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PROVING A NEGATIVE—WHEN THE TAXPAYER DENIES RECEIPT

INTRODUCTION

The Tax Court attaches a presumption of correctness to the Commissioner's tax assessment in an Internal Revenue Service (IRS) deficiency notice.¹ The taxpayer has the burden of proving the notice erroneous.² When the IRS bases the assessment on the disallowance of deductions, placing the burden of proof on the taxpayer is reasonable because the taxpayer has better access to evidence of the underlying transactions. It is also appropriate to assign the taxpayer the burden of proof when a deficiency notice asserts undeclared income and the taxpayer contests the inclusion. In such a case, the taxpayer can rely upon his or her records to show that money received was a gift, that the IRS incorrectly calculated the amount realized on the sale of an asset, or any other reason why the disputed amount should not be included in income.

Different questions arise, however, when the taxpayer denies receipt of the money or benefit. Unlike a case where the taxpayer can prevail by proving a positive, for example, that the amount received was a gift or was part of the asset's basis, the taxpayer denying receipt must prove a negative—nonreceipt. On occasion, courts have acknowledged the inequity that results from requiring the taxpayer to produce evidence of a nonevent by reviewing the IRS determination for arbitrariness.³

This Note first reviews the normal burden of proof and presumption of correctness in litigation between the IRS and taxpayers in Tax Court.⁴ It then examines the ways in which courts allow an allegation or showing of IRS arbitrariness to alter the normal operation of the burden of proof and presumption of correctness in cases of undeclared income.⁵ The Note contends that courts inadequately distinguish between the issues involved in denial of receipt cases and those involved in other issues related to undeclared income. Consequently, the case law reveals a confusing array of standards as to what constitutes arbitrariness and how it must be shown.

The Note concludes that the present system of reviewing denial of receipt cases to determine whether the IRS notice is arbitrary fails to

¹ See *infra* notes 16-22 and accompanying text.

² See *infra* note 9.

³ See *infra* text accompanying note 36.

⁴ See *infra* text accompanying notes 9-28.

⁵ See *infra* Parts III-V.

redress the inequity of forcing the taxpayer to prove a negative.⁶ Analogizing from the procedure for contesting an accumulated earnings tax,⁷ the Note proposes the establishment of a procedure that requires the IRS to prove receipt if the taxpayer files a sworn statement of denial with supporting facts.⁸

I

BURDENS OF PROOF AND PRESUMPTION OF CORRECTNESS IN TAX COURT

In Tax Court the taxpayer normally bears both the initial burden of production and the ultimate burden of persuasion.⁹ The federal courts of appeals¹⁰ concur with this allocation of the burdens of production and persuasion when the taxpayer is challenging a deficiency notice based on disallowance of a deduction.¹¹ To prevail, the taxpayer must prove that the IRS determination is wrong, and must prove the correct amount of the deduction.¹² When the deficiency is assessed on undeclared income, most courts maintain the burden of persuasion on the taxpayer to prove the determination erroneous,¹³ but do not uniformly

⁶ See *infra* text accompanying notes 83-86.

⁷ See *infra* notes 97-98 and accompanying text.

⁸ See *infra* notes 81-99 and accompanying text.

⁹ "The burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in his answer, it shall be upon the respondent." TAX CT. R. 142(a).

The term "burden of proof" encompasses two different concepts: the burden of persuasion and the burden of production. If, at the close of all the evidence, the trier of fact determines that both sides have presented evidence of equal weight, the party with the burden of persuasion loses. The burden of production, on the other hand, is the burden of coming forward with evidence. The burden of production shifts when a party meets and successfully rebuts the evidence previously submitted by its opponent; the burden of persuasion rarely shifts. See H. DUBROFF, *THE UNITED STATES TAX COURT: AN HISTORICAL ANALYSIS* 320 (1979); Piper & Jerge, *Shifting the Burden of Proof in Tax Court*, 31 TAX LAW. 303, 304 (1978) (discussing distinction between two burdens in context of Tax Court). The tendency of courts to refer, at times, to burden of proof without specification contributes to confusion in the area and increases the difficulty of analysis.

¹⁰ The Tax Court will follow a court of appeals decision "which is squarely in point where appeal from [the Tax Court's] decision lies to that Court of Appeals and to that court alone." *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970) (footnote omitted), *aff'd*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971).

¹¹ *E.g.*, *Rockwell v. Commissioner*, 512 F.2d 882, 886 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975) ("[T]here is no dispute that the taxpayer bears the burden of proof in substantiating claimed deductions.").

¹² See *Burnet v. Houston*, 283 U.S. 223, 227 (1931) ("The burden of proof to establish a deductible loss and the amount of it, clearly, was upon the [taxpayer]."). *But cf. Welch v. Commissioner*, 297 F.2d 309, 311 (4th Cir. 1961) (Tax Court "not justified in basing its decision upon the failure of the taxpayer to show the precise amount of the deductions").

¹³ *Llorente v. Commissioner*, 74 T.C. 260, 277 (1980) (Tannenwald, J., concurring) (no distinction in burden of proof should be made between cases of deductions and unreported income), *aff'd in part and rev'd in part*, 649 F.2d 152 (2d Cir. 1981); *United States v. Rexach*, 482

require the taxpayer to prove the correct amount.¹⁴ In some circuits, however, once the taxpayer produces enough evidence to show that the determination could be erroneous, the burden of persuasion is on the Commissioner to establish the existence and amount of the deficiency.¹⁵

The Supreme Court first referred to the presumption of correctness of an IRS deficiency notice in *Welch v. Helvering*.¹⁶ The Court noted that the Commissioner's ruling has "the support of a presumption of correctness," while the "[taxpayer] has the burden of proving it to be wrong."¹⁷ The concept of presumptive correctness stated in *Welch* was not new to tax proceedings;¹⁸ it followed a long-recognized principle that the government's administrative actions are presumed correct.¹⁹

Courts and commentators attribute several functions to the pre-

F.2d 10, 17 (1st Cir.) ("burdens of going forward and of ultimate persuasion are always on the taxpayer"), *cert. denied*, 414 U.S. 1039 (1973).

