Current Federal Tax Developments

Week of March 4, 2019

Edward K. Zollars, CPA
(Licensed in Arizona)

ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF MARCH 4, 2019

Published in 2019 by Kaplan Financial Education.

Printed in the United States of America.

Current Federal Tax Developments

Kaplan Professional Education

Table of Contents

Section: 111
Tax Benefit Rule of §111 Should Shield State Tax Refunds For Taxpayers Over the SALT Limit

Citation: Online Discussions, 2/28/19

This week a number of questions arose in different forums regarding the potential taxability of a state income tax refund for taxpayers where the taxpayers had their state tax deductions limited by the $10,000 limit on such deductions under IRC §164(b)(6). The question was whether a portion of the refund equal to the refund amounts times the ratio of income taxes to total state and local taxes subject to the $10,000 limit will be considered taxable in 2019.

Some tax software have been providing reports of potentially taxable refunds based on the ratio calculation. The rumors suggest that at least some sources at the IRS have indicated that this prorated refund calculation is what should be reported in 2019. But is such a calculation correct?

IRC §111 is a provision that should keep most of these refunds from being taxable. IRC §111(a) provides:

> *Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter.*

The law does recognize that a deduction, while not reducing current year tax, might impact a carryover that later could reduce tax. So there is a special rule found at IRC §111(c) to deal with carryovers:

> *(c) Treatment of carryovers*
>
> *For purposes of this section, an increase in a carryover which has not expired before the beginning of the taxable year in which the recovery or adjustment takes place shall be treated as reducing tax imposed by this chapter.*

Reg. §1.111-1(b)(2)(i) provides the definition of the *recovery exclusion* which will not be subject to tax.

> *The recovery exclusion for the taxable year for which section 111 items were deducted or credited (that is, the "original taxable year") is the portion of <u>the aggregate amount of such deductions and credits which could be disallowed without causing an increase in any tax</u> of the taxpayer imposed under subtitle A (other than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E, chapter 2 of the Internal Revenue Code of 1939). For the purpose of such recovery exclusion, consideration must be given to the effect of net operating loss carryovers and carrybacks or capital loss carryovers.*

This provision is often referred to as the "tax benefit rule" and is what has served to limit inclusion of the state income tax deduction in the past due to various circumstances, including when the alternative minimum tax applied to a taxpayer.

The provision looks at whether, had the amount that was later recovered not been claimed on the original return, there would be either a change in tax for that year or a change in a carryover (net operating loss, capital loss, etc.) that could affect tax in a different year. If the removal of the deduction would not have impacted either the tax for the year of deduction or any of the carryovers, the recovery is not taxable.

To illustrate the application of this provision to the current situation, let's consider the following example:

Example 1

Joe and Denise Smith itemize deductions on their 2018 income tax return. On Schedule A they listed real estate taxes of $7,000 and state income taxes of $7,000. When their 2018 state income tax return was prepared, the couple received a state tax refund of $2,000.

The Smith's total taxes subject to the $10,000 limit was $14,000, resulting in an allowed deduction of $10,000 and a similar reduction in their taxable income. If $2,000 of their state income taxes were to be disallowed by the IRS, their total taxes before the limit would drop to $12,000. However, their deduction would remain at $10,000 and their taxable income and tax would remain unchanged. The change would also have no effect on any net operating loss or capital loss on the Smith's return for 2018.

Thus, the $2,000 refund is excluded from their 2019 income due to the operation of IRC §111.

Example 2

Assume the same facts except their state tax refund was $5,000. In this case only $4,000 of the refund represents amount that would not serve to increase their tax should it be disallowed on exam. If the full $5,000 refund were disallowed, their limited tax deduction under §164 would drop to $9,000 from $10,000, resulting an increase in taxable income and an increase in tax that can be traced to $1,000 of the refund.

IRC §111 would still serve to exclude $4,000 of the refund from their 2019 income. But $1,000 of the refund would be reported as income on their 2019 income tax return, as that amount is not protected by this tax benefit rule.

