7491(c) provided that the IRS has the burden of production for any penalty, addition to tax, or additional amount (penalties). Although I.R.C. § 7491 does not provide a definition of the phrase "burden of production", the Tax Court concluded in Higbee that Congress' intent as to the meaning of the burden of production is evidenced from the following legislative history in I.R.C. § 7491(c):

> 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 the taxpayer's responsibility to (any not the Secretary's obligation) to raise those issues.

As such, the IRS must go forward with sufficient evidence indicating that it is appropriate to impose the relevant penalty, addition to tax or additional amount. For example, if a late-filing addition to tax is imposed, the IRS will have the burden to provide the Tax Court a certified transcript of account or other record to show when the income tax return was filed. The taxpayer then has the burden of proof to prove why the late-filing addition to tax should not be imposed.

When preparing the Tax Court petition, the taxpayer will want to consider alleging the following, if applicable:

a. that the examination began after July 22, 1998;
b. that the taxpayer substantiated all items required under title 26;
c. that the taxpayer maintained all records required under title 26 and cooperated with reasonable requests by the IRS for witnesses, information, documents, meetings and interviews; and
d. in the case of a partnership, corporation, or trust, the taxpayer's net worth does not exceed $7 million.

If penalties or additions to tax are involved, the taxpayer should allege that the burden of production is on the IRS and that the taxpayer should not be liable for the penalties or additions to tax due to reasonable cause, substantial authority, or a similar provision.

Finally, in the prayer, consideration should be given to requesting the Tax Court shift the burden of proof to the IRS under I.R.C. § 7491 and similarly, finding that the IRS has the burden of production for the penalty or addition to tax.

At the time the answer is filed by the IRS, the IRS is required under Tax Court Rule 36 to make specific admissions or denials of each material allegation in the petition. Since the IRS reviews the administrative file prior to answering a petition, a specific admission or denial should be plead in the answer as to all relevant predicates that apply.

As more practitioners become familiar with I.R.C. § 7491 and the limitations imposed therein, close factual issues, where the burden of proof is shifted to the IRS, should be decided in the taxpayer's favor if the practitioner is careful in dotting the "i's" and crossing the "t's" at the various administrative stages of the audit and the appellate review and at the time Tax Court petition is filed.

Federal Legislative Update

BY JEFFREY B. FUGAL, QUARLES & BRADY STREICH LANG, LLP

The "Job Creation and Worker Assistance Act of 2002," signed by President Bush on March 9, 2002, provided the following three changes to the Internal Revenue Code:

A. FIRST YEAR "BONUS" DEPRECIATION

A taxpayer may recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Different types of property generally are assigned applicable recovery periods and depreciation methods. Currently, a taxpayer may also elect to deduct up to $24,000 of the cost of qualifying property placed in service during the taxable year (see I.R.C.§ 179).

The Act allows a 30% first-year depreciation bonus on certain property acquired after September 10, 2001, and before September 11, 2004. The principal types of qualifying property are computer software, assets having a depreciation period for 20 years or less, and leasehold improvements made in business (i.e., nonresidential) premises. In order to qualify, the property must be placed in service before January 1, 2005, except that certain constructed property can qualify if placed in service before January 1, 2006.

Example. On March 1, 2002, a taxpayer acquires and places in service qualified property that costs $500,000. The property qualifies for the expensing election under I.R.C.§ 179. The taxpayer is first allowed a $24,000 deduction and, as a result of the Act, is then allowed an additional first-year "bonus" depreciation deduction of $142,800 [($500,000 original cost less the I.R.C.§ 179 deduction of $24,000) multiplied by 30%]. Finally, the remaining adjusted basis of $333,200 ($500,000 original cost less the I.R.C.§ 179 deduction of $24,000 and the bonus depreciation deduction of $142,800) will be "recovered" pursuant to the general depreciation rules.

B. FIVE-YEAR CARRYBACK OF NET OPERATING LOSSES

A net operating loss ("NOL") is, generally, the amount by which a taxpayer's allowable deductions exceed the taxpayer's gross income. NOLs may be carried back two years and carried forward 20 years to offset taxable income in such years. The Act temporarily extends the general NOL carryback period to five years (from two years) for NOLs arising in taxable years ending in 2001 and 2002. A taxpayer can elect to forgo the five-year carryback period and apply the general NOL rules found in I.R.C.§ 172. This 5-year carryback provision is effective for NOLs generated in taxable years ending after December 31, 2000.