¹⁴ *E.g.*, *Carson v. United States*, 560 F.2d 693, 696 (5th Cir. 1977) ("In a Tax Court deficiency proceeding, once the taxpayer has established that the assessment is erroneous, the burden shifts to the government to prove the correct amount of any taxes owed."); *Clark v. Commissioner*, 266 F.2d 698, 706 (9th Cir. 1959) (taxpayer need not prove actual amount of deficiency).

¹⁵ In these minority decisions, the Commissioner's production burden is satisfied by the presumption of correctness. If the taxpayer overcomes the presumption and meets his or her production burden, the burden of persuasion remains on the Commissioner to prove the existence and amount of deficiency. In *Sharwell v. Commissioner*, 419 F.2d 1057, 1060 (6th Cir. 1969), for example, the Court of Appeals for the Sixth Circuit held that the taxpayer has the burden of proving the incorrectness of a deficiency determination. This burden is procedural and is met if the taxpayer produces evidence from which it could be found that he or she did not receive the income. If met, "the burden of proof shifts back to the Commissioner to prove the existence and amount of the deficiency." *Id.* (quoting *Foster v. Commissioner*, 391 F.2d 727, 735 (4th Cir. 1968)). *See also* *Stout v. Commissioner*, 273 F.2d 345 (4th Cir. 1959). *But see* *United States v. Rexach*, 482 F.2d 10, 16 n.3 (1st Cir.) (suggesting that *Foster* is not inconsistent with prevailing view), *cert. denied*, 414 U.S. 1039 (1973).

The Ninth Circuit has vacillated on the question of who has the burden of persuasion in a case of undeclared income. *Compare* *Rockwell v. Commissioner*, 512 F.2d 882, 885-86 (9th Cir. 1975) (it "might make sense" to shift burden of persuasion when taxpayer meets burden of production in cases of undeclared income but no need to decide this issue because dispute involved deduction) *and* *Herbert v. Commissioner*, 377 F.2d 65, 71 (9th Cir. 1967) (general rule is that burden of proof is on Commissioner to establish "receipt of income") *with* *Clark v. Commissioner*, 266 F.2d 698, 709 (9th Cir. 1959) (taxpayers "failed to sustain their burden of proof that . . . [they] had not received the benefit arising from these unreported sales").

¹⁶ 290 U.S. 111 (1933).

¹⁷ *Id.* at 115 (dicta). In making this statement, the Court relied in part on its holding in *Wickwire v. Reinecke*, 275 U.S. 101 (1927), that "the decision of the Commissioner of Internal Revenue was not conclusive, but only furnished *prima facie* evidence of its correctness." 290 U.S. at 105. The lower courts in *Wickwire* had held that the Commissioner's finding could not be reviewed "unless impeached for fraud, bad faith, or mistaken legal theory." *Id.* at 103.

¹⁸ *See, e.g.*, *Avery v. Commissioner*, 22 F.2d 6, 8 (5th Cir. 1927) (well-settled rule that Commissioner's findings are *prima facie* correct).

¹⁹ H. DUBROFF, *supra* note 9, at 324. *But see* *Rice, Tax, Fact and Fiction: Presumptions in Tax Cases*, 1 S.D.L. REV. 56, 59-60 (1956) (arguing that this concept is insupportable when applied to IRS because of its prosecutive capacity).

The Revenue Act of 1924, ch. 234, § 900, 43 Stat. 253, which created the Board of Tax Appeals (predecessor to the Tax Court), allowed the Board to develop its own procedures and

sumption of correctness. First, and most commonly, courts contend that the presumption sets the threshold level of the taxpayer's initial production burden.²⁰ To overcome the presumption, the taxpayer must produce enough evidence to show that the determination could be erroneous. Second, the presumption fulfills the symbolic function of emphasizing that the taxpayer has the burden of persuasion.²¹ A third, more substantive purpose of the presumption is to increase the quantity and quality of the evidence needed to prevail, thereby assuring that the taxpayer produces all the evidence in his or her possession.²²

Judicial opinions vary regarding the effect that overcoming the presumption of correctness has on the allocation of the burdens of proof.²³ The prevailing view is that when the taxpayer presents sufficient evidence to show that the determination could be erroneous, the presumption vanishes and the burden of production shifts to the Commissioner.²⁴ The ultimate burden of persuasion, however, remains on the taxpayer.²⁵ Hence, even if the taxpayer overcomes the presumption by showing that the determination could be erroneous, the Commissioner can still prevail without producing any evidence if the court remains unpersuaded by the taxpayer's case.²⁶

Decisions of the Tax Court occasionally appear to depart from this approach by finding for the taxpayer because the IRS failed to produce evidence after the presumption was overcome.²⁷ A more accurate expla-

rules of evidence. In general, the Board adopted the forms of procedure from federal court tax proceedings. See H. DUBROFF, *supra* note 9, at 151.

²⁰ *E.g.*, *Rockwell v. Commissioner*, 512 F.2d 882, 885 (9th Cir. 1975) (presumption is "procedural device" requiring taxpayer to come forward with evidence).

²¹ *Llorente v. Commissioner*, 74 T.C. 260, 276 (1980) (Tannenwald, J., concurring) ("only function of [presumption of correctness] is to make clear . . . that the burden of proof is and remains upon the taxpayer"), *aff'd in part and rev'd in part*, 649 F.2d 152 (2d Cir. 1981).

²² See Note, *Federal Income Taxation—Deficiency Assessments in Unreported Income Cases*, 59 GEO. WASH. L. REV. 641, 644 & n.17 (1981).

There is no presumption that the IRS is correct on questions of law. 9 J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* § 50.64 (J. Doheny rev. ed. 1982).

²³ The Supreme Court has acknowledged the confusion among the circuit courts as to whether rebutting the presumption of correctness shifts the burden of persuasion to the Commissioner, but has declined to decide the issue. *United States v. Janis*, 428 U.S. 433, 442 (1976).

²⁴ See, *e.g.*, *Potts, Davis & Co. v. Commissioner*, 431 F.2d 1222, 1225 (9th Cir. 1970). But see *United States v. Rexach*, 482 F.2d 10, 17 (1st Cir.) ("burdens of going forward and of ultimate persuasion . . . never shift to the Commissioner"), *cert. denied*, 414 U.S. 1039 (1973).