******

Section: 280E
Fifth Amendment Does Not Allow Taxpayer to Avoid Burden of Proving Business Did Not Traffic in Controlled Substances

Citation: Feinberg, et at v. Commissioner, Case No. 18-9005, CA10, 2/26/19

The Tenth Circuit denied a taxpayer's attempt to force the IRS to bear the burden of proof that an LLC operating as an S corporation was trafficking in a controlled substance that would lead to a denial of most business deductions per IRC §280E in the case of *Feinberg, et at v. Commissioner*, Case No. 18-9005, CA10. The taxpayer argued that, despite the fact that the burden of proof generally falls on the taxpayer to prove the right to a deduction, to do so in this case would involve a violation of the taxpayers' Fifth Amendment privilege.

This was the second trip up to the Tenth Circuit for the taxpayers in this exam. While their first trip was ultimately successful in the eventual result, if not 100% in the decision, this second trip was not fruitful for the clients.

IRC §280E denies deductions, other than costs of sales, for any business found to trafficking in controlled substances. Total Health Concepts, LLC, the entity in question, was an entity licensed by the state of Colorado to operate two medical marijuana dispensaries. The IRS presumed the entity did just that in its business for the years in question.

During the examination in question the IRS issued a request for information about the nature of the entity's business. The taxpayers objected that the material in question was protected by their Fifth Amendment privilege and eventually took the matter to the Tenth Circuit, resulting in first decision from the Court (*Feinberg v. Commissioner*, 808 F.3d 813, 814 (10th Cir. 2015), which the Court refers to as *Feinberg I* in the current decision).

The current decision summarized the results in that case as follows:

> *We noted the tax court proceedings "took an especially curious turn" when the Commissioner sought to compel discovery because "[i]n tax court, after all, it's the petitioners who carry the burden of showing the IRS erred in denying their deductions — and by invoking the privilege and refusing to produce materials that might support their deductions the petitioners no doubt made their task just that much harder." Id. We then denied the writ, concluding the Taxpayers' Fifth Amendment privilege could be protected by an appeal in the normal course. Id. at 816.*
>
> *After the ruling in Feinberg I, the Commissioner abandoned the discovery request…*

The IRS went to trial without having obtained the material relating to the nature of THC's business. THC did not produce any evidence of its own regarding the nature of its business in the trial. The Tax Court ruled against the taxpayer, but not based on THC being involved in trafficking.

Rather, the Tax Court ruled that the taxpayers had not substantiated the business expenses for which a deduction was claimed. Both THC and the IRS agreed that the agency had never advanced the argument that THC had not substantiated deductions and that the deductions should not be disallowed on that basis.

Not surprising THC appealed the decision. The IRS, while agreeing that the Tax Court's decision itself was flawed, argued that the Tax Court had erred when it did not deny the deductions based on the IRS's position that THC was trafficking in a controlled substance. Thus, the IRS argued for the same result based on information already on the record.

The IRS pointed out that the taxpayers had not presented any evidence to overcome the presumption that the IRS had correctly categorized their business as trafficking in controlled substances. Having not even attempted to meet their burden of proof on this issue, the taxpayers had presented no facts that could have reasonably led the Tax Court to determine they had met their burden to show the IRS position was in error.

The taxpayers argued that a series of Supreme Court cases supported their position that they should not be sanctioned for failing to produce information that could itself be incriminating. As the Court of Appeals summarized the rulings "the Fifth Amendment privilege barred prosecution for failing to provide self-incriminating information." But in this case the taxpayers were not being criminally prosecuted for failing to provide proof regarding their §280E status.