C. CHANGES TO IMPACT OF COD INCOME ON S CORP SHAREHOLDER BASIS: ANTI-GITLITZ LEGISLATION

An S corporation is generally not subject to the corporate income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. To prevent double taxation of these items, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder may deduct losses only to the extent of a shareholder's basis in his or her S corporation stock plus the shareholder's adjusted basis in any indebtedness of the S corporation to the shareholder. Any loss that is disallowed by reason of lack of basis is "suspended" at the corporate level and is carried forward and allowed in any subsequent year in which the shareholder has adequate basis in the stock or debt.

Gross income generally includes income from the discharge of indebtedness. However, income from the discharge of indebtedness of a taxpayer in a bankruptcy case or when the taxpayer is insolvent (to the extent of the insolvency) is excluded from income. The taxpayer is required to reduce tax attributes, such as net operating losses, certain carryovers, and basis in assets, to the extent of the excluded income. In the case of an S corporation, the eligibility for the exclusion and the attribute reduction are applied at the corporate level. For this purpose, a shareholder's suspended loss is treated as a tax attribute that is reduced. Thus, if the S corporation is in bankruptcy or is insolvent, any income from the discharge of indebtedness realized by an S corporation is excluded from income, however, the S corporation must reduce its tax attributes (including any suspended losses).

Example. An S corporation shareholder has an adjusted basis of zero in her S corporation stock. The S corporation borrows $10 from a third party and subsequently loses the entire $10. Because the shareholder has no basis in her stock, the $10 loss is "suspended" at the corporate level. If the $10 debt is forgiven when the S corporation is in bankruptcy or is insolvent, the $10 of debt forgiveness is excludible income, however, the $10 "suspended" loss must be eliminated and is not passed through to the shareholder.

The United States Supreme Court recently ruled in *Gitlitz v. Commissioner* that income from the discharge of indebtedness of an S corporation that is excluded from income because the S corporation is in bankruptcy or is insolvent is treated as an "item of income" which increases the adjusted basis of a shareholder's stock in the S corporation. As a result, losses that would otherwise be suspended may pass through to a shareholder even though the shareholder did not economically incur the discharge of indebtedness income.

Example. The facts are the same as in the previous example. Under *Gitlitz*, if the $10 of debt is forgiven when the S corporation is in bankruptcy or is insolvent, the debt forgiveness is treated as an "item of income" and the shareholder's adjusted stock basis is increased by $10. Because the shareholder has sufficient tax basis in her S corporation stock, the entire $10 loss will pass through to the shareholder.

The Act overrides *Gitlitz* by providing that discharge of indebtedness of an S corporation that is excludible from income because the S corporation is in bankruptcy or is insolvent is not taken into account as an "item of income" and thus does not increase the basis of its shareholders' stock in the corporation.

Example. The facts are the same as in the previous example. Under the Act, if the $10 of debt is forgiven when the S corporation is in bankruptcy or is insolvent, the debt forgiveness is not treated as an "item of income" and the shareholders adjusted stock basis remains zero. As a result, the $10 loss is "suspended" at the corporate level and is then eliminated pursuant to the attribute reduction rules.

WE NEED YOUR NOMINATIONS!!

The Tax Section of the State Bar of Arizona will, for the second year, continue the awards program for the outstanding employee of the Internal Revenue Service and the outstanding employee of the Arizona Department of Revenue. The purpose of this Award program is to increase our members' understanding and respect for the individuals who work for the IRS and ADOR in the performance of their duties. The award for each will consist of a plaque and will be presented at the Arizona State Bar Convention on Thursday, June 6, 2002, at the Tax Section Breakfast.

If you would like to nominate an appropriate person for these awards, please contact James Benham by telephone at (502) 254-6044 or by e-mail at sclark@moorebenham.com.

Your nominee(s) should:

1. Demonstrate a positive attitude when dealing with taxpayers and taxpayer representatives.
2. Communicate well with taxpayers and their representatives.
3. Maintain professional decorum and courtesy in dealing with taxpayers and taxpayer representatives.
4. Participate in CLE programs sponsored by the Bar or related CLE organizations.
5. Resolve matters competently and quickly.
6. Demonstrate personal candor as to the IRS/ADOR position in communicating with opposing counsel.
7. Acknowledge material facts which are favorable to taxpayer.
8. Be willing to consider alternative theories under existing law.
9. Make requests for information which are reasonable and relevant to the issues involved.
10. Promote the practice of tax law through education of taxpayers and the taxpayers' representatives regarding substantive and procedural rules of tax law.