²⁵ See 2A L. CASEY, *FEDERAL TAX PRACTICE* § 8.6 (1981); Dubroff & Grossman, *The United States Tax Court: An Historical Analysis*, 42 ALBANY L. REV. 191, 205 (1978).

²⁶ H. DUBROFF, *supra* note 9, at 323; *accord* *Demkowicz v. Commissioner*, 551 F.2d 929, 931 & n.6 (3d Cir. 1977).

²⁷ *E.g.*, *Schildhaus v. Commissioner*, 28 T.C.M. (CCH) 1463, 1470 (1969) ("[Taxpayer's] evidence was sufficient to overcome the presumption of correctness . . . and, since [Commissioner] did not go forward with any evidence . . . , these items should not be included in . . . gross income . . ."), *aff'd*, 442 F.2d 1343 (2d Cir. 1971). *Accord* *Herbert v. Commissioner*, 377 F.2d 65, 70 (9th Cir. 1967) (once taxpayer rebuts presumption of correctness, burden of proving taxpayer received income is on Commissioner).

nation of these cases, however, is that the taxpayer not only overcame the presumption of correctness, but met the persuasion burden as well.²⁸ When the taxpayer's evidence is this substantial, the Commissioner cannot prevail without producing further evidence.

II

DISTINGUISHING RECEIPT FROM OTHER ISSUES OF UNDECLARED INCOME

Although courts acknowledge differences in burdens of proof between deficiencies assessed on undeclared income and deficiencies based on disallowed deductions,²⁹ few undeclared income decisions clearly distinguish between issues relating to a taxpayer's denial of receipt of money or other benefits and issues relating to a taxpayer's contention that money or benefits admittedly received are not includible in income. Questions of includibility in income focus on whether money received was a gift, on the amount realized as income on a sale, the valuation of an asset, or the timing of recognition of gain as income. These cases are analogous to those involving deductions in that the taxpayer generally has the best access to evidence of the nature of the transaction.³⁰ Placing the burden of persuasion on the taxpayer in these cases is, therefore, reasonable.

The substantive tax issues involved in determining whether certain transactions result in recognizable income to the taxpayer differ significantly from the issues attendant to taxpayer denial of receipt cases. In these cases the taxpayer confronts the difficult task of proving a negative—that is, of proving nonreceipt. The Tax Court has attempted in some cases to ease the taxpayer's burden by denying the IRS the benefit of relying solely on the presumption of correctness without direct evidence if the taxpayer alleges that the deficiency notice is arbitrary.³¹

²⁸ Casey resolves this discrepancy by saying that, after the presumption is overcome, the production burden does not shift until the taxpayer produces sufficient evidence to establish a prima facie case. The Commissioner would then lose for failure to submit further evidence. 2A L. CASEY, *supra* note 25, § 8.6; accord H. DUBROFF, *supra* note 9, at 321-33.

²⁹ See *supra* notes 11-14 and accompanying text.

³⁰ See Rice, *supra* note 19, at 62.

³¹ See *infra* note 36 and accompanying text.

The Tax Court may also relax the standard for making out a prima facie case to shift the burden of production to the Commissioner when the taxpayer has the burden of persuasion to establish nonreceipt. *E.g.*, Llorente v. Commissioner, 74 T.C. 260, 277 (1980) (Tannenwald, J., concurring), *aff'd in part and rev'd in part*, 649 F.2d 152 (2d Cir. 1981); Schildhaus v. Commissioner, 28 T.C.M. (CCH) 1463, 1469, *aff'd*, 442 F.2d 1343 (2d Cir. 1971); see 9 J. MERTENS, *supra* note 22, § 50.61.

III ARBITRARINESS IN THE CONTEXT OF UNDECLARED INCOME

An allegation of arbitrariness is a request for the court to "look behind the statutory notice" to examine the procedures or motives of the IRS.³² The Tax Court generally refuses to determine whether a deficiency notice is arbitrary.³³ The principal rationale for this rule is that, because a Tax Court proceeding is a *de novo* trial, the Tax Court evaluates the tax assessment based on the evidence submitted without concern for possible IRS improprieties committed earlier in the process.³⁴ Recently, however, the Tax Court has developed an exception to this general rule.³⁵ In cases involving undeclared income, it will now consider a taxpayer's allegation of arbitrariness if the Commissioner relies solely on the presumption of correctness and does not submit any direct evidence.³⁶ No clear standard has emerged, however, for defining arbitrariness in the context of these undeclared income cases.

In *Helvering v. Taylor*,³⁷ the Supreme Court first recognized that government arbitrariness in a case of alleged undeclared income alters the allocation of burdens. In *Taylor* the court of appeals found that the Commissioner's apportionment of the purchase price as basis between preferred and common stock was unfair and erroneous, rendering the tax determination excessive. For this reason, the appellate court reversed the Board of Tax Appeals' decision sustaining the Commissioner's ruling. Arguing before the Supreme Court, the Commissioner contended that the burden was on the taxpayer to prove the correct amount. Because he had not done so, the Board's determination of the amount owed was valid. Thus, the sole issue for decision was whether

³² *Llorente v. Commissioner*, 74 T.C. 260, 264 (1980), *aff'd in part and rev'd in part*, 659 F.2d 152 (2d Cir. 1981).

³³ *See id.*; *Jackson v. Commissioner*, 73 T.C. 394, 400 (1979); *Greenberg's Express, Inc. v. Commissioner*, 62 T.C. 324, 327 (1974).

³⁴ *See, e.g.*, *Greenberg's Express, Inc. v. Commissioner*, 62 T.C. 324, 329 (1974) (discriminatory audit procedures would not invalidate assessment); *Suarez v. Commissioner*, 58 T.C. 792, 813 (1972) (no rule requiring Tax Court to ascertain whether IRS relied on improper evidence). *See generally* 9 J. MERTENS, *supra* note 22, § 50.59 (general rule because *de novo* trial) & § 50.61 (determination need not be based on admissible evidence).

The rationale that a *de novo* trial makes it unnecessary to determine if the notice is arbitrary is inadequate because the presumption of correctness afforded the deficiency notice plays such a key role in that trial.