As the panel noted:

> *The Taxpayers fail to explain how requiring them to bear the burden of proving the IRS erred in applying § 280E to calculate their civil tax liability is a form of compulsion equivalent to a statute that imposes criminal liability for failing to provide information subjecting the party to liability under another criminal statute. Here, the Taxpayers must choose between providing evidence that they are not*

> *engaged in the trafficking of a controlled substance or forgoing the tax deductions available by the grace of Congress. In the cases cited by the Taxpayers, the petitioners were faced with a choice of whether to be prosecuted criminally because they did not provide the information, or to be prosecuted criminally because they did. The circumstances are easily distinguishable.*

The panel notes that THC had been warned in *Feinberg I* about the potential consequences of refusing to produce evidence of the nature of their business in a tax case:

> *To be sure, "by invoking the privilege and refusing to produce the materials that might support their deductions the [Taxpayers] no doubt made their task [of proving the IRS erred in denying their deductions] that much harder." Feinberg I, 808 F.3d at 815. But "a party who asserts the privilege against self-incrimination must bear the consequences of [the] lack of evidence." United States v. Goodman, 527 F. App'x 697, 700 (10th Cir. 2013) (quotation marks omitted). Rylander teaches that the Taxpayers' possible failure of proof on an issue on which they bear the burden is not "compulsion" for purposes of the Fifth Amendment.*

In a footnote at the very end of the opinion the Court summarizes the issues of taxation of state legal marijuana businesses:

> *The Taxpayers are understandably frustrated with the loss of their business expense deductions under § 280E. Despite operating in accordance with state law controlling the distribution of medical marijuana, the Taxpayers are subject to greater federal tax liability than other legitimate state businesses. But state legalization of marijuana cannot overcome federal law. See Hancock v. Train, 426 U.S. 167, 178 (1976) ("It is a seminal principle of our law 'that the [United States C]onstitution and the laws made in pursuance thereof are supreme; that they control the constitution and laws of the respective States, and cannot be controlled by them.'" (quoting McCulloch v. Maryland, Wheat. 316, 426 (1819))). Thus, the Taxpayers' remedy must come from Congressional change to § 280E or 21 U.S.C. § 812(c)(Schedule I) rather than from the courts.*

Section: 6109
IRS Did Not Exceed Its Authority in Charging a Fee to Issue and Renew PTINs

Citation: Montrois, et al v. United States, Case No. 17-5204, CA DC., 3/1/19

The Court of Appeals for the District of Columbia reversed a prior lower court ruling that barred the IRS from charging a fee to issue or renew Preparer Tax Identification Numbers (PTINs) in the case of *Montrois, et al v. United States*, Case No. 17-5204, CA DC.

In June of 2017 the U.S. District Court for the District of Columbia ruled in this case that the IRS, following a ruling in the case of *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014), lacked the authority to impose a fee on tax preparers to obtain and renew PTINs. The original case argued that the fee violated the provisions of the Independent Offices Appropriations Act that the IRS used to justify the fee.

The District Court found that the fee no longer conferred benefits on the affected preparers in exchange for the fee. As the appellate panel's opinion summarized the ruling:

> *The court reasoned in part that, for an assessment to qualify as a fee under that Act as opposed to an unauthorized general tax, the assessment must relate to a specific benefit conferred to an identifiable set of users. But here, the court emphasized, essentially any person can obtain a PTIN after Loving*

> *invalidated the PTIN eligibility criteria, such that the PTIN program, in the court's view, could no longer be said to benefit a particular set of individuals rather than the public in general. Id. at 67. The court also rejected the IRS's argument that the PTIN fee could be sustained based on an interest in protecting tax-return preparers' social security numbers. The court believed that the agency had not adequately raised or explained that rationale when it issued the rule establishing the fee. Id.*

The District Court issued a permanent injunction barring the IRS from collecting the fee. The IRS, while ending collection of the fee, filed an appeal with the Court of Appeals for the DC Circuit.

The DC Circuit panel found the District Court's ruling in error.

The panel first found that the IRS did provide a service to preparers in exchange for the fee. The generation and use of PTINs allows tax preparers to avoid using their social security numbers as identification on returns filed with the agency. The IRS has personnel and resources devoted to providing this service.

The panel found that this service does confer a specific benefit on preparers. The panel found that the confidentiality protection offered by the PTIN service is adequate on its own to count as the necessary benefit received in exchange for a fee. Even though the maintenance of confidentiality was not stated as a benefit justifying the program when the IRS proposed and instituted the fee in 2009, the panel found the issue of protecting preparer identities was the key driving force behind the original establishment of the PTIN program two decades earlier.

