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## Individuals

### Tax Regulations - Internal Revenue Service Restructuring and Reform Act of 1998 - Title III Taxpayer Protection and Rights (Burden of Proof)

September 10, 1998

MEMORANDUM FOR DISTRIBUTION

<b>FROM:</b>	Bob Wenzel, Chief Operations Officer
<b>SUBJECT:</b>	Internal Revenue Service Restructuring and Reform Act of 1998 - Title III Taxpayer Protection and Rights (Burden of Proof)

The Internal Revenue Service Restructuring and Reform Act of 1998 was signed into law effective July 22, 1998. Title III of the Act, Taxpayer Protection and Rights, also cited as the "Taxpayer Bill of Rights 3, (TBOR 3)," is the subject of this memorandum. More specifically, we want to bring to your attention Subtitle A containing Section 3001 of the bill which addresses Burden of Proof. Please also note that the provisions of the law are contained in new section 7491 of the Internal Revenue Code.

Congress is concerned that individual and small business taxpayers are at a disadvantage when they must litigate federal tax matters with the Internal Revenue Service. Congress believes that it is inappropriate for the Service to rely solely upon statistical data obtained from third party sources to reconstruct unreported income for a taxpayer. Congress further believes that, in a court proceeding, the IRS should not be able to rest on the presumption of correctness if it does not provide any evidence relating to penalties.

New section 7491(a) places the burden of proof on the Service in any court proceedings where the taxpayer has introduced credible evidence with respect to factual issues relevant to ascertaining the taxpayer's tax liability.

To qualify, the taxpayer must:

1. comply with all substantiation requirements of the Code;
2. maintain all the records required by the Code;
3. cooperate with the Service's reasonable requests for information; and,
4. if the taxpayer is a corporation, partnership, or trust, meet certain net worth qualifications.

Where the Service reconstructs a taxpayer's income solely through the use of statistical information of unrelated taxpayers, section 7491(b) places the burden of proof on the Service in any court proceeding. Section 7491(c) provides that the Service shall have the burden of production in a court proceeding relating to the appropriateness of applying any penalties, additions to tax, and additional amounts imposed by the Internal Revenue Code to the taxpayer. It should be noted that additional amounts are amounts that can be assessed by the Service which are not considered additions to tax or penalties. An example of an additional amount would be the IRC 6673 sanctions. It should be noted that the definition of "additional amounts" under IRC 7491(c) does not include any excise taxes.

It is important to distinguish between the burden of proof and burden of production. The burden of proof encompasses both the burden of persuasion and the burden of going forward with the evidence. To say that a party bears the burden of persuasion is to say that the party must persuade the court that its position is correct; if the party fails to meet its burden, it will lose the case. In the past, the taxpayer bore this burden and had to convince the Court that the Service was wrong. A burden of production, however, is a lesser burden, in that it can be

met if the party who bears it comes forward with evidence supporting its position. In the past, the taxpayer bore the burden of production with respect to both the deficiencies and penalties. Under new section 7491(c), the Service now bears the burden of production with respect to the determination that a penalty applies. Once the Service has met the burden of production, the taxpayer retains the burden of persuading the court that the penalty is not appropriate, by raising defenses such as reasonable cause to the penalty.

If the taxpayer complies with the statutory requirements, the Service must now assume the burden of showing to the satisfaction of the Court that the tax liability as redetermined was correct; and the taxpayer no longer bears the burden of proof. It is critical that examiners now document their workpapers to reflect the degree of taxpayer cooperation. In addition, the examiners must fully describe documents used to support audit conclusions and proposed tax adjustments. Examiners must also prepare documents which will fully describe the steps taken and the analysis which supports audit conclusions.

Good auditing and good litigation practice, similar to most determinations in the past, will ordinarily produce sufficient evidence to sustain the burden of proof. The Service and Chief Counsel have not, in the past, generally relied upon the taxpayer's failure of proof to sustain the asserted liability, but rather have affirmatively shown the proper liability. Continued adherence to these practices will satisfy the new standard, but it is now extremely important that a thorough examination and documentation of the liability be performed prior to the initiation of litigation.

**The following action (not all inclusive) can no longer be taken by the Service:**

- The Service can no longer rely on the taxpayer's failure to satisfy the burden of proof in court cases where the taxpayer has a reasonable factual dispute with the Service.

**The following are some actions (not all inclusive) the Service can take:**

- The Service can emphasize its examination procedures to further stress good examination techniques. Evidence should be gathered and preserved from the earliest stage of a case, documenting where the taxpayer has cooperated and the extent to which he or she did cooperate and produce information.
- All requirements of the law with respect to the treatment of an item for tax purposes should be explored and documented. Counsel will similarly emphasize good trial preparation and evidence production practice to satisfy the government's evidentiary burden.
- The Service can use statistical data from unrelated taxpayers to determine a taxpayers' income as a component of its traditional indirect methods of establishing income. There is no reason to abandon the usage of statistical information; rather a thorough examination will likely produce other circumstantial evidence that will support the income determination. In these instances, the use of statistical information will not be the sole means to determine income.

It should be noted for purposes of clarification that in the past, both the IRM and court decisions required the Service to supplement a Bureau of Labor Statistics (BLS) or a Consumer Price Index (CPI ) reconstruction with direct evidence of the amount and likely source of a taxpayer's income.

In a number of court cases decided within the past 2 years, where the Service failed to present direct evidence of a taxpayer's income producing activity, BLS and CPI reconstructions were not sustained. Appeal from these adverse decisions was not recommended because the Service had failed to abide by its internal practices and, therefore, the determinations should not have been made.

**Anticipated Future Actions:** We plan to take the following actions in implementing this new legislation affecting the change in burden of proof:

- Review and revise as appropriate the Internal Revenue Manual, Income Tax Regulations, Publication 1, Your Rights as a Taxpayer, and any other applicable Service publications to better inform the public of the specifics of IRC 7491.

Please note that Publication 1, Your Rights as a Taxpayer, and Publication 556,

Examination of Returns, Appeal Rights, and Claims for Refund, are being revised to include a section which discusses the shift in burden of proof from the taxpayer to the Service if the taxpayer meets certain conditions. Attached to this memorandum is an explanation of the new procedures which will be included in the above-referenced publications. Until the new publications are printed (approximately December 1, 1998), compliance personnel should distribute a copy of this attachment when taxpayers are contacted.

- Develop and deliver a CPE Technical Training Module to all Examination (including Service Center Examination), International, and EP/EO personnel.
- Issue an information release to the public.

[Attachment](#)

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Regional Chief Compliance Officers  
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