³⁵ Under certain circumstances, the Tax Court will also "look behind" the deficiency notice when the taxpayer's constitutional rights are violated. *Guzzetta v. Commissioner*, 78 T.C. 173, 180-84 (1982). In *Suarez v. Commissioner*, 58 T.C. 792 (1972), the Tax Court developed a broad exception for constitutional violations which was limited in *Guzzetta* as a result of the intervening *Janis* decision. *See infra* text accompanying notes 41-44.

³⁶ *Llorente v. Commissioner*, 74 T.C. 260, 264 (1980), *aff'd in part and rev'd in part*, 649 F.2d 152 (2d Cir. 1981); *Jackson v. Commissioner*, 73 T.C. 394, 410 (1979); *see* 9 J. MERTENS, *supra* note 22, § 50.61.

³⁷ 293 U.S. 507 (1935).

the taxpayer had the burden of establishing the correct amount of tax owed after a finding that the assessed deficiency was arbitrary.³⁸

The Court held that the taxpayer did not have to establish the amount owed: "We find nothing . . . that gives any support to the idea that the commissioner's determination, shown to be without rational foundation and excessive, will be enforced unless the taxpayer proves he owes nothing or . . . shows the correct amount."³⁹ The *Taylor* opinion did not, however, address any substantive aspects of defining arbitrariness nor any procedural aspects of alleging or showing arbitrariness. As a result, the Court's statement that "[u]nquestionably the burden of proof is on the taxpayer to show that the commissioner's determination is invalid,"⁴⁰ must be considered dicta.

The Supreme Court first discussed the substance of arbitrariness in the context of tax assessment in *United States v. Janis*.⁴¹ Janis was arrested for bookmaking activity, and subsequently the IRS assessed wagering taxes against him. The IRS reached its assessment by extrapolating from betting records seized in a police raid. When the search warrant relied on in the raid was later quashed, Janis sought to suppress the IRS's use of the illegally seized evidence in the tax assessment proceedings.⁴² The Court noted that, because Janis submitted no evidence, under the normal presumption he could not prevail. "But the present case may well not be the usual situation. What we have is a 'naked' assessment without *any* foundation" if the illegal evidence is not admitted.⁴³ The Court concluded that if the district court had correctly excluded the evidence, it was correct in ruling for Janis: "[P]roof that an assessment is utterly without foundation is proof that it is arbitrary and erroneous."⁴⁴ The *Janis* Court, however, admitted the evidence, and so the references to arbitrary assessment are dicta.

Judicial opinions differ on the procedural aspects of alleging arbitrariness—whether the taxpayer must show that the IRS determination

³⁸ *Id.* at 511-12.

³⁹ *Id.* at 514.

⁴⁰ *Id.* at 515. Judge Fay characterized the *Taylor* holding as follows: "[I]f the taxpayer has shown the notice of deficiency to be arbitrary and excessive, then the respondent must show the correct amount . . ." Llorente v. Commissioner, 74 T.C. 260, 271 (1980) (Fay, J., concurring) (emphasis in original), *aff'd in part and rev'd in part*, 649 F.2d 152 (2d Cir. 1981). Accord Piper & Jerge, *supra* note 9, at 318; Sampanis, *A View of the Evidentiary Prerequisites for the Presumption of Correctness in Tax Deficiency Cases*, 8 REV. TAX'N INDIVIDUALS 49, 53 (1984); Note, *supra* note 22, at 648.

A more narrow reading of the *Taylor* holding, however, is that, assuming a deficiency notice is arbitrary and excessive, the taxpayer does not have to prove the correct amount owed. The Court's statement that the burden of persuasion is on the taxpayer to prove the determination invalid is dictum.

⁴¹ 428 U.S. 433 (1976).

⁴² *Id.* at 436-38.

⁴³ *Id.* at 441 (emphasis in original).

⁴⁴ *Id.* at 442.

is arbitrary or whether the burden is on the Commissioner to show that it is not.⁴⁵ The *Taylor* dicta places the burden on the taxpayer to show that the deficiency determination is invalid;⁴⁶ the *Janis* dicta indicates that a tax assessment may be found arbitrary without the taxpayer submitting any evidence.⁴⁷ This apparent discrepancy is attributable to the different factual circumstances of *Taylor* and *Janis*.

In *Taylor* the taxpayer was not denying receipt of funds, but was disputing the amount realized as income on the sale of stock; the issue was the apportionment of a purchase price between preferred and common stock.⁴⁸ The critical evidence stemmed from the taxpayer's acknowledged transactions. No policy reason exists in such cases to refrain from placing the burden of proof on the taxpayer "to show that the commissioner's determination is invalid."⁴⁹

In contrast, the issue in *Janis* was proof of receipt. The IRS based its deficiency notice on alleged wagering; the critical evidence was the illegally seized records.⁵⁰ This fundamental difference in factual context justifies the different procedural approaches propounded in the two cases.

IV

ARBITRARINESS WHEN THE TAXPAYER DENIES RECEIPT

Recognizing the inequity of requiring the taxpayer to prove a negative, courts have struggled to define a precise standard for assessing an allegation of IRS arbitrariness in denial of receipt cases. Because these cases often involve alleged illegal activity by the taxpayer, the standard for admissibility of evidence that the IRS can use to show that a deficiency notice is not arbitrary may be as significant as the standard used to define arbitrariness.⁵¹

*Weimerskirch v. Commissioner*⁵² involved a contested deficiency assessed on alleged undeclared income from illegal heroin sales. At the

⁴⁵ Compare *United Aniline Co. v. Commissioner*, 316 F.2d 701, 704 (1st Cir. 1963) (taxpayer never loses burden of proving Commissioner's determination erroneous) and *Llorente v. Commissioner*, 74 T.C. 260, 271 (1980) (Fay, J., concurring) (*Taylor* holding requires taxpayer to show notice is arbitrary), *aff'd in part and rev'd in part*, 649 F.2d 152 (2d Cir. 1981) with *Gerardo v. Commissioner*, 552 F.2d 549, 554 (3d Cir. 1977) (Commissioner must provide "some predicate evidence" connecting taxpayer with money-making activity in order to support presumption of correctness) and *Carson v. United States*, 560 F.2d 693, 698 (5th Cir. 1977) (some evidence that taxpayer was engaged in money-making activity is necessary predicate for presumption of correctness).

⁴⁶ See *supra* text accompanying note 40.

⁴⁷ See *supra* text accompanying notes 43-44.