Judge Cohen Speaks at January 30 Tax Law Section Luncheon

By Jack Beaver, Moore & Benham, PLC

The Honorable Mary Ann Cohen of the U.S. Tax Court spoke to the Tax Section at its monthly luncheon on January 30. Although it was an unusually cold and wet Phoenix day, Judge Cohen was treated to a warm reception from the Tax Section members gathered at the University Club. In her remarks, Judge Cohen, formerly Chief Judge of the Tax Court, touched on a number of issues currently facing the Tax Court. First, she provided an update on the status of cases in front of the Tax Court. As of the end of 2001, there were 15,849 pending cases. This number was expected to rise, however, because the Tax Court's mail had been slowed by the recent incidents of anthrax-tainted mail. Upon the outbreak of the anthrax scare, mail delivery to the Tax Court was halted. It resumed on November 28 but not before the decision was made to irradiate all incoming mail. This irradiation process, combined with as the substantial backlog of mail that accumulated before mail delivery was reinstated, has substantially delayed the processing of the Tax Court's workload. In addition, currently docketed cases have been affected since correspondence, including trial memoranda, have not been reaching Tax Court judges before the dates set for trial.

After the Tax Court update, Judge Cohen's primary topic for the luncheon concerned an emerging trend in the Tax Court regarding *pro se* taxpayers. Her observation was that many middle class taxpayers, including professionals and public employees, increasingly are not being represented by attorneys but rather are relying on the often-misguided tax advice of non-lawyers. In many instances these taxpayers simply refuse to cooperate with the Internal Revenue Service and, by the time their cases reach trial in the Tax Court, the taxpayers are either unwilling to back away from their positions or lack the information needed to back away. Although she has found that some of these unrepresented taxpayers are tax protestors, many are not. They often are wage earners or small business people who end up being taxed more than they would have been if they had cooperated. This is usually because, by not cooperating, they wind up offering no proof for their claimed deductions. In her estimation, many of these people can afford to hire a tax lawyer and, by doing so, they would increase the likelihood of favorable results at the Tax Court.

As a possible solution to this problem, Judge Cohen suggested that the State Bar undertake a program of education for individuals with tax disputes. She suggested the use of public service announcements or other types of public education that are designed to reach these taxpayers and inform them of their options regarding tax disputes. She noted that the State Bar of California has produced a video for *pro se* taxpayers. Judge Cohen stressed, however, that any such educational programs should be structured in such a way that they are not perceived as adverse to taxpayer interests.

Judge Cohen's comments and concerns were well-received by the audience. After a short question and answer session, the meeting adjourned. Although the luncheon was brief, those in attendance appreciated the fact that Judge Cohen found time in her busy schedule to speak to the Tax Section. It is hoped that she will speak to the Tax Section again the next time the Tax Court calendar brings her to Phoenix.

APPLICANTS NEEDED FOR STATE BOARD OF TAX APPEALS

The Governor's Office has asked the State Bar to help find an attorney to nominate to the State Board of Tax Appeals. This board reviews and hears complaints about sales, use, income and all other state taxes except property taxes, which are handled by the State Board of Equalization.

The board meets about two times per month, depending upon workload. Each meeting is 1/2 day or less and is always on a Tuesday. Two or 3 cases are considered at each meeting and no more than 2 hearings may be held. The board is supported by 2-1/2 staff members.

Applicants must be residents of the state and have knowledge & experience in taxation. A. R. S. § 38-212 also requires that applicants have a continuous recorded registration with the same political party or as an independent for at least two years immediately preceding appointment. Arizona statutes also provide that each member shall receive; 1) One hundred fifty dollars per day for time spent in the performance of official duties and 2) such travel and other expenses as provided by law for other state officers.

To apply for this position applicants must go to the Governor's website at www.governor.state.az.us/b&c/application2.cfm, complete the application, and send it in with a résumé. For more information, please contact Anne Lynch, Governor's Special Assistant, at (602) 542-1742.

Mark Your Calendars

The Tax Section invites you to attend a breakfast meeting at 7:30 a.m. on Thursday, June 6, 2002 held during the Arizona State Bar Convention located at the Westin La Paloma in Tucson, Arizona

Catered breakfast will be provided for a small charge.

More information to follow.