New York State Bar Association

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NYSBA

November 25, 1998

Steven U. Teitelbaum, Esq.
Deputy Commissioner and Counsel
New York State Department of Taxation
and Finance
W.A. Harriman Campus, Building 9
Albany, NY 12227-0215

Re: Burden of Proof

Dear Mr. Teitelbaum:

In a recent letter you solicited the views of the Tax Section on whether New York's tax laws should be changed to conform to the recent federal change regarding the burden of proof in tax cases. As you know, in 1995 and 1997, while the federal burden of proof provision was under consideration in Congress, the Tax Section submitted letters expressing our concerns about the then proposed shift in the burden of proof (copies of which are attached). While some of our specific comments were addressed in the legislation as enacted (section 7491 of the Internal Revenue Code), we continue to believe that the shift in burden of proof is not an effective

remedy for problems — real or perceived — in the tax dispute resolution system. Therefore, we would generally oppose a shift in the burden of proof in New York tax cases, including cases pending before the New York State and New York City Tax Appeals Tribunals, for the reasons already set forth in our earlier submissions on the topic.

The principal concern that we expressed with respect to the shift in the burden of proof at the federal level was the possibility that it would lead to more intrusive audits and increased controversy and litigation. This concern applies with even greater force at the State and City levels because of the nature of the issues raised in State and City proceedings.

Many issues that are frequently litigated in New York are particularly fact-specific, with the relevant facts solely in the possession of the taxpayer. These types of issues arise in disputes, for example, concerning residency and domicile, income apportionment factors, the "distortion" required for combined reporting, the status of income or expense as business- or investment-related, and the treatment of payments designated as deferred compensation. Because of their nature, the litigation of disputes raising these issues (particularly, residency and domicile) can already be quite intrusive for the taxpayer. A shift in the burden of proof to the Department of Taxation and Finance would only increase the need for the Department to delve into the affairs of the taxpayer in order to develop the facts to carry its burden. Moreover, in our judgment, without significant cooperation from the taxpayer, it could be difficult for the Department to carry the burden in many of these cases.

State and local tax litigation also involves a set of substantive issues not present under federal tax law dealing with the interpretation and application of the United States Constitution and the taxation of out-of-state activities. Questions of nexus, for example, turn on

factual issues that could very well be resolved on the basis of the burden of proof. Whether these different types of substantive issues give rise to procedural concerns that differ from those generally presented in federal tax litigation is a question that should be considered before implementing a change in the burden of proof.

Consideration also should be given to the administrative ability of the State and City to bear a shift in the burden of proof. While New York State and City are among the largest state and local tax systems in the country, with fairly large professional staffs, their resources, in terms of audit and litigation, are not as extensive as those of the federal government. How a change in the burden of proof might actually affect the working of tax administration, or the conduct of audits, should be fully explored.

Having raised the above concerns, we also believe that conformity with federal tax treatment remains an important goal. Despite the differences between the federal tax system, on the one hand, and the State and City systems, on the other, there are many cases that present the same substantive legal and factual issues in both systems — e.g., the basic determinations of income and deduction, valuation questions, etc. If an issue has been resolved after a dispute at the federal level, we would not wish to see a situation created where, due to a different burden of proof in State or City proceedings, an argument could be made that the federal result should not be accepted, or that the issue could freely be litigated all over again. While the possibility of such an occurrence may be remote, the goal of federal conformity is so important that the possibility should not be overlooked.

We would be happy to work with the Department of Taxation and Finance in evaluating a change in the burden of proof. We believe the issues would be best developed by

analyzing the merits and potential problems from a variety of perspectives, including those of government auditors and litigators, the Administrative Law Judges and Tribunal commissioners, and trial-seasoned taxpayer advocates. We recognize that an in-depth study of the issue would take some time, and thus delay the implementation of any change in the law. We believe, however, that the issue is sufficiently important, and sufficiently different from the federal debate, to merit separate analysis. We look forward to discussing this important issue with you in further detail.