⁴⁸ *Taylor*, 293 U.S. at 511.

⁴⁹ *Id.* at 515.

⁵⁰ *Janis*, 428 U.S. at 436-37.

⁵¹ See *infra* notes 71-76 and accompanying text.

⁵² 596 F.2d 358 (9th Cir. 1979).

trial below, Weimerskirch presented four witnesses and his tax return; the IRS produced no evidence. After in camera inspection of IRS files and informers' reports, to which Weimerskirch was denied access, the Tax Court determined that the IRS was not arbitrary and held that Weimerskirch failed to overcome the presumption of correctness.⁵³

The Ninth Circuit reversed, holding that "[a] deficiency determination which is not supported by the proper foundation of substantive evidence is clearly arbitrary and erroneous."⁵⁴ The court stated in dicta that the Commissioner "cannot rely on the presumption in the absence of a minimal evidentiary foundation" even when the taxpayer is silent and offers no evidence.⁵⁵

In *Gerardo v. Commissioner*,⁵⁶ the Third Circuit required that, "in order to give effect to the presumption [of correctness] . . . , some evidence must appear which would support an inference of the taxpayer's involvement in gambling activity during the period covered by the assessment."⁵⁷ Gerardo had been convicted of conspiracy to operate a lottery for the period August 1966 to February 1967; the IRS subsequently estimated gambling income from April 1966 through February 1967 and assessed a deficiency.⁵⁸ Although the Tax Court, relying on the presumption of correctness, upheld the entire assessment, the Third Circuit reversed in part and eliminated the receipts attributed to April through August 1966, for which there was no evidence.⁵⁹

In *Llorente v. Commissioner*,⁶⁰ the Second Circuit applied a standard similar to that adopted by the Ninth Circuit.⁶¹ The *Llorente* court held that proof of involvement with an activity is insufficient to show that the IRS was not arbitrary; "the evidence of record must at least link the taxpayer with some tax-generating acts"⁶² The Second Circuit rejected the Tax Court's application of a standard similar to the Third

⁵³ 67 T.C. 672, 678 (1977), *rev'd*, 596 F.2d 358 (9th Cir. 1979).

⁵⁴ 596 F.2d at 362 (footnote omitted).

⁵⁵ *Id.* at 361 (dicta). The Tax Court has criticized this approach, "find[ing] practical difficulty in applying such a broadly stated rule." *Jackson v. Commissioner*, 73 T.C. 394, 404 (1979).

The Ninth Circuit has recently restated its *Weimerskirch* rule as follows: "[N]o presumption of correctness attaches to deficiency determinations in which the IRS charges a taxpayer with additional income but provides no factual showing that the taxpayer actually received the income in question." *United States v. Zolla*, 724 F.2d 808, 809 (9th Cir. 1984) (dicta).

⁵⁶ 552 F.2d 549 (3d Cir. 1977).

⁵⁷ *Id.* at 554. This Third Circuit standard, requiring "some evidence . . . which would support an inference of the taxpayer's involvement," is weaker than the Ninth Circuit standard, requiring a factual showing of actual receipt. *See supra* note 55.

⁵⁸ 552 F.2d at 551-52.

⁵⁹ *Id.* at 554.

⁶⁰ 649 F.2d 152 (2d Cir. 1981).

⁶¹ *See supra* note 55.

⁶² 649 F.2d at 156. *But cf.* *Sampanis*, *supra* note 40, at 67 (criticizing the Second Circuit for not taking the opportunity presented in *Llorente* to formulate clearer guidelines).

Circuit's formulation in *Gerardo*.⁶³ The Tax Court had held in *Llorente* that the deficiency notice was not arbitrary because there were sufficient facts showing that the taxpayer had engaged in the activity.⁶⁴ Hearsay evidence based on information from an informant linked Llorente to a cocaine purchase,⁶⁵ and an undercover agent testified to hearing Llorente refer to a drug shipment. In addition, Llorente had been indicted and subsequently pled guilty to charges of conspiring to possess and sell a controlled substance. Although this evidence established "peripheral contact with illegal conduct," the Second Circuit nevertheless held that it was insufficient to link the taxpayer to tax-generating acts.⁶⁶

The Tax Court itself refused to uphold the presumption of correctness in *Jackson v. Commissioner*.⁶⁷ In denying the receipt of money from drug sales, Jackson offered only his own "self-serving denials" in evidence.⁶⁸ Although such denials are ordinarily insufficient to overcome the presumption, the Tax Court, deeming this to be one of the "rare occasions" requiring an exception,⁶⁹ found the determination to be arbitrary and excessive on the basis of the highly suspect information submitted by the IRS: the agent who prepared the deficiency notice against Jackson had relied on information from an informant who had been arrested and was cooperating to get a lighter sentence. The informant later fled; after rearrest, he refused to cooperate and was convicted.⁷⁰

The preceding examples demonstrate that the different standards for determining arbitrariness reflect judicial disagreement regarding the type of evidence which may be used to meet that standard.⁷¹ The Tax

⁶³ See *supra* note 57 and accompanying text.

⁶⁴ *Llorente v. Commissioner*, 74 T.C. 260, 266 (1980), *aff'd in part and rev'd in part*, 649 F.2d 152 (2d Cir. 1981). A dissenting opinion argued that the majority missed the point, that "the primary question to be answered is not whether petitioner was associated with the drug business but whether respondent was reasonable in his assertion that petitioner had \$54,000 of unreported income from that source." 74 T.C. at 281 (Drennen, J., dissenting).

⁶⁵ The IRS reconstructed Llorente's income by the expenditure method. See *infra* note 89. The IRS documented living costs and the purchase of a tavern and asserted a sizeable expenditure for cocaine. The Second Circuit held that the IRS failed to establish that Llorente had purchased the drugs.

⁶⁶ *Llorente v. Commissioner*, 649 F.2d at 156-57.

⁶⁷ 73 T.C. 394, 401-03 (1979).

⁶⁸ *Id.* at 399.

⁶⁹ *Id.* at 401.

⁷⁰ The agent believed the information against Jackson was credible. The Tax Court disagreed, finding that "the elaborate construct set out in the deficiency notice, based solely as it was on a secondhand report of peripheral statements made by an unreliable informant, turns out to be sheer gossamer." *Id.* at 403.