The fact that the IRS had used the mandatory registration program that was struck down in the *Loving* case as the primary reason it began collecting the fee did not invalidate the fee, since confidentiality remains a benefit obtained by preparers under the program. The *Loving* decision may reduce the costs the IRS will incur, that only goes to the reasonableness of the fee, not whether the IRS may assess such a fee.[1]

The panel was also not impressed with the District Court's holding that no fee could be charged sinc there were no special requirements to obtain a PTIN once the mandatory registration program was struck down in the *Loving* case. The panel held:

> *It does not matter, though, that the service and benefit are theoretically available to the general public. What matters is that the service is provided to, and the corresponding benefit is received by, the specific group of persons who in fact pay the fee.*

The Court did not rule the IRS fee charged immediately before the ruling barring collection was a reasonable amount, rather sending the case back to the trial court for a decision on that issue. But the panel did rule that the IRS is justified in charging a fee so long as its reasonably in line with the agency's costs incurred to run this program.

---

[1] In fact, the IRS reduced the fee from $50 to $35 following its loss in the *Loving* case.

Section: 6654
At the Last Minute the IRS Grants Extension of Time For Farmers and Fisherman to File and Pay Tax Under Special Estimated Tax Penalty Rule

Citation: Notice 2019-17, 2/28/19

Individual farmers and fishermen are subject to special rules under IRC §6654(i)(1)(A) & (B) that exempt them from an underpayment penalty under §6654 if they make a single estimated tax payment in the amount due by January 15 of the year following the year the taxes are due. However, under IRC §6654(i)(1)(D) these individuals get a second chance if they miss that January 15 date for their one estimate. They are still not subject to an underpayment penalty if they file their return by March 1 of the year following the year in question and pay the resulting tax.

IRC §6654(i)(2) defines "farmers and fishermen" for this purpose as follows:

> *(2) Farmer or fisherman defined An individual is a farmer or fisherman for any taxable year if—*
>
> > *(A) the individual's gross income from farming or fishing (including oyster farming) for the taxable year is at least 66⅔ percent of the total gross income from all sources for the taxable year, or*
> >
> > *(B) such individual's gross income from farming or fishing (including oyster farming) shown on the return of the individual for the preceding taxable year is at least 66⅔ percent of the total gross income from all sources shown on such return.*

This year the farmers and fishermen were granted an extension on that March 1 due date by Notice 2019-17. The IRS provides following justification for this last minute grant of relief in Section 2 of the Notice:

> *Due to certain changes in the rules that affect farmers and fishermen, the Treasury Department and IRS anticipate that farmers and fishermen may have difficulty accurately determining and paying their tax liability for the 2018 taxable year by March 1, 2019.*

The qualifying farmers and fishermen will obtain an extension of time under the conditions noted below:

> *Under the authority granted by section 6654(e)(3)(A), the addition to tax under section 6654 for failure to make an estimated tax payment for the 2018 tax year is waived for any qualifying farmer or fisherman who files his or her 2018 income tax return and pays in full any tax due by April 15, 2019, or by April 17, 2019, for those taxpayers who live in Maine or Massachusetts.*

The notice provides that taxpayers must take the following steps to indicate their return qualifies for this relief:

> *Farmers and fishermen requesting this waiver of the addition to tax must attach Form 2210-F, Underpayment of Estimated Tax by Farmers and Fishermen, to their 2018 tax return. The form can be submitted electronically or on paper. The taxpayer's name and identifying number should be entered at the top of the form, and the waiver box (Part I, Box A) should be checked. The rest of the form should be left blank.*

Section: 6751
Supervisory Review Not Required for Substantial Underpayment Penalty Generated When Taxpayer Failed to Respond to Unreported Income Notice

Citation: Walquist v. Commissioner, 152 TC No. 3, 2/25/19

The case of *Walquist v. Commissioner*, 152 TC No. 3, looks at first glance to be just a run of the mill tax protestor case, as the Court noted the taxpayer, in response to an automated IRS notice regarding unreported income, filed a Tax Court petition that contained the following:

> *On November 27, 2017, petitioners submitted to this Court a purported petition that consisted of a copy of the notice of deficiency, on each page of which they had written "REFUSAL FOR CAUSE." Petitioners appended various documents containing assertions commonly advanced by tax protesters, including assertions that U.S. currency is not "lawful money" and that they "have no obligations or liability to even file a return" because they "intend to only handle legal money." Petitioners also advanced the more novel (but equally frivolous) argument that this Court should garnish the wages of the Secretary of the Treasury for an amount equal to petitioners' outstanding tax liability.*

As the tone of the Court's description suggests, the arguments did not carry the day in front of Judge Lauber.

