

## Substantiation Outline

1. Notice of Deficiency
  - a. Representatives should always obtain 2 documents when first speaking with a client or potential client in Tax Court:
    - i. First, representatives should get a copy of the Notice of Deficiency, which generally limits the issues and amounts in controversy. If the client does not have their Notice of Deficiency, then ask IRS Counsel for a copy.
    - ii. Second, representatives should obtain a copy of the Service's Pretrial Memorandum. The Pretrial Memorandum updates the Tax Court on the case's status, the facts, potential witnesses, disputed issues and evidentiary questions. *See* I.R.M. 35.4.9.2.1.
  - b. Generally the Tax Court will not look behind the Service's determination of a deficiency; the notice of deficiency generally enjoys a presumption of correctness. *Greenberg's Express, Inc. v. Commissioner*, 62 T.C. 324, 327 (1974); *Clapp v. Commissioner*, 875 F.2d 1396, 1402-03 (9th Cir. 1989).
  - c. Representatives should review both the Notice of Deficiency and Pretrial Memorandum to be sure the Service is arguing only the issues raised in the Notice of Deficiency. If the Service argues new issues, the Service should acknowledge that it has the burden of proof on those issues. T.C. Rule 142.
2. Burden of Proof
  - a. Generally, if a taxpayer introduces credible evidence regarding any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed, the IRS has the burden of proof with respect to that issue. *See* §7491(a).
    - i. Limitations.
      1. To shift the burden of proof, the taxpayer must substantiate her evidence. §7491(a)(2)(A).
      2. Taxpayer must have kept required records and cooperate with reasonable requests by the IRS for access to witnesses, information, documents, meetings and interviews. §7491(a)(2)(B).
      3. The general rule does not apply to any issue if the Internal Revenue Code provides for a specific burden or proof on that issue.
      4. If the weight of the evidence favors one party on a particular issue, the Tax Court does not need to decide the allocation of the burden of proof under §7491(a) with

respect to that issue. *E.g.*, *Knudsen v. Commissioner*, T.C. Memo. 2007-340.

### 3. Unreported Income

- a. The Service's determination of deficiency does not benefit from the presumption of correctness when the government's proposed assessment is "arbitrary and erroneous." *Helvering v. Taylor*, 293 U.S. 507, 515 (1935).
- b. IRS must introduce "some" evidence linking unreported income to taxpayer. *Weimerskirch v. Commissioner*, 596 F.2d 358 (9th Cir. 1979). A "bald assertion" on an information return is probably insufficient. *Portillo v. Commissioner*. 932 F.2d 1128, 1133 (5th Cir. 1991); *see* § 6201(d). Once the Service introduces some evidence linking the taxpayer to the income, the burden of proof then shifts back to the taxpayer to show that the item is not income.
- c. 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 3rd party and the taxpayer has fully cooperated with the Secretary, the Secretary shall have the burden of producing reasonable and probative information concerning such deficiency in addition to such information return." § 6201(d).
- d. The Service does not have to investigate a "bald assertion" in an information return if the Service does not rely on the information return to determine that a deficiency exists. *Woodall v. Commissioner*, 964 F.2d 361, 363 (5th Cir. 1992); *Sunik v. Commissioner*, T.C. Memo. 2001-195.

### 4. Reported Income

- i. Income reported on a return generally will be considered an admission of a party opponent under Fed. R. Evid. 801 if offered into evidence by the Service. *Estate of Hall v. Commissioner*, 92 T.C. 312, 337-38 (1989).
- ii. But admissions on a return cannot be considered binding without eviscerating the *de novo* standard the Tax Court applies to deficiency cases.
- iii. "Cogent evidence" to the contrary may overcome an admission on a return. *Id.* *E.g.*, *Waring v. Commissioner*, 412 F.2d 800 (3d Cir. 1969).
- iv. *Danielson* Rule: "A party can challenge the tax consequences of his [admission in an agreement] as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967).
- v. The *Danielson* rule only applies in cases appealable to the third, fifth, sixth, eleventh and federal circuits (*i.e.*, circuits that have adopted the *Danielson* rule). *Elrod v. Commissioner*, 87 T.C. 1046 (1986).
- vi. "Strong Proof" rule: If the taxpayer has structured a transaction or agreement in a particular manner, but later wishes to have the

transaction treated differently, the Tax Court will require the taxpayer to offer strong proof that the transaction should be treated differently. The required strong proof is greater than the preponderance of the evidence. *Illinois Power Co. v. Commissioner*, 87 T.C. 1417, 1434 (1986); *Coleman v. Commissioner*, 87 T.C. 178, 204 (1986), aff'd without published opinion, 833 F.2d 303 (3d Cir. 1987); *O'Malley v. Commissioner*, T.C. Memo. 2007-79, *Norwest Corp. v. Commissioner*, 111 T.C. 105, 140, 145 (1998).

- vii. Of course, if the return is not properly authenticated, it is not admissible. *See* Fed. R. Evid. 901. *Cahn v. Nicholas*, 408 F.2d 1, 3 (5th Cir. 1969) (unsigned return inadmissible); *United States v. Kelley*, 305 Fed. Appx 705, 708 (2d Cir. 2009) (same, but harmless error in admitting unsigned return); *United States v. Novelli*, 381 F.Supp. 2d 1125 (C.D. Cal. 2005) (DOJ trial attorney's declaration cannot authenticate tax return).

## 5. Deductions & Credits

- a. The allowance of deductions from income is an act of legislative grace, so taxpayer generally bears the burden of proving deductions. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934); T.C. Rule 142.
  - i. Even taxpayers who come to Tax Court with no records have a chance to win all or part of their case based on their testimony. Credible testimony may establish a reasonable basis for allowing most deductions and credits. *Cohan v. Commissioner*, 39 F.2d 540; *Union Carbide Corp. & Subs. v. Commissioner*, T.C. Memo. 2009-50 (research credit).
  - ii. Strict statutory substantiation rules apply to some deductions (*e.g.*, §§ 170(f)(8), 274(d)), so the *Cohan* rule is inapplicable to those items.
  - iii. Doctrine of substantial compliance may apply even in cases that demand strict substantiation, provided that the taxpayer fulfilled the essential statutory purpose. *E.g.* *Bond v. Commissioner*, 100 T.C. 32, 41 (1993).

## 6. Evidence

- a. Fact Finding. The Tax Court has the power to determine disputed questions of fact and to draw inferences from the facts and circumstances. As long as its findings of fact and inferences are reasonable and supported by substantial evidence, the Tax Court's findings must stand on review. *See Wichita Terminal Elevator Co. v. Commissioner*, 162 F.2d 513, 515 (10th Cir. 1947), *aff'g* 6 T.C. 1158 (1946).
- b. If a taxpayer's case would be helped by the testimony of absent witnesses, it is often a good idea to have the taxpayer testify as to why the witnesses are unavailable, to guard against a finding of fact based on a negative inference. "The rule is well established that the failure of a party to

introduce evidence within his possession and which, if true, would be favorable to him, gives rise to the presumption that if produced it would be unfavorable.” *Wichita Terminal*, 6 T.C. at 1165.

- c. D.C. Circuit law should control evidentiary questions. *See* T.C. Rule 143(a); § 7453.
- d. Service transcripts and Forms 4340 may be admissible for limited purposes if properly authenticated.
- e. Information returns are hearsay.
- f. Almost all evidence in the Service’s administrative file is hearsay and difficult for the Service to authenticate.
- g. Rule 274 relaxes the rules of evidence in S-cases, but it should not lessen the evidentiary burden (if any) on the Service.