In *Jackson*, the Tax Court did not decide what would have happened if the IRS had submitted no evidence. This question was addressed in *Llorente dicta* in which the court indicated that the Commissioner cannot rely solely on the presumption of correctness. See *supra* text accompanying notes 31 & 35-36.

⁷¹ See, e.g., *Llorente v. Commissioner*, 74 T.C. 260, 266 n.4 (1980), *aff'd in part and rev'd in*

Court permits the IRS to submit inadmissible evidence for the limited purpose of showing that a deficiency notice is not arbitrary.⁷² One judge has criticized this practice because it allows the court to “[bootstrap] the evidence which it claims is admissible to show that the notice of deficiency was not arbitrary in order to establish a presumption based on evidence which would not be admissible to prove the deficiency.”⁷³ The Ninth Circuit requires a foundation of “substantive evidence”⁷⁴ to support a deficiency determination, while in *Llorente* the Second Circuit rejected the use of hearsay to support the rational basis of a deficiency notice because such evidence was inadmissible to establish the truth of the facts asserted.⁷⁵ When courts do rely on hearsay evidence of receipt to determine whether an allegation is arbitrary, it is difficult and often impossible for the taxpayer to overcome the presumed correctness of the IRS deficiency assessment.⁷⁶

V

EFFECT OF SHOWING ARBITRARINESS ON BURDENS OF PROOF AND PRESUMPTION OF CORRECTNESS

The Supreme Court, in *Taylor*, held that an arbitrary deficiency determination is unenforceable and the taxpayer has no burden to prove the correct amount.⁷⁷ The Court, in dicta, said, “The fact that the commissioner’s determination of a deficiency was arbitrarily made may reasonably be deemed sufficient to require the board [of tax appeals] to set it aside.”⁷⁸ The Tax Court, instead of regarding an arbitrary determination as invalid, simply shifts the production burden to the Commissioner; a showing of arbitrariness does not render the IRS deficiency

part, 649 F.2d 152 (2d Cir. 1981). Indeed, there is some intra-Circuit disagreement as well. See *infra* note 74.

⁷² *E.g.*, *Llorente*, 74 T.C. at 265 & n.3; *Jackson v. Commissioner*, 73 T.C. 394, 400 (1979). The Tax Court rules provide that trials “be conducted in accordance with the rules of evidence applicable in trials without a jury in the United States District Court for the District of Columbia.” TAX CT. R. 143(a).

⁷³ *Llorente*, 74 T.C. at 282 (Drennen, J., dissenting). See also Note, *supra* note 22, at 655-56 (arguing that Tax Court’s approach of requiring evidence linking taxpayer to activity provides loophole for devious taxpayer, while affording little protection to innocent taxpayer because standard applied is so lax).

⁷⁴ *Weimerskirch v. Commissioner*, 596 F.2d 358, 362 (9th Cir. 1979). *But see Avery v. Commissioner*, 574 F.2d 467, 468 (9th Cir. 1978) (hearsay evidence admissible for limited purpose of showing IRS did not act arbitrarily in assessing deficiency). The *Weimerskirch* court attempts to distinguish *Avery*, but skirts the issue as to the admissibility of hearsay evidence. *Weimerskirch*, 596 F.2d at 362 n.7.

⁷⁵ *Llorente v. Commissioner*, 649 F.2d 152, 157 (2d Cir. 1981).

⁷⁶ Note, *supra* note 22, at 656-57 (court implicitly decides hearsay testimony is trustworthy when it bases its decision that a determination is not arbitrary on such evidence); see *supra* text accompanying note 73.

⁷⁷ *Helvering v. Taylor*, 293 U.S. 507, 514 (1935).

⁷⁸ *Id.* (dicta) (citations omitted).

notice null and void.⁷⁹ This result is the same as when the taxpayer shows that the determination is erroneous: the presumption of correctness vanishes, shifting the burden of production to the Commissioner, but leaving the burden of persuasion on the taxpayer.⁸⁰

VI PROPOSAL

When the IRS assesses a deficiency item based on undeclared income, the contesting taxpayer has three options—deny receipt, deny that the benefits received are includible in income, or dispute the amount of income. This Note proposes a procedure for altering the normal burdens of proof when the taxpayer denies receipt.⁸¹

The rationale for placing the burden of persuasion on the taxpayer in Tax Court proceedings is the assumption that the taxpayer has the best knowledge of, or best access to, evidence of the underlying transactions. This burden is reasonable when the taxpayer is called on to prove an affirmative, such as sustaining a deduction or showing the character or amount of income. Different policy questions arise when the taxpayer must prove a negative—nonreceipt. This proposal is intended to assure that the IRS develops and presents a *prima facie* case before the taxpayer needs to assume the difficult task of substantiating

⁷⁹ *E.g.*, *Suarez v. Commissioner*, 58 T.C. 792, 814 (1972); *see also, e.g.*, *Llorente v. Commissioner*, 74 T.C. 260, 264 (1980) (“a showing . . . that the statutory notice is arbitrarily excessive . . . has the effect of shifting the burden of going forward with the evidence”) (*dicta*), *aff’d in part and rev’d in part*, 649 F.2d 152 (2d Cir. 1981). *But cf.* *Llorente v. Commissioner*, 649 F.2d 152, 155 n.4 (2d Cir. 1981) (noting that six judges of Tax Court majority disagreed on effect a finding of arbitrariness would have on burdens of persuasion and production); *see also* *Scar v. Commissioner*, 81 T.C. 855, 862 (1983) (*dicta*) (“the burden of going forward or the burden of proof is shifted”). The examples indicate that the question of what burdens shift remains unsettled. *See generally* *Piper & Jerge, supra* note 9, at 313 (noting that *Taylor* did not make clear what burden shifts; inference from subsequent cases is that only burden of production shifts). As observed *supra* note 29, the First Circuit argues that neither burden ever shifts to the Commissioner.

Judge Tannenwald argues that a showing of arbitrariness shifts the burden of proof to the Commissioner. *Llorente v. Commissioner*, 74 T.C. 260, 278-79 (1980) (Tannenwald, J., concurring), *aff’d in part and rev’d in part*, 649 F.2d 152 (2d Cir. 1981). Because Judge Tannenwald speaks of two burdens, the burden of proof and the burden of going forward with the evidence, *id.* at 276-77, his use of the phrase “burden of proof” is assumed to refer to the burden of persuasion as used in this Note.