Very truly yours,

Steven C. Todrys

cc: Michael H. Urbach
Judith Hard

New York State Bar Association

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NYSBA

October 21, 1997

VIA FEDERAL EXPRESS

The Honorable Bill Archer
Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am writing as the Chair of the Tax Section of the New York State Bar Association with respect to the proposal to shift the burden of proof from taxpayers to the Internal Revenue Service in certain cases to be described in legislation to be considered by the Ways & Means Committee tomorrow.[1] It is our understanding that the shift will occur with respect to individual taxpayers and entities described in Section 7430(c)(4)(A)(ii), *i.e.* relatively small businesses.[2] In addition, we understand that the bill will only apply with respect to an issue if (1) the taxpayer asserts "a reasonable dispute" with respect to such issue and (2) the taxpayer has "fully cooperated with the Secretary with respect to such issue, including

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1 This letter was drafted by the undersigned. Helpful comments were received from Peter L. Faber, Carolyn J. Lee, Richard L. Reinhold, Michael L. Schler and Robert H. Scarborough. It has not been approved by the Executive Committee of the Tax Section.

2 It is not clear how the provision will apply in the case of partnership items, but we assume that it will be applied at the partnership level.

providing, within a reasonable period of time, access to and inspection of all witnesses, information and documents within the control of the taxpayer, as reasonably requested by the Secretary." Furthermore, the bill would provide that nothing in it shall "be construed to override any requirement of this title to substantiate any item".

We are troubled by the fact that the language of the proposal did not become available to the public until today, even though we understand it is to be considered by the Ways and Means Committee within the next twenty-four hours. Assuming that a review of the burden of proof issue is appropriate, as the National Commission on Restructuring the Internal Revenue Service (the "National Commission") has proposed, we believe that the proper procedure is not hastily to enact legislation of this broad nature. We think that a change in the burden of proof represents a major change in the manner in which the Internal Revenue Code is to be enforced and, consequently, may give rise to changes in the way in which taxpayers view compliance with the law. In 1995, we commented on another proposal to alter the burden of proof; while that legislation differed from that now being proposed, we believe that the general thrust of our comments is still valid and a copy of them is attached. We continue to believe that the difficulties which the Internal Revenue Service will face in proving facts, such as the valuation of property (*e.g.* a closely held business) or the state of mind of a taxpayer, will seriously adversely affect the functioning of the tax system.

An article in The New York Times on Monday, October 20th suggested that one of the goals of the provision is to send a message that, in any dispute between the Internal Revenue Service and a taxpayer, both sides are to receive equal treatment. We are not sure that we would describe the playing field that way; it is the taxpayer who has control of most or all of the relevant information and it is for that reason that the historic consensus has been that the burden of proof should, of necessity, be on the taxpayer, as the party in the litigation best able to sustain it.

Hence, we are concerned that the message of the bill may prove to be quite different from that intended. We fear that it will encourage those - and they are significant in number - who would prefer not to pay their taxes in accordance with the law, to cut corners, believing that the Internal Revenue Service will not be able to prove its case even if they are audited. This taxpayer reliance on the bill may prove to be misguided, but the root of our tax system is voluntary compliance, not the audit process, and any breakdown in voluntary compliance would be an extremely serious result. Hence, we view this legislation as one which could have significant deleterious effects, and its enactment without appropriate consideration and full analysis seems wholly inappropriate.

In addition, we are concerned by several technical aspects of the Bill.

First, we do not know what the effect of this legislation would be on IRS audits. In the past we, and others, have expressed concern that it will force the IRS audit procedures to be more intrusive than they are now, making them even more exasperating and expensive for taxpayers than they are today. We continue to have this concern.

Second, we foresee many disputes over the application of this provision. Moreover, these disputes will now have to be resolved prior to the trial in order to determine the burden of proof.