But the case is not a reported Tax Court case for how the opinion disposed of these arguments. Rather the case took a look at how the provisions found at IRC §6751(b)(1) apply in the case of an automatically generated substantial underpayment penalty under IRC §6662.

IRC §6751(b)(1) provides a requirement before a penalty may be assessed against a taxpayer:

> *(b) Approval of assessment*
>
> > *(1) In general*
> >
> > *No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.*

Recent cases have clarified how this should be applied in cases where the IRS asserts a penalty. As the opinion notes:

> *The Commissioner's burden of production under section 7491(c) includes establishing compliance with section 6751(b), which requires that penalties be "personally approved (in writing) by the immediate supervisor of the individual making such determination." See Chai v. Commissioner, 851 F.3d 190, 217, 221-222 (2d Cir. 2017), aff'g in part, rev'g in part T.C. Memo. 2015-42; Graev v. Commissioner (Graev III), 149 T.C. __ (Dec. 20, 2017), supplementing and overruling in part Graev v. Commissioner (Graev II), 147 T.C. 460 (2016).*

In this case, the penalty was triggered when the taxpayer failed to reply to the initial IRS inquiry regarding unreported income.

> *The IRS processed the examination of petitioners' 2014 return through its ACE system, employing its CEAS software program. This software program ascertained through third-party document matching that petitioners had total income of $95,327.5 The program computed a tax liability of $13,832 and*

calculated a penalty equal to 20% of that sum ($13,832 × 20% = $2,766.40). When petitioners failed to respond to the computer-generated 30-day letter, the CEAS program automatically generated a notice of deficiency setting forth a deficiency and penalty in these amounts.

There are two exceptions to the requirement to have supervisory approval, one of which the Court found relevant in this case, found at IRC §6751(b)(2)(B):

> *(2) Exceptions*
>
> *Paragraph (1) shall not apply to—*
>
> > …
> >
> > *(B) any other penalty automatically calculated through electronic means.*

The penalty in question (the one at §6662(d)(1)(A) is described by the Court as follows:

> *For individual taxpayers, the substantial understatement penalty applies if the understatement of income tax for a particular year "exceeds the greater of(i) 10 percent of the tax required to be shown on the return * * *, or (ii) $5,000." Sec. 6662(d)(1)(A). The penalty (as relevant here) is calculated at a flat rate of 20% of the "underpayment of tax required to be shown on * * * [the] return." See sec. 6662(a). This penalty is thus calculated mathematically, both in terms of whether it applies and the rate at which it is imposed.*

The Court found that, in this case, that exception applies:

> *Because the penalty was determined mathematically by a computer software program without the involvement of a human IRS examiner, we conclude that the penalty was "automatically calculated through electronic means," sec. 6751(b)(2)(B), as the plain text of the statutory exception requires.*

The Court also noted that the IRS has outlined a position on when the penalty is considered to be calculated through electronic means and when it is considered to require the supervisory approval:

> *This conclusion is consistent with the IRS' interpretation of its obligations under section 6751, as set forth in the IRM.6 The IRM explains that the agency's general practice is to require written approval of all penalties by the immediate supervisor of the examiner proposing the penalty, while noting that penalties automatically calculated through electronic means are excluded from this requirement. See IRM pt. 4.19.13.5.2 (Jan. 1, 2016). In 2018 the IRM was amended to state explicitly that substantial understatement penalties determined by the CEAS software program are exempt from the supervisory approval requirement:*
>
> > *Correspondence examination cases in which the Substantial Under-statement Penalty is systemically asserted will fall within the exception for penalties automatically calculated through electronic means if the taxpayer does not submit any response to the 30-day letter proposing the penalty. <u>However, if the taxpayer submits a response, written or otherwise, that challenges the penalty, or the amount of tax to which the penalty is attributable, then the immediate supervisor of the Service employee considering the response must input the CEAS non-action note specifically approving the penalty prior to the issuance of any SNOD [statutory notice of deficiency] that includes the penalty.</u> [IRM pt. 4.19.13.6.2(5) (Feb. 9, 2018).7]*