The Second Circuit has followed the *Taylor* lead by ordering that an item in the Commissioner’s assessment without evidentiary support, and therefore arbitrary, “must be eliminated from the Notice of Deficiency.” *Llorente v. Commissioner*, 649 F.2d 152, 157 (2d Cir. 1981).

Overcoming the presumption for one item or showing one item to be arbitrary will not affect the presumption in favor of other items in the notice. *E.g.*, *Clark v. Commissioner*, 266 F.2d 698, 707 (9th Cir. 1959); *see also* 9 J. MERTENS, *supra* note 22, § 50.61.

⁸⁰ *See supra* notes 24-25 and accompanying text.

⁸¹ This proposal does not affect the current approach to dealing with other cases of undeclared income. A strong argument could be made for separating issues of receipt, then treating the remaining cases the same as deductions, i.e., requiring the taxpayer to show correct amount. *See Rice, supra* note 19, at 65-68.

nonreceipt.⁸²

Under the present system, a taxpayer denying receipt must overcome the presumption of correctness by presenting sufficient evidence that the deficiency determination could be erroneous.⁸³ The presumption of correctness establishes the threshold level of evidence the taxpayer must produce. Some courts have responded to the inherent difficulties of proving a negative by refusing to allow the IRS to rely on the presumption without showing that the deficiency determination is not arbitrary.⁸⁴ Hearsay and other inadmissible evidence is often admissible to show the absence of arbitrariness and to support the presumption of correctness,⁸⁵ thereby reinstating the taxpayer's evidentiary threshold without providing a real indication of the substantive quality of the IRS case. This procedure often artificially and unfairly increases the quantum of evidence necessary to meet the taxpayer's initial production burden because the court does not weigh the taxpayer's evidence against the actual strength of the IRS evidence until the taxpayer overcomes the presumption of correctness.⁸⁶ Thus, the taxpayer may fail to overcome a presumption of correctness which attaches by the limited use of hearsay or other inadmissible evidence when, in fact, there is scant substantive evidence supporting the IRS deficiency notice.

This Note proposes that the Tax Court develop a procedure whereby a taxpayer denying receipt of money or benefits may submit to the Tax Court a sworn statement of denial, together with a statement of supporting facts, and thereby shift the burden of proof to the Commissioner. The statement would have to contain affirmative representations of the taxpayer's position, not mere denials of the deficiency assessment.⁸⁷ To prevent a taxpayer from using discovery to determine how much the IRS can prove before deciding how much to deny, the procedure would require submission of the denial statement and supporting facts prior to any requests for discovery under the Tax Court rules. Furthermore, to discourage taxpayers from denying receipt simply to shift the burden of proof to the Commissioner, the procedure would subject any person making willful misrepresentations to penalties for fraudulent

⁸² Under the present system the IRS may be called upon to establish the correct amount when the taxpayer has shown the deficiency determination to be erroneous. *See supra* notes 8-9 and accompanying text. Under this proposal, the IRS may not have to establish the correct amount as frequently because the presumption of correctness will attach to the amount after proof of receipt.

⁸³ *See supra* text accompanying note 24.

⁸⁴ *See supra* notes 31 & 35-36 and accompanying text.

⁸⁵ *See supra* notes 72-76 and accompanying text.

⁸⁶ *See supra* text accompanying notes 20-24.

⁸⁷ *See* *United States v. Abrahams*, 604 F.2d 386, 394 (5th Cir. 1979) (discussing "exculpatory no" doctrine limiting liability for fraud and willful misrepresentation when defendant or suspect, in interview he did not initiate, replies to questions only in negative).

statements or perjury.⁸⁸

Under the proposed procedure, the Commissioner would bear the burden of persuading the court by a preponderance of the evidence that the taxpayer received money or benefits in excess of the gross income declared or receipts acknowledged in the statement of denial. Once the Commissioner produces evidence of receipt or establishes income through a reconstruction method,⁸⁹ the presumption of correctness should attach to the amount of the deficiency assessed on that income. Although the IRS would retain the burden of persuasion to prove receipt, the taxpayer would have the burden of persuasion to establish an amount lower than that alleged by the IRS. The taxpayer could submit evidence regarding the reasonableness of the amount asserted but evidence from the actual transaction showing a lower amount would also tend to show the taxpayer's knowledge of that amount. In most cases, therefore, a taxpayer submitting evidence from the actual transaction after having sworn denial of receipt would risk liability for perjury or fraudulent statement.

Under this proposal, a taxpayer who denies receipt of money or benefits could opt to proceed under the current burdens and presumption. The taxpayer should not be allowed to place an initial burden of substantiation on the IRS, however, by alleging that the deficiency notice imputing receipt is arbitrary. If the taxpayer opts for the current system and denies receipt, the IRS would be entitled to rely on the presumption of correctness without producing direct evidence. One advantage the taxpayer may see in the current system is the opportunity this system affords him to allege inconsistent theories in the pleadings.⁹⁰ The taxpayer can alternatively deny receipt and allege that, if received, the money is not includible in income. In selecting this strategy, the taxpayer would have to weigh such advantages against the risk of failing to overcome the presumption of correctness and failing to sustain the burden of persuasion.

A taxpayer opting to shift the burden as proposed in this Note would have to submit a sufficient, sworn statement of denial and supporting facts. The taxpayer could admit part of the deficiency and submit the statement to shift the burden of persuasion for the remainder.

⁸⁸ *E.g.*, 18 U.S.C. § 1001 (1982) (false statements to government agencies); 18 U.S.C. § 1621 (1982) (perjury); 26 U.S.C. § 7207 (1982) (fraudulent statements to IRS).

⁸⁹ Income can be reconstructed, for example, through the "net worth" method by establishing a baseline net worth at a particular time, then demonstrating the increase in net worth plus nondeductible expenditures. *See, e.g.*, *Holland v. United States*, 348 U.S. 121, 125 (1954) (criminal prosecution). The "cash expenditures" method, not generally considered accurate, reconstructs income by subtracting ascertainable cash receipts from ascertainable cash expenditures. Any unexplained excess represents unreported income. *See, e.g.*, *Goldberg v. Commissioner*, 239 F.2d 316, 318 (5th Cir. 1956). *See generally* 2 J. MERTENS, *supra* note 22, § 12.12 (discussing income reconstruction methods and their application).