Thus, for example, we are unclear as to the meaning of the requirement that the taxpayer "assert a reasonable dispute". Does this mean that the taxpayer need merely put the issue into his or her pleadings or is the taxpayer required to present some evidence to support his or her position, in which event the effect of the statute may be primarily to shift the burden of persuasion to the Internal Revenue Service once the taxpayer has established a reasonable factual underpinning for his or her position? Similarly, while we agree that full cooperation from the taxpayer should be a necessary underpinning for any shift in the burden of proof, we fear that there will be constant

disputes, all necessarily taking place before the trial can proceed, as to whether the taxpayer has fully cooperated with the Secretary's reasonable requests. The problem is aggravated by the absence from the provision of any clear statement as to what effect the taxpayer's loss of his or her records will have. For example, is it relevant whether the loss of the records was due to an act of God (such as fire or flood) or was negligent, inadvertent, or due to untidy housekeeping? If the reason for the loss is relevant, how is the cause of the loss to be determined?[3] We also wonder under what circumstances records in the possession of a third party, such as a foreign trustee, will be considered under the "control" of the taxpayer. Obviously, we have not been able to make a complete analysis of the many problems which may arise, but we merely point them out to illustrate the many issues to which this bill gives rise and the extent to which it may well make the litigation of tax cases more complicated and expensive.

Moreover, we are concerned that these issues will make settlements at the administrative level more difficult. At present, the burden of proof in any subsequent litigation is clear but, under this Bill, that will be another subject of contention. If that issue is not capable of resolution by the parties, it will increase the difficulty of resolving the substantive issues in dispute administratively and will lead to further litigation.

Finally, the provision in the legislation, that it does not override any requirement of the need to substantiate any items, introduces additional uncertainty. For example, does this mean that in any case in which a deduction is at issue, the taxpayer is required to prove only the existence of the payment or does it also require the taxpayer to substantiate all matters necessary to establish his deduction, e.g. if the issue is whether a meal was deductible, must the taxpayer show only that the expense was incurred or must he or she also prove who was present and what was discussed? Similarly, if the issue is whether a

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[3] The Bill is unclear as to who will have the burden of proving the facts necessary to determine whether there will be a shift in the burden of proof.

borrowing on which interest was paid was personal or used for investment, what must the taxpayer prove to substantiate his or her deduction: the payment of the interest or the use of the loan proceeds?

To summarize, we are greatly concerned that this legislation will adversely impact voluntary compliance and encourage some taxpayers to attempt to avoid their proper tax obligations. We think this is so without regard to whether the impact of the statute in litigated cases is or is not substantial. Moreover, we think the provision is likely to lead to long disputes over which party has the burden of proof, which will both increase the amount of tax litigation and the expense of conducting it.

For these reasons, we urge that legislation shifting the burden of proof not be enacted without further examination, particularly without permitting time for the public to review it and comment upon its various aspects, including especially the message which is being sent, and the impact it will have on compliance with, and enforcement of, the tax law, and on tax litigation. In addition allocation of the burden of proof in civil tax disputes should await the report of the General Accounting Office proposed by the National Commission. We therefore strongly urge that the provision be deleted from the Bill.

An identical letter has been sent to Congressman Rangel.

Very truly yours,

Richard O. Loengard, Jr.
Chair

cc: Honorable Donald C. Lubick
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March 23, 1995

MEMORANDUM TO THE MEMBERS OF THE HOUSE WAYS & MEANS SUBCOMMITTEE ON OVERSIGHT*

Re: H.R. 390 -- Burden of Proof in Tax Cases

We understand the House Ways & Means Subcommittee on Oversight is conducting hearings on Friday, March 24, 1995, on H.R. 390, a bill that would amend the Internal Revenue Code (i) to shift the burden of proof on all matters in all tax cases to the government; (ii) to require a specific identification of regulations requiring recordkeeping; and (iii) to