The IRM sets out a similar position regarding other computer-determined penalties, such as those calculated through the Automated Underreporter program.

The opinion notes that Congress imposed the supervisory approval rule to insure that the IRS did not use the threat of penalties to pressure taxpayers into concessions. In this case, where the penalty had been computer generated without any human review, that risk of the "bargaining chip" issue doesn't exist.

*Computer-determined penalties likewise resemble additions to tax in that they typically do not raise the concern that prompted Congress to enact the supervisory-approval requirement. Congress' goal in enacting section 6751(b)(1) was to ensure that penalties are "only * * * imposed where appropriate and not as a bargaining chip." See S. Rept. No. 105-174, at 65 (1998), 1998-3 C.B. 537, 601. "The statute was meant to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle." Chai, 851 F.3d at 219 (citing legislative history). Where, as here, a penalty is determined by a computer software program and never reviewed by a human being, it could hardly be considered a "bargaining chip." Rather, like an addition to tax under section 6651, 6654, or 6655, it is added to the tax automatically according to a predetermined mathematical formula.*

The Court found that it would not be practical to impose the supervisory approval requirement on this sort of penalty assessment:

… if we were to construe the penalty here as requiring supervisory approval, it is hard to imagine how the IRS would demonstrate satisfaction of this requirement. Section 6751(b)(1) requires that the initial determination of a penalty assessment be "personally approved (in writing) by the immediate supervisor of the individual making such determination." The penalty at issue was calculated and instantiated in letter form by a computer software program. Because the computer did this without human intervention, no "individual making such determination" appears to exist. And if the computer itself were regarded as "the individual making such determination" — that would be difficult to square with the statute's plain text — we would have to determine who "the immediate supervisor" of the computer (or the software program) is. As Lear said prophetically on the heath: "[T]hat way madness lies."9

Section: 7602
IRS Failed to Give Adequate Notice for Contacting a Third Party in Exam When Only Publication 1 Was Provided

Citation: J.B.; P.B. v. United States of America, No. 16-15999, CA9, 2/26/19

The Ninth Circuit Court of Appeals ruled in the case of *J.B.; P.B. v. United States of America*, No. 16-15999, CA9 that the IRS failed to provide the taxpayers with reasonable notice in advance of the agency's intent to contact third parties as required by §7602.

IRC §7602(c)(1) provides the following mandate before the IRS contacts third parties in an examination:

(c) Notice of contact of third parties

(1) General notice

An officer or employee of the Internal Revenue Service may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of such taxpayer without providing reasonable notice in advance to the taxpayer that contacts with persons other than the taxpayer may be made.

IRS Publication 1, Your Rights as a Taxpayer, contains the following text on page 2 of the two page publication:

> ***Potential Third Party Contacts***
>
> *Generally, the IRS will deal directly with you or your duly authorized representative. However, we sometimes talk with other persons if we need information that you have been unable to provide, or to verify information we have received. If we do contact other persons, such as a neighbor, bank, employer, or employees, we will generally need to tell them limited information, such as your name. The law prohibits us from disclosing any more information than is necessary to obtain or verify the information we are seeking. Our need to contact other persons may continue as long as there is activity in your case. If we do contact other persons, you have a right to request a list of those contacted. Your request can be made by telephone, in writing, or during a personal interview.*

The IRS argued that, since the taxpayer had been given that notice at the start of the exam, that served as the required reasonable notice in advance of any contact with a third party in an exam.