⁹⁰ 2 L. CASEY, *supra* note 25, § 7.2.

For example, if the IRS asserts undeclared income of \$50,000 from a particular source, the taxpayer could admit receipt of \$20,000 and deny the remaining \$30,000. Although admitting receipt of the \$20,000, the taxpayer could still contest its inclusion in income but would have the burdens of persuasion and production (against the presumption of correctness) on that issue. The presumption of correctness would attach to the entire \$50,000 when the IRS produced evidence that the taxpayer received in excess of the \$20,000 admitted. The taxpayer would then have to submit proof of the lower amount. This production burden could shift throughout the trial, but ultimately, if the Commissioner persuades the court that the taxpayer received more than the admitted \$20,000, the taxpayer must prove any lesser amount to avoid a deficiency based on the full \$50,000.

If the taxpayer chose to deny the whole amount, the presumption would attach when the IRS proved receipt of any significant amount, e.g., \$5,000.⁹¹ The taxpayer could still contest the amount on the grounds of reasonableness and other evidence, depending on the nature of the asserted transaction.

Under this proposal, a taxpayer denying receipt of money or benefits attributed to him or her in an IRS deficiency notice could place the burden of persuasion on the Commissioner by submitting a statement of denial and supporting facts rather than alleging arbitrariness in the IRS deficiency notice. This tactic would reduce the evidentiary issues that have arisen over the use of inadmissible evidence to determine that a deficiency notice was not arbitrary.⁹² The Commissioner would not be required to show the determination is nonarbitrary, and therefore would not need to submit hearsay and other normally inadmissible evidence for that limited purpose. Rather, the Commissioner would submit evidence for the truth of the underlying facts: such evidence would be subject to the normal rules of evidence for admissibility.⁹³ Under this proposal, the quantum of the burden on the taxpayer to substantiate nonreceipt would be directly related to the strength of the evidence put forward by the IRS.⁹⁴ The taxpayer denying receipt would no longer risk failing to overcome the artificially erected presumption of correctness in what may be a weak IRS case, simply because he or she could not produce sufficient evidence of nonreceipt.

⁹¹ The amount necessary to trigger the presumption would be discretionary with the Tax Court. The amount proven at this stage must be sufficiently substantial for it to be reasonable to attach the presumption of correctness to the whole amount.

⁹² See *supra* notes 72-76 and accompanying text.

⁹³ See *supra* note 72. The proposal in this Note would not preclude the use of inadmissible evidence in preparing a deficiency notice. See *supra* note 34 and accompanying text.

⁹⁴ See *supra* text accompanying notes 83-86.

Other exceptions exist, in both the Tax Court rules⁹⁵ and the statutes,⁹⁶ which place the burden of persuasion on the Commissioner for certain issues. The proposal offered in this Note is based on the statutory scheme for the accumulated earnings tax.⁹⁷ That tax imposes a penalty on certain accumulated corporate earnings. The Code presumes that a corporation accumulates earnings beyond its reasonable business needs only for the purpose of avoiding tax on its shareholders. The burden of proving otherwise falls on the corporation, but the corporation can shift the burden to the IRS by submitting a sufficient statement of the business purposes and supporting facts for the accumulation.⁹⁸ The accumulated earnings tax was developed, in part, in response to taxpayers who incurred substantial expense and effort to litigate deficiencies which the IRS had not adequately screened or analyzed.⁹⁹

The policy argument for placing the burden of persuasion on the Commissioner is even stronger in the case of a taxpayer denying receipt than in the accumulated earnings tax situation. A taxpayer in a nonreceipt case does not necessarily have a transaction or records from which to build a case. On the other hand, the corporation contesting the accumulated earnings tax has best access to all the financial and programmatic plans and projections used in deciding whether to accumulate earnings or to declare a dividend.

CONCLUSION

The burden of persuasion falls on the taxpayer in most tax proceedings because no one has better knowledge of receipts or better access to evidence of transactions. In proving nonreceipt of extra money, however, the taxpayer faces almost insurmountable difficulties. Absent witnesses or records of nonreceipt, the taxpayer must often rely on his or her credibility as a witness, and the Tax Court gives little weight to self-serving denials. In addition, many of the cases of contested receipt are brought by taxpayers allegedly involved in illegal activities. Evidence of these activities, introduced to sustain the presumption of correctness,

⁹⁵ The Commissioner has the burden of proving any new matter, increases in deficiency, or affirmative defense pleaded in his answer. TAX CT. R. 142(a).

⁹⁶ *E.g.*, I.R.C. § 83(d) (1982) (burden of proving formula price in nonlapse restriction is not fair market value); I.R.C. § 162(c) (1982) (burden of proving illegality of bribes and kickbacks); I.R.C. § 6902(a) (1982) (burden of proving transferee liability).

⁹⁷ I.R.C. §§ 533-34 (1982).

⁹⁸ The corporation "is required in the statement only to present facts sufficient to show the basis of the grounds it relies upon, not to establish its case." If the statement is sufficient "to shift the burden of proof. . . the Government must assume the burden of persuasion that the accumulation was unreasonable. The party having the burden of proof does not merely have the burden of coming forward with evidence; it has the burden of persuasion and once fixed that burden does not shift." 2 L. CASEY, *supra* note 25, § 7.3a, at n.4 (citations omitted).

⁹⁹ H.R. REP. NO. 1337, 83d Cong., 2d Sess. (1954).

further undermines the taxpayer's credibility, even though the evidence may not show that the taxpayer received money.

The courts have used the indefinable catch-all concept of arbitrariness to deal with the inequity of requiring the taxpayer to prove a negative. The various standards and procedural questions described in this Note are indicative of the difficult balancing which comes into play when a taxpayer denies receipt of money or benefits attributed to him or her in an IRS deficiency notice.

This Note recommends removing disputes over denial from the rubric of arbitrariness. The Note proposes instituting a procedure analogous to that available in contesting an accumulated earnings tax, by which the taxpayer, with a sworn statement of denial and sufficient supporting facts, can place the burden of persuasion on the IRS.

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