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* This memorandum was prepared by Carolyn Joy Lee, Chair of the Tax Section, with input and helpful commentary from: Andrew N. Berg, Wm. L. Burke, John A. Corry, Peter L. Faber, Stuart J. Goldring, Richard O. Loengard, Stephen L. Millman, James M. Peaslee, Robert Plautz, Richard L. Reinhold, Donald Schapiro, Joel Scharfstein, Michael L. Schler, Michelle P. Scott, Esta Stecher, Jonathan A. Small, David E. Watts, and Philip R. West.

increase the limit on civil damages for unauthorized collection activities from $100,000 to $1,000,000, and to exempt such awards from income tax. We take no position on the second and third sections of the bill.

It is however our strong opinion that the proposal to shift the burden of proof on all issues in tax cases to the government is an exceptionally bad idea. This proposal would, in our view, seriously undermine the voluntary compliance that is essential to our federal tax system, and would likely lead to audits and litigation of unprecedented intrusiveness and intensity.

Consider a few simple examples of the problems this bill presents. Under present law, a taxpayer who has claimed a deduction must substantiate the deduction by producing evidence thereof. Under the proposed legislation, however, it would appear that, instead of the taxpayer being required to substantiate his deductions, the IRS instead would be required to prove that the taxpayer did not make the expenditures for which deductions are claimed. In a similar vein, it would be difficult for the government to prove that an expenditure was made for personal rather than business purposes, or to prove the relationship (or lack thereof) between a taxpayer and its affiliate, or

to prove the value of property, when the taxpayer controls the evidence. And how will the government be able effectively to pursue a transfer pricing case involving persons and records located in foreign jurisdictions? What happens in these cases if the taxpayer no longer has the relevant records and claims to be unable at the time of the audit to provide evidence? What evidence is the Internal Revenue Service required to present to meet its burden of proof? These questions -- a tiny sample of the issues this bill presents -- illustrate the fundamental problems that would arise if the burden of proof is imposed on the party who does not control or have full and timely access to the evidence.

In our view the tax system simply cannot function if the burden of proof on <u>all</u> matters in <u>all</u> tax cases is shifted to the government. The knowledge that one must substantiate and prove the items on one's tax returns is a tremendously important element of our system of self-assessed taxes. The bill would remove that check on all filers, and further compound the government's burden on the very small percentage of returns that are audited.

We are also concerned that if the burden of proof is imposed upon the Internal Revenue Service

federal audits will become much more intensive and intrusive, as the Service will need to probe much more deeply into the taxpayer's affairs, and frequently into the affairs of people collaterally involved in the matter, to meet its burden of proof. Similarly, the shift in burden of proof also will likely affect tax litigation, as taxpayers will want to avoid making stipulations, preferring instead to let the government prove its case. This could materially increase the burden of tax litigation on the courts, especially the Tax Court. The administration of the tax law is thus likely to become far more costly if the burden of proof on all matters is shifted to the government.

We do not doubt that H.R. 390 is well-intentioned. We recognize that abuses do occur, and that there are cases in which taxpayers have incurred great hardship and expense defending against what proved to be baseless assertions of tax liability. We also acknowledge that there may be aspects of the tax law in which it could be appropriate to shift the burden of proof to the government. The recent report of the Joint Committee on Taxation on H.R. 390 (JCX-15-95) included a list of fourteen specific civil provisions of the Code in which the Commissioner bears the burden of proof; it may well be appropriate and

timely to give considered analysis to whether there are additional types of issues that should be added to this list.

We believe however, that this proposal to effect a global shift in the burden of proof on all matters in all tax cases is misguided, and we trust that, upon further consideration, this proposal will be rejected. This bill raises more than just some arcane issue of tax procedure; enactment of this bill would eviscerate voluntary tax compliance, and vastly complicate audits, inflicting enormous damage on the integrity of the federal tax system.

We urge that this proposal not be enacted. If you or your staffs would like to discuss this further please do not hesitate to contact the Chair of the Tax Section.