In this case the taxpayers were the unlucky "winners" in the National Research Program (NRP) audit, the exam where the IRS meticulously goes through the taxpayer's documents in order to help the agency determine tax compliance in general and design more effective targeted programs. Such exams are very time consuming and stressful for the taxpayers involved.

In this case the taxpayers had asked the IRS to excuse them from the NRP audit program due to the taxpayer's age and health. The IRS denied the request and the taxpayers filed suit to stop the audit in US District Court.

Although the suit continued, the IRS wanted to move forward with the audit. The taxpayer in this case was an attorney who accepted assignments to represent indigent defendants from the California Supreme Court in capital cases. Since the taxpayers were fighting the exam, the IRS decided to attempt to obtain information from the California Supreme Court for "billing statements, invoices or other documents" that lead to payment to the taxpayer. The IRS took this step without giving notice to the taxpayers that they were going to seek information from the party that was controlling the cases the taxpayer was assigned, information that could contain significant information regarding the individuals the taxpayer had represented.

The taxpayers eventually discovered the IRS was pursuing this information when their daughter, who was listed as their personal representative, received a notice of service of summons in the mail. The taxpayers challenged the summons in District Court. The District Court found that the IRS had failed to provide sufficient advance notice of the request, specifically rejecting the IRS's contention that the statement in Publication 1 they had issued to the taxpayers two years earlier served as sufficient notice for requests for third parties throughout the exam. The District Court granted the taxpayer's request to quash the summons and the IRS appealed that decision to the Ninth Circuit Court of Appeals.

The Appeals Court noted that the advance notice rule helps protect a taxpayer's reputation when the IRS goes too far afield in its request. While the taxpayer is allowed, under §7609, to attempt to quash a summons once it is issued, the mere issuance of a summons to a third party can damage the taxpayer's reputation. To prevent the contact with third parties, the taxpayer could decide to voluntarily provide the information, avoiding the negative inference a party (such as an employer) might draw when it appears the party in question is "in trouble" with the IRS.

The panel noted that §7602 provides three exceptions which, in the view of the Court, provided evidence the intent was to allow the taxpayer to provide information in most cases prior to the IRS seeking information from third parties. Those exceptions under §7602(c)(3) allow the IRS to skip giving advance notice if:

- The taxpayer had already authorized the contact;
- The IRS believes, with good cause, that the notice might jeopardize the IRS's ability to collect the tax due or risk a reprisal against a third party; or
- There is a pending criminal investigation against the taxpayer.

None of those situations applied in this case and so, the Court concluded, the notice to the taxpayer should have been sufficient to allow the taxpayer a chance to provide the information before the third party was contacted.

The panel ruled that the notice in Publication 1 was not sufficient to meet that obligation. As the panel noted:

> *Publication 1, alone, does not offer this level of specificity. It simply tells the taxpayer that the IRS may "sometimes talk with other persons if we need information that you have been unable to provide . . ."; it does not reference specific documents or people, or even categories of documents or people. When the IRS uses Publication 1 as it was used here, mailed with an introductory letter and divorced from any specific request for documents, we do not think it reasonable for the IRS to fear that a person who received the publication would have enough information to spoil a criminal investigation or retaliate against a potential third-party source.*

The Court also found that their reading requiring the taxpayer to get notice in a fashion that would reasonably apprise the taxpayer of the contact had support in the legislative history of IRC §7602, noting:

> *The notice requirement's proponents were the members of the Senate Finance Committee, which adopted an amendment that prohibited the IRS from contacting "any person other than the taxpayer" unless the IRS provided "reasonable notice to the taxpayer that such contact will be made." H.R. 2676, 105th Cong. § 3417 (as passed by Senate May 7, 1998). The Committee recognized that taxpayer protections needed to be robust because "[s]uch contacts may have a chilling effect on the taxpayer's business and could damage the taxpayer's reputation in the community." S. Rep. No. 105-174, at 77 (1998), reprinted in 1998-3 C.B. 537, 613 (1998)*

Ultimately, the panel concludes:

> *A reasonable notice must provide the taxpayer with a meaningful opportunity to volunteer records on his own, so that third-party contacts may be avoided if the taxpayer complies with the IRS's